

# Rules and Regulations

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## FEDERAL HOUSING FINANCE BOARD

### 12 CFR Parts 925, 930, 931, 932, and 933

[No. 2001-24]

RIN 3069-AB06

#### Capital Requirements for Federal Home Loan Banks

**AGENCY:** Federal Housing Finance Board.

**ACTION:** Final rule.

**SUMMARY:** The Federal Housing Finance Board (Finance Board) is modifying the capital and related regulations that were adopted on December 20, 2000. Many of the changes were identified in response to an advance notice of proposed rulemaking (ANPR) relating to unforeseen issues that were not addressed by the final capital rule. In addition to making certain conforming amendments, the Finance Board is clarifying that the Federal Home Loan Banks (Banks) may pay dividends on Class A stock from retained earnings; providing Banks with discretion to prohibit members from transferring Bank stock; defining the phrase “charges against the capital of the Bank;” clarifying the off-balance sheet conversion factors for commitments to make advances and commitments to acquire loans; changing the provision governing the membership termination date for members seeking to voluntarily withdraw from the Bank System; and adding a requirement that a Bank make certain disclosures to its members before its capital plan can be implemented. The Finance Board is also: providing Banks with authority to suspend the redemption of Class A or Class B stock if continued redemption would seriously affect the Bank’s capital position or raise other safety or soundness concerns and adopting a provision requiring Banks to establish a

deadline in their capital plans by which a member must opt-out of the stock conversion process.

**DATES:** The final rule is effective November 26, 2001.

#### FOR FURTHER INFORMATION CONTACT:

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#### SUPPLEMENTARY INFORMATION:

##### I. Statutory and Regulatory Background

The Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 133 Stat. 1338 (November 12, 1999) (GLB Act), amended the Federal Home Loan Bank Act (Bank Act) to change, among other things, the capital structure of the Banks from a “subscription” structure to one that includes both risk-based and minimum leverage requirements. The GLB Act also required the Finance Board to prescribe uniform capital standards for the Banks and required each Bank to adopt and implement a capital plan consistent with provisions of the GLB Act and Finance Board regulations.

On March 2, 2001, the Finance Board approved an ANPR to help identify issues or uncertainties that had not been contemplated by, or fully addressed in, the final capital rule or that had arisen only after the Banks had begun to develop their capital plans. *See* 66 FR 14093 (Mar. 9, 2001). On August 8, 2001, the Finance Board published for notice and comment a notice of proposed rulemaking (proposed rule) addressing a small number of modifications to the capital and related regulations. *See* 66 FR 41462 (Aug. 8, 2001). Many of the changes proposed were identified in response to the ANPR. In addition to proposing certain conforming amendments, the Finance Board proposed to: clarify that the Banks may pay dividends on Class A stock from retained earnings; provide

Banks with discretion to prohibit members from transferring Bank stock; define the phrase “charges against the capital of the Bank;” clarify the off-balance sheet conversion factor for commitments to make advances and commitments to acquire loans; change the provision governing the membership termination date for members seeking to withdraw voluntarily from the Bank System; and add a requirement that a Bank make certain disclosures to its members before its capital plan can be implemented. The proposed rule also addressed other issues arising under the capital rule that, based on the ANPR comments, appeared to require additional explanation, even though no amendment to the regulation with respect to these issues was proposed.

After considering the comments on the proposed rule, the Finance Board is adopting many of the changes as proposed, and is substantially modifying a number of others. The Finance Board is also adopting a few changes after commenters prompted the Finance Board to reconsider issues that, when proposing the rule amendments, the Finance Board had indicated such issues would not require rule changes. The final rule being adopted herein will become effective 30 days from its date of publication in the **Federal Register**, in accordance with the Administrative Procedure Act. *See* 5 U.S.C. 553(d). Banks, however, may immediately rely on the changes adopted herein in developing their capital plans. Further, because some Banks have already submitted their respective capital plans to the Finance Board for approval or others may not have sufficient time to alter a capital plan already approved by the their boards of directors before October 29, 2001 (when final plans are to be submitted to the Finance Board), the Finance Board emphasizes that Banks’ boards of directors may amend their capital plan submissions at any time up until the time the Finance Board considers the capital plan for approval.

##### II. Comments on and Changes to the Proposed Regulations

The Finance Board received seven comment letters related to the proposed rule. One comment, from a Bank, was sent on behalf of all twelve Banks. Four Banks submitted separate comments. Comment letters were also submitted by

two trade associations. On August 20, 2001, Finance Board staff met with representatives of three Banks, along with a law firm representing the Banks, to discuss disclosure requirements in the proposed rule. A summary of this meeting was designated as a comment. After considering these comments the Finance Board has made a number of changes to the proposed regulations. In other cases, the Finance Board believes that no change to the proposed rule is warranted or that the Finance Board could address the comment by clarifying the meaning of regulatory text or a statutory provision. The Finance Board discusses below those comments that referenced provisions in the proposed rule amendments or that raised issues that the Finance Board has not previously fully or clearly addressed.

*Voluntary withdrawal from membership.* In the proposed rule, the Finance Board proposed amending § 925.26(b) to address a membership termination issue raised by a scenario described in comments to the ANPR. See 66 FR at 41463, 41473. Under that scenario, a member was required to hold Class B shares to support outstanding borrowing from a Bank and to hold Class A shares as a condition of membership. As adopted in December 2000, § 925.26(b) set the effective date of a member's termination as of the date on which the last of the applicable stock redemption periods ended for the member's stock, whether the stock in question was held as membership stock, as activity-based stock, or as excess stock. Thus, this provision prevented the Bank from redeeming Class A stock at the end of the six-month redemption period because that stock would have been required to be held as a condition of continued membership in the Bank until the membership terminated at the end of the five-year redemption period applicable to the member's outstanding Class B stock.

Because the rule appeared effectively to extend the redemption notice period for Class A stock in the situation described above by linking the membership termination to activity-based stock purchase requirements, thereby burdening members unnecessarily, the Finance Board proposed to change it. Under the proposed change, the membership of an institution that had submitted a notice of withdrawal would have terminated as of the date on which the last of the applicable stock redemption periods ended for the stock held as a condition of membership, as that requirement was set out in the Bank's capital plan, unless the institution decided not to withdraw

and cancelled its notice of withdrawal prior to that date. This proposed change would have, in situations like those described above, enabled the Bank to redeem the Class A shares that were held as a condition of membership at the end of six months, unless a Bank also required a member to hold Class B stock as a condition of membership. In most cases, however, the Finance Board believed that the rule change would have helped assure that the redemption date for the Class A stock held as a condition of membership would have corresponded to the date on which the member's withdrawal became effective.

No commenter objected to the proposed change. One commenter, however, raised a question about how the effective date of a member's voluntary withdrawal would be affected by the member's purchase, after it had submitted its notice of withdrawal, of additional stock to satisfy an increase in its membership stock requirement. Under 925.26(b) as proposed, if a Bank's capital plan required a member to hold Class B stock as a condition of membership, voluntary termination of membership would ordinarily occur five years from the date the member submitted its notice to withdraw. However, if two years into the five-year redemption period, the membership requirement increased and the member purchased additional Class B stock to satisfy the increase, the language in § 925.26(b), as proposed, could be read to suggest that the effective date of the member's voluntary withdrawal would become five years after the purchase of the additional stock, or in effect, seven years after the member first submitted its notice of voluntary withdrawal. Such an outcome was not intended by the Finance Board. Therefore, the Finance Board, in adopting this provision, has altered the proposed language to make clear that the effective date of termination for a member that voluntarily withdraws from membership is the date on which the last of the applicable stock redemption periods ends for membership stock that the member held on the date it submitted its withdrawal notice.

An example illustrates how a member's voluntary termination would operate under the amendment to section 925.26(b). At the time it submits its notice of voluntary withdrawal, a member holds 100 shares of Class B stock to satisfy its membership stock requirement. Two years into its five-year redemption period, the member purchases 20 shares of Class B stock to satisfy an increase in its membership stock requirement. The effective date of the member's voluntary withdrawal

would be unchanged by the purchase of additional stock, and on that date, the membership stock held as of the date the member filed the notice to withdraw would become subject to redemption while, as explained below, the additional 20 shares purchased to satisfy the increase in the membership stock requirement would become excess.

*Stock purchased by withdrawing member.* In response to the proposed rule, a commenter raised two concerns regarding stock purchased by a withdrawing member. First, the commenter raised the scenario of a member that, after filing its withdrawal notice, purchased additional stock, either to satisfy its membership stock purchase requirement, or to support additional business activity. Assuming such stock were Class B stock, unless the redemption period for such stock were deemed to have begun on the date of the member's withdrawal notice, the commenter argued, the redemption period for such stock could extend well after the termination of the institution's membership.

The Finance Board believes that, with respect to stock purchased by a withdrawing member to support additional business activity, such a scenario does not require a regulatory change. It is true that in this scenario, if the stock purchased to support additional activity is Class B stock, the redemption period would extend beyond the effective date of the member's voluntary withdrawal. However, once the activity related to the stock was liquidated, the stock would become excess and subject to repurchase at the Bank's discretion.

