

finds good cause that notice and public comment are unnecessary under section 553(b)(B) of the Administrative Procedure Act (APA), 5 U.S.C. 553(b)(B).

Effective Date

NCUA also finds good cause to dispense with the 30-day delayed effective date requirement under section 553(d)(3) of the APA. The rule is technical rather than substantive. The rule will, therefore, be effective immediately upon publication of this notice.

Regulatory Flexibility Act

An initial regulatory flexibility analysis under the Regulatory Flexibility Act is required only when an agency is required to publish a general notice of proposed rulemaking for any proposed rule. 5 U.S.C. 603. As noted previously, NCUA has determined that it is unnecessary to publish a notice of proposed rulemaking for this rule. Accordingly, an initial regulatory analysis is not required. Moreover, since this final rule imposes no new requirements and makes only a technical amendment, NCUA has determined and certifies that this rule will not have any significant economic impact on a substantial number of small credit unions (primarily those under \$1 million in assets).

Small Business Regulatory Enforcement Fairness Act

Title II of the Small Business Regulatory Enforcement Fairness Act (SBREFA) of 1996 (Pub. L. 104-121) provides, generally, for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by section 551 of the Administrative Procedures Act. 5 U.S.C. 551. The Office of Management and Budget has reviewed this rule and has determined that for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 it is not a major rule.

Paperwork Reduction Act

NCUA has determined that the final rule does not increase paperwork requirements under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*) and regulations of the Office of Management and Budget.

Executive Order 13132 Statement

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent

regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. NCUA has determined that this final rule does not constitute a policy that has federalism implications for purposes of the executive order.

List of Subjects in 12 CFR Part 790

Credit unions.

By the National Credit Union Administration Board on April 13, 2000.

Becky Baker,

Secretary of the Board.

For the reasons stated in the preamble, NCUA amends 12 CFR chapter VII as set forth below:

PART 790—DESCRIPTION OF NCUA; REQUESTS FOR AGENCY ACTION

1. The authority citation for part 790 continues to read as follows:

Authority: 12 U.S.C. 1766, 1789, 1795f.

§ 790.2 [Amended]

2. Amend § 790.2 as follows:

a. In paragraph (b)(7), remove “Technology and Information Systems” and add, in its place, “Chief Information Officer”.

b. In paragraph (b)(10), remove “Office of Technology and Information Services” in the heading and add, in its place, “Office of the Chief Information Officer”.

c. In paragraph (b)(10), remove “Director of the Office of Technology and Information Services” in the first sentence and add, in its place, “Chief Information Officer”.

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FEDERAL HOUSING FINANCE BOARD

12 CFR Parts 900, 917 and 940

[No. 2000-14]

RIN 3069-AA90

Powers and Responsibilities of Federal Home Loan Bank Boards of Directors and Senior Management

AGENCY: Federal Housing Finance Board.

ACTION: Final rule.

SUMMARY: The Federal Housing Finance Board (Finance Board) is promulgating new regulations to set forth the responsibilities of the boards of directors and senior management of the Federal Home Loan Banks (Banks) as a means of ensuring that they fulfill their duties to operate the Banks in a safe and sound manner and in furtherance of the Banks' housing finance and community lending mission.

EFFECTIVE DATE: This final rule is effective on May 31, 2000.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

I. The Proposed Rule

On January 3, 2000, the Finance Board published for comment a proposed rule to add to its regulations a new part 917, setting forth a state-of-the-art corporate governance framework for the Banks' boards of directors and senior management. *See* 65 FR 81 (2000). The 30-day public comment period closed on February 2, 2000. The Finance Board received a total of sixteen comment letters: eleven from Banks, three from trade associations and one from a Bank director.

II. Comments on the Proposed Rule and Analysis of Changes Made in the Final Rule

A. General

While all commenters suggested modifications to the proposed rule, six expressed general support for the overall purpose of the rule. No commenters expressed general opposition to the rule, but two commenters believed that the rule as a whole was too detailed. Specifically, one commenter (a Bank) opposed the proposed rule's detailed allocation of responsibilities between Banks' boards of directors and senior management and recommended that each Bank's board of directors be permitted to determine the appropriate allocation of responsibilities between itself and the Bank's senior management. Another commenter (a trade association) stated that the rule would create unnecessary administrative burdens and operational complexities.

It is the opinion of the Finance Board that an active and informed board of directors is one of the cornerstones of safe and sound Bank operation. The agency understands that, as is the case with any bank or corporation, most of a Bank's day-to-day operational functions will be undertaken by management and other Bank personnel. However, while a

Bank's board of directors may the delegate the execution of managerial functions to Bank employees, the responsibility for seeing that these functions are properly executed may not be delegated. Part of the reason for the detailed nature of the rule is to make these responsibilities clear.

Now that the Banks have been given full responsibility for their own corporate governance, the ability of the Finance Board to ensure the safety and soundness of the Banks lies primarily in its ability to examine the Banks and to take action pursuant to Bank examinations. The material set forth in part 917 also is intended in part to make clear the standards against which Banks will be examined. Although the rule is detailed in some respects, the Finance Board believes that it is preferable to state explicitly the standards to which the Bank's boards of directors and management will be held than to promulgate a more general governance rule the application of which would remain ambiguous until specific examination concerns arise.

B. Renumbering of Certain Provisions

As part of a proposed rule to amend its advances regulation, 12 CFR part 950, the Finance Board will be proposing to add to part 917 a requirement that each Bank have in place at all times a member products policy to address various aspects of the financial products that the Bank provides to its members and associates. In this final rule, the Finance Board has reserved § 917.4 for the member products policy provision.

In addition, the strategic planning provision, which appeared in the proposed rule as § 917.9, has been moved to § 917.5 in the final rule. This was done in order to give part 917 a more logical structure by placing the provisions requiring Banks' board of directors to adopt major written policies or plans (*i.e.*, the risk management policy, the member products policy and the strategic plan) in consecutive sections. Consequently, the sections numbered as 917.4 through 917.8 in the proposed rule have been redesignated as §§ 917.6 through 917.10 in the final rule.

C. Definitions—§§ 900.1 and 917.1

As reflected in the proposed rule, the Finance Board has begun the process of revising its regulations to refer to nonmember mortgagees who are eligible under section 10b of the Federal Home Loan Bank Act (Bank Act), 12 U.S.C. 1430b, to obtain advances from the Banks as "associates." In addition to a desire to use less cumbersome

terminology, this change arises from the Finance Board's concern that, to those not familiar with the nuances of the Bank System, the use of the term "nonmember mortgagee" could imply that the Banks are transacting business with entities beyond those authorized by statute. The term "associate" more accurately reflects the fact that these entities have a Congressionally-sanctioned relationship with the Banks, albeit one that falls short of full Bank membership.

In its recent regulatory reorganization rulemaking, the Finance Board established in its regulations a new part 900, to contain definitions of terms that are used often throughout the Finance Board's regulations. *See* 65 FR 8253 (2000). By creating this part, the Finance Board intended both to standardize common terms used in the regulations and to eliminate repetitive definitions and excessive definitional cross-references throughout the regulations. Although this is the first rulemaking in which the term "associate" has been used, the Finance Board intends eventually to use the term throughout its regulations. Accordingly, the term, which appeared in § 917.1 of the proposed rule, has been moved to part 900 (§ 900.1) in the final rule.

Section 917.1 of the rule continues to contain definitions of terms that are used in the substantive provisions of part 917, but that are not used frequently enough throughout the Finance Board's regulations to warrant inclusion in part 900. Changes made to, and comments regarding, these definitions are discussed below in the context of the substantive provisions to which the definitions relate.

D. General Authorities and Duties of Bank Boards of Directors—§ 917.2

Section 917.2(b)(1) of the rule requires that each director carry out his or her duties in good faith, in a manner such director believes to be in the best interests of the Bank, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. One commenter (a Bank), while supporting this regulatory statement of the standard of care, suggested that the Finance Board state explicitly in the final rule that Bank directors and management are subject to the same standard of care as directors of ordinary corporations are under state law.

