UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

CHRISTOPHER ROBERTS, and THOMAS P. FISCHER, Plaintiffs, v. THE FEDERAL HOUSING FINANCE AGENCY, in its capacity as Conservator of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, MELVIN L. WATT, in his official capacity as Director of the Federal Housing Finance Agency, JACOB J. LEW, in his official capacity as Secretary of the Treasury, and THE DEPARTMENT OF THE TREASURY, Defendants.	Civil Action No. 1:16-CV-02107

MEMORANDUM IN SUPPORT OF MOTION TO DISMISS BY DEFENDANTS FEDERAL HOUSING FINANCE AGENCY AS CONSERVATOR FOR FANNIE MAE AND FREDDIE MAC, AND FHFA DIRECTOR MELVIN L. WATT

Plaintiffs' Amended Complaint should be dismissed for the reasons stated in Defendants' Joint Brief and Treasury's Individual Brief. In this brief, the Federal Housing Finance Agency and Melvin L. Watt (together, "FHFA Defendants") provide two additional arguments for dismissal. First, Plaintiffs' claims are barred by 12 U.S.C. § 4623(d), which 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 . . . or to review, modify, suspend, terminate, or set aside such classification or action." Second, legislation enacted in 2015 supports the conclusion that the Third Amendment was within the statutory powers of

FHFA and Treasury under HERA—providing further support for the Joint Brief's argument that Section 4617(f) bars the relief Plaintiffs seek.

ARGUMENT

I. Section 4623(d) Bars Plaintiffs' Claims

Section 4623(d) of HERA provides another independent ground for dismissing Plaintiffs' claims. This statutory provision protects supervisory actions taken by FHFA's Director when acting in his capacity as regulator of the Enterprises. Separate from FHFA's powers and functions as Conservator, FHFA's Director is empowered by statute to classify the capital levels of the Enterprises on a quarterly basis, as part of the Director's ongoing monitoring of the Enterprises' safety and soundness. *See* 12 U.S.C. §§ 4611-4624. The Director is also empowered to take a variety of supervisory actions concerning the Enterprises' capital, which can culminate in the appointment of a conservator or receiver. *Id.* Section 4623(d), in turn, protects the Director's exercise of powers in this regard, barring any judicial action that would affect either a capital classification decision by the Director, or any supervisory action taken by the Director with regard to the capital of the Enterprises. In particular, 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 (other than appointment of a conservator under section 4616 or 4617 of this title . . .) or to review, modify, suspend, terminate, or set aside such classification or action." 12 U.S.C. § 4623(d).

Here, although 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 effectiveness" of actions taken by FHFA wholly in its regulatory capacity. 12 U.S.C. § 4623(d). Specifically, Plaintiffs' claims and requested relief would override FHFA's *regulatory* action, taken in October 2008, to suspend and replace the

capital classification system and regulatory capital requirements with a new capital paradigm (the "October 2008 Action").

The October 2008 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 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, *available at* http://goo.gl/MzpAUH (attached as **Exhibit A**). In announcing this action, taken pursuant to his supervisory powers over the Enterprises, the Director declared that, although FHFA "will continue to closely monitor capital levels" of the Enterprises, "***the existing statutory and FHFA-directed regulatory capital requirements will not be binding during the conservatorship***." *Id.* (emphasis added). Plaintiffs acknowledge this action of the Director in the Amended Complaint. Am. Compl. ¶ 146 ("FHFA has announced that, during the conservatorship, existing statutory and FHFA-directed regulatory capital requirements will not be binding on the Companies.").

The October 2008 Action was a supervisory action that 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 Action 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. The new capital paradigm established via the October 2008 Action 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. Further, the FHFA Examination Manual--which governs supervision of the Enterprises and implementation of FHFA regulatory policy through the examination process--implements the October 2008 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 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]").[1]

Plaintiffs' claims directly implicate FHFA's regulatory action suspending capital classifications for the Enterprises in conservatorship and permitting them to be "capitalized" by the Treasury commitment. In particular, Plaintiffs argue that the Conservator acted outside of its statutory powers and functions in agreeing to the Third Amendment because it allegedly does not put the Enterprises in a "sound and solvent" condition. *See, e.g.*, Am. Compl. ¶ 26, 102, 116-119, 131. Indeed, Plaintiffs specifically argue that the Third Amendment "[f]orc[es] the Companies to operate in [an] inherently unsafe and unsound condition" because it allegedly makes the Enterprises unable to comply with traditional capital standards. *Id.* ¶ 115. For example, Plaintiffs allege:

> All other financial institutions are required to retain minimum levels of capital that ensure that they can withstand the vicissitudes of the economic cycle and are prohibited from paying dividends when they are not adequately capitalized. The Companies, in contrast, are not allowed to retain capital but instead must pay their entire net worth over to Treasury as a quarterly dividend. In other words, whereas other financial institutions are subject to *minimum* capital standards, the Net Worth Sweep makes the Companies

[1] *See also* 12 C.F.R. § 1234.8(a)(1) (joint financial regulator rule acknowledging that the Enterprises in conservatorship are operating "with capital support from the United States").