For example, assume that two years into its five-year redemption period, a withdrawing member takes down a four-year advance, supporting it by purchasing additional Class B stock on which it immediately files a notice of redemption. When the membership expires in year five, there would still be one year left on the member's advance. When the advance is paid off one year later, the stock supporting that activity would become excess, subject to repurchase at the Bank's discretion, even though one year still remains to run on that stock's five-year redemption period.

Similarly, with respect to Class B stock that a withdrawing member purchases to satisfy an increase in its membership stock requirement, such stock would not be subject to redemption until some time after the effective date of the member's voluntary termination. However, as explained more fully below, this stock would be

considered excess stock as of the effective date of the member's voluntary termination. As excess, such stock could be repurchased at the Bank's discretion under the terms of the capital plan.

The example used previously also illustrates how a member's voluntary termination would operate under the amendment to § 925.26(b). At the time it submits its notice of voluntary withdrawal, a member holds 100 shares of Class B stock to satisfy its membership stock requirement. Two years into its five year redemption period, the member purchases 20 shares of Class B stock to satisfy an increase in its membership stock requirement. The effective date of the member's voluntary withdrawal would be unchanged by the purchase of additional stock, and would remain five years from the date it submitted its notice to withdraw from the Bank.<sup>1</sup> Further, assuming the member filed a redemption notice for the additional 20 shares at the time they were purchased, such shares could be redeemed three years after the member's voluntary termination was effective. Such shares could be repurchased by the Bank under the terms of its capital plan, however, at any time after the effective date of voluntary termination because after such date, such shares would be considered excess.

With regard to this latter point, some question may arise as to whether membership stock held after termination may be considered excess because of a provision in section 6(e)(2) of the Bank Act which provides:

Excess Stock: Shares of stock held by a member shall not be deemed to be "excess stock" for purposes [of a Bank's discretion to repurchase excess stock under section 6(e)(1)] by virtue of a member's submission of a notice of intent to withdraw from membership or termination of its membership in any other manner.

The Finance Board, however, believes that section 6(e)(2) of the Bank Act does not preclude membership stock becoming excess upon the termination of membership pursuant to a member's voluntary withdrawal. Instead, the Finance Board interprets section 6(e)(2) as preventing a Bank from deeming excess the membership stock of a member that voluntarily withdraws from membership merely because the member has filed a notice of withdrawal. Nothing precludes a Bank, however, from considering stock as excess when membership actually

terminates pursuant to a voluntary withdrawal because, under the statute, the stock is no longer required as a condition of membership. The Finance Board believes this interpretation is also consistent with the statutory provision governing voluntary termination of membership which sets forth that the applicable stock redemption notice period begins when the member files its notice to withdraw and that stock may be redeemed at the end of that period. See 12 U.S.C. 1426(d)(1).

Furthermore, the Finance Board believes that use of the phrase "termination \* \* \* in any other manner" means that the second restriction in Section 6(e)(2) of the Bank Act applies to termination of membership by a process other than the filing of a voluntary notice of withdrawal, in other words as applying to members that are involuntarily terminated, or terminated through merger or consolidation with a nonmember or member of another Bank. Thus, section 6(e)(2) of the Bank Act prevents a Bank from deeming stock as excess because a member is involuntarily terminated or its membership terminates because of a merger or consolidation. This interpretation is consistent with the clear legislative intent, expressed in section 6(d)(2)(B)(i) of the Bank Act, 12 U.S.C. 1426(d)(2)(B)(i), that a Bank pay a member whose membership was terminated involuntarily " \* \* \* in cash the par value of [its] stock, upon the expiration of the applicable notice period \* \* \* (emphasis added)." *Id.* See also, 12 U.S.C. 1426(d)(2)(C) (automatically commencing redemption period for stock upon involuntary termination of membership). The wording concerning excess stock in section 6(e)(2) of the Bank Act in conjunction with the termination provisions of section 6(d) of the Bank Act, therefore, effectively establishes different points at which stock may be deemed excess during the membership termination process for institutions that withdraw from membership voluntarily and for institutions whose membership is terminated through other means.

It should also be noted that, unlike with voluntary terminations, when a membership is terminated involuntarily or because of a merger or consolidation, termination is effective immediately. Thus a Bank would never face the scenario where increases in the Bank's membership stock requirement would result in an involuntarily terminated member purchasing additional stock while it awaited redemption of its stock.

The commenter also expressed a second concern about dividends

received as Bank stock (stock dividends) during the period after a member had filed a withdrawal notice. The commenter believed that unless the redemption period for such stock dividends were deemed to have begun on the date of the notice of withdrawal, a member would never be able to redeem all its stock because it would continue to receive stock dividends, and stock dividends on the stock dividends, *ad infinitum*.

The Finance Board does not believe that the above scenario requires an amendment to the capital rule because a Bank could address this issue in its capital plan. For example, a capital plan could provide that withdrawing members would receive cash dividends instead of stock dividends or that such dividends be paid in Class A stock, which would allow redemption after six months. More importantly, to the extent that shares received as stock dividends exceed the amount a member is required to hold under a capital plan's minimum investment provisions, the stock would be excess, subject to repurchase under the terms of a Bank's capital plan.

*Merger and excess stock calculation.* One commenter expressed concern about statements in the proposed rule regarding whether stock held by a member of one Bank may be considered to be excess stock, which would be eligible for repurchase by the Bank, whenever that institution merges into a member of another Bank or into a nonmember. See 66 FR at 41471. The Finance Board indicated that, under the Bank Act such a merger could not, in and of itself, cause the disappearing member's stock to be deemed excess stock. The Finance Board also stated, however, that as a practical matter, some or all of the stock owned by that member could become excess stock as a result of the Bank's next calculation of each member's minimum stock purchase requirement, depending on the terms of a Bank's membership requirements.<sup>2</sup> *Id.* The commenter indicated that at a Bank where Class B stock was used to satisfy the membership stock requirement, the membership stock of a disappearing member should remain at the same level

<sup>2</sup> For example, an institution that had its charter cancelled because of a merger or consolidation would no longer exist as a separate entity, and upon normal recalculation of the membership requirement, a Bank would have no basis to apply the membership requirement. The membership requirement, therefore, would become zero upon recalculation not because membership was terminated, but because the former member no longer existed. This reasoning would not be applicable to an institution that continued to exist as a separate entity after termination of its membership.

<sup>1</sup> Of course, a Bank could provide in its capital plan a provision which automatically commences the redemption period upon purchase, for stock purchased after a member submits a notice of voluntary withdrawal. See 66 FR at 41463.

during the stock's five-year redemption period, and should not be subject to being deemed excess stock.

The Finance Board does not believe that the comment requires any regulatory change. Even if the Bank stock of a withdrawing member were deemed excess stock, it would remain part of the Bank's capital for the duration of the redemption period, unless the Bank exercised its discretion to repurchase it. Thus, whether such stock ceases to be part of the Bank's capital before the end of the redemption period is a decision that is at the complete discretion of the Bank.

*Rolling redemption.* In the proposed rule, the Finance Board responded to a concern raised by a Bank that § 931.7(a) could permit a member to file a redemption notice against all of its stock, even while such stock was needed to support membership or activity requirements, allowing what the commenter described as a "rolling redemption." The Finance Board concluded that members would not have had a great deal of incentive to engage in rolling redemptions, especially if the Bank intended to aggressively manage its excess stock position. Further, the Finance Board pointed out that § 931.7(a) permitted a Bank to impose a fee, to be specified in its capital plan, on a member that canceled a pending notice of redemption, and that fee could have also reduced the incentive to engage in rolling redemptions. Thus, the Finance Board did not propose any changes to its rules in response to the concern about rolling redemptions. See 66 FR at 41471.

The Finance Board received one comment on this issue. The commenter disagreed with the Finance Board's conclusion that the redemption notice cancellation fee would deter a member from maintaining standing notices to redeem all their stock and provided examples of how the fee could be evaded. The commenter recommended amending the capital rule to permit the Banks to require a member to cancel a redemption notice associated with stock when the member seeks to use such stock to support a business activity that extends beyond, or matures after, the original redemption period.

The Finance Board has reconsidered its previous reasoning and finds merit in the arguments put forth by the commenter. To address the commenter's concerns, the Finance Board is adopting an amendment to § 931.7(a) of its rules to provide that a member's redemption request will be automatically cancelled if the Bank is unable to redeem the member's stock within five business

days after the completion of the statutory redemption period. For example, under this change, if Class B stock specified for redemption were being used to support an activity at the completion of the five-year redemption period, the redemption notice would be cancelled if the activity were not liquidated within five business days and a new notice would have to be filed, starting anew the waiting period, if the member still wished to redeem the stock. This cancellation would still be subject to applicable fees specified in the Bank's capital plan. The five-day business period which a Bank must wait before canceling the redemption notice is intended to allow a member the option of liquidating the activity which is supported by the stock, if such early liquidation of the transaction is allowed under agreements with the Bank.

