

Membership

Introduction

Pursuant to Section 4 of the FHLBank Act, any building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, savings bank, or any insured depository institution satisfying the requirements of that section may become a member of an FHLBank. Although an FHLBank's grant of membership to an institution generally does not itself expose the FHLBank to risk, the membership approval process still requires the adoption and implementation of an adequate risk management process. This is particularly true because almost all members will utilize various FHLBank products and services, such as obtaining credit and using correspondent banking services. Granting membership to an ineligible entity or failing to perform sufficient due diligence in the approval process can potentially expose the FHLBank to significant risk, especially credit and operational risk. Regardless of the type of member, management must establish and follow prudent membership approval procedures.

In order to become a member of an FHLBank, an eligible institution must be authorized under state law to engage in the activities associated with membership, such as owning FHLBank stock, borrowing funds, and pledging assets to secure those borrowings. Lending to a member that is not federally insured may pose greater risks in the event of a receivership, bankruptcy or conservatorship because of risks relating to the priority of its claim and ability to recover collateral not present in an FDIC receivership.

Part 925 of the Finance Board regulations establishes eligibility requirements, a membership application process and capital stock requirements for FHLBank membership, as well as procedures for the termination of FHLBank membership (including the liquidation of member indebtedness, settlement of outstanding business transactions and redemption or repurchase of capital stock) in the event of voluntary withdrawal from membership, involuntary termination of membership or merger or consolidation involving member and nonmember institutions. Part 925 also contains provisions governing the readmission of members to FHLBank membership, FHLBank access to member information and the display of official FHLBank membership insignia.

Once an FHLBank has converted to a capital structure plan under Part 933 of the Finance Board regulations, the provisions of that plan governing the required minimum investment in FHLBank stock, capital stock structure and issuance, stock transfers and termination of FHLBank membership must also be considered as these may affect the application of specific requirements of Part 925 in certain instances.

The eligibility requirements and application process for organizations seeking to be certified by FHLBanks as housing associates are set forth in Part 926 of the Finance Board regulations. FHLBanks can make advances to housing associates even though they are not FHLBank members.

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Eligibility Requirements

Pursuant to Section 4(a) of the FHLBank Act and Section 925.6 of the Finance Board regulations, eligible institutions include depository institutions and insurance companies that:

- (1) Are duly organized under federal or state law;
- (2) Are inspected and regulated under state or federal banking or similar laws;
- (3) Either originate or purchase long-term home mortgage loans (loans with an original term-to-maturity of five years or more), including holding mortgage-backed securities representing an undivided interest in long-term mortgage loans;
- (4) Have at least 10 percent of their total assets in residential mortgages, if federally insured depository institutions other than “Community Financial Institutions” as defined in Section 925.1;
- (5) Are of such financial condition that the FHLBank may safely make advances to them;
and
- (6) Possess management and a home financing policy whose character is consistent with sound and economical home financing.

An applicant for FHLBank membership satisfying the requirements of Sections 925.6 through 925.16 of the Finance Board regulations will be presumed, subject to rebuttal by the FHLBank, to comply with the eligibility requirements of Section 4(a) of the FHLBank Act and Section 925.6 of the Finance Board regulations. Section 925.17 of the Finance Board regulations sets forth regulatory rebuttable presumption rules that permit an FHLBank to “rebut” such presumption and deny membership.

Membership Application Process

FHLBank membership application requirements are described generally in Section 925.2 of the Finance Board’s regulations. An applicant for membership in an FHLBank is required to submit an application satisfying the requirements of Part 925 to the FHLBank, including a written resolution or certification duly adopted by the applicant’s board of directors, or by an individual with authority to act on the board’s behalf, that the applicant (1) has reviewed the requirements of Part 925 and has provided, to the best of the applicant’s knowledge, the most recent, accurate and complete information available and (2) will promptly supplement the application with any relevant information that comes to the applicant’s attention prior to the FHLBank’s decision to approve or deny the application.

