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### **Preface**

In carrying out their housing finance and community investment mission, FHLBanks offer advances, mortgage purchase programs, and other services in an evolving competitive environment. In doing so, the FHLBanks assume market, credit, and operational risks. The risk management processes of each FHLBank must reflect and be adequate to manage each type and level of risk undertaken.

The variety and complexity of the risks undertaken by the FHLBanks carry implications for the examination and supervision of the FHLBanks. A principal interest in the examination process is whether and how the FHLBank manages risk so that it operates in a safe and sound manner while achieving its mission requirements.

A risk-based approach to supervision is important to the effective and efficient use of resources. Central to this approach are the following processes: (i) identification of risks as market, credit or operational; (ii) measurement of risks; and (iii) evaluation of the effectiveness of the risk management processes employed by the FHLBank's board of directors and senior management. As appropriate or as otherwise noted, references to the FHLBanks shall include the Office of Finance and the Financing Corporation.

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The general powers of the Finance Board include the power to supervise and examine the FHLBanks, to promulgate and enforce regulations and orders in carrying out the provisions of the FHLBank Act, and to suspend or remove for cause a director, officer, employee or agency of any FHLBank or the Office of Finance. Sections 2B and 20, respectively, of the FHLBank Act require the Finance Board to (i) make annual reports to Congress and (ii), at least annually, require examinations and reports of condition of all FHLBanks. The Finance Board also conducts annual examinations of the Office of Finance and the Financing Corporation under authority of the FHLBank Act.

The Board of Directors of the Finance Board has charged the Office of Supervision with the responsibility for the ongoing supervision of the FHLBank System. Through its examination and other supervisory activities, the Office of Supervision may take or recommend supervisory action to ensure the continued safe and sound condition of the each FHLBank and the achievement of its housing finance and community lending mission.

Annual on-site examinations are the cornerstone of the Office of Supervision's supervisory activities. On an ongoing basis, the Office of Supervision monitors FHLBank operations, financial condition and performance, legal compliance and actions taken in response to previously-identified deficiencies. In addition to examinations, activities undertaken by the Office of Supervision to assess the operations of FHLBanks include periodic on-site visitations, off-site monitoring, and System-wide or "horizontal" reviews (which focus on a specific FHLBank activity, function, or program).

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The Office of Supervision has several tools for resolving issues identified in the FHLBanks' operations. Most deficiencies identified through supervisory activities are resolved in the normal course of business. For more serious situations, the Office of Supervision may issue a supervisory determination that requires corrective action. To resolve serious and intractable management problems, the Office of Supervision may recommend to the Finance Board a change in the board of directors or management of an FHLBank. The Office of Supervision's supervisory process consists of several interrelated activities. Following is a description of these activities.

### **1) Supervisory Strategy**

The supervisory strategy is a plan for supervising an individual FHLBank. At the conclusion of an examination of an FHLBank and after meeting with the institution's board of directors, the examiner-in-charge develops a supervisory strategy that identifies key areas of risk and addresses the timeframe and the focus of the supervision of the FHLBank for the next year. For example, a supervisory strategy for an FHLBank might state that the focus for the next year will be on the quality of risk management and financial accounting. The on-site portion of the examination would focus heavily on these areas to determine their adequacy. An intervening visitation and the next examination would focus on these areas and follow up on remedial actions taken by the FHLBank to address deficiencies reported at the last examination.

The supervisory strategy is developed in consultation with modelers, accountants, analysts, and other staff and serves to alert Finance Board officials as to the general supervisory direction that will be taken with regard to the FHLBank.

From the supervisory strategy development process, the examiner-in-charge prepares a supervisory strategy, which provides specifics as to how the strategy will be addressed in the coming year. The supervisory strategy includes information on the proposed date and timeframe for the on-site examination and periodic visitation(s) and the staff who were consulted in the plan's development. The supervisory strategy discusses changes in the FHLBank's operations and management of which examiners should be aware, and concludes with an overview of the institution and emerging supervisory issues.

The supervisory strategy must be approved by the portfolio manager and should be updated throughout the year as new issues develop and existing issues are resolved.

