Discussion of the FHLBanks' Capital Structure and Regulatory Capital Requirements

March 23, 2018

The following Q&A summarizes the capital structure of the Federal Home Loan Banks (FHLBanks). The Gramm-Leach-Bliley Act of 1999 (GLB Act) amended the Federal Home Loan Bank Act (FHLBank Act) to permit each FHLBank to issue one or two classes of capital stock, each with sub-classes. The Federal Housing Finance Agency (FHFA) has implemented the prompt corrective action provisions of the Housing and Economic Recovery Act of 2008. The FHFA rule defined the criteria for capital classifications and established critical capital levels for the FHLBanks.

What capital structure does the GLB Act permit?

Each FHLBank is permitted to issue one or two classes of capital stock, each with sub classes to its members. Members can redeem Class A stock by giving six-months written notice, and members can redeem Class B stock by giving five-years written notice, subject to certain restrictions. Most FHLBanks only issue Class B stock, with certain FHLBanks offering sub-classes of Class B stock, which represent either membership or activity-based stock requirements based upon the terms of the respective FHLBank's capital plan. The two sub-class Class B stockholders may or may not have the same voting rights and dividend rates, which are based on the terms of the respective FHLBank's capital plan.

What are the capital stock purchase requirements for members of FHLBanks?

Each member shall purchase capital stock in the FHLBank of which it is a member in an amount specified by the FHLBank's capital plan. Each FHLBank requires its members to maintain a membership and/or activity-based stock balance based upon the terms of the respective FHLBank's capital plan. Members can redeem Class A stock by giving six-months written notice, and members can redeem Class B stock by giving five-years written notice, subject to certain restrictions. Any member that withdraws its membership from an FHLBank may not acquire shares of any FHLBank for five years after the date on which its divestiture of capital stock is completed, unless the institution has canceled its notice of withdrawal prior to that date. This restriction does not apply if the member is transferring its membership from one FHLBank to another FHLBank on an uninterrupted basis.

Each class of FHLBank stock is considered putable by the member and an FHLBank may repurchase, in its sole discretion, any member's stock investments that exceed the required minimum amount. However, there are significant statutory and regulatory restrictions on the obligation to redeem, or right to repurchase, the outstanding stock. As a result, whether or not a member may have its capital stock in an FHLBank repurchased (at an FHLBank's discretion at any time before the end of the redemption period) or redeemed (at a member's request, completed at the end of a redemption period) will depend on whether the applicable FHLBank is in compliance with those restrictions.

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What regulatory capital requirements must the FHLBanks meet?

Each FHLBank is subject to three capital requirements under its capital plan and FHFA rules and regulations.

- Risk-Based Capital - Each FHLBank must maintain at all times permanent capital, defined as the amount paid-in for Class B stock, plus the amount of an FHLBank's retained earnings, as determined in accordance with GAAP. Mandatorily redeemable capital stock is considered permanent capital for regulatory purposes. Each FHLBank must maintain at all times permanent capital in an amount at least equal to the sum of its credit risk, market risk, and operations risk capital requirements, all of which are calculated in accordance with the rules and regulations of the FHFA.

    - Each FHLBank’s credit risk capital must at all times equal the sum of its credit risk capital charges for all assets, off-balance sheet items, and derivatives contracts. These computations are based on, among other requirements, the credit risk percentages assigned to each item by the FHFA.
    - Each FHLBank’s market risk capital must at all times equal the sum of the market value of its portfolio at risk from market movements, primarily interest rates, that could occur during times of market stress plus the amount, if any, by which the current market value of its total capital is less than 85% of its book value of total capital.
    - Each FHLBank’s operations risk capital must at all times equal 30% of the sum of its credit risk and market risk capital requirements. The FHFA can approve a reduction in this percentage if an FHLBank meets alternative requirements.

- Regulatory Capital - Each FHLBank must maintain at all times a total regulatory capital-to-assets ratio of at least four percent. Capital for regulatory capital adequacy purposes is defined as the sum of each FHLBank’s:

    - permanent capital;
    - amounts paid-in for Class A stock;
    - general loss allowance, if consistent with GAAP and not established for specific assets; and
    - other amounts from sources determined by the FHFA as available to absorb losses.

    Regulatory capital also includes mandatorily redeemable capital stock. Capital stock is classified as mandatorily redeemable after an FHLBank member exercises a written redemption right, gives notice of intent to withdraw from membership, or attains non-member status by merger or acquisition, relocation, charter termination, or involuntary termination from membership.

- Leverage Capital - Each FHLBank must maintain at all times a leverage capital-to-assets ratio of at least five percent. Leverage capital is defined as the sum of permanent capital weighted 1.5 times and all other capital without a weighting factor.

    The FHFA may require an FHLBank to maintain greater minimum capital levels than are required based on FHFA rules and regulations.

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What happens if an FHLBank does not meet one or more of its capital requirements?

Under FHFA regulations, any FHLBank that fails to meet its minimum capital requirement may not pay a dividend or redeem or repurchase capital stock.

An FHLBank may not redeem or repurchase any capital stock if, following such redemption or repurchase, the FHLBank would fail to satisfy any of its minimum capital requirements. No FHLBank stock may be redeemed or repurchased if the FHLBank becomes undercapitalized.

An FHLBank may not redeem or repurchase any capital stock without approval of the FHFA if either its board of directors or the FHFA determines that it has incurred, or is likely to incur, losses resulting, or expected to result, in a charge against capital while such charges are continuing or expected to continue.

