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Federal Housing Finance Agency Issues Prompt Corrective Action Regulations for Federal Home Loan Banks

The Federal Housing Finance Agency ("FHFA") on January 30, 2009, published an interim final rule ("Rule") that implements the prompt corrective action ("PCA") provisions of section 1142 of the Housing and Economic Recovery Act of 2008 ("HERA"). The Rule's provisions generally mirror those that have been in effect with regard to commercial banks and savings associations since 1992. *See* ***"Analysis of and Issues Related to the Housing and Economic Recovery Act,"*** 21st Century Money, Banking & Commerce Alert No. 08-07-30. The Rule establishes four capital classifications for Federal Home Loan Banks ("FHLBanks") and implements the PCA provisions that apply to FHLBanks that are not deemed to be adequately capitalized.

The FHFA released the Rule at a time when the FHLBanks have issued a variety of statements regarding their capital and dividend paying status. The Rule emphasizes the importance of FHLBanks, similar to commercial banks and savings associations, taking proactive steps to remain adequately capitalized. Once an FHLBank falls into an undercapitalized status, it will become subject to extensive supervisory authority of the FHFA and a range of mandatory or discretionary regulatory and market restrictions that will come into existence. For example, FHLBanks would need to review their operating and financial contracts and counterparty agreements to determine whether a capital deficiency or the application of the PCA requirements to the FHLBank will trigger defaults or otherwise impact the terms of those contracts and agreements.

The Rule also raises the possibility that the FHFA will in the future establish an additional capital classification not contained in HERA for FHLBanks that are well-capitalized. The FHFA suggests that it might place significant restrictions on FHLBanks, which while adequately capitalized, do not meet the test for well-capitalized status.

1. Capital Classifications

The PCA provisions are keyed off four capital classifications:[1]

[1] The Director of the FHFA will determine the capital classification of an FHLBank no less than once a quarter. The Director may make a capital determination more frequently and may make a determination for one or more FHLBanks without making a determination for all of the FHLBanks. The FHFA must give an FHLBank written notification before finalizing any action to classify

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- Adequately capitalized (meets or exceeds all of its risk-based and leverage capital requirements); [2]
- Undercapitalized (does not meet one or more of its capital requirements, but it is not significantly or critically undercapitalized);
- Significantly undercapitalized (permanent or total capital is less than 75% of its capital requirements, but it is not critically undercapitalized); and
- Critically undercapitalized (total capital is less than or equal to 2% of total assets).

Discretionary Reclassification

The Director may at any time downgrade an FHLBank by one capital category based on specified conduct, decreases in the value of collateral pledged to it, or a determination by the Director that it is engaging in unsafe and unsound practices or is in an unsafe and unsound condition. Before implementing a reclassification, the Director is required to provide the FHLBank with written notice of the proposed action and an opportunity to submit a response.

2. Consequences of Undercapitalized Status

Undercapitalized FHLBanks

An FHLBank that is classified as undercapitalized is subject to a series of mandatory actions.

- It must submit a capital restoration plan and fulfill all terms, conditions and obligations contained in an approved plan.[3]

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or reclassify an FHLBank and give the FHLBank an opportunity to submit information that it considers relevant. An FHLBank must provide written notification to the FHFA within ten calendar days of any event or development that has caused or is likely to cause its permanent or total capital to fall below the level necessary to maintain its current capital classification or the proposed capital classification or reclassification under a notice provided to the FHLBank.

[2] The leverage requirements for FHLBanks that operate under a capital plan are the requirements that an FHLBank (i) maintain total capital equal to at least 5% of its total assets, with total capital being computed by multiplying permanent capital (amounts paid for Class B stock and retained earnings) by 1.5 times and adding any other component of total capital; and (ii) maintain total capital equal to at least 4% of its total assets without the 1.5 times multiplier.

[3] The Plan must provide for the restoration of compliance with capital requirements within a reasonable period of time. It must be feasible given general market conditions and the condition of the FHLBank. Among other things, the Plan shall (i) describe the actions the Bank will take, including any changes that the FHLBank will make to member stock purchase requirements, to ensure that the FHLBank will become adequately capitalized, (ii) specify the types and levels of activities in which the FHLBank will engage during the term of the Plan, and (iii) provide a schedule for meeting specific goals under the Plan.

The Rule requires that an FHLBank must submit a capital restoration plan no later than 10 calendar days after it receives a notice that a plan is required or the FHLBank's capital classification mandates a restoration plan. The Director may extend this deadline if the Director determines that an extension is necessary. This deadline is very short. It contrasts with the 45-day period for the submission of a capital restoration plan that applies under the federal banking regulators PCA rules. If this requirement remains in place, it will put a premium on contingency planning by FHLBanks that face the potential of becoming less than adequately capitalized.

The Director has a 30-day period to approve or disapprove a plan, subject to a 30-day extension. If the Director does not approve the FHLBank's proposed plan, the FHLBank must submit a new plan within 30 days of notification of the disapproval, subject to extension.

An FHLBank must implement and fulfill all provisions of an approved plan. The Director may appoint the FHFA as conservator or receiver of an undercapitalized or significantly undercapitalized FHLBank if the FHLBank materially fails to submit a plan acceptable to the Director within the required time frames or to implement a plan that has been approved by the Director. The FHLBank, however, may bring an action in federal district court to remove the FHFA as conservator or receiver.

- The FHLBank may not make any capital distribution that would result in the FHLBank being reclassified as significantly undercapitalized or critically undercapitalized or make a capital distribution if such distribution would violate any statutory or regulatory restriction on redemptions, repurchases or dividends.[4]

- It may not permit its average total assets in any calendar quarter to exceed its average total assets during the preceding calendar quarter, unless the Director has approved the FHLBank's capital restoration plan, and the Director determines that (i) the increase is consistent with the approved capital plan, and (ii) the ratio of tangible equity to the FHLBank's total assets is increasing at a rate sufficient to enable the FHLBank to become adequately capitalized within a reasonable time and is consistent with the capital plan schedule.

- The FHLBank may not acquire directly or indirectly any interest in any entity or engage in any business activity, unless certain conditions regarding Director approval are met.[5]

The FHFA is required to monitor the condition of any undercapitalized FHLBank and to monitor the FHLBank's compliance with its capital plan.

Significantly Undercapitalized FHLBanks

An FHLBank that is classified as significantly undercapitalized is subject to mandatory restrictions beyond those that apply to an undercapitalized FHLBank. It may not pay a bonus to any executive officer without the written approval of the Director[6] or compensate an executive officer in excess of the average rate of compensation of that officer during the preceding 12 months without the prior written approval of the Director.[7]

The FHFA can also take discretionary actions with regard to a significantly undercapitalized FHLBank.[8] These include:

- Limiting the increase or requiring a reduction in on- or off-balance sheet obligations of the FHLBank.

- Limiting the increase or requiring a reduction in assets held.

- Requiring capital and/or retained earnings to be increased.

- Modifying, limiting, or terminating any activity of the FHLBank.

An undercapitalized FHLBank must be reclassified as significantly undercapitalized if the FHLBank (i) does not submit a plan on a timely basis, (ii) the Director does not approve a plan submitted by the FHLBank, or (iii) the Director determines that the FHLBank has failed in any material respect to comply with its approved plan.

4 Under the Rule, an adequately capitalized FHLBank may not make a capital distribution if after doing so it would be less than adequately capitalized, subject to certain specified exceptions.

5 The Rule does not provide any indication of what would constitute an "interest" in an entity.

6 The Rule states that a bonus includes any amount paid or accruing to an executive officer under a profit sharing arrangement.

7 That calculation cannot include any bonus or profit sharing paid to the executive officer during the preceding 12 month period.

8 Such discretionary actions are subject to notice to the FHLBank and an opportunity to submit information to the Director. A discretionary action relating to an undercapitalized institution or significantly undercapitalized institution will be treated as an order for which the Director may apply for enforcement in federal district court. An FHLBank or an executive officer or director may be subject to an enforcement action for failure to comply with such an order. An FHLBank that is not classified as critically undercapitalized may obtain judicial review of any final capital classification or of any final decision by the Director with regard to an FHLBank's capital classification, a reclassification, or discretionary actions with respect to an undercapitalized or significantly undercapitalized FHLBank.

- Taking steps to improve the management at the FHLBank by
    - Ordering a new election for the FHLBank's board of directors,
    - Dismissing particular directors or executive officers who held office for more than 180 days prior to the date on which the FHLBank became undercapitalized,[9] and
    - Ordering the FHLBank to hire qualified executive officers, subject to approval by the Director.
- Reclassifying a significantly undercapitalized FHLBank as a critically undercapitalized FHLBank.[10]

Critically Undercapitalized FHLBanks

The Director has the discretion to appoint a receiver or conservator for a critically undercapitalized FHLBank but must do so in certain designated circumstances.[11] Within 30 days of appointment of a receiver or conservator, the FHLBank may sue to remove the conservator or receiver.

3. Additional Issues for Comment

The FHFA indicated that it is considering using the PCA Rule as a vehicle to create incentives for FHLBanks to maintain capital levels significantly in excess of adequate capitalized status. The FHFA suggests that it would do this by establishing a well-classified capital classification and by providing that FHLBanks that are adequately capitalized but not well-capitalized would be subject to significant restrictions including (i) a prohibition on repurchasing excess stock before the expiration of the statutory redemption period, (ii) limitations on dividends, and (iii) limitations on new business activities. The FHFA concedes that the PCA provisions of HERA do not provide for a well-capitalized classification or for the restrictions that the FHFA suggests. Instead, the FHFA points to the general authority of the agency to ensure the safe operation of the FHLBanks as the basis for such an approach.

Beyond the authority issue, the FHFA's request for comments raises a series of fundamental issues for the FHLBank system, including the appropriate roles of retained earnings and market value of equity in the operation and supervision of the FHLBanks.

The FHFA's request for comments also offers an express opportunity for FHLBanks to inform the FHFA of concerns regarding the operation of the risk-based capital requirement, in particular, the capital implications of the market risk component. Even more important, it provides the FHLBanks with an opportunity to speak to a variety of issues in the current economic environment which, given the nature of the FHLBank system and its balance sheet, may arbitrarily impact the financial statements in ways that are not necessarily the most efficient or appropriate.

Comments on the Rule and the additional issues raised by the FHFA must be submitted by April 30, 2009.

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[9] Such dismissals would not be subject to the enforcement provisions regarding removals of directors and officers.

[10] Such a reclassification could occur if the FHLBank (i) does not submit a plan on a timely basis, (ii) the Director does not approve a plan submitted by the FHLBank, or (iii) the Director determines that the FHLBank has failed to make reasonable, good faith efforts to comply with its approved plan.

[11] These circumstances are (i) if the assets of the FHLBank are, and during the preceding 60 days have been, less than its obligations to creditors and others, or (ii) if the FHLBank is not, and during the previous 60 days has not been, paying its debts on a regular basis as they come due.

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