

**DEPARTMENT OF HOUSING AND  
URBAN DEVELOPMENT**

**Office of Federal Housing Enterprise  
Oversight**

**12 CFR Part 1777**

**RIN 2550-AA12**

**Prompt Supervisory Response and  
Corrective Action**

**AGENCY:** Office of Federal Housing  
Enterprise Oversight, HUD.

**ACTION:** Final rule.

**SUMMARY:** The Office of Federal Housing Enterprise Oversight (OFHEO) is issuing a final rule to set forth the procedures by which OFHEO administers the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, under which OFHEO takes prompt corrective action in response to specified declines in the capital levels of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises). The rule also implements a system of prompt supervisory responses to be taken whenever developments internal or external to an Enterprise, as identified by the agency on a case-by-case basis, may warrant special supervisory review by OFHEO. The initiation of a special supervisory review pursuant to such a procedure does not of itself indicate that an Enterprise is in an unsound condition; rather, it means only that OFHEO is undertaking a focused inquiry to ascertain the likely consequences of a particular development or developments for the Enterprise.

**EFFECTIVE DATE:** February 25, 2002.

**FOR FURTHER INFORMATION CONTACT:** Alfred M. Pollard, General Counsel, (202) 414-3788 or David W. Roderer, Deputy General Counsel, (202) 414-6924 (not toll-free numbers), 1700 G Street NW, Fourth Floor, Washington, DC 20552. The telephone number for the Telecommunications Device for the Deaf is: (800) 877-8339 (TDD only).

**SUPPLEMENTARY INFORMATION:**

**Background**

Title XIII of the Housing and Community Development Act of 1992, Public Law 102-550, entitled the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (1992 Act), established OFHEO. OFHEO is an independent office within the Department of Housing and Urban Development with responsibility for

ensuring that the Enterprises are adequately capitalized and operate safely and in conformity to the requirements of applicable statutes, rules and regulations, including their respective charter acts.<sup>1</sup> The Enterprises were established to effect specific public purposes under Federal law, including the provision of liquidity to the residential mortgage market and the promotion of the availability of mortgage credit benefiting low- and moderate-income families and areas that are underserved by lending institutions.<sup>2</sup>

The enumerated statutory authorities of the Director explicitly include the authority to issue rules to carry out the duties of the Director,<sup>3</sup> as well as other broad supervisory powers essentially similar to those of the Federal bank regulatory agencies. OFHEO is empowered to conduct examinations of the Enterprises; to require the Enterprises to provide reports;<sup>4</sup> to establish capital standards for the Enterprises;<sup>5</sup> and, in appropriate circumstances, to exercise administrative enforcement authority. OFHEO's range of enforcement authorities include, among other things, the power to issue temporary and permanent cease and desist orders to an Enterprise or its executive officers or directors, and to otherwise sanction or impose civil money penalties when appropriate.<sup>6</sup> OFHEO's enforcement regime, addressing the scope of these authorities and the applicable rules of practice and procedure, is set forth in part 1780 of OFHEO's regulations.<sup>7</sup>

In addition, subtitle B of the 1992 Act requires OFHEO to establish certain capital thresholds for the Enterprises.<sup>8</sup> The statute directs OFHEO to assign capital classifications to the Enterprises based on those capital thresholds, and authorizes OFHEO to reclassify an Enterprise notwithstanding the thresholds.<sup>9</sup> An Enterprise that is not

classified as "adequately capitalized" is required to obtain OFHEO's approval for, and carry out, a formal plan to restore the Enterprise's capital. Statutory provisions also prohibit an Enterprise from making any capital distribution that would result in the Enterprise not meeting the capital thresholds, absent OFHEO's approval, and imposes additional restrictions on capital distributions so long as the Enterprise is not classified as adequately capitalized. An Enterprise that is not classified as adequately capitalized may also be subject to a variety of regulatory limitations and restrictions as deemed to be appropriate by OFHEO.<sup>10</sup>

On April 10, 2001, OFHEO published a notice of proposed rulemaking at 66 FR 18694 seeking public comment on a proposal to issue a rule describing the scope of the actions the agency is authorized to take under certain prompt corrective action statutory provisions applicable to the Enterprises at 12 U.S.C. 4614 through 4618, 4619(b) through (e), 4622 and 4623, as well as the procedures by which such actions will be carried out. OFHEO also sought public comment on adopting a proposed prompt supervisory response procedure, separate from the capital-based prompt corrective action regime, under which OFHEO proposed to monitor various supervisory concerns in addition to an

maintained by the Enterprise. For these purposes, OFHEO assesses the Enterprises' capital by reference to two standards. The first capital standard is based on ratios of core capital instruments to on balance sheet assets and off balance sheet obligations. The ratios are set according to percentages contained in 12 U.S.C. 4612 and 4613, subject to certain adjustments by OFHEO, and calculated in accordance with guidance from OFHEO under part 1750 of OFHEO's regulations (12 CFR Part 1750). The statute provides for a "minimum capital" level based on these ratios, as well as a "critical capital" level, based on lower ratios, that triggers additional enforcement requirements and authorities under subtitle B of the 1992 Act. The other capital standard is risk-based. On September 13, 2001, OFHEO published a final rule amending 12 CFR Part 1750 to implement this capital standard. 66 FR 47729. Rather than applying leverage ratios, this risk-based capital standard requires the Enterprises to hold sufficient total capital to maintain a positive capital position during a hypothetical ten-year stress period characterized by statutorily prescribed stressful credit conditions and large movements in interest rates, plus an additional amount to cover management and operations risk. As directed by 12 U.S.C. 4611, OFHEO has developed a stress test which, when applied to an Enterprise's book of business, will project the amount of total capital that would be necessary to survive the stresses described in the statute during the stress period. However, as provided in 12 U.S.C. 4614(d) and 4615(c), OFHEO is not to include consideration of an Enterprise's total capital during the classification process, until September 13, 2002.

<sup>10</sup> For a more detailed description of the prompt corrective action provisions of subtitle B of the 1992 Act, see 66 FR 18696-18698 (April 10, 2001)(OFHEO's NPR on prompt supervisory response and PCA).

<sup>1</sup> 12 U.S.C. 4513(a). See also 12 U.S.C. 4513(b)(1)-(5), 4517, 4521(a)(2)-(3), 4631(a)(3), 4636(a)(1).

<sup>2</sup> See Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1451 *et seq.*; Federal National Mortgage Association Charter Act, 12 U.S.C. 1716 *et seq.*; 1992 Act at 12 U.S.C. 4561-4567, 4562 note.

<sup>3</sup> 12 U.S.C. 4513(b)(1).

<sup>4</sup> 12 U.S.C. 4514, 4517, 1456(c), 1723a(k).

<sup>5</sup> 12 U.S.C. 4611-4614.

<sup>6</sup> 12 U.S.C. 4631-4641.

<sup>7</sup> 12 CFR part 1780; see 66 FR 18040 (April 5, 2001)(OFHEO final rule amending purpose and scope section of part 1780, to summarize agency's statutory enforcement powers).

<sup>8</sup> See 12 U.S.C. 4614-4619, 4622, 4623.

<sup>9</sup> Subtitle B of the 1992 Act directs OFHEO to classify the Enterprises into one of four capital classifications ("adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized,"), based on the level of capital

Enterprise's capital classification, and to pursue early action by an Enterprise to preclude losses or possible losses, or to address particular threats to safety and soundness. The proposed procedure would be part of OFHEO's ongoing supervisory program that includes monitoring and examination of Enterprise activities on a continuous basis. The prompt supervisory response approach would complement and not supplant ongoing review programs. Similar to the procedures under the capital-based, prompt corrective action regime, as proposed the prompt supervisory response provision would have established a set of "tripwires," looking to specifically enumerated developments proposed to be appropriate junctures for a supervisory review to ascertain the financial or operational consequences of such developments upon the Enterprise. Under the proposal, the occasion of a specified tripwire event or condition would have triggered an automatic supervisory response by OFHEO.

OFHEO received comments on these proposals from Fannie Mae, Freddie Mac, and one former senior government official. The three commenters questioned the need for the prompt supervisory response regime. They similarly asserted that, since OFHEO already conducts continuous and comprehensive on-site supervision of the Enterprises and can work with the Enterprises informally to resolve any significant supervisory issues that arise, the prompt supervisory response approach would add nothing to OFHEO's ability to exercise supervisory oversight for the Enterprises.

The prompt supervisory response approach reflects OFHEO's commitment to use a broad-based method to effectuate early identification of and supervisory action regarding potentially adverse developments or conditions affecting the Enterprises, by moving beyond the capital-based focus of prompt corrective action in appropriate circumstances. The prompt supervisory response approach mandates no specific conduct by the Enterprises; indeed, the need for action is to be ascertained on a case-by-case basis. In those instances in which the Enterprise has already undertaken appropriate steps, OFHEO anticipates that no additional action will be necessary. The approach also increases the transparency of the procedures and analytical framework OFHEO is to use in such matters. The role of OFHEO to ensure the safety and soundness of the Enterprises is not restricted to examination and capital monitoring functions on the one hand and to an enforcement or prompt

corrective action procedures on the other. OFHEO's duty to ensure the Enterprises are adequately capitalized and operate safely<sup>11</sup> means that the agency is charged by Congress to act to ensure the safety and soundness of the Enterprises at all points on the supervisory spectrum between examination and enforcement.<sup>12</sup> Thus, OFHEO is also charged with ensuring that each Enterprise acts prudently in dealing with perceived problems as they emerge.

OFHEO has taken the comments provided into consideration and is now issuing a final rule, with several modifications. In formulating Subpart A, the final prompt supervisory response rule, OFHEO has adopted a less rigid approach to identify developments warranting specific supervisory response under the rule, while the supervisory response process set out in the rule has been adopted as proposed, without substantive change. OFHEO has also made certain modifications to Subpart B, the prompt corrective action provisions of the rule. The final rule, along with the comments and modifications, are described below.

#### **Prompt Supervisory Response Provisions of the Proposed Rule**

Subpart A establishes a system of prompt supervisory response to be taken when developments internal or external to an Enterprise, as identified by OFHEO, warrant special supervisory review. In order to provide a broad early intervention regime that addresses both capital-related and non-capital-related supervisory concerns, the rule describes how OFHEO may initiate specified prompt supervisory responses to address non-capital considerations that are outside the primary focus of the prompt corrective action regime, of Subpart B.

#### *Authority, Purpose, and Scope*

In their comments, each Enterprise asserted that the prompt supervisory response rule, as proposed, exceeded OFHEO's statutory authority, and should be wholly withdrawn. The rule—as proposed, and as adopted in final form here—contemplates that a letter be issued directing an Enterprise to respond to OFHEO's inquiry or that OFHEO may require an Enterprise to prepare and carry out an acceptable action plan. The Enterprises argue that this procedure would bypass specified

statutory thresholds and procedural protections contained in the 1992 Act, under which OFHEO may only issue cease and desist orders or require capital restoration plans in certain narrowly defined circumstances, pursuant to defined due process procedures. Moreover, the Enterprises asserted that OFHEO has no explicit statutory mandate to establish safety and soundness standards by regulation or other guidance.

As OFHEO discussed in the preamble to the proposed rule, the prompt supervisory response approach is simply a procedural framework through which OFHEO may employ its current array of supervisory tools and regulatory authority to confront special factual scenarios. The 1992 Act, at 12 U.S.C. 4631(a)(3)(A), sets out OFHEO's authority to order an Enterprise to cease and desist unsafe or unsound practices.<sup>13</sup> By identifying and working with an Enterprise to eliminate perceived unsafe or unsound conditions or practices through an interactive supervisory process, such as is reflected in the prompt supervisory response approach, instead of resorting directly to an adjudicative enforcement action, OFHEO seeks to carry out its oversight responsibilities and neither exceeds its statutory authority nor circumvents the procedural scheme contained in 12 U.S.C. 4631. Any subsequent use of formal or informal enforcement procedures will be dependent, in large part, upon Enterprise action to address supervisory concerns, and will be undertaken pursuant to the applicable statutory procedures.

OFHEO rejects assertions that the agency has no explicit statutory mandate to establish safety and soundness standards by regulation or guideline. The 1992 Act, at 12 U.S.C. 4513, particularly 12 U.S.C. 4513(b)(1) and (b)(5), explicitly establishes such authority without reservation. More pertinently, the prompt supervisory response rule does not establish supervisory standards or specify remedies; rather, it establishes a supervisory process.

As described in § 1777.1(a) and 1777.1(b) of the final rule, the regulation is being issued under OFHEO's broad statutory authority to take such actions as the Director of OFHEO deems appropriate to ensure that the Enterprises operate in a safe and sound

<sup>11</sup> See, e.g., 12 U.S.C. 4513(a).

<sup>12</sup> See, e.g., 12 U.S.C. 4513(b)(5)(OFHEO authorized to take such actions and perform such functions as OFHEO determines necessary regarding "\* \* \* other matters relating to safety and soundness" (emphasis added)).

<sup>13</sup> OFHEO has responded to Enterprise challenges to its authority to institute cease and desist proceedings to address unsafe or unsound practices. See 66 Fed. Reg. 18040, 18041 (April 5, 2001) (discussion of Fannie Mae's and Freddie Mac's comments on OFHEO's procedural rules for enforcement actions).

manner, together with OFHEO's reporting<sup>14</sup> and examination<sup>15</sup> authorities. As set out in § 1777.1(b), the purpose of subpart A of the rule is to fashion an early intervention regime to address matters of supervisory concern to OFHEO under its congressional mandate in addition to the capital considerations already focused upon by the prompt corrective action regime. However, as stated in § 1777.1(b) of the final rule, OFHEO's initiation of the procedures under the rule does not necessarily indicate that an unsound condition exists; rather, the final rule is consistent with the process that OFHEO employs in reviewing the conduct of an Enterprise's affairs as a safety and soundness regulator. The possible supervisory responses described below, including a supervisory letter, an action plan, or a notice to show cause, as they might be used under the rule, do not constitute orders under the 1992 Act for purposes of 12 U.S.C. 4631 or 4636. They are simply steps in a predictable and organized process under which OFHEO will review issues and, as necessary and appropriate, provide supervisory guidance to an Enterprise.

#### *Developments Prompting Supervisory Response*

In § 1777.10 of the proposed rule, OFHEO proposed to adopt a list of nine possible developments that would cause OFHEO to initiate a special review under the prompt supervisory response process. The proposed list included both external indicators tied to market factors, as well as internal indicators tied to factors within a particular Enterprise. The Enterprises submitted separate comments objecting to each of the nine proposed "triggers" on various grounds. In some instances, the Enterprises agreed that occurrence of a particular trigger event might indicate a potential for financial difficulties for the Enterprise, but asserted that the proposed triggers generally failed to take into account countervailing factors that could ameliorate any supervisory concern about a particular development. The Enterprises also asserted that the proposed triggers focused on matters that would most often have innocuous underlying causes, and would likely have already been subject to identification and assessment by the Enterprises and by OFHEO prior to the time that a prompt supervisory response inquiry might be initiated under the rule. OFHEO does not agree with the Enterprises' conclusions. OFHEO does agree that ongoing supervision and

examination are central to its regulatory oversight, and OFHEO notes that ameliorative actions and prudent planning by an Enterprise to address a particular development would be relevant to a supervisory inquiry or suggested remedy under the prompt supervisory response approach.

The final version of § 1777.10 revises the approach of the proposed rule. In response to the comments, the list of developments prompting a supervisory response has been revised by deleting certain proposed developments and by retaining others, either as proposed or with modifications. The revised list retains proposed § 1777.10(a) (relating to declines in the Housing Price Index) and proposed paragraph (j), redesignated as paragraph (e) (as to the discretionary authority of the Director to initiate a supervisory letter in other circumstances). The final rule modifies § 1777.10(c) to provide only that changes in "publicly reported" net income are the type of development addressed, and similarly paragraph (d) to provide only that changes in "publicly reported" net interest margin are the type of development addressed. The final rule modifies § 1777.10(d) to raise the threshold amount of change in delinquent loans contemplated under this paragraph from one half of one percent to one percent, more appropriately defining the point that prompts a supervisory response. Based on comments received, the final rule does not include earlier proposed paragraphs (b) (relating to interest rate risk measures), (f) (matters related to equity calculations), (g) (matters related to data system operational problems), (h) (matters related to external auditor changes) and (i) (matters related to board meetings). The deletion of those paragraphs does not preclude their consideration as developments that might merit a supervisory response either under routine examination and supervision procedures of OFHEO or under the discretionary authority retained by the Director, under redesignated subsection (e).<sup>16</sup> OFHEO will continue to review and refine the list of early warning indicators and to identify additional developments that may signal a significant possibility of difficulties so as to warrant a prompt supervisory response.

<sup>16</sup> Redesignated § 1777.10(e) provides that a supervisory response may be initiated upon the occurrence of "[a]ny other development, including conduct of an activity by an Enterprise, that OFHEO determines in its discretion presents a risk to the safety and soundness of the Enterprises or is a possible violation of applicable law, regulation, or order."

In their comments, both Enterprises noted that proposed § 1777.10 (j), redesignated (e) in the final rule, would be sufficient to encompass all of the possible developments with which OFHEO was concerned under proposed § 1777.10. In addition, Freddie Mac noted that proposed § 1777.10 (j) most closely approximates OFHEO's existing oversight practices because it incorporates discretionary elements and implicitly suggests that OFHEO will consider the context of particular developments before initiating the prompt supervisory response process. Under § 1777.10 (e) of the final rule, the Director of OFHEO has the discretion to initiate the prompt supervisory response process whenever he or she is concerned about a development or condition relating to an Enterprise's safety and soundness, regardless of whether it has manifested an impact on the Enterprise's capital level. Developments and conditions of concern to the Director under § 1777.10 (e) might be detected by OFHEO in connection with an examination of the Enterprises, or in some other manner as the agency conducts its continuous supervisory and oversight functions.

#### *Supervisory Response*

Section 1777.11 of the final rule sets out the various forms of supervisory response that may be taken under the regulation. As noted earlier, all elements of the response process are recognized and existing elements of OFHEO's oversight authorities. The final rule adopts the approach of the proposal with only conforming changes and one clarification. Under the procedures set forth under the final rule, there are several levels of response.

In each case, OFHEO is to initiate a Level I supervisory action under § 1777.11(a) within five days of OFHEO's determination under § 1777.10 that a development or condition warrants supervisory response. The Enterprise will receive a supervisory letter advising the Enterprise that OFHEO has begun the prompt supervisory response process to address the development or condition and setting forth such other information and specific directions as the Director deems appropriate in light of the circumstances. For example, OFHEO may direct the Enterprise to provide information about the situation, to respond to OFHEO's specific questions or concerns, to take corrective or remedial action, or other preventative action as deemed appropriate.

Based on the Enterprise's response to the supervisory letter and other relevant concerns, OFHEO will promptly

<sup>14</sup> 12 U.S.C. 4514, 1456(c), 1723a(k).

<sup>15</sup> 12 U.S.C. 4517.

determine whether additional supervisory response under the rule is necessary. The Enterprise's response to the supervisory letter may cause OFHEO to conclude that the subject development creates no substantial supervisory concern or that the Enterprise's management of the risks and concerns presented by the development is adequate. In other instances, the supervisory letter process may cause OFHEO to conclude that a heightened level of supervisory concern is warranted, yet the letter process itself and continuing supervisory dialogue may be all that is needed to ensure that the Enterprise undertakes sufficient preventative or remedial measures.

If additional supervisory action is deemed necessary, OFHEO has a variety of alternatives under § 1777.11. Level II supervisory action, as set out in § 1777.11(b), provides for a special review of an Enterprise. A special review may be useful in supplementing information already obtained by OFHEO through the examination process, and might provide OFHEO with a clearer picture of the situation than could otherwise be obtained through letters or reports. Such review could be conducted by OFHEO's Office of General Counsel, Office of Research and Model Development, Office of Examination and Oversight, Office of Policy Analysis and Research, or such other department or individual as designated by the Director. In light of such a special review, OFHEO will determine whether further supervisory action is warranted.

Under Level III supervisory action set out in § 1777.11(c), OFHEO may direct an Enterprise to prepare and submit an action plan addressing the development or condition. Among other things, the Enterprise's action plan may be required to include information about the circumstances leading up to the subject condition or development and an assessment of its possible effects upon the Enterprise. The Enterprise may also be asked to describe its proposed course of action for dealing with the development, including an analysis of available alternatives. If OFHEO determines that the action plan is insufficient to resolve the supervisory issues created by the development, OFHEO may direct the Enterprise to revise the plan. However, if OFHEO determines that the supervisory issues will not be resolved even under a revised plan, OFHEO may determine to initiate other supervisory responses.

Under Level IV supervisory action, as set out in § 1777.11(d), OFHEO will require the Enterprise to show cause why OFHEO should not initiate formal

enforcement action against the Enterprise. OFHEO is not, however, required to issue a show cause notice prior to initiating an administrative enforcement action.

The three commenters alleged that the prompt supervisory response process represents a "one-size-fits-all" approach that would unnecessarily limit OFHEO's flexibility and discretion, as well as the agency's ability to formulate timely, fact-specific, and flexible responses to emerging supervisory issues. OFHEO disagrees with that characterization. OFHEO is well aware of the necessity for a regulatory agency to apply its expertise to specific supervisory problems in light of the particular attendant facts, and to do so swiftly. Nothing in the prompt supervisory response process limits the flexibility necessary for OFHEO to meet its supervisory responsibilities. As the exclusive safety and soundness regulator of the Enterprises, OFHEO has been constituted with broad supervisory authorities in order to detect and address any safety and soundness concerns that may arise, and has broad enforcement powers to ensure that any safety and soundness deficiency or violation of law is promptly remedied, possibly long before harm to an Enterprise reaches the level of capital impairment. OFHEO's concerns may include an array of considerations—ranging, for example, from matters such as declining collateral values to asset quality, liquidity, and operational difficulties—that could result in substantial harm to an Enterprise before capital is impaired. OFHEO will analyze the totality of each situation, rather than awaiting a decline in capital to initiate agency action. If an analysis reveals a supervisory concern, then OFHEO's response might reasonably include a mixture of early warning and early action initiatives that would be effective before specific problems seriously affect an Enterprise.

OFHEO designed the prompt supervisory response process to provide it flexibility as a supervisor, both in structuring the scope of the review and in overseeing the Enterprise's implementation of responsive measures. Under § 1777.11(a), OFHEO will issue a supervisory letter commencing the prompt supervisory response review, but the content of the letter will depend entirely on the "particular circumstances and the nature of the development." There are then three additional levels of available supervisory responses under § 1777.11(b) through (d), but OFHEO's decision as to which, if any, of the levels to use will be based on the

Enterprise's "response to the supervisory letter and other appropriate factors." At every level of supervisory response in § 1777.11(b) through (d), the rule expressly states that OFHEO will assess the effectiveness of actions as well as other relevant factors in determining whether additional supervisory action is appropriate. As stated in the preamble to the proposed rule, the levels of supervisory response need not be carried out sequentially, and OFHEO may pursue simultaneous actions. In the final rule, OFHEO has expanded the text of the rule at § 1777.11(a)(4), so as to avoid confusion on this point.<sup>17</sup> In addition, as reflected in § 1777.2 and § 1777.12, the prompt supervisory response process in no way limits OFHEO's discretion to use any of its other supervisory tools and authorities to respond to the particular situation. OFHEO also rejects the suggestion that the prompt supervisory response process would not be rapid. The supervisory letter is to be issued within five days after OFHEO determines that a development or condition warrants review under the rule, and the text of § 1777.11 requires OFHEO to implement any additional levels of supervisory response promptly and review the effectiveness of such response promptly.

Finally, the commenters expressed concerns that, if the prompt supervisory response approach results in public disclosure of supervisory actions, discussions, or correspondence, the contents could be misunderstood by the public and could cause the markets to lose confidence in the Enterprises. However, as reflected in § 1777.2(b), supervisory responses issued under § 1777.11 do not constitute public orders enforceable under 12 U.S.C. 1371 or 1376, and, as noted in § 1777.1(b), OFHEO's initiation of procedures under the prompt supervisory response regime does not necessarily indicate that an unsound condition exists.

#### **Implementation of the Prompt Corrective Action Provisions of the 1992 Act by the Final Rule**

Subpart B of the final rule describes the scope of actions OFHEO is authorized to take under the prompt corrective action provisions applicable to the Enterprises under the 1992 Act at 12 U.S.C. 4614 through 4618, 4619(b) through (e), 4622 and 4623, as well as the procedures by which such actions are to be carried out. The

<sup>17</sup> With the exception of nonsubstantive changes made to conform § 1777.11 of the final rule to the revised § 1777.10, OFHEO has made no other alterations to § 1777.11.

following is an overview of the provisions of the final rule and the statutory authorities implemented thereby. Freddie Mac and Fannie Mae submitted numerous comments on proposed Subpart B, which OFHEO has taken into account in formulating the final rule. These comments are addressed below, as part of the description of the section of the final rule to which each comment pertains.

#### *Authority, Purpose, Scope, and Implementation Dates*

The authority, purpose, and scope of subpart B are set out in § 1777.1(a) and (c), which briefly review the statutes underlying the rule. Subpart B is issued under OFHEO's broad authorities to take such actions as are deemed appropriate by the Director of OFHEO to ensure that the Enterprises maintain adequate capital and operate in a safe and sound manner, as established by 12 U.S.C. 4513, 4631, 4632, and 4636, as well as under the specific prompt corrective action provisions contained in subtitle B of the 1992 Act (12 U.S.C. 4611 through 4623), the Federal Home Loan Mortgage Corporation Act at 12 U.S.C. 1452(b)(2), and the Federal National Mortgage Association Charter Act at 12 U.S.C. 1718(c)(2). These provisions authorize OFHEO to administer certain capital requirements for the Enterprises, to classify the capital of the Enterprises based on capital levels specified in the 1992 Act, and, in appropriate circumstances, to exercise discretion to reclassify an Enterprise into a lower capital category. Under these provisions, there are also automatic consequences for an Enterprise that is not classified as adequately capitalized, as well as discretionary authority for OFHEO to require an Enterprise to take remedial actions.

As discussed in § 1777.1(d), the 1992 Act directs OFHEO to determine capital classifications for the Enterprises by reference to three capital "triggers" (the minimum capital level, the critical capital level, and the risk-based capital level). Notably, however, 12 U.S.C. 4614(d) delays consideration of the risk-based capital level until one year after OFHEO's risk-based capital rule becomes effective, that is, September 13, 2001. Section 4615 of Title 12, which sets out the supervisory actions to be taken as applicable to an Enterprise that is classified as undercapitalized, similarly provides that its provisions will not take effect until one year after OFHEO's risk-based capital rule becomes effective. Section 4614(d) provides that, until that time, an Enterprise shall be classified as

adequately capitalized if the Enterprise maintains an amount of capital that equals or exceeds the minimum capital level.

Therefore, under subpart B of the final rule at § 1777.20, different sets of capital classifications will apply before and after September 13, 2002. Section 1777.20(a) contains the "permanent" set of capital classifications taking the risk-based capital level into account as well as the minimum capital level and critical capital level. This set of capital classifications will apply any time after September 13, 2002.

The currently applicable "temporary" set of capital classifications is contained in § 1777.20(c) as an exception to § 1777.20(a) that applies until September 13, 2002. This currently applicable set of classifications is based on an Enterprise's minimum capital level and critical capital level, reflecting the classification criteria presently used by OFHEO. Section 4614(a) of Title 12, when read together with 12 U.S.C. 4616(c)<sup>18</sup> and 12 U.S.C. 4617(d),<sup>19</sup> indicates that Congress intended OFHEO to classify the Enterprises for prompt corrective action purposes by reference to minimum capital and critical capital levels, pending expiration of the one-year post-effectiveness period for the risk-based capital test.

#### *Preservation of Other Authority*

As set forth in § 1777.2(b) through (c), the prompt corrective action provisions are but one aspect of OFHEO's broad supervisory authority to ensure that each Enterprise maintains capital that is adequate for its safe and sound operation. In their comments, the Enterprises objected to language in § 1777.2(b) that states OFHEO has authority to require an Enterprise to hold capital in addition to that necessary to comply with the minimum and risk-based capital levels, when in OFHEO's judgment circumstances indicate additional capital is necessary or appropriate in light of the overall strength of the Enterprise and market conditions. The Enterprises argue that the minimum and risk-based capital levels defined by the statute are exclusive, and OFHEO is not vested under law with discretion to require the Enterprises to hold additional capital.

<sup>18</sup> 12 U.S.C. 4616(c) provides that statutory provisions requiring prompt corrective action with regard to a significantly undercapitalized Enterprise are to be effective from the time the Enterprise is first classified under 12 U.S.C. 4614.

<sup>19</sup> 12 U.S.C. 4617(d) provides that statutory provisions requiring prompt corrective action with regard to a critically undercapitalized Enterprise are to be effective from the time the Enterprise is first classified under 12 U.S.C. 4614.

OFHEO disagrees and has adopted § 1777.2(b) without change. Subtitle B of the 1992 Act, establishing the minimum and risk-based capital levels, contains no language to the effect that such levels are exclusive. The 1992 Act taken as a whole demonstrates congressional understanding that capital by itself is but one indicator of the financial health or weakness of an Enterprise. All circumstances must be weighed in determining the capital adequacy of an Enterprise. That is, differing conditions may warrant greater capital to ensure the strength and viability of an Enterprise. Thus, under 12 U.S.C. 4513(a), it is the supervisory responsibility of OFHEO to ensure that the Enterprises are adequately capitalized and operating safely. Under 12 U.S.C. 4513(b), OFHEO has exclusive authority to take such actions as it determines necessary regarding the safety and soundness of the Enterprises.

An Enterprise's maintenance of capital sufficient to meet the minimum capital level and risk-based capital level does not alone establish that the Enterprise possesses sufficient capital to operate safely and soundly in all circumstances. The legislative history of the 1992 Act indicates that Congress specifically debated whether subtitle B established the exclusive capital levels for the Enterprises or instead represented a minimum "floor" level. In the end, Congress concluded that subtitle B takes the "floor" approach, and that OFHEO's safety and soundness authority includes the ability to require an Enterprise to hold additional capital whenever circumstances indicate supplementary capital is appropriate in consideration of the Enterprise's overall safety and soundness.<sup>20</sup> Similarly, the language of 12 U.S.C. 4614(a)(1) provides that, for an Enterprise to be classified as adequately capitalized, the Enterprise should "meet or exceed" the minimum and risk-based capital levels (emphasis added).

In addition to its authority to require the Enterprises to maintain additional capital as a safety and soundness matter, OFHEO is authorized, as reflected in § 1777.2(c) of the final rule, to take various kinds of supervisory action to deal with capital deficiencies at an Enterprise, other than or in addition to the prompt corrective action provisions. The 1992 Act grants OFHEO broad discretion to take other supervisory

<sup>20</sup> See, e.g., 138 Cong. Rec. S9353-54 (July 1, 1992)(colloquy between Senator Metzenbaum and Senator Reagle concerning the effect of section 202 of S. 2733, which is substantially the same as 12 U.S.C. 1362); 138 Cong. Rec. H11102 (Oct. 3, 1992)(colloquy between Mr. Gonzalez, Mr. Frank, and Mr. Leach).

actions as may be deemed by OFHEO to be appropriate, including issuing temporary and permanent cease and desist orders, imposing civil money penalties, appointing a conservator, entering into a written agreement the violation of which is actionable through enforcement proceedings, or entering into any other formal or informal agreement with an Enterprise. Moreover, the initiation of a particular action or a combination of actions does not foreclose OFHEO from pursuing any other action.

#### Definitions

The definitions in § 1777.3 cross-reference to OFHEO's capital rules at 12 CFR part 1750 in defining core and total capital. Section 1777.3 defines the minimum capital level as the minimum amount of core capital specified for an Enterprise pursuant to 12 U.S.C. 4612, as determined under OFHEO's capital rules at § 1750.4. The definition of the critical capital level in § 1777.3 refers to the calculation of core capital required to meet the minimum capital level under § 1750.4 of OFHEO's capital rules, making the appropriate adjustments thereto in order to implement the lower percentages specified in 12 U.S.C. 4613 as compared to 12 U.S.C. 4612. Thus, § 1777.3 defines the critical capital level as the amount of core capital that is equal to the sum of one half of the amount determined under § 1750.4(a)(1) and five-ninths of the amounts determined under § 1750.4(a)(2) through § 1750.4(a)(7). Section 1777.3 defines the risk-based capital level to mean the amount of total capital specified for an Enterprise pursuant to 12 U.S.C. 4611, as determined under OFHEO's risk-based capital regulations in 12 CFR part 1750.<sup>21</sup>

The definitions of "affiliate" and "Enterprise" are taken from 12 U.S.C. 4502(1) and 4502(6), respectively. The 1992 Act, in defining an Enterprise to include the Enterprise's affiliates, vests OFHEO with the same broad jurisdiction over the supervision and regulation of such affiliates as the agency has over the operations and activities of the federally chartered entity. Section 4502(1) defines an affiliate to be any entity that controls, is controlled by, or is under common control with an Enterprise. The 1992 Act does not, however, define control, thereby leaving the term to be interpreted by OFHEO in light of the context in which the term is to be used and the particular provision of the 1992

Act at issue.<sup>22</sup> In its comments, Freddie Mac disagreed with OFHEO's statement to this effect in the preamble to the proposed rule, and instead asserted that the term should be interpreted to have a single meaning throughout the 1992 Act. However, as seen in other laws, when Congress intends that an agency use a single definition of "control" throughout an entire act in connection with an "affiliate" definition, Congress enacts a statutory definition of "control," including language in the definition that specifies the test to be applied. *See, e.g.*, 12 U.S.C. 1813(w)(5); 12 U.S.C. 1841(a)(2). Where, as is the case in the 1992 Act, the term is not defined, Congress leaves the term to be defined by the expert agency in light of the particular context in which it is to be used and the particular substantive provision at issue.

The term "capital distribution" as defined in the rule is taken from 12 U.S.C. 4502(2). Both Enterprises' comments included objections to one aspect of OFHEO's proposed definition, under which an Enterprise's payment to repurchase its shares for the purpose of fulfilling an obligation of the Enterprise under an employee stock ownership plan that is qualified under section 401 of the Internal Revenue Code of 1986 (26 U.S.C. 401 *et seq.*) or any substantially equivalent plan would not be treated as a capital distribution so long as it was approved in writing by OFHEO in advance. The Enterprises argue that, under 12 U.S.C. 4502(2)(B), OFHEO's only proper approval function goes to the issue of whether an employee stock ownership plan is substantially equivalent to a plan that is qualified under section 401 of the Internal Revenue Code, and the Enterprises are not required to obtain OFHEO's approval of payments made to fulfill the Enterprises' repurchase obligations under the plan.

The language of 12 U.S.C. 4502(2)(B) is susceptible to either the proposed or the subsequently suggested interpretation. Upon further review, OFHEO has modified the final version of § 1777.3 to eliminate the requirement that the Enterprises obtain OFHEO's prior written approval for stock

repurchases by employee stock ownership plans and such substantially equivalent plans. Under the revised language, payments made by an Enterprise to repurchase its shares for the purpose of fulfilling the Enterprise's obligation under an ESOP that is qualified under IRC 401 will not be defined as capital distributions. The same types of payments made to ESOPs that are substantially equivalent to 401-qualified ESOPs will also enjoy the exception, so long as OFHEO determines that the plan in question is substantially equivalent to a 401-qualified ESOP.

Section 4502(2) authorizes OFHEO to define additional transactions as capital distributions by regulation for these purposes. OFHEO has at this time identified no other transactions to be deemed capital distributions beyond those listed in the statutory definition.

#### Capital Classifications and Discretionary Reclassification

Section 1777.20(a) sets out the capital classifications that, as discussed above, will be applicable to the Enterprises after September 13, 2002, taking the risk-based capital level into account as well as the minimum and critical capital levels. Until then, the classifications under § 1777.20(c), discussed below, apply to the Enterprises. Section 1777.20(a) sets out the capital classifications as follows:

- *Adequately capitalized:* An Enterprise will be classified as adequately capitalized if the Enterprise meets the risk-based capital level and the minimum capital level, unless OFHEO has exercised its discretion to reclassify the Enterprise into a lower capital classification;
- *Undercapitalized:* An Enterprise will be classified as undercapitalized if it meets the minimum capital level but does not meet the risk-based capital level, unless OFHEO has exercised its discretion to reclassify the Enterprise into a lower capital classification;
- *Significantly undercapitalized:* An Enterprise will be classified as significantly undercapitalized if the Enterprise meets the critical capital level but fails to meet the minimum capital level, unless OFHEO has exercised its discretion to reclassify the Enterprise as critically undercapitalized;
- *Critