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Analysis of and Issues Related to the Housing and Economic Recovery Act of 2008

Part I: Reregulation of the Federal Home Loan Banks

On July 30, 2008, President Bush signed the Housing and Economic Recovery Act of 2008 ("Act") into law.

The Act covers a wide range of areas related to housing finance and government sponsored enterprises ("GSEs"). It addresses, among other things, (i) the establishment of a new regulatory agency, the Federal Housing Finance Agency ("FHFA"), to supervise the Federal Home Loan Banks ("FHLBanks") and Freddie Mac and Fannie Mae (the "Enterprises") (together, "Regulated Entities"); (ii) significant new provisions governing the FHLBanks; (iii) new provisions governing the Enterprises; (iv) assistance for homeowners; (v) licensing requirements for mortgage loan originators; and (vi) improvements to the Federal Housing Administration.

This Alert is Part I of our analysis and is limited to a discussion of selected aspects of the Act that are of direct application to the FHLBanks and generally does not address the treatment of the Enterprises.

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Summary of Pivotal Changes and Impacts

1. **Streamlined Authority.** The FHLBanks will operate under a more streamlined regulatory structure to the extent that ultimate decision-making authority for the supervision of FHLBanks will be held by a single individual, the Director of the FHFA ("FHFA Director" or "Director"). This contrasts with the structure of the current Federal Housing Finance Board ("FHFB") where authority has been diffused among five board members and senior agency officials.

2. **Link to the Enterprises.** There will be a closer tie between the supervision of the FHLBanks and the supervision of the Enterprises. Over time the performance and the practices of the FHLBanks and the Enterprises will likely be measured against each other and likely will result in an increased convergence of regulatory treatment and supervisory practices.

3. **Increased Treasury Role.** The Secretary of the Treasury ("Secretary") will be a member of the board that oversees the FHFA so the Department of the Treasury ("Treasury") will now have a direct, ongoing role in regard to the operation of the FHLBanks. This will provide the Treasury with a powerful platform from which to advocate for and perhaps implement its views, whether political or economic, regarding the appropriate operations and treatment of the FHLBanks and the Enterprises.

4. **Increased Federal Reserve Board Role.** Through the end of 2009, as part of the temporary expanded authority of the Treasury to purchase securities of the Regulated Entities under extraordinary circumstances, the Board of Governors of the Federal Reserve System ("FRB") will also have statutory authority to provide input to the FHFA Director in regard to certain specified aspects of the supervision of the Regulated Entities.

5. **Convergence with FDIC-Insured Institution Treatment.** The FHLBanks will be regulated more like commercial banks and savings institutions with accounts insured by the Federal Deposit Insurance Corporation ("FDIC"), despite the absence of federal deposit insurance or any similar federal obligation running to the FHLBanks. FHLBanks will now be subject to the same types of regulation that commercial banks and thrifts are with regard to prompt corrective action, receivership, enforcement and prudential standards.

6. **Potential Mortgage Securitization Opportunity.** The FHLBanks will be presented with a potential opportunity to become full-fledged competitors with the Enterprises in the area of mortgage securitization as Congress has expressly directed the FHFA to make recommendations as to whether the FHLBanks should proceed with such activities.

7. **Transition Period.** There will be an important initial period as the new agency confronts difficult issues regarding the stability of the Enterprises and evaluates the current status and future prospects of the individual FHLBanks.

8. **Issuance of New Regulations and Policies.** The FHFA will be required to issue a series of new regulations and policies governing the FHLBanks. This will give the FHLBanks numerous opportunities to contribute their views on how the future direction of supervision and regulation should be shaped.

Key FHLBank-Related Provisions

1. New Regulatory Agency

The Act establishes the FHFA as the new regulatory agency for the Regulated Entities.[1] The FHFA will be an independent agency of the federal government. It will replace the FHFB and the Office of Federal Housing Enterprise Oversight ("OFHEO"), both of which will be abolished one year after the enactment of the Act.[2]

1.1. Federal Housing Oversight Board

The FHFA will be overseen by the Federal Housing Oversight Board ("FHFA Board").[3] The FHFA Board will be comprised of the Secretaries of the Departments of the Treasury and of Housing and Urban Development, the Chairman of the Securities and Exchange Commission ("SEC") and the FHFA Director. The FHFA Director will serve as Chairperson.

The FHFA Board will have a different and more limited role than the FHFB Board has played. It is only required to meet on a quarterly basis. The Act provides that the FHFA Board's responsibilities are "advising" the FHFA Director regarding overall strategies and policies.[4] Thus, for example, while the Board of the FHFB had to act in order to take enforcement action against

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[1] Section 1101.

[2] Sections 1301, 1311. The Act creates some ambiguity in this area. On one hand, it appears to anticipate that the FHFA will immediately have responsibility for the Regulated Entities upon enactment of the Act. On the other hand, it retains the existence of the FHFB and OFHEO for a one-year period (although, as of the date of enactment, it repeals sections 2A and 2B of the Federal Home Loan Bank Act("FHLBank Act"), which established the FHFB and set forth its powers and duties). In that regard, the Act provides that the Board of the FHFB and the Director of OFHEO shall manage and pay their employees until the employees transfer to the FHFA and may take any other action necessary for winding up the agency. At the same time, as discussed below in section 1.5, the Act provides that specified FHFB and OFHEO actions that remain in effect as of the abolishment of the agencies will be enforceable by or against the Director of the FHFA. This suggests that some residual regulatory authority will be retained by the FHFB and OFHEO during the one-year transition period. If Congress were immediately removing such regulatory authority from the FHFB and OFHEO, arguably it would have specified the date of enactment of the Act as the relevant date for the enforceability of FHFB and OFHEO actions by or against the FHFA Director. The repeal of section 2B of the FHLBank Act also eliminates the provision that had abolished the joint or collective offices of the FHLBanks, other than the Office of Finance. The Act contains a number of references to the Office of Finance, but does not expressly address its corporate status or governance.

[3] Section 1103.

[4] The Act further provides that the FHFA Board may not exercise any executive authority, and that the FHFA Director may not delegate to the FHFA Board any of the functions, powers, or duties of the FHFA Director.

an FHLBank, this authority will be lodged solely with the FHFA Director. Similarly, the FHFA Director, rather than the FHFA Board, will have the authority to issue regulations.[5]

The extent to which other members of the FHFA Board will seek to use their positions to shape policy regarding the roles and operations of the Regulated Entities remains to be seen. In the current unsettled environment, it seems likely that the Secretary of the Treasury will be a significant voice in the deliberations of the FHFA Board.

1.2. FHFA Director

The Act establishes the position of Director of the FHFA as the head of the agency.[6] The Director will be appointed by the President, subject to confirmation by the Senate. The Director will serve a five-year term, subject to removal for cause by the President. The current director of the OFHEO will automatically become the Director of the FHFA until a successor is confirmed.[7]

The FHFA Director is responsible for overseeing the prudential operations of each Regulated Entity and to ensure that:

- it operates in a safe and sound manner, including maintenance of adequate capital and internal controls;
- its operations and activities foster liquid, efficient, competitive, and resilient national housing finance markets;
- it complies with applicable law and regulations;
- it carries out its statutory mission only through activities that are authorized under and consistent with law; and
- its activities and the manner in which it is operated are consistent with the public interest.[8]

The FHFA Director is given the authority to issue any regulations, guidelines or orders necessary to carry out the Director's duties.[9]

Perhaps of great significance to the FHLBanks and any future challenges to the regulatory actions of the Director, the Act provides that prior to issuing any regulation or taking any other formal or informal agency action of general applicability relating to the FHLBanks, including the issuance of an advisory document or examination guidance, the Director must consider the differences between the FHLBanks and the Enterprises with respect to the FHLBanks:

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[5] The Act requires the FHFA Board to testify annually before Congress. This testimony is to address, among other things, (i) the safety and soundness of the Regulated Entities, (ii) any material deficiencies in the conduct of the operations of the Regulated Entities, and (iii) an evaluation of the performance of the Regulated Entities in carrying out their missions.

[6] Section 1101.

[7] This, of course, makes the first Director critical in the initial development of agency policies and the selection of key agency personnel.

[8] Section 1102. The authorities and responsibilities of the Director for the FHLBanks do not track identically those given the Board of the FHFB under the FHLBank Act. For example, the FHLBank Act provided that the Board of the FHFB was required to ensure that the FHLBanks are "able to raise funds in the capital markets." 12 U.S.C. § 1422a(a)(B)(iii).

[9] Section 1107.