### **2) Pre-Examination Planning**

Thorough pre-examination analysis and a well-defined examination scope are the keys to the execution of an efficient and effective examination. Before the commencement of each examination, the examiner-in-charge, specialists from other divisions and the examination team prepare three sets of documents: (i) the examination alert letter; (ii) the pre-examination analyses memoranda; and (iii) the examination scope memorandum.

***Alert Letter.*** Addressed to the FHLBank president, the alert letter announces the commencement, timing, and staffing of the planned examination. The alert letter is sent to the

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FHLBank approximately two months before the beginning of the on-site portion of the examination and requests information on such matters as investments, advances, mortgages, community investments, auditing, and membership that should be delivered to examiners prior to the examination. Enclosed with the alert letter are questionnaires to key executives of the institution and a request list of documents. Similar letters are sent to the chairman of the board of directors, chairman of the audit committee and chief financial officer requesting information on their functions and principal concerns for the operations and future of the FHLBank.

***Pre-Examination Analysis Memoranda.*** Prepared by the examiner-in-charge and assisting examiners and other Office of Supervision staff, these memoranda are based on information received from the information request list, data obtained through the Call Report System (CRS), past examination findings and workpapers, and other evaluative information, as available.

***Examination Scope Memorandum.*** Based on the pre-examination analyses, this memorandum sets the scope of the on-site portion of the examination. As with the supervisory strategy, the scope memorandum must be approved by the appropriate portfolio manager(s).

### **3) On-Site Examinations**

On-site examinations of each of the FHLBanks are conducted on an annual basis. In examinations of FHLBanks, examiners: (i) assess the credit, market, and operational risks in the FHLBank's operations and the management, control and reporting of those risks; (ii) evaluate the FHLBank's financial condition and performance, capital adequacy, and corporate governance; (iii) assess the FHLBank's affordable housing and community investment programs; and (iv) determine an FHLBank's compliance with its own policies and procedures, the rules and regulations of the Finance Board, and other applicable laws.

In contrast, reflecting the differing type of operations of the Office of Finance, examiners reviewing that entity: (i) evaluate the Office of Finance's corporate governance; (ii) assess the operational risks in the Office of Finance's operations and the management, control and reporting of those risks; and (iii) determine the Office of Finance's compliance with its own policies and procedures, as well as Finance Board rules, regulations and policies. The examination of the Office of Finance also includes an assessment of the process and procedures of the Office of Finance for preparing the combined financial statements of the FHLBank System.

During examinations of the FHLBanks, examiners review and test systems, controls, and reports for adequacy and accuracy, evaluate financial condition and performance, corporate governance (including strategic planning), and review board of directors and committee meeting minutes. In addition, examiners review actions taken based on audit and examination findings. During the course of the examination, the examiner-in-charge meets with the FHLBank's executive management, as well as the institution's chairman and audit committee chairman, to discuss preliminary findings.

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At the end of their review, the examiners prepare written findings memoranda that are discussed with line and senior management. Management is asked to address the examiners' findings, including planned actions to correct deficiencies and violations.

At the conclusion of the examination, the examiner-in-charge assigns composite and component ratings of "1" to "4" to an FHLBank, based on the totality of factors, including the level and direction of market, credit and operational risk, the adequacy of risk management policies and practices, financial performance and condition (including capital management), corporate governance, and affordable housing and the administration of the FHLBank's community investment activities. In the case of examinations of the Office of Finance, the examiner-in-charge assigns composite and component ratings based upon the quality of corporate governance and the level and direction of operational risk and the quality of risk management.

The report of examination is written by the examiner-in-charge, subject to the review and approval of the portfolio manager. Subsequently, the report is presented by the examiner-in-charge to the board of directors of the FHLBank and a copy is distributed to the Board of Directors of the Finance Board.

### **4) Periodic On-Site Visitations and Reviews**

In addition to on-site examinations, the examiner-in-charge, together with other appropriate staff, may conduct periodic on-site visitations. The purpose of these visits is to monitor the FHLBanks' progress in addressing deficiencies previously identified, evaluate financial condition and performance, and identify emerging issues.

In preparation for each on-site visitation, the FHLBank analyst prepares an analysis of the most recent financial information obtained through the CRS and identifies trends and issues for discussion with FHLBank management. At the conclusion of the visitation, the examiner-in-charge prepares an internal memorandum, which includes a discussion of financial performance and condition, emerging supervisory issues and concerns, and, as applicable, compliance with written agreements with the Finance Board. The internal memorandum is distributed to appropriate Office of Supervision management.