Overall, part 917 charges Bank directors and management with many specific duties and responsibilities in connection with the operation of the Banks. In addition, § 917.2(b)(1) sets

forth a general standard of care with which the specific duties are to be executed. While the Finance Board believes that this regulatory standard of care is equivalent to the legal standard that normally applies to officers and directors of state-chartered corporations under state law, the Finance Board declines to make explicit reference to state law in the regulation. Part 917 specifically enumerates both the specific and general standards that the Finance Board has determined are appropriate, and it is by these express standards—and not by any ambiguous reference to state law—that the actions of Bank directors and management will be measured by the Finance Board.

In addition, several commenters expressed their opinion that, while § 917.2(b)(1) sets forth a standard of care identical to that which exists under the law of most states, various specific provisions in proposed part 917 appeared to impose a greater duty upon directors and management by essentially requiring them to guarantee the outcome of actions taken by other parties. The Finance Board has reviewed the provisions in question and has made amendments to several of them (specifically, final rule §§ 917.3(a)(2)(iv), 917.3(c), 917.6(b)(2) and 917.7(e)(2), all discussed in greater detail below) in order to make clear that, while a Bank's board of directors and senior management are required to adopt certain policies and order certain actions that are "reasonably designed" to achieve a particular result, the officers and directors do not have the responsibility to guarantee that, in executing these policies or orders, Bank employees will achieve the precise result specified. However, by requiring that policies and orders be "reasonably" designed to achieve the desired result, the Finance Board does intend to require that officers and directors take all objectively reasonable measures necessary to design the policy or order, and oversee its implementation, in such a way as to maximize the chances of the desired result being achieved.

Section 917.2(b)(3) of the proposed rule would have required that every Bank director "be financially literate, or become financially literate within a reasonable time after appointment or election." One commenter (a Bank) suggested that the Finance Board explicitly define the term "financially literate" in the final rule, using the explanation of the term set forth in the preamble to the proposed rule. The Finance Board agrees that the meaning of the term "financially literate" was unclear in the proposed rule. However, instead of defining the term, the Finance

Board has opted in the final rule to eliminate its use altogether and to require, more plainly, that at the time of his or her election, or within a reasonable time thereafter, each director have a working familiarity with basic finance and accounting practices, including the ability to read and understand the Bank's balance sheet and income statement and to ask substantive questions of management and the internal and external auditors.

Three commenters (two Banks and one trade association) opposed this requirement on the grounds that elected directors—who are primarily chief executives or senior officers of financial institutions—are likely to meet the standard, while appointed directors are chosen by the Finance Board, thereby giving the agency plenary power to select only those individuals who have a working familiarity with basic finance and accounting practices. Similarly, two other Banks questioned the requirement, given that the Banks have no power to lobby for the appointment or election of any director.

The Finance Board agrees that elected directors, as representatives of member financial institutions, would presumably meet the requirement of § 917.2(b)(3) with ease. The agency does not agree that this fact logically leads to the conclusion that the requirement should not be included in the rule.

The Finance Board also agrees that, because it is responsible for the appointment of each Bank's public interest directors, it has the power to use financial literacy as a criterion in the appointment process. However, the intent of the requirement set forth in § 917.2(b)(3) is not to eliminate from consideration for Bank directorships individuals who do not currently possess a working familiarity with basic finance and accounting practices, regardless of any other relevant qualifications they may possess. Instead, the purpose of § 917.2(b)(3) is to require that those who do not possess such familiarity become so educated to the extent that they can effectively carry out their duties as directors. The Finance Board trusts that any individual who merits consideration as either an elected or appointed Bank director would be capable of learning in a very short period of time how to read the Bank's income statement and balance sheet and how the data set forth therein relate to the general operations of the Bank. The Finance Board also believes that this requirement will impose little burden on the Banks, especially if the option of such education is made a part of existing director orientation programs.

E. Risk Management—§ 917.3

Section 917.3(a)(1) of the rule requires that, within 90 days of the effective date of the final rule, each Bank have in effect at all times a risk management policy. Section 917.3(b) of the rule sets forth the requirements for this policy. As it appeared in the proposed rule, § 917.3(b)(1) required that the risk management policy “describe how the Bank will comply with its capital structure plan, after such plan is approved by the Finance Board.”

Four commenters (two Banks and two trade associations) stated that the proposed rule was unclear as to whether the risk management policy must immediately state how the Bank will comply with capital requirements that will not be known until after the 90-day implementation period, or whether the policy is to be amended after the Finance Board issues a final rule on capital and subsequently approves that Bank's capital structure plan. Three of these commenters (one Bank and two trade associations) stated that the Finance Board should not require a Bank to adopt its risk management plan until 90 days after that Bank's capital structure plan has been approved by the Finance Board. The remaining Bank stated that the Finance Board should allow the Banks 180 days after the publication of the final rule to adopt their risk management policies.

Of course, the Finance Board does not intend to require that the Banks describe how they will comply with a capital regulation or a capital structure plan that will not yet exist at the end of the 90-day implementation period. In the final rule, § 917.3(b)(1) has been revised to more clearly state that this risk management policy requirement will apply only after the Finance Board has adopted its new capital regulations and has approved the Bank's capital structure plan. At that time, a Bank will need to amend its existing policy to add the material required under this provision.

The Finance Board declines to extend the risk management policy implementation period beyond 90 days after the effective date of the final rule. It is the agency's view that, pursuant to the Federal Home Loan Bank System Financial Management Policy (FMP) (which is the Finance Board policy that currently addresses Bank risk management), Banks should already have in place policies that largely conform to the requirements of § 917.3(b). The rule does not require that a Bank adopt a new risk management policy if one is already in place that meets the requirements of § 917.3(b), but

requires merely that the Bank have such a policy “in effect at all times” after the end of the 90-day period.

Even if a Bank must amend its existing policy, or adopt an entirely new risk management policy, in order to conform to new § 917.3(b), the necessary changes should be easily accomplished by the close of the 90-day implementation period given that, under the FMP, the Banks have very little discretion regarding the management of the risk components that must be addressed in the risk management policy. As the substantive requirements of the FMP are gradually superseded in the coming year by new regulations that are likely to give the Banks more discretion in the area of risk management and capital structure, each Bank will need to make appropriate amendments to its risk management policy.

Proposed § 917.3(a)(2)(iv) would have required each Bank's board of directors to ensure that policies and procedures are in place to achieve Bank compliance at all times with its risk management policy. Four commenters (all Banks) opposed this language on the ground that it would be unreasonable to require the Bank's board of directors to act as a guarantor that the Bank would always be in compliance with the risk management policy. The Finance Board recognizes that a Bank's board of directors typically is not involved in the day-to-day operations of the Bank and, therefore, would not be in a position constantly to monitor and enforce employee compliance with Bank policies and procedures. Accordingly, the Finance Board has revised the language of § 917.3(a)(2)(iv) to require only that the board ensure that policies and procedures are in place “that are reasonably designed” to achieve “continuing” Bank compliance with its risk management policy.

Sections 917.3(b)(3)(i) and (ii) require that each Bank's risk management policy set forth standards for the Bank's management of credit risk and market risk, respectively. One commenter (a Bank) suggested that the Finance Board amend the definitions of both market risk and credit risk, which in proposed § 917.1 referred to the “market value” of a Bank's portfolio and of a particular obligation, respectively, to refer also to the “estimated fair value” of assets. In the final rule, these two definitions have been revised to add references to “estimated fair value if market value is not available.”

The same Bank also suggested that the Finance Board define the terms “market value” and “estimated fair value” in the final rule. Because these terms are

standard accounting terms, *see, e.g.*, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, App. D, ¶ 534(j), the Finance Board has determined that they need not be defined in the final rule.

The same Bank also suggested that the definition of “market risk” be amended to include changes in interest rate volatility as an underlying causal factor. Because the Finance Board believes that the concept of changes in interest rate volatility are subsumed within the general term “changes in interest rates,” which is included in the definition of market risk, it finds the suggested revision to be unnecessary.

