Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FEDERAL HOUSING FINANCE BOARD

12 CFR Parts 900, 917, 926, 944, 950, 952, 961 and 980

[No. 2000–16]

RIN 3069–AA97

Federal Home Loan Bank Advances, Eligible Collateral, New Business Activities and Related Matters

AGENCY: Federal Housing Finance Board.

ACTION: Proposed rule.

SUMMARY: The Federal Housing Finance Board (Finance Board) is proposing to amend its Advances Regulation and other regulations to implement the requirements of the Federal Home Loan Bank System Modernization Act of 1999 by: allowing the Federal Home Loan Banks (Banks) to accept from community financial institution members (CFI members) new categories of collateral to secure advances; expanding the purposes for which the Banks may make long-term advances to CFI members; and removing the limit on the amount of a member's advances that may be secured by other real estate-related collateral. The Finance Board also is proposing related and other technical changes to its regulations on General Definitions, Powers and Responsibilities of Bank Boards of Directors and Senior Management, Federal Home Loan Bank Associates, Community Support Requirements, Community Investment Cash Advance Programs and Standby Letters of Credit, and a new regulation on New Business Activities.

DATES: The Finance Board will accept comments on the proposed rule in writing on or before June 7, 2000.

ADDRESSES: Send comments to Elaine L. Baker, Secretary to the Board, by electronic mail at *bakere@fhfb.gov,* or by regular mail at the Federal Housing Finance Board, 1777 F Street, NW., Washington, DC 20006. Comments will be available for public inspection at this address.

FOR FURTHER INFORMATION CONTACT: James L. Bothwell, Director, (202) 408–2821, Scott L. Smith, Deputy Director, (202) 408–2991, or Julie Paller, Senior Financial Analyst, (202) 408–2842, Office of Policy, Research and Analysis; or Eric E. Berg, Senior Attorney-Advisor, (202) 408–2589, Eric M. Radenbush, Senior Attorney-Advisor, (202) 408–2932, or Sharon B. Like, (202) 408–2930, Office of General Counsel, Federal Housing Finance Board, 1777 F Street, NW., Washington, DC 20006.

SUPPLEMENTARY INFORMATION:

I. Background and Overview of Proposed Rule

A. Historical Benefits of Federal Home Loan Bank System

The Federal Home Loan Bank System (Bank System) comprises twelve regional Banks that are instrumentalities of the United States organized under the authority of the Federal Home Loan Bank Act (Bank Act). *See* 12 U.S.C. 1423, 1432(a). The Banks are cooperatives; only members of a Bank may own the capital stock of a Bank and only members and certain eligible nonmember borrowers (associates) (such as state housing finance agencies) may obtain access to the products provided by a Bank. *See* 12 U.S.C. 1426, 1430(a), 1430b. Each Bank is managed by its own board of directors and serves the public by enhancing the availability of residential housing finance and community lending credit through its members and associates. *See* 12 U.S.C. 1427. Any eligible institution (typically, an insured depository institution) may become a member of a Bank by satisfying certain criteria and by purchasing a specified amount of a Bank's capital stock. *See* 12 U.S.C. 1424, 1426; 12 CFR part 925.

As government sponsored enterprises (GSEs), the Banks are granted certain privileges that enable them to borrow funds in the capital markets on terms more favorable than could be obtained by private entities, so that the Bank System generally can borrow funds at a modest spread over the rates on U.S. Treasury securities of comparable maturity. The Banks pass along their GSE funding advantage to their members, and ultimately to consumers, by providing secured loans, called advances, and other financial products and services at rates and terms that would not otherwise be available to their members.

The Banks must fully secure advances with eligible collateral. *See* 12 U.S.C. 1430(a). At the time of origination or renewal of an advance, a Bank must obtain a security interest in collateral eligible under one or more of the collateral categories set forth in the Bank Act. *See* 12 U.S.C. 1430(a) (as amended).

Under section 10 of the Bank Act and part 950 of the Finance Board's regulations, the Banks have broad authority to make advances in support of residential housing finance, which includes community lending, defined, in the proposed rule, as providing financing for economic development projects for targeted beneficiaries and, for CFIs, purchasing or funding small business loans, small farm loans or small agri-business loans. *See* 12 U.S.C. 1430(a), (i), (j); 12 CFR parts 900, 950. The Banks also are required to offer two programs, the Affordable Housing Program (AHP) and the Community Investment Program (CIP), to provide subsidized or at-cost advances, respectively, in support of unmet housing finance or targeted economic development credit needs. *See* 12 U.S.C. 1430(i), (j); 12 CFR parts 951, 952. In addition, section 10(j)(10) of the Bank Act authorizes the Banks to establish additional Community Investment Cash Advance (CICA) Programs for targeted community lending, defined as providing financing for economic development projects for targeted beneficiaries. *See* 12 U.S.C. 1430(j)(10); 12 CFR part 952.

B. Expanded Access to Bank System Benefits

On November 12, 1999, the President signed into law the Federal Home Loan Bank System Modernization Act of 1999 (Modernization Act) [1] which, among other things, amended the Bank Act by providing smaller lenders with greater access to membership in the Bank System and greater access to Bank advances. The Modernization Act established a category of members consisting of FDIC-insured depository institutions with less than $500,000,000 in average total assets (based on an average of total assets over three years)

[1] The Modernization Act is Title VI of the Gramm-Leach-Bliley Act, Pub. L. No. 106–102, 113 Stat. 1338 (Nov. 12, 1999).

called community financial institutions, or CFIs, [2] and authorized the Banks to make long-term advances to CFI members for the purposes of providing funds for small businesses, small farms and small agri-businesses. *See* Modernization Act, sections 602, 604(a)(2), 605. The Modernization Act also authorized the Banks to accept from CFI members as security for advances secured loans for small business, agriculture, or securities representing a whole interest in such secured loans. *See id.,* section 604(a)(5)(C).

For all members, the Modernization Act removed the statutory limit on the amount of aggregate outstanding advances that could be secured by ''other real estate-related collateral,'' which had been capped at 30 percent of a member's capital. *See id.*, section 604(a)(5)(B). Banks, therefore, are now authorized to accept other real estate-related collateral as security for advances to any member as long as the collateral has a readily ascertainable value and the Bank is able to perfect a security interest in that collateral. *See* 12 U.S.C. 1430(a)(3)(D) (as amended).

The Finance Board is proposing to amend its regulations to implement the new statutory authorities described above. Because the primary duty of the Finance Board is to ensure that the Banks operate in a safe and sound manner, the proposed rule includes certain safeguards. The Finance Board believes that, because the Banks have had no experience with the new types of nonmortgage-related collateral authorized in the Modernization Act and in this proposed rule, and have made only limited use of ''other real estate-related'' collateral, the Banks will need to build capacity to evaluate the new types of collateral and must exercise caution even in accepting higher volumes of ''other real estate-related'' collateral. Banks will need to learn how to value small business loans and agriculture loans before accepting such loans from CFI members as security for advances. For these reasons, the Finance Board is proposing to treat these activities as new lines of business. Thus, part 980 of the proposed rule would require a Bank, prior to accepting for the first time the new categories of collateral from CFI members, or significantly higher volumes of ''other real estate-related'' collateral, to file a notice with the Finance Board containing information that demonstrates that the Bank has the capacity, sufficiency of experience, and expertise to safely value, discount and manage the risks associated with the particular types of collateral to be accepted. In evaluating a Bank's notice of new collateral activities, the Finance Board intends to encourage conservative discounting of new collateral until the Bank gains experience in valuing such collateral.

Prior to the enactment of the Modernization Act, section 10(e) of the Bank Act restricted access to Bank advances to Bank members that did not meet the qualified thrift lender (QTL) test.[3] These restrictions limited the purposes for which non-QTL members could obtain advances, limited Bank System-wide advances to non-QTL members to 30 percent of total Bank System advances outstanding, and gave QTL members a priority over non-QTL members in obtaining advances. *See* 12 U.S.C. 1430(e)(1), (2) (1994). The Bank Act also established a statutory presumption, for the purpose of determining the minimum amount of Bank capital stock that a member must purchase pursuant to section 6(b) of the Bank Act, that each member has at least 30 percent of its assets in home mortgage loans. *See* 12 U.S.C. 1430(e)(3) (1994). Coupled with the section 6(b) requirement that all members must subscribe to Bank stock equaling at least one percent of the member's aggregate unpaid loan principal, this presumption effectively limited the dollar amount of advances that a non-QTL member could obtain in relation to the amount of Bank stock it had purchased. *See id.*

The Modernization Act repealed section 10(e) of the Bank Act in its entirety, thereby providing access to Bank advances without regard to the percentage of housing-related assets a member holds. *See* Modernization Act, section 604(c). In a recently adopted Interim Final Rule, the Finance Board removed the provisions in its Membership and Advances Regulations containing the additional capital stock purchase requirements and limitations on advances applicable to non-QTL members. *See* 65 FR 13866 (March 15, 2000). The Finance Board is proposing in this rule to remove all remaining references to non-QTL status from its Advances Regulation. *See* 12 CFR 950.1, 950.21 (1999).

C. Related Amendments

The Finance Board also is proposing to revise its regulations to: (1) Amend part 900 (General Definitions) to add a new, broader definition of ''community lending'' that would include, for CFI members, purchasing or funding small business loans, small farm loans and small agri-business loans; (2) add a new section in part 917 (Powers and Responsibilities of Bank Boards of Directors and Senior Management) to set forth the responsibilities of a Bank's board of directors regarding member products policies; (3) add a new part 926 (Federal Home Loan Bank Associates) to address separately the eligibility requirements for associates that currently are contained in part 950; (4) replace the term ''community lending'' with the term ''targeted community lending'' in part 944 (Community Support Requirements) and part 952 (Community Investment Cash Advance Programs) to differentiate ''targeted community lending'' referred to in those parts from the broader definition of ''community lending'' proposed in part 900; (5) make technical and conforming changes to the collateral provisions in part 961 (Standby Letters of Credit); and (6) add a new part 980 (New Business Activities) setting forth the standards and procedures under which a Bank may engage in new business activities, including the acceptance of new types of collateral.

II. Analysis of Proposed Rule

A. Modernization Act Amendments Establishing Newly Eligible Collateral

1. New CFI-Eligible Collateral

a. Collateral eligible as security for advances to CFI members or their affiliates. The Modernization Act amended the Bank Act to allow CFI members to pledge new types of collateral as security for advances, specifically, secured loans for small business or agriculture, or securities representing a whole interest in such secured loans. *See* Modernization Act, section 604(a)(5)(C). Proposed § 950.7(b)(1) implements this amendment by authorizing the Banks to accept from CFI members or their affiliates as security for advances, small business loans, small farm loans or small agri-business loans fully secured by collateral other than real estate, or securities representing a whole interest in such loans, provided that (i) the loans

[2] The Finance Board recently adopted an Interim Final Rule that amended the Finance Board's Membership Regulation to implement the Modernization Act amendments regarding membership in the Bank System. *See* 65 FR 13866 (March 15, 2000).