### **5) Horizontal Reviews**

"Horizontal reviews" are another supervisory activity that the Office of Supervision undertakes to assess an activity, function, or program across all twelve of the FHLBanks. These reviews lend themselves to timely comparison of the operations, strategies, and policies in place at the FHLBanks. Through these reviews, the Office of Supervision identifies best practices and shares these through dissemination of a report of findings from the horizontal review. In addition, concerns, deficiencies and other matters can be identified in the horizontal review. These are often addressed in advisory bulletins issued by the Office of Supervision following the review.

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### **6) Off-Site Monitoring Activities**

Apart from examiners, other Finance Board staff monitors the FHLBanks on an ongoing basis through the analysis of CRS data, audited financial statements, strategic business plans, and other reports. These individuals work to support the supervision of the FHLBanks and assist in the development of the supervisory strategy. In addition, these individuals may participate in the on-site examinations as situations warrant. The Finance Board staff that provides assistance to the examination staff includes:

***Accountants:*** Accountants evaluate FHLBank accounting and auditing matters and provide expertise on relevant pronouncements by such groups as the Financial Accounting Standards Board and the Institute of Internal Auditors. The accountants work closely with examiners on technical accounting matters in developing examination findings and conclusions. The accountants also review combined FHLBank System financial statements issued by the Office of Finance for conformity with law, regulation and Generally Accepted Accounting Principles.

***Attorneys:*** The Office of General Counsel provides advice on legal issues that arise during an examination and other supervisory activities. When safety and soundness concerns or conduct in violation of the law or regulations necessitate enforcement action, the Office of the General Counsel advises on the appropriate level of response, based on the law and facts underlying the concern or violation. If the response is a written supervisory agreement, the attorneys work with the Office of Supervision in drafting comprehensive, binding documents.

***FHLBank Analysts:*** FHLBank analysts review board of directors meeting minutes and provide summary memoranda to the examiner-in-charge, monitor and analyze CRS data, and prepare semi-annual FHLBank profiles. The FHLBank analysts also assess market developments that may affect the FHLBank System and prepare papers on conditions and trends and their effects on FHLBank System condition, profitability, and stability. The analysts work closely with the examiners in developing the scope of examinations and routinely participate in the examinations.

***Risk Measurement and Modeling Specialists:*** Risk measurement and modeling specialists support the examination function through the use of financial models, such as the measurements of interest-rate-risk exposure and market value sensitivity at each FHLBank. They also evaluate proposed changes to the internal market risk models that the FHLBanks use to calculate risk-based capital requirements. An off-site risk monitoring program analyzes quarterly data and risk exposure reports prepared by each FHLBank using its own risk modeling systems. These specialists work closely with the examiners on technical modeling matters in developing examination findings and conclusions.

***Risk Monitoring Analysts:*** Risk monitoring analysts provide data management support on economic, financial, housing and CRS data, FHLBank System structure, and membership. They also develop the Office of Supervision's information architecture and maintain its data dictionary. The data dictionary contains a detailed description and identifiers for accessing data related to the financial, mortgage, affordable housing, and membership activities of the FHLBanks. These analysts work closely with the examiners in providing information to develop the scope of examinations.

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***Affordable Housing Specialists:*** Affordable housing specialists provide guidance on FHLBank affordable housing and community investment activities, such as the FHLBank homeownership set-aside program, including adherence to regulations and guidelines for disbursement of funds to households, retention of documents, eligible income calculations, and scoring criteria. Affordable housing specialists also provide information on the scope of the on-site examination, including review of information reporting to the FHLBank's board of directors. The affordable housing program and community investment activities of each FHLBank are examined under a separate examination program.

### **7) Regulatory Requests: Approvals, No-Action Letters, Regulatory Interpretations, Waivers, Reviews of Disputed Supervisory Determinations, Case-by-Case Determinations, and New Business Activities**

#### **a) Regulatory Requests Pursuant to Part 907 of the Finance Board's Regulations**

The Office of Supervision and the Office of General Counsel work jointly to address requests under Part 907 of the Finance Board regulations for approvals, no-action letters, waivers, case-by-case determinations, and reviews of disputed supervisory determinations. Such requests are described below.