Section 917.3(b)(3)(iii) of the rule requires that each Bank’s risk management policy set forth standards for the Bank’s management of day-to-day operational liquidity needs and contingency liquidity needs. One commenter (a Bank) recommended that the definition of “contingency liquidity,” set forth in § 917.1, include both maturing advances and off-balance sheet sources of funds that a Bank can use to help meet liquidity needs if access to capital markets is impeded. Because the Finance Board considers maturing advances to be included within paragraph (2) of the definition of “contingency liquidity” (self-liquidating assets with a maturity of seven days or less), it has chosen not to list maturing advances separately in the definition.

Regarding off-balance sheet items, during a funding crisis, a Bank may be expected to lose access to normal sources of unsecured borrowings such as deposits or federal funds. However, even if, due to a funding crisis, a Bank were to lose access to its normal sources of unsecured borrowing, it is expected that the Bank would continue to have access to previously-established irrevocable lines of credit from AAA- or AA-rated financial institutions, through either deposits or the federal funds market. Accordingly, the Finance Board has amended the definition of “contingency liquidity” in the final rule to include these sources of funds.

One commenter (a Bank), noting that the proposed rule contained a definition of “contingency liquidity,” but did not define “operational liquidity,” requested that a definition of “operational liquidity” be added to the final rule. In response, the Finance Board has, in final § 917.1, defined “operational liquidity” as including sources of cash from both a Bank’s ongoing access to the capital markets and its holding of liquid assets to meet operational requirements in a Bank’s normal course of business.

Section 917.3(c) of the rule requires that each Bank’s senior management perform an annual risk assessment to identify and evaluate all material risks that could adversely affect the achievement of the Bank’s performance objectives and compliance requirements. One commenter (a Bank) requested that the Finance Board include in the final rule a definition of the word “material.” The same Bank opposed the requirement that a Bank identify and evaluate “all” material risks, stating that the “innocent failure” to identify a risk that is deemed by a Finance Board examiner to be “material” could expose the Bank’s board and management to criticism.

Because “material risk” is a standard accounting concept, *see, e.g.*, FASB Statement of Financial Accounting Concepts No. 2; SEC Staff Accounting Bulletin No. 99, the Finance Board finds it unnecessary to define the term in the final rule. Additionally, because the Finance Board would consider the failure of a Bank’s management to identify any material risk—whether innocent or intentional—to be a matter of supervisory concern, the agency declines to eliminate the word “all” from § 917.3(c). However, so as not to set an unreasonable regulatory standard, the Finance Board has amended § 917.3(c) in the final rule to require only that the risk assessment be “reasonably designed” to identify and evaluate all material risks.

F. Strategic Planning Requirement and Mission—§ 917.5 and Part 940

Section 917.5 of the final rule (§ 917.9 in the proposed rule) requires that, beginning 90 days after the effective date of the final rule, each Bank’s board of directors have in effect at all times a strategic business plan that describes how the Bank’s business activities will achieve the mission of the Bank. In the proposed rule, the “mission of the Banks” was defined in paragraph (a) of the strategic business plan section. In the final rule, this mission provision remains substantively unchanged, but is moved from part 917 and to a new part 940, entitled “Mission of the Banks.”

The mission provision describes the mission of the Banks as providing to their members and associates financial products and services, including but not limited to advances, that assist and enhance their members’ and associates’ financing of housing and community lending. Three commenters (all Banks) stated their belief that individual Banks should have the responsibility for establishing their own mission statements. One Bank stated that each Bank’s mission statement should be a

reflection of how the Bank, its board, its management and shareholders construe the authority granted under the Federal Home Loan Bank Act (Bank Act). The Bank further stated that the Bank Act does not explicitly define the mission of the Banks and does not require that the Finance Board do so. Another Bank commented that the drafting of a mission statement is fundamentally a management responsibility that should be exercised by the entity’s board of directors and not by the entity’s regulator.

The Bank Act authorizes the Finance Board to supervise the Banks and to promulgate and enforce such regulations and orders as are necessary from time to time to carry out the provisions of the Bank Act. *See* 12 U.S.C. 1422b(a)(1). Among the provisions of the Bank Act are those outlining the duties of the Finance Board, which include the duty to “ensure” that the Banks carry out their housing finance mission. *See id.* at 1422a(a)(3)(B)(ii). Many of the comment letters received in response to the proposed rule criticized the Finance Board for using the word “ensure” in some of the provisions setting forth specific duties of Bank directors, noting that the word implies that the directors would have a duty to “guarantee” that Bank employees would carry out the board’s directives with precision. The Finance Board agrees that the word “ensure” connotes an affirmative obligation that carries a high degree of responsibility. Thus, the use of the word “ensure” in section 2A(a)(3)(B)(ii) of the Bank Act makes clear that, consistent with the safe and sound operation of the Banks, the Finance Board has the duty to take active measures, using all available avenues, to see to it that the Banks carry out their housing finance mission.

Because Congress has not expressly defined the term “housing finance mission,” it is the responsibility and the privilege of the Finance Board—as the body charged with the duty to ensure that the Banks fulfill that mission and, more generally, as the supervisory regulator of the Banks and the agency charged with the administration of the Bank Act—to construe the term reasonably in light of the totality of the Act. It is the position of the Finance Board that, when Congress amended the Bank Act in 1989 to require the Banks to offer Affordable Housing Programs (AHP) and Community Investment Programs (CIP) and authorized the Banks to offer Community Investment Cash Advance Programs (CICA), the Banks’ “housing finance mission,” as referenced in section 2A(a)(3)(B)(ii),

came to include support not only for the financing of traditional housing-related activities, but also for those types of community lending that the Banks are authorized by statute to support and that indirectly enhance traditional housing finance by helping to create and sustain thriving and livable communities. See 12 U.S.C. 1430(i), (j).

Section 940.2 of the final rule implements in regulation this description of the Banks' "housing finance mission." Although, as discussed, the Finance Board believes that support of community lending is an integral part of the Banks' statutory housing finance mission, it has used the terms "housing" and "community lending" separately in § 940.2 and in other parts of the regulations in order to make clear that the Banks' housing finance mission goes beyond the parameters that the term "housing finance" would traditionally connote.

Regarding the substance of the mission provision, seven commenters (five Banks and two trade associations) stated that the scope of the provision was too narrow. Specifically, several commenters noted that the mission provision does not reference the Banks' new authority to extend advances to CFI's for the purpose of funding loans to small businesses, small farms and small agri-businesses. One of the Banks stated that, if the Finance Board must enact a mission provision, the agency should draft the provision broadly enough to support all activities explicitly allowed by the Bank Act. Similarly, two of the Banks opined that the mission provision does not include sufficient reference to other types of investments, products and services that may directly contribute to mission achievement. Yet another Bank stated that the mission provision should recognize the need to use member's capital prudently and effectively, particularly in light of the recent statutory change to an all-voluntary membership base.

As drafted, the mission provision does not appear to consider as mission-related activities related to those purposes addressed by the Modernization Act—namely facilitating the funding of loans by CFI's to small businesses, small farms and small agri-businesses. However, the Finance Board has recently approved for publication a proposed rule to amend its advances regulation to incorporate the new CFI-related advance authorities. As part of this rule, the Finance Board is proposing to amend the term "community lending," as defined in part 952 of the regulations, to include these authorities. Because the mission provision incorporates the term

"community lending," it will also encompass the new CFI-related authorities once the Finance Board promulgates a final rule amending its advances regulation, most likely in the third quarter of 2000. Presently, the Finance Board is in the midst of an ambitious regulatory agenda intended to implement in a timely manner the statutory changes brought about by the Modernization Act. In order to accomplish these changes effectively, the agency must necessarily proceed one step at a time. With many interrelated regulations, it will in some cases take two or more rulemakings before a change can be fully integrated into all relevant aspects of the Finance Board's regulatory scheme. In order to make clear immediately that the CFI-related authorities, as well as support for the financing of multi-family housing, are considered to be part of each Bank's mission, the Finance Board has added to § 917.5(a) a requirement that performance goals for these areas be included in each Bank's strategic plan.