[3] The ''qualified thrift lender'' test is set forth in section 10(m) of the Home Owners' Loan Act, 12 U.S.C. 1467a(m), and applies directly only to savings associations. Originally enacted in 1987, the QTL test was intended to ensure that savings associations remained committed to the business of providing housing-related loans. Failure to meet the test subjected both the savings association and its holding company to certain statutory penalties, including reduced access to Bank advances for the association. In 1989, Congress revised the QTL test and the penalties for failing to meet it, including more severe restrictions on access to Bank advances for savings associations, as well as for commercial banks, that did not meet the test.

have a readily ascertainable liquidation value and can be freely liquidated in due course; and (ii) the Bank can perfect a security interest in such collateral (CFI-eligible collateral). Proposed § 950.7(b)(1) also requires that, prior to accepting any such CFI-eligible collateral, a Bank shall meet the new business activity requirements of part 980 of the proposed rule, described below. This requirement is intended to ensure that a Bank has the capacity to value, discount and manage the newly eligible collateral prior to making advances secured by such collateral.

Proposed § 950.7(b)(1) does not explicitly refer to secured loans for agriculture, as does the Modernization Act. *See* Modernization Act, section 604(a)(5)(C). Instead, the Finance Board has interpreted ''agriculture loans'' to mean small farm loans and small agri-business loans, and substituted these terms, in the text of proposed § 950.7(b)(1). These terms also appear in proposed § 950.3, which sets forth the authorized purposes of long-term Bank advances, so their use in proposed § 950.7(b)(1) is consistent with the Finance Board's general policy of employing uniform terminology in its regulations whenever possible.

Although the Finance Board could authorize the Banks to accept all secured agriculture loans as collateral from CFI members, the Finance Board is proposing, by interpreting agriculture loans to mean small farm loans and small agri-business loans, to allow only secured ''small'' agriculture loans to be included as eligible collateral. The Finance Board believes that permitting the Banks to accept as collateral only ''small'' agriculture loans is consistent with both the Banks' mission of assisting members with community lending and with the Modernization Act's emphasis on small institutions' lending to small enterprises. *See* Modernization Act, sections 602, 604(a)(3), 604(a)(5)(C).

Proposed § 950.7(b)(1) excludes loans secured by real estate because these types of loans are included in proposed § 950.7(a)(4).

In view of the greater risks inherent in non-mortgage, CFI-eligible collateral, the Finance Board, for safety and soundness reasons, considered whether limits or restrictions should be established on the types of collateral that could secure such loans or securities pledged by a CFI member or affiliate to secure an advance. For example, small business loans secured by accounts receivable or inventory, or small farm loans secured by crops or livestock, which may present greater risks than other types of secured small business or small farm loans, could have been excluded from the forms of eligible collateral. However, the Finance Board has chosen not to impose limits or restrictions in the proposed rule, but instead to require the Banks to have policies and capacity to value the collateral, whatever it may be. The Finance Board believes that proposed § 950.10(a), which requires that each Bank determine the value of collateral in accordance with the Bank's member products policy (established pursuant to proposed § 917.4), should minimize the Banks' exposure to risk in accepting CFI-eligible collateral. The Finance Board expects such policies, if they are properly developed and implemented, to take the appropriate risk factors into account in their valuation and discounting procedures. Of course, the policies, and the Banks' activities in this regard, also would be subject to examination by the Finance Board and to the new activities requirements of proposed part 980, discussed below. Accordingly, the proposed rule does not establish limits on the types of collateral that may secure such loans or securities pledged by a CFI member or affiliate. The Finance Board specifically requests comment on whether certain types of CFI-eligible collateral should be prohibited as eligible collateral on the basis of risk.

b. Types of collateral—Definitions of ''small business loans,'' ''small farm loans'' and ''small agri-business loans''. To facilitate the safe and sound implementation of the Banks' authority to accept new types of collateral to secure advances to CFI members, the Finance Board is proposing to amend § 950.1 by defining the terms ''small business loans,'' ''small farm loans'' and ''small agri-business loans.'' For loans below a prescribed aggregate amount, the proposed definitions use loan size as a proxy for business size. For loans above the ceiling amount, business data specific to the borrowing enterprise (such as annual gross receipts) would determine whether a loan fits within the definition.

The business size approach provides greater accuracy, but may result in costs that deter CFI members from fully employing Banks as a funding source for loans to the small businesses and small farms in their communities. The loan size approach is less precise, but has the advantage of lower implementation costs, since it involves information already available to Federally regulated financial institutions in the reports they are required to file with their primary federal regulator.

The Finance Board believes that the proposed definitions represent an appropriate compromise between these two approaches that will allow CFI members to use Bank System funding to finance the small businesses and small farms in their communities, as authorized by the Modernization Act. *See* Modernization Act, section 604(a)(5)(C).

(i) ''Small business loans''

Proposed § 950.1 defines ''small businesses loans'' as either: (1) Loans (including the aggregate of all loans to a particular borrower) with an original amount of not more than $1 million that are reported on either Schedule SB of the Thrift Financial Report filed by savings associations as ''permanent mortgage loans secured by nonfarm, nonresidential properties'' or ''nonmortgage, nonagricultural commercial loans,'' or Schedule RC–C, Part II of the Report of Condition and Income (Call Report) filed by insured commercial banks and FDIC-supervised savings banks as ''loans secured by nonfarm nonresidential properties'' or ''commercial and industrial loans to U.S. addresses''; or (2) loans for which the CFI, on a case-by-case basis, documents that the borrower meets the eligibility standards for a small business concern under the Small Business Administration's (SBA) regulations at 13 CFR part 121, or any successor provisions.

The Finance Board considered several possible definitions of a small business loan. One possible definition is a loan to a business that meets the eligibility standards for a small business concern under the Small Business Act and SBA regulations.[4] The Small Business Act defines an eligible small business as one that is independently owned and operated and not dominant in its field of operation. *See* 15 U.S.C. 632. The Small Business Act also states that in determining what is a small business, the definition shall vary from industry to industry to adequately reflect industry differences. *See id.* § 632(a)(3). The SBA developed size standards that define the maximum size of an eligible small business, based either on ''annual receipts'' or number of employees. 13 CFR 121.201. SBA regulations define ''annual receipts'' as total income plus

[4] Under the Small Business Act, the size of a manufacturing concern is determined on the basis of average employment, the size of a business concern providing services is determined on the basis of annual gross receipts over a period of not less than 3 years, and the size of other business concerns is determined on the basis of business data over a period of not less than 3 years. See 15 U.S.C. 632(b)(2)(C)(1996), The Small Business Administration implements these statutory standards with industry specific size regulations under 13 CFR part 121.

the cost of goods sold. 13 CFR 121.104. The size standards are based on Standard Industrial Classification (SIC) code, and generally are as follows:

Industry	Size
Retail and Service	$3.5 to $21.5 million
Construction	$7.0 to $17.0 million
Agriculture	$0.5 to $9.0 million
Wholesale	No more than 100 employees
Manufacturing	500 to 1,500 employees

When affiliations exist with other companies, the primary business activity must be determined both for the applicant business as well as for the entire affiliated group. 13 CFR 121.103.

The Finance Board recognizes that member institutions are not apt to compile the type of information necessary to determine whether a business borrower qualifies as a small business under the SBA definition, and that requiring that such information be collected would impose additional costs on CFI members. Thus, the Finance Board considered other alternatives, including a definition of a small business based on the reporting requirements for loans to small businesses and small farms promulgated by the Federal Financial Institutions Examination Council (FFIEC).[5]

Section 122 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires the Federal banking agencies to annually collect from insured depository institutions such information on small business and small farm lending as the agencies may need to assess the availability of credit to these sectors of the economy.[6] Section 122 of FDICIA does not specify the types of information that the agencies must collect on small business and small farm loans, but it does indicate that the reporting requirement may be implemented by collecting data on the total number and aggregate dollar amount of loans to small businesses and agricultural loans to small farms. Section 122 of FDICIA also suggests that information on charge-offs and loan income be collected, but FFIEC determined that such information would not add sufficient value to the assessment of credit availability to justify the cost to institutions of reporting the information. *See* 57 FR 21410 (May 20, 1992).

On May 20, 1992, FFIEC published proposed reporting requirements on small business and small farm lending. *See id.* Because the terms ''small business'' and ''small farm'' were not defined in FDICIA, FFIEC proposed to use annual sales as the basis upon which to identify small businesses and small farms. Businesses and farms with annual sales of less than $10 million and $500,000, respectively, were deemed to be ''small.'' *See id.*

Many of the comment letters received from institutions indicated that the implementation costs of the proposed FFIEC data collection would be excessive. *See* 57 FR 54235, 54237. A comparison of the expected costs with the expected benefits of the information led FFIEC to consider whether other reporting alternatives might be available that would allow institutions to report information of comparable value at a lower cost to the industry. *See id.*

Based on these considerations, FFIEC decided to use loan size as a proxy for business and farm size. As a rationale for using this approach, FFIEC, in the Supplemental Information section of the adopting release, indicated that it had reviewed data reported in the 1989 National Survey of Small Business Finances, a survey of firms with fewer than 500 employees, and concluded that the data indicated a strong correlation between size of business and loan size. In addition, several of the commentators had recommended that loan size be used as a proxy for business size. *See id.*

FFIEC decided to use the original amount of the loan rather than the current balance because an institution's loans with balances below a certain amount would include loans of varying original amounts to all sizes of borrowers that have been partially repaid.

As a rationale for the upper limit of $1 million for small business loans, FFIEC stated that more loans above this loan size category would tend to be made to larger businesses than in the category of loans of $1 million or less. In addition, FFIEC indicated that the more than 9,500 institutions with less than $100 million in assets would generally be constrained by their lending limits from making loans to businesses that would be considered ''large.'' *See id.* at 54238.

The final FFIEC rule also requires financial institutions to report business loans with original amounts of $100,000 or less, more than $100,000 through $250,000, and more than $250,000 through $1 million. *See id.*

The Finance Board is proposing to define a small business loan based on the loan size standards established by the FFIEC agencies. Because this information on loan size is readily available to financial institutions, this approach will avoid burdensome costs to CFI members that might deter such members from using Banks as a funding source for loans to small businesses. The Finance Board also recognizes that applying only the FFIEC standard would exclude loans that exceed $1 million to businesses that meet the eligibility standards for a small business concern under the SBA's regulations. 13 CFR 121.104. To allow such loans to be eligible to secure advances to CFI members, the proposed definition of ''small business loans'' includes a qualifying alternative that does not impose a loan size restriction if the CFI member can document on a case-by-case basis that the borrower meets the eligibility standards for a small business concern under the SBA's regulations.

The Finance Board expects that CFI members initially will rely on the part of the proposed definition of small business loans that emphasizes loan size. However, over time, CFI members would have the opportunity to implement procedures to establish a borrower's size based on the SBA's regulatory standards, and thereby be in a position to rely on that part of the definition that does not restrict loan size. The Finance Board requests comment on whether there may be any other appropriate methods of categorizing or defining small business loans.

