

**FEDERAL HOUSING FINANCE BOARD****12 CFR Part 935**

[No. 99-21]

RIN 3069-AA83

**Prohibition on Payment of Fee In Lieu of Mandatory Excess Capital Stock Redemption**

AGENCY: Federal Housing Finance Board.

ACTION: Interim final rule.

**SUMMARY:** The Federal Housing Finance Board (Finance Board) is amending its regulation governing Federal Home Loan Bank (Bank) advances to prohibit the Banks from imposing or accepting a fee in lieu of redeeming a member's excess capital stock held in the Bank. The Finance Board has determined that allowing the payment of such fees would detract from the agency's ongoing efforts and initiatives to ensure that the Banks carry out their housing finance and community investment mission.

**EFFECTIVE DATE:** This interim final rule shall be effective on April 6, 1999. The Finance Board will accept written comments on this interim final rule on or before May 6, 1999.

**FOR FURTHER INFORMATION CONTACT:** Joseph A. McKenzie, Deputy Chief Economist, (202) 408-2845, Office of Policy, Research and Analysis; or Sharon B. Like, Senior Attorney-Advisor, (202) 408-2930, or Jane S. Converse, Senior Attorney-Advisor, (202) 408-2976, Office of General Counsel, Federal Housing Finance Board, 1777 F Street, N.W., Washington, D.C. 20006.

**SUPPLEMENTARY INFORMATION:****I. Statutory and Regulatory Background****A. The Banks' Housing Finance and Community Investment Mission**

The Federal Home Loan Bank System (Bank System) is comprised of 12 District Banks that are federally chartered and managed by boards of directors that set policies pursuant to regulations established by the Finance Board. As government-sponsored enterprises (GSEs), the Banks act as intermediaries in the capital markets, raising funds on favorable terms and passing the proceeds on to member institutions in the form of advances (loans).

Under section 10(a) of the Federal Home Loan Bank Act (Bank Act) and part 935 of the Finance Board's regulations, the Banks have broad authority to make advances in support of housing finance, which includes

community investment finance. See 12 U.S.C. 1430(a), (i), (j); 12 CFR part 935. The Banks also are required to offer two programs, the Affordable Housing Program (AHP) and the Community Investment Program (CIP), to provide subsidized or at-cost advances, respectively, in support of unmet housing finance or economic development credit needs. See 12 U.S.C. 1430(i), (j); 12 CFR parts 960, 970. In addition, section 10(j)(10) of the Bank Act, as implemented by a recently issued Finance Board regulation, authorizes the Banks to establish Community Investment Cash Advance (CICA) Programs for community lending, defined as providing financing for economic development projects for targeted beneficiaries. See 12 U.S.C. 1430(j)(10); 63 FR 65536 (Nov. 27, 1998).

The Bank Act provides that the Finance Board's primary duty is to ensure that the Banks operate in a financially safe and sound manner. See *id.* section 1422a(a)(3)(A). The Bank Act further provides that, to the extent consistent with this primary duty, the Finance Board also is responsible for supervising the Banks, ensuring that the Banks carry out their housing finance mission, and ensuring that the Banks remain adequately capitalized and able to raise funds in the capital markets. See *id.* section 1422a(a)(3)(B).

**B. Statutory and Regulatory Minimum Capital Stock, Dividend and Redemption Provisions**

Under the Bank Act and implementing Finance Board regulations, a member's required minimum capital stock investment in its Bank is the greater of: (1) 1 percent of the member's aggregate unpaid loan principal (defined as the member's home mortgage loans, home purchase contracts, and similar obligations) but not less than \$500; (2) 0.3 percent of the member's total assets; or (3) 5 percent of total advances outstanding to the member. In the case of members that are not "qualified thrift lenders" (QTLs), the third option is computed as 5 percent of total advances outstanding to the member divided by the member's "actual thrift investment percentage" (as defined in 12 U.S.C. 1467a(m)). See 12 U.S.C. 1426(b)(1), (2), (4); 1430(c), (e)(1), (3); 12 CFR 933.20(a).

Section 6(b)(1) further provides that the Bank shall annually adjust, at such time and in such manner as the Finance Board may by regulations or otherwise prescribe, the amount of capital stock held by each member so that such member shall have invested its minimum capital stock requirement. See

*id.* section 1426(b)(1); 12 CFR 933.22(b)(1). Section 6(b)(1) also provides that if the Bank finds that the investment of any member in capital stock is greater than that required under section 6(b), the Bank may, unless prohibited by the Finance Board, in its discretion and upon application of the member, retire the capital stock of such member in excess of the amount so required. See *id.* section 1426(b)(1); 12 CFR 933.22(b)(2).

