No. 14-5243 (Consolidated with 14-5254, 14-5260, 14-5262)

IN THE UNITED STATES COURT OF APPEALS FOR
THE DISTRICT OF COLUMBIA CIRCUIT

PERRY CAPITAL, LLC, *et al.*,
Plaintiffs-Appellants,

v.

JACOB J. LEW, in his official capacity as the Secretary of the Department of the Treasury, *et al.*,
Defendants-Appellees.

On Appeal from the United States District Court for the District of Columbia

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CORRECTED SUPPLEMENTAL BRIEF OF APPELLEES FEDERAL HOUSING FINANCE AGENCY AND MELVIN L. WATT, FANNIE MAE, AND FREDDIE MAC IN RESPONSE TO THE COURT'S JUNE 21, 2016 ORDER

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

Pursuant to D.C. Circuit Rule 28(a)(1), the undersigned counsel declare:

A. Parties and Amici

The plaintiffs below and appellants in these consolidated cases are Perry Capital, LLC, for and on behalf of investment funds for which it acts as investment manager (14-5243); Fairholme Funds, Inc., on behalf of its series, the Fairholme Fund (14-5254); Fairholme Fund, a series of Fairholme Funds, Inc. (14-5254); Berkley Insurance Company (14-5254); Acadia Insurance Company (14-5254); Admiral Indemnity Company (14-5254); Admiral Insurance Company (14-5254); Berkley Regional Insurance Company (14-5254); Carolina Casualty Insurance Company (14-5254); Midwest Employers Casualty Insurance Company (14-5254); Nautilus Insurance Company (14-5254); Preferred Employers Insurance Company (14-5254); Arrowood Indemnity Company (14-5260); Arrowood Surplus Lines Insurance Company (14-5260); Financial Structures Limited (14-5260); Melvin Bareiss (14-5262); Joseph Cacciapelle (14-5262); John Cane (14-5262); Francis J. Dennis, derivatively on behalf of the Federal National Mortgage Association (14-5262); Michelle M. Miller (14-5262); Marneu Holdings Co., derivatively on behalf of the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (14-5262); United Equities Commodities, Co. (14-5262); 111 John

Realty Corp., derivatively on behalf of the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (14-5262).

Listed as Plaintiffs-Appellees on the Court's docket for No. 14-5262 are Mary Meiya Liao; American European Insurance Company; Barry P. Borodkin; and Barry P Borodkin Sep Ira.

Defendants below and appellees here are the United States Department of the Treasury (14-5243, 14-5254, 14-5260, 14-5262); Federal Housing Finance Agency (14-5243, 14-5254, 14-5260, 14-5262); Jacob J. Lew, in his official capacity as the Secretary of the Department of the Treasury (14-5243, 14-5260, 14-5262); Melvin L. Watt, in his official capacity as Director of the Federal Housing Finance Agency (14-5243, 14-5254, 14-5260); Federal National Mortgage Association (14-5260, 14-5262); and Federal Home Loan Mortgage Corporation (14-5260, 14-5262).

There were no amici or intervenors in the district court. Amici in this Court are National Black Chamber of Commerce; Timothy Howard; Independent Community Bankers of America; Association of Mortgage Investors; William M. Isaac; Robert H. Hartheimer; 60 Plus Association, Inc.; Center for Individual Freedom; Investors Unite; Louise Rafter; Josephine Rattien; Stephen Pattien; Pershing Square Capital Management, LP; Better Markets, Inc., and Jonathan R Macey.

B. Rulings Under Review

Appellants seek review of (1) the Memorandum Opinion and Order entered on September 30, 2014, by the Honorable District Court Judge Royce Lamberth granting defendants' motion to dismiss, and (2) the Order Denying Plaintiff-Appellants' Motion for Supplementation of the Administrative Record, Limited Discovery, Suspension of Briefing on the Defendants' Dispositive Motions, and a Status Conference, also entered on September 30, 2014. The district court's memorandum opinion and order is available on Westlaw. *See Perry Capital LLC v. Lew*, 70 F. Supp. 3d 208 (D.D.C. Sep. 30, 2014); J.A.316.

C. Related Cases

This case was not previously before this Court or any court other than the district court. Counsel is aware of no related cases within the meaning of D.C. Cir. R. 28(a)(1)(C).

There are multiple cases involving similar issues and parties pending in the Court of Federal Claims: *Washington Federal v. United States*, No. 13-385C; *Fairholme Funds, Inc. v. United States*, No. 13-465C; *Cacciapalle v. United States*, No. 13-466C; *American European Insurance Co. v. United States*, No. 13-496C; *Arrowood Indemnity Co. v. United States*, No. 13-698C; *Dennis v. United States*, No. 13-542C; *Fisher v. United States*, No. 13-608C; *Shipmon v. United States*, No. 13-672C; *Reid v. United States*, No. 14-152C; and *Rafter v. United*

States, No. 14-740C. *Cacciapalle, American European Insurance, and Dennis* have been consolidated, and *Cacciapalle* has been designated as a putative class action.

In addition, cases raising similar issues are currently pending in the United States District Courts. *Saxton v. FHFA*, No. 15-cv-47 (N.D. Iowa); *Jacobs v. FHFA*, No. 15-cv-708 (D. Del.); *Robinson v. FHFA*, No. 7:15-cv109 (E.D. Ky.); *Roberts v. FHFA*, No. 1:16-cv-2107 (N.D. Ill.); *Pagliara v. Federal National Mortgage Association*, No. 1:16-cv-00193 (D. Del.); *Pagliara v. Federal Home Loan Mortgage Corp.*, No. 1:16-cv-00337 (E.D. Va.); and *Voacolo v. Federal National Mortgage Association, et al.*, No. 1:16-cv-1324 (D.D.C.).

s/ Howard N. Cayne
Howard N. Cayne

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INTRODUCTION

The Federal Housing Finance Agency and Melvin L. Watt (together, "FHFA"), Fannie Mae, and Freddie Mac respectfully respond to Question 2 in the Court's June 21, 2016 Order regarding the Class Plaintiffs' claims against FHFA and the Enterprises. We do not address Question 1 of the Court's Order because it relates only to claims against Treasury.

Question 2 asks (i) whether FHFA, Fannie Mae, and Freddie Mac are subject to suit absent a waiver of sovereign immunity for Class Plaintiffs' common law claims, and (ii) for the source of subject-matter jurisdiction for those claims. Further, the Court asks "whether the FHFA's challenged actions were taken solely in the agency's capacity as conservator for Fannie Mae and Freddie Mac, or whether they were taken in whole or in part in a regulatory capacity."

FHFA and the Enterprises have not asserted sovereign immunity, but there is no viable source of subject-matter jurisdiction over the claims in any event, as HERA expressly bars it. This is so because, although Class Plaintiffs purport to challenge only actions taken by FHFA as Conservator, the relief they seek, and the judicial findings on which such relief would necessarily be based, would unlawfully "affect . . . the issuance or effectiveness" of actions taken by FHFA wholly in its "regulatory capacity." 12 U.S.C. § 4623(d); *see* n.4, *infra*. The withdrawal of jurisdiction effected by Section 4623(d) applies without regard to

whether suit is brought against the Enterprises, the Conservator, the Regulator, or any combination thereof—no matter which one or more of these entities Plaintiffs opt to name as defendants, the Court has no jurisdiction to affect the effectiveness of the FHFA regulatory actions at issue here. 12 U.S.C. § 4623(d).

It is clear that a judgment for Class Plaintiffs would in fact affect the effectiveness of a covered regulatory action. Class Plaintiffs' claims and requested relief would undermine FHFA's *regulatory* action in October 2008 creating a new capital regime (the "October 2008 Regulatory Action"). FHFA as regulator suspended the pre-Conservatorship capital classification system that previously sought to ensure the safety and soundness of the Enterprises by mandating the accumulation and maintenance of balance sheet capital. FHFA as regulator created a new capital paradigm that relies on the PSPAs and Treasury's financial commitment thereunder as capital-equivalents. This new capital regime gives the Conservator the flexibility to operate the Enterprises without the constraints of balance sheet capital requirements or standards. FHFA News Release: FHFA Announces Suspension of Capital Classifications During Conservatorship, http://goo.gl/MzpAUH (attached as Exhibit A).

Class Plaintiffs' claim that that the Conservator's agreement to the Third Amendment has caused the Enterprises to be operated in an unsafe and unsound manner thereby entitling them to compensatory damages would impermissibly

diminish the effectiveness of the new capital paradigm pursuant to which the Director intended to afford the Conservator with the broadest possible operational flexibility to conduct the ongoing operations. HERA withdraws jurisdiction from the Court to hold that the October 2008 Regulatory Action creating the new capital regime is unsafe and unsound, or to hold the Conservator liable for operating consistent with the new regulatory scheme via the Third Amendment.

I. FHFA and the Enterprises Have Not Asserted Sovereign Immunity

The Order first asks whether FHFA, Fannie Mae, and Freddie Mac are subject to suit here absent a waiver of sovereign immunity.[1] Sovereign immunity is not applicable to the Enterprises, which are government-sponsored but private entities subject to their own "sue and be sued" clauses. *See FDIC v. Meyer*, 510 U.S. 471, 483 (1994) (holding that a sue-and-be-sued clause waives sovereign immunity unless there is a "clear" showing that Congress intended otherwise); 12 U.S.C. § 1723a(a) (Fannie Mae has the power "to sue and to be sued, and to complain and to defend, in any court of competent jurisdiction"); *id.* § 1452(c) (Freddie Mac has the power "to sue and be sued, complain and defend, in any

[1] Class Plaintiffs assert breach of contract and breach of the implied covenant of good faith and fair dealing (against FHFA, Fannie Mae, and Freddie Mac), and breach of fiduciary duty (against FHFA). Class Plaintiffs had also asserted, but have not appealed dismissal of, a claim for just compensation (against FHFA). Fairholme and Arrowood have also asserted common law claims, and they fail for the same reasons as those brought by the Class Plaintiffs.

State, Federal, or other court").

FHFA, in its capacity as Conservator, has not asserted sovereign immunity with respect to the Conservator's execution of the Third Amendment.[2] FHFA as Regulator enjoys sovereign immunity, except to the extent explicitly waived by statute, such as the Federal Tort Claims Act, the APA and the Tucker Act.

In any event, issues of immunity need not be reached because, as explained below, HERA plainly bars the exercise of jurisdiction over all of the claims presented.

II. HERA Divests the Court of Subject-Matter Jurisdiction Because the Relief Sought by Class Plaintiffs Would Affect the Effectiveness of FHFA's Regulatory Actions in Direct Violation of Section 4623(d)

We do not disagree with Class Plaintiffs' hypothetical observation that, in the absence of HERA's jurisdiction-withdrawal provisions, the charters of Fannie Mae and Freddie Mac would provide subject-matter jurisdiction over this action. Suppl. Br. for Class Pls. at 16-18, 19-20. However, Class Plaintiffs' hypothetical

[2] In addressing the question whether FHFA as Conservator is a government actor for purposes of constitutional claims, the District Court for the District of Columbia has held that "FHFA as conservator of Fannie Mae is not a government actor." *Herron v. Fannie Mae*, 857 F. Supp. 2d 87, 96 (D.D.C. 2012) (appeal pending, Nos. 16-5070, 16-5091 (D.C. Cir.)). Other courts have reached the same conclusion in the context of the Federal Deposit Insurance Corporation (FDIC) acting as conservator or receiver of banks. *See O'Melveny & Myers v. Fed. Deposit Ins. Corp.*, 512 U.S. 79, 85 (1994) (FDIC acting as receiver "is not the United States"); *Ameristar Fin. Servicing Co. LLC v. United States*, 75 Fed. Cl. 807, 812 (2007) (dismissing claim because the FDIC as conservator "was not acting as the United States").

observation is just that—hypothetical—because HERA does in fact divest this Court of jurisdiction over all of Plaintiffs' claims.[3]

Section 4623(d) withdraws jurisdiction over claims where exercise of jurisdiction over such claims, whether by "injunction or otherwise" would "affect" the "effectiveness of any . . . action of the Director." 12 U.S.C. § 4623(d).[4] We have been unable to locate any other Act of Congress that provides any other federal financial institution regulatory agency with a similarly all-encompassing bar on judicial actions that impair the "effectiveness" of covered regulatory action. The explicit terms of this jurisdiction-withdrawal statute deprive the court of jurisdiction to take any action, whether by injunction or otherwise, that would limit or constrain the effectiveness of a covered regulatory action.