***Approvals*** are written statements issued to an FHLBank approving a transaction, activity or other matter that requires Finance Board action under the FHLBank Act or Finance Board rule, regulation, policy or order. Approvals may be issued by the Director of the Office of Supervision or the General Counsel.

***No-Action Letters*** are written statements issued to an FHLBank providing that the Office of Supervision will not recommend supervisory or other action to the Board of Directors of the Finance Board for failure to comply with a specific provision of a Finance Board rule, regulation, policy, or order. No-Action Letters are issued by the Director of the Office of Supervision.

***Regulatory interpretations*** are written guidance issued with respect to application of the FHLBank Act or a Finance Board rule, regulation, policy, or order to a transaction or activity. Regulatory Interpretations are issued by the General Counsel.

***Waivers*** are written statements issued by the Board of Directors of the Finance Board to a FHLBank or a member of an FHLBank that waive a provision, restriction, or requirement of a Finance Board rule, regulation, policy, or order, or a required submission of information, not otherwise required by law, in connection with a particular transaction or activity. A Waiver can be granted only if it is not inconsistent with the law and does not adversely affect any substantial existing rights and upon a determination that application of the provision, restriction, or requirement would adversely affect achievement of the purposes of the FHLBank Act, or upon a showing of good cause.

***Reviews of disputed Supervisory Determination*** are conducted by the Board of Directors of the Finance Board. For the purposes of Part 907, a Supervisory Determination

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includes a finding, such as an unsafe and unsound practice or condition, weakness, or violation, by the Finance Board that is set forth in a report of examination, order or directive. It also includes any order or directive concerning safety and soundness or compliance matters that requires mandatory action by an FHLBank. An FHLBank may also seek review of the rating assigned by the Office of Supervision under the FHLBRS.

*Case-by-Case Determinations* are final decisions by the Board of Directors of the Finance Board requested by an FHLBank concerning matters that require a determination, finding or approval by the Board of Directors under the FHLBank Act or Finance Board regulations, for which no controlling statutory, regulatory or other Finance Board standard previously has been established, and that, in the judgment of the Board of Directors, are best resolved on a case-by-case basis by a ruling applicable only to the FHLBank that filed the request (and any entity permitted to intervene in the Board of Directors' consideration of the request) and not by adoption of a rule of general applicability.

All applications for a waiver or approval or request for no-action letter or regulatory interpretation pursuant to Part 907 of the Finance Board regulations must be signed by the president of the FHLBank and must include identifying information, the relevant section of the statute or regulation, identification of the determination or relief requested, including alternative relief requested if the primary relief is denied, a statement as to why relief is needed, facts and circumstances giving rise to the application, references to relevant authorities, previous requests for related waivers, no-action letters, approvals and interpretations, an opinion of counsel supporting the request, and a certification of statements in the submission. Requests for reviews of disputed supervisory determinations and case-by-case determinations under Part 907 must comply with the requirements set forth in that part.

### **b) Responses to New Business Activity Notices Pursuant to Part 980 of the Finance Board's Regulations**

The Finance Board provides *responses to notices of new business activities* that must be submitted by an FHLBank pursuant to Part 980 of the Finance Board regulations prior to the FHLBank's undertaking of an activity that involves collateral, risks, or operations that the institution has not previously accepted, managed or undertaken, as appropriate. (For new business activity requests relating to an FHLBank acceptance of collateral enumerated in Section 950.7(a)(4) of the Finance Board's regulations, the institution may commence the new activity immediately upon the Finance Board's receipt of the new business activity notice.)

The Finance Board may respond to a notice of a new business activity by providing consent for the FHLBank to undertake the particular activity and set forth terms and conditions that apply to the activity. Alternatively, the agency may, within 60 days of receipt of a new activity notice, issue a notice to the FHLBank: (i) disapproving the activity; (ii) instructing the FHLBank not to commence the activity pending further consideration by the Finance Board; (iii) declaring an intent to examine the FHLBank;

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(iv) establishing conditions for the Finance Board's approval of the activity; or (v) containing other instructions or information that the Finance Board deems appropriate under the circumstances.