Section 16(a) of the Bank Act provides, among other things, that dividends may be paid by the Banks with the approval of the Finance Board. See 12 U.S.C. 1436(a). Section 6(g) of the Bank Act provides that all stock of any Bank shall share in dividend distributions without preference. See *id.* section 1426(g). Section 934.17 of the Finance Board's regulations on the operations of the Banks implements these provisions by providing, among other things, that dividends may be paid by the Banks in cash or in the form of stock. See 12 CFR 932.3; 63 FR 65683, 65687 (Nov. 30, 1998) (redesignating § 932.3 as § 934.17).

Section 935.15(b) of the Finance Board's Advances Regulation provides that "[a] Bank, after providing 15 calendar days advance written notice to a member, may unilaterally redeem that amount of the member's Bank stock that exceeds" the member's minimum statutory and regulatory capital stock requirements. See 12 CFR 935.15(b). Section 935.15(b) further provides that the Bank shall have discretion to determine the timing of such unilateral redemption, provided that the Bank's redemption policy is consistent with the requirement in section 7(j) of the Bank Act that the affairs of the Bank shall be administered fairly and impartially and without discrimination in favor of or against member borrowers, see 12 U.S.C. section 1427(j).

The Bank Act and § 935.15(b) of the Advances regulation are silent on whether a Bank, in administering its mandatory redemption policy, may impose on or accept from a member a fee in lieu of redeeming the member's excess Bank capital stock.

**II. Analysis of the Interim Final Rule****A. Proposed Fee In Lieu of Mandatory Excess Capital Stock Redemption**

A Bank has adopted a policy, effective March 31, 1999, pursuant to which the Bank generally will redeem that amount of each member's capital stock exceeding 115 percent of the member's minimum statutory capital stock requirement, with an option, if lawful and appropriate, for the member to pay

a fee to the Bank in lieu of such redemption. The Bank has requested confirmation from the Finance Board that the proposed fee would be authorized under the Bank Act and Finance Board regulations.

As noted above, the Bank Act and § 935.15(b) of the Finance Board's Advances regulation are silent on whether a Bank may impose on or accept from a member a fee in lieu of redeeming the member's excess Bank capital stock. Even though the Bank Act is susceptible to an interpretation that the payment of such fees would be authorized under law, the Finance Board has determined that allowing the payment of such fees would detract from the agency's ongoing efforts and initiatives to ensure that the Banks carry out their housing finance and community investment mission, as discussed below. Therefore, the Finance Board is adopting this interim final rule prohibiting the payment of such fees. Although this interim final rule will become effective on the date of publication in the **Federal Register**, the Finance Board requests comment on all aspects of the rule during a 30-day comment period.

According to the Bank, the purpose of the Bank's proposed redemption policy is to enhance the Bank's competitiveness vis a vis other Banks by increasing its earnings per share and therefore its dividend rate. The Bank forecasts that mandatory redemption of surplus capital stock or payment of the fee in lieu of redemption would add approximately 12 basis points to the Bank's quarterly dividend. The Bank has a number of large members owned by holding companies that also have subsidiaries located in other Bank districts. The Bank is concerned that these members may discontinue borrowing from the Bank and that their affiliates will become members and borrow from these other Banks because those Banks pay higher dividend rates than the Bank.

Under the Bank's proposed policy, the Bank would unilaterally redeem "surplus" capital stock (defined by the Bank as capital stock in excess of 115 percent of minimum capital stock requirements but not less than \$100,000) held by all members, unless the member pays a fee to the Bank, on a monthly basis, to continue holding its surplus capital stock. The 115 percent threshold was adopted to allow membership flexibility for future borrowings from the Bank and absorb the stock dividends. The \$100,000 minimum was adopted in order to reduce the operational impact of the redemption policy on smaller members.

The Bank states that the fee, which is 1.65 percent of the value of a member's surplus capital stock, was designed to make the Bank financially indifferent to a member's decision to continue to hold surplus capital stock. The fee income paid to the Bank would act as an offset to the dividend dilution caused by those members holding surplus capital stock.

As of August 31, 1998, the Bank had excess capital stock of \$554 million, or 14 percent of its total capital of \$3.9 billion. The Bank's total "surplus" capital stock, as of August 31, 1998, was \$312 million. One mandatory thrift member held 70 percent of the Bank's total surplus capital stock as of that date. The Bank has excess capital stock, in part, because it pays members quarterly stock dividends rather than cash dividends. The Bank has indicated that paying a stock dividend rather than a cash dividend provides tax benefits for its members, and the Bank intends to continue paying stock dividends for this reason.