> subject to a capital *maximum*—any amount of retained capital that they hold in excess of a small and diminishing capital buffer is swept to Treasury on a quarterly basis. The effect of the Net Worth Sweep is thus to force the Companies to operate in perpetuity on the brink of insolvency . . . . In other contexts, federal regulators understand such an arrangement to be fundamentally unsafe and unsound, if not altogether unlawful.

Id. ¶ 116.

Plaintiffs' argument, and their demand that the Third Amendment be rescinded on this basis, is directly contrary to and would plainly "affect . . . the effectiveness" of the regulatory action taken by FHFA to suspend the existing capital classifications and regulatory capital requirements, and to regulate and supervise the Enterprises in conservatorship as having been "capitalized via the [PSPAs]." FHFA Examination Manual at "Capital," p. 1. Further, Plaintiffs' allegations confirm that none of the Third Amendment-related actions challenged in this litigation would have or could have been taken by the Conservator had the Director not previously taken the regulatory action necessary 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 Plaintiffs' favor would thus "affect . . . the effectiveness of"--of the Director's *regulatory* action taken in October 2008.

More generally, were the Court to adopt Plaintiffs' claims, it would effectively nullify the purpose and intended effect of the October 2008 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). Rescinding the Third Amendment on the ground that it fails to promote safety and soundness would doubtless "affect . . . the effectiveness" of the Director's October 2008 action (and also "affect," "review," "modify," "terminate," and/or "set aside" the Action). Section 4623(d) thus bars

Plaintiffs' claims challenging the Third Amendment as inconsistent with sound and solvent operations or the purported statutory obligations and duties of FHFA as Conservator or regulator.

In sum, although Plaintiffs' claims purport to target only the Conservator, they nevertheless seek to limit "the effectiveness" of covered actions taken by FHFA wholly in its regulatory capacity. A ruling in favor of 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.

II. Recently Enacted Federal Legislation Confirms that FHFA and Treasury Acted Within Their Statutory Authority in Executing the Third Amendment

As explained in Defendants' Joint Brief, the Conservator and Treasury acted squarely within their respective statutory authorities in executing the Third Amendment, and thus 12 U.S.C. § 4617(f) bars the relief Plaintiffs seek. The Consolidated Appropriations Act, 2016 (the "Act"), enacted on December 18, 2015, provides further support for this conclusion. *See* Pub. L. No. 114-113, § 702, Tit. VII, Div. O, 129 Stat. 2242 (Dec. 18, 2015).

The Act directly addresses the PSPAs, amending certain aspects of those agreements while leaving other aspects intact. In particular, the Act bars Treasury from selling or otherwise disposing of its preferred shares in the Enterprises, which it holds by virtue of the PSPAs, until at least January 1, 2018. *Id.* § 702(b).[2] The Act otherwise leaves in place Treasury's rights and

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[2] Treasury otherwise had such authority under 12 U.S.C. § 1719(g)(2)(B) ("The Secretary of the Treasury may, at any time, subject to the terms of the security or otherwise upon terms and conditions and at prices determined by the Secretary, sell any obligation or security acquired by the Secretary under this subsection.") and 12 U.S.C. § 1455(*l*)(2)(B) (same).

authority under the PSPAs. *See id*. Most significantly, Congress expressly recognized that the PSPAs had been amended by virtue of the Third Amendment by referencing that amendment in the "Definitions" section of the Act. Pub. L. No. 114-113, § 702(a) (defining the "Senior Preferred Stock Purchase Agreement" as the September 26, 2008 "Amended and Restated Senior Preferred Stock Purchase Agreement, dated September 26, 2008, as such Agreement has been amended on May 6, 2009, December 24, 2009, *and August 17, 2012* . . . .") (emphasis added).