A notice of new business activities submitted by an FHLBank must include a description of the new business activity, the FHLBank's assessment of the risks associated with the activity and its capacity to safely administer and address such risks, the FHLBank's criteria to determine member or housing associate eligibility to participate in the activity, a good faith estimate of the dollar volume of the new activity over the short- and long-term, and an opinion of counsel citing legal authority for the activity. In its review and response to such a notice, the Finance Board may consider the safety and soundness implications of the proposed activity, as well as its compliance with statutes and regulations, responsiveness to member needs, and effectiveness in supporting the nation's housing finance system. Actions on new business activity requests have been delegated to the Director of the Office of Supervision.

### **8) Supervisory Actions**

The Finance Board and the Office of Supervision possess several tools for resolving deficiencies identified within an FHLBank's operations. These tools range from informal to formal remedies. Formal remedies include cease-and-desist, temporary cease-and-desist, civil money penalty, and suspension or removal orders. Informal remedies include board of directors resolutions adopted by the institution, memoranda of understanding, and written agreements. Several of these formal and informal remedies are also available for deficiencies identified in the Office of Finance's operations. Most matters are resolved through moral suasion and can be corrected through the normal course of business; however, the Finance Board may take "supervisory" action. The range of supervisory actions available to the Finance Board is discussed below.

#### ***a) Supervisory Actions Pursuant to Section 2B(a)(5) of the FHLBank Act and Part 908 of the Finance Board Regulations***

Pursuant to Section 2B(a)(5) of the FHLBank Act and Part 908 of the Finance Board regulations, the Finance Board may initiate a proceeding to obtain a cease-and-desist order, temporary cease-and-desist order or order assessing civil money penalties from the Board of Directors of the Finance Board. An FHLBank may stipulate to a cease-and-desist or other order or may contest the order, in which case there is an evidentiary hearing on the record before an administrative law judge. The three types of orders do the following:

- 1) A cease-and-desist order requires an FHLBank or its directors or executive officer to take affirmative action to correct a condition resulting from a violation or practice, or places limitations on the activities or functions of the FHLBank or its directors or executive officers. Such a proceeding is commenced by the issuance of a notice of charges that, among other things, specifies the alleged misconduct and the relief sought.



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- 2) A temporary cease-and-desist order can be issued at the same time as the notice of charges commencing a proceeding for a permanent cease-and-desist order and immediately imposes the relief sought in that proceeding. A temporary cease-and-desist order remains in effect pending completion of that proceeding and can only be issued if necessary to protect the FHLBank from ongoing or expected harm.
- 3) An order assessing civil money penalties imposes a money penalty on an FHLBank or its directors or executive officers for a violation or for conduct specified in Part 908. The amount of the penalty is determined by the Finance Board based upon factors and limits set out in Part 908. Such a proceeding is commenced by the issuance of a notice of assessment of a civil money penalty that, among other things, specifies the alleged misconduct and the relief sought.

The Finance Board may initiate a supervisory action under Section 2B(a)(5) of the FHLBank Act and Part 908 of the Finance Board regulations against an FHLBank in case of:

- 1) Unsafe or sound conduct or practice;
- 2) Conduct that causes or is likely to cause loss to the institution;
- 3) Violations of law or regulation; and
- 4) Violations of a Finance Board order, agreement between the Finance Board and the FHLBank, or a condition imposed in writing by the Finance Board in connection with the granting of an application or other request by the FHLBank.

The Finance Board may also initiate a cease-and-desist proceeding when it has reasonable cause to believe that an FHLBank or its director or executive officer is *about to* engage in practices or violations set forth in Section 908.4(a) of the Finance Board regulations.

In determining whether to initiate a formal supervisory action against an FHLBank, the Finance Board may consider the following factors:

- 1) Overall condition and risk profile of the FHLBank;
- 2) Nature, severity and frequency of the condition, practice or violation;
- 3) Board of directors' and management's past record of taking remedial or corrective action;
- 4) Board of directors' and management's ability to correct the deficiency; and
- 5) Likelihood that the conduct, violation, or practice will continue if corrective or supervisory action is not taken.