- cooperative ownership structure,
- mission of providing liquidity to members,
- affordable housing and community development mission,
- capital structure,
- joint and several liability, and
- any other differences that the Director considers appropriate.[10]

The Director is also authorized to review and, if warranted, reject any acquisition or transfer of a controlling interest in a Regulated Entity.[11]

The FHFA will operate through three deputy directors.

- The Deputy Director of the Division of FHLBank Regulation is to have such functions, powers and duties as the FHFA Director shall prescribe with respect to the oversight of the FHLBanks.
- The Deputy Director of the Division of Enterprise Regulation is to have such functions, powers and duties as the FHFA Director shall prescribe with respect to the oversight of the Enterprises.
- The Deputy Director for Housing Mission and Goals is to have such functions, powers and duties with respect to the oversight of the housing mission and goals of the Enterprises and with respect to oversight of the housing finance and community and economic development mission of the FHLBanks, as the Director shall prescribe. The Deputy Director is instructed to consider the differences between the Enterprises and the FHLBanks.[12]

1.3. Assessments

The costs and expenses of the FHFA will be funded by annual assessments on the FHLBanks and the Enterprises, which will be paid semiannually.[13] Assessments on the FHLBanks cannot be used to pay for the costs of supervising the Enterprises and assessments on the Enterprises cannot be used to pay for the cost of supervising the FHLBanks.[14] The FHFA Director will have

[10] Section. 1201. The responsibility to develop this record when making determinations about covered actions regarding the FHLBanks creates an interesting requirement that may provide a basis to challenge FHFA actions under the Administrative Procedure Act.

[11] Section 1102. The Act does not provide a definition of what would constitute a controlling interest in an FHLBank, or how such a review process, if applicable, would operate. This provision may raise the question of whether Congress contemplates the possibility of some type of ownership interest in an FHLBank that differs from the current structure in which, as a practical matter, member rights are extremely limited.

[12] Section 1101.

[13] Section 1106.

[14] This requirement creates a responsibility on the FHFA to develop a system that will support a determination that actions taken in regard to Freddie Mac and Fannie Mae were not "paid for" by assessments on the FHLBanks, and vice versa. Thus could cause the Director to take actions to demarcate agency personnel and functions in a manner that would not

authority to impose higher assessments on FHLBanks that give rise to additional costs with regard to undercapitalized FHLBanks, enforcement activities, or supervisory activities.

1.4. Authority to Require Reports

The Act provides that the FHFA Director may require an FHLBank to submit regular and special reports to the Director.[15] The Director may require an FHLBank to submit a report to the Director after the declaration of any capital distribution by the FHLBank and before making the capital distribution. The Act also provides for the imposition of civil money penalties of varying amounts for the failure to make a report or for submitting any false or misleading report.

1.5. Transition

The Act provides for the establishment of regulatory authority by the FHFA over the FHLBanks as of the date of enactment of the Act, unless otherwise specified.[16] The Act provides that all regulations, orders, determinations and resolutions issued, made, prescribed or allowed to become effective by the FHFB, in effect on the date of the abolition of the FHFB at the end of the one-year period beginning on the date of enactment of the Act, shall be enforceable by, or against the FHFA Director until modified, terminated, set aside or superseded in accordance with applicable law by the Director, a court or operation of law.[17]

2. Temporary Provisions Relating to Government Investment in the Regulated Entities

Recent market concern regarding the financial condition and prospects of the Enterprises led to last-minute amendments to the Act. These amendments, which are intended to facilitate government financial support of the Regulated Entities, apply in the same form to both of the Enterprises and the FHLBanks.[18] Intended or not, to a large degree they reinforce the market perception that the US government stands behind the GSEs.

2.1. Additional Purchase Authority of the Secretary of the Treasury

The FHLBank portion of this provision amends section 11 of the Federal Home Loan Bank Act ("FHLBank Act") to provide that in addition to the long-standing authority for the Treasury to purchase up to $4 billion of FHLBank obligations, the Secretary is now temporarily authorized, in extraordinary circumstances,[19] to purchase any obligations issued by any FHLBank under any provision of the FHLBank Act on such terms and conditions and amounts as the Secretary may

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otherwise occur. Some may argue that the need for such separations defies the rationale for combining the FHFB and OFHEO.

[15] Section 1104. This provision is similar to the data reporting requirements recently adopted by the FHFB. 12 C.F.R. pt. 914.

[16] Section 1163. The effective date provision is contained in Title I of the Act, rather than in Title III, which provides for the one-year transition period for the abolition of the FHFB and OFHEO.

[17] Section 1312. This provision does not expressly distinguish between actions taken by the Board of the FHFB and the staff. While the staff does not issue regulations, orders or resolutions, it does make "determinations" and these presumably would be included within the matters that would be enforceable by or against the FHFA Director. What constitutes a "determination" in a particular circumstance may become a matter of dispute.

[18] Section 1117.

[19] The Secretary must determine that such action is necessary to (i) provide stability to the financial markets, (ii) prevent disruptions in the availability of mortgage finance, and (iii) protect taxpayers.

determine ("Additional Purchase Authority").[20] Notwithstanding this authorization, the Act provides that nothing related to the Secretary's Additional Purchase Authority requires an FHLBank to issue obligations or securities to the Secretary without mutual agreement between the Secretary and the FHLBank. The Act further provides that nothing in the Secretary's Additional Purchase Authority permits or authorizes the Secretary, without the agreement of the FHLBank, to engage in open market purchases of common securities of any FHLBank.

The Act sets forth several general considerations that the Secretary should take into account to protect taxpayers in connection with any exercise of the Additional Purchase Authority. These factors are:

- the need for preferences or priorities regarding payments to the government;
- limits on maturity or disposition of obligations or securities to be purchased;
- the FHLBank's plan for the orderly resumption of private market funding or capital market access;
- the probability of the FHLBank fulfilling the terms of any such obligation or security, including repayment;
- the need to maintain the FHLBank's status as a private shareholder-owned company; and
- restrictions on the use of FHLBank resources, including limitations on the payments of dividends and executive compensation and any such other terms and conditions as appropriate for those purposes.

If the Secretary exercises the Additional Purchase Authority, the Secretary must report to specified Congressional committees on the necessity of the action and the determinations made in regard to the conditions triggering the purchase and the terms and conditions of the purchase. This likely ensures that the use of this authority will occur only in remote, emergency situations.

The Secretary may, at any time, exercise any rights received in connection with such purchases or sell any obligation acquired subject to the terms of the security or otherwise upon terms and

[20] Note that the Act refers to purchases of obligations or securities of an individual FHLBank rather than referring to purchases of FHLBank System consolidated obligations. The Act refers to "obligations" or "securities," sometimes in combination and sometimes individually and does not specifically address (i) whether the instruments that may be purchased could include equity interests or certain equity features, (ii) how such instruments would relate to the restrictions on an FHLBank's issuance of equity contained in section 6 of the FHLBank Act, or (iii) how they would relate from a priority point of view to consolidation obligations. It is possible that an issuance under this section could be structured as subordinated debt that might be given regulatory capital treatment by the FHFA. To date only the FHLBank of Chicago has subordinated notes outstanding. To the extent that the provision is focused on providing liquidity to a particular FHLBank, it appears to assume a situation where the FHLBank is either precluded or limited in its ability to issue consolidated obligations through the Office of Finance. These and other issues would presumably have to be addressed by the FHFA.

conditions and at prices determined by the Secretary. The Secretary's authority to exercise the Additional Purchase Authority expires on December 31, 2009.[21]

2.2. Compensation Provisions

The Act provides that during the period ending on December 31, 2009:

> "The [FHFA] Director shall have the power to approve, disapprove, or modify executive compensation of the Federal Home Loan Bank, as defined under Regulation S-K, 17 C.F.R. 229."

This provision ("Compensation Authority") raises a number of questions. For example, is the Compensation Authority triggered only upon the exercise of the Additional Purchase Authority and, in such event, only with respect to an individual FHLBank as to which the Secretary has exercised the Additional Purchase Authority? Or does it apply to all FHLBanks during the period from enactment to December 31, 2009?[22] Furthermore, how will the FHFA Director's authority, if applicable, be exercised?

2.3. Federal Reserve Board Consultation

During the period that ends on December 31, 2009, the FHFA Director is required to consult with the FRB Chairman with respect to the risks posed by the Regulated Entities to the financial system prior to (i) issuing any proposed or final regulations, orders, or guidelines with respect to the FHFA's authority regarding prudential management standards, safe and sound operations of and capital requirements and portfolio standards applicable to the Regulated Entities; or (ii) any decision to place a Regulated Entity into conservatorship or receivership. The Director must also share information with the FRB on a regular, periodic basis as determined by the Director and the FRB regarding the capital, asset and liabilities, financial condition, and risk management practices of the Regulated Entities, as well as any information related to financial market stability.[23]

3. FHLBank Corporate Governance Provisions

Each FHLBank will be governed by a board of directors comprised of 13 members, or such other number as the FHFA Director determines appropriate.[24] This provision eliminates the prior version of the FHLBank Act that permitted the FHFB to increase the size of FHLBank boards in

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[21] The right of the Secretary to hold any obligations acquired under the Additional Purchase Authority, or to exercise rights with respect to such obligations is not subject to the December 31, 2009, sunset date.