What actions can an FHLBank take to build capital?

The Joint Capital Enhancement Agreement, as amended (Capital Agreement), is intended to enhance the capital position of each FHLBank. The Capital Agreement provides that each FHLBank will allocate 20% of its net income each quarter to a separate restricted retained earnings account until the balance of that account equals at least one percent of that FHLBank's average balance of outstanding consolidated obligations for the previous quarter. These restricted retained earnings are not available to pay dividends.

Management and the board of directors of each FHLBank review the capital structure of that FHLBank on a periodic basis to ensure the capital structure supports the risk associated with its assets and addresses applicable regulatory and supervisory matters. In addition, an individual FHLBank may, at its discretion, institute a higher capital requirement to meet internally-established thresholds or to address supervisory matters, or may limit dividend payments as part of its retained earnings policies.

An FHLBank’s board of directors can suspend redemptions of stock if it finds that redemptions would result in the FHLBank failing to maintain adequate capital considering risks faced by the FHLBank or would otherwise prevent the FHLBank from operating in a safe and sound manner.

How does an FHLBank pay dividends on its stock?

According to FHFA regulations and the terms of the Capital Agreement, an FHLBank's board of directors may declare and pay dividends, in either cash or capital stock, from unrestricted retained earnings. An FHLBank is prohibited from paying a dividend if it has failed to meet any capital requirements or would fail to meet such a requirement after paying the dividend.

The FHFA rule defined the capital classifications and critical capital levels for the FHLBanks. What are the definitions and requirements of these capital classifications?

The FHFA has implemented the prompt corrective action provisions of the Housing and Economic Recovery Act of 2008, as amended. The FHFA regulation defines four capital classifications for the FHLBanks:

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- Adequately capitalized. An FHLBank will be considered adequately capitalized if the FHLBank has sufficient permanent and total capital to meet or exceed its risk-based and minimum capital requirements.

- Undercapitalized. An FHLBank will be considered undercapitalized if the FHLBank does not have sufficient permanent or total capital to meet one or more of its risk-based or minimum capital requirements, but such deficiency is not large enough to classify the FHLBank as significantly undercapitalized or critically undercapitalized.

- Significantly undercapitalized. An FHLBank will be considered significantly undercapitalized if the amount of permanent or total capital held by the FHLBank is less than 75% of what is required to meet any one of its risk-based or minimum capital requirements (e.g., less than a 3% capital-to-assets ratio), but such deficiency is not large enough to classify the FHLBank as critically undercapitalized.

- Critically undercapitalized. An FHLBank will be considered critically undercapitalized if the amount of total capital held by the FHLBank is less than or equal to the critical capital level, which is an amount equal to 2% of the FHLBank's total assets.

The Director of the FHFA has discretion to reclassify an FHLBank's capital classification under certain circumstances generally related to safety and soundness concerns.

What prompt corrective actions will occur if an FHLBank is classified as other than adequately capitalized?

An FHLBank classified as undercapitalized must submit a capital restoration plan to the FHFA for approval, execute the approved plan, suspend dividend payments and excess stock redemptions or repurchases, and not permit growth of its average total assets in any calendar quarter beyond the average total assets of the preceding quarter, unless otherwise approved by the FHFA. Additionally, an FHLBank may not acquire, directly or indirectly, an equity interest in any operating entity (other than as necessary to enforce a security interest granted to the FHLBank) nor engage in any new business activity, unless:

- The Director of the FHFA has approved the FHLBank's capital restoration plan, the FHLBank is implementing the capital restoration plan, and the Director of the FHFA determines that proposed acquisition or activity will further achievement of the goals set forth in that plan; or

- The Director of the FHFA determines that the proposed acquisition or activity will be consistent with the safe and sound operation of the FHLBank and will further the FHLBank's compliance with its risk-based and minimum capital requirements in a reasonable period of time.

An FHLBank classified as significantly undercapitalized is subject to mandatory restrictions beyond those that apply to an undercapitalized FHLBank. The FHLBank may not pay a bonus to or increase compensation of its executive officers, without prior approval of the FHFA. The FHFA may also take discretionary actions with regard to a significantly undercapitalized FHLBank, including:

- limiting the increase or requiring a reduction in on- or off-balance sheet obligations of the FHLBank;

- limiting the increase or requiring a reduction in assets held;

- requiring capital and/or retained earnings to be increased;
- modifying, limiting, or terminating any activity of the FHLBank; and
- taking steps to improve the management at the FHLBank by ordering a new election for the FHLBank's board of directors, dismissing particular directors or executive officers who held office for more than 180 days prior to the date on which the FHLBank became undercapitalized, and ordering the FHLBank to hire qualified executive officers, subject to approval by the Director of the FHFA.

If an FHLBank is classified as critically undercapitalized, the FHFA may place an FHLBank in conservatorship or receivership. An FHLBank will be placed in mandatory receivership if (1) the assets of an FHLBank are less than its obligations during a 60-day period or (2) the FHLBank is not, and during a 60-day period has not, been paying its debts on a regular basis. Until such time the FHFA is appointed as conservator or receiver for a critically undercapitalized FHLBank, the FHLBank is subject to all mandatory restrictions and obligations applicable to a significantly undercapitalized FHLBank and will remain subject to any ongoing restrictions or obligations that the Director of the FHFA has imposed on the FHLBank, or any restrictions or obligations that are applicable to the FHLBank under the terms of an approved capital restoration plan.

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