#### *B. The Banks Are Significantly Overcapitalized*

By many standards, the 12 Banks are significantly overcapitalized. As of December 31, 1998, the 12 Banks had total capital stock of \$22.8 billion, with \$2.8 billion, or 12.6 percent, of this amount constituting capital stock in excess of the Banks' statutory minimum capital stock requirements. On a risk-adjusted basis (using the current risk-based standards applicable to federally regulated depositories), the total capital is estimated at 22 percent of the Banks' total assets, a level far above that of large commercial banks and other housing GSEs.<sup>1</sup> The highest percentage of excess capital stock to total capital stock at a Bank was 30.1 percent, and the lowest was 1.2 percent.

Even without excess capital stock in the Bank System, *i.e.*, capital stock at only the statutorily required minimum stock levels, the Banks would be significantly overcapitalized. A redemption of all excess capital stock in the Bank System would reduce the Banks' risk-based capital ratio to approximately 19.2 percent.

Members have excess capital stock holdings, in part, because they receive

stock dividends from the Banks. Currently, five Banks pay stock dividends, and seven Banks pay cash dividends. The Internal Revenue Service has ruled that the issuance of stock dividends by the Banks is not taxable income for members. See IRS Rev. Rul. 90-98, November 26, 1990, 1990-48-IR.B.4, 26 CFR 1.305-2. However, cash dividends and redemptions of stock received as dividends generally are taxable income to members. See 26 U.S.C. 301(c), 302(a). Because of the deferred tax liability associated with stock dividends, many members may have allowed their stock dividends to accumulate rather than request redemption of their capital stock, as is their option under the Bank Act. See 12 U.S.C. 1426(b)(1).

The members' holdings of excess capital stock are concentrated, with the largest holder of excess capital stock having 9 percent of the Bank System's total excess capital stock. The top five holders of excess capital stock represent 19 percent of the Bank System's total excess capital stock.

Excess capital stock holdings also arise where members' total assets, home mortgage loans or outstanding advances have decreased since their last capital stock purchases, or where members have changed to QTL status, thereby reducing their advances-based capital stock requirement. Members may continue to hold some excess capital stock in order to minimize the transaction costs associated with capital stock purchases that would be required if the member's levels of total assets, home mortgage loans or outstanding advances fluctuate.

#### *C. The Banks' Arbitrage Activities With Non-Core Mission Assets Detract From the Mission of the Banks To Promote Housing Finance and Community Investment*

The Banks pay dividends on all capital stock, including excess capital stock. Since the average Bank System dividend rate of 6.64 percent exceeds the rate of return a Bank can earn by investing members' capital in core mission assets, a Bank must leverage its excess capital stock to pay dividends. The leveraging cannot involve advances, since they are already capitalized by required capital stock. Thus, the Banks must leverage excess capital stock by investing in non-core mission assets in order to generate sufficient earnings to pay a uniform dividend on all capital stock, including the excess capital stock.

There is a strong correlation between the amount of excess capital stock at a Bank and the level of that Bank's non-

<sup>1</sup> A depository institution generally is deemed to be "well-capitalized" if it has a total risk-based capital ratio of 10 percent or greater, a Tier 1 risk-based capital ratio of 6 percent or greater, and a leverage ratio of 5 percent or greater. See 12 CFR 6.4(b)(1), 208.33(b)(1), 325.103(b)(1), 565.4(b)(1). The minimum capital requirement for the other housing GSEs—the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation—generally is 2.5 percent of on-balance sheet assets plus .45 percent of off-balance sheet obligations. See 12 U.S.C. 4612(a).

core mission assets. In demonstrating the correlation between excess capital stock and non-mission-related assets, the Finance Board looked at the concept of "core mission assets," defined as Bank advances, which include AHP advances and subsidies, CIP advances, community lending advances, Mortgage Partnership Finance assets, and other

assets generated for the Banks by members and nonmember borrowers. Core mission assets do not include mortgage-backed securities (MBS) and money market instruments, which are not generated for the Banks by members or nonmember borrowers and their purchase by the Banks does not materially facilitate housing and

community lending by members or nonmember borrowers. As demonstrated in the following table, the Banks with the highest levels of excess capital stock also have the lowest ratios of core mission assets to consolidated obligations:

EXCESS CAPITAL STOCK AND CORE MISSION ASSETS

Bank	Core mission assets to consolidated obligations (%)	Descending rank	Excess capital stock to total capital stock (%)	Rank
A .....	86.5	1	10.4	7
B .....	85.1	2	1.0	1
C .....	81.8	3	10.2	6
D .....	81.3	4	4.2	2
E .....	80.7	5	3.0	3
F .....	79.7	6	7.8	4
G .....	70.5	7	9.3	5
H .....	69.4	8	17.1	10
I .....	65.4	9	26.8	11
J .....	63.8	10	15.2	8
K .....	59.9	11	30.1	12
L .....	58.6	12	16.2	9
Bank System .....	75.8	.....	12.6	.....

Approximately 75.8 percent of total Bank System consolidated obligations are invested in core mission assets.

The four Banks with the highest ratios of core mission assets to consolidated obligations had ratios of excess capital stock to total capital stock of 10.4 percent, 1.2 percent, 10.4 percent, and 4.2 percent. The five Banks with the lowest ratios of core mission assets to consolidated obligations had the highest ratios of excess capital stock to total capital stock. Of these five, three pay stock dividends, and one pays the highest dividend in the Bank System. At present, core mission assets are no more than 86.5 percent of consolidated obligations at any Bank.

The Finance Board believes that the Banks' arbitrage activities for the purpose of generating sufficient earnings to pay adequate dividends on excess capital stock detract from the mission of the Banks to promote housing finance and community investment, by encouraging activities not related to the Banks' mission and thereby detracting from the financial incentive to engage in mission-related activity. While the Banks' interest in paying a reasonable dividend to members is a legitimate business consideration, and it is appropriate to redeem excess capital stock to assist in this purpose, allowing members to pay a fee in lieu of such mandatory redemption would perpetuate excess capital stock at the Banks and the

Banks' continued need to invest in non-core mission assets to pay dividends on such excess stock.

*D. Amendment of Advances Regulation To Prohibit Payment of Fee In Lieu of Mandatory Excess Capital Stock Redemption—§ 935.15(b)*

For the reasons discussed above, this interim final rule amends § 935.15(b) of the Finance Board's Advances regulation to prohibit the Banks from imposing on or accepting from a member a fee in lieu of mandatory redemption of the member's excess capital stock. Specifically, the interim final rule adds a new paragraph (b)(2) which provides that: "A Bank may not impose on or accept from a member a fee in lieu of redeeming the member's excess Bank capital stock."

In addition, the second sentence of current § 935.15(b), which is redesignated as paragraph (b)(1), is revised to clarify that the Bank's implementation of its redemption policy, and not just the timing of redemptions, shall be consistent with the requirement of section 7(j) of the Bank Act (12 U.S.C. 1427(j)) that the affairs of the Bank shall be administered fairly and impartially and without discrimination in favor of or against any member borrower.

This action is taken as an interim final rule, effective on the date of publication in the **Federal Register**, because the

Bank's proposed fee policy is intended to be effective on March 31, 1999.

**III. Issues For Consideration**

*Reducing Levels of Excess Capital Stock by Prohibiting Payment of Stock Dividends and Requiring Unilateral Redemption of Excess Capital Stock*

The Finance Board believes that the Banks' levels of excess capital stock should be significantly reduced. As discussed above, the Banks are substantially overcapitalized and, thus, reduction in the amount of their excess capital would not adversely affect the safety and soundness of the Banks. The statutory minimum capital stock requirements guarantee that a Bank's capital stock will grow as the scope of its operations increases.

As discussed above, excess capital stock requires the Banks to generate earnings, through investments in non-core mission assets, in order to pay dividends on such stock, which is not needed to capitalize advances and other core mission assets. The Banks' arbitrage activities for this purpose detract from the mission of the Banks to promote housing finance and community investment, by encouraging activities not related to the Banks' mission and thereby detracting from the financial incentive to engage in mission-related activity. A reduction in the amount of excess capital stock would reduce the amount of capital stock on which dividends must be paid, thereby

reducing the level of arbitrage activities conducted in order to generate earnings to pay dividends on such capital stock.

One cause of the Banks' excess capital stock levels is the payment by some Banks of stock dividends rather than cash dividends to members. Prohibiting the Banks from paying stock dividends would help reduce excess capital stock levels in the Bank System and the consequent arbitrage activities.

Another way to reduce excess capital stock in the Bank System and thereby reduce arbitrage activities in non-core mission assets by the Banks, would be to require the Banks to unilaterally redeem members' excess capital stock. In the past year, five Banks unilaterally redeemed their excess capital stock expressly for the purpose of reducing the amount of their money market investments.