Pursuant to Section 2B(a)(1) and (a)(5) of the FHLBank Act and Part 908 of the Finance Board's regulations, the Finance Board may also enter into a Written Agreement with an FHLBank that prescribes in article-by-article form those restrictions and corrective and remedial measures to return the institution to a safe and sound condition. An FHLBank's violation of a Written Agreement can provide a

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legal basis for the Finance Board to obtain a cease-and-desist order or order assessing civil money penalties against the FHLBank or its directors or executive officers.

Section 2B(a)(5) of the FHLBank Act and Part 908 of the Finance Board regulations authorize the agency's use of cease-and-desist, temporary cease-and-desist and civil money penalty assessment proceedings, as well as Written Agreements, in response to deficiencies identified in the operations of the FHLBanks. Section 2B(a)(5) and Part 908 do not provide explicit authority for the Finance Board's use of these remedies in response to deficiencies identified in the operations of the Office of Finance.

***b) Action Pursuant to Section 2B(a)(2) of the FHLBank Act to Suspend or Remove a Director, Officer, Employee or Agent***

Pursuant to Section 2B(a)(2) of the FHLBank Act, the Finance Board may suspend or remove for cause a director, officer, employee or agent of an FHLBank upon the communication of the cause of such suspension or removal to that person and to the FHLBank. Section 2B(a)(2) also authorizes the Finance Board to take such action with respect to a director, officer, employee or agent of the Office of Finance. Neither the FHLBank Act nor the Finance Board regulations prescribes a procedure for the agency's exercise of this supervisory remedy.

***c) Other Supervisory Actions***

The Finance Board may pursue other types of actions to address issues at an FHLBank that require supervisory response under Section 2B of the FHLBank Act. These actions provide more explicit guidance and direction than is normally contained in a report of examination. These types of actions may be in the form of a resolution of the FHLBank's board of directors or a memorandum of understanding. These remedies are also available to respond to supervisory issues at the Office of Finance.

A board of directors resolution is prepared by an FHLBank, adopted by its board of directors and addresses one or more specific supervisory concerns identified by the Office of Supervision. A board of directors resolution is not legally binding, but failure by an FHLBank to honor commitments made in a resolution may provide evidence for a supervisory action pursuant to Section 2B(a)(2) or (a)(5) of the FHLBank Act.

A memorandum of understanding is drafted by the Finance Board and normally involves more serious matters. The Finance Board issues a determination and notification of failure to meet safety and soundness standards to the FHLBank and requires corrective action. A memorandum of understanding is not legally binding. If the FHLBank fails to implement corrective action, the Finance Board can take additional steps to ensure that the safety and soundness provisions of the FHLBank Act are met in a timely manner.

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The following types of actions or events may trigger the Office of Supervision seeking a board of directors resolution or memorandum of understanding:

- 1) Adverse examination rating;
- 2) Unsatisfactory condition or inaccurate or inadequate books and records of the FHLBank;
- 3) Lack of compliance by FHLBank management or board of directors with Office of Supervision directives; or
- 4) Failure to address supervisory findings.

In determining whether to initiate one of the aforementioned supervisory actions against an FHLBank, the Office of Supervision considers the following factors:

- 1) Nature and severity of the problem, including safety and soundness issues; and
- 2) Nature and extent of corrective action previously undertaken by the FHLBank.

### **9) Judicial Enforcement and Review of Orders**

Pursuant to Section 2B of the FHLBank Act and Part 908 of its regulations, the Finance Board may bring an action in Federal District Court for the District of Columbia to obtain judicial enforcement of any cease-and-desist order, temporary cease-and-desist order, order assessing a civil money penalty, or any other effective order adopted by the agency's board of directors.

Section 2B of the FHLBank Act and Part 908 of the Finance Board regulations authorize a party to obtain judicial review of a final decision or order by the Board of Directors of the Finance Board to cease-and-desist or assess a civil money penalty by filing a petition with the United States Court of Appeals for the District of Columbia Circuit within 30 days after the date of service of the final decision or order. The provisions also authorize a party that has been served with a temporary cease-and-desist order to apply to the U.S. District Court for the District of Columbia within 10 days after such service for an injunction setting aside, limiting or suspending the enforcement, operation or effectiveness of the temporary order pending the completion of the hearing on the grant of a permanent cease-and-desist order.