Congress thus decided to circumscribe Treasury's authority in one area (the right to sell its shares), but to leave intact all other provisions of the PSPAs as amended, necessarily including Treasury's entitlement to the net worth dividend under the Third Amendment. This decision demonstrates that the scope of the Conservator's and Treasury's powers includes the authority to execute the Third Amendment. As the Supreme Court has held, "[w]here an agency's statutory construction has been fully brought to the attention of the public and the Congress, and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned." *N. Haven Bd. of Ed. v. Bell*, 456 U.S. 512, 535 (1982) (internal quotation marks and citation omitted); *see also Doe v. Bin Laden*, 663 F.3d 64, 69 (2d Cir. 2011) ("'Congress is presumed to be aware of a judicial interpretation of a statu[tory section]' and partial amendment of a statute without touching the previously interpreted section 'constitutes an implicit adoption of [the prior] interpretation,' absent a clear indication to the contrary." (quoting *Elkimya v. Dep't of Homeland Security*, 484 F.3d 151, 154 (2d Cir. 2007)).

There can be no doubt that the PSPAs, including each of the three amendments thereto, have "been fully brought to the attention of . . . Congress." *N. Haven Bd. of Ed.*, 456 U.S. at 535. Again, in the Act itself, Congress expressly referenced the Third Amendment's August 17, 2012

revisions to the PSPAs in the "Definitions" provision of Section 702(a). Pub. L. No. 114-113, § 702(a). And Treasury has reported to Congress about the Enterprises' fulfillment of its payment obligations under the PSPAs. *See, e.g.*, 12 U.S.C. §1455(*l*)(1)(D).

Moreover, officials of both FHFA and Treasury have testified before Congress about the operation and effect of the net worth dividend,[3] and specifically about whether the then-proposed "Jumpstart GSE Reform Act," ultimately adopted as part of the Act, would affect the PSPAs, which by that time already had been amended to include the net worth dividend.[4] Specifically, on April 18, 2013, a Senate Banking Committee member asked then Acting FHFA Director DeMarco how the proposed legislation would affect the PSPAs. Mr. DeMarco explained that the then-proposed legislation would not affect the operation of the Conservatorships under the PSPAs as revised by the Third Amendment, or the continued payments to Treasury for the benefit of taxpayers:

> [It] does not have any effect on the current state of conservatorship or the terms of the Preferred Stock Purchase Agreements (PSPAs). The bill will ensure that the returns on investment that the taxpayers funded through the PSPAs with each Enterprise continue to benefit the taxpayers . . . .[5]

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[3] *See, e.g.*, *Sustainable Hous. Fin.: An Update from the Dir. of the Fed. Hous. Fin. Agency: Hearing Before the Comm. on Fin. Servs.*, 114th Cong. 21-22 (2015) (statement of Melvin L. Watt), *available at* https://goo.gl/BWKay4.

[4] *Oversight of Fed. Hous. Fin. Agency: Evaluating FHFA as Regulator and Conservator: Hearing Before the Comm. on Banking, Hous., and Urban Affairs*, 113th Cong. 56-57 (2013) (statement of Edward DeMarco), *available at* https://goo.gl/2w6awm.

[5] *Id.*

Finally, Congress is also aware of the litigation about the Third Amendment.[6] Thus, when it enacted the Consolidated Appropriations Act, Congress was fully informed regarding the PSPAs, the net worth dividend, and the litigation surrounding it. Congress considered whether the Act would affect the Third Amendment, was assured that the Third Amendment would not be disturbed, and enacted the statute. In these circumstances, passage of the Act serves as congressional confirmation that the Third Amendment was within the statutory authority of the Conservator and Treasury, and therefore Plaintiffs' challenge to the net worth dividend is precluded by § 4617(f). *See N. Haven Bd. of Ed.*, 456 U.S. at 535.

CONCLUSION

For the foregoing reasons, as well as the reasons stated in the Joint Brief and Treasury's Brief, FHFA respectfully requests the Court dismiss with prejudice all claims asserted against it.

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[6] In a speech on the Senate floor prior to passage of the Act, Senator Corker rejected as "totally inappropriate" the recapitalization and release of the Enterprises, noting that passage of this legislation "put[s] to bed the idea that returning to the status quo is an option." 161 Cong. Rec. S8760-61 (daily ed. Dec. 17, 2015) (statement of Sen. Corker). Senator Corker recognized "that the hedge funds still have claims to deal with in court" noting that the now just-passed legislation "does not prejudice those claims." *Id.* at S8760; *see also id.* at S8857 (daily ed. Dec. 18, 2015) (statement of Sen. Brown). While the new legislation does not directly address the ongoing litigation, it does support the conclusion that Congress views the net worth dividend as within the statutory authority of FHFA and Treasury. *See N. Haven Bd. of Ed.*, 456 U.S. at 535.

Dated: July 13, 2016

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing was filed electronically using the Court's CM/ECF system, causing a true and correct copy to be served on all counsel of record.

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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.

<u>Other Regulatory Requirements</u>

> *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

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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