The Finance Board recognizes that payment of stock dividends has Federal tax advantages to members over payment of cash dividends, and that excess capital stock redemptions incur Federal tax liabilities for members. However, the private financial advantage to members from minimizing their taxes through the payment of stock dividends, while having no safety and soundness implications for the Banks, ultimately detracts from the Banks' housing finance and community investment mission and serves no other legitimate business purpose for the Banks.

Accordingly, simultaneously with this rulemaking, the Finance Board in a separate Advance Notice of Proposed Rulemaking (ANPRM) published elsewhere in this issue of the **Federal Register**, is requesting comment on how, by what means, and to what extent prohibiting or limiting the Banks' ability to pay stock dividends to members would assist the Finance Board in achieving the goal of reducing excess capital stock in the Bank System. Similarly, the Finance Board is requesting comment on whether the Banks should be required to unilaterally redeem members' excess Bank capital stock to help achieve the goal of reducing excess capital stock in the Bank System. Regarding required unilateral redemption of excess capital stock, the Finance Board specifically requests comment on whether a member should be allowed to maintain some amount of excess capital stock, e.g., 10 percent of its total minimum capital stock requirement, in anticipation of fluctuations in its assets or outstanding advances that may affect its minimum

capital stock requirement. The Finance Board also requests comment on what the timing of unilateral redemptions should be, e.g., no less frequently than quarterly, semi-annually, or annually at the time of the Banks' adjustments of the members' minimum capital stock requirements? The Finance Board also requests comment on whether the currently required 15 days' notice to members before redemption should be retained or modified. In addition, the Finance Board requests comment on whether § 933.23 of the Finance Board's membership regulation, which permits a member to purchase excess capital stock if approved by the Bank, should be removed or modified. See 12 CFR 933.23.

In the alternative, the Finance Board requests comment on whether the Banks should be permitted to hold excess capital stock, but be prohibited from paying dividends on such stock, as a way to reduce the Banks' arbitrage activities with non-core mission assets. The Finance Board also requests comment on whether and to what extent excess capital stock holdings could be allowed so long as they are not being leveraged in the consolidated obligations market. In addition, the Finance Board requests comment on whether excess capital stock holdings should be permitted for a limited period of time, such as up to six months, where the member indicates that it intends to increase its advance borrowings during that time period.

Comments received in response to the ANPRM will be reviewed and considered by the Finance Board in preparation for further action in connection with the issues discussed in the ANPRM.

#### IV. Regulatory Flexibility Act

Because no notice of proposed rulemaking is required for this interim final rule, the provisions of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) do not apply.

#### V. Paperwork Reduction Act

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

#### VI. Notice and Public Participation

The Finance Board for good cause finds that the notice and public comment procedure required by the Administrative Procedure Act is

impracticable, unnecessary or contrary to the public interest in this instance, because the change made by this interim final rule prohibits an immediately pending Bank action that would detract from the Banks' mission to promote housing finance and community investment. See 5 U.S.C. 553(b)(3)(B).

#### List of Subjects in 12 CFR Part 935

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

Accordingly, the Finance Board hereby amends title 12, chapter IX, part 935 of the *Code of Federal Regulations* as follows:

#### PART 935—ADVANCES

1. The authority citation for part 935 continues to read as follows:

**Authority:** 12 U.S.C. 1422a(a)(3), 1422b(a)(1), 1426, 1429, 1430, 1430b, 1431.

2. Section 935.15 is amended by revising paragraph (b) to read as follows:

#### § 935.15 Capital stock requirements; unilateral redemption of excess stock.

\* \* \* \* \*

(b) *Unilateral redemption of excess capital stock; fee in lieu prohibited.* (1) A Bank, after providing 15 calendar days advance written notice to a member, may require the redemption of that amount of the member's Bank capital stock that exceeds the capital stock requirements set forth in paragraph (a) of this section or, in the case of a non-QTL member, the capital stock requirements set forth in § 935.13(a)(1)(ii) of this part, provided the minimum amount required in sections 6(b)(1) and 10(e)(3) of the Act is maintained. The Bank shall have the discretion to determine the timing of such unilateral redemption. The Bank's implementation of its redemption policy shall be consistent with the requirement of section 7(j) of the Act (12 U.S.C. 1427(j)) that the affairs of the Bank shall be administered fairly and impartially and without discrimination in favor of or against any member borrower.

(2) A Bank may not impose on or accept from a member a fee in lieu of redeeming the member's excess Bank capital stock.

Dated: March 19, 1999.

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

**Bruce A. Morrison,**  
*Chairman.*

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