The automatic cancellation of a redemption request, of course, would also be applied to stock if the stock were required to be held as a condition of membership at the time the applicable redemption period ended. The Finance Board notes, however, that this provision only applies if the stock cannot be redeemed because it must be held by the member to fulfill one of its minimum investment requirements. Thus, the provision would not apply where the Bank could not redeem stock because the Bank would be below its regulatory capital requirements after the redemption or for a reason set forth in § 931.8 of the Finance Board rules, as that rule is being amended today, 12 CFR 931.8.

*Discretionary redemption of stock.* In response to the ANPR, a few commenters noted that Finance Board rules appeared to require a Bank to redeem a member's excess stock at the end of the statutory redemption period, unless certain statutory or regulatory restrictions applied. These commenters stated their belief that this approach was contrary to the Bank Act. See 66 FR at 41470–71. The Finance Board disagreed with this assessment and noted the discretion maintained by the Banks to repurchase stock and reiterated its position that it was not apparent from the GLB Act that a Bank could deny a redemption request if certain statutory or regulatory limitations on redemption did not apply. *Id.*

One commenter urged the Finance Board again to reconsider its position on this issue, citing concerns that the redemption rules, as written, may affect tax treatment of stock dividends and accounting treatment of Bank stock. In response to this comment, the Finance Board has carefully reconsidered its position on discretionary redemption.

The Finance Board, however, continues to believe its earlier statements on this issue are correct. *Id.* at 41470. Further, the Finance Board's view is based in part on the fact that Congress in considering the GLB Act specifically rejected a class of non-redeemable stock. See H.R. Conf. Rep. No. 106–434 (discussing section 608 of the GLB Act). Interpreting the statute to allow the Banks sole discretion to redeem excess stock would effectively give the Banks the right to create a class of non-redeemable stock.

The Finance Board also believes that the Bank Act provides a large degree of discretion to a Bank to affect the amount of stock that it must redeem. In this respect, a Bank may adjust minimum investment provisions in its capital plan to require members to hold additional stock, effectively rendering such stock ineligible for redemption. This is especially true in light the amendments to § 931.7(a) being adopted herein, and discussed above. Further, the Finance Board has interpreted its rules to allow a Bank to provide minimum investment ranges in its capital plan so a Bank may adjust its minimum investment requirement within such range quickly. In cases where a Bank must amend its capital plan to change the minimum investment requirements, the Bank would need to seek Finance Board approval of the amendment, but the Finance Board intends to consider such requests expeditiously.

*Authority for Banks to suspend redemption of stock.* In considering the issue of a Bank's discretion to redeem stock, the Finance Board carefully reviewed its current regulations and weighed whether its current regulations were sufficiently flexible to allow a Bank to address an unforeseen or quickly arising situation in which the cash out-flow associated with redemptions would affect the Bank's ability to continue operating in a safe and sound manner or would weaken its capital position. In this respect, Finance Board regulations clearly prohibit the redemption of stock in situations where a Bank would be below its regulatory capital requirements after such redemption or where a Bank has experienced losses or projects future losses that would impair capital. See 12 CFR 931.7(c) and 931.8. The Finance Board also retains the right for reasons of safety and soundness to require the Banks to hold capital above the minimum total capital or risk-based capital requirements. See 12 CFR 932.2(b) and 932.3(b). By exercising such right, the Finance Board would effectively reduce the amount of stock that the Bank could redeem.

However, it is less clear whether the rules give a Bank clear authority to suspend redemption if it believes that its capital requirement may be rising in the future or if it believes that the capital requirements do not fully reflect the risk on the Bank's balance sheet. For example, the risk of certain newly-developed financial instruments may not become apparent until certain market conditions evolve, and a Bank may feel that such newly-apparent risks are not fully captured in the Finance Board credit or market-risk rules, or will result in a steady rise in a Bank's regulatory capital requirements over a period of time. While the Finance Board has authority to address such situations by raising capital requirements or changing its rules, it may be more prudent for the Banks to act immediately to stop redemptions in particularly volatile situations and let the Finance Board adjust its regulatory requirements in a more deliberate fashion.

The Bank Act also clearly provides certain statutory prohibitions on the redemption or repurchase of Bank stock so that the redemption or repurchase of such stock does not endanger a Bank's capital position. See 12 U.S.C. 1426(f). The Finance Board interprets this goal as applying both to immediate situations in which redemption or repurchase would bring a Bank below regulatory capital requirements and to situations in which a Bank has a reasonable belief that current redemption or repurchase of stock would cause the Bank to fail to maintain adequate capital in the near-term. It is less clear, however, that the Finance Board regulations address this latter situation.

In addition, the Bank Act imposes various obligations on the Banks and on the Finance Board. Among the duties imposed on the Finance Board are the requirements that it ensures that the Banks operate in a financially safe and sound manner, that the Banks remain adequately capitalized, and that the Banks carry out their housing finance mission. See 12 U.S.C. 1422a(a)(3). The Finance Board recognizes that cash outflow associated with redemption of stock could affect the Banks' ability to carry out other obligations or otherwise operate in a safe and sound manner. The Finance Board believes that, given its statutory duties and obligations, it maintains full authority to restrict the redemption or repurchase of stock on safety and soundness grounds. Again, however, the Finance Board is concerned that its rules do not clearly give a Bank flexibility to exercise their judgment in situations that are fast

evolving and moving in directions that cannot be readily ascertained.

To assure that its regulations address these situations, the Finance Board is, pursuant to authority in 12 U.S.C. 1422a, 1422b and 1426(a), adopting § 931.8(b). This regulation provides a Bank's board of directors, or a subcommittee of the board, with authority and discretion to suspend the redemption of stock if the continued redemption of stock would cause (at some future date) the Bank to fail to meet its regulatory capital requirements, would prevent the Bank from maintaining adequate capital against a risk or potential risk not fully captured in the Finance Board's regulations, or would otherwise prevent the Bank from operating in a safe and sound manner. Moreover, as safety and soundness regulator, the Finance Board believes that it would need to be informed of any condition that caused a Bank to invoke the authority granted by this provision. Thus, the provision requires a Bank to inform the Finance Board in writing within two business days that it has invoked the authority granted it under § 931.8(b). In addition, the Bank must provide the Finance Board with its reasons for suspending stock redemptions, including a description of the conditions that led to the suspension, and describe the Bank's strategies and time frame for addressing those conditions. The regulation also makes clear that in granting the Banks this discretion, the Finance Board retains authority to require the Banks to re-institute redemptions subject to whatever terms and conditions the Finance Board may set. The rule also prohibits a Bank from exercising its discretion to repurchase excess stock without the Finance Board's written permission during such time as a suspension of redemption under § 931.8(b) is in effect.

The Finance Board believes that the rule is needed for contingency purposes. In addition, the Finance Board emphasizes that the condition related to the failure to meet a minimum capital requirement in § 931.8(b) differs from the limitation set forth in § 931.7(c) in that it is forward looking and is intended to address a situation in which the Bank projects that continued redemptions over the near term will leave the Bank without sufficient capital to meet its regulatory requirements in the future. Thus, if current redemptions would cause a Bank to fall below regulatory capital requirements, the limitations in § 931.7(c) would apply and the Bank would not need to comply with the conditions of § 931.8(b).

*Opt-out provision.* In their joint comment letter, the twelve Banks urged the Finance Board to address the question of members who would be in the process of withdrawing on the effective date of the capital plan. The issue arose in part because of the proposed requirement in the disclosure rule that a Bank provide the required disclosure at least 20 days before the effective date of its capital plan. The Banks pointed out that they had wanted to put in their capital plans a firm opt-out date by which a member must submit its notice to withdraw if the member did not want to have its existing capital stock converted into Class A or Class B stock. If a capital plan contained such an opt-out date, the Banks stated, disclosure should be made before that date.

Some Banks, in their individual comment letters, also pointed out that Finance Board staff's position concerning draft capital plans was that the Banks could not use an opt-out provision to restrict the members' rights to withdraw from the System upon six-months prior notice. Thus, Finance Board staff believed a member could withdraw from the System and, in effect, opt out of the conversion process up until the effective date of the capital plan. Further, the staff believed that if the withdrawal notice were submitted before the effective date of a capital plan, the member's right to withdraw on six-months notice would have been reserved and should have been applied to any Class A or Class B stock received by the member upon conversion. One Bank's comment letter expressed concern about the operational problems related to conversion procedures and capital stock programming requirements if members were allowed to opt out of conversion up to the effective date. The Banks in their joint comment letter also questioned whether there would be statutory authority to allow Banks to redeem Class B stock on less than five years notice, as the Finance Board staff suggested.

The Banks reviewed various options for addressing the opt-out issue, but they believed some of these approaches raised legal or operational issues. They pointed out, however, that the Finance Board previously determined that it had authority to waive the six-month notice period for withdrawal and urged the Finance Board to use this authority to address the unique circumstances associated with the transition to the new capital structure. Specifically, the Banks wished to be able to adopt a flexible opt-out deadline and allow all members who withdrew from a Bank before this deadline to terminate membership and

have their old stock redeemed on or before the effective date of a Bank's capital plan. The Banks also suggested that the Finance Board adopt a rule requiring members that did not file a notice of withdrawal before the opt-out date to have their existing stock converted into Class A or Class B stock as required under a capital plan and to be subject to the new, applicable notice periods associated with those classes of stock. One Bank also urged the Finance Board explicitly to allow the Banks to convert to cash the stock of institutions whose membership would be terminated as of the effective date, but nevertheless had outstanding advances, and to hold that cash as collateral against the outstanding advances.<sup>3</sup> The Bank also urged the Finance Board to deem receipt by a Bank of a notice to withdraw as receipt by the Finance Board of that notice.

The Finance Board has carefully considered the Banks' comments and finds many of the Banks arguments persuasive. As a starting point, the Finance Board recognizes that the Bank Act does not explicitly address how a Bank is to handle a member that, as of the effective date of a capital plan, has submitted a notice to withdraw from the Bank but for which the statutory six-month notice period has not yet been completed. *See* 12 U.S.C. 1426(e)(1994). Nor has the Finance Board previously addressed how this withdrawal issue should be addressed by the Banks in light of the statutory silence on this issue. The Finance Board does believe, however, that the preliminary position voiced by its staff that the statute allows a member to withdraw from the System on six-months notice up until the effective date of the capital plan raises questions from both an operational and a legal perspective, and, therefore, declines to adopt that position.

The GLB Act holds that a Bank shall apply the stock purchase and retention requirements that were in effect immediately prior to its enactment until the capital plan of that Bank is implemented. Under the regulatory structure adopted by the Finance Board, a Bank's capital plan is considered implemented on its effective date when the stock purchase and retention requirements (*i.e.*, the minimum investment requirements) for members adopted in the capital plan and the capital requirements (and transition provisions) adopted by the Finance Board under the authority set forth in the GLB Act would be applied. *See* 12 CFR 931.9. *See also* 66 FR 8262, 8279–

80 (Jan. 30, 2001)(discussing 12 CFR 931.9). Thus, while the six month notice period for withdrawal from membership are applied up until the effective date of a Bank's capital plan, the withdrawal provisions set forth in the GLB Act amendments to the Bank Act should be applied after the capital plan's effective date. *See* 12 U.S.C. 1426(d).

The Finance Board believes that this view is also the most consistent with other provisions of the GLB Act. The GLB Act provides that the Finance Board may permit Banks to issue only those classes of stock authorized thereunder, and sets forth specific redemption periods for both Class A and Class B stock. *See* 12 U.S.C. 1426(a)(4). Deeming the six-month notice period for withdrawal to apply to Class B stock issued on the effective date of the capital plan would raise questions whether the Finance Board were allowing an unauthorized class of "old" stock to be issued, or alternatively, allowing a redemption period that differs from the statutory requirement. Thus, the approach that requires the pre-GLB Act withdrawal provision to apply up to the effective date but that applies the withdrawal provision set forth in the GLB Act to membership termination and the accompanying redemption of stock after such date appears to be the most consistent with the Bank Act, as amended.

The Finance Board also has, on at least one occasion, waived the statutory six-month notice period for withdrawal. *See* Fin. Bd. Res. No. 97–89 (Dec. 30, 1997). In that case, the Finance Board noted that it acted pursuant to an opinion of the Office of General Counsel that the Finance Board had authority as a matter of law, to waive the statutory six-month notice period provided that the waiver did not: (1) endanger the financial stability of the Bank from which the member was withdrawing; (2) endanger the safety and soundness of the Bank System as a whole, or (3) frustrate the purposes of the statutory provision. *Id.* In this regard, the Finance Board recognizes that some Banks may wish to allow members to opt out of the conversion process on less than six-months notice, either to speed up the transition process or to allow members to make their decision closer to the effective date. Thus, as a general matter, the Finance Board recognizes that applying its waiver authority to allow the Banks some flexibility in managing the unique issues related to the transition from the old subscription-based capital to the new risk-based capital system may strengthen the transition process and advance the

overall statutory goals of the Bank Act as amended by the GLB Act.

To codify its view of the withdrawal provisions discussed above and in response to the concerns raised in comments on the proposed rule, the Finance Board has decided to adopt § 933.2(e) as part of this final rulemaking to require each Bank to establish in its capital plan an opt-out date by which a member that does not wish to convert to the new Class A or Class B stock must file its notice to withdraw with the Finance Board. This opt-out date can be no more than six months prior to the effective date of the capital plan, assuring that a Bank does not extend the withdrawal notice period beyond the six months currently required under the Bank Act.

The rule, however, in reliance on the Finance Board's waiver authority discussed above, will allow a Bank to set its opt-out date less than six months prior to the effective date of the capital plan. The Finance Board, by approving a capital plan that has an opt-out date that is less than six months before the effective date of the capital plan, will be simultaneously waiving the six-month notice period for withdrawal contained in § 6(e) of the Bank Act prior to its amendment by the GLB Act. When considering a capital plan with such an opt-out date, the Finance Board, therefore, will have to be satisfied that the opt-date will not endanger the safety and soundness of the Bank in question or the Bank System more generally nor be contrary to the withdrawal provision in the statute. Among the factors the Finance Board will consider in this regard are whether the opt-out date provides the Bank with sufficient time to adjust to unexpected withdrawals prior to the effective date and whether the Bank expects or is reasonably certain that member withdrawal will not negatively affect its conversion plans. The Finance Board also wishes to emphasize that it expects the opt-out date to be a specific date keyed to the effective date (*e.g.*, four months before the effective date) and will not consider a range of dates.

Section 933.2(e), as adopted, also requires each Bank's capital plan to provide that a member that does not file its notice to withdraw from the Bank on or before the opt-out date will be subject to the withdrawal requirements set forth in the Bank's capital plan. For a member of a Bank that requires an institution to hold Class B stock as a condition of membership, this would mean that the member would become subject to the five-year redemption period associated with Class B stock upon the conversion of its existing stock to Class B stock,

<sup>3</sup> The Finance Board will consider addressing this situation on a case-by-case basis should it arise.

even though the member may have filed its notice to withdraw prior to the effective date of the capital plan. In this regard, the Finance Board will consider using its waiver authority to allow members that missed an opt-out date filing to terminate their membership on the effective date of the capital plan, upon a request of the Bank. In considering such a waiver, the Finance Board will review the effects of letting the member leave the System on its Bank's capital position, as well as review other safety and soundness implications of the request.

Section 933.2(e), as adopted, also makes clear that a Bank shall consider the period of time after the member files its notice to withdraw but before the effective date of the capital plan in calculating the applicable stock redemption periods for the Class A or Class B stock that are converted from existing stock on the effective date of the capital plan. The voluntary withdrawal provisions in the Bank Act both before and after its amendment by the GLB Act required the withdrawal notice period to commence upon the member's filing of its notice to withdraw. *Cf.* 12 U.S.C. 1426(e)(1994) and 12 U.S.C. 1426(d)(1). The Finance Board, therefore, believes that it is consistent with the GLB Act provisions to allow the date that the member's notice of withdrawal was first filed with the Finance Board to carry over when existing stock is converted into Class A or Class B stock. This approach also results in the applicable stock redemption periods remaining five years from the date the notice was filed for Class B stock and six months from the date the notice was filed for Class A stock, as required by the GLB Act. Section 933.2(e), as adopted, does not alter current procedures which require that a notice to withdraw be filed with the Finance Board to become effective. This long standing practice is required by the Bank Act and has not generally resulted in delays in member filings. Of course, on the effective date of a Bank's capital plan, voluntary withdrawal from that Bank would be governed by § 925.26 of the Finance Board's rules, 12 CFR 925.26, which requires that members provide their notices of withdrawal to the Bank.

This final provision being adopted by the Finance Board also does not alter the current practices for calculating the effective date of termination of membership. Under these procedures, a member whose notice of withdrawal is received by the Finance Board on February 1 would be given a membership termination date of August 1 (i.e., the count is six months not 180

days). Thus, by the same token, a Bank that wished to have an effective date of August 1, 2003, could set its opt-out date no earlier than February 1, 2003.

In adopting § 933.2(e), the Finance Board is requiring all Banks to set an opt-out date in their capital plans. The Finance Board fully expects this change may require some Banks to amend the plans that they initially submitted and has no objection to a Bank's altering its capital plan after the submission date.

The Finance Board also agrees with the Banks' comments that the disclosure requirement should be tied to the opt-out date to assure that members have information that would aid in their decisions whether to convert existing stock to the new Class A and/or Class B stock. Therefore, the Finance Board is adopting in the final disclosure rule (more fully discussed below) a requirement that all information required to be provided to members by § 933.5 be transmitted, sent, or given to members between forty-five and sixty days before the opt-out date established in a Bank's capital plan. The Finance Board believes that this deadline will provide members sufficient time to review the information provided by the Bank and to make follow-up inquiries if necessary while still being sufficiently close to the opt-out date.