(ii) ''Small Farm Loans''

Proposed § 950.1 defines ''small farm loans'' as either: (1) Loans (including the aggregate of all loans to a particular borrower) with an original amount of not more than $500,000 that are reported on either Schedule SB of the Thrift Financial Report filed by savings associations as ''loans secured primarily by farms,'' or Schedule RC–C, Part II of the Report of Condition and Income filed by insured commercial banks and FDIC-supervised savings banks as ''loans secured by farmland (including farm residential and other improvements)''; or (2) loans for which the CFI, on a case-by-case basis, documents that the borrowers meet the eligibility standards for a small business concern under the SBA's regulations at 13 CFR part 121, or any successor provisions.

As with the proposed definition of ''small business loans,'' the proposed

[5] FFIEC is a formal interagency body empowered to prescribe uniform principals, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Coporation, the National Credit Union Adminstration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision and to make recommendations to promote uniformity in the supervision of financial institutions. *See* 12 U.S.C. 3301 *et. seq.*

[6] Section 122 of FDICIA (Pub. L. No. 102–242, 105 Stat. 2251 (12 U.S.C. 1817 note)).

definition of ''small farm loans'' represents a compromise between the precision of the SBA's regulations, which include size parameters for farm enterprises,[7] and the practicality of FFIEC's standards for small farm loans. Accordingly, the definition of ''small farm loans'' is identical to the definition of ''small business loans,'' except for the items referred to on Schedule SB and Schedule RC–C, and the upper limit of $500,000, which corresponds to the upper limit FFIEC applies to small farm loans. The particular schedule items referenced in the definition of ''small farm loans'' are the items in the schedules that most closely correlate to small farm activity and lending.

As a rationale for the upper limit of $500,000 for small farm loans, the notice accompanying FFIEC's final rule stated that data from the Second Quarter 1992 Agricultural Finance Databook prepared by the Federal Reserve Board (Databook) indicates that less than five percent of all non-real estate loans to farmers in recent years are made in amounts of $100,000 or more. See 57 FR 54238. The Databook also estimated that, in 1991, the average size of non-real estate loans to farmers with original amounts of $100,000 or more was $540,000. *See id.* Thus, FFIEC determined that a $1 million loan size cutoff for small farm loans would likely capture an extremely high percentage of all farm loans. FFIEC concluded that a loan size cutoff of $500,000 would be appropriate in order to reduce the likelihood that loans that have been made to large farms are reported as part of an institution's loans to small farms. *See id.*

The FFIEC final rule also requires financial institutions to report farm loans with original amounts of $100,000 or less, more than $100,000 through $250,000, and more than $250,000 through $500,000. *See id.* The Finance Board requests comment on whether there may be any other appropriate methods of categorizing or defining small farm loans.

(iii) ''Small agri-business loans''

Proposed § 950.1 defines ''small agri-businesses loans'' as either: (1) Loans (including the aggregate of all loans to a particular borrower) with an original amount of not more than $500,000 that are reported on either Schedule SB of the Thrift Financial Report filed by savings associations as ''nonmortgage, commercial loans to finance agricultural production and other nonmortgage commercial loans to farmers,'' or Schedule RC–C, Part II of the Report of Condition and Income filed by insured commercial banks and FDIC-supervised savings banks as ''loans to finance agricultural production and other loans to farmers''; or (2) loans for which the CFI, on a case-by-case basis, documents that the borrowers meet the eligibility standards for a small business concern under the SBA's regulations at 13 CFR part 121, or any successor provisions.

The proposed definition of ''small agri-business loans'' is identical to the definition of ''small farm loans'' except for the items referred to on Schedule SB and Schedule RC–C, which more closely correlate to small agri-business activity and lending. As with the proposed definitions of ''small business loans'' and ''small farm loans'', the proposed definition of ''small agri-business loans'' represents a compromise between the SBA size standards for agricultural businesses,[8] and FFIEC's standards for small agri-business loans, as identified by the schedule items referenced in the definition. The Finance Board requests comment on whether there may be any other appropriate methods of categorizing or defining small agri-business loans.

c. *Change in CFI Status.* Proposed § 950.7(b)(2) addresses how a Bank should deal with a CFI member that has advances outstanding secured by CFI-eligible collateral that loses its CFI status. Proposed § 950.7(b)(2) prohibits a Bank from accepting as security for new advances CFI-eligible collateral from a member that no longer qualifies as a CFI member. However, in order to prevent a situation where a member must quickly obtain alternative funding, proposed § 950.7(b)(2) provides that a Bank shall not require a member that loses its CFI status and has outstanding advances secured by CFI-eligible collateral to repay such advances prior to the stated maturities, or to provide substitute collateral, eligible under paragraphs (a)(1) through (5), based solely on the member's change in CFI status.

Proposed § 950.7(b)(2) also authorizes a Bank to allow such member to renew maturing advances secured by CFI-eligible collateral for up to 6 months. This is intended to provide the member with sufficient time to wind down advances and replace them with other funding in an orderly fashion. It is not uncommon for members to obtain short-term advances that frequently renew for additional terms. In that case, the member could have difficulty securing alternative funding if all or most of its advances mature within a short period of time. The Finance Board specifically requests comment on whether allowing renewals of such advances is appropriate and, if so, whether allowing renewals for up to 6 months would provide sufficient time for members to obtain alternative funding.

2. Cash or Deposits in a Bank

Current § 950.9 of the Advances Regulation (redesignated as § 950.7 in the proposed rule) sets forth the types of eligible collateral that a Bank may accept to secure advances. The Modernization Act revised section 10(a)(3) of the Bank Act to add ''cash'' to the types of eligible collateral. *See* Modernization Act, section 604(a)(5)(A). Proposed § 950.7(a)(3) implements this change by adding cash as eligible collateral.

3. Other Real Estate-Related Collateral

The Modernization Act amended section 10(a)(4) of the Bank Act by removing the limit on the dollar amount of advances that may be secured other real estate-related collateral, which had been set at 30 percent of the member's capital. *See* Modernization Act, section 604(a)(5)(B). Section 950.7(a)(4) of the proposed rule implements this change by removing the 30 percent limitation. Proposed § 950.7(a)(4)(iii), however, provides that a Bank shall not make total advances to all members secured by other real estate-related collateral in an aggregate amount that would exceed 25% of the highest level of advances previously secured by such collateral, until the Bank has met the new business activity requirements of proposed part 980.

The Finance Board specifically requests comment on what the appropriate threshold should be for triggering the new business activity requirement with respect to the use of other real estate-related collateral, and whether there should be any other limits on the use of such collateral to ensure that the Banks' lending against this type of collateral is done in a safe and sound manner. The Finance Board also specifically requests comment on whether members should be required to pledge all available collateral under proposed §§ 950.7(a)(1) through (3) prior to pledging other real estate-related collateral under paragraph (4) in order to prevent members from using only their least liquid collateral to secure Bank advances. While each Bank has the discretion to include such a requirement in its member products policy, it may be appropriate for the Finance Board to require that such a provision be included in such policies, especially in light of the Modernization Act authorization for the Finance Board to review, and increase, the Banks'

[7] *See* 13 CFR 121.201.

[8] See 13 CFR 121.201.

standards for other real estate-related collateral. *See* Modernization Act, section 604(a)(7).

Current § 950.9(a)(4)(i)(A) of the Advances Regulation requires other real estate-related collateral to have a readily ascertainable value. The Finance Board believes that the liquidation value of collateral, and the ability to liquidate the collateral quickly, is a more appropriate measure of the value of other real estate-related collateral securing an advance, particularly given the lifting of the 30 percent cap. Accordingly, proposed § 950.7(a)(4)(i)(A) provides that other real estate-related collateral have a readily ascertainable liquidation value and be able to be freely liquidated in due course. This change also is proposed in § 950.7(b)(1)(i).

4. Removal of Combination Business or Farm Property From Definition of ''Residential Real Property''

Under current § 950.1, the term ''residential real property'' is defined to include combination business or farm property, where at least 50 percent of the total appraised value of the combined property is attributable to the residential portion of the property or, in the case of a CFI, combination business or farm property on which is located a permanent structure actually used as a residence (other than for temporary or seasonal housing), where the residence constitutes an integral part of the property. 12 CFR 950.1. This provision was intended to allow mortgage loans on such properties to qualify as eligible collateral and be included in a member's total residential housing assets for the purpose of qualifying for membership and obtaining long-term advances. The Modernization Act's removal of the statutory limit on the amount of advances that may be secured by other real estate-related collateral appears to have eliminated the necessity of allowing combination business or farm property to be counted under the mortgage loan category of eligible collateral. In addition, the Modernization Act's removal of the requirement that CFI members have 10 percent of their assets in residential mortgage loans to qualify for membership and the expansion of the purposes for which advances may be made to CFI members also reduce the significance of counting such combination properties as residential mortgage loans. Accordingly, the Finance Board has proposed removing combination business or farm property from the definition of ''residential real property'' in § 950.1. The Finance Board specifically requests comment on whether there are any reasons to retain combination business or farm property in the definition of ''residential real property.''

B. New Business Activity Requirement

As discussed above, the proposed changes in types and amounts of collateral that may be pledged to secure advances will present new management challenges for the Banks. In order to ensure that entering into these and other new types of business activities will not create safety and soundness concerns, the Finance Board is proposing to add a new part 980 to its regulations. Proposed § 980.3 requires a Bank to provide at least 60 days prior written notice to the Finance Board of any new business activity that the Bank wishes to undertake—including the acceptance of increased volumes of other real estate-related collateral and of new CFI-eligible collateral for the first time—so that the Finance Board may disapprove, examine or impose restrictions on such activities, as necessary, on a case-by-case basis. In addition to the acceptance of new or increased volumes of collateral, proposed § 980.1 defines a ''new business activity'' as any business activity undertaken, transacted, conducted or engaged in by a Bank that has not been previously approved by the Finance Board, including: (1) A business activity that has not been undertaken previously by that Bank, or was undertaken previously under materially different terms and conditions; (2) a business activity that entails risks not previously and regularly managed by that Bank, its members, or both, as appropriate; or (3) a business activity that involves operations not previously undertaken by that Bank. The test of what constitutes a new business activity for a particular Bank is intended to focus attention on worthy new activities. The prior notice requirement would apply to any Bank desiring to pursue a new activity, even if another Bank has already undertaken the same activity. With respect to accepting either newly eligible collateral or significantly higher volumes of other real estate-related collateral, the written notice required by proposed § 980.3(b) must include: a description of the classes or amounts of collateral proposed to be accepted by the Bank; a copy of the Bank's member products policy; a copy of the Bank's procedures for determining the value of the collateral in question; and a demonstration of the Bank's capacity, personnel, technology, experience and expertise to value, discount and manage the risks associated with the collateral in question. This requirement is intended to ensure that a Bank has the capacity to value, discount and manage the additional collateral prior to making advances secured by such collateral.

C. Clarification of Other Collateral Provisions in Existing Regulation

1. Securities Representing Equity Interests in Eligible Collateral

Current § 950.9(a)(5) of the Advances Regulation provides that a Bank may accept as collateral any security, such as mutual fund shares, the ownership of which represents an undivided equity interest in underlying assets, all of which qualify either as: (i) eligible collateral under paragraph (a)(1) (mortgage loans and privately issued mortgage-backed securities) or paragraph (a)(2) (agency securities); or (ii) cash or cash equivalents. As discussed above, cash is now included as eligible collateral under paragraph (a)(3). Accordingly, for greater clarity, a reference to paragraph (a)(3) is included in proposed § 950.7(a)(5)(i) and the reference to cash in paragraph (a)(5)(ii) is removed.