It should also be noted that the mission provision is not intended to be an all-encompassing description of every function that a Bank is authorized to undertake. As mentioned in several of the comment letters, there are many ways in which a Bank may serve its members and associates that do not fall within the parameters of the mission provision. The point of the mission provision, in combination with the strategic planning requirement, is to require the Banks to focus primarily upon carrying out their housing finance mission and to do so in a profitable manner.

Finally one commenter (a trade association) expressed concern that the Finance Board's promulgation of the mission provision, in combination with the strategic planning requirement, is inconsistent with the content of an October 18, 1999 letter from Finance Board Chairman Bruce Morrison to Senator Phil Gramm and Congressman Jim Leach. In that letter, Chairman Morrison stated that, upon the enactment of the Modernization Act, the Finance Board would withdraw its Financial Management and Mission Achievement (FMMA) proposed rulemaking, see 64 FR 52163 (1999), and would take no action to promulgate proposed or final regulations limiting Bank assets or advances beyond those regulations currently in effect, except to the extent necessary to protect the safety and soundness of the Banks. As discussed, this rule does nothing to limit Bank assets or advances of any kind, but merely requires the Banks to adopt a strategic plan setting forth how

their assets, advances and other products and services will contribute to fulfillment of the Banks' mission.

The requirements regarding the content of the Banks' strategic plans remain in part 917, at § 917.5. Regarding the actual strategic plan requirement, one commenter (a Bank) expressly opposed specific strategic planning requirements, stating that each Bank should be permitted to determine the strategic planning methodology most appropriate for the Bank to pursue its mission. As mentioned above, it is the duty of the Finance Board to ensure that the Banks carry out their statutory mission. The Finance Board has determined that, in order to fulfill this duty, it must require the Banks to focus upon the development of profitable products and services that enhance the carrying out of this mission. This is the intent behind the strategic planning requirement.

One commenter (a Bank) asked whether the strategic business plan may consist of multiple documents generated and approved by a Bank's board of directors in a sequential manner. Nothing in the rule prohibits the Banks from drafting and approving elements of the strategic business in a sequential fashion, so long as: (1) It is clear which documents comprise the strategic business plan; and (2) these documents, as a whole, meet the requirements set forth in § 917.5.

Five commenters (three Banks and two trade associations) opposed the 90-day time limit the Banks have been given to adopt their strategic business plans. Two of the Banks suggested that the rule be revised to permit the Banks to adopt the plan during their next scheduled annual planning process. Another of the Banks requested that the Banks be given one year to adopt their plans. The trade associations suggested that the Finance Board delay imposition of the strategic planning requirement until the implementation of each Bank's new capital structure. The Finance Board believes that, under current requirements, the Banks should already have most elements of the strategic plan in place and that, therefore, the adoption of the full plan under § 917.5 within 90 days should not be overly burdensome. Accordingly, the 90-day requirement remains unchanged in the final rule.

G. Internal Control System—§ 917.6

Section 917.6 of the final rule (§ 917.4 of the proposed rule) sets forth requirements pertaining to the establishment and maintenance of a Bank's internal control system. Section 917.6(a)(1) enumerates the areas of

concern that each Bank's internal control system should be designed to address. Section 917.6(a)(2) sets forth several of the ongoing internal control activities that the Finance Board has determined are necessary in order to adequately address the concerns referred to in paragraph (a)(1). One commenter (a Bank) opposed the non-exclusive listing of required ongoing internal control activities in § 917.6(a)(2), stating that the list added little, if anything, to the regulation.

In determining whether a Bank's internal control system adequately addresses the areas of concern set forth in paragraph (a)(1), Finance Board examiners will be looking to determine whether the Bank is effectively carrying out the ongoing internal control activities listed in paragraph (a)(2). Accordingly, the Finance Board finds it preferable to list explicitly some of the internal control activities on which examiners will focus so that each Bank will be aware in advance of the standards that will be applied in the examination of its internal control system.

Section 917.6(b) of the rule lists the internal control responsibilities of each Bank's board of directors. In the proposed rule, paragraph (b)(2) would have required that each Bank's board ensure that an effective and comprehensive internal audit of the internal control system is performed annually. Four commenters (three Banks and one Bank director) objected to the proposed rule language on the ground that it appeared to require Bank boards of directors to "guarantee" that employees carrying out an internal control audit would do so effectively and comprehensively. The commenters argued that this regulatory standard would exceed the legal standard that normally applies to corporate directors under state law. In response to these concerns, and to emphasize that the regulatory standard of care applicable to Bank directors is equivalent to the legal standard that normally applies to corporate directors under state law, the Finance Board has revised § 917.6(b)(2) in the final rule to require only that: (1) The board require an annual internal audit of the Bank's internal control system; and (2) the audit plan is reasonably designed to be effective and comprehensive.

Two commenters (one Bank and one trade association) suggested that the Finance Board modify § 917.6(b)(2) to enable Banks to distinguish between high- and low-risk internal control areas and that audits of low-risk areas be required less frequently than annually. The Federal Deposit Insurance Act

(FDIA) requires that each insured depository institution prepare annually, among other things, a report signed by the chief executive officer and the chief accounting or financial officer of the institution that contains: (A) A statement of the management's responsibilities for (i) preparing financial statements; (ii) establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (iii) complying with the laws and regulations relating to safety and soundness; and (B) an assessment, as of the end of the institution's most recent fiscal year, of (i) the effectiveness of such internal control structure and procedures; and (ii) the institution's compliance with the laws and regulations relating to safety and soundness. *See* 12 U.S.C. 1831m(b)(2); *see also* 12 CFR part 363 (FDIC implementing regulations). These FDIA provisions essentially require that each FDIC-insured financial institution perform an annual comprehensive audit of its internal control system. Section 917.6(b)(2) of the rule is intended to apply a similar requirement to the Banks and therefore remains unchanged in the final rule.

One commenter (a Bank) also objected to the requirement, set forth in § 917.6(b)(6), that a Bank's board of directors report to the Finance Board in a timely manner any internal control deficiencies found and the corrective action taken. The commenter suggested that the Banks be required to report only significant internal control deficiencies that have the potential to impact a Bank's safety and soundness. As the entity charged by statute with ensuring the safety and soundness of the Banks, *see* 12 U.S.C. 1422a(a)(3)(A), it is ultimately the statutory responsibility of the Finance Board to determine which deficiencies may impact upon the safety and soundness of a Bank. As such, final § 917.6(b)(6) continues to hold each Bank's board of directors responsible for reporting all known internal control deficiencies to the Finance Board.

Section 917.6(b)(8) of the rule requires that each Bank's board of directors review all delegations of authority to specific personnel or committees and require that such delegations state the extent of the authority and responsibilities delegated. One commenter (a Bank) requested clarification as to whether, under this provision, it would be permissible for a Bank's management to make particular delegation decisions, so long as the Bank's board of directors reviews the delegations. The Finance Board understands that decisions regarding delegations of authority among specific

Bank personnel will most likely be made by a Bank's management as part of its responsibility for the day-to-day operations of the Bank. Such management decisions are permissible under § 917.6(b)(8), provided that the Bank's board of directors reviews the delegations and requires that the delegations state the extent of the power delegated.

Section 917.6(c) of the rule addresses the responsibilities of each Bank's senior management for the establishment, implementation and maintenance of the Bank's internal control system. As it appeared in the proposed rule, this provision would have required that senior management ensure that Bank personnel fully understand and comply with all policies, procedures and legal requirements. One commenter (a trade association) requested that the Finance Board amend this provision to require only that management ensure that Bank personnel understand and comply with policies, procedures and requirements applicable to their positions and responsibilities. Although this was implicit in the proposed rule, the Finance Board agrees that the provision may have appeared to be overly-burdensome as written. Therefore, the agency has revised § 917.6(c)(2) to add the requested clarification.