Part 925 contemplates that an FHLBank with whom a membership application has been filed will obtain and review information and documents required from the applicant to

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establish or rebut any rebuttable presumption of the applicant's satisfaction of eligibility requirements. In determining whether an applicant, other than an insurance company, has complied with the financial condition eligibility requirement of Section 925.11, an FHLBank must obtain from the applicant and review the following documents:

- (1) Regulatory Financial Reports. Regulatory financial reports filed by the applicant with its appropriate regulator for the last six calendar quarters and three year-ends preceding the date the FHLBank receives the application.
- (2) Financial Statement. The most recent independent audit of the applicant conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the applicant, or such other audit, review or compilation of financial statements permitted under Section 925.11(a)(2).
- (3) Regulatory Examination Report. The applicant's most recent available regulatory examination report prepared by its appropriate regulator, a summary prepared by the FHLBank of the applicant's strengths and weaknesses as cited in the regulatory examination report, and a summary prepared by the FHLBank or applicant of actions taken by the applicant to respond to examination weaknesses.
- (4) Enforcement Actions. A description prepared by the FHLBank or applicant of any outstanding enforcement actions against the applicant, reports as required by the enforcement action, and verbal and written indications, if available, from the appropriate regulator of how the applicant is complying with the terms of the enforcement action; and
- (5) Other Information. Any other relevant document or information concerning the applicant that comes to the FHLBank's attention in reviewing the applicant's financial condition.

An applicant, other than an insurance company, will be deemed to be in compliance with the financial condition eligibility requirement if it satisfies the composite examination rating, capital, and minimum performance standard requirements of Section 925.11(b). An insurance company applicant will be deemed to meet the financial condition eligibility requirement if it satisfies the requirements of Section 925.16 regarding capital.

The FHLBank is required to prepare a written digest for each applicant stating whether the applicant has satisfied the requirements of the rebuttable presumption of compliance with eligibility requirements, together with the FHLBank's findings and the related reasons. The digest, together with all other documents required in Sections 925.6 through 925.18 (including all documents required to establish or rebut a presumption), and additional documents submitted by the applicant, or otherwise obtained or prepared by the FHLBank, concerning the applicant, and the decision resolution to be adopted by the FHLBank disposing of the application, are required to be maintained in a membership file for the applicant. The file shall be maintained for at least three years after the

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FHLBank's decision to approve or disapprove the membership application and the resolution of any appeal to the Finance Board under Section 925.5.

An FHLBank may delegate its authority to approve membership applications only to a committee of the FHLBank's board of directors, the FHLBank president, or a senior officer who reports directly to the FHLBank president other than an officer with responsibility for business development. The FHLBank is required to act on a membership application within 60 calendar days of the date the institution deems the application to be "complete," as that term is defined in Section 925.3, and thereafter to provide the applicant and the Finance Board with a copy of the FHLBank's decision resolution within three days of the rendering of the decision. The decision resolution must be duly adopted by the FHLBank's board of directors, by a committee of the board, or by an officer having delegated authority from the board to approve membership applications, and must state the following:

- (a) That the statements in the digest, described above, are accurate to the best of the FHLBank's knowledge and are based on a diligent and comprehensive review of all available review of all information identified in the digest; and
- (b) Where the decision resolution is to approve the application for membership, that the applicant is authorized under the laws of the United States and of the appropriate state to become a member of, purchase stock in, do business with, and maintain deposits in, the FHLBank to which the applicant has applied, and the applicant meets all of the membership criteria of the FHLBank Act and Part 925 of the Finance Board regulation.

Where the FHLBank's decision resolution is to deny the membership application, the applicant may file a written appeal of the decision with the Finance Board within 90 days of the date of the FHLBank's decision. The appeal process is governed by Section 925.5 of the Finance Board regulations.

Regulatory Environment

The primary regulations, standards and guidance that pertain to FHLBank membership are set forth below:

- 1) ***Rules and Regulations of the Federal Housing Finance Board***, which include the following parts and sections relevant to membership approval:

Section 915.4(a) of the Finance Board regulations requires an FHLBank to file an annual capital stock report to the Finance Board that provides information on its members' capital stock.

Part 917 of the Finance Board regulations addresses powers and responsibilities of FHLBank boards or directors and senior management. In particular, Section 917.3, Risk Management, Section 917.4, Bank Member Products Policy, Section 917.5,

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Strategic Business Plan, and Section 917.6, Internal Control System, are pertinent.

Part 925 of the Finance Board regulations addresses FHLBank membership, including eligibility requirements, application process, reporting requirements, and other matters.

Part 944 of the Finance Board regulations addresses members' adherence to community support standards, documentation of community support activities and the periodic submission of a community support statement to the Finance Board.

Section 950.4(e) of the Finance Board regulations requires the FHLBanks to provide the Finance Board with a report of advances and commitments outstanding to each of its members in accordance with the instructions provided in the Data Reporting Manual adopted by the Finance Board.

- 2) ***Advisory Bulletins of the Federal Housing Finance Board*** that provide supervisory guidance relating to the topic of membership activities are:

Advisory Bulletins 02-03, dated February 13, 2002 and 03-2, dated February 10, 2003, provide guidance on specific attributes to be considered by FHLBanks in the formation of their business continuity plans and the establishment of bilateral agreements with other FHLBanks.

FHLBank Environment

Within the FHLBank System, organizational structures for membership activities may vary and require coordination with other departments and functions, such as membership services, credit services, correspondent bank services, information technology, legal, risk management, executive management, management committees, and the board of directors. In general, the membership application process consists of the following steps:

- 1) A potential applicant requests and submits an application for membership; several of the FHLBanks have application forms on their respective websites. Some FHLBanks also require additional information, such as member management responses to regulatory examination reports or additional financial information, at the time of application.
- 2) The FHLBank will review the application, determine whether it is complete and whether the applicant is otherwise eligible to become a member, and request additional information based on this review. The FHLBank must act on a complete application within 60 calendar days of receipt.
- 3) The FHLBank's board of directors or designee approves the applicant for membership. The new member is required to purchase FHLBank stock within 60 calendar days of membership approval. Some FHLBanks may require submission of funds for stock purchase at the time of application.

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- 4) Within three business days of an FHLBank's decision of a membership application, the FHLBank must provide the applicant and the Finance Board with a copy of the FHLBank's decision resolution.
- 5) Upon approval of a membership application, the FHLBank should contact the Finance Board to institute the issuance of an identification number for data entry in the membership system.

Federal Housing Finance Board Membership System

The membership system was developed as a central repository for information collected by the Finance Board from the FHLBanks about members and housing associates. The membership database maintains general and financial information including membership status, holdings of advances, and FHLBank capital stock.

The membership system and membership database also do the following:

- 1) Maintain member profile information and status changes, such as information regarding mergers, voluntary withdrawals, changes in principal place of business, charter relocations, and charter conversions;
- 2) Provide for the assignment of identification numbers for new approvals; and
- 3) Maintain quarterly membership financial information reported by the FHLBanks, such as advances, commitments and capital stock outstanding for members and housing associates and financial information (total assets and residential mortgage loans) compiled from call report information the member filed with its regulator.

Risks Associated with Membership Activities

An FHLBank's primary risks relating to membership are set forth below.

1) Lack of Sound Corporate Governance (Board of Directors and Senior Management oversight)

- a) Key risks arising from and controls over membership activities are not adequately identified, assessed, and monitored.
- b) Information technology used in membership activities is not aligned with the FHLBank's goals and strategies.
- c) Exceptions to policies governing membership activities are not properly reviewed and reported to senior management and the board of directors.
- d) The FHLBank's financial performance and compliance with established goals, policies, procedures, accounting and regulatory requirements are not properly reviewed and monitored due to inadequate, inaccurate and/or untimely reporting to the board of directors and senior management.
- e) Internal control weaknesses arising from membership activities that potentially affect financial reporting have not been adequately identified, assessed and disclosed.
- f) Inaccurate reporting of membership activities to the Finance Board.

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- g) Duties, responsibilities, and expertise of staff conducting membership activities, including segregation of operational and control functions, are not adequately defined.
- h) Duties, responsibilities, and liabilities are not adequately addressed with outside service providers and vendors used in membership activities.
- i) Losses due to errors and fraud arising for membership activities are not effectively mitigated through insurance or other means.
- j) A business continuity plan has not been developed and tested for membership activities.
- k) Independent audit coverage and testing is limited; auditors are inexperienced or lack the technical expertise in membership activities to test the control environment.

2) *Credit Risk*

- a) Inadequate membership approval policies, procedures and internal controls exist to allow the FHLBank to manage and monitor the overall credit risk profile of the FHLBank.
- b) The FHLBank extends credit to an applicant that does not satisfy the financial condition eligibility requirement for membership.

3) *Operational Risk*

- a) Management information systems do not adequately meet the needs of the FHLBank's business lines, resulting in the use of various manual processes and workarounds which can result in errors pertaining to membership activities.
- b) Lack of technical expertise and experience may imperil the continuation of membership activities in the event of key personnel turnover or absences.
- c) Legal documents used in membership activities are incomplete, missing, unenforceable, not in compliance with federal and state requirements or otherwise inadequate to protect the FHLBank's interests. Review of the eligibility of potential insurance company members is particularly important, as state law generally governs insurance company membership eligibility and will likely vary within the FHLBank's district.
- d) Legal documents and data used in membership activities cannot be readily recreated and/or required tasks performed in the event of a disaster.
- e) SAS 70 reviews are not obtained, or alternative methods not performed, to obtain assurances on the internal control environment of outside service providers used in membership activities.
- f) Member consolidations, competition, adverse legislation, judicial decisions, or other external factors result in reduced FHLBank membership.
- g) Insurance coverage applicable to membership activities has not been evaluated and obtained to mitigate the FHLBank's risks and exposure.
- h) Procedures that govern the destruction and retention of membership records have not been established or followed.
- i) Failure to adhere to membership eligibility requirements may result in approval of

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ineligible applicants or rejection of eligible applicants.

Specific Risk Controls Related to Membership Activities

An FHLBank's controls relating to its membership activities are set forth below.

1) Credit Administration

Since FHLBank membership, or FHLBank certification in the case of a housing associate, is necessary to obtain advances or participate in acquired member asset programs, credit administration activities and controls will often overlap with membership approval procedures. As a result, the development and maintenance of sound and effective credit administration procedures is important in the identification, management and monitoring of the risk exposures associated with membership activities.

2) Legal

In connection with new or revised products, services or business prospects, FHLBank legal staff reviews applicable regulatory requirements, consultant and vendor contracts, and other FHLBank documentation to protect the FHLBank's interests.

Examination Guidance

A work program for Membership accompanies this narrative. What follows below are illustrative examples of attributes that should be considered by the examiner in completing the analyses required in the work program. In determining the extent of review and testing to be conducted in completing each analysis, the examiner should take into account his or her assessment of the quality and effectiveness of corporate governance, risk management, internal controls and audit coverage relating to the institution's membership activities.

In order to minimize duplication of efforts, the examiner for this area should coordinate efforts with the evaluations that are performed by the examiner responsible for the review of the FHLBank's secured credit activities.

1) Organizational structure

- a) Identify key personnel and their primary duties, responsibilities and technical expertise.
- b) Evaluate the staffing and skill level, segregation of duties, and cross-training of personnel.
- c) Review coordination with other departments or functions such as membership services, credit services, correspondent bank services, legal, information technology, risk management and executive management.
- d) Evaluate significant changes in the foregoing since the last examination.

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- 2) ***Establishment of risk tolerances and development of key policies and oversight by the board of directors. Evaluate the adequacy of senior management oversight and the risk management function for membership activities, which may include the following:***
- a) Review the risk management policy for compliance with Section 917.3(b) as it relates to membership activities.
 - b) Review the strategic business plan for compliance with Section 917.5(a) as it relates to membership. Determine the status of goals and objectives and how these are monitored.
 - c) Review relevant board of directors committee structure and delegated authorities.
 - d) Review relevant management committee structure and delegated authorities.
- 3) ***Key FHLBank policies and procedures, which may include those relating to the following:***
- a) Review membership applications and determine if they have been reviewed by the FHLBank's legal counsel and approved by the board of directors (or permitted designee) as required under Part 925.
 - b) Determine if FHLBank management has established policies that require consideration and evaluation of state laws that may govern: (i) membership eligibility of applicants; (ii) authority of applicants to own FHLBank stock, borrow funds, and pledge assets to secure borrowings; and (iii) treatment of claims and collateral in conservatorship or receivership. These considerations may be particularly important with respect insurance company applicants.
 - c) Determine if the FHLBank has established membership approval policies and procedures that require the evaluation of the financial condition of applicants.
 - d) Determine if the FHLBank has established membership approval policies and procedures under which the FHLBank determines that applicants meet other eligibility requirements, such as long-term residential mortgage origination and investment.
 - e) Review the FHLBank's marketing efforts as they relate to new membership activities.
 - f) Evaluate the accuracy of the FHLBank's member products policy.
 - g) Review departmental policies and procedures and determine if these are current, complete, and consistent with the FHLBank's policies and Finance Board regulations.
 - h) Determine if FHLBank management has established policies related to termination of FHLBank membership (including the liquidation of member indebtedness, settlement of outstanding business transactions and redemption or repurchase of capital stock) in the event of voluntary withdrawal from membership, involuntary termination of membership or merger or consolidation involving a member and nonmember for compliance with Part 925.
 - i) Review the adequacy of the FHLBank's ongoing analysis and monitoring of its membership base (much of this may occur in the FHLBank's credit function).

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Assess the adequacy of reporting to the FHLBank's board of directors and management regarding the FHLBank's membership base.

4) Risk assessment under Part 917 and internal control evaluation under SARBOX

- a) Evaluate the effectiveness of the annual risk assessment and determine if it reasonably identifies and evaluates all material risks, both quantitative and qualitative aspects, of membership activities. Investigate any action plans arising from the assessment and corrective actions.
- b) Evaluate the effectiveness of the evaluations conducted pursuant to SARBOX that identify the key risks and controls pertaining to financial reporting relating to membership activities and evaluate potential fraud, and procedures implemented to periodically attest to the adequacy of the control environment.

5) Internal audit, external audit, and outside consultants reports

- a) Evaluate the adequacy of the scope, testing, and workpapers completed by internal audit and determine the status of corrective actions for findings.
- b) Evaluate the adequacy of the scope and testing completed by external audit and determine the status of corrective actions for findings.
- c) Evaluate the adequacy of the objectives and scopes of reviews performed by outside consultants and determine the status of management's actions regarding recommendations.
- d) Review the corrective actions taken in response to internal and external audit findings.
- e) Review the actions taken in response to consultant recommendations.

6) Information technology and controls

Identify and assess the automated and manual systems and applicable controls for marketing membership and processing membership activities, such as applications, withdrawals, mergers and capital stock. Specific attributes to consider are as follows:

- a) Authorized users;
- b) Authorized functions for each user;
- c) Security of confidential information;
- d) Interfaces with the advance and collateral systems;
- e) Information on the FHLBank's website;
- f) Utilization of spreadsheets; and
- g) Business continuity and recovery.

7) Identification and evaluation of controls and significant changes to the activity or function

- a) Evaluate the workflow and processes as well as controls, including the level and direction of risk and the quality of risk management.

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- b) Evaluate any significant changes that have been implemented since the last examination or are being considered that may affect the FHLBank's risk profile such as management, systems, key personnel, regulatory requirements and processing.

8) *Testing*

Conduct testing as appropriate. The scope of testing should be based on the preliminary review of governance, risk management, internal controls and audit coverage. Specific examples include, but are not limited to, the following:

- a) Review a sample of membership applications and approvals to ensure compliance with Part 925, as detailed above. The sample should include a variety of applications, including housing associations and insurance companies, if applicable.
- b) Review a sample of member information and verify accuracy with the FHLBank's MIS and/or reporting applications.
- c) Verify the accuracy of membership information reported to the Finance Board.
- d) Evaluate the adequacy and accuracy of reports used by management and the board of directors.

9) *Assessment of Risks*

Summarize the results of the activity or function examined in a separate memorandum. The memorandum must articulate the risks and the management of those risks. It should also clearly and specifically describe the basis and analysis for the assessment. The memorandum should discuss the type(s) of risk (market, credit, operational); the level of the risk (low, moderate, high); the direction of the risk (stable, decreasing, increasing); and the quality of risk management (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.

10) *Items requiring follow-up at the next on-site visitation*

Identify key issues that have been communicated to management (written or oral) that require follow-up during the next on-site visitation.