The current Advances Regulation does not include a definition of ''cash equivalents.'' Proposed § 950.1 defines ''cash equivalents'' as investments that: (1) Are readily convertible into known amounts of cash; (2) have a remaining maturity of 90 days or less at the acquisition date; and (3) are held for liquidity purposes. This definition would codify a Finance Board regulatory interpretation (Regulatory Interpretation 2000–RI–1 (March 6, 2000)) that allowed a Bank to accept as collateral under § 950.7(a)(5), shares of mutual funds that enter into certain limited types of repurchase agreements. For cash management purposes, mutual funds typically hold securities, pursuant to repurchase agreements, that represent short-term investments as part of their daily cash management activities. A mutual fund's ability to enter into such repurchase agreements, typically with a maturity of less than 90 days, allows the excess cash in the fund to be invested without losing liquidity or incurring price risk. Even mutual funds with particularly restrictive investment limitations, such as those limited to mortgage loans, government securities, and agency securities, typically use repurchase agreements to maintain a liquidity position and manage the fund.

The Financial Accounting Standards Board (FASB) defines ''cash equivalents'' for financial reporting purposes as short-term, highly liquid investments that are both: (a) readily convertible into cash; and (b) so near their maturity that they present

insignificant risk of changes in value because of changes in interest rates. *See* FAS 95 Paragraphs 8–10. FASB also states that, generally, only investments with original maturities of three months or less qualify under that definition. *See id.*

The proposed definition of ''cash equivalents'' is derived from the FASB definition, but would adapt it by requiring that investments have a remaining maturity of 90 days or less at the acquisition date, because this standard is more practical to implement than a requirement that investments be so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. In addition, a requirement that the investments be held for liquidity purposes is being included in the proposed definition. The Banks will be required to determine on a case-by-case basis whether this requirement has been met.

Other real estate-related collateral under current § 950.9(a)(4) was not originally included in current § 950.9(a)(5)(i) because the dollar amount of advances that could be secured by other real estate-related collateral was limited to 30 percent of the member's capital and the Finance Board believed this limitation would result in monitoring complexities that would make the inclusion of other real estate-related collateral in § 950.9(a)(5)(i) impractical. *See* 64 FR 16618 (April 6, 1999). As discussed above, the Modernization Act amended section 10(a)(4) of the Bank Act by removing the 30 percent cap on other real estate-related collateral. *See* Modernization Act, section 604(a)(5)(B). Since this impediment has been eliminated, proposed § 970.7(a)(5)(i) includes a reference to other real estate-related collateral under proposed § 950.7(a)(4).

2. Bank Restrictions on Eligible Collateral

Section 9 of the Bank Act provides that the Banks have discretion to deny, or to approve with conditions, a request for an advance, and section 10(a)(1) confers on the Banks the authority to determine whether collateral is sufficient to fully secure an advance. *See* 12 U.S.C. 1429, 1430(a)(1). Current § 950.9(b) of the Advances Regulation grants a Bank the discretion to further restrict the types of eligible collateral it will accept as security for advances based on the creditworthiness or operations of the borrower, the quality of the collateral, or other reasonable criteria. 12 CFR 950.9(b). The Finance Board believes that the discretionary authority conferred on the Banks by current § 950.9(b) is unnecessary in light of the Banks' statutory authority, and because the factors listed in current § 950.9(b) are ordinarily considered in valuing collateral. Accordingly, the Finance Board proposes to remove current § 950.9(b).

3. Pledge of Advances Collateral by Affiliates

The Bank Act does not directly address the acceptance of eligible collateral from an affiliate, apart from section 10(e) of the Bank Act, which gives a priority to any security interest granted by a member or its affiliates, subject to certain exceptions. *See* 12 U.S.C. 1430(e). Implicit in Congress' inclusion of collateral pledged by an affiliate in the so-called ''superlien provision'' is the authority for the Banks to accept collateral from members' affiliates. Accordingly, the Finance Board has determined that Congress has authorized the Banks to accept collateral not only from a wholly-owned subsidiary, but from any affiliate of a member, and is proposing to state that expressly in proposed § 950.7(f).

Proposed § 950.7(f)(1) requires that the pledge of collateral by an affiliate of a member used to secure advances to the member shall either directly secure the member's obligation to repay the advances, or secure a surety or other agreement under which the affiliate has assumed, along with the member, a primary co-obligation to repay the advances made to the member. Because the Bank Act requires that each advance be fully secured, *see* 12 U.S.C. 1430(a), a guaranty by an affiliate of a member's obligation, backed by the eligible assets held by the affiliate, would not meet the requirements of the Bank Act or the proposed rule, as the collateral would then be securing the affiliate's secondary obligation and not the advance itself. As provided by proposed § 950.7(f)(1), however, where the affiliate enters into a surety arrangement under which it assumes a primary joint and several co-obligation to repay the advance made to the member, and fully secures this primary surety obligation with eligible collateral, such collateral would be considered as securing the advance itself, as required by the statute.

Proposed § 950.7(f)(2) requires the Bank to obtain from an affiliate, and maintain, a legally enforceable security interest pursuant to which the Bank's legal rights and privileges with respect to the collateral are functionally equivalent in all material respects to those that the Bank would possess if the member were to pledge the same collateral directly. The Bank would be required to have on file adequate documentation demonstrating this functional equivalence. The Finance Board anticipates that Banks that decide to accept collateral from affiliates of members will need to make this determination on a case-by-case basis, after careful legal review and analysis, taking into consideration the structure of the transaction and the law of the state that governs the transaction.

These proposed regulatory additions represent a modification of an earlier proposal on third-party collateral that was published for comment by the Finance Board, but that was subsequently withdrawn. In December 1998, the Finance Board published a proposed rule to amend the Advances Regulation (at that time designated as 12 CFR part 935), that, among other things, would have permitted the Banks to accept pledges of eligible collateral from a member's ''qualifying investment subsidiary'' (QIS) if the Bank were able to obtain and maintain a security interest in the collateral pursuant to which its rights and privileges were functionally equivalent to those that the Bank would possess if the member were to pledge the collateral directly. Under the December 1998 proposed rule, the term ''qualifying investment subsidiary'' would have included business entities that: (1) Are wholly owned by a member; (2) are operated solely as passive investment vehicles on behalf of that member; and (3) hold only cash equivalents and assets that are eligible collateral under §§ 935.9(a)(1) and (2) of the Advances Regulation. *See* 63 FR 67625 (Dec. 8, 1998).

In proposing the December 1998 amendments, the Finance Board intended to codify into regulation a series of Finance Board regulatory interpretations regarding the acceptance of eligible collateral held by a real estate investment trust and state security corporation subsidiaries. However, in response to the proposed rule, a large number of commenters questioned the Finance Board's proposal to address only pledges of collateral from a narrow class of wholly-owned subsidiaries, while ignoring collateral arrangements with other types of affiliates that may be permissible under the Bank Act. In light of these comments, the Finance Board removed the QIS provisions from the text of the final rule pending further analysis of the issue. *See* 64 FR 16618 (April 6, 1999).

In conjunction with new § 950.7(f), the proposed rule would amend § 950.1 by defining an ''affiliate'' as any business entity that controls, is controlled by, or is under common

control with, a member. The proposed definition of ''affiliate'' is intended to limit the scope of eligible third-party collateral to assets over which the member exercises control or shares control.

4. Bank Advances Policy

The proposed rule removes existing § 950.3 of the Finance Board's Advances Regulation. That section requires each Bank's board of directors to adopt and review a policy on advances and outlines some basic criteria for the content of the advances policy. The Finance Board is proposing to move the requirement for the Bank's board of directors to adopt and periodically re-adopt an advances or credit policy to new § 917.4, ''Bank Member Products Policy.'' The Finance Board believes it would make for a more logical presentation in its regulations to have all of the requirements for Bank policies contained in one regulatory part (part 917), rather than to have such requirements scattered throughout its regulations. The proposed requirements for Bank member products policies are discussed in section F. 2., below.

5. Removal of Non-QTL Definitions

Proposed § 950.1 deletes the following qualified thrift lender (QTL)-related definitions from the Advances Regulation: definitions of the terms ''Actual thrift investment percentage'' or ''ATIP''; ''Non-Qualified Thrift Lender Member''; ''Qualified Thrift Lender'' or ''QTL''; and ''Qualified Thrift Lender test'' or ''QTL test.'' 12 CFR 950.1. These terms are being removed to conform the Advances Regulation to the Modernization Act, which repealed all non-QTL advances provisions in the Bank Act. *See* Modernization Act, section 604(c).

D. Modernization Act Amendment to Long-term Advances Purpose Provision for CFI Members

Section 10(a) of the Bank Act formerly provided that all long-term advances shall be made only for the purpose of providing funds for residential housing finance. *See* 12 U.S.C. 1430(a) (1994). This purpose is set forth in current § 950.14(a), and is implemented by use of a proxy test set forth in current § 950.14(b). 12 CFR 950.14(a), (b). Specifically, current § 950.14(b)(1) provides that, before funding a long-term advance (*i.e.,* an advance with a maturity greater than five years), a Bank shall determine that the principal amount of all long-term advances currently held by the member does not exceed the total book value of the member's ''residential housing finance assets.'' 12 CFR 950.1, 950.14(b)(1). ''Residential housing finance assets'' are defined in current § 950.1 to mean any of the following: (1) Loans secured by residential real property; (2) mortgage-backed securities; (3) participations in loans secured by residential real property; (4) loans or investments financed by advances made pursuant to a CICA program; (5) loans secured by manufactured housing, regardless of whether such housing qualifies as residential real property; or (6) any loans or investments which the Finance Board, in its discretion, otherwise determines to be residential housing finance assets. 12 CFR 950.1. Current § 950.14(b)(1) requires a Bank to determine the total book value of the member's residential housing finance assets using the most recent Thrift Financial Report, Report of Condition and Income, or financial statement made available by the member. 12 CFR 950.14(b)(1). This proxy test was determined by the Finance Board to be an operationally feasible compliance monitoring mechanism for residential housing finance assets to implement the statutory requirement that long-term advances be only for residential housing finance purposes. *See* 57 FR 45338 (Oct. 1, 1992).

The Modernization Act amended section 10(a) of the Bank Act to provide that a Bank may make long-term advances not only for the purpose of providing funds for residential housing finance, but also for the purpose of providing funds to any CFI for small businesses, small farms and small agri-businesses. *See* Modernization Act, section 604(a)(3). Accordingly, the proposed rule amends current § 950.14 by adding this new purpose in redesignated § 950.3. Proposed § 950.3(a) provides that a Bank shall make long-term advances only for the purpose of enabling any member to purchase or fund new or existing residential housing finance assets, which include, for CFI members, small business loans, small farm loans and small agri-business loans.

Instead of the statutory terms ''small businesses,'' ''small farms'' and ''small agri-businesses,'' proposed § 950.3 utilizes the terms ''small business loans,'' ''small farm loans'' and ''small agri-business loans,'' which the Finance Board is proposing to define for purposes of identifying the new types of collateral that Banks are authorized to accept from CFI members. *See* Modernization Act, section 604(a)(5)(C). The Finance Board believes that a single set of terms that would apply to both CFI-eligible collateral and the new purposes for which Banks may make advances to CFI members will reduce confusion and otherwise provide an efficient means of implementing the new authorities conferred on the Banks in regard to their CFI members. Further, the Modernization Act provides that the terms ''small business,'' ''small farm'' and ''small agri-business'' shall have the meanings given to those terms by regulation of the Finance Board. *See* Modernization Act, section 604(a)(7). Accordingly, the Finance Board is interpreting the statutory phrase ''providing funds to any community financial institution for small businesses, small farms, and small agri-businesses'' to mean making advances to CFI members for small business loans, small farm loans and small agri-business loans. Proposed § 950.3(b)(1) maintains the proxy test in its current form. However, proposed revisions to certain definitions will have the effect of including small business loans, small farm loans and small agri-business loans in the denominator of the proxy test for CFI members.

Specifically, the proposed rule would amend § 900.1 by adding a new definition of ''community lending,'' which would apply, wherever it appears, in all of the Finance Board's regulations. The term ''community lending'' currently is defined in § 952.3 of the CICA Regulation as ''providing financing for economic development projects for targeted beneficiaries.'' 12 CFR 952.3. The definition of ''community lending'' proposed for § 900.1 would add to that definition, ''and, for community financial institutions, purchasing or funding small business loans, small farm loans or small agri-business loans, as defined in § 950.1 of this chapter.'' This addition to the definition implements changes made by the Modernization Act and supports the Finance Board's belief that CFI lending to small businesses, small farms and small agri-businesses is community lending. For purposes of the CICA and Community Support Regulations, the current definition of ''community lending,'' redesignated in this proposed rule as ''targeted community lending,'' would continue to apply.

Concurrently, the Finance Board is proposing to amend the definition of ''residential housing finance assets'' to change the element that currently reads ''Loans or investments financed by advances made pursuant to a CICA program'' to ''Loans or investments qualifying under the definition of community lending in § 900.1 of this chapter.''

Thus, by operation of the revised definitions of ''residential housing

finance assets'' and ''community lending,'' the proxy test calculation of the total book value of residential housing assets will include, for CFI members, small business loans, small farm loans and small agri-business loans. This result implements section 604(a)(5)(C) of the Modernization Act, which authorizes a Bank to make long-term advances to CFIs for the purpose of providing financing for small businesses, small farms and small agri-businesses. *See* Modernization Act, section 604(a)(5)(C).

Current § 950.14(b)(1) allows a Bank to determine the total book value of residential housing financial assets using the most recent Thrift Financial Report, Report of Condition and Income, or financial statement made available by the member. 12 CFR 950.14(b)(1). Proposed § 950.3(b)(1) adds to this list ''other reliable documentation'' made available by the member. This revision is intended to give the Banks more flexibility in the form of documentation they use in administering the proxy test, as long as the data supplied by the member is reliable.

E. Clarification of Other Advances Provisions in Current Regulation

1. Pricing

The Finance Board is taking this opportunity to clarify a provision of the Advances Regulation dealing with the pricing of advances. Current § 950.6(b)(1) requires each Bank to price its advances to members taking into account two factors: (1) The marginal cost to the Bank of raising matching maturity funds in the marketplace; and (2) the administrative and operating costs associated with making such advances to members. 12 CFR 950.6(b)(1). A separate provision, current § 950.8(b)(1), provides that each Bank shall establish and charge a prepayment fee pursuant to a specified formula which sufficiently compensates the Bank for providing a prepayment option on an advance, and which acts to make the Bank financially indifferent to the borrower's decision to repay the advance prior to its maturity date. 12 CFR 950.8(b)(1). These provisions do not clearly indicate whether Banks must consider the costs of associated options and the administrative costs of funding advances with such options in pricing an advance. Further, because current § 950.6(b)(1) merely requires the Bank ''to take into account'' the marginal cost to the Bank of raising matching maturity funds in the marketplace, and the administrative and operating costs associated with making such advances to members, the current rule allows a Bank to price an advance below its marginal cost of funds, a practice the Finance Board could find to be an unsafe and unsound practice in some circumstances and one the Finance Board wishes to discourage.

Therefore, redesignated § 950.5(b)(1) of the proposed rule prohibits a Bank from pricing an advance below the Bank's marginal cost of funds, which is to include the cost of any embedded options, plus the administrative and operating costs associated with making the advance when funding an advance with similar maturity and options characteristics.

Proposed § 950.5(b)(3)(i) provides that the aforementioned prohibition would not apply to a Bank's CICA programs. This is intended to provide the Banks with maximum flexibility in designing and offering AHP and other CICA programs. Proposed § 950.5(b)(3)(ii) provides that the proposed prohibition also would not apply to any other advances that are volume limited and specifically approved by a Bank's board of directors. This exception is intended to allow a Bank to price targeted advances at below the cost of funds for some special purpose that does not meet all of the criteria for CICA advances. It is intended that the special purpose involve some social benefit, such as providing relief from a natural disaster. The proposed exception would also allow a Bank to conduct market testing of alternative pricing strategies for advances.

2. Convertible Advances Disclosure

Current § 950.6(d)(1) of the Advances Regulation provides that a Bank that offers a putable advance to a member shall disclose in writing to such member the type and nature of the risks associated with putable advance funding, and that such disclosure should include detail sufficient to describe such risks. 12 CFR 950.6(d)(1). A convertible advance is similar to a putable advance in that it carries risks associated with a triggering event, usually a shift in a designated interest rate index. Accordingly, redesignated § 950.5(d)(1) of the proposed rule makes the current disclosure requirements for putable advances applicable to convertible advances as well. Current § 950.6(d)(2) is not proposed to be revised because replacement funding is not an issue for convertible advances, as convertible advances involve only a change in the stated interest rate, not the repayment of funds. The Finance Board requests comment on whether there are other appropriate requirements for putable or convertible advances.

F. Other Technical Changes

1. Federal Home Loan Bank Associates—Part 926

Eligibility requirements for associates (nonmember borrowers), including application procedures and requirements for advances to associates, currently are contained in the Advances Regulation. *See* 12 CFR 950.22, 950.23. For the sake of greater organizational clarity, the proposed rule sets forth the associate eligibility requirements and advances requirements in separate regulations, by moving the associate eligibility requirements to a new part 926 under subpart B. No substantive changes are being proposed for subpart B.

As part of a continuing effort to revise and achieve consistency in regulatory nomenclature regarding nonmember borrowers, the proposed rule would amend the text, where appropriate, to refer to nonmember borrowers who are eligible under 10b of the Bank Act, 12 U.S.C. 1430b, to obtain advances from the Banks, as associates. The definition of ''associate'' was recently added to 12 CFR 900.1, which contains definitions of terms that apply to all parts of the Finance Board's regulations. Accordingly, the proposed rule would change the title of subpart B to ''Advances to Associates.'' Since the term ''associates'' is defined in § 900.1, the Finance Board is not proposing that it be defined in any of the individual parts addressed by this rulemaking.

2. Bank Member Products Policy—Section 917.4

In its recently adopted final rule, Powers and Responsibilities of Bank Boards of Directors and Senior Management, the Finance Board consolidated all of the requirements for the Bank's board of directors' operational policies into one regulatory part, part 917, rather than have such requirements scattered throughout its regulations.[9] Proposed § 917.4 would add to that part a new requirement for adoption by a Bank's board of directors of a member products policy that would combine the requirements for an advances policy from current § 950.3(a), with the requirements for a standby letter of credit policy from current § 961.5(a), into one policy. The proposed member products policy also would address other products that the Banks may offer, such as acquired member assets.

[9] The Finance Board adopted part 917, ''Powers and Responsibilities of Bank Boards of Directors and Senior Management,'' as a final rule at its March 22, 2000 Board of Directors meeting.

Under proposed § 917.4(b), a Bank's member products policy would be required to address the following items: the credit underwriting criteria to be applied to advances (including renewals) and standby letters of credit; collateralization (including levels, valuation and discounts) for advances and standby letters of credit; advances-related fees (including any schedules or formulas pertaining to such fees); standards and criteria for pricing member products (including differential pricing of advances pursuant to § 950.4(b)(2)); criteria regarding the pricing of standby letters of credit (including any special pricing provisions for standby letters of credit that facilitate the financing of projects that are eligible for any CICA programs under part 952); the maintenance of appropriate systems, procedures and internal controls; and the maintenance of appropriate operational and personnel capacity.

A Bank's member products policy also must provide that, for any draw made by a beneficiary under a standby letter of credit, the member will be charged a processing fee calculated in accordance with § 975.6(b).

Under proposed § 917.4(a)(2), each Bank's board of directors would be required to review the Bank's member products policy annually, amend the policy as appropriate, and re-adopt the policy, including interim amendments, not less often than every three years.

References to the ''advances policy'' in other sections of the Finance Board's current regulations are proposed to be changed to references to the ''member products policy.''

3. Bank Credit Mission—Removal of Section 950.2

In the Finance Board's recently adopted final rule on parts 900, 917 and 940, the Finance Board revised part 940 to add a new definition of the mission of the Banks.[10] Accordingly, the proposed rule removes existing § 950.2 of the Finance Board's Advances Regulation, which states the primary credit mission of the Banks and how the Banks must fulfill such mission, as no longer necessary.

4. Community Support Requirements and Community Investments Cash Advance Programs—Parts 944 and 952

As discussed previously, the proposed rule would amend part 944 and § 952.3 by re-designating the term ''community lending'' as ''targeted community lending,'' with no substantive change to the corresponding definition. This revision is intended to differentiate CICA community lending, which is targeted, from the broader term ''community lending'' that the Finance Board proposes to add to § 900.1. The broader definition of ''community lending'' in § 900.1 would include, for CFIs, purchasing or funding small business loans, small farm loans and small agri-business loans, as defined in § 950.1 of this chapter.

5. Standby Letters of Credit—Part 961

The proposed rule would amend part 961 to update cross-references to reflect the reorganization of Finance Board regulations, change references from nonmember mortgagees to associates and make other technical and conforming changes.

III. Paperwork Reduction Act

This proposed rule does not contain any collections of information pursuant to the Paperwork Reduction Act of 1995. *See* 33 U.S.C. 3501 *et seq.* Therefore, the Finance Board has not submitted any information to the Office of Management and Budget for review.

IV. Regulatory Flexibility Act

The proposed 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 proposed rule, if promulgated as a final rule, will not have a significant economic impact on a substantial number of small entities.

List of Subjects in 12 CFR Parts 900, 917, 926, 944, 950, 952, 961 and 980

Community development, Credit, Federal home loan banks, Housing, Reporting and recordkeeping requirements.

Accordingly, the Finance Board hereby proposes to amend title 12, chapter IX, parts 900, 917, 926, 944, 950, 952, 961 and 980, Code of Federal Regulations, as follows:

PART 900—GENERAL DEFINITIONS

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

Authority: 12 U.S.C. 1422, 1422b(a)(1).

2. Amend § 900.1 by adding, in alphabetical order, definitions of ''community financial institution'', ''community financial institution asset cap'', and ''community lending'', to read as follows:

§ 900.1 Definitions applying to all regulations.