The October 2008 Regulatory Action was taken one month into the conservatorships, when FHFA's then-Director James B. Lockhart III announced that he had "determined that it is prudent and in the best interests of the market to

[3] In addition, for reasons stated in prior briefing and at oral argument, Section 4617(f) bars Plaintiffs' injunctive and declaratory claims challenging Conservator-actions, including execution of the Third Amendment. Further, Section 4617(b)(2)(A)(i) bars *all* of Plaintiffs' claims because of the Conservator's succession to "all rights" of the Enterprises' stockholders.

[4] Section 4623(d) provides that "no court shall have jurisdiction to affect, by injunction or otherwise, the issuance or effectiveness of any classification or action of the Director under this subchapter [II]." The subchapter in which Section 4623(d) appears addresses "Required Capital Levels for Regulated Entities," "FHFA's Special Enforcement Powers," and various "Supervisory Powers" the Director may take with regard to the capital of the Enterprises. *See* 12 U.S.C. §§ 4611-4624. The subchapter also includes, among other things, Section 4617, which outlines the powers and functions of the Conservator. *See id.* § 4617(a)(2), (b).

suspend capital classifications of Fannie Mae and Freddie Mac during the conservatorship, in light of the United States Treasury's Senior Preferred Stock Purchase Agreement." FHFA News Release: *FHFA Announces Suspension of Capital Classifications During Conservatorship*. The Director noted that Treasury "provided two facilities to support the Enterprises [in conservatorship]. The GSE Credit Facility . . . [and] [t]he Senior Preferred Stock Purchase Agreement." *Id.*

The October 2008 Regulatory Action established a new capital regime for the Enterprises, one where balance sheet capital no longer served as the controlling measure of safety and soundness. The FHFA Examination Manual—which governs supervision of the Enterprises and implementation of FHFA regulatory policy through the examination process—implements the October 2008 Regulatory Action by directing the FHFA's Examination and Supervisory staff to treat the Enterprises as having been "capitalized via the [PSPAs]." FHFA Examination Manual at "Capital," p. 1, http://goo.gl/BXpdSU (attached as Exhibit B); *see also id.* at p. 16 (stating that supervisory examinations should be conducted with the understanding that "[a]ny capital needs [of the Enterprises] . . . are fulfilled by Treasury under the [PSPAs].")

The essential thrust of Class Plaintiffs' complaint and briefing directly implicates FHFA's regulatory action suspending capital classifications for the Enterprises in conservatorship and permitting them to be "capitalized" by the

Treasury commitment. For example, the Class Plaintiffs attack FHFA's "announce[ment] that, during the conservatorship, existing statutory and FHFA-directed regulatory capital requirements will not be binding on the Companies." Class Compl. ¶ 97. Plaintiffs also allege that the Third Amendment has undermined the safety and soundness of the Enterprises: "because of the Third Amendment, Fannie Mae is now in a worse position with respect to its core capital than it was before the record profitability achieved in the first quarter of this year." *Id*. Class Plaintiffs contend that paying dividends to Treasury in cash and "[b]orrowing money to pay a dividend on paper profits is directly contrary to operating the Companies in a safe and sound manner and restoring them to financial health [by accumulating capital]." *Id*. at ¶ 98; *see also id*. at ¶ 99 ("the Companies can never accumulate capital").

These allegations confirm that the challenged Third Amendment actions are intimately intertwined with the Director's regulatory decision to suspend the existing classification system and to adopt the capital regime that has governed Enterprise operations since October 2008. A ruling by the Court in Class Plaintiffs' favor would affect the effectiveness of the *regulatory* action taken by FHFA to (1) suspend the existing capital classification system and regulatory capital requirements, and (2) regulate and supervise the Enterprises in conservatorship as having been "capitalized via the Senior Preferred Stock

Purchase Agreements (SPSPAs) with the United States Treasury (Treasury)." FHFA Examination Manual at "Capital," p. 1 (directing examiners and field supervisors to regulate and supervise the Enterprises in conservatorship as having been "capitalized via the Senior Preferred Stock Purchase Agreements (SPSPAs) with the United States Treasury (Treasury)").

More generally, judicial action adopting Class Plaintiffs' claims of wrongful conduct and granting compensatory relief would effectively nullify the purpose and intended effect of the October 2008 Regulatory Action, to vest the Conservator with maximum flexibility to operate the Enterprises free of the restraints of the capital classification system and "in the best interests of the [Enterprises] or the Agency," 12 U.S.C. § 4617(b)(2)(J).[5]

In the earlier briefing prompted by the written question handed to counsel immediately prior to oral argument, the Class Plaintiffs erroneously argued that Section 4623(d) is limited to claims for injunctive relief. *See* Suppl. Br. for Class Pls. at 6 (Apr. 22, 2016). The congressional withdrawal of jurisdiction effected by Section 4623(d) contains no such limitation, and the operative terms of this withdrawal statute are materially different from the jurisdiction-withdrawal statutes

[5] Section § 4617(f) also bars the Court from interfering with the actions of the FHFA as *Conservator* to pay (or not pay) dividends. An award of money damages in an amount equal to hypothetical dividends is nothing other than injunctive relief camouflaged as a monetary award, and, as such, it is barred by § 4617(f).

to which Class Plaintiffs attempt to analogize. Class Plaintiffs point to cases interpreting a different withdrawal statute, 12 U.S.C. § 1818(i), to argue that money damage claims are not barred by the different terms of Section 4623(d) (*see* Suppl. Br. for Class Pls. at 7). Section 1818(i) bars only court actions that would "affect by injunction or otherwise the issuance or enforcement of" a bank regulator's notices or orders.[6] In contrast Section 4623(d) bars any court action that would "*affect*, by injunction or otherwise, *the issuance or effectiveness of*" the Director's supervisory actions. (emphasis added).

* * *

In short, the Court should reject Plaintiffs' argument that Section 4623(d) does not bar their demand for compensatory relief because they did not include the FHFA in its regulatory capacity as a named defendant in their complaint. The applicability of Section 4623(d) is determined not by looking at the parties listed on the caption of a complaint. The Court is required to assess whether a ruling in favor of Class Plaintiffs would diminish or limit the effectiveness of the October 2008 Regulatory Action. Defendants respectfully submit that such a ruling would

[6] Class Plaintiffs also argue that other provisions of HERA suggest that FHFA may be liable for money damages in certain limited circumstances, and thus Section 4623(d) cannot be read to preclude money damages claims. *See* Suppl. Br. for Class Pls. at 7-8. But these provisions are inapplicable because they pertain to the FHFA when it acts in its capacity as conservator or receiver—not in its capacity as safety and soundness regulator for the Enterprises. *See, e.g.*, 12 U.S.C. §§ 4617(d)(3), 4617(b)(18), 4617(b)(6), 4617(b)(9), 4617(j)(4).

limit the "effectiveness" of covered actions taken by FHFA wholly in its regulatory capacity. A ruling in favor of Class Plaintiffs would tie the hands of the FHFA as both Regulator and Conservator, usurp its ability to determine if, how and when to accumulate balance sheet capital or pay dividends, and force the Conservator to operate the Enterprises—and the Regulator to supervise the Enterprises—under an old capital and supervisory regime where balance sheet capital is the critical measure of safety and soundness.

CONCLUSION

For the foregoing reasons—in addition to the bar against challenges to Conservator actions set forth in Section 4617(f), and the succession to all shareholder rights set forth in Section 4617(b)(2)(A)(i)—this Court should affirm the judgment below because § 4623(d) divests the Court of subject-matter jurisdiction over Class Plaintiffs' claims, which necessarily would affect the effectiveness of FHFA's regulatory actions.

Dated: July 15, 2016

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION, TYPEFACE REQUIREMENTS, AND TYPE STYLE REQUIREMENTS

I hereby certify as follows:

1. This brief complies with the type-volume limitation of Federal Rule of Appellate Procedure 32(a)(7)(B) and the Court's June 21, 2016 Order, because this supplemental brief does not exceed 5,000 words in length, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii);

2. This brief complies with the typeface requirements of Federal Rule of Appellate Procedure 32(a)(5) and the type style requirements of Federal Rule of Appellate Procedure 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Word 2007, in 14-point Times New Roman font.

Dated: July 15, 2016

/s/ Howard N. Cayne
Howard N. Cayne

Counsel for Appellees Federal Housing Finance Agency and Melvin L. Watt

CERTIFICATE OF SERVICE

I hereby certify that on July 15, 2016, I electronically filed the foregoing document with the United States Court of Appeals for the District of Columbia Circuit by using the appellate CM/ECF system.

I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

/s/ Howard N. Cayne
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Counsel for Appellees Federal Housing Finance Agency and Melvin L. Watt

SUPPLEMENTAL ADDENDUM OF PERTINENT AUTHORITIES

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SUPPLEMENTAL ADDENDUM OF PERTINENT AUTHORITIES

12 U.S.C. § 4617. Authority over critically undercapitalized regulated entities

(a) Appointment of the Agency as conservator or receiver

(1) In general

Notwithstanding any other provision of Federal or State law, the Director may appoint the Agency as conservator or receiver for a regulated entity in the manner provided under paragraph (2) or (4). All references to the conservator or receiver under this section are references to the Agency acting as conservator or receiver.

(2) Discretionary appointment

The Agency may, at the discretion of the Director, be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity.

(3) Grounds for discretionary appointment of conservator or receiver

The grounds for appointing conservator or receiver for any regulated entity under paragraph (2) are as follows:

(A) Assets insufficient for obligations

The assets of the regulated entity are less than the obligations of the regulated entity to its creditors and others.

(B) Substantial dissipation

Substantial dissipation of assets or earnings due to--

(i) any violation of any provision of Federal or State law; or

(ii) any unsafe or unsound practice.

(C) Unsafe or unsound condition

An unsafe or unsound condition to transact business.

(D) Cease and desist orders

Any willful violation of a cease and desist order that has become final.

(E) Concealment

Any concealment of the books, papers, records, or assets of the regulated entity, or any refusal to submit the books, papers, records, or affairs of the regulated entity, for inspection to any examiner or to any lawful agent of the Director.

(F) Inability to meet obligations

The regulated entity is likely to be unable to pay its obligations or meet the demands of its creditors in the normal course of business.

(G) Losses

The regulated entity has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the regulated entity to become adequately capitalized (as defined in section 4614(a)(1) of this title).

(H) Violations of law

Any violation of any law or regulation, or any unsafe or unsound practice or condition that is likely to--

(i) cause insolvency or substantial dissipation of assets or earnings; or

(ii) weaken the condition of the regulated entity.

(I) Consent

The regulated entity, by resolution of its board of directors or its shareholders or members, consents to the appointment.

(J) Undercapitalization

The regulated entity is undercapitalized or significantly undercapitalized (as defined in section 4614(a)(3) of this title), and--

(i) has no reasonable prospect of becoming adequately capitalized;

(ii) fails to become adequately capitalized, as required by--

(I) section 4615(a)(1) of this title with respect to a regulated entity; or

(II) section 4616(a)(1) of this title with respect to a significantly undercapitalized regulated entity;

(iii) fails to submit a capital restoration plan acceptable to the Agency within the time prescribed under section 4622 of this title; or

(iv) materially fails to implement a capital restoration plan submitted and accepted under section 4622 of this title.

(K) Critical undercapitalization

The regulated entity is critically undercapitalized, as defined in section 4614(a)(4) of this title.

(L) Money laundering

The Attorney General notifies the Director in writing that the regulated entity has been found guilty of a criminal offense under section 1956 or 1957 of Title 18 or section 5322 or 5324 of Title 31.

(4) Mandatory receivership

(A) In general

The Director shall appoint the Agency as receiver for a regulated entity if the Director determines, in writing, that--

(i) the assets of the regulated entity are, and during the preceding 60 calendar days have been, less than the obligations of the regulated entity to its creditors and others; or

(ii) the regulated entity is not, and during the preceding 60 calendar days has not been, generally paying the debts of the regulated entity (other than debts that are the subject of a bona fide dispute) as such debts become due.

(B) Periodic determination required for critically undercapitalized regulated entity

If a regulated entity is critically undercapitalized, the Director shall make a determination, in writing, as to whether the regulated entity meets the criteria specified in clause (i) or (ii) of subparagraph (A)--

(i) not later than 30 calendar days after the regulated entity initially becomes critically undercapitalized; and

(ii) at least once during each succeeding 30-calendar day period.

(C) Determination not required if receivership already in place

Subparagraph (B) does not apply with respect to a regulated entity in any period during which the Agency serves as receiver for the regulated entity.

(D) Receivership terminates conservatorship

The appointment of the Agency as receiver of a regulated entity under this section shall immediately terminate any conservatorship established for the regulated entity under this chapter.

(5) Judicial review

(A) In general

If the Agency is appointed conservator or receiver under this section, the regulated entity may, within 30 days of such appointment, bring an action in the United States district court for the judicial district in which the home office of such regulated entity is located, or in the United States District Court for the District of Columbia, for an order requiring the Agency to remove itself as conservator or receiver.

(B) Review

Upon the filing of an action under subparagraph (A), the court shall, upon the merits, dismiss such action or direct the Agency to remove itself as such conservator or receiver.

(6) Directors not liable for acquiescing in appointment of conservator or receiver

The members of the board of directors of a regulated entity shall not be liable to the shareholders or creditors of the regulated entity for acquiescing in or consenting in good faith to the appointment of the Agency as conservator or receiver for that regulated entity.

(7) Agency not subject to any other Federal agency

When acting as conservator or receiver, the Agency shall not be subject to the direction or supervision of any other agency of the United States or any State in the exercise of the rights, powers, and privileges of the Agency.

(b) Powers and duties of the Agency as conservator or receiver

(1) Rulemaking authority of the agency

The Agency may prescribe such regulations as the Agency determines to be appropriate regarding the conduct of conservatorships or receiverships.

(2) General powers

(A) Successor to regulated entity

The Agency shall, as conservator or receiver, and by operation of law, immediately succeed to—

(i) all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity; and

(ii) title to the books, records, and assets of any other legal custodian of such regulated entity.

(B) Operate the regulated entity

The Agency may, as conservator or receiver—

(i) take over the assets of and operate the regulated entity with all the powers of the shareholders, the directors, and the officers of the regulated entity and conduct all business of the regulated entity;

(ii) collect all obligations and money due the regulated entity;

(iii) perform all functions of the regulated entity in the name of the regulated entity which are consistent with the appointment as conservator or receiver;

(iv) preserve and conserve the assets and property of the regulated entity; and

(v) provide by contract for assistance in fulfilling any function, activity, action, or duty of the Agency as conservator or receiver.

(C) Functions of officers, directors, and shareholders of a regulated entity

The Agency may, by regulation or order, provide for the exercise of any function by any stockholder, director, or officer of any regulated entity for which the Agency has been named conservator or receiver.

(D) Powers as conservator

The Agency may, as conservator, take such action as may be—

(i) necessary to put the regulated entity in a sound and solvent condition; and

(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.

(E) Additional powers as receiver

In any case in which the Agency is acting as receiver, the Agency shall place the regulated entity in liquidation and proceed to realize

upon the assets of the regulated entity in such manner as the Agency deems appropriate, including through the sale of assets, the transfer of assets to a limited-life regulated entity established under subsection (i), or the exercise of any other rights or privileges granted to the Agency under this paragraph.

(F) Organization of new enterprise

The Agency may, as receiver for an enterprise, organize a successor enterprise that will operate pursuant to subsection (i).

(G) Transfer or sale of assets and liabilities

The Agency may, as conservator or receiver, transfer or sell any asset or liability of the regulated entity in default, and may do so without any approval, assignment, or consent with respect to such transfer or sale.

(H) Payment of valid obligations

The Agency, as conservator or receiver, shall, to the extent of proceeds realized from the performance of contracts or sale of the assets of a regulated entity, pay all valid obligations of the regulated entity that are due and payable at the time of the appointment of the Agency as conservator or receiver, in accordance with the prescriptions and limitations of this section.

(I) Subpoena authority

(i) In general

(I) Agency authority

The Agency may, as conservator or receiver, and for purposes of carrying out any power, authority, or duty with respect to a regulated entity (including determining

any claim against the regulated entity and determining and realizing upon any asset of any person in the course of collecting money due the regulated entity), exercise any power established under section 4588 of this title.

(II) Applicability of law

The provisions of section 4588 of this title shall apply with respect to the exercise of any power under this subparagraph, in the same manner as such provisions apply under that section.

(ii) Subpoena

A subpoena or subpoena duces tecum may be issued under clause (i) only by, or with the written approval of, the Director, or the designee of the Director.

(iii) Rule of construction

This subsection shall not be construed to limit any rights that the Agency, in any capacity, might otherwise have under section 4517 or 4639 of this title.

(J) Incidental powers

The Agency may, as conservator or receiver—

(i) exercise all powers and authorities specifically granted to conservators or receivers, respectively, under this section, and such incidental powers as shall be necessary to carry out such powers; and

(ii) take any action authorized by this section, which the Agency determines is in the best interests of the regulated entity or the Agency.

(K) Other provisions

(i) Shareholders and creditors of failed regulated entity

Notwithstanding any other provision of law, the appointment of the Agency as receiver for a regulated entity pursuant to paragraph (2) or (4) of subsection (a) and its succession, by operation of law, to the rights, titles, powers, and privileges described in subsection (b)(2)(A) shall terminate all rights and claims that the stockholders and creditors of the regulated entity may have against the assets or charter of the regulated entity or the Agency arising as a result of their status as stockholders or creditors, except for their right to payment, resolution, or other satisfaction of their claims, as permitted under subsections (b)(9), (c), and (e).

(ii) Assets of regulated entity

Notwithstanding any other provision of law, for purposes of this section, the charter of a regulated entity shall not be considered an asset of the regulated entity.

. . .

(6) Provision for judicial determination of claims

(A) In general

The claimant may file suit on a claim (or continue an action commenced before the appointment of the receiver) in the district or territorial court of the United States for the district within which the principal place of business of the regulated entity is located or the United States District Court for the District of Columbia (and such court shall have jurisdiction to hear such claim), before the end of the 60-day period beginning on the earlier of—

(i) the end of the period described in paragraph (5)(A)(i) with respect to any claim against a regulated entity for which the Agency is receiver; or

(ii) the date of any notice of disallowance of such claim pursuant to paragraph (5)(A)(i).

(B) Statute of limitations

A claim shall be deemed to be disallowed (other than any portion of such claim which was allowed by the receiver), and such disallowance shall be final, and the claimant shall have no further rights or remedies with respect to such claim, if the claimant fails, before the end of the 60-day period described under subparagraph (A), to file suit on such claim (or continue an action commenced before the appointment of the receiver).

. . .

(9) Payment of claims

(A) In general

The receiver may, in the discretion of the receiver, and to the extent that funds are available from the assets of the regulated entity, pay creditor claims, in such manner and amounts as are authorized under this section, which are—

(i) allowed by the receiver;

(ii) approved by the Agency pursuant to a final determination pursuant to paragraph (7) or (8); or

(iii) determined by the final judgment of any court of competent jurisdiction.

(B) Agreements against the interest of the Agency

No agreement that tends to diminish or defeat the interest of the Agency in any asset acquired by the Agency as receiver under this section shall be valid against the Agency unless such agreement is in writing and executed by an authorized officer or representative of the regulated entity.

(C) Payment of dividends on claims

The receiver may, in the sole discretion of the receiver, pay from the assets of the regulated entity dividends on proved claims at any time, and no liability shall attach to the Agency by reason of any such payment, for failure to pay dividends to a claimant whose claim is not proved at the time of any such payment.

(D) Rulemaking authority of the Director

The Director may prescribe such rules, including definitions of terms, as the Director deems appropriate to establish a single uniform interest rate for, or to make payments of post-insolvency interest to creditors holding proven claims against the receivership estates of the regulated entity, following satisfaction by the receiver of the principal amount of all creditor claims.

. . .

(18) Treatment of claims arising from breach of contracts executed by the conservator or receiver

(A) In general

Notwithstanding any other provision of this subsection, any final and unappealable judgment for monetary damages entered against the conservator or receiver for the breach of an agreement executed or

approved in writing by the conservator or receiver after the date of its appointment, shall be paid as an administrative expense of the conservator or receiver.

(B) No limitation of power

Nothing in this paragraph shall be construed to limit the power of the conservator or receiver to exercise any rights under contract or law, including to terminate, breach, cancel, or otherwise discontinue such agreement.

. . .

(d) Provisions relating to contracts entered into before appointment of conservator or receiver

. . .

(3) Claims for damages for repudiation

(A) In general

Except as otherwise provided under subparagraph (C) and paragraphs (4), (5), and (6), the liability of the conservator or receiver for the disaffirmance or repudiation of any contract pursuant to paragraph (1) shall be—

(i) limited to actual direct compensatory damages; and

(ii) determined as of—

(I) the date of the appointment of the conservator or receiver; or

(II) in the case of any contract or agreement referred to in paragraph (8), the date of the disaffirmance or repudiation of such contract or agreement.

(B) No liability for other damages

For purposes of subparagraph (A), the term "actual direct compensatory damages" shall not include—

(i) punitive or exemplary damages;

(ii) damages for lost profits or opportunity; or

(iii) damages for pain and suffering.

(C) Measure of damages for repudiation of financial contracts

In the case of any qualified financial contract or agreement to which paragraph (8) applies, compensatory damages shall be—

(i) deemed to include normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract and agreement claims; and

(ii) paid in accordance with this subsection and subsection (e), except as otherwise specifically provided in this section.

. . .

(f) Limitation on court action

Except as provided in this section or at the request of the Director, no court may take any action to restrain or affect the exercise of powers or functions of the Agency as a conservator or a receiver.

. . .

(j) Other Agency exemptions

(1) Applicability

The provisions of this subsection shall apply with respect to the Agency in any case in which the Agency is acting as a conservator or a receiver.

(2) Taxation

The Agency, including its franchise, its capital, reserves, and surplus, and its income, shall be exempt from all taxation imposed by any State, county, municipality, or local taxing authority, except that any real property of the Agency shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed, except that, notwithstanding the failure of any person to challenge an assessment under State law of the value of such property, and the tax thereon, shall be determined as of the period for which such tax is imposed.

(3) Property protection

No property of the Agency shall be subject to levy, attachment, garnishment, foreclosure, or sale without the consent of the Agency, nor shall any involuntary lien attach to the property of the Agency.

(4) Penalties and fines

The Agency shall not be liable for any amounts in the nature of penalties or fines, including those arising from the failure of any person to pay any real property, personal property, probate, or recording tax or any recording or filing fees when due.

. . .

12 U.S.C. § 4623. Judicial review of Director action

(a) Jurisdiction

(1) Filing of petition

A regulated entity that is not classified as critically undercapitalized and is the subject of a classification under section 4614 of this title or a discretionary supervisory action taken under this subchapter by the Director (other than action to appoint a conservator under section 4616 or 4617 of this title or action under section 4619 of this title) may obtain review of the

classification or action by filing, within 10 days after receiving written notice of the Director's action, a written petition requesting that the classification or action of the Director be modified, terminated, or set aside.

(2) Place for filing

A petition filed pursuant to this subsection shall be filed in the United States Court of Appeals for the District of Columbia Circuit.

(b) Scope of review

The Court may modify, terminate, or set aside an action taken by the Director and reviewed by the Court pursuant to this section only if the court finds, on the record on which the Director acted, that the action of the Director was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with applicable laws.

(c) Unavailability of stay

The commencement of proceedings for judicial review pursuant to this section shall not operate as a stay of any action taken by the Director. Pending judicial review of the action, the court shall not have jurisdiction to stay, enjoin, or otherwise delay any supervisory action taken by the Director with respect to a regulated entity that is classified as significantly or critically undercapitalized or any action of the Director that results in the classification of a regulated entity as significantly or critically undercapitalized.

(d) Limitation on jurisdiction

Except as provided in this section, no court shall have jurisdiction to affect, by injunction or otherwise, the issuance or effectiveness of any classification or action of the Director under this subchapter (other than appointment of a conservator under section 4616 or 4617 of this title or action under section 4619 of this title) or to review, modify, suspend, terminate, or set aside such classification or action.

EXHIBIT A

News Release

FHFA Announces Suspension of Capital Classifications During Conservatorship

Discloses Minimum And Risk-Based Capital Classifications As Undercapitalized For The Second Quarter 2008 For Fannie Mae And Freddie Mac

FOR IMMEDIATE RELEASE

10/9/2008

Washington, D.C. – James B. Lockhart III, Director of the Federal Housing Finance Agency (FHFA), the safety and soundness regulator for Fannie Mae and Freddie Mac and the Federal Home Loan Banks, placed Fannie Mae and Freddie Mac into conservatorship on September 7, 2008. The capital requirements and classification process articulated in statute are established as part of a prompt corrective action framework that requires supervisory actions to be taken promptly and in a graduated manner that culminates, in the most serious cases, in the appointment of a conservator or receiver. While in conservatorship status, the Enterprises will not be subject to other prompt corrective action requirements. The Treasury Department, in conjunction with the conservatorship, provided two facilities to support the Enterprises. The GSE Credit Facility is available to provide liquidity through secured loans as needed. The Senior Preferred Stock Purchase Agreement ensures that for the very long-term that both entities will have positive net worth. The Director is, therefore, announcing several capital-related decisions impacting future reporting processes.

Suspension of Capital Classifications During Conservatorship

The Director has determined that it is prudent and in the best interests of the market to suspend capital classifications of Fannie Mae and Freddie Mac during the conservatorship, in light of the United States Treasury's Senior Preferred Stock Purchase Agreement. FHFA will continue to closely monitor capital levels, but the existing statutory and FHFA-directed regulatory capital requirements will not be binding during the conservatorship.

Management During Conservatorship

In accordance with the Senior Preferred Stock Agreement FHFA, as conservator, has directed the Enterprises to focus on managing to a positive stockholder's equity. Both Enterprises during conservatorship will work to ensure that they fulfill their mission of providing liquidity, stability and affordability to the mortgage market.

Disclosure of Capital Positions During Conservatorship

During the conservatorship, FHFA will not issue a quarterly capital classification. The Enterprises will continue to submit capital reports to FHFA during the conservatorship. Relevant capital figures (minimum capital requirement, core capital, and GAAP net worth) will be available in the Enterprises' quarterly 10-Q filings, as well as on FHFA's website to ensure market transparency. FHFA does not intend to publish critical capital, risk-based capital, or subordinated debt levels during the conservatorship. In light of its new authority under the Housing and Economic Recovery Act, FHFA will be revising minimum capital and risk-based capital requirements.

Second Quarter Capital Classification

Director Lockhart is classifying Fannie Mae and Freddie Mac as of June 30, 2008, prior to the conservatorship, as undercapitalized using FHFA's discretionary authority provided in the statute. Both Fannie Mae and Freddie Mac have publicly released financial results for the second quarter 2008. Although both Enterprises' capital calculations for June 30, 2008 reflect that they met the FHFA and statutory requirements for capital, the continued market downturn during late July and August raised significant questions about the sufficiency of capital. The following factors, which led to the need for conservatorship, support the Director's decision to downgrade the classification to undercapitalized:

- Accelerating safety and soundness weaknesses, especially with regard to credit risk, earnings outlook, and capitalization;
- Continued and substantial deterioration in equity, debt, and MBS market conditions;
- The current and projected financial performance and condition of each company as reflected in its second quarter financial reports and our ongoing examinations;
- The inability of the companies to raise capital or to issue debt according to normal practices and prices;
- The critical importance of each company in supporting the country's residential mortgage market; and
- Concerns that a growing proportion of their respective statutory core capital consisted of intangible assets.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended by the Federal Housing Finance and Regulatory Reform Act, Division A of the Housing and Economic Recovery Act, Public Law No. 111-289, Stat. 2654 (2008) requires the FHFA Director to determine the capital level and classification of the Enterprises not less than quarterly, and to report the results to Congress. FHFA classifies the Enterprises as adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized. The Enterprises are required by federal statute to meet both minimum and risk-based capital standards to be classified as adequately capitalized. The Director has the authority to make a discretionary downgrade of the capital adequacy classification should certain safety and soundness conditions

arise that could impact future capital adequacy. This classification requirement serves no purpose once an Enterprise has been placed into conservatorship.

SECOND QUARTER CAPITAL RESULTS

Minimum Capital

Fannie Mae's FHFA-directed capital requirement on June 30, 2008 was $37.5 billion and its statutory minimum capital requirement was $32.6 billion. Fannie Mae's core capital of $47.0 billion exceeded the FHFA-directed capital requirement by $9.4 billion.

Freddie Mac's FHFA-directed capital requirement on June 30, 2008 was $34.5 billion and its statutory minimum capital requirement was $28.7 billion. Freddie Mac's core capital of $37.1 billion exceeded the FHFA-directed minimum capital requirement by $2.7 billion.

Enterprise Minimum Capital Requirement (Billions of Dollars) (a,b)				
	Fannie Mae		**Freddie Mac**	
	30-Jun-08	31-Mar-08	30-Jun-08	31-Mar-08
Minimum Capital – Statutory Requirement	32.631	31.335	28.709	26.937
Minimum Capital – FHFA Directed Requirement	37.525	37.602	24.451	32.324
Core Capital	46.964	42.676	37.128	38.319
Surplus (Deficit) (based on FHFA Directed Requirement)	9.439	5.074	2.676	5.995
Surplus as a Percent of FHFA Directed Requirement	25.2%	13.5%	7.8%	18.5%

a. Numbers may not add due to rounding.

b. FHFA has directed both Fannie Mae and Freddie Mac to maintain additional capital in excess of the statutory minimum capital requirement. The excess capital requirement has been in place since January 28, 2004, for Freddie Mac and since September 30, 2005, for Fannie Mae. For both Enterprises the requirement was reduced from 30% to 20% on March 19, 2008. On May 19, 2008 the requirement was further reduced for Fannie Mae to 15%. The FHFA-directed minimum capital requirements and capital surplus numbers stated in these charts reflect the inclusion of the additional FHFA-directed capital requirements of 15% for Fannie Mae and 20% for Freddie Mac for the quarter-end June 30, 2008.

Risk-Based Capital

As of June 30, 2008, Fannie Mae's risk-based capital requirement was $36.3 billion. Fannie Mae's total capital of $55.6 billion on that date exceeded the requirement by $19.3 billion.

As of June 30, 2008, Freddie Mac's risk-based capital requirement was $20.1 billion. Freddie Mac's total capital of $42.9 billion on that date exceeded the requirement by $22.8 billion.

Enterprise Risk-Based Capital Requirement (Billions of Dollars) (a)								
Interest Rate Scenario	**Fannie Mae**				**Freddie Mac**			
	30-Jun-08		31-Mar-08		30-Jun-08		31-Mar-08	
	Up	Down	Up	Down	Up	Down	Up	Down
Risk Based Capital Requirement	6.196	36.288	14.344	23.099	0.237	20.139	5.127	26.060
Total Capital		55.568		47.666		42.916		42.173
Surplus (Deficit)		19.280		24.567		22.777		16.113

a. Numbers may not add due to rounding.

DEFINITION OF CAPITAL STANDARDS

Core Capital is the sum of outstanding common stock, perpetual, noncumulative preferred stock, paid-in capital, and retained earnings. Core capital does not include Accumulated Other Comprehensive Income (AOCI), which is captured as part of stockholder's equity.

Total Capital is the sum of Core Capital plus the allowance for loan losses.

Minimum Capital represents an essential amount of capital needed to protect an Enterprise against broad categories of business risk. For purposes of minimum capital, an Enterprise is considered by law adequately capitalized if core capital—common stock; perpetual noncumulative preferred stock; paid in capital; and retained earnings—equals or exceeds minimum capital. The minimum capital standard is 2.5 percent of assets plus 0.45 percent of adjusted off-balance-sheet obligations, including guaranteed mortgage securities.

The FHFA-directed capital requirement is the amount of capital the Enterprise is required to maintain to compensate for increased operational risks including systems, accounting, and internal control risks. The level is prescribed by the Director of FHFA. This requirement is calculated by multiplying the statutory minimum capital requirement by 1.x times, where x equals the percentage requirement in effect for the time period. On March 19, 2008, FHFA announced an agreement with the Enterprises to reduce the FHFA-directed capital requirement from 30 percent to 20 percent in recognition of the significant remediation efforts and the commitments by the Enterprises to raise significant new capital and to retain substantial surpluses over the FHFA-directed requirement. The FHFA-directed requirement as of June 30, 2008 was 1.20 times the statutory minimum capital requirement for Freddie Mac and 1.15 times the statutory minimum capital requirement for Fannie Mae.

FHFA's risk-based capital requirement is the amount of total capital—core capital plus a general allowance for loan losses less specific reserves—that an Enterprise must hold to absorb projected losses flowing from future

adverse interest-rate and credit-risk conditions specified by statute, plus 30 percent mandated by statute to cover management and operations risk. The risk-based capital standard is based on stress test results calculated for the two statutorily prescribed interest rate scenarios, one in which 10-year Treasury yields rise 75 percent (up-rate scenario) and another in which they fall 50 percent (down-rate scenario). Changes in both scenarios are generally capped at 600 basis points. The risk-based capital level for an Enterprise is the amount of total capital that would enable it to survive the stress test in whichever scenario is more adverse for that Enterprise, plus 30 percent of that amount to cover management and operations risk.

The **critical capital** level is the amount of core capital below which an Enterprise must be classified as critically undercapitalized and generally must be placed in conservatorship. Critical capital levels are computed consistent with the Federal Housing Enterprises Safety and Soundness Act of 1992 as follows: One-half of the portion of minimum capital requirement associated with on-balance-sheet assets plus five-ninths of the portion of the minimum capital requirement associated with off-balance-sheet obligations. The critical capital trigger is irrelevant during the conservatorship period.

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The Federal Housing Finance Agency (FHFA) combines the responsibilities of the Office of Federal Housing Enterprise Oversight (OFHEO), the Federal Housing Finance Board (FHFB) and the HUD government-sponsored enterprise (GSE) mission team to regulate Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks. Together these 14 GSEs provide funding for $6.2 trillion of residential mortgages in the U.S.

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EXHIBIT B

Introduction

Capital is critical in the evaluation of a regulated entity's financial condition. Capital protects the stakeholders, including shareholders/members, other Federal Home Loan Banks (FHLBanks) in the case of a particular FHLBank, and bondholders. Capital provides a measure of assurance to the shareholders of the Enterprises (Fannie Mae and Freddie Mac), members of the FHLBanks, and the public that the respective institution will continue to operate, honor its obligations, and fulfill its mission. This module refers to the FHLBanks and the Enterprises collectively as regulated entities.

The level, quality, and composition of capital are important in determining capital adequacy. Capital includes stock issued to the Enterprises' shareholders and FHLBanks' members. Another key element of capital, retained earnings, provides protection to these capital investments by absorbing losses.

The organizational structure of the Enterprises and FHLBanks are fundamentally different. Further, capital composition and statutory capital requirements are different for the Enterprises and the FHLBanks.

- The Enterprises, although in Conservatorship since September 2008 because they became critically undercapitalized, are publicly companies that – prior to Conservatorship – were permitted to issue common and preferred stock. The Enterprises' stocks are delisted from the New York Stock Exchange. In Conservatorship the Enterprises are capitalized via the Senior Preferred Stock Purchase Agreements (SPSPAs) with the United States Treasury (Treasury). In Conservatorship, the Enterprises have not been subject to the periodic, regulatory capital measurement requirements. For purposes of background, however, this module describes regulatory capital requirements as if they were in effect.
- The FHLBanks are cooperatives capitalized by the stock purchases of member institutions. As cooperatives, FHLBank stock represents the ownership interest of the members. Capital at an FHLBank is distinguished by the fact that much of the FHLBank's capital is redeemable. Typically, members of the FHLBanks can redeem capital stock at par with appropriate notice and the amount of capital stock outstanding may fluctuate with changes in borrowings and other activities. FHLBanks can repurchase "excess" stock at their discretion.

The capital requirements for the Enterprises and the FHLBanks are governed by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (as amended) (the Safety and Soundness Act), the Federal Home Loan Bank Act (as amended), and by FHFA capital regulations. In assessing the adequacy of capital, it is important to look beyond the level of capital in relation to assets. A regulated entity should maintain capital commensurate with the nature and extent of the risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The forward view of capital is best defined in terms of the institution's assets and their ability

to generate future cash flows. Determination of a regulated entity's future capital needs typically requires a combination of actions, including assessing the capital plan of the regulated entity, modeling future income, and stress testing. Furthermore, examiners must assess qualitative factors to evaluate the adequacy of capital as well as the circumstances and risks of the particular regulated entity.

The board of directors is responsible for ensuring the maintenance of adequate capital. The board must oversee the capital management function to ensure continued and long-term financial viability. Key components of capital management are: (a) adequate capital planning that includes stress scenarios, establishment of a risk appetite, and an optimum capital goal that identifies an acceptable capital buffer (including retained earnings goals for FHLBanks); (b) reasonable dividend policies; and (c) compliance with all capital-related regulatory requirements.

Senior management is responsible for developing and implementing appropriate capital management policies and procedures.

Regulatory Environment

The primary authorities governing, or relevant to, capital of the Enterprises and the FHLBanks are set forth below. The examiner should ensure that the regulated entity and its legal counsel have considered the application of such authorities to a regulated entity.

1) ***The Federal Housing Finance Regulatory Reform Act of 2008 (Section 1, Division A of the Housing and Economic Recovery Act of 2008) amended certain provisions of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the Safety and Soundness Act). Parts and sections relevant to capital include the following:***

   Section 1108 required the FHFA Director to establish prudential management and operations standards for the regulated entities.

   Section 1110 amended section 1361 of the Safety and Soundness Act regarding risk-based capital standards for the regulated entities.

   Section 1111 amended section 1362 of the Safety and Soundness Act regarding minimum capital standards.

   Sections 1141, 1142, 1143, 1144, and 1145 amended sections 1363, 1364, 1365, 1366 and 1367, respectively, of the Safety and Soundness Act regarding prompt corrective actions (PCA).

2) ***The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. 4501, et seq. (the Safety and Soundness Act). The Safety and Soundness Act***

contains the following provisions relevant to the Enterprises' capital:

12 U.S.C. Chapter 46, Subchapter II addresses required capital levels for regulated entities, special enforcement powers, and reviews of assets and liabilities. Specific parts and sections relative to capital include:

12 U.S.C. 4502(7) defines core capital.

12 U.S.C. 4611 defines risk-based capital requirements.

12 U.S.C. 4612 establishes minimum capital levels.

12 U.S.C. 4613 establishes critical capital levels.

12 U.S.C. 4614 defines capital classifications for PCA purposes.

12 U.S.C. 4615 discusses limitations on undercapitalized enterprises.

12 U.S.C. 4616 discusses limitations on significantly undercapitalized enterprises.

12 U.S.C. 4617 discusses limitations on critically undercapitalized enterprises.

12 U.S.C. 4618 addresses procedures for giving notice of classification or reclassification within a particular capital classification, and enforcement actions.

12 U.S.C. 4622 establishes procedures and requirements for capital restoration plans.

12 U.S.C. 4623 addresses judicial review of Director action.

12 U.S.C. 4624 allows the Director to establish criteria governing the portfolio holdings of the Enterprises, to ensure that the holdings are backed by sufficient capital and consistent with the mission and the safe and sound operations of the Enterprises. It also provides the Director with the authority to make temporary adjustments to the established standards and require the Enterprises to dispose of or acquire any asset.

3) ***The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires, among other things, certain financial companies with total consolidated assets of more than $10 billion, and which are regulated by a primary federal financial regulatory agency, to conduct annual stress tests to determine whether they have the capital to absorb losses because of adverse economic conditions. Section 165(i)(2)(C) of the Dodd-Frank Act requires FHFA, in coordination with the Federal Reserve Board of Governors and the Federal Insurance Office, to issue consistent and comparable regulations for annual stress***

testing. FHFA published a final rule effective October 28, 2013. The rule is applicable to Fannie Mae, Freddie Mac and the FHLBanks.

12 CFR 1238 of the FHFA's regulations sets forth the basic requirements for implementing stress tests and reporting the results. FHFA will supplement the rule annually with reporting schedules, guidance, and orders.

Dodd Frank Stress Tests Summary Instructions and Guidance dated November 26, 2013, provide all regulated entities with specific information in modeling the DFAST, and may assist examiners in developing a planned scope of review commensurate with the risks associated with the particular regulated entity.

4) ***Rules and Regulations of the Federal Housing Finance Agency (FHFA) and its predecessor, the Office of Federal Housing Enterprise Oversight (OFHEO), which include the following parts and sections relevant to the Enterprises' and FHLBanks' capital:***

12 CFR 1225 of the FHFA's regulations provides standards for imposing a temporary increase in the minimum capital requirements for any regulated entity.

12 CFR 1237.12 of the FHFA's regulations prohibits capital distributions for any regulated entity while in Conservatorship without the approval of the Director.

12 CFR 1720 of OFHEO's regulations establishes minimum safety and soundness requirements, including standards for asset growth, the requirement for strategies in key areas, and policies and controls to implement those strategies.

12 CFR 1750 of OFHEO's regulations defines the methodology for computing the minimum capital requirement and the risk-based capital level for each Enterprise.

12 CFR Part 1777 of OFHEO's regulations define capital categories for prompt corrective action and requirements for notification of category and submission of capital restoration plans.

5) ***Federal Home Loan Bank Act (FHLBank Act)***

Section 6 of the FHLBank Act sets forth the capital structure of the FHLBanks. Specifically, Section 6 establishes leverage capital requirements for the FHLBanks, requires the Director to establish risk-based capital standards, and establishes requirements for FHLBank capital structure plans and other related matters. Section 6 also provides definitions for "permanent capital" and "total capital". Section 6 also limits a FHLBank's ability to redeem or repurchase stock by prohibiting such transactions if a FHLBank would fail to meet any capital requirement after the transaction, and further prohibits repurchases or redemptions without prior FHFA

approval if the FHLBank has incurred, or is likely to incur, losses that would result in charges against the capital of the FHLBank.

Section 16 of the FHLBank Act separately provides that a FHLBank may pay dividends only from its previously retained earnings or from its current earnings remaining after certain specified reductions.

6) ***Rules and Regulations of the FHFA and its predecessor, Federal Housing Finance Board (Finance Board), which include the following parts and sections relevant to the FHLBank's capital:***

12 CFR 917.3(b)(1) of the Finance Board's regulations requires each FHLBank's risk management policy to include the specific steps that the FHLBank will take to comply with its capital plan. This section also requires each FHLBank to include target ratios of total capital/total assets and permanent capital/total assets at which the FHLBank intends to operate, where such ratios are in excess of the minimum leverage and risk-based capital ratios and may be expressed as a range of ratios or a single ratio.

12 CFR 917.9 of the Finance Board's regulations requires that an FHLBank's board of directors declare and pay a dividend only from previously retained earnings or current net earnings and only if such payment will not result in a projected impairment of the par value of the institution's capital stock. This section also prohibits an FHLBank's board of directors from declaring or paying a dividend based on projected or anticipated earnings or if the par value of the FHLBank's stock is impaired or is projected to become impaired after paying such dividend.

12 CFR Part 930 of the Finance Board's regulations sets forth definitions applying to capital regulations.

12 CFR Part 931 of the Finance Board's regulations defines the classes of capital stock, procedures relating to capital stock, and limitations on the payment of dividends.

12 CFR 931.4 of the Finance Board's regulations requires that dividends only be paid out of previously retained earnings or current net earnings only in accordance with its capital plan, and may not pay any dividend if, after doing so, the FHLBank would fail to meet any minimum capital requirements.

12 CFR 931.8(a) of the Finance Board's regulations prohibits an FHLBank from redeeming or repurchasing any stock without the prior written approval of the FHFA if either the board of directors of the FHLBank, or the FHFA, has determined that the FHLBank has or is likely to incur losses that result in, or are likely to result in, charges against capital of the FHLBank.

12 CFR 932 of the Finance Board's regulations defines minimum total capital, leverage capital, and risk-based capital requirements, as well as guidance on how each capital requirement is calculated.

12 CFR 933 of the Finance Board's regulations requires the board of directors of each FHLBank to submit a capital plan to the Finance Board for approval which complies with 12 CFR 931, and which has sufficient total and permanent capital to comply with the regulatory capital requirements of 12 CFR 932.

12 CFR 1229 of the FHFA's regulations establishes capital classifications for Prompt Corrective Action and provides restrictions and remedies required by the FHLBanks in accordance with their capital classification.

12 CFR 1237.12 of the FHFA's regulations prohibits capital distributions for any regulated entity while in Conservatorship without the approval of the Director.

12 CFR 1261.4(a) of the FHFA regulations requires an FHLBank to file an annual capital stock report with the FHFA that provides information on its members' capital stock. FHFA uses the information on the members' stockholdings in allocating member directorships among the states in each FHLBank's district.

12 CFR 1263.23(b) of the FHFA's regulations prohibits any FHLBank with outstanding excess stock greater than 1 percent of its total assets from declaring or paying any stock dividends or otherwise issuing any excess stock. 12 CFR 1263.23(b) also prohibits any FHLBank from issuing excess stock, if after issuance, its outstanding excess stock would be greater than 1 percent of its total assets.

7) ***Rules and Regulations of the FHFA (12 CFR Part 1236):*** FHFA's final rule on Prudential Management and Operations Standards (PMOS), Standards 1, 8 and 10 establish the need for the regulated entities to ensure processes are in place to appropriately identify, manage, monitor, and control risk exposures and the need for a regulated entity to maintain financial records in compliance with Generally Accepted Accounting Principles.

8) ***Advisory Bulletins of the Federal Housing Finance Board that provide supervisory guidance relating to capital include the following:***

Advisory Bulletin 03-04, dated March 18, 2003, provides guidance on what FHLBanks should include in capital plan amendment submissions for FHFA approval. The advisory bulletin also describes the amount of time that will likely be necessary to complete the FHFA's review of the FHLBank's submission.

Advisory Bulletin 03-08, dated August 18, 2003, requires the board of directors to

adopt a retained earnings policy and to review the FHLBank's analysis of the adequacy of its retained earnings.

Advisory Bulletin 09-01, dated July 20, 2009, provides guidance regarding the disclosure of preliminary capital classifications for Prompt Corrective Action.

Issues Specific to the Regulated Entities

Capital Adequacy

The FHLBanks and the Enterprises are subject to capital regulations requiring minimum regulatory capital levels. When assessing the adequacy of capital, it is important to consider factors that may require the regulated entity to maintain capital at a higher level than the regulatory minimums. The following provides a summary of factors that may be considered when evaluating capital. A particular factor may not be applicable to all regulated entities given the inherent differences between the Enterprises and the FHLBanks.

Overall Financial Condition of the Regulated Entity

A regulated entity's operations and overall financial condition are important in the assessment of capital. Asset quality problems can quickly deplete capital. Poor earnings performance can hinder capital formation. Poor internal controls could lead to losses that could potentially impair capital. Examiner judgment is required to review capital adequacy in relation to the overall financial condition. The examiner should consider the level of capital in relation to the risks on balance sheet and off balance sheet. Each regulated entity should have adequate modeling capabilities to establish its risk appetite and assess its capital needs, including under stress scenarios, and evaluate potential risks to capital. In addition, the assessment of capital should include consideration of the level, quality, and trend of earnings; the reasonableness of dividends; sensitivity to interest rate risk; and volatility in capital and earnings caused by certain accounting standards.

Composition of Capital

The Enterprises were placed in Conservatorship in September 2008 because they were critically undercapitalized. They receive financial support from Treasury through the SPSPA and they are not expected to rebuild capital levels as all excess earnings are swept to Treasury in accordance with the SPSPA, as amended.

For the FHLBanks, the level of retained earnings is critically important, as it is available to absorb losses and protect the par value of the capital stock. Losses in excess of the level of retained earnings may impair the ability of the FHLBank to buy and sell stock at par. Advisory Bulletin 03-08 entitled *Capital Management and Retained Earnings* dated August 18, 2003 requires that each FHLBank assess the level of retained earnings at least

annually in light of alternative possible future forecasts. When assessing the need for retained earnings, the FHLBank should consider potential risks that could directly affect capital needs. The greater the market, credit, or operational risk to an institution, the greater its need for retained earnings.

In addition, Advisory Bulletin 03-08 requires that each FHLBank adopt a retained earnings policy that specifies the priority the FHLBank places on retained earnings relative to dividends. Examiners should evaluate these forecasts and policies to ensure that they are reasonable and do not negatively stress the FHLBank's future capital position. Examiners should determine whether the level of excess stock or mandatory redeemable stock might affect future capital adequacy.

Capital Remedies

The FHFA may use a variety of statutory tools to address capital deficiencies. When a regulated entity falls below a classification of Adequately Capitalized, FHFA will take action to address the capital deficiency, and the statutory tools available are linked to the capital classification level. Generally, a regulated entity must submit a capital plan if its capital adequacy becomes a concern, declines below thresholds established in the regulations, or if the Director uses discretionary authority either to lower the regulated entity's capital classification or to impose higher capital requirements.

Dodd Frank Act Stress Test (DFAST)

Fannie Mae, Freddie Mac, and the FHLBanks are required to complete a DFAST commencing in 2014 (Section 165(i)(2) of the Dodd Frank Act and 12 CFR 1238.3 of the FHFA's Regulations). These stress tests require that the regulated entities utilize base line information and run scenarios to simulate severe and sudden, financial and economic events. The scenarios stress the regulated entities' abilities to absorb the financial impacts given the balance sheets' compositions and forecasted compositions at the time the regulatory stress tests are run. FHFA annually may supplement the rule with reporting schedules, Orders or instructions as necessary.

Issues Specific to the FHLBanks

Capital Components

Capital Stock

Members of the FHLBanks must purchase capital stock as a condition of membership (known as membership investment requirement). FHLBanks also may also require members to purchase capital stock when they engage in activities with the FHLBank, such as obtaining an advance or an acquired member asset. (See the *Advances and Collateral* and the *Acquired Member Assets* modules.) The FHLBank Act defines two classes of capital stock, Class A capital stock and Class B capital stock.

> *Class A Capital Stock* is redeemable in cash at par six months following submission by a member of a written notice of its intent to redeem such shares.
>
> *Class B Capital Stock* is redeemable in cash at par five years following submission by a member of a written notice of its intent to redeem such shares. Class B stock confers ownership interest in the retained earnings, surplus, undivided profits, and equity reserves of the FHLBank.

Each FHLBank establishes its membership investment requirements and activity stock requirements per class of stock in its capital structure plan. (see 12 CFR Part 933 of the Finance Board regulations.) An FHLBank may amend its capital structure plan to change its investment and activity stock, but the amendments must be approved by the FHFA before they may take effect. Advisory Bulletin 03-04, *Amendments to Capital Plans*, dated March 18, 2003 describes procedures for submitting an amendment to the FHFA for approval.

Capital stock also includes *mandatorily redeemable capital stock* and *excess capital stock*.

> Mandatorily redeemable capital stock is defined as member capital stock that is subject to a redemption request. Although the FHFA considers mandatorily redeemable capital stock to be regulatory capital, Accounting Standards Codification (ASC) 480-10 *Distinguishing Liabilities from Equity* requires that it be reported as a liability and any dividends paid be reported as interest expense.
>
> Excess capital stock - defined as capital stock of an FHLBank that exceeds the aggregate amount of capital stock that each individual FHLBank membership must hold in order to meet its investment and activity stock purchase requirements - may exist for a number of reasons, including changes in member borrowing activity, the accumulation of stock dividends, and restrictions on capital redemptions and repurchases. Excess capital stock is included in regulatory capital.

Retained Earnings

Retained earnings represent an important component of capital at the FHLBanks since members can redeem capital stock with proper notice or after the redemption period expires. Losses in excess of current period earnings are charged first to retained earnings. If losses exceed retained earnings, capital stock is impaired. The FHLBank would then determine if the impairment was temporary or other than temporary based upon applicable accounting guidance.

In 1989, Congress established the Resolution Funding Corporation (RefCorp) to provide funding to the Resolution Trust Corporation to finance its efforts to resolve the savings and loan crisis. RefCorp issued approximately $30 billion of long-term bonds, the last of which was scheduled to mature in April 2030. Since 1999, all but two of the FHLBank's quarterly payments exceeded the $75 million benchmark calculation required to pay the obligation in full by its original maturity. As a result, the FHLBanks have paid the obligation in full effective July 15, 2011.

Subsequent to the fulfillment of the RefCorp obligation, the FHFA approved amendments to each FHLBank's capital plan that requires each FHLBank to allocate 20 percent of its net income to a restricted retained earnings account until the restricted account reaches a target of one percent of that FHLBank's outstanding consolidated obligations. Under the retained earnings provisions, the FHLBanks are prohibited from paying dividends from restricted retained earnings.

Accumulated Other Comprehensive Income

Accumulated Other Comprehensive Income (AOCI) is included in the equity section of the balance sheet for GAAP purposes and is used to accumulate unrealized gains or losses. The two principal components of AOCI for the FHLBanks are unrealized gains and losses on available for sale securities and the non-credit portion of other than temporary impairment on private-label mortgage-backed securities. The calculation of regulatory capital excludes AOCI.

Regulatory Capital versus GAAP Capital

Differences exist between capital reported by the FHLBanks on financial statements under GAAP and regulatory capital per FHFA regulations. The following table indicates similarities and differences between the capital measures.

Component	**Regulatory Capital**	**GAAP Capital**
Capital Stock – Membership Investment Requirement	Yes	Yes

Capital Stock – Activity Requirement	Yes	Yes
Capital Stock – Excess Stock	Yes	Yes
Capital Stock - Mandatorily Redeemable Capital Stock	Yes	No
Retained Earnings	Yes	Yes
Accumulated Other Comprehensive Income	No	Yes

Regulatory Capital Requirements

The FHLBanks are required to maintain capital that is sufficient to cover the credit risk, market risk, and operational risk to which the FHLBank is subject. The FHLBank Act requires that the FHLBanks meet both a leverage capital requirement and a risk-based capital requirement.

Permanent Capital Definition

The FHLBank Act defines "permanent capital" as the amounts paid for an FHLBank's Class B stock and the FHLBank's retained earnings as determined in accordance with GAAP.

Total Capital Definition

The FHLBank Act defines "total capital" to include permanent capital, the amounts paid for Class A stock, any general allowance for losses that are not held against specific assets (as determined in accordance with GAAP and FHFA regulations), and any other amounts available to absorb losses that the FHFA determines by regulation to be appropriate to be included in capital. (The FHFA has not determined "any other amounts available to absorb losses" to be appropriate to be included in capital.)

FHFA regulations require that "general allowance for loan losses" be consistent with GAAP and not include any amounts held against specific assets or class of assets, such as AMA, of the FHLBank.

Total Capital Requirement

Each FHLBank is required to maintain a ratio of total capital to total assets of no less than 4 percent. Each FHLBank is also required to maintain a leverage ratio of total capital to total assets of 5 percent. In calculating the leverage ratio, the amounts paid in for Class B stock and the amounts of retained earnings (permanent capital) are multiplied by 1.5 percent, and all other items of total capital are included at face value.

Risk-Based Capital Requirement

Each FHLBank is required to maintain permanent capital in an amount that is sufficient, as determined in accordance with Finance Board regulations, to cover the credit, market, and operational risks to which the FHLBank is subject, as set forth below.

Credit risk capital requirement - Equal to the sum of the FHLBank's credit risk capital charges for all on-balance sheet assets, off-balance items, and derivatives contracts. Section 932.4 of the Finance Board's regulations sets forth the specific requirements for calculating the credit risk capital requirement.

Market risk capital requirement - Equal to the sum of (1) the market value of the FHLBank's portfolio at risk, estimated by the FHLBank's approved internal risk model and (2) the amount by which the FHLBank's current market value of total capital is less than 85 percent of the FHLBank's book value of total capital. Section 932.5 of the Finance Board's regulations sets forth the specific requirements for calculating the market risk capital requirement.

Operational risk capital requirement - Equal to 30 percent of the sum of the FHLBank's credit and market risk capital requirements. Section 932.6 of the Finance Board's regulations sets forth this requirement and allows an FHLBank to substitute an alternative method for calculating operational risk if such method is approved by the FHFA.

Other Regulatory Requirements

Capital Plans – The 1999 amendments to the FHLBank Act required the board of directors of each FHLBank to submit, not later than October 29, 2001, to the Finance Board a plan to implement a new capital structure for the FHLBank. Each FHLBank's capital structure plan must comply with the requirements of Part 931, regarding FHLBank Capital Stock, and must result in the FHLBank having sufficient total and permanent capital to comply with the regulatory capital requirements of Part 932 regarding FHLBank Capital Requirements. As of January 1, 2012, all FHLBanks have implemented approved capital plans.

Target Operating Ratios - Section 917.3(b)(1) of Finance Board regulations requires the FHLBanks to set target ratios of total regulatory capital to total assets and permanent capital to total assets at which the FHLBank intends to operate. These target ratios should be in excess of the minimum leverage and risk-based capital ratios. The target ratios are to be included in the FHLBank's risk management policy.

Dividends – Section 917.9 and 931.4 of the Finance Board regulations allow an FHLBank to declare or pay dividends on Class A or Class B stock only out of previously retained earnings or current net earnings and may not declare or pay a

dividend if the par value of the FHLBank's stock is impaired or is projected to become impaired after paying such dividend. Dividends must conform to the FHLBank's capital plan, although the capital plan may establish different dividend rates or preferences for each class or subclass of stock.

Excess Stock Threshold - Section 1263.23(b) of the FHFA regulations prohibits any FHLBank with outstanding excess stock greater than 1 percent of its total assets from declaring or paying any stock dividends or otherwise issuing any excess stock. Section 1263.23(b) also prohibits any FHLBank from issuing excess stock if, after issuance, its outstanding excess stock would be greater than 1 percent of its total assets.

Prompt Corrective Action

12 CFR Part 1229 of the FHFA's regulations sets forth standards and remedies under the Prompt Corrective Action rule for the FHLBanks.

Each quarter, the FHFA's Director determines each FHLBank's capital classification in accordance with the following PCA definitions:

Adequately capitalized - Except where the Director has exercised authority to reclassify an FHLBank, an FHLBank shall be considered adequately capitalized if, at the time of the determination under 12 CFR 1229.2(a), the FHLBank has sufficient permanent and total capital, as applicable, to meet or exceed its risk-based and minimum capital requirements.

Undercapitalized - Except where the Director has exercised authority to reclassify an FHLBank, an FHLBank shall be considered undercapitalized if, at the time of the determination under 12 CFR 1229.2(a), the FHLBank does not have sufficient permanent or total capital, as applicable, to meet any one or more of its risk-based or minimum capital requirements but such deficiency is not of a magnitude to classify the FHLBank as significantly undercapitalized or critically undercapitalized.

Significantly undercapitalized - Except where the Director has exercised authority to reclassify an FHLBank, an FHLBank shall be considered significantly undercapitalized if, at the time of the determination under 12 CFR 1229.2(a), the amount of permanent or total capital held by the FHLBank is less than 75 percent of what is required to meet any one of its risk-based or minimum capital requirements but the magnitude of the FHLBank's deficiency in total capital is not sufficient to classify it as critically undercapitalized.

Critically undercapitalized - Except where the Director has exercised authority to reclassify an FHLBank, an FHLBank shall be considered critically

undercapitalized if, at the time of the determination under 12 CFR 1229.2(a), the total capital held by the FHLBank is less than or equal to the critical capital level for an FHLBank as defined under 12 CFR 1229.1.

The regulation provides discretionary reclassification authority to the Director and specifies certain restrictions and remedies under PCA. An adequately capitalized FHLBank may not make a capital distribution if after doing so the FHLBank's capital would not be sufficient to maintain a classification of adequately capitalized. If an FHLBank becomes undercapitalized, significantly undercapitalized, or critically undercapitalized, the FHLBank must submit a capital restoration plan to the FHFA. The regulation also places limits on capital distributions, asset growth, new business activities, and executive officer compensation depending on the capital classification.

Advisory Bulletin 2009-AB-01, *Disclosure of Preliminary Capital Classifications* dated July 20, 2009 states that preliminary capital classifications should be treated as unpublished information under Part 911 of the Finance Board's regulations and provides guidance as to when the preliminary capital classification should be disclosed in financial statements. Note that Part 911 of the Finance Board regulations has been replaced by Part 1214 of the FHFA regulations, and that the term "unpublished information" has been replace by the term "confidential supervisory information." Capital classifications of the FHLBanks would be considered to be "confidential supervisory information" and subject to the prohibitions on disclosure, without the Director's written approval, in Section 1214.3.

Issues Specific to the Enterprises

Capital Components

The statutory components of capital under the Safety and Soundness Act include:

Common Stock

The Enterprises were authorized to issue common stock; during Conservatorship they are not permitted to do so without the approval of the FHFA and Treasury. The par value of the outstanding shares of common stock is included in capital.

Non-Cumulative Perpetual Preferred Stock

The Enterprises were authorized to issue non-cumulative perpetual preferred stock; during Conservatorship they are not allowed to do this without approval of the FHFA and Treasury. The par value of such preferred stock is reflected in this capital account. Preferred stock has preference over common stock for dividend payments and in the event of liquidation. Perpetual preferred stock has no fixed date on which invested capital will be returned to the shareholder, although there are redemption privileges held

by the Enterprises. Non-cumulative preferred stock means that dividends will not accumulate if undeclared and paid.

Paid-in Capital for Common and Preferred Stock

Paid-in capital represents the premium paid over and above par value for the purchase of common stock or preferred stock. Paid in capital for common stock and non-cumulative perpetual preferred stock is included in regulatory capital; paid in capital for cumulative perpetual preferred stock is not included in regulatory capital.

Retained Earnings

Retained earnings represent the cumulative amount of earnings not paid out as dividends.

Accumulated Other Comprehensive Income

Accumulated Other Comprehensive Income (AOCI) is included in the GAAP equity section of the financial statements. It is used to accumulate unrealized gains or losses. The two principal components of AOCI for the Enterprises are unrealized gains and losses on available for sale (AFS) securities and the non-credit portion of other than temporary impairment (OTTI) on private-label mortgage-backed securities. If regulatory capital was calculated for the Enterprises, AOCI would be excluded from the calculation.

Regulatory Capital versus GAAP Capital

Differences exist between capital reported by the Enterprises on financial statements under GAAP and regulatory capital per regulations. The following table indicates where these definitions are the same and where they differ.

GAAP Capital	**Regulatory Capital**
Common Stock – Par value	Common Stock – Par Value
Non-Cumulative Perpetual Preferred Stock – Par Value	Non-Cumulative Perpetual Preferred Stock – Par Value
Cumulative Perpetual Preferred Stock – Par Value	N/A
Paid-in Capital – Common Stock	Paid-in Capital – Common Stock
Paid-in Capital - Non-Cumulative Perpetual Preferred Stock	Paid-in Capital - Non-Cumulative Perpetual Preferred Stock
Paid-in Capital - Cumulative Perpetual Preferred Stock	N/A
Trust Preferred Securities	N/A
Retained Earnings	Retained Earnings

Accumulated Other Comprehensive Income	N/A

Regulatory Capital Requirements

The Enterprises are generally required to maintain minimum capital levels, as determined by regulations, to mitigate credit, market, interest rate and operational risks. As noted previously, the FHFA placed the Enterprises into Conservatorship in September 2008 and suspended capital classifications after the 3Q08 capital classification under the Safety and Soundness Act. Appropriate capital requirements will be implemented if and when the Enterprises exit Conservatorship. At this time, the FHFA monitors the capital needs of the Enterprises and authorizes special draws from Treasury pursuant to the SPSPAs to ensure each Enterprise maintains a positive GAAP net worth.

After Conservatorship, both Enterprises' common and preferred stocks were delisted from the New York Stock Exchange (NYSE). They currently trade in the over-the-counter market. Given the Conservatorships, FHFA suspended regulatory capital classifications. FHFA has not issued capital classifications since September 2008. Any capital needs (ensuring both Enterprises maintain positive GAAP net worth) are fulfilled by Treasury under the SPSPAs. Information about these agreements is available on the FHFA's website and in all SEC filings by the Enterprises.

The SPSPAs require the Enterprises to maintain positive GAAP net worth. Any need for funding will increase the Liquidation Preference Share price (the stock value) by an amount commensurate with the draw needs of the Enterprise. Under this arrangement, FHFA administers the draws and subsequent dividend payments to Treasury by the Enterprises.

Capital requirements for the Enterprises are discussed below; however, due to the Conservatorship, examiners need not conduct supervisory activities related to these requirements.

Core Capital

The Safety and Soundness Act defines core capital as (as determined in accordance with GAAP) the sum of the par or stated value of outstanding common stock; the par or stated value of outstanding perpetual, noncumulative preferred stock; paid-in capital; and retained earnings. The core capital of an Enterprise does not include any amounts that the Enterprise could be required to pay, at the option of investors, to retire capital instruments.

Total Capital

This measure of capital is determined by summing core capital, the general allowance, and reserves the Director deems as part of total capital; it excludes specific reserves. For regulatory measurement purposes, total capital must exceed risk-based capital.

Minimum Capital

The Safety and Soundness Act establishes a formulaic measurement of the Enterprises' on- and off-balance sheet assets. This is a measure to ensure that asset growth does not exceed a sustainable capital base and to ensure on and off balance sheet asset growth is effectively managed. The general calculation requires 2.5 percent of the on-balance sheet assets plus 0.45 percent of the adjusted off-balance sheet assets as the minimum capital requirement. The result is then compared to the Enterprise's core capital.

Risk-Based Capital

The Enterprises were subject to a risk-based capital test prior to Conservatorship. It was published in 2001, implemented in 2002 and suspended in 2011. FHFA does not currently use this model.

FHFA previously required the Enterprises to maintain capital levels that exceeded estimates resulting from risk-based modeling of capital needs. An assessment of the Enterprise's capital requirements included estimating additional capital needs based on changing internal and external factors. The Safety and Soundness Act requires a capital measure that measures risk in the context of the overall portfolio, including the effectiveness of the Enterprise's risk management activities. The stress test simulated an Enterprise's financial performance over a 10-year period under severe economic conditions, including high levels of mortgage defaults, with associated losses and large, sustained movements in interest rates. The estimated capital required to survive the stress test is compared to the total capital figure. The total capital level must exceed the binding risk-based capital requirement. A shortfall results in an undercapitalized condition for an Enterprise.

Prompt Corrective Action

Standards and remedies for Prompt Corrective Action for the Enterprises are detailed in 12 CFR Part 1777 of OFHEO's rules and regulations.

The Safety and Soundness Act requires the FHFA's Director to determine the Enterprise's capital classification, on a quarterly basis. Since the Enterprises have been in Conservatorship, the capital classifications for each have been suspended. When the capital classifications were issued by FHFA, they were based upon the following:

> *Adequately capitalized* – Except where the Director has exercised the authority to reclassify an Enterprise, an Enterprise shall be considered adequately capitalized

if, at the time of the determination under 12 CFR 1777.21(a), the Enterprise holds total capital equaling or exceeding the risk-based capital level and holds core capital equaling or exceeding the minimum capital level.

Undercapitalized - Except where the Director has exercised the authority to reclassify an Enterprise, an Enterprise shall be considered undercapitalized if, at the time of the determination under 12 CFR 1777.21(a), the Enterprise holds total capital less than the risk-based capital level and holds core capital equaling or exceeding the minimum capital level.

Significantly undercapitalized - Except where the Director has exercised the authority to reclassify an Enterprise, an Enterprise shall be considered significantly undercapitalized if, at the time of the determination under 12 CFR 1777.21(a), the Enterprise holds core capital less than the minimum capital level and holds core capital equaling or exceeding the critical capital level.

Critically undercapitalized - Except where the Director has exercised the authority to reclassify an Enterprise, an Enterprise shall be considered critically undercapitalized if, at the time of the determination under 12 CFR 1777.21(a), the Enterprise holds core capital less than the critical capital level.

The capital regulations provide discretionary reclassification authority to the Director and specify certain restrictions and remedies under the PCA provisions. An Enterprise may not make a capital distribution if, after doing so, the Enterprise's total capital would be less than risk-based capital or the core capital of the Enterprise would be less than the minimum capital level without the prior approval of the FHFA. In addition, if the Enterprise is not classified as adequately capitalized, it shall make no capital distribution that would result in the Enterprise being classified into a lower capital classification than the one to which it is classified at the time of the distribution. Finally, if the Enterprise is classified as significantly or critically undercapitalized, it may not make any capital distribution without the prior written approval of the FHFA. If an Enterprise is classified as undercapitalized, significantly undercapitalized, or critically undercapitalized, the Enterprise must submit a capital restoration plan in writing to the FHFA.

Examination Guidance

The workprogram for the Capital module is detailed below. If this module is included in the examination scope, the examiner must perform work steps sufficient in coverage to document the basis for conclusions on the quantity of risk and quality of risk management pertaining to this area. The Examiner is not required to perform each workstep, but must document the reason(s) for omitting a portion of the workprogram. Transaction testing, however, is mandatory and must evidence sufficient worksteps from Section 4, *Testing* to support the findings and conclusions from this examination module.

In determining the extent of review and testing to be conducted in completing each examination, the examiner should take into account and document applicable FHFA off-site monitoring or analysis reports, such as analyses of the quality and effectiveness of corporate governance practices, financial condition and performance, economic and housing industry conditions, internal controls, and audit coverage relating to the institution's capital management.

NOTE: Text in (*italics*) referenced in a workstep represents illustrative guidance that serves as suggestions for specific inquiry.

1. Scope of Examination Work Performed

1) Review past reports of examination for outstanding issues or previous problems related to capital.

2) Review FHFA off-site monitoring or analysis reports, and workpapers produced as part of on-going monitoring, related to capital.

3) Assess the status or review the remediation progress based on management's commitments of any outstanding examination findings (e.g., Matters Requiring Attention, Violations, or Recommendations) or remediation plans pertaining to the Enterprise's management of multifamily credit risk.

4) Review internal audit reports for outstanding issues relating to capital.

5) Review minutes of meetings of the board of directors and relevant board and management committees for any issues regarding capital.

6) Review on-going reporting related to the regulated entity's capital position, including reports in the FHFA call reporting system.

7) Review any reports dealing with the financial condition and performance of the regulated entity.

8) Identify potential risks to the institution's capital position.

9) For FHLBanks, in conjunction with examiners responsible for the credit, market and operational risk areas, consider the adequacy of capital in protecting the regulated entity from future losses.

10) For FHLBanks, evaluate the regulated entity's current capital levels and conclude on the adequacy of capital in meeting regulatory requirements. If warranted, make recommendation to the Director on adjusting capital requirements.

Summarize the work performed in the examination of capital. To the extent there were modifications to the originally planned scope based on concerns identified during the examination, document those changes and the reasons for such changes.

2. Description of Risks

1) Review recent SEC filings for issues or concerns related to capital.

2) Review any prompt corrective actions and any limitations placed on the institution.

3) Review any enforcement actions to determine any capital restrictions.

4) Review information from the Call Report System for trends in capital since the previous examination.

5) Identify and assess any changes in the institution's products or condition that might affect capital.

6) Identify and assess any market, regulatory or other events that might affect capital.

7) Review income projections for the regulated entity. Assess forecasts for AOCI. Conclude on the effect these financial forecasts may have on capital needs in the future. Determine if capital is likely to be adversely affected by these projections.

3. Risk Management

Risk Identification Process

1) Based on worksteps performed under **Description of Risks**, assess and conclude on the adequacy of the institution's risk identification process. *(Has the institution appropriately identified all areas of potential risk that could affect capital? Is risk exposure monitored on an ongoing basis? Does the institution report on risk exposure to the appropriate parties within the organization?)*

2) Evaluate the effectiveness of the annual risk assessment and determine if it reasonably identifies all material risks, both quantitative and qualitative aspects, of

the institution's capital management program. Investigate any action plans arising from the assessment and check corrective actions for effectiveness.

3) Evaluate the effectiveness of management planning, reporting and responding to capital needs of the organization. (*Has management adequately considered potential threats to the institution's capital in its risk identification process? How has management planned and, responded to the DFAST results?)*

4) Identify and analyze executive management communication to the Board regarding meaningful and significant risks faced by the institution.

Organizational Structure

1) Determine how decisions regarding retained earnings and dividends are made and who is responsible.

2) Evaluate the quality of capital management staffing.

3) Assess the adequacy of contingency procedures that ensure data accuracy.

4) Evaluate executive level capital management *(Are individuals charged with managing the regulated entity's overall financial condition aware of risks? Do they consider these risks when making decisions related to the entity's capital position?)*

Policy and Procedure Development

1) Assess the adequacy of the retained earnings and dividend policy. (*Are retained earnings in excess of required risk-based capital? Does the institution's retained earnings target consider credit, market, and operational risks? What confidence level does the institution use in determining its target? Does the institution consider the various risks it considers in determining its retained earnings target to be independent or correlated? To what extent does the institution use insurance products to mitigate operational risks?)*

2) Assess the adequacy of the risk management policy as it pertains to capital.

3) Evaluate procedures to ensure compliance with capital regulations and the effectiveness of those procedures.

4) Evaluate procedures to ensure compliance with internal policies and the effectiveness of those procedures.

Risk Metrics

1) Evaluate the method used to determine dividend levels and retained earnings levels and ascertain the extent of board involvement in these decisions.

2) Review the reasonableness of the strategic plan and budget as it relates to capital.

3) Assess capital plans and evaluate the plans relative to actual results for the period under examination.

4) Assess the appropriateness of capital risk metrics.

5) Identify and analyze management- produced metrics for board of directors use. *(Are they produced periodically? Are the metrics, meaningful? Does the board understand the information? Does the board question management and direct them to take action(s)?)*

Reporting

1) Evaluate the reporting to executive management of capital risk metrics. (*Do such metrics appropriately consider all aspects of potential risk to the organization? Is management communicating the data that the executive management needs to know?*

2) Evaluate the reporting to the board of capital risk metrics. *(Do such metrics appropriately consider all aspects of potential risk to the organization? Is executive management communicating the data that the board needs to know?)*

3) Evaluate and conclude on the appropriateness of metrics and reporting. (*Does reporting include an evaluation of potential risks to the institution's capital?)*

Internal/External Audit

1) Evaluate the adequacy of the scope, testing, and workpapers completed by internal audit. (*Has the audit function considered potential threats to capital and evaluated the appropriateness and accuracy of reporting capital levels?*)

2) Evaluate the adequacy of the scope and testing completed by external audit and determine the status of corrective actions for findings. (*Are all areas of potential risk considered? If not, why not? Are reasons for not including certain areas within the scope of the audit work reasonable and supported?)*

Information Technology

1) Identify and assess the automated and manual systems and applicable controls used for determining capital ratios and capital risk metrics.

2) Evaluate potential concerns related to manual entry and non-automated feeds of information. *(Are reports produced accurate and timely?)*

Compliance

1) Evaluate and conclude on the adequacy of the regulated entity's efforts to ensure compliance with regulatory guidance.

2) Identify actions necessary, if applicable, to address the failure to meet regulatory requirements or the regulated entity's policy/ procedural requirements.

3) Evaluate and conclude on the adequacy of the institution's efforts to ensure compliance with its own internally-developed standards related to capital adequacy.

4. Testing

1) Evaluate the DFAST process. Reference should be made to "Dodd Frank Stress Tests Summary Instructions and Guidance" dated November 26, 2013 and any subsequent amendments to this document. The examination of DFAST at the Enterprises also should be in alignment with any parameters defined by the SPSPA. *(Are the regulated entities able to absorb losses stemming from DFAST? Is the regulated entity's DFAST process based upon a core foundation of strong internal controls for the following risk disciplines: governance, modeling, market, credit, operational and enterprise-wide risks?)*

2) For the FHLBanks, ensure all capital ratios comply with regulations.

3) Evaluate the institution's compliance with plans developed for the management of capital.

4) Assess the long-term and recent trend of total GAAP capital and total regulatory capital.

5) For the FHLBanks, assess the long-term and recent trends of the institution's retained earnings.

6) For the FHLBanks, evaluate and conclude on the adequacy of the FHLBank's actions to establish restricted retained earnings accounts per the terms of the System-wide agreement.

7) For the FHLBanks. assess the recent and long-term trends of capital stock.

5. Conclusions

1) Summarize conclusions for all examination work performed, including work performed by other FHFA staff as it relates to the regulated entity's capital. Develop a memorandum describing the risks to the institution related to capital and the regulated entity's management of those risks. The memorandum should clearly and articulately describe the basis of conclusions reached and summarize the analysis completed. Discuss the types of risk the regulated entity is exposed to in the capital area (*e.g.*, market, credit, operational); the level of risk exposure; the direction of risk (stable, decreasing, increasing); and the quality of risk management practices (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative. For FHLB examinations, the memorandum should include a recommended rating for the Capital area based on the FHFA examination rating system.

2) Conclude on the responsiveness to previous examination findings. Evaluate the adequacy of the regulated entity's response to previous examination findings and concerns.

3) Develop findings and prepare supporting memoranda, as appropriate. Based on examination work performed, develop findings communicating concerns identified during the examination. Findings should identify the most significant risks to the institution and the potential effect to the regulated entity resulting from the concerns identified. Findings should describe a remediation plan specifying the appropriate corrective action to address examination concerns and establish a reasonable deadline for the regulated entity to remediate the finding. Communicate preliminary findings to the EIC, other interested examiners, and senior FHFA staff, as appropriate. Discuss findings with regulated entity personnel to ensure the findings are free of factual errors or misrepresentations in the analysis.

4) Develop a list of follow-up items to evaluate during the next annual examination. In addition to findings developed in the steps above, include concerns noted during the examination that do not rise to the level of a finding. Potential concerns include issues the regulated entity is in the process of addressing, but require follow-up work to ensure actions are completed appropriately. In addition, potential concerns should include anticipated changes to the institution's practices or anticipated external changes that could affect the institution's future capital needs or management practices.

Workprogram

1. Scope of Examination Work Performed

Workpapers must document the examination activities undertaken to evaluate potential risks related to capital.

2. Description of Risks

- Identify areas of concern related to capital
- Assess current risks and trends in the risk to the institution related to capital
- Evaluate changes within the institution or industry affecting risk
- Evaluate the entity's own risk-identification practices and conclude on their adequacy

3. Risk Management

- Assess and conclude on the adequacy of the institution's risk identification process
- Assess and conclude on the overall adequacy of internal controls, including an evaluation of:
  - The regulated entity's organizational structure
  - Policy and procedure development for this area
  - Appropriateness of risk metrics established in this area
  - Reporting by management and the board
- Assess and conclude on the internal and external audit of risks
- Assess and conclude on the adequacy of information technology and controls related to capital
- Assess and conclude on the adequacy of the institution's efforts to ensure:
  - Compliance with laws, regulations and other supervisory guidance
  - Compliance with the organization's policies and procedures

4. Testing

- Complete testing, as appropriate, to assess adherence with examination standards

5. Conclusions

- Summarize conclusions for all examination work performed related to capital
  - Conclude on the level of risk to the institution
  - Include an assessment of the adequacy of an institution's monitoring of risk and establishment of internal controls to mitigate risk
- Conclude on responsiveness to examination findings from previous examinations
- Develop examination findings , as appropriate
- Identify areas requiring follow-up examination activities or monitoring