Furthermore, to assure that members fully understand the ramifications of the opt-out provision, § 933.5(c)(4)(iv) of the final disclosure rule requires a Bank to provide the opt-out date in the disclosure materials. Because a Bank will know the intended effective date of its capital plan by the time the disclosure document is provided, the Finance Board expects that Bank to provide the calendar date for the opt-out deadline. Along with disclosing this opt-out date, the Bank also must explain the consequences to members of not filing the withdrawal notice on or before the opt-out date.

*Disclosure to members.* In proposing § 933.5, the Finance Board intended to provide a baseline for a Bank's disclosure about its financial condition, its capital plan, and the capital conversion process. The Finance Board decided to propose this rule after the Banks requested further clarification of Finance Board staff guidance that had outlined the types of communications with members that staff believed would help the Banks demonstrate the feasibility of implementation of their capital plans, as is required by § 933.2(g) of the Finance Board's rules, 12 CFR 933.2(g). The Finance Board noted that because use of disclosure documents could play an important role in member outreach and that the quality of a Bank's

disclosure on a number of issues would play an important role in the Finance Board's review of the Banks' capital plans, there was merit in responding to the requests for additional guidance by adopting a rule in this area. *See* 66 FR at 41467-68.

Proposed § 933.5 would have required a Bank to provide a member with certain specified information at least 20 days before the effective date of the capital plan. In developing this proposed requirement, the Finance Board looked to disclosure standards established by the Securities and Exchange Commission (SEC), and specifically, the rule would have required the Banks to provide disclosure meeting the requirements of Item 11(a) through (d) and Item 12(a) and (e) of Schedule 14A of the SEC's proxy rules (17 CFR 240.14a-101, Items 11 and 12). The Finance Board noted that Items 11 and 12 are "usually thought of as mutually exclusive provisions," but given the unique nature of the Banks and the conversion process, the Finance Board believed that appropriate disclosures from both Items should be provided to members. *Id.* The proposed rule would also have required the Banks to provide certain specific financial information to the members that was in scope, form, and content consistent with SEC's regulations S-X and S-K (17 CFR parts 210 and 229), as well as to provide pro forma balance sheet and income statements. The proposal would have allowed the Banks to incorporate by reference any of the financial information that had been incorporated in any Bank or Bank System report or that had been filed along with the capital plan with the Finance Board. Under proposed § 933.5, the Banks would also have had to provide members with a brief statement as to the anticipated accounting treatment and the federal income tax consequences of the transaction and with other information.

The Finance Board received four comment letters on various aspects of the disclosure requirements. One of the letters was on behalf of all twelve Banks. Three Banks also commented separately on specific aspects of the proposed disclosure rule. To the extent that the commenters addressed the same issues, the comment letters were generally consistent in their requests for changing the proposed rule.

In their joint comment letter, the twelve Banks stated that it was important for the Finance Board to clarify the premise under, which it was adopting the disclosure regulation. They noted that the Finance Board had explained that the proposed disclosure



regulations were intended to help the Banks satisfy the disclosure criteria suggested by Finance Board staff in the Capital Plan Feasibility Guidance that had been provided by letter to the Bank presidents in May 2001. The Banks, however, viewed the staff guidance as applicable only to the outreach process which should be completed before the Banks filed their capital plans on October 29, 2001, while the disclosure required under the proposed rule would not occur until after approval of the capital plan.

The Finance Board agrees that clarification on this point is necessary. The criteria contained in the staff's guidance concerning the Banks' communications with their members indicated that a Bank was expected to disclose information about specific requirements in its capital plan. Because the Finance Board expects that the review process of a capital plan is likely to result in changes to the capital plan as originally submitted, information about specific provisions cannot be disclosed with certainty until after the Finance Board actually approves the plan.<sup>4</sup> This fact creates a timing problem under the staff guidance in that a Bank cannot submit complete information about its outreach effort until after a capital plan is approved, but at the same time, the guidance suggested that a capital plan could not be approved until after such information was submitted. Section 933.5(a), as adopted, addresses this timing problem by stating that a capital plan cannot become effective until the disclosure required under the rule is provided to the members. In this respect, the disclosure rule is intended to replace the staff guidance concerning a Bank's communication with its membership.

The Finance Board notes, however, that a Bank may wish to provide a narrative as supplemental information supporting the approval of the capital plan which describes member reaction to the version of the capital plan that it submits for approval and describes any issues that members saw as key to their acceptance of the capital plan. The Finance Board also emphasizes that § 933.5 as adopted only sets forth the minimum disclosure requirements, and does not prevent the Banks from undertaking additional outreach or disclosing additional information at any time.

The Banks in their joint comment letter also raised concerns about the approach to disclosure proposed in

§ 933.5 and about some of the specific information that the Finance Board was proposing be disclosed under the rule. Most importantly, the Banks emphasized that the wholesale incorporation of the SEC's rules was problematic for several reasons. First, the Banks stated that the specific proxy disclosure items from the SEC rules cited by the Finance Board were in some cases mutually exclusive and in other cases overlapping. This fact, the Banks believed, made it difficult to determine what information had to be disclosed and could lead to different Banks applying different standards. Moreover, the Banks believed that the SEC regulations were not designed to address either the unique capital structure of the Banks or the unique circumstances surrounding the recapitalization which created additional difficulties in discerning what disclosure would be required. The Banks also questioned whether SEC precedent would be applied to its disclosure and cited the expense and difficulties for the Banks, which have not been subject to the SEC requirements, to develop the expertise in this area necessary to prepare their disclosure documents.

The Banks also objected to the provisions in proposed § 933.5(b)(1)(ii) which would have required the Banks to provide members with quarterly pro forma balance sheet and income statements. The Banks believed that this information would be so highly speculative and be based on such a detailed set of assumptions so as to be of little use to members. The Banks also voiced concern about the liability associated with requiring disclosure of such highly speculative financial information. As an alternative to the disclosure of the pro forma financial information, the Banks suggested that they be required to provide members with a pro forma capitalization table that would reflect the new capital structure of a Bank and with a narrative discussion of known material trends that could affect the liquidity, capital resources or continuing operations of the Bank. Two Banks also submitted separate comment letters emphasizing these points with one of the Banks suggesting that the narrative discussion may also include a statement of management's plans and objectives for future operations.

In developing the proposed disclosure rule, the Finance Board had turned to the SEC proxy rules (and related precedent) because it believed these rules provide a valuable model and a degree of certainty for the Banks as to the disclosure requirements. The

Finance Board continues to believe that the SEC rules provide the best model for disclosure requirements but also understands the Banks' concerns that their unique capital structure makes the wholesale adoption of these rules confusing. The Finance Board has also reconsidered the proposed requirement that the Banks provide specific pro forma financial information to their members in light of the Banks' comments. As a result, the Finance Board has restructured the final disclosure rule to address the Banks' concerns and to more closely relate the SEC disclosure requirements to the capital plans of the Banks and is adopting § 933.5 as discussed below.

First, the Finance Board has deleted the specific references in its rules to the SEC proxy requirements. Instead, the Finance Board now describes in § 933.5(b) of the final rule the specific information that a Bank must disclose about the Class A and/or Class B stock that the Bank intends to issue on the effective date of its plan. (Thus, to the extent that a Bank's capital plan does not call for the issuance of Class A stock, the Bank's disclosure document would not be required to address Class A stock.) Specifically, § 933.5(b), as adopted, requires a Bank to briefly outline with regard to the Class A and/or Class B stock that it intends to issue: dividend rights, the terms of the conversion, the terms and conditions of a member's rights to have the Class A and/or Class B stock redeemed or repurchased, voting rights and preferences associated with the stock, liquidation rights, and a member's liability to further calls or to assessments by the Banks. The final disclosure provision also requires the Banks to describe any differences with regard to these rights between existing Bank stock and the new Class A and Class B stock. The Banks will also be required to discuss briefly the reasons for the conversion, the general effect of the conversion on a member's rights, and outline any other material features concerning the conversion.

Further, to assure that each Bank adequately discloses how provisions in its capital plan may affect a member's rights, the Finance Board has adopted § 933.5(c)(4) to require a Bank to disclose certain additional information related to its capital plan to the extent that the information was not provided to fulfill the requirements of § 933.5(b). Specifically, § 933.5(c)(4) requires each Bank to describe the minimum stock investment requirements set forth in the capital plan, to review the procedures for the Bank to amend the capital plan, to describe any restrictions (not

<sup>4</sup> These changes may result from comments made by the Finance Board staff or from a Bank's reconsideration of its capital plan.



disclosed elsewhere) on a member's right to redeem or to have its stock repurchased or to make use of its stock to fulfill its minimum stock investment requirement, and to describe a member's rights to have its stock redeemed or repurchased upon the member's voluntary or involuntary termination of membership.