In addition, one commenter (a Bank) objected to the use of the word "ensure" in § 917.6(c)(2), and also to its use in § 917.6(c)(6), which requires that senior management ensure adherence to the lines of authority and responsibility established by the Bank's board of directors. Contrary to the role of the Bank's board of directors, which sets overall policy and oversees the operations of the Bank in a general sense, the management of the Bank is responsible for day-to-day operations, including the direct supervision of Bank employees. As such, Bank management should be in a position: (1) To educate employees regarding policies, procedures and legal requirements related to their positions and regarding lines of authority and responsibility relevant to their positions; (2) to determine on a regular basis whether employees are complying with these policies, procedures and requirements and lines of authority and responsibility; and (3) to take prompt corrective action when it is discovered that they are not so complying. Accordingly, the Finance Board has determined that use of the word "ensure" in §§ 917.6(c)(2) and (6) is appropriate.

H. Audit Committees—§ 917.7

Section 917.7 of the final rule (§ 917.5 in the proposed rule) addresses the powers and responsibilities of Bank audit committees. One commenter (a Bank) stated generally that the language of the rule suggests that audit committees will interact directly with Bank management as an independent source of authority, while, under traditional notions of corporate governance, the audit committee acts as an agent of the full board. Nothing in the audit committee provisions of the rule is intended to suggest that the authority of a Bank's audit committee derives other than from its status as agent of the full board of directors. References in the rule to direct audit committee supervision of, or authority over, the internal auditor or other Bank employees are to powers that the Finance Board has determined a Bank audit committee must possess in order to be effective. These powers would be delegated by the full board of directors to the audit committee as part of the audit committee charter.

Section 917.7(b) of the rule addresses the required composition of Bank audit committees. Specifically, § 917.7(b)(1) requires that the audit committee comprise at least five persons drawn from the Bank's board of directors. One commenter (a trade association) opposed this requirement, stating that the rule contradicts Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (Feb. 8, 1999) (Blue Ribbon Committee Report), which establishes a minimum of three directors.

Section 917.7(b)(2) requires that each Bank's audit committee include a balance of representatives of: (i) community financial institutions (CFIs) and other members; and (ii) appointive and elective directors of the Bank. One commenter (a Bank) opposed the diversity requirement, stating that the safety and soundness issues that face the Banks are straightforward and that the requirement adds to the complexity of the audit committee without adding to its ability to deal with issues of safety and soundness. Another commenter (a trade association) opposed the diversity requirement, stating that it has no basis in the Blue Ribbon Committee Report. Two commenters (both Banks) suggested that the Finance Board remove the provision requiring a balance between representatives of CFIs and other members, stating that there can be no assurance that a particular Bank's board of directors will have any elected directors representing a CFI.

Finally, one commenter (a trade association) opposed the diversity requirement as written, suggesting that large borrowers be precluded from serving on the audit committee.

As stated in the proposed rule, the Finance Board included the diversity requirement in the rule in order to prevent dominance of the audit committee by any particular interest. Section 917.7(a)(1) sets the minimum audit committee membership at five (instead of the three established by the Blue Ribbon Committee Report) because the Finance Board has determined that this is the minimum number required to achieve adequately diverse representation on a Bank's audit committee. The Finance Board rejects suggestions that it eliminate the requirement that there be a balance of representation between CFIs and other members. If there are no CFI representatives on a Bank's board of directors, there will obviously be no one to serve on the audit committee in that capacity and the Bank would not be in violation of the regulation for failure to appoint a non-existent CFI director to the board. Section 917.7(b)(4) requires that at least one member of each Bank's audit committee have extensive accounting or related financial management experience. Three commenters (two Banks and one trade association) expressly supported this requirement. One of the Banks requested that the Finance Board clarify the meaning of the phrase "extensive accounting or related financial management experience." The Blue Ribbon Committee Report uses the phrase "accounting or related financial management expertise," where "expertise" signifies "past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities." Although the Finance Board has chosen to use the word "experience" in order to express the standard more clearly, the explanation contained in the Blue Ribbon Committee Report is equally applicable to the standard set forth in final § 917.7(b)(4).

In the proposed rule, the Finance Board requested comment on two specific questions regarding the composition of a Bank's audit committee. First, the Finance Board asked whether, in the final rule, the provision requiring that at least one member of the audit committee have

extensive accounting or related financial management experience should be made to apply specifically to the chair of the audit committee. Eight commenters (six Banks and two trade associations) opposed, and no commenters supported, the inclusion of this requirement in the final rule. The primary objection to this idea was that such a requirement might prevent an individual with other important qualifications, such as proven administrative ability, from serving as chair. Most commenters expressed a belief that, so long as at least one member of the committee has extensive financial or accounting experience, it would add little to the effectiveness of the audit committee to require that the chair specifically possess such experience. The Finance Board agrees with these arguments and, therefore, has not included this requirement in the final rule.

Second, the Finance Board asked whether the final rule should require that the vice chair of the board of directors serve as chair of the audit committee, to enable Banks to pay the audit committee chair at a higher rate of compensation. Twelve commenters (nine Banks and three trade associations) opposed, and no commenters supported, the inclusion of this requirement in the final rule. Most commenters believed that this decision properly should be left to a Bank's board of directors. Others expressed concern that, far from being an incentive, service as vice chair would only distract the audit committee chair from his or her audit committee duties. The Finance Board also agrees with these comments and, therefore, has not included this requirement in the final rule.

Section 917.7(c) of the rule prohibits any member of a Bank's board of directors from serving on the audit committee if he or she has a disqualifying relationship with the Bank or its management that would interfere with the exercise of that director's independent judgment. This section includes a non-exclusive list of relationships that would disqualify a board director for audit committee service regardless of the attendant circumstances. In the proposed rule, paragraph (4) of this list deemed as disqualifying "being an immediate family member of an individual who is, or has been in any of the past five years, employed by the Bank." Two commenters (both Banks) suggested that the Finance Board amend this provision to refer only to family members who are employed by the Bank "as an executive officer." The commenters pointed out that the suggested language conforms to

the standard set forth in the Blue Ribbon Committee Report and that a director's familial relationship with a low-ranking Bank employee would be likely to have little effect on the director's independent judgment.

The Finance Board agrees that, on its face, a familial relationship with a low-ranking Bank employee should not disqualify a director from service on the Bank's audit committee and, therefore, has added the requested language to final § 917.7(c)(4). However, if circumstances surrounding the relationship were to cast doubt upon the director's ability to act independently, that director would still be prohibited from serving on the audit committee pursuant to the general prohibition against disqualifying relationships set forth in the introductory paragraph of § 917.7(c).

In addition, one commenter (a Bank) requested clarification that the concept of "independence" does not in any way preclude elected directors associated with Bank members from serving on the audit committee. Given that, under § 917.7(b)(2), a Bank is expressly required to have on its audit committee elective directors that represent both CFI and non-CFI members, § 917.7(c) should not be read as overriding this requirement. Only if an industry representative were to have a direct personal or financial relationship with the Bank or its senior employees would that director's independence be called into question under § 917.7(c).

Section 917.7(e) enumerates the duties applicable to Bank audit committees. Under the proposed rule, paragraph (2) of this section would have required, among other things, that each Bank's audit committee ensure that policies are in place to achieve disclosure and transparency regarding the Bank's true financial performance and governance practices. One commenter (a Bank) requested that the Finance Board modify the language of this paragraph to refer instead to policies that are "reasonably designed" to achieve disclosure and transparency regarding the Bank's true financial performance and governance practices. The commenter argued that the language of the proposed rule appeared to require that audit committee members "guarantee" that Bank employees would implement these policies without error and that the precise result intended would be achieved. The Finance Board agrees that, in the proposed rule, this provision appeared to impose upon audit committee members a regulatory requirement that exceeds the legal standard that normally applies to

corporate directors under state law. Accordingly, the Finance Board has amended § 917.7(e)(2) in the final rule to include the requested language.

I. Budgets, Dividends and Bylaws—§§ 917.8, 917.9 and 917.10

Sections 917.8, 917.9 and 917.10 of the final rule address the power and responsibilities of Banks' boards of directors and senior management regarding, respectively, budget preparation and reporting requirements, dividends and Bank bylaws. These provisions already appear in existing part 917 as §§ 917.6, 917.7 and 917.8, respectively, having been redesignated from old §§ 934.7, 934.16 and 934.17, respectively, in the recent final rulemaking that reorganized and renumbered the Finance Board's regulations. See 65 FR 8253 (2000). Each of these provisions has also been substantively amended as part of the Finance Board's recent rulemaking that devolved various corporate governance authorities to the Banks in response to statutory changes made by the Federal Home Loan Bank Modernization Act of 1999 (Modernization Act), Pub. L. No. 106-102, Title VI (1999). See 64 FR 71275 (1999) (interim final rule); 65 FR 13663 (2000) (final rule). As such, no further amendments are made to these provisions in this final rule, other than their redesignation as §§ 917.8, 917.9 and 917.10.

III. Regulatory Flexibility Act

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

IV. Paperwork Reduction Act

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

List of Subjects in 12 CFR Parts 900, 917 and 940

Community development, Credit, Federal home loan banks, Housing.

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

PART 900—GENERAL DEFINITIONS

1. The authority citation for part 900 continues to read as follows:

Authority: 12 U.S.C. 1422b(a).

2. In § 900.1, add a definition of "associate" to read as follows:

§ 900.1 Definitions applying to all regulations.

* * * * *

Associate means an entity that has been approved as a nonmember mortgagee pursuant to subpart B of part 950 of this chapter.

* * * * *

3. In subchapter C, revise part 917 to read as follows:

PART 917—POWERS AND RESPONSIBILITIES OF BANK BOARDS OF DIRECTORS AND SENIOR MANAGEMENT

Sec.

917.1 Definitions.

917.2 General authorities and duties of Bank boards of directors.

917.3 Risk management.

917.4 Bank member products policy.

[Reserved]

917.5 Strategic business plan.

917.6 Internal control system.

917.7 Audit committees.

917.8 Budget preparation.

917.9 Dividends.

917.10 Bank bylaws.

Authority: 12 U.S.C. 1422a(a)(3), 1422b(a)(1), 1427, 1432(a), 1436(a), 1440.

§ 917.1 Definitions.

As used in this part:

Business risk means the risk of an adverse impact on a Bank's profitability resulting from external factors as may occur in both the short and long run.

Capital structure plan means the plan establishing and implementing a capital structure that each Bank is required to submit to the Finance Board under 12 U.S.C. 1426(b).

Community financial institution has the meaning set forth in § 925.1 of this chapter.

Contingency liquidity means the sources of cash a Bank may use to meet its operational requirements when its access to the capital markets is impeded, and includes:

(1) Marketable assets with a maturity of one year or less;

(2) Self-liquidating assets with a maturity of seven days or less;

(3) Assets that are generally accepted as collateral in the repurchase agreement market; and

(4) Irrevocable lines of credit from financial institutions rated not lower than the second highest credit rating category by a credit rating organization

regarded as a Nationally Recognized Statistical Rating Organization by the Securities and Exchange Commission.

Credit risk means the risk that the market value, or estimated fair value if market value is not available, of an obligation will decline as a result of deterioration in creditworthiness.

Immediate family member means a parent, sibling, spouse, child, dependent, or any relative sharing the same residence.

Internal auditor means the individual responsible for the internal audit function at the Bank.

Liquidity risk means the risk that a Bank will be unable to meet its obligations as they come due or meet the credit needs of its members and associates in a timely and cost-efficient manner.

Market risk means the risk that the market value, or estimated fair value if market value is not available, of a Bank's portfolio will decline as a result of changes in interest rates, foreign exchange rates, equity and commodity prices.

Operational liquidity means sources of cash from both a Bank's ongoing access to the capital markets and its holding of liquid assets to meet operational requirements in a Bank's normal course of business.

Operations risk means the risk of an unexpected loss to a Bank resulting from human error, fraud, unenforceability of legal contracts, or deficiencies in internal controls or information systems.

Reportable conditions means matters that represent significant deficiencies in the design or operation of the internal control system that could adversely affect a Bank's ability to record, process, summarize and report financial data consistent with the assertions of management.

§ 917.2 General authorities and duties of Bank boards of directors.

(a) *Management of a Bank.* The management of each Bank shall be vested in its board of directors. While Bank boards of directors may delegate the execution of operational functions to Bank personnel, the ultimate responsibility of each Bank's board of directors for that Bank's management is non-delegable.

(b) *Duties of Bank directors.* Each Bank director shall have the duty to:

(1) Carry out his or her duties as director in good faith, in a manner such director believes to be in the best interests of the Bank, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like

position would use under similar circumstances;

(2) Administer the affairs of the Bank fairly and impartially and without discrimination in favor of or against any member;

(3) At the time of appointment or election, or within a reasonable time thereafter, have a working familiarity with basic finance and accounting practices, including the ability to read and understand the Bank's balance sheet and income statement and to ask substantive questions of management and the internal and external auditors; and

(4) Direct the operations of the Bank in conformity with the requirements set forth in the Act and this chapter.

(c) *Authority regarding staff and outside consultants.* (1) In carrying out its duties and responsibilities under the Act and this chapter, each Bank's board of directors and all committees thereof shall have authority to retain staff and outside counsel, independent accountants, or other outside consultants at the expense of the Bank.

(2) Bank staff providing services to the board of directors or any committee of the board under paragraph (c)(1) of this section may be required by the board of directors or such committee to report directly to the board or such committee, as appropriate.

§ 917.3 Risk management.

(a) *Risk management policy.* (1) *Adoption.* Beginning August 29, 2000, each Bank's board of directors shall have in effect at all times a risk management policy that addresses the Bank's exposure to credit risk, market risk, liquidity risk, business risk and operations risk and that conforms to the requirements of paragraph (b) of this section and to all applicable Finance Board regulations and policies.

(2) *Review and compliance.* Each Bank's board of directors shall:

(i) Review the Bank's risk management policy at least annually;

(ii) Amend the risk management policy as appropriate;

(iii) Re-adopt the Bank's risk management policy, including interim amendments, not less often than every three years; and

(iv) Ensure that policies and procedures are in place that are reasonably designed to achieve continuing Bank compliance with the risk management policy.

(b) *Risk management policy requirements.* In addition to meeting any other requirements set forth in this chapter, each Bank's risk management policy shall:

(1) After the Bank's capital structure plan is approved by the Finance Board,

describe how the Bank will comply with its capital structure plan;

(2) Set forth the Bank's tolerance levels for the market and credit risk components; and

(3) Set forth standards for the Bank's management of each risk component, including but not limited to:

(i) Regarding credit risk arising from all secured and unsecured transactions, standards and criteria for, and timing of, periodic assessment of the creditworthiness of issuers, obligors, or other counterparties including identifying the criteria for selecting dealers, brokers and other securities firms with which the Bank may execute transactions; and

(ii) Regarding market risk, standards for the methods and models used to measure and monitor such risk;

(iii) Regarding day-to-day operational liquidity needs and contingency liquidity needs:

(A) An enumeration of specific types of investments to be held for such liquidity purposes; and

(B) The methodology to be used for determining the Bank's operational and contingency liquidity needs;

(iv) Regarding operations risk, standards for an effective internal control system, including periodic testing and reporting; and

(v) Regarding business risk, strategies for mitigating such risk, including contingency plans where appropriate.

(c) *Risk assessment.* The senior management of each Bank shall perform, at least annually, a risk assessment that is reasonably designed to identify and evaluate all material risks, including both quantitative and qualitative aspects, that could adversely affect the achievement of the Bank's performance objectives and compliance requirements. The risk assessment shall be in written form and shall be reviewed by the Bank's board of directors promptly upon its completion.

§ 917.4 Bank member products policy. [Reserved]

§ 917.5 Strategic business plan.

(a) *Adoption of strategic business plan.* Beginning 90 days after the effective date of this section, each Bank's board of directors shall have in effect at all times a strategic business plan that describes how the business activities of the Bank will achieve the mission of the Bank consistent with part 940 of this chapter. Specifically, each Bank's strategic business plan shall:

(1) Enumerate operating goals and objectives for each major business activity and for all new business activities, which must include plans for

maximizing activities that enhance the carrying out of the mission of the Bank, consistent with part 940 of this chapter;

(2) Discuss how the Bank will:

(i) Address credit needs and market opportunities identified through ongoing market research and consultations with members, associates and public and private organizations; and

(ii) Notify members and associates of relevant programs and initiatives;

(3) Establish quantitative performance goals for Bank products related to multi-family housing, small business, small farm and small agri-business lending ;

(4) Describe any proposed new business activities or enhancements of existing activities; and (5) Be supported by appropriate and timely research and analysis of relevant market developments and member and associate demand for Bank products and services.

(b) *Review and monitoring.* Each Bank's board of directors shall:

(1) Review the Bank's strategic business plan at least annually;

(2) Amend the strategic business plan as appropriate;

(3) Re-adopt the Bank's strategic business plan, including interim amendments, not less often than every three years; and

(4) Establish management reporting requirements and monitor implementation of the strategic business plan and the operating goals and objectives contained therein.

(c) *Report to Finance Board.* Each Bank shall submit to the Finance Board annually a report analyzing and describing the Bank's performance in achieving the goals described in paragraph (a)(3) of this section.

§ 917.6 Internal control system.

(a) *Establishment and maintenance.*

(1) Each Bank shall establish and maintain an effective internal control system that addresses:

(i) The efficiency and effectiveness of Bank activities;

(ii) The safeguarding of Bank assets;

(iii) The reliability, completeness and timely reporting of financial and management information and transparency of such information to the Bank's board of directors and to the Finance Board; and

(iv) Compliance with applicable laws, regulations, policies, supervisory determinations and directives of the Bank's board of directors and senior management.

(2) Ongoing internal control activities necessary to maintain the internal control system required under paragraph (a)(1) of this section shall include, but are not limited to:

(i) Top level reviews by the Bank's board of directors and senior management, including review of financial presentations and performance reports;

(ii) Activity controls, including review of standard performance and exception reports by department-level management on an appropriate periodic basis;

(iii) Physical and procedural controls to safeguard, and prevent the unauthorized use of, assets;

(iv) Monitoring for compliance with the risk tolerance limits set forth in the Bank's risk management policy;

(v) Any required approvals and authorizations for specific activities; and

(vi) Any required verifications and reconciliations for specific activities.

(b) *Internal control responsibilities of Banks' boards of directors.* Each Bank's board of directors shall ensure that the internal control system required under paragraph (a)(1) of this section is established and maintained, and shall oversee senior management's implementation of such a system on an ongoing basis, by:

(1) Conducting periodic discussions with senior management regarding the effectiveness of the internal control system;

(2) Ensuring that an internal audit of the internal control system is performed annually and that such annual audit is reasonably designed to be effective and comprehensive;

(3) Requiring that internal control deficiencies be reported to the Bank's board of directors in a timely manner and that such deficiencies are addressed promptly;

(4) Conducting a timely review of evaluations of the effectiveness of the internal control system made by internal auditors, external auditors and Finance Board examiners;

(5) Directing senior management to address promptly and effectively recommendations and concerns expressed by internal auditors, external auditors and Finance Board examiners regarding weaknesses in the internal control system;

(6) Reporting any internal control deficiencies found, and the corrective action taken, to the Finance Board in a timely manner;

(7) Establishing, documenting and communicating an organizational structure that clearly shows lines of authority within the Bank, provides for effective communication throughout the Bank, and ensures that there are no gaps in the lines of authority;

(8) Reviewing all delegations of authority to specific personnel or

committees and requiring that such delegations state the extent of the authority and responsibilities delegated; and

(9) Establishing reporting requirements, including specifying the nature and frequency of reports it receives.

(c) *Internal control responsibilities of Banks' senior management.* Each Bank's senior management shall be responsible for carrying out the directives of the Bank's board of directors, including the establishment, implementation and maintenance of the internal control system required under paragraph (a)(1) of this section by:

(1) Establishing, implementing and effectively communicating to Bank personnel policies and procedures that are adequate to ensure that internal control activities necessary to maintain an effective internal control system, including the activities enumerated in paragraph (a)(2) of this section, are an integral part of the daily functions of all Bank personnel;

(2) Ensuring that all Bank personnel fully understand and comply with all policies, procedures and legal requirements applicable to their positions and responsibilities;

(3) Ensuring that there is appropriate segregation of duties among Bank personnel and that personnel are not assigned conflicting responsibilities;

(4) Establishing effective paths of communication upward, downward and across the organization in order to ensure that Bank personnel receive necessary and appropriate information, including:

(i) Information relating to the operational policies and procedures of the Bank;

(ii) Information relating to the actual operational performance of the Bank;

(iii) Adequate and comprehensive internal financial, operational and compliance data; and

(iv) External market information about events and conditions that are relevant to decision making;

(5) Developing and implementing procedures that translate the major business strategies and policies established by the Bank's board of directors into operating standards;

(6) Ensuring adherence to the lines of authority and responsibility established by the Bank's board of directors;

(7) Overseeing the implementation and maintenance of management information and other systems;

(8) Establishing and implementing an effective system to track internal control weaknesses and the actions taken to correct them; and

(9) Monitoring and reporting to the Bank's board of directors the effectiveness of the internal control system on an ongoing basis.

§ 917.7 Audit committees.

(a) *Establishment.* The board of directors of each Bank shall establish an audit committee, consistent with the requirements set forth in this section.

(b) *Composition.* (1) The audit committee shall comprise five or more persons drawn from the Bank's board of directors, each of whom shall meet the criteria of independence set forth in paragraph (c) of this section.

(2) The audit committee shall include a balance of representatives of:

(i) Community financial institutions and other members; and

(ii) Appointive and elective directors of the Bank.

(3) The terms of audit committee members shall be appropriately staggered so as to provide for continuity of service.

(4) At least one member of the audit committee shall have extensive accounting or related financial management experience.

(c) *Independence.* Any member of the Bank's board of directors shall be considered to be sufficiently independent to serve as a member of the audit committee if that director does not have a disqualifying relationship with the Bank or its management that would interfere with the exercise of that director's independent judgment. Such disqualifying relationships include, but are not limited to:

(1) Being employed by the Bank in the current year or any of the past five years;

(2) Accepting any compensation from the Bank other than compensation for service as a board director;

(3) Serving or having served in any of the past five years as a consultant, advisor, promoter, underwriter, or legal counsel of or to the Bank; or

(4) Being an immediate family member of an individual who is, or has been in any of the past five years, employed by the Bank as an executive officer.

(d) *Charter.* (1) The audit committee of each Bank shall adopt, and the Bank's board of directors shall approve, a formal written charter that specifies the scope of the audit committee's powers and responsibilities, as well as the audit committee's structure, processes and membership requirements.

(2) The audit committee and the board of directors of each Bank shall:

(i) Review, assess the adequacy of and, where appropriate, amend the Bank's audit committee charter on an annual basis;

(ii) Amend the audit committee charter as appropriate; and

(iii) Re-adopt and re-approve, respectively, the Bank's audit committee charter not less often than every three years.

(3) Each Bank's audit committee charter shall:

(i) Provide that the audit committee has the responsibility to select, evaluate and, where appropriate, replace the internal auditor and that the internal auditor may be removed only with the approval of the audit committee;

(ii) Provide that the internal auditor shall report directly to the audit committee on substantive matters and that the internal auditor is ultimately accountable to the audit committee and board of directors; and

(iii) Provide that both the internal auditor and the external auditor shall have unrestricted access to the audit committee without the need for any prior management knowledge or approval.

(e) *Duties.* Each Bank's audit committee shall have the duty to:

(1) Direct senior management to maintain the reliability and integrity of the accounting policies and financial reporting and disclosure practices of the Bank;

(2) Review the basis for the Bank's financial statements and the external auditor's opinion rendered with respect to such financial statements (including the nature and extent of any significant changes in accounting principles or the application therein) and ensure that policies are in place that are reasonably designed to achieve disclosure and transparency regarding the Bank's true financial performance and governance practices;

(3) Oversee the internal audit function by:

(i) Reviewing the scope of audit services required, significant accounting policies, significant risks and exposures, audit activities and audit findings;

(ii) Assessing the performance and determining the compensation of the internal auditor; and

(iii) Reviewing and approving the internal auditor's work plan;

(4) Oversee the external audit function by:

(i) Approving the external auditor's annual engagement letter;

(ii) Reviewing the performance of the external auditor; and

(iii) Making recommendations to the Bank's board of directors regarding the appointment, renewal, or termination of the external auditor;

(5) Provide an independent, direct channel of communication between the Bank's board of directors and the internal and external auditors;

(6) Conduct or authorize investigations into any matters within the audit committee's scope of responsibilities;

(7) Ensure that senior management has established and is maintaining an adequate internal control system within the Bank by:

(i) Reviewing the Bank's internal control system and the resolution of identified material weaknesses and reportable conditions in the internal control system, including the prevention or detection of management override or compromise of the internal control system; and

(ii) Reviewing the programs and policies of the Bank designed to ensure compliance with applicable laws, regulations and policies and monitoring the results of these compliance efforts;

(8) Review the policies and procedures established by senior management to assess and monitor implementation of with the Bank's strategic business plan and the operating goals and objectives contained therein; and

(9) Report periodically its findings to the Bank's board of directors.

(f) *Meetings.* The audit committee shall prepare written minutes of each audit committee meeting.

§ 917.8 Budget preparation.

(a) *Adoption of budgets.* Each Bank's board of directors shall be responsible for the adoption of an annual operating expense budget and a capital expenditures budget for the Bank, and any subsequent amendments thereto, consistent with the requirements of the Act, this section, other regulations and policies of the Finance Board, and with the Bank's responsibility to protect both its members and the public interest by keeping its costs to an efficient and effective minimum.

(b) *No delegation of budget authority.* A Bank's board of directors may not delegate the authority to approve the Bank's annual budgets, or any subsequent amendments thereto, to Bank officers or other Bank employees.

(c) *Interest rate scenario.* A Bank's annual budgets shall be prepared based upon an interest rate scenario as determined by the Bank.

(d) *Board approval for deviations.* A Bank may not exceed its total annual operating expense budget or its total annual capital expenditures budget without prior approval by the Bank's board of directors of an amendment to such budget.

§ 917.9 Dividends.

A Bank's board of directors may 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 capital stock of the Bank. Dividends on such capital stock shall be computed without preference.

§ 917.10 Bank bylaws.

A Bank's board of directors shall have in effect at all times bylaws governing the manner in which the Bank administers its affairs and such bylaws shall be consistent with applicable laws and regulations as administered by the Finance Board.

4. In subchapter F, add a new part 940 to read as follows:

PART 940—MISSION OF THE BANKS

Sec.

940.1 Definitions.

940.2 Mission of the Banks.

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

§ 940.1 Definitions.

Community lending has the meaning set forth in § 952.3 of this chapter.

§ 940.2 Mission of the Banks.

The mission of the Banks is to provide to their members and associates financial products and services, including but not limited to advances, that assist and enhance such members' and associates' financing of:

(a) Housing, including single-family and multi-family housing serving consumers at all income levels; and

(b) Community lending.

Date: March 22, 2000.

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

Bruce A. Morrison,
Chairman.

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BILLING CODE 6725-01-P

applicable to certain Boeing Model 727 and 727C series airplanes, that requires one-time inspections of the exterior body skin located at the forward corners of the mid-galley door hinge cutouts to detect cracking, and corrective actions, if necessary. This AD also requires modification of the body skin of the mid-galley door hinge cutouts. This amendment is prompted by a report indicating that, during fatigue testing on a Boeing Model 727 series airplane, a crack was found in the body skin at the lower forward corners of the mid-galley door hinge cutouts due to cabin pressurization cycles. The actions specified by this AD are intended to prevent such fatigue cracking of the body skin, which could result in reduced structural integrity of the fuselage and consequent loss of cabin pressurization.

DATES: Effective June 5, 2000.

The incorporation by reference of certain publications listed in the regulations is approved by the Director of the Federal Register as of June 5, 2000.

ADDRESSES: The service information referenced in this AD may be obtained from Boeing Commercial Airplane Group, P.O. Box 3707, Seattle, Washington 98124-2207. This information may be examined at the Federal Aviation Administration (FAA), Transport Airplane Directorate, Rules Docket, 1601 Lind Avenue, SW., Renton, Washington; or at the Office of the Federal Register, 800 North Capitol Street, NW., suite 700, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Walter Sippel, Aerospace Engineer, Airframe Branch, ANM-120S, FAA, Transport Airplane Directorate, Seattle Aircraft Certification Office, 1601 Lind Avenue, SW., Renton, Washington 98055-4056; telephone (425) 227-2774; fax (425) 227-1181.

SUPPLEMENTARY INFORMATION: A proposal to amend part 39 of the Federal Aviation Regulations (14 CFR part 39) to include an airworthiness directive (AD) that is applicable to certain Boeing Model 727 and 727C series airplanes was published in the **Federal Register** on November 22, 1999 (64 FR 63753). That action proposed to require one-time inspections of the exterior body skin located at the forward corners of the mid-galley door hinge cutouts to detect cracking; corrective actions, if necessary; and modification of the body skin of the mid-galley door hinge cutouts.

Comments

Interested persons have been afforded an opportunity to participate in the

making of this amendment. Due consideration has been given to the comments received.

Airplanes Not Affected

On behalf of two of its members, the Air Transport Association of America (ATA) comments that no airplanes operated by those two members are affected by this proposal. The ATA makes no further comment or request.

Request to Remove Airplanes From Applicability

One commenter, the manufacturer, requests that the FAA revise the applicability statement of the proposed AD to remove two airplanes. The commenter states that, according to its records, the airplanes having line numbers 153 and 339 were determined to be irreparable on August 8, 1965, and February 16, 1968, respectively.

The FAA does not concur with the commenter's request. Though the commenter states that the airplanes were determined to be irreparable, the FAA considers it possible that the subject airplanes could be repaired by an entity other than the manufacturer. Should one of these airplanes be repaired and added to the U.S. Register in the future, the FAA finds that, to ensure safe operation, the airplane must be inspected, repaired, and modified, as applicable, in accordance with the requirements of this AD. No change to the final rule is necessary.

Conclusion

After careful review of the available data, including the comments noted above, the FAA has determined that air safety and the public interest require the adoption of the rule as proposed.

Cost Impact

There are approximately 1,516 Boeing Model 727 and 727C series airplanes of the affected design in the worldwide fleet. The FAA estimates that 3 airplanes of U.S. registry will be affected by this AD.

The FAA estimates that it will take approximately 1 work hour per airplane to accomplish the required inspections of the body skin at the corners of the mid-galley door hinge cutouts, and that the average labor rate is \$60 per work hour. Based on these figures, the cost impact of the inspections required by this AD on U.S. operators is estimated to be \$180, or \$60 per airplane.

The FAA also estimates that it will take approximately 28 work hours per airplane to accomplish the repair and modification, and that the average labor rate is \$60 per work hour. Required parts will cost approximately \$1,023 per

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 98-NM-293-AD; Amendment 39-11705; AD 2000-08-19]

RIN 2120-AA64

Airworthiness Directives; Boeing Model 727 and 727C Series Airplanes

AGENCY: Federal Aviation Administration, DOT.

ACTION: Final rule.

SUMMARY: This amendment adopts a new airworthiness directive (AD),