* * * * *

Community financial institution or CFI means an institution—

(1) The deposits of which are insured under the Federal Deposit Insurance Act; and

(2) That has, as of the date of the transaction at issue, less than the community financial institution asset cap in total assets, based on an average of total assets over the three years preceding that date.

Community financial institution asset cap means, for 2000, $500 million. Beginning in 2001 and for subsequent years, the cap shall be adjusted annually by the Finance Board to reflect any percentage increase in the preceding year's Consumer Price Index (CPI) for all urban consumers, as published by the U.S. Department of Labor. Each year, as soon as practicable after the publication of the previous year's CPI, the Finance Board shall publish notice by **Federal Register**, distribution of a memorandum, or otherwise, of the CPI-adjusted cap.

Community lending means providing financing for economic development projects for targeted beneficiaries, and, for community financial institutions, purchasing or funding small business loans, small farm loans or small agri-business loans, as defined in § 950.1 of this chapter.

* * * * *

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

3. The authority citation for part 917 continues to read as follows:

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

4. Add § 917.4 to read as follows:

§ 917.4 Bank member products policy.

(a) *Adoption and review of member products policy.* (1) *Adoption.* Beginning 90 days after the effective date of this section, each Bank's board of directors shall have in effect at all times a policy that addresses the Bank's management of products offered by the Bank to members and associates, including but not limited to advances, letters of credit and acquired member assets, consistent with the requirements of the Act, paragraph (b) of this section, and all applicable Finance Board regulations and policies.

[10] Section 940.2 was adopted as a final rule by the Finance Board at its March 22, 2000 Board of Directors meeting as part of the rulemaking for part 917, ''Powers and Responsibilities of Federal Home Loan Bank Boards of Directors and Senior Management.''

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

(i) Review the Bank's member products policy annually;

(ii) Amend the member products policy as appropriate; and

(iii) Re-adopt the member products policy, including interim amendments, not less often than every three years.

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

(1) Address credit underwriting criteria to be applied in evaluating applications for advances, standby letters of credit, and renewals;

(2) Address appropriate levels of collateralization, valuation of collateral and discounts applied to collateral values for advances and standby letters of credit;

(3) Address advances-related fees to be charged by each Bank, including any schedules or formulas pertaining to such fees;

(4) Address standards and criteria for pricing member products, including differential pricing of advances pursuant to § 950.4(b)(2) of this chapter, and criteria regarding the pricing of standby letters of credit, including any special pricing provisions for standby letters of credit that facilitate the financing of projects that are eligible for any of the Banks' CICA programs under part 952 of this chapter;

(5) Provide that, for any draw made by a beneficiary under a standby letter of credit, the member will be charged a processing fee calculated in accordance with the requirements of § 975.6(b) of this chapter;

(6) Address the maintenance of appropriate systems, procedures and internal controls; and

(7) Address the maintenance of appropriate operational and personnel capacity.

5. Revise the heading of subchapter D to read as follows:

SUBCHAPTER D—FEDERAL HOME LOAN BANK MEMBERS AND ASSOCIATES

6. In subchapter D, add a new part 926 to read as follows:

PART 926—FEDERAL HOME LOAN BANK ASSOCIATES

Sec.

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

§ 926.1 Definitions.

As used in this part:

Advance has the meaning set forth in § 950.1 of this chapter.

Governmental agency means the governor, legislature, and any other component of a federal, state, local, tribal, or Alaskan native village government with authority to act for or on behalf of that government.

HUD means the Department of Housing and Urban Development.

State housing finance agency or *SHFA* means:

(1) A public agency, authority, or publicly sponsored corporation that serves as an instrumentality of any state or political subdivision of any state, and functions as a source of residential mortgage loan financing in that state; or

(2) A legally established agency, authority, corporation, or organization that serves as an instrumentality of any Indian tribe, band, group, nation, community, or Alaskan Native village recognized by the United States or any state, and functions as a source of residential mortgage loan financing for the Indian or Alaskan Native community.

§ 926.2 Bank authority to make advances to associates.

Subject to the provisions of the Act and part 950 of this chapter, a Bank may make advances to an entity that is not a member of the Bank if the Bank has certified the entity as an associate under the provisions of this part.

§ 926.3 Associate eligibility requirements.

(a) *General.* A Bank may certify as an associate any applicant that meets the following requirements, as determined using the criteria set forth in § 926.4:

(1) The applicant is approved under title II of the National Housing Act (12 U.S.C. 1707, *et seq.*);

(2) The applicant is a chartered institution having succession;

(3) The applicant is subject to the inspection and supervision of some governmental agency;

(4) The principal activity of the applicant in the mortgage field consists of lending its own funds; and

(5) The financial condition of the applicant is such that advances may be safely made to it.

(b) *State housing finance agencies.* In addition to meeting the requirements in paragraph (a) of this section, any applicant seeking access to advances as a SHFA pursuant to § 950.17(b)(2) of this chapter shall provide evidence satisfactory to the Bank, such as a copy of, or a citation to, the statutes and/or regulations describing the applicant's structure and responsibilities, that the applicant is a state housing finance agency as defined in § 926.1.

§ 926.4 Satisfaction of eligibility requirements.

(a) *HUD approval requirement.* An applicant shall be deemed to meet the requirement in section 10b(a) of the Act and § 926.3(a)(1) that it be approved under title II of the National Housing Act if it submits a current HUD Yearly Verification Report or other documentation issued by HUD stating that the Federal Housing Administration of HUD has approved the applicant as a mortgagee.

(b) *Charter requirement.* An applicant shall be deemed to meet the requirement in section 10b(a) of the Act and § 926.3(a)(2) that it be a chartered institution having succession if it provides evidence satisfactory to the Bank, such as a copy of, or a citation to, the statutes and/or regulations under which the applicant was created, that:

(1) The applicant is a government agency; or

(2) The applicant is chartered under state, federal, local, tribal, or Alaskan Native village law as a corporation or other entity that has rights, characteristics, and powers under applicable law similar to those granted a corporation.

(c) *Inspection and supervision requirement.* (1) An applicant shall be deemed to meet the inspection and supervision requirement in section 10b(a) of the Act and § 926.3(a)(3) if it provides evidence satisfactory to the Bank, such as a copy of, or a citation to, relevant statutes and/or regulations, that, pursuant to statute or regulation, the applicant is subject to the inspection and supervision of a federal, state, local, tribal, or Alaskan native village governmental agency.

(2) An applicant shall be deemed to meet the inspection requirement if there is a statutory or regulatory requirement that the applicant be audited or examined periodically by a governmental agency or by an external auditor.

(3) An applicant shall be deemed to meet the supervision requirement if the governmental agency has statutory or regulatory authority to remove an applicant's officers or directors for cause or otherwise exercise enforcement or administrative control over actions of the applicant.

(d) *Mortgage activity requirement.* An applicant shall be deemed to meet the mortgage activity requirement in section 10b(a) of the Act and § 926.3(a)(4) if it provides documentary evidence satisfactory to the Bank, such as a financial statement or other financial

documents that include the applicant's mortgage loan assets and their funding liabilities, that it lends its own funds as its principal activity in the mortgage field. For purposes of this paragraph, lending funds includes, but is not limited to, the purchase of whole mortgage loans. In the case of a federal, state, local, tribal, or Alaskan Native village government agency, appropriated funds shall be considered an applicant's own funds. An applicant shall be deemed to satisfy this requirement notwithstanding that the majority of its operations are unrelated to mortgage lending if its mortgage activity conforms to this requirement. An applicant that acts principally as a broker for others making mortgage loans, or whose principal activity is to make mortgage loans for the account of others, does not meet this requirement.

(e) *Financial condition requirement.* An applicant shall be deemed to meet the financial condition requirement in § 926.3(a)(5) if the Bank determines that advances may be safely made to the applicant. The applicant shall submit to the Bank copies of its most recent regulatory audit or examination report, or external audit report, and any other documentary evidence, such as financial or other information, that the Bank may require to make the determination.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069–0005 with an expiration date of November 30, 2002.)

§ 926.5 Associate application process.

(a) *Authority.* The Banks are authorized to approve or deny all applications for certification as an associate, subject to the requirements of the Act and this part. A Bank may delegate the authority to approve applications for certification as an associate only to a committee of the Bank's board of directors, the Bank president, or a senior officer who reports directly to the Bank president other than an officer with responsibility for business development.

(b) *Application requirements.* An applicant for certification as an associate shall submit an application that satisfies the requirements of the Act and this part to the Bank of the district in which the applicant's principal place of business, as determined in accordance with part 925 of this chapter, is located.

(c) *Bank decision process.* (1) *Action on applications.* A Bank shall approve or deny an application for certification as an associate within 60 calendar days of the date the Bank deems the application to be complete. A Bank shall deem an application complete, and so notify the applicant in writing, when it has obtained all of the information required by this part and any other information it deems necessary to process the application. If a Bank determines during the review process that additional information is necessary to process the application, the Bank may deem the application incomplete and stop the 60-day time period by providing written notice to the applicant. When the Bank receives the additional information, it shall again deem the application complete, so notify the applicant in writing, and resume the 60-day time period where it stopped.

(2) *Decision on applications.* The Bank or a duly delegated committee of the Bank's board of directors, the Bank president, or a senior officer who reports directly to the Bank president other than an officer with responsibility for business development shall approve, or the board of directors of a Bank shall deny, each application for certification as an associate by a written decision resolution stating the grounds for the decision. Within three business days of a Bank's decision on an application, the Bank shall provide the applicant and the Finance Board with a copy of the Bank's decision resolution.

(3) *File.* The Bank shall maintain a certification file for each applicant for at least three years after the date the Bank decides whether to approve or deny certification or the date the Finance Board resolves any appeal, whichever is later. At a minimum, the certification file shall include all documents submitted by the applicant or otherwise obtained or generated by the Bank concerning the applicant, all documents the Bank relied upon in making its determination regarding certification, including copies of statutes and regulations, and the decision resolution.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069–0005 with an expiration date of November 30, 2002.)

§ 926.6 Appeals.

(a) *General.* Within 90 calendar days of the date of a Bank's decision to deny an application for certification as an associate, the applicant may submit a written appeal to the Finance Board that includes the Bank's decision resolution and a statement of the basis for the appeal with sufficient facts, information, analysis, and explanation to support the applicant's position. Appeals shall be sent to the Federal Housing Finance Board, 1777 F Street, NW., Washington, DC 20006, with a copy to the Bank.

(b) *Record for appeal.* Upon receiving a copy of an appeal, the Bank whose action has been appealed shall provide to the Finance Board a complete copy of the applicant's certification file maintained by the Bank under § 926.5(c)(3). Until the Finance Board resolves the appeal, the Bank shall promptly provide to the Finance Board any relevant new materials it receives. The Finance Board may request additional information or further supporting arguments from the applicant, the Bank, or any other party that the Finance Board deems appropriate.

(c) *Deciding appeals.* Within 90 calendar days of the date an applicant files an appeal with the Finance Board, the Finance Board shall consider the record for appeal described in paragraph (b) of this section and resolve the appeal based on the requirements of the Act and this part.

(The Office of Management and Budget has approved the information collection contained in this section and assigned control number 3069–0005 with an expiration date of November 30, 2002.)

PART 944—COMMUNITY SUPPORT REQUIREMENTS

7. The authority citation for part 944 continues to read as follows:

Authority: 12 U.S.C. 1422a(a)(3)(B), 1422b(a)(1), 1429, and 1430.

8. Amend part 944 by removing the term ''community lending'' wherever it appears, and, in its place, adding the term ''targeted community lending''.

§ 944.6 [Amended]

9. Amend § 944.6(b)(2) by removing the term ''nonmember borrowers'' and, in its place, adding the term ''associates''.

PART 950—ADVANCES

10. The authority citation for part 950 continues to read as follows:

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

11. The table of contents for part 950 is revised to read as follows:

Subpart A—Advances to Members

12. Amend § 950.1 by:

a. Adding, in alphabetical order, a definition of ''affiliate'';

b. Adding, in alphabetical order, a definition of ''cash equivalents'';

c. Removing the definitions of ''Actual thrift investment percentage'' or ''ATIP'', ''combination business or farm property'', ''Non-Qualified Thrift Lender member'', ''Qualified Thrift Lender'' or ''QTL'', and ''Qualified Thrift Lender test'' or ''QTL test'';

d. Amending the definition of ''Community Investment Cash Advance'' or ''CICA'' by removing the term ''community lending'', and, in its place, adding the term ''targeted community lending'';

e. Revising paragraph (4) of the definition of ''residential housing finance assets'';

f. Amending the definition of ''residential real property'' by removing paragraph (1)(v); and

g. Adding, in alphabetical order, definitions of ''small agri-business loans'', ''small business loans'', and ''small farm loans'', to read as follows:

§ 950.1 Definitions.

* * * * *

Affiliate means any business entity that controls, is controlled by, or is under common control with, a member.

* * * * *

Cash equivalents means investments that—

(1) Are readily convertible into known amounts of cash;

(2) Have a remaining maturity of 90 days or less at the acquisition date; and

(3) Are held for liquidity purposes.

* * * * *

Residential housing finance assets means any of the following:

* * * * *

(4) Loans or investments qualifying under the definition of ''community lending'' in § 900.1 of this chapter;

* * * * *

Small agri-business loans means loans:

(1) With an original amount (including the aggregate of all loans to a particular borrower) of not more than $ 500,000 that are reported on either: Schedule SB of the Thrift Financial Report filed by savings associations as ''nonmortgage, commercial loans to finance agricultural production and other nonmortgage commercial loans to farmers,'' or Schedule RC–C, Part II of the Report of Condition and Income filed by insured commercial banks and FDIC-supervised savings banks as ''loans to finance agricultural production and other loans to farmers;'' or

(2) For which the CFI, on a case-by-case basis, documents that the borrower meets the eligibility standards for a small business concern under the Small Business Administration's regulations at 13 CFR part 121, or any successor provisions.

Small business loans means loans:

(1) With an original amount (including the aggregate of all loans to a particular borrower) of not more than $1,000,000 that are reported on either: Schedule SB of the Thrift Financial Report filed by savings associations as ''permanent mortgage loans secured by nonfarm, nonresidential properties'' or ''nonmortgage, nonagricultural commercial loans,'' or Schedule RC–C, Part II of the Report of Condition and Income filed by insured commercial banks and FDIC-supervised savings banks as ''loans secured by nonfarm, nonresidential properties,'' or ''Commercial and industrial loans to U.S. addresses;'' or

(2) For which the CFI, on a case-by-case basis, documents that the borrower meets the eligibility standards for a small business concern under the Small Business Administration's regulations at 13 CFR part 121, or any successor provisions.

Small farm loans means loans:

(1) With an original amount (including the aggregate of all loans to a particular borrower) of not more than $500,000 that are reported on either: Schedule SB of the Thrift Financial Report filed by savings associations as ''loans secured primarily by farms,'' or Schedule RC–C, Part II of the Report of Condition and Income filed by insured commercial banks and FDIC-supervised savings banks as ''loans secured by farmland (including farm residential and other improvements);'' or

(2) For which the CFI, on a case-by-case basis, documents that the borrower meets the eligibility standards for a small business concern under the Small Business Administration's regulations at 13 CFR part 121, or any successor provisions.

* * * * *

13. Remove § 950.2.

14. Remove § 950.3.

15. Section 950.4 is redesignated as § 950.2.

16. Section 950.14 is redesignated as § 950.3, and the heading and paragraphs (a) and (b)(1) are revised to read as follows:

§ 950.3 Purpose of long-term advances; proxy test.

(a) A Bank shall make long-term advances only for the purpose of enabling any member to purchase or fund new or existing residential housing finance assets, which include, for CFI members, small business loans, small farm loans and small agri-business loans.

(b)(1) Prior to approving an application for a long-term advance, a Bank shall determine that the principal amount of all long-term advances currently held by the member does not exceed the total book value of residential housing finance assets held by such member. The Bank shall determine the total book value of such residential housing finance assets, using the most recent Thrift Financial Report, Report of Condition and Income, financial statement or other reliable documentation made available by the member.

* * * * *

17. Section 950.5 is redesignated as § 950.4.

18. Section 950.6 is redesignated as § 950.5, and paragraphs (b)(1), (b)(2)(ii), (b)(3), (d)(1) and (d)(3) are revised to read as follows:

§ 950.5 Terms and conditions for advances.

* * * * *

(b) *Advance pricing.* (1) *General.* A Bank shall not price its advances to members below:

(i) The marginal cost to the Bank of raising matching term and maturity funds in the marketplace, including embedded options; and

(ii) The administrative and operating costs associated with making such advances to members.

(2) * * *

(ii) Each Bank shall include in its member products policy required by § 917.4 of this chapter, standards and criteria for such differential pricing and shall apply such standards and criteria consistently and without discrimination to all members applying for advances.

(3) *Exceptions.* The advance pricing policies contained in paragraph (b)(1) of this section shall not apply in the case of:

(i) A Bank's CICA programs; and

(ii) Any other advances that are volume limited and specifically approved by the Bank's board of directors.

* * * * *

(d) *Putable or convertible advances.* (1) *Disclosure.* A Bank that offers a putable or convertible advance to a member shall disclose in writing to such member the type and nature of the risks associated with putable or convertible advance funding. The disclosure should include detail sufficient to describe such risks.

(2) *Replacement funding for putable advances.* If a Bank terminates a putable advance prior to the stated maturity date of such advance, the Bank shall offer to provide replacement funding to the member.

* * * * *

19. Section 950.8 is resdesignated as § 950.6, and paragraphs (a) and (b)(1) are revised to read as follows:

§ 950.6 Fees.

(a) *Fees in member products policy.* All fees charged by each Bank and any schedules or formulas pertaining to such fees shall be included in the Bank's member products policy required by § 917.4 of this chapter. Any such fee schedules or formulas shall be applied consistently and without discrimination to all members.

(b) *Prepayment fees.* (1) Except where an advance product contains a prepayment option, each Bank shall establish and charge a prepayment fee pursuant to a specified formula which makes the Bank financially indifferent to the borrower's decision to repay the advance prior to its maturity date.

* * * * *

20. Section 950.9 is redesignated as § 950.7, paragraphs (a) introductory text, (a)(3), (a)(4), (b) and (c) are revised, and paragraphs (a) (5) and (f) are added, to read as follows:

§ 950.7 Collateral.

(a) *Eligible security for advances to all members.* At the time of origination or renewal of an advance, each Bank shall obtain from the borrowing member or, in accordance with paragraph (f) of this section, an affiliate of the borrowing member, and thereafter maintain, a security interest in collateral that meets the requirements of one or more of the following categories:

* * * * *

(3) *Cash or deposits.* Cash or deposits in a Bank.

(4) *Other real estate-related collateral.* (i) Other real estate-related collateral provided that:

(A) Such collateral has a readily ascertainable liquidation value and can be freely liquidated in due course; and

(B) The Bank can perfect a security interest in such collateral.

(ii) Eligible other real estate-related collateral may include, but is not limited to:

(A) Privately issued mortgage-backed securities not otherwise eligible under paragraph (a)(1)(ii) of this section;

(B) Second mortgage loans, including home equity loans;

(C) Commercial real estate loans; and

(D) Mortgage loan participations.

(iii) A Bank shall not make total advances to all members secured by other real estate-related collateral in an aggregate amount that would exceed the highest level of total advances secured by such collateral that the Bank has previously made by more than 25 percent until it has met the new business activity requirements of part 980 of this chapter.

(5) *Securities representing equity interests in eligible advances collateral.* Any security the ownership of which represents an undivided equity interest in underlying assets, all of which qualify either as:

(i) Eligible collateral under paragraphs (a)(1), (2), (3) or (4) of this section; or

(ii) Cash equivalents.

(b) *Additional collateral eligible as security for advances to CFI members or their affiliates.* (1) *General.* Subject to the limitations set forth in part 980 of this chapter, a Bank is authorized to accept from CFI members or their affiliates as security for advances small business loans, small farm loans or small agri-business loans fully secured by collateral other than real estate, or securities representing a whole interest in such loans, provided that:

(i) Such collateral has a readily ascertainable liquidation value and can be freely liquidated in due course; and

(ii) The Bank can perfect a security interest in such collateral.

(2) *Change in CFI status.* A Bank may not accept as security for new advances collateral under this section from a member that loses its CFI status. A Bank shall not require a member that loses its CFI status and has outstanding advances secured by collateral under this section to repay such advances prior to the stated maturities or to provide substitute collateral eligible under paragraphs (a)(1) through (5) of this section, based solely on the member's change in status, and may allow such member to renew maturing advances secured by collateral under this section for up to 6 months.

(c) *Additional advances collateral.* The provisions of paragraph (a) of this section shall not affect the ability of any Bank to take such steps as it deems necessary to protect its secured position on outstanding advances, including requiring additional collateral, whether or not such additional collateral conforms to the requirements for eligible collateral in paragraphs (a) or (b) of this section or section 10 of the Act (12 U.S.C. 1430).

* * * * *

(f) *Pledge of advances collateral by affiliates.* Assets held by an affiliate of a member that are eligible as collateral under paragraphs (a) or (b) of this section may be used to secure advances to that member only if:

(1) The collateral is pledged to secure either:

(i) The member's obligation to repay advances; or

(ii) A surety or other agreement under which the affiliate has assumed, along with the member, a primary obligation to repay advances made to the member; and

(2) The Bank obtains and maintains a legally enforceable security interest pursuant to which the Bank's legal rights and privileges with respect to the collateral are functionally equivalent in all material respects to those that the Bank would possess if the member were to pledge the same collateral directly, and such functional equivalence is supported by adequate documentation.

21. Section 950.10 is redesignated as § 950.8.

22. Section 950.11 is redesignated as § 950.9.

23. Section 950.12 is redesignated as § 950.10, and is revised to read as follows:

§ 950.10 Collateral valuation; appraisals.

(a) *Collateral valuation.* Each Bank shall determine the value of collateral securing the Bank's advances in accordance with the collateral valuation procedures set forth in the Bank's member products policy established pursuant to § 917.4 of this chapter.

(b) *Fair application of procedures.* Each Bank shall apply the collateral valuation procedures consistently and fairly to all borrowing members, and the valuation ascribed to any item of collateral by the Bank shall be conclusive as between the Bank and the member.

(c) *Appraisals.* A Bank may require a member to obtain an appraisal of any item of collateral, and to perform such other investigations of collateral as the Bank deems necessary and proper.

24. Section 950.15 is redesignated as § 950.11.

25. Section 950.17 is redesignated as § 950.12.

26. Section 950.18 is redesignated as § 950.13.

27. Section 950.20 is redesignated as § 950.14 and transferred to subpart A.

28. Section 950.19 is redesignated as § 950.15.

29. The heading of Subpart B is revised to read as follows:

Subpart B—Advances to Associates

30. Section 950.21 is redesignated as § 950.16, and is revised to read as follows:

§ 950.16 Scope.

Except as otherwise provided in §§ 950.14 and 950.17, the requirements of subpart A apply to this subpart.

31. Sections 950.22 and 950.23 are removed.

32. Section 950.24 is redesignated as § 950.17, and is amended by:

a. Removing the words ''nonmember mortgagee'' and ''nonmember mortgagees'', wherever they appear, and, in their place, adding the words ''associate'' and ''associates'', respectively; and

b. In paragraph (b)(2)(i) introductory text, removing the term ''§ 950.22(d)'', and, in its place, adding the term ''§ 926.3(b)'';

c. In paragraph (b)(2)(i)(B), removing the terms ''§ 950.9(a)(3)'' and ''§ 950.22(d)'', and in their place, adding the terms ''§ 950.7(a)(3)'' and ''§ 926.3(b),'' respectively; and

d. Revising paragraph (b)(2)(i)(C), to read as follows:

§ 950.17 Advances to associates.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(C) The real estate-related collateral described in § 950.7(a)(4), provided that such collateral is comprised of mortgage loans on one-to-four family or multifamily residential property.

* * * * *

PART 952—COMMUNITY INVESTMENT CASH ADVANCE PROGRAMS

33. The authority citation for part 952 continues to read as follows:

Authority: 12 U.S.C. 1422b(a)(1) and 1430.

34. Amend § 952.3 by removing the definition of ''nonmember borrower''.

35. Amend part 952 by:

a. Removing the term ''community lending'', wherever it appears, and, in its place, adding the term ''targeted community lending''; and

b. Removing the terms ''nonmember borrower'' and ''nonmember borrowers'', wherever they appear, and, in their place, adding the terms ''associate borrower'' and ''associate borrowers'', respectively.

PART 961—STANDBY LETTERS OF CREDIT

36. The authority citation for part 961 continues to read as follows:

Authority: 12 U.S.C. 1422b, 1429, 1430, 1430b, 1431.

37. Amend § 961.1 by:

a. Removing the definition of ''community lending'';

b. Removing the definition of ''nonmember mortgagee'';

c. Removing the definition of ''nonmember SHFA'';

d. Adding the definition of ''SHFA associate''; and

e. Removing the definition of ''small business'', to read as follows:

§ 961.1 Definitions.

* * * * *

SHFA associate means an associate that is a ''state housing finance agency,'' as that term is defined in § 926.1 of this chapter, and that has met the requirements of § 926.3(b) of this chapter.

* * * * *

38. Amend part 961 by:

a. Removing the terms ''nonmember mortgagee'' and ''nonmember mortgagees'', wherever they appear, and, in their place, adding the terms ''associate'' and ''associates'', respectively; and

b. Removing the terms ''nonmember SHFA'' and ''nonmember SHFAs'', wherever they appear, and, in their place, adding the terms ''SHFA associate'' and ''SHFA associates'', respectively.

39. Amend § 961.2 by revising paragraphs (a)(2), (c)(1), and (c)(2)(i), to read as follows:

§ 961.2 Standby letters of credit on behalf of members.

(a) * * *

(2) To assist members in facilitating community lending;

* * * * *

(c) *Eligible collateral.* (1) Any standby letter of credit issued or confirmed on behalf of a member may be secured in accordance with the requirements for advances under § 950.7(a) of this chapter.

(2) * * *

(i) Collateral eligible to secure advances under § 950.7(b)(1) of this chapter, regardless of whether the applicant is a community financial institution;

* * * * *

40. Amend § 961.3 by:

a. In the introductory text of paragraph (a), removing the term ''§§ 950.24(b)(1)(i) or (ii)'' and, in its place, adding the term ''§§ 950.17(b)(1)(i) or (ii)'';

b. Revising paragraph (a)(2); and

c. In paragraph (b), removing the term ''950.24(b)(2)(i)(A), (B) or (C)'' and, in its place, adding the term ''950.17(b)(2)(i)(A), (B) or (C)'', to read as follows:

§ 961.3 Standby letters of credit on behalf of associates.

(a) * * *

(2) To assist associates in facilitating community lending;

* * * * *

41. Amend § 961.4 by removing the term ''§§ 969.5. 950.24(b)(2)(i)(B) or 950.24(d)'' in paragraph (a)(1) and, in its place, adding the term ''§§ 950.17(b)(2)(i)(B), 950.17(d), or 969.2''.

42. Amend § 961.5 by:

a. Revising paragraph (a); and

b. In paragraph (b)(2), removing the reference to ''§§ 950.9(b), 950.9(d), 950.9(e), 950.10, 950.11 and 950.12'', and, in its place, adding a reference to §§ 950.7(d), 950.7(e), 950.8, 950.9 and 950.10'', to read as follows:

§ 961.5 Additional provisions applying to all standby letters of credit.

(a) *Requirements.* Each standby letter of credit issued or confirmed by a Bank shall:

(1) Contain a specific expiration date, or be for a specific term; and

(2) Require approval in advance by the Bank of any transfer of the standby letter of credit from the original beneficiary to another person or entity.

* * * * *

43. In subchapter J, add a new part 980 to read as follows:

PART 980—NEW BUSINESS ACTIVITIES

Sec.

Authority: 12 U.S.C. 1422a(a)(3), 1422b(a), 1431(a), 1432(a).

§ 980.1 Definitions.

As used in this part:

New business activity means any business activity undertaken, transacted, conducted, or engaged in by

a Bank that has not been previously undertaken, transacted, conducted, or engaged in by that Bank, or was previously undertaken, transacted, conducted, or engaged in under materially different terms and conditions, and that:

(1) Involves the acceptance of collateral enumerated under §§ 950.7(a)(4)(i) and (ii) of this chapter in an amount greater than that set forth in § 950.7(a)(4)(iii);

(2) Involves the acceptance of classes of collateral enumerated under § 950.7(b) of this chapter for the first time;

(3) Entails risks not previously and regularly managed by that Bank, its members, or both, as appropriate; or

(4) Involves operations not previously undertaken by that Bank.

§ 980.2 Limitation on Bank authority to undertake new business activities.

No Bank shall undertake any new business activity except in accordance with the procedures set forth in this part.

§ 980.3 New business activity notice requirement.

At least sixty days prior to undertaking a new business activity, a Bank shall submit to the Finance Board a written notice containing the following information:

(a) *General requirements.* Except as provided in paragraph (b) of this section, a Bank's notice of new business activity shall include:

(1) An opinion of counsel citing the statutory, regulatory, or other legal authority for the new business activity;

(2) A good faith estimate of the anticipated dollar volume of the activity over the short-and long-term;

(3) A full description of:

(i) The purpose and operation of the proposed activity;

(ii) The market targeted by the activity;

(iii) The delivery system for the activity;

(iv) The effect of the activity on the housing, or relevant community lending, market; and

(4) A demonstration of the Bank's capacity, through staff, or contractors employed by the Bank, sufficiency of experience and expertise, to safely administer and manage the risks associated with the new activity;

(5) An assessment of the risks associated with the activity, including the Bank's ability to manage these risks and the Bank's ability to manage the risks associated with increasing volumes of the new activity; and

(6) The criteria that the Bank will use to determine the eligibility of its members or associates to participate in the new activity.

(b) *New collateral activities.* If a proposed new business activity relates to the acceptance of collateral under § 950.7 of this chapter, a Bank's notice of new business activity shall include:

(1) A description of the classes or amounts of collateral proposed to be accepted by the Bank;

(2) A copy of the Bank's member products policy, adopted pursuant to § 917.4 of this chapter;

(3) A copy of the Bank's procedures for determining the value of the collateral in question, established pursuant to § 950.10 of this chapter; and

(4) A demonstration of the Bank's capacity, personnel, technology, experience and expertise to value, discount and manage the risks associated with the collateral in question.

§ 980.4 Commencement of new business activities.

A Bank may commence a new business activity:

(a) Sixty days after receipt by the Finance Board of the notice of new business activity under § 980.3, if the Finance Board has not issued to the Bank a notice of disapproval, a notice of intent to examine, or a request for additional information under § 980.5; or

(b) Immediately upon issuance by the Finance Board of a letter of approval under § 980.6.

§ 980.5 Notice by the Finance Board.

(a) *Issuance.* Within sixty days after receipt of a notice of new business activity under § 980.3, the Finance Board may issue to a Bank a notice that:

(1) Disapproves the new business activity;

(2) Instructs the Bank not to commence the new business pending further consideration by the Finance Board;

(3) Declares an intent to examine the Bank;

(4) Requests additional information including but not limited to the requests listed in § 980.7;

(5) Establishes conditions for the Finance Board's approval of the new business activity, including but not limited to the conditions listed in § 980.7; or

(6) Contains other instructions or information that the Finance Board deems appropriate under the circumstances.

(b) *Effect.* Following receipt of a notice issued pursuant to paragraph (a) of this section, a Bank may not undertake any new business activity that is the subject of the notice until the Bank has received the Finance Board's consent pursuant to § 980.6.

§ 980.6 Finance Board consent.

The Finance Board may at any time provide consent for a Bank to undertake a particular new business activity and setting forth the terms and conditions that apply to the activity, with which the Bank shall comply if the Bank undertakes the activity in question.

§ 980.7 Examinations; requests for additional information.

(a) *General.* Nothing in this part shall limit in any manner the right of the Finance Board to conduct any examination of any Bank.

(b) *Requests for additional information and conditions for approval.* With respect to a new business activity, nothing in this part shall limit the right of the Finance Board at any time to:

(1) Request further information from a Bank concerning a new business activity; and

(2) Require a Bank to comply with certain conditions in order to undertake, or continue to undertake, the new business activity in question, including but not limited to:

(i) Successful completion of pre-or post-implementation safety and soundness examinations;

(ii) Demonstration by the Bank of adequate operational capacity, including the existence of appropriate policies, procedures and controls;

(iii) Demonstration by the Bank of its ability to manage the risks associated with accepting increasing volumes of particular collateral, or holding increasing volumes of particular assets, including the Bank's capacity reliably to value, discount and market the collateral or assets for liquidation;

(iv) Demonstration by the Bank that the new business activity is consistent with the housing finance and community lending mission of the Banks and the cooperative nature of the Bank System; and

(v) Finance Board review of any contracts or agreements between the Bank and its members or associates.

Dated: March 22, 2000.

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

Bruce A. Morrison,

Chairman.

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