As already discussed above, § 933.5(c)(4), as adopted, also requires a Bank to disclose the last date by which a member's written notice to withdraw from membership must be received by the Finance Board for the member not to have its existing stock converted to Class A and/or Class B stock and to explain the ramifications of not filing a notice to withdraw on or before that date. As also discussed more fully above, the date by which a Bank must make the disclosure required by § 933.5 is tied to the opt-out date set in a Bank's capital plan, and under § 933.5(a), as adopted, a Bank must transmit the required disclosure to members between forty-five and sixty days before the opt-out date.

The Finance Board has also modified § 933.5 with regard to the proposed disclosure of pro forma financial information, and, as requested by the Banks, § 933.5, as adopted, no longer requires the Banks to provide members with quarterly pro forma balance sheets and income statements. Instead, § 933.5(c)(1)(ii) requires each Bank to provide a pro forma capitalization table that reflects the expected new capital structure of the Bank, an estimate of the Bank's risk-based capital requirement under § 932.3 of the Finance Board rules, and an estimate of the Bank's total capital-to-asset ratio (where total capital would be regulatory total capital as defined in part 930 of the Finance Board's rules, 12 CFR part 930). This information should be based on actual financial data as of the date of the latest balance sheet required to be provided by § 933.5(c)(1)(i) of the disclosure regulation. Thus, the rule requires a Bank to show an estimate of what its capitalization, risk-based capital requirement, and total capital-to-asset ratio would have been, if the conversion process had occurred as of the applicable year-end date. The Banks are also required to disclose any material assumptions, and the basis for these assumptions, underlying the pro forma capitalization table, the estimated risk-based capital requirement, and the total capital-to-asset ratio.

Furthermore, § 933.5(c)(2) has been added to the final rule to require the Banks to provide members with a narrative discussing anticipated developments that could materially

affect the liquidity, capital, earnings or continuing operations of a Bank, including those developments that could affect dividends, product volumes, investment volumes, new business lines, and risk profile. Because this narrative is viewed as a replacement for the proposed disclosure of the pro forma financial information, the Finance Board expects that the narrative will be forward looking. At the same time, however, the Finance Board used the term "anticipated developments" to indicate that it expects the Banks to discuss in its narrative those developments that, in the Bank's opinion, may be likely to unfold, given important trends, the Bank's business strategies, and the general economic conditions existing at the time the disclosure is made. The Finance Board also expects that the narrative will provide members with sufficient information to understand the underlying reasons for a Bank's views.

The Banks also requested that the Finance Board make some additional changes to the proposed rule to clarify some of the disclosure requirements. With regard to the requirement in proposed § 933.5(b)(1)(i) that the audited balance sheets and statements of income and cash flows be consistent in scope, form, and content with Regulation S-X and S-K, the Banks commented in their joint letter that this standard may be viewed as different from the current standard required of the Banks. In this respect, they pointed out that § 989.4 of the Finance Board rules, 12 CFR 989.4, stated that quarterly or annual statements issued by an individual Bank should be consistent in both form and content with the financial statements presented in the combined Bank System annual or quarterly financial reports. Two Banks reiterated this point in their individual letters. The Finance Board did not intend that the financial disclosure required under § 933.5 be different in form or content from what is currently required for an individual Bank's or the Bank System's financial reports. Thus, § 933.5(c)(1)(i), as adopted, requires that the audited balance sheets and statements of income and cash flow meet the requirements of § 989.4 of the Finance Board rules in form and content. As did the proposed rule, the final disclosure regulation still requires the Banks to provide members with audited balance sheets as of the end of the two most recent fiscal years, audited statements of income and cash flows for each of the three fiscal years preceding the date of the most recent audited balance sheet being presented, and

unaudited interim financial statements as of and for appropriate interim dates.

The disclosure rule, as adopted, also allows the Banks to incorporate by reference any of the financial information required to be disclosed under § 933.5(c)(1), if that information was contained in an annual or quarterly Bank report, so long as that report conformed with the requirements of § 989.4 of the Finance Board rules, or an annual or quarterly Bank System report. See § 933.5(c)(1)(iii). To incorporate this information by reference, the final rule, as proposed, requires a Bank only to identify the incorporated information in the disclosure to members, and no other steps need be taken by a Bank. The final rule, as adopted, however, did not carry over from the proposed rule the right to incorporate by reference information that would have been filed with the Finance Board along with the Bank's capital plan. This provision had been proposed mainly to facilitate the incorporation by reference of the pro forma financial information that the proposed rule would have required Banks to provide to members. Because the pro forma financial information no longer must be disclosed to members and because filing information with the Finance Board would not necessarily mean the information is readily available to Bank members, the Finance Board has deleted this provision from the final rule.

The Banks in their joint comment letter also expressed concern with the wording of proposed § 933.5(b)(4), which would have required the Banks to provide members with a brief statement as to the anticipated accounting treatment and the federal income tax consequences of the conversion transaction. The Banks felt that the use of the phrase "federal income tax consequences" raised the issue of whether the Finance Board intended the Banks to provide tax advice to their members. The Banks suggested that the rule be rewritten to require the Banks to provide a statement of the federal income tax considerations that may be relevant to members as a result of the transaction. The Finance Board notes that it is common practice in disclosure documents to provide information on the potential tax implications of a transaction and such disclosure does not generally raise concerns that the disclosing party is acting as a tax advisor. The Finance Board, however, also did not intend to imply that the Banks were to act, or would in any way be acting, as tax advisors to the members with regard to the conversion transaction. Thus, in adopting the final disclosure rule, the wording of this

requirement, now set forth at § 933.5(c)(6), has been changed to state that a Bank shall provide its members with a statement as to the anticipated accounting treatment for the conversion transaction and the federal income tax implications of the transaction that members should consider in consultation with their own accounting and tax advisors.

A number of disclosure requirements have also been adopted as proposed, although the requirements appear in a different section of the final rule. Thus, a Bank is required to provide members, if applicable, with a description of any amendments that it anticipates making to its by-laws or other governance documents as a result of the implementation of its capital plan. See § 933.5(c)(3). The Bank must also state in its disclosure document a name, address and telephone number for members to direct a written or oral request to obtain, free of charge, a copy of the capital plan and any other instrument or document that defines the member's rights. See § 933.5(c)(5). The final disclosure rule also makes clear (in § 933.5(d)) that nothing in § 933.5 shall create or shall be deemed to create any rights in any third party. As the Finance Board explained when proposing this provision, the disclosure rule is meant to add consistency, clarity, and precision to the disclosure process, and it is not the Finance Board's intention to impose liability under the federal securities laws on the Banks, or to create any private right of action in any third party. See 66 FR at 41468.

The Finance Board also notes that it is not prescribing a form to be used by Banks in providing the disclosure, which provides a great deal of flexibility to the Banks in this respect. However, the Finance Board expects that no matter what form is chosen, the disclosure documents will provide the required information to members in clear narratives and will not merely incorporate language taken directly from a capital plan or the Finance Board rules. The disclosure should also be referenced to the specific rights or obligations set forth in the Bank's capital plan. For example, a Bank that requires that only Class A stock be held as a condition of membership would be expected to discuss its withdrawal provisions in terms of the six month applicable notice period related to that class of stock while Banks that require Class B stock be held as a condition of membership would discuss withdrawal as requiring a five-year notice period.

### III. Other Provisions Adopted in the Final Rule

The Finance Board did not receive any comments or received only favorable comments on a number of the rule changes that it proposed in August 2001. As discussed below, these provisions are being adopted in substance, as proposed.

*Charges against capital.* In comments to the ANPR, seven Banks stated that the phrase "charges against the capital of the Bank" as used in § 931.8 of the Finance Board rules was ambiguous. The main concern was that the phrase could be read to require the Banks to seek written permission of the Finance Board to redeem or repurchase stock anytime a Bank expected to incur, or actually had incurred, even a small loss. See 66 FR at 41465–66. As the Finance Board pointed out, the phrase itself was used in the Bank Act. See 12 U.S.C. 1426(f). After applying rules of statutory construction and considering the goals of and other relevant provisions in the Bank Act, the Finance Board concluded that the phrase was not meant to trigger the requirements of § 931.8 whenever a Bank projected or experienced loss. See 66 FR at 41465–66. The Finance Board therefore proposed to define in § 930.1 the phrase "charges against the capital of the Bank" as meaning an other than temporary decline in the Bank's total equity that causes the value of total equity to fall below the Bank's aggregate capital stock amount. This definition would effectively trigger the requirements of § 931.8 (which given other changes adopted as part of this final rulemaking are now found at § 931.8(a)) only when a Bank experiences a charge against its capital stock.

The Finance Board received one comment on this matter in response to the proposed rule, and that comment supported adoption of the definition as proposed. Therefore, for the reasons set forth in the **SUPPLEMENTARY INFORMATION** section of the preamble of the proposing release for this rule, the Finance Board is adopting in § 930.1 the definition of "charges against the capital of the Bank," as proposed.

*Dividends on Class A stock.* In the proposed rule, the Finance Board proposed to amend § 931.4 to state expressly that a Bank may pay dividends on both Class A and Class B stock from either of the sources specified in 12 U.S.C. 1436(a), *i.e.*, retained earnings and current net earnings. See 66 FR at 41464, 41473. This change was proposed to address concern that because section 6(h) of the Bank Act, 12 U.S.C. 1426(h), granted

Class B stockholders an ownership interest in their Bank's retained earnings, the Bank's authority to pay dividends on Class A stock from retained earnings could be called into question.

In the proposed rule, the Finance Board concluded that, given the intent of Congress to allow an individual Bank, subject to Finance Board regulation, to determine the dividend rights for any class of stock that it issues, it appeared unlikely that the Congress also intended to preclude a Bank from paying any dividends on the Class A stock. The Finance Board further indicated that if the Congress had intended that result, it was more likely that the Congress would have done so expressly, rather than indirectly by enacting a new provision that was somewhat at odds with a long-standing provision of the Bank Act regarding the available sources of dividends for Bank stock. Moreover, the Finance Board continued, construing these provisions of the Bank Act in a manner that would effectively have precluded the payment of dividends on the Class A stock could have made it difficult, if not impossible, for a Bank to sell Class A stock to its members. That would have been an absurd result, in light of the clear intent of the Congress to create a new capital structure for the Banks and ultimately, the Finance Board determined that it should construe these provisions to allow the payment of dividends on Class A stock from retained earnings, as those amounts may be calculated under GAAP. See 66 FR at 41464.

The Finance Board received no comments objecting to the proposed change to § 931.4, and adopts it as proposed for the reasons set forth in the preamble of the proposing release.

*Transfer of capital stock.* In the proposed rule, the Finance Board proposed amending § 931.6 to allow a Bank the option of generally prohibiting its members from transferring Bank stock. If a Bank chose to allow transfers, the transfers clearly would have been subject to the Bank's approval. See 66 FR at 41465, 41473. A conforming change regarding transfer of stock was also proposed to §§ 933.2(e)(3) and (4). *Id.* at 41465, 41474.

This proposal arose out of a comment received in response to the ANPR. Upon consideration of this comment, the Finance Board stated that it would have been consistent with the discretion afforded a Bank in the GLB Act "to establish standards, criteria, and requirements for the \* \* \* transfer \* \* \* of stock issued by that bank," *id.* at 12 U.S.C. 1426(c)(5)(B), to allow a Bank, as part of its capital plan, either

to prohibit any transfers of its stock among its members or to permit these transfers subject to the conditions currently set forth in § 931.6.

Under the proposed change, each Bank would have been required to state in its capital plan whether a member may transfer capital stock of the Bank, and, if such transfers were allowed, to specify the procedures that a member must follow to effect the transfer, and to specify that any transfer may only have been undertaken in the limited circumstances set forth in § 931.6. The proposed amendment also expressly provided that a Bank, in its capital plan, may have required a member to obtain the Bank's approval to effect the transfer of stock.

The Finance Board received no comment opposing the amendment to § 931.6, and is adopting it as proposed. The Finance Board also adopted in substance the conforming changes proposed to §§ 933.2(e)(3) and (4), although, because of other amendments adopted in this final rule, these amended paragraphs have been redesignated and adopted as §§ 933.2(f)(3) and (f)(4).

*Off-balance sheet credit conversion factors.* In the proposed rule, the Finance Board proposed amending Table 2 of § 932.4(f) so that the 100 percent credit conversion factor for off-balance sheet items would have applied only to commitments to make advances with certain drawdowns and commitments to acquire loans subject to certain drawdown. Further, the Finance Board proposed to define certain drawdown in § 930.1 to mean a legally binding agreement that committed the Bank to make an advance or to acquire a loan, at or by a specified date in the future. See 66 FR at 41466–67.

These changes were proposed in response to concerns that the 100 percent credit conversion factor for commitments to make advances and to acquire loans as adopted in Table 2 in December 2000 were broader than the requirements of other federal bank regulators. For instance, Table 2 as adopted appeared to require a 100 percent conversion factor for “master commitments” to acquire loans under Acquired Member Asset (AMA) programs even though such commitments were not an accurate indicator of future acquisition. It was pointed out that other federal bank regulators would have applied a 100 percent conversion factor only to commitments subject to certain drawdown, (i.e., commitments that an institution is legally obligated to honor at a specified future date no matter what change may have occurred in the

counterparty's financial situation.) Because it was generally the intent of the Finance Board to conform to the extent possible its credit risk charges to the Basle Accord as currently incorporated by the federal bank regulatory agencies, the Finance Board proposed to revise the credit conversion factors of Table 2 so that the 100 percent credit conversion factor applies only to commitments subject to certain drawdown and to provide a definition of certain drawdown to assure this result.

The Finance Board received one comment from a Bank supporting the proposed changes to §§ 930.1 and 932.4(f) and, therefore, adopts them as proposed.

*Conforming changes.* No comments were received on the conforming changes as described in the **SUPPLEMENTARY INFORMATION** section of the proposed rule. See 66 FR at 41468. These conforming changes are being adopted by the Finance Board as proposed.

#### IV. Regulatory Flexibility Act

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

#### V. Paperwork Reduction Act

The final rule does not contain any collections of information pursuant to the Paperwork Reduction Act of 1995. See 44 U.S.C. 3501 *et seq.* Therefore, the Finance Board has not submitted any information to the Office of Management and Budget for review.

#### Lists of Subjects

##### 12 CFR Part 925

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

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

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

Accordingly, the Federal Housing Finance Board amends title 12, chapter IX of the Code of Federal Regulations as follows:

#### PART 925—MEMBERS OF THE BANKS

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

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

2. Amend § 925.26 by revising paragraph (b) to read as follows:

##### § 925.26 Voluntary withdrawal from membership.

\* \* \* \* \*

(b) *Effective date of withdrawal.* The membership of an institution that has submitted a notice of withdrawal shall terminate as of the date on which the last of the applicable stock redemption periods ends for the stock that the member is required to hold, as of the date that the notice of withdrawal is submitted, under the terms of a Bank's capital plan as a condition of membership, unless the institution has cancelled its notice of withdrawal prior to the effective date of the termination of its membership.

\* \* \* \* \*

3. Amend § 925.27 by revising paragraph (c) to read as follows:

##### § 925.27 Involuntary termination of membership.

\* \* \* \* \*

(c) *Membership rights.* An institution whose membership is terminated involuntarily under this section shall cease being a member as of the date on which the board of directors of the Bank acts to terminate the membership, and the institution shall have no right to obtain any of the benefits of membership after that date, but shall be entitled to receive any dividends declared on its stock until the stock is redeemed or repurchased by the Bank.

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

4. The authority citation for part 930 continues to read as follows:

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

5. In § 930.1 add, in correct alphabetical order the definitions for *Certain drawdown* and *Charges against the capital of the Bank*, to read as follows:

##### § 930.1 Definitions.

\* \* \* \* \*

*Certain drawdown* means a legally binding agreement that commits the Bank to make an advance or acquire a loan, at or by a specified future date.

*Charges against the capital of the Bank* means an other than temporary decline in the Bank's total equity that causes the value of total equity to fall below the Bank's aggregate capital stock amount.

\* \* \* \* \*

## PART 931—FEDERAL HOME LOAN BANK CAPITAL STOCK

6. The authority citation for part 931 continues to read as follows:

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

7. Amend § 931.4 by revising the first sentence of paragraph (a) to read as follows:

### § 931.4 Dividends.

(a) \* \* \* A Bank may pay dividends on Class A or Class B stock, including any subclasses of such stock, only out of previously retained earnings or current net earnings, and shall declare and pay dividends only as provided by its capital plan. \* \* \*

8. Amend § 931.6 by revising the first sentence of the section and adding a new sentence at the end of the section to read as follows:

### § 931.6 Transfer of capital stock.

A Bank in its capital plan may allow a member to transfer any excess capital stock of the Bank to another member of that Bank or to an institution that has been approved for membership in that Bank and that has satisfied all conditions for becoming a member, other than the purchase of the minimum amount of Bank stock that it is required to hold as a condition of membership. \* \* \* The Bank may, in its capital plan, require a member to receive the approval of the Bank before a transfer of the Bank's stock, as allowed under this section, is completed.

9. Amend § 931.7 by adding, before the last sentence of paragraph (a), two new sentences to read as follows:

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

(a) \* \* \* A request by a member (whose membership has not been terminated) to redeem specific shares of stock shall automatically be cancelled if the Bank is prevented from redeeming the member's stock by paragraph (c) of this section within five business days from the end of the expiration of the applicable redemption notice period because the member would fail to maintain its minimum investment in the stock of the Bank after such redemption. The automatic cancellation of a member's redemption request shall have the same effect as if the member had cancelled its notice to redeem stock prior to the end of the redemption notice period, and a Bank may impose a fee (to be specified in its capital plan) for automatic cancellation of a redemption request. \* \* \*

\* \* \* \* \*

10. Amend § 931.8 by revising the heading of the section, redesignating the current text as paragraph (a), adding a new heading to paragraph (a), and adding new paragraph (b) to read as follows:

### § 931.8 Other restrictions on the repurchase or redemption of Bank stock.

(a) *Capital impairment.* \* \* \*  
(b) *Bank discretion to suspend redemption.* A Bank, upon the approval of its board of directors, or of a subcommittee thereof, may suspend redemption of stock if the Bank reasonably believes that continued redemption of stock would cause the Bank to fail to meet its minimum capital requirements as set forth in §§ 932.2 or 932.3 of this chapter, would prevent the Bank from maintaining adequate capital against a potential risk that may not be adequately reflected in its minimum capital requirements, or would otherwise prevent the Bank from operating in a safe and sound manner. A Bank shall notify the Finance Board in writing within two business days of the date of the decision to suspend the redemption of stock, informing the Finance Board of the reasons for the suspension and of the Bank's strategies and time frames for addressing the conditions that led to the suspension. The Finance Board may require the Bank to re-institute the redemption of member stock. A Bank shall not repurchase any stock without the written permission of the Finance Board during any period in which the Bank has suspended redemption of stock under this paragraph.

## PART 932—FEDERAL HOME LOAN BANK CAPITAL REQUIREMENTS

11. The authority citation for part 932 continues to read as follows:

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

12. Amend § 932.4 by revising paragraph (d) heading, revising the first sentence in paragraph (e)(2)(ii)(E) and revising Table 2, which follows paragraph (f)(1), to read as follows:

### § 932.4 Credit risk capital requirement.

\* \* \* \* \*

(d) *Credit risk capital charge for derivative contracts.* \* \* \*

(e) \* \* \*

(2) \* \* \*

(ii) \* \* \*

(E) The credit risk percentage requirement for mortgage assets that are acquired member assets described in § 955.2 of this chapter shall be assigned from Table 1.2 of this part based on the rating of those assets after taking into

account any credit enhancement required by § 955.3 of this chapter.

\* \* \*

\* \* \* \* \*

(f) \* \* \*

(1) \* \* \*

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

Instrument	Credit conversion factor (In percent)
Asset sales with recourse where the credit risk remains with the Bank .....	100
Commitments to make advances subject to certain drawdown.	
Commitments to acquire loans subject to certain drawdown.	
Standby letters of credit .....	50
Other commitments with original maturity of over one year.	
Other commitments with original maturity of one year or less .....	20

\* \* \* \* \*

## PART 933—BANK CAPITAL STRUCTURE PLANS

13. The authority citation for part 933 continues to read:

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

14. Amend § 933.2 by redesignating paragraphs (e), (f) and (g) as paragraphs (f), (g), and (h), respectively, adding new paragraph (e), redesignating newly designated paragraphs (f)(4), (f)(5) and (f)(6) as paragraphs (f)(5), (f)(6) and (f)(7), respectively, revising newly designated paragraph (f)(3), and adding new paragraph (f)(4) to read as follows:

### § 933.2 Contents of plan.

\* \* \* \* \*

(e) *Members wishing not to convert existing stock.* The capital plan shall establish an opt-out date on or before which a member that does not wish to convert its existing stock into Class A and/or Class B stock must file a written notice to withdraw from membership with the Finance Board. This opt-out date shall not be more than six months before the effective date of the capital plan. (For purposes of applying this provision, the membership of an institution that files its notice to withdraw with the Finance Board on or before the opt-out date established in a capital plan shall terminate six months from the date that the notice of withdrawal was filed with the Finance

Board or on the effective date of the Bank's capital plan, whichever date is earlier.) The capital plan shall further provide that any member that is in the process of withdrawing on the effective date of the capital plan but did not file its written notice to withdraw from membership with the Finance Board on or before this opt-out date, shall have its existing stock converted into Class A and/or Class B stock as required by the capital plan, and that the effective date of withdrawal for such member shall be established in accordance with §§ 925.26(b) and (c) of this chapter, provided, however, that the applicable stock redemption periods calculated under § 925.26(c) of this chapter shall commence on date the member first submitted its written notice to withdraw to the Finance Board.

(f) \* \* \*

(3) Shall specify whether the stock of the Bank may be transferred among members, and, if such transfer is allowed, shall specify the procedures that a member should follow to effect such transfer, and that the transfer shall be undertaken only in accordance with § 931.6 of this chapter;

(4) Shall specify that the stock of the Bank may be traded only between the Bank and its members;

\* \* \* \* \*

15. Add new § 933.5 to read as follows:

**§ 933.5 Disclosure to members concerning capital plan and capital stock conversion.**

(a) No capital plan shall become effective until disclosure required by paragraphs (b) and (c) of this section has been provided to members. All disclosure required under this section shall be transmitted, sent or given to members not less than 45 days and not more than 60 days prior to the opt-out date established in the Bank's capital plan in accordance with § 933.2(e).

(b) The following information shall be provided to members about the Class A and/or Class B stock that a Bank intends to issue on the effective date of its capital plan:

(1) With regard to each class or subclass of authorized stock, a description of:

- (i) Dividend rights;
- (ii) The terms of conversion;
- (iii) Redemption and repurchase rights;
- (iv) Voting rights and preferences,
- (v) Liquidation rights; and
- (vi) Any liability to further calls or to assessments by the Banks;

(2) A description of any material differences between the securities to be converted into Class A and/or Class B stock and the Class A and/or Class B

stock with regard to the rights addressed in paragraph (b)(1) of this section.

(3) A statement of the reasons for the conversion to Class A and/or Class B stock and of the general effect thereof upon the rights of existing members; and

(4) A description of any other material features concerning the Bank's initial issuance of Class A and/or Class B stock.

(c) In addition to the disclosure about Class A and/or Class B stock, the following information shall be provided to members:

(1) The Bank shall disclose financial information as follows:

(i) Audited balance sheets as of the end of the two most recent fiscal years, audited statements of income and cash flows for each of the three fiscal years preceding the date of the most recent audited balance sheet being presented, and unaudited interim balance sheets and statements of income and cash flows as of and for appropriate interim dates that in form and content meet the requirements of § 989.4 of this chapter;

(ii) A pro forma capitalization table that reflects the Bank's projected new capital structure relative to its actual capitalization as of the date of the latest balance sheet required to be provided to members by paragraph (c)(1)(i) of this section. The Bank shall also provide a description of any material assumptions underlying the pro forma capitalization table and the basis for these assumptions, and shall provide estimates of its risk-based capital requirement, calculated in accordance with § 932.3 of this chapter, and of its total capital-to-asset ratio (both of which shall be based on the same financial data used for the capitalization table), along with a discussion of material assumptions underlying these estimates and the basis for these assumptions; and

(iii) Any of the financial information required to be disclosed by paragraph (c)(1) of this section may be incorporated by reference, provided the information being incorporated is contained in an annual or quarterly Bank report prepared in accordance with § 989.4 of this chapter or an annual or quarterly Bank System report, and the disclosure identifies the information being incorporated by reference;

(2) A narrative discussion of anticipated developments that could materially affect the liquidity, capital, earnings or continuing operations of the Bank, including those affecting dividends, product volumes, investment volumes, new business lines and risk profile.

(3) A description of any amendments anticipated to be made to the Bank's by-

laws, policies or other governance documents as a result of the implementation of the capital plan;

(4) To the extent that such information has not been provided under paragraph (b) of this section, the Bank shall disclose information related to the capital plan as follows:

(i) A description of the minimum stock investment requirements set forth in the capital plan;

(ii) A statement outlining the requirements for amending the capital plan;

(iii) A description of any restrictions or limitations under a Bank's capital plan on a member's rights to buy, or redeem its class A or class B stock, to have such stock repurchased, or otherwise to make use of such stock to fulfill the member's minimum stock investment requirement;

(iv) A statement setting forth the opt-out date, on or before which a member's written notice to withdraw must be filed with the Finance Board (as established in accordance with § 933.2(e) of this part) for the member not to have its existing Bank stock converted to Class A or Class B stock on the effective date of the Bank's capital plan and describing the effect on a member's effective date of withdrawal of failing to file its notice to withdraw on or before the opt-out date; and

(v) A description of a member's rights under the capital plan to have its stock redeemed or repurchased upon voluntary or involuntary termination of its membership;

(5) The Bank should state the name, address and telephone number where members may direct written or oral requests for a copy of the capital plan and any other instrument or document that defines the rights of the member/stockholders. This information shall be provided to the members without charge; and

(6) The Bank shall provide a statement as to the anticipated accounting treatment for the transaction and the federal income tax implications of the transaction that members should consider in consultation with their own accounting and tax advisors.

(d) Nothing in this section shall create or be deemed to create any rights in any third party.

Dated: October 19, 2001.

By the Board of Directors of the Federal Housing Finance Board.

**J. Timothy O'Neill,**  
Chairman.

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