[22] There would appear to be a strong legal argument that the Compensation Authority is only applicable once the Secretary has exercised the Additional Purchase Authority and only with respect to the FHLBank as to which the Additional Purchase Authority was exercised. Moreover, as a policy matter, there is no reasonable basis to impose this restriction on FHLBanks that have not been participants in a transaction that involves the exercise of the Secretary's Additional Purchase Authority.

[23] By establishing this consultative and information sharing process, Congress has established a process under which the FRB, which has responsibility for the Federal Reserve Banks that can in some respects be viewed as competitors with the FHLBanks, will be given a potentially significant role in relation to the FHLBanks. The way that this relationship is established at the beginning will determine the role that FRB will play and how potential business conflicts will be addressed.

[24] Section 1202.

districts comprised of five or more states beyond the standard fourteen members. The FHFA Director retains the authority, however, to determine the size of a particular FHLBank's board. As a result, it remains to be seen whether there will be a change in the size of any particular FHLBank's board of directors. The current provision regarding grandfathered individual state member directorships is retained, except that the grandfathered directorship provision will not apply to the directorships of an FHLBank resulting from the merger of any FHLBanks. Each director will now serve for a four-year term rather a three-year term as previously provided. Any member of an FHLBank board of directors elected or appointed prior to the date of enactment of the Act may continue to serve on the board of directors for the remainder of the director's term.

A majority of the directors must be "member directors." A member director is an individual who is an officer or director of an institution that is a member of the FHLBank. Member directors will continue to be elected by the member institutions located in a particular state, subject to the existing cap on member votes.

The Act takes a new approach to the selection of what had previously been referred to as appointive directors. The Act requires that at least 2/5 of the members of an FHLBank's board be comprised of independent directors. Independent directors are divided into two categories: (i) those who qualify as public interest directors, and (ii) those who do not fall into this category ("Other Independent Directors"). A public interest director is an individual who has more than four years of experience in representing consumer or community interests on banking services, credit needs, housing, or financial consumer protections. At least two of the independent directors on an FHLBank board must qualify as public interest directors.

Each Other Independent Director must have demonstrated knowledge of, or experience in, financial management, auditing and accounting, risk management practices, derivatives, project development, or such other knowledge as the FHFA Director provides by regulation.

Independent directors are to be elected by the members entitled to vote from among persons nominated by the FHLBank's board of directors. Such independent directors shall be elected by a plurality of the votes of the entire membership of the FHLBank with each institution casting the number of votes that it may cast for the member director positions. The procedures for the nomination and election of independent board members are to be set forth in the bylaws of each FHLBank in a manner consistent with regulations of the FHFA.

The new approach to independent directors, which will allow FHLBanks to ensure that their boards operate at full strength, should be a welcome change from the lengthy period when many FHLBanks operated with numerous appointive director positions unfilled.

The Act eliminates the current limitation on FHLBank director compensation, which in 2008 limited the compensation of an FHLBank chairperson to approximately $32,000 and the compensation of an FHLBank director to approximately $19,000. Director compensation will be subject to approval by the FHFA. Current FHFB regulations deem director compensation in an amount within the existing statutory limitations to have been approved by the FHFB for purposes of section 7(i) of the FHLBank Act.[25] The FHFA Director will be required to include information on

[25] 12 C.F.R. § 918.5.

the compensation and expenses paid by the FHLBanks to their directors in the Director's annual report to Congress.

4. Voluntary Mergers of FHLBanks

The Act provides that any FHLBank may, with the approval of the FHFA Director and the boards of directors of the FHLBanks involved, merge with another FHLBank.[26] The Act requires the FHFA Director to issue regulations establishing the conditions and procedures for the consideration and approval of any voluntary merger, including the procedures for member approval. Most notable from a legal point of view, the Act imposes a member approval requirement where one was not expressly contained in the prior version of the FHLBank Act, and none is contained in a capital plan of an FHLBank.[27] In a particular case, a member approval requirement may have a significant impact on the viability of a transaction. The Act authorizes the FHFA Director to reduce the number of FHLBank districts below eight due to voluntary merger or due to a liquidation of an FHLBank.[28]

5. Liquidation or Reorganization of an FHLBank

The Act retains the current authority for the FHLBank regulator to liquidate or reorganize any FHLBank. However, it adds a new requirement that at least 30 days prior to liquidating or reorganizing any FHLBank, the FHFA Director shall notify the FHLBank of its determination to take such action and the facts and circumstances upon which such determination is based.[29] An FHLBank that receives such a notice may contest the FHFA Director's determination in a hearing before the Director on the record under the Administrative Procedure Act. The Act does not specifically address a process for judicial review of an adverse decision by the FHFA Director in such a hearing.

This provision is quite different from the approach that is applied by the FDIC and the federal bank regulatory agencies in their receivership operations. The FDIC and the federal bank regulatory agencies are under no legal obligation to notify an institution that it is about to be placed in receivership or conservatorship. In fact, as a matter of practice such an institution does not receive prior notice of such an intended receivership or conservatorship. As a result, any challenge to the action occurs after the action has taken place.

Since the FHLBanks are subject to securities disclosure requirements under the Securities Exchange Act of 1934 ("Exchange Act"), receipt of such a notice from the Director may be an event that triggers a public disclosure by the FHLBank of an impending liquidation or reorganization of that particular FHLBank. The recent experience at IndyMac Federal Bank suggests that the announcement of such an intention by the FHFA or public attention to a hearing before the FHFA could have a destabilizing impact on the FHLBank in question, or potentially the broader FHLBank System and the Enterprises in general. As practical matter, this suggests that such notice is not an option that the FHFA will want to use. We expect that the FHFA would

[26] Section 1209.

[27] Any FHFA regulation on this topic will presumably have to address what approval requirement will apply and what type of voting rights will be provided to individual members.

[28] Section 1210.

[29] Section 1214.

pursue a voluntary merger as a resolution to a problem FHLBank, or that it might seek to avoid the 30-day prior notice provision by obtaining the consent of the FHLBank's directors to a liquidation or reorganization.

6. Prompt Corrective Action

As noted above, the Act takes major strides in the direction of treating the FHLBanks for regulatory supervision purposes in a manner very similar to FDIC-insured depository institutions. A primary example of this trend is the prompt corrective action ("PCA") provisions of the Act that are largely drawn from the prompt corrective action provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA").[30]

6.1. Capital Classifications

The Act requires the FHFA Director to issue regulations within 180 days of the enactment of the Act establishing four capital classifications for the FHLBanks.[31] The required classifications are:

- adequately capitalized,
- undercapitalized,
- significantly undercapitalized, and
- critically undercapitalized.

In establishing these classifications the FHFA Director is to take into consideration the capital classifications established for the Enterprises, with such modifications as the Director determines are appropriate to reflect the differences in operations between the FHLBanks and the Enterprises. While Congress specified the specific capital requirements for each of the four capital classifications as applied to the Enterprises,[32] it did not do so with respect to the FHLBanks, except as to the adequately capitalized and undercapitalized classifications.

The FHFA Director is given the authority to reclassify an FHLBank in three circumstances:

- If (i) the FHLBank is engaging in conduct that could result in a rapid depletion of total capital, (ii) the value of collateral pledged has decreased significantly, or (iii) the value of property subject to mortgages held by the FHLBank has decreased significantly.
- After notice and an opportunity for hearing, the Director determines that the FHLBank is in an unsafe or unsound condition.
- If the FHLBank is the subject of a cease and desist order based upon an unsatisfactory examination rating.

In the event of a reclassification: (i) an adequately capitalized FHLBank may be reclassified as undercapitalized, (ii) an undercapitalized FHLBank may be reclassified as significantly

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[30] 12 U.S.C. § 1831*o*.

[31] Section 1142.

[32] *See* 12 U.S.C. § 4614(a).

undercapitalized, and (iii) a significantly undercapitalized FHLBank may be reclassified as critically undercapitalized.

6.1.1. Adequately Capitalized Status; Minimum Capital Levels

The minimum capital level for each FHLBank shall be the minimum leverage requirement established for the FHLBank under section 6(a)(2) of the FHLBank Act, which requires an FHLBank to maintain (i) a ratio of total capital to assets of 5.0% (applying a 1.5 multiplier to the paid-in amount of Class B stock and retained earnings) and (ii) a ratio of total capital to assets of 4.0% (without the use of multiplier).[33] Thus, it would appear that as a general matter, an FHLBank that meets these requirements would be deemed to be "adequately capitalized" under the PCA regulations to be issued by the FHFA Director, and that an FHLBank that does not meet this requirement, would, at a minimum, be deemed to be "undercapitalized." It is also to be expected that an FHLBank will have to meet its risk-based capital requirement in order to be classified as adequately capitalized.

The FHFA Director has the authority to establish a minimum capital requirement for the FHLBanks that is higher than the level that is specified in the Act to the extent needed to ensure that the FHLBanks operate in a safe and sound manner.[34]

The FHFA Director may temporarily establish by order an individual minimum capital requirement for a particular FHLBank in excess of the general minimum capital requirement when the Director determines that such an increase is necessary and consistent with prudential regulation and the safety and soundness of the FHLBank. The FHFA Director is required to rescind a temporary minimum capital level when the Director determines that the circumstances or facts no longer justify its imposition. Regulations governing the Director's temporary minimum capital requirement authority must be issued by the FHFA.

The FHFA Director, by regulation or order, may establish capital or reserve requirements with respect to a product or activity of an FHLBank to ensure that the FHLBank operates in a safe and sound manner with sufficient capital and reserves to support the risks that arise in the operations and management of the FHLBank.

6.1.2. Risk Based Capital Requirements

The Act modifies the current risk-based capital requirement contained in section 6 of the FHLBank Act to require the Director to establish by regulation risk-based capital standards for the FHLBanks that will ensure that the FHLBanks operate in a safe and sound manner with sufficient

[33] Section 1111.

[34] Increases in the minimum capital requirements for a particular FHLBank could adversely impact the financial results of the FHLBank. An increase could also trigger additional stock purchase requirements for FHLBank members under the terms of the applicable capital plan. FHFB regulations currently provide the FHFB with the authority to increase minimum total capital and risk based capital requirements on an individual FHLBank basis. 12 C.F.R. §§ 932.2(b), 932.3(b).

permanent capital and reserves to support the risks that arise in the operations and management of the FHLBanks.[35]

6.1.3. Critical Capital Level

The FHFA Director must establish by regulation the critical capital level for FHLBanks.[36] Unlike with respect to the minimum capital level, the Act does not establish a specific benchmark for this requirement. The Director is instructed to give due consideration of the critical capital level established for the Enterprises, with such modifications as the Director determines to be appropriate to reflect the difference in operations between the FHLBanks and the Enterprises.[37] Regulations establishing the critical capital level are required to be issued within 180 days of the enactment of the Act.

6.2. Supervisory Actions Based on Capital Classification

As is the case in FDICIA, the Act sets forth a range of actions that are either required or permissible if an FHLBank is deemed to be in an undercapitalized or lower capital classification. These specific requirements and restrictions have not previously applied to undercapitalized FHLBanks, but similar provisions have applied to the Enterprises since 1992 under statutory provisions that will now become applicable to the FHLBanks.

6.2.1. General Restriction on Capital Distributions

The Act provides that an FHLBank generally may not make a capital distribution (*e.g.*, pay a dividend) if, after making the distribution, the FHLBank would be undercapitalized.[38] The Act does permit the Director to allow an FHLBank to redeem, repurchase, or otherwise acquire shares notwithstanding this provision if it is done in connection with the issuance of additional shares or obligations of the FHLBank in at least an equivalent amount and will reduce the financial obligations of the FHLBank or otherwise improve its financial condition.

6.2.2. Supervisory Actions for Undercapitalized FHLBanks

If an FHLBank becomes undercapitalized, it must submit a capital restoration plan for approval by the FHFA Director, that must, among other things, (i) specify the actions the FHLBank will take to become adequately capitalized, (ii) establish a schedule for completing the actions set forth in the plan, and (iii) specify the level and type of activities in which the FHLBank will engage during the term of the plan.[39] Upon approval, the FHLBank must carry out the plan.[40]

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[35] Section 1110. This provision replaces the prior requirement that referred to the credit risk and market risk to which an FHLBank is subject.

[36] Section 1141.

[37] Congress has provided that an Enterprise will be deemed to be critically undercapitalized if it (i) does not meet its risk based capital requirements, (ii) does not meet its critical capital level (which is generally 1.25% of on-balance sheet assets, 0.25% of the unpaid balance of outstanding mortgage-backed securities and substantially equivalent instruments issued or guaranteed by the Enterprise, and 0.25% of other off-balance sheet obligations of the Enterprise as set forth in 12 USC. § 4613(a)), or (iii) is otherwise classified as critically undercapitalized. 12 USC. § 4614(a)(4).

[38] Section 1142.

[39] Section 1143.

An FHLBank that is classified as undercapitalized may not make any capital distribution that would result in the FHLBank being reclassified as significantly undercapitalized or critically undercapitalized.[41]

If an FHLBank becomes undercapitalized, the FHFA Director is required to (i) closely monitor the condition of the FHLBank, (ii) closely monitor compliance with the capital restoration plan and restrictions and requirements imposed on the FHLBank, and (iii) periodically review the plan and the restrictions and requirements imposed under the plan to determine whether they are achieving their intended purpose.

An undercapitalized FHLBank may not permit its average total assets during any calendar quarter to exceed its average total assets during the preceding calendar quarter, unless (i) the FHFA Director has accepted its capital restoration plan, (ii) any increase in total assets is consistent with the plan, and (iii) the ratio of tangible equity to assets of the FHLBank increases during the calendar quarter at a rate sufficient to enable the FHLBank to become adequately capitalized within a reasonable time.

Such an FHLBank may not directly or indirectly acquire any interest in any entity or engage in any new activity unless (i) the FHFA Director has accepted the FHLBank's capital restoration plan, (ii) the FHLBank is complying with the plan, and (iii) the Director determines that the proposed action is consistent with and will further the achievement of the plan, or the Director determines that the proposed action will further the purposes of the relevant statute.

An undercapitalized FHLBank must be reclassified as significantly undercapitalized if (i) it does not submit a capital restoration plan that is substantially in compliance with the requirements within the applicable period, (ii) the Director does not approve a capital restoration plan, or (iii) the Director determines that the FHLBank has failed to comply with the capital restoration plan and to fulfill the schedule for an approved plan in any material respect.

Finally, the FHFA Director may take any of the actions authorized to be taken with respect to a significantly undercapitalized FHLBank if the Director determines that such actions are necessary to carry out the purposes of the applicable statute

6.2.3. Supervisory Actions for Significantly Undercapitalized FHLBanks

If an FHLBank becomes significantly undercapitalized, it must submit a capital restoration plan for approval by the FHFA Director and carry out the plan after approval.[42] An FHLBank that is significantly undercapitalized may not make any capital distribution that would result in it being

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[40] It remains to be seen whether and to what extent an FHLBank's capital restoration plan might rely upon the Secretary's exercise of the Additional Purchase Authority.

[41] While several provisions in the PCA portions of the Act could be read to suggest that undercapitalized FHLBanks may make capital distributions, the Act did not amend section 6(f) of the FHLBank Act, which provides that an FHLBank may not make any distribution of its retained earnings unless, following such distribution, the FHLBank would continue to meet all applicable capital requirements. FHFB regulations also provide that in no event shall an FHLBank declare or pay any dividend on its capital stock if after doing so the FHLBank would fail to meet any of its minimum capital requirements. Nor shall an FHLBank that is not in compliance with any of its minimum capital requirements declare or pay any dividend on its capital stock. 12 C.F.R. § 931.4.

[42] Section 1144.

reclassified as critically undercapitalized. An FHLBank that is classified as significantly undercapitalized may not make any other capital distribution unless the Director approves the distribution after determining that it meets specified requirements.

The Director is required to take one or more of the following actions with regard to a significantly undercapitalized FHLBank:

- Limit any increase in, or order the reduction of, any obligations of the FHLBank, including off-balance sheet obligations.
- Limit or prohibit the growth of the assets of the FHLBank or require contraction of the assets of the FHLBank.
- Require the FHLBank to acquire new capital in a form or amount determined by the Director.
- Require the FHLBank to terminate, reduce or modify any activity that the Director determines creates an excessive risk to the FHLBank.
- Take one or more of the following actions –
  - o Order a new election for the board of directors of the FHLBank.
  - o Require the FHLBank to dismiss from office any director or executive officer who had held office for more than 180 days immediately before the date on which the FHLBank became undercapitalized (such a dismissal shall not be treated as a removal under the Director's enforcement powers); or
  - o Require the FHLBank to employ qualified executive officers (whose appointment may be made subject to the approval of the Director).

The FHFA Director may also require the FHLBank to take any other action that the Director determines will better carry out the purposes of the applicable statutory provision than any of the other specified actions.

A significantly undercapitalized FHLBank may not, without the prior written approval of the FHFA Director (i) pay any bonus to any executive officer or (ii) provide compensation to any executive officer at a rate exceeding the average rate of compensation of that officer (excluding bonuses, stock options, and profit sharing) during the 12 calendar months preceding the calendar month in which the FHLBank became significantly undercapitalized.

6.2.4. Authority Over Critically Undercapitalized FHLBanks; Appointment of a Conservator or Receiver

The FHFA may be appointed, at the discretion of the Director, as conservator or receiver of an FHLBank.[43]

[43] Section 1145.

The grounds for discretionary appointment of a conservator or receiver include the following:

- The FHLBank's assets are less than the obligations of the FHLBank to its creditors and others.
- There has been a substantial dissipation of assets or earnings due to any violation of any provision of federal or state law or any unsafe or unsound practice.
- The FHLBank is in an unsafe or unsound condition to transact business.
- There has been any willful violation of a final cease and desist order.
- The FHLBank has incurred or is likely to incur losses that will deplete all or substantially all of its capital,[44] and there is no reasonable prospect for the FHLBank to become adequately capitalized.
- The FHLBank by resolution of its board of directors, its shareholders, or members consents to the appointment.[45]
- The FHLBank fails to become adequately capitalized, fails to submit an acceptable capital restoration plan, or materially fails to implement a capital restoration plan.
- The FHLBank is critically undercapitalized.
- The Attorney General notifies the Director that the FHLBank has been found guilty of certain money laundering-related criminal offenses.

The Act establishes certain circumstances in which the appointment of the FHFA as receiver is mandatory:

- The Director determines that the assets of the FHLBank are, and during the preceding 60 calendar days have been less than the obligations of the FHLBank to its creditors and others.
- The FHLBank is not, and during the preceding 60 calendar days has not been generally paying its debts as such debts become due.

If the FHFA is appointed as conservator or receiver of an FHLBank, the FHLBank may, within 30 days of such appointment, bring an action in a specified federal district court seeking an order

[44] Although not specified in the Act, presumably the reference to capital is to regulatory capital which would include shares that are subject to a pending redemption notice, which are not included in the calculation of GAAP capital.

[45] The Act provides that the members of the board of directors of an FHLBank shall not be liable to the shareholders of the FHLBank for acquiescing in or consenting in good faith to the appointment of the FHFA as conservator or receiver of the FHLBank. This appears to be intended to encourage board of director cooperation with FHFA conservatorship or receivership determinations. This exculpation clause is not entirely protective as it does not shield the directors from potential liability in the different actions that could be brought by the FHFA in its regulatory capacity as a conservator or receiver, or actions brought by bondholders and other third parties.

requiring the FHFA to remove itself as conservator or receiver.[46]

7. FHLBank Receivership or Conservatorship

Until the passage of the Act, the FHLBanks had operated essentially without any specific statutory or regulatory provisions governing how an FHLBank, its creditors, its counterparties, its vendors, and shareholders would be treated in a liquidation.[47] The Act changes this dramatically by importing to a large degree the extensive receivership and conservatorship provisions contained in section 11 of the Federal Deposit Insurance Act ("FDI Act") and applying them to the FHLBanks.[48]

The receivership and conservatorship provisions of the Act address, among other things, the following areas:

- The powers and obligations of the FHFA as a conservator or receiver.[49]
- The authority of the receiver to determine claims, including the timing, procedures, and appeal process relating to such claims.[50]
- The treatment of secured creditors.
- Actions brought by a conservator or receiver.
- Provisions regarding the avoidance of fraudulent transfers.

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[46] This is similar to the authority provided in the case of a receivership of a bank or thrift. It essentially provides the shareholders an opportunity to challenge such an action, but is subject to an extraordinarily short statute of limitations. In the case of an FHLBank, this litigation would have to be supported and paid for by the member stockholders.

[47] Section 26 of the FHLBank Act contained only a general reference to the liquidation or reorganization of an FHLBank, subject to such regulations or orders as the FHFB may prescribe and providing for the FHLBank's stock being paid off and retired in whole or in part, subject to paying or making provision for the payment of its liabilities. The case law on this authority dates back over half a century. *O'Melveny & Meyers v. Myers*, 200 F.2d 420 (9th Cir. 1952).

[48] Section 1145.

[49] Where the prudential regulator can also become the conservator or receiver, as was the case with the Federal Home Loan Bank Board, which was the governing board of the Federal Savings and Loan Insurance Corporation, there are certain conflicts and considerations that come into play which create difficult decisions, particularly with regard to the continuing borrowing of the FHLBank and how it positions itself while it remains independent.

[50] The Act establishes the following priority for unsecured claims:

(i) administrative expenses;
(ii) any other general or senior liability of the FHLBank;
(iii) any obligation subordinated to general creditors;
(iv) any obligation to shareholders or members as a result of their status as shareholder or member.

Interestingly, the Act generally imports the principle of 12 U.S.C. § 1823(e) regarding the non-recognition of certain agreements that tend to diminish the interests of the FDIC. This principle derives from situations where the FDIC generally has a financial interest because of its role as a deposit insurer. The FHFA acting as a receiver for an FHLBank would not have a comparable financial stake, and thus does not appear to have a comparable concern regarding the diminution of particular assets.

- The authority of the FHFA to establish a limited-life entity (similar to a bridge bank) that could be authorized to acquire assets from an FHLBank that is in default or in danger of default.[51]

- The authority of a conservator or receiver to repudiate contracts and the damages for repudiation.

- The treatment of qualified financial contracts (*e.g.*, swaps, repurchase agreements, and other counterparty agreements).

The Act gives the FHFA express rulemaking authority with respect to receivership and conservatorship matters.

An FHLBank receivership would be quite different from a typical FDIC receivership. Unlike an FDIC-insured institution, the vast majority of the liabilities of an individual FHLBank are also the joint and several liabilities of eleven other FHLBanks. In addition, an FHLBank has the exclusive right to serve the customers located in a particular geographic territory. Thus, any decision on how to address an FHLBank that is placed in receivership would have to consider both how to maintain maximum confidence in FHLBank System consolidated obligations and how to continue to provide liquidity and other services to the institutions located in the affected district. Such factors that do not come into play in an FDIC receivership.[52]

8. Prudential Management Standards

In another provision drawn from the FDI Act,[53] the FHFA Director must establish standards either in the form of regulations or guidelines for each FHLBank relating to the following:

- Adequacy of internal controls and information systems taking into account the nature and scale of business operations.

- Independence and adequacy of internal audit systems.

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[51] A limited-life entity would not be permitted to assume liabilities of an FHLBank in default or in danger of default in an amount that exceeds the amount of assets purchased or transferred from the FHLBank to the limited-life entity. The FHFA is required to wind up the affairs of a limited-life entity no later than two years after its organization, subject to the authority of the Director to extend the entity for three additional one-year periods.

An FHLBank is deemed to be in default if there has been an adjudication or other determination by a court or the FHFA pursuant to which a conservator, receiver, limited-life entity, or legal custodian is appointed by an FHLBank. An FHLBank is deemed to be in danger of default if, in the opinion of the FHFA, the FHLBank is not likely to be able to pay its obligations in the normal course of business, or the FHLBank has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect that the capital of the FHLBank will be replenished. Section 1002.

[52] Any effort by the FHFA to continue to raise funds for an FHLBank placed in conservatorship or receivership, or by a limited-life entity, through continued access to consolidated obligation issuances would raise significant issues regarding the evaluation of the financial impact of the joint and several liability of the FHLBanks for the FHLBank System consolidated obligations, as well as the regulatory requirement that each FHLBank maintain an individual issuer credit rating of at least the second highest credit rating. 12 C.F.R. § 966.3(c).

The operation of a conservatorship or receivership without a fund to backstop such operation is likely also to create formidable challenges.

[53] 12 U.S.C. § 1831p-1.

- Management of interest rate exposure.
- Management of market risk.
- Adequacy and maintenance of liquidity and reserves.
- Management of asset and investment portfolio growth.
- Investments and acquisitions of assets by the FHLBank to ensure that they are consistent with law.
- Overall risk management processes.
- Management of credit and counterparty risk.
- Maintenance of adequate records in accordance with consistent accounting policies.
- Such other operational and management standards as the FHFA Director determines to be appropriate.[54]

If the FHFA Director finds that an FHLBank fails to meet any standard established by regulation, the FHLBank must submit an acceptable plan to correct the deficiency. If the standard is established by guideline, the Director has discretion as to whether to require the submission of a corrective plan. If a corrective plan is required, it must be submitted not later than 30 days after the Director's determination, and the Director must generally act on the plan not later than 30 days after receipt.

If an FHLBank fails to submit an acceptable plan within the required time period, or fails in any material respect to implement an accepted plan, the Director will by order require the FHLBank to correct the deficiency. The Act gives the Director the discretion to take one or more of the following actions by order until the deficiency is corrected:

- Prohibit the FHLBank from permitting its average total assets during any calendar quarter to exceed its average total assets during the preceding calendar quarter or restrict the rate at which the average total assets of the FHLBank may increase from one calendar quarter to another.
- Require the FHLBank to increase its ratio of total capital to assets.
- Require the FHLBank to take any other action that the Director believes will better carry out the purposes of the statute.[55]

[54] Section 1108.

[55] The Director must take one of the three actions if: (i) the FHLBank has failed to meet any standard; (ii) had not corrected the deficiency; and (iii) during the 18-month period before the FHLBank failed to meet the standard, the FHLBank underwent "extraordinary growth," as defined by the Director.

9. Enforcement Provisions

The enforcement provisions that had previously been contained in the FHLBank Act are superseded by a new set of comprehensive FDI Act-based provisions that will apply to the FHLBanks and their entity-affiliated parties.[56]

9.1. Cease and Desist Proceedings

The Director may initiate a cease and desist proceeding if, in the opinion of the Director, an FHLBank or an entity-affiliated party is engaging or has engaged, or the Director has reasonable cause to believe that such FHLBank or party is about to engage, in an unsafe or unsound practice in conducting the business of the FHLBank or the Office of Finance, or is violating or has violated, or the Director has reasonable cause to believe is about to violate, a law, rule, regulation, or order or any condition imposed in writing by the Director in connection with the granting of any application or other request by the FHLBank or the Office of Finance or any written agreement entered into with the Director.[57] The Act provides that if an FHLBank receives a less-than-satisfactory rating for asset quality, earnings or liquidity in its most recent examination report, the Director may (if the deficiency is not corrected) deem the FHLBank to be engaging in an unsafe or unsound practice.

If the Director finds that any conduct or violation specified in a notice of charges has been established, the Director may issue an order requiring a party to cease and desist from any such conduct or violation. The order may require the party to take affirmative action to correct or remedy the conditions resulting from such conduct or violation. Affirmative action requirements may include an order:

- requiring restitution, reimbursement, indemnification or guarantee against loss if a party was unjustly enriched in connection with such conduct or violation or the violation or practice involved a reckless disregard for any law or applicable regulations or prior order of the Director;
- requiring the FHLBank to seek restitution, or to obtain reimbursement, indemnification or guarantee against loss;
- restricting the growth of the FHLBank;
- requiring the FHLBank to dispose of any loan or asset involved;

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[56] An entity-affiliated party generally means: (i) any director, officer, employee, or controlling stockholder of, or agent for, an FHLBank; (ii) any shareholder, affiliate, consultant, or joint venture partner of an FHLBank, and any other person, as determined by the Director, that participates in the conduct of the affairs of a regulated entity, provided that a member of the FHLBank shall not be deemed to have participated in the affairs of the FHLBank solely by virtue of being a shareholder of, or obtaining advances from, the FHLBank; (iii) any independent contractor for an FHLBank (including any attorney, appraiser, or accountant) if (a) the independent contractor knowingly or recklessly participates in any violation of law or regulation, any breach of fiduciary duty, or any unsafe or unsound practice and (b) such violation, breach or practice caused, or is likely to cause, more than a minimal financial loss to, or have a significant adverse effect on, the FHLBank; (iv) any not-for-profit corporation that receives its principal funding on an ongoing basis from an FHLBank; and (v) the Office of Finance. Section 1002.

[57] Section 1151.

- requiring the FHLBank to rescind agreements or contracts;
- requiring the FHLBank to employ qualified officers or employees; and
- requiring the FHLBank to take such other action as the Director determines may be appropriate.

The order may also place limitations on the activities or functions of the FHLBank, or an entity-affiliated party, executive officer, or director of the FHLBank.

As with such enforcement actions brought by federal banking regulators, there is usually an effort to reach agreement between the regulator and the institution in order to avoid the issuance of a notice of charges and the commencement of an administrative proceeding. In the absence of a consent agreement, a hearing will be held before an administrative law judge ("ALJ"), who will issue an opinion that may or may not be accepted by the agency head. Only at the point where the agency either accepts or rejects the ALJ's decision may the institution appeal to a federal court and be heard outside of the administrative process. This will be the same process for an action brought by the FHFA against an FHLBank or an entity-affiliated party.

9.2. Temporary Cease and Desist Proceedings

From time to time, federal banking regulators are so concerned with the actions of an institution or the condition of the market that they believe that it is inappropriate to wait the many months that it might take to secure a cease and desist through the regular administrative process. In such cases, the agency will pursue immediate action, subject to a judicial hearing after the fact to determine the legality and appropriateness of its actions. This will also be the case with the FHFA.

If the Director finds that the actions specified in a notice of charges in a cease and desist proceeding, or the continuation thereof, is likely to cause insolvency or significant dissipation of assets or earnings of the FHLBank, or is likely to weaken the condition of the FHLBank prior to the completion of the proceedings, the Director may issue a temporary order requiring that the FHLBank or entity-affiliated party cease and desist from any such violation or practice and require the FHLBank or entity-affiliated party to take affirmative action to prevent or remedy the insolvency, dissipation, condition or prejudice pending completion of such proceedings.[58] A party that receives such an order may apply to the US District Court for the District of Columbia for an injunction limiting or setting aside the temporary cease and desist order, but it must do so within 10 days after service of the order.

9.3. Civil Money Penalties

Like the federal bank regulators, the Director is also authorized to impose three tiers of civil money penalties on an FHLBank or an entity-affiliated party.[59]

First tier penalties are up to $10,000 for each day a violation continues if the FHLBank or entity-affiliated party violates (i) specified laws or regulations, (ii) a final or temporary enforcement order,

[58] Section 1152.
[59] Section 1155.

(iii) any condition imposed in writing by the Director in connection with the grant of any application or other request by the FHLBank, or (iv) any written agreement between the FHLBank and the Director.

Second tier penalties are up to $50,000 for each day that specified conduct continues if (i) the FHLBank or entity-affiliated party (a) commits any first tier violation, (b) recklessly engages in an unsafe or unsound practice in conducting the affairs of the FHLBank, or (c) breaches any fiduciary duty and (ii) such conduct is (a) part of a pattern or practice of misconduct, (b) causes or is likely to cause more than a minimal loss to the FHLBank, or (c) results in pecuniary gain or other benefit to such party.

Third tier penalties not to exceed $2,000,000 for each day that specified conduct continues may be imposed if an FHLBank or entity-affiliated party (i) knowingly commits (a) a first tier violation, (b) engages in any unsafe or unsound practice in conducting the affairs of the FHLBank, or (c) breaches any fiduciary duty; and (ii) knowingly or recklessly causes a substantial loss to the FHLBank or a substantial pecuniary gain to such party by reason of such violation, practice, or breach.[60]

9.4. Removal or Prohibition Authority

The Act also contains suspension, removal and prohibition authority similar to that used by bank regulators. These provisions authorize the FHFA Director to suspend or remove an entity-affiliated party from office, or prohibit the party's participation in any manner in the affairs of the FHLBank, subject to certain rights to a hearing.[61] The Act also provides that a person who is subject to such an order is generally prohibited from serving with or participating in the affairs of any Regulated Entity and the Office of Finance.

10. Executive Compensation

The FHLBanks will become subject to a provision that has applied to the Enterprises since 1992 that provides that the FHFA Director shall prohibit the FHLBanks from providing compensation to any executive officer of an FHLBank that is not reasonable and comparable to compensation for employment in other similar businesses (including other publicly held financial institutions or major financial services companies) involving similar duties and responsibilities.[62]

The Act adds new guidance in applying this prohibition. The guidance is unusual in that it contemplates both a retrospective and prospective aspect. Thus, in making a reasonableness determination, the Director may take into consideration any factors the Director considers relevant, including any wrongdoing on the part of the executive officer.[63] The Act amends the FHLBank Act to provide that an FHLBank may not transfer, disburse, or pay compensation to any executive officer, without the approval of the Director, for matters being reviewed under the provision relating to the prohibition of excessive compensation.

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[60] An FHLBank is prohibited from reimbursing or indemnifying any individual for a third tier penalty.

[61] Section 1153.

[62] Section 1113.

[63] Wrongdoing includes any fraudulent act or omission, breach of trust or fiduciary duty; violation of law, regulation, order or written agreement; and insider abuse with respect to the FHLBank.

These provisions respond to recent court rulings in which executive officers of Freddie Mac successfully challenged attempts by OFHEO to freeze employment and termination benefits during the course of administrative proceedings under OFHEO's excessive compensation authority. The new provisions are troubling as they do not involve an exercise of an enforcement authority that is subject to certain recognized principles, but rather purport to give the Director the authority to use hindsight to effectively unilaterally renegotiate executive compensation arrangements that may be uniformly viewed as being appropriate and non-excessive at the time they were entered into.

11. Limitations on Golden Parachutes and Indemnification Payments

In another provision drawn from the FDI Act,[64] the Act gives the FHFA Director the authority to prohibit or limit, by regulation or order, any golden parachute payment or indemnification payment.[65] The Director must prescribe by regulation the factors to be considered in deciding whether to prohibit or limit such payments.[66]

The term "golden parachute" is not limited to an employment or severance agreement triggered by a change in control. Although it is a much broader concept, the FHFA's authority is limited to a payment to an affiliated party pursuant to an obligation of the FHLBank that (i) is contingent on the termination of such party's affiliation with the FHLBank and (ii) is received on or after the date on which (a) the FHLBank became insolvent, (b) a conservator or receiver is appointed, or (c) the Director determines that the FHLBank is in a troubled condition (as defined in regulations issued by the Director).[67]

The term "indemnification payment" is limited to a payment by an FHLBank for the benefit of any person who is or was an affiliated party to pay or reimburse such person for any liability or legal expense with regard to any administrative proceeding or civil action instituted by the FHFA which results in a final order under which such person (i) is assessed a civil money penalty, (ii) is removed or prohibited from participating in the conduct of the affairs of the FHLBank, or (iii) is required to take any affirmative action to correct certain conditions resulting from violations or

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[64] 12 U.S.C. § 1828(k). *See also* 12 C.F.R. pt. 359.

[65] Section 1114.

[66] These factors may include: (i) whether there is a reasonable basis to believe that the affiliated party has committed any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the FHLBank that has had a material impact on the financial condition of the FHLBank; (ii) whether there is a reasonable basis to believe that the affiliated party is substantially responsible for the insolvency of the FHLBank, the appointment of a conservator or receiver for the FHLBank, or the troubled condition of the FHLBank (as defined by the Director); (iii) whether there is reasonable basis to believe that the affiliated party has materially violated any applicable provision of federal or state law or regulation that has had a material effect on the financial condition of the FHLBank; (iv) whether the affiliated party was in a position of managerial or fiduciary responsibility; and (v) the length of time that the party was affiliated with the FHLBank and the degree to which the payment reasonably reflects the compensation earned over the period of time, and represents a reasonable payment for services rendered.

[67] The Act excludes payments made pursuant to certain retirement plans, pursuant to a bona fide deferred compensation plan or arrangement which the Director determines by regulation or order to be permissible, or any payment made by reason of death or disability.

A payment that would be a golden parachute but for the fact that such payment was made before a triggering date will be treated as a golden parachute payment if the payment was made in contemplation of the triggering event.

practices by order of the Director.[68] Thus, this provision will not apply to liability or legal expense related to other types of actions.

12. Housing Goals for Mortgage Purchases

The Act directs the FHFA Director to establish housing goals with respect to the purchase of mortgages, if any, by the FHLBanks.[69] Such goals are to be consistent with the goals for loans to low- and moderate-income families and certain other categories that are established for the Enterprises. The FHFA Director must consider the unique mission and ownership structure of the FHLBanks, and is required to establish interim transitional goals for each of the two calendar years following the date of enactment of the Act.

The impact of this provision will depend on the ongoing volume of acquired member assets ("AMA") activity by the individual FHLBanks, the characteristics of activity relative to the housing goals established for the Enterprises, and the strictness of the transition requirements that are established by the FHFA Director.

13. Public Use Database Regarding Mortgage Purchases

Each FHLBank must provide reports regarding information on mortgages purchased, if any, to the FHFA in a form determined by the FHFA Director.[70] This reporting is to include, among other things, the data that is required to be reported under the Home Mortgage Disclosure Act. The FHFA Director, in turn, will be required to make this information (subject to certain potential exclusions) available to the public. This type of information is generally used by government authorities and consumer organizations to, among other things, seek to identify potential discriminatory lending practices.

14. Liberalization of Qualification as a Community Financial Institution

The Act significantly increased the maximum permissible asset size for an FHLBank member institution to be deemed to be a community financial institution ("CFI") and thereby qualify for the benefits associated with such status.[71] The Act increases the asset cap for CFI status, which had been set by the FHFB at $625 million for 2008 to $1 billion, subject to ongoing annual adjustment for inflation.

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[68] The Act provides that the indemnification provision shall not be construed as prohibiting any FHLBank from purchasing any commercial insurance policy or fidelity bond, except that, subject to any requirement for affirmative action, such insurance policy or bond shall not cover any legal or liability expense of the FHLBank that is described in the provision. Similar language in the FDI Act has been interpreted by the FDIC to provide that a prohibited indemnification payment does not include a reasonable payment by an insured institution which is used to purchase any commercial insurance policy or fidelity bond provided that such policy or bond shall not be used to pay or reimburse an affiliated person for the cost of any judgment or civil money penalty assessed in an administrative proceeding or civil action commenced by a federal banking agency, but may be used to pay any legal or professional expenses incurred in connection with such proceeding or action or the amount of restitution to the insured institution. 12 C.F.R. § 359.1(l)(2)(i).

[69] Section 1205.

[70] Section 1212.

[71] Section 1211.

15. Eligibility of Community Development Financial Institutions for Membership

The Act amends section 4 of the FHLBank Act to authorize an entity that is certified as a community development financial institution ("CDFI") to be eligible to become a member of an FHLBank.[72] There are currently over 800 CDFIs, most of which are entities that were not previously eligible for FHLBank membership.[73]

16. FHLBank Refinancing Authority for Certain Residential Mortgage Loans

The Act amends the affordable housing program provision of the FHLBank to give the Director the authority to issue a regulation that during a two-year period beginning on the date of enactment will establish a percentage of subsidized advances that may be used to refinance loans that are secured by a first mortgage on a primary residence of any family having an income at or below 80% of the median income for the area.[74]

17. Reporting of Fraudulent Loans

The FHFA Director will require an FHLBank to establish and maintain procedures to discover and report to the Director any purchase or sale of a fraudulent loan or financial instrument, or suspicion of a possible fraud relating to the purchase or sale of any loan or financial instrument.[75] The Act provides a safe harbor from liability for an FHLBank or an entity-affiliated party that, in good faith, makes or requires another party to make such a report or for failing to provide notice of such report to the person who is the subject of the report or to any persons identified in the report.

18. Securities Law Provisions

The Act amends the Exchange Act to require that each FHLBank register and maintain its registration of a class of its common stock under section 12(g) of the Exchange Act not later than 120 days after the date of enactment of the Act.[76] The FHLBanks are already operating under a FHFB regulatory requirement to register a class of equity securities with the SEC.[77] The Act also requires each FHLBank to comply with the audit committee rules issued by the SEC under section 10A(m) of the Exchange Act.

The Act provides a series of exemptions from the federal securities law provisions that largely track the accommodations that the FHLBanks received just prior to their registration under the Exchange Act.[78] The SEC is required to promulgate such rules as may be necessary or

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[72] Section 1206.

[73] *805 Certified Community Development Financial Institutions as of 7-1-2008*, CDFI Fund, *available at* http://www.cdfifund.gov/docs/certification/cdfi/CDFIbyOrgName.pdf.

[74] Section 1218.

[75] Section 1115.

[76] Section 1112.

[77] 12 C.F.R. § 998.2.

[78] Section 1208. The Act provides that the FHLBanks shall be exempt from compliance with sections 13(a), 14(a), and 14(c) of the Exchange Act and the related SEC regulations; section 15 of the Exchange Act and related SEC regulations with respect to transactions in the capital stock of an FLHBank; section 17A of the Exchange Act and related SEC regulations with respect to the transfer of the securities of an FHLBank; and the Trust Indenture Act of 1939. Members of the FHLBank System shall also be exempt from compliance with sections 13(d), 13(f), 13(g), 14(d)

appropriate in the public interest or in furtherance of the relevant section of the Act and the exemptions provided in that section. In issuing regulations under this section, the SEC must consider the distinctive characteristics of the FHLBanks when evaluating:

- the accounting treatment with respect to the payment to Refcorp,
- the role of the combined financial statements of the FHLBanks,
- the accounting classification of redeemable capital stock, or
- the accounting treatment related to the joint and several nature of the obligations of the FHLBanks.

19. Information Sharing Among FHLBanks

The FHLBanks have a unique inter-relationship as a result of their status as independently owned and managed entities that nevertheless are jointly and severally liable for the vast majority of the funds that are used by the FHLBanks. In order to better enable the individual FHLBanks to evaluate the financial and disclosure impacts of their financial obligations stemming from this joint and several liability, the Act provides that the FHFA Director shall make available to the FHLBanks such reports, records or other information as may be available relating to the condition of any FHLBank.[79]

The Director is required to issue regulations to facilitate the sharing of such information directly among the FHLBanks. An FHLBank responding to a request from another FHLBank or from the Director for information may request that the Director determine that such information is proprietary and that the public interest requires that such information not be shared. The Director shall not be deemed to have waived any privilege applicable to any information concerning an FHLBank by transferring, or permitting the transfer of, that information to any other FHLBank for the purposes set forth in the statute.

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and 16 of the Exchange Act and related SEC regulations with respect to ownership of or transactions in the capital stock of the FHLBanks by members. Capital stock issued by the FHLBanks are exempted securities within the meaning of section 3(a)(2) of the Securities Act of 1933 ("Securities Act") and exempted securities within the meaning of section 3(a)(12)(A) of the Exchange Act, except to the extent provided in section 38 of the Exchange Act. The debentures, bonds, and other obligations issued under section 11 of the FHLBank Act are (i) exempted securities within the meaning of section 3(a)(2) of the Securities Act; (ii) government securities within the meaning of section 3(a)(42) of the Exchange Act; and (iii) government securities within the meaning of section 2(a)(16) of the Investment Company Act of 1940. In a departure from the overall exemptive nature of the securities law provisions, the Act states that a person (other than an FHLBank effecting transactions for members of the FHLBank System) that effects transactions in the capital stock or other obligations of an FHLBank, for the account of others or for that person's account, as applicable, is a broker or dealer for purposes of specified provisions of the Exchange Act, but is excluded from the term government securities broker under section 3(a)(43) of the Exchange Act and the term government securities dealer under section 3(a)(44) of the Exchange Act. The FHLBanks are exempt from periodic reporting requirements relating to the disclosure of (i) related party transactions that occur in the ordinary course of business of the FHLBanks and their members and (ii) the unregistered sales of equity securities. Finally, the Act provides that SEC rules relating to tender offers shall not apply in connection with transactions in the capital stock of the FHLBanks.

[79] Section 1207.

20. Reports Regarding Advances Collateral

The Act requires the FHFA Director to provide an annual report to specified congressional committees on the collateral pledged to the FHLBanks by individual FHLBank and by type of collateral.[80]

21. Study on Securitization of AMA

The Act opens the door wide on the potential for FHLBanks to become competitors to the Enterprises in the purchase and securitization of home mortgages. This is an area that previously evolved over time through regulatory actions of the FHFB. In the Act, Congress makes it clear that the FHFA Director should undertake an open-minded, wide-ranging evaluation of the appropriate role of the FHLBanks in this area.

Accordingly, the FHFA Director is required to conduct a study to be submitted to Congress no later than a year after enactment of the Act on the securitization of home mortgage loans purchased or to be purchased from member institutions under AMA programs ("Securitization Study").[81] The Securitization Study is to consider the:

- benefits and risks associated with the securitization of AMA;
- potential impact of securitization upon liquidity in the mortgage and broader credit markets;
- ability of the FHLBanks to manage the risks associated with such a program;
- impact of such a program on the existing activities of the FHLBanks, including their mortgage portfolios and advances; and
- joint and several liability of the FHLBanks and the cooperative structure of the FHLBank System.

The FHFA Director is instructed to consult with a wide range of parties in conducting the Securitization Study, including the FHLBanks, the Office of Finance, representatives of the mortgage lending industry and structured finance participants. Moreover, the FHFA Director is expressly required to establish a process for the formal submission of comments in conducting the Securitization Study.

The Securitization Study must also include policy recommendations based on the analysis of the FHFA Director of the feasibility of mortgage-backed securities issuance by the FHLBanks or an individual FHLBank and the risks and benefits associated with such a program or programs.

It is regrettable that Congress waited until 2008 to clearly express its willingness to consider AMA securitization. The development of the FHLBank AMA programs has been seriously limited by a lack of regulatory willingness to act on broad securitization authorization due largely to apparent concern over potential adverse congressional reaction. At the same time, any new consideration of this topic and possible reinvigoration of AMA programs and related securitizations comes at a

[80] Section 1212.
[81] Section 1215.

difficult time as the basic structure of the mortgage purchase and securitization model of the Enterprises comes under enormous pressure and scrutiny.

The Securitization Study may trigger actions that could have a very significant impact on the future operations of the FHLBanks and suggest that the FHLBanks take full advantage of the opportunities provided by the Act to provide their input in connection with the study.

22. Study on Advances Collateral

The Act requires the FHFA Director to submit to specific congressional committees within one year of enactment of the Act a study on the extent to which loans and securities used as collateral to support FHLBank advances are consistent with federal banking agency interagency guidance on nontraditional mortgage products.[82]

23. Refcorp Reports

The Act requires the FHFA Director to provide semiannual reports to specified House and Senate Committees on the projected date for the completion of the FHLBank Refcorp contributions.[83]

24. Inclusion of Minorities and Women in FHLBank Activities

The Act requires that each FHLBank establish a minority outreach program to ensure the inclusion (to the maximum extent possible) in contracts entered into by the FHLBank of minorities and women and business owned by minorities and women.[84] Each FHLBank is required to establish an Office of Minority and Women Inclusion, or designate an office of the FHLBank, that shall be responsible for carrying out the purposes of these provisions. Each FHLBank is to develop and implement standards and procedures to ensure, to the maximum extent possible, the inclusion and utilization of minorities, and women and women-owned businesses in all business and activities of the FHLBank. The Act provides that the processes of each FHLBank for review and evaluation of contract proposals and to hire service providers shall include a component that gives consideration to the diversity of the applicant. Each FHLBank is required to include in its annual report submitted to the FHFA Director specified information regarding its actions in this regard.

25. Actions to be taken by FHFA in regard to the FHLBanks

The Act identifies a series of potential regulatory or other actions relating to the FHLBanks that may be required to be taken by the FHFA.

New regulations either are, or may be, issued in regard to the following areas:

- Nomination and election of independent directors of FHLBanks.
- Voluntary mergers of FHLBanks.
- Capital categories for prompt corrective action purposes.

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[82] Section 1217.
[83] Section 1213.
[84] Section 1116.

- Information sharing among FHLBanks.
- FHLBank receivership and conservatorship.
- FHLBank prudential management standards.
- Limitations on golden parachutes and indemnification payments.
- FHLBank director compensation approval.

Other actions governing the operations of the FHLBanks that are to be addressed are:

- Establishment of transitional and permanent housing goals for purchases of mortgages by the FHLBanks.
- Establishment of reporting requirements for mortgages purchased by FHLBanks.
- Establishment of a public reporting process for FHLBank mortgage purchase data.

The following studies are to be provided to Congress regarding FHLBank matters:

- A study prepared with the assistance of public comment and FHLBank input on the securitization of mortgages purchased by the FHLBanks.
- A study on the compliance of FHLBank advance collateral with banking agency nontraditional mortgage product guidance.

Conclusion

In its search for a "World Class Regulator," Congress has now, among other things, inextricably linked the FHLBanks with Fannie Mae and Freddie Mac. While the goal is noble, the practical result is likely to be far more complicated and often politicized.

Each of these entities performs important public finance roles that have led to the creation of one of the best housing finance delivery systems on the planet. But they are different in their inherent constitutional make-up, starting with the fact the FHLBanks are wholesale finance cooperatives that are not subject to the same pressures that accompany being a public company traded on an exchange among shareholders who expect returns rather than access to liquidity.

Perhaps as much as any other governmental regulatory system, this one affects and regulates the capital markets and to some degree, the health of the US economy. The events of the last three months have certainly proven this effect, as the Treasury has had to intervene on behalf Fannie Mae and Freddie Mac in unprecedented ways. In this context, it is clear that the creation of the FHFA is a significant step with enormous power to influence the flow of housing credit and the health of the capital markets. That places upon it a reciprocal responsibility to blend regulation with sound market instincts so as not to under-regulate the GSEs, or over-regulate the housing and capital markets in a way that ensures financial mediocrity. Experience suggests that in the end, a "World Class Regulator" cannot be created by the sweep of a pen. It will be so when events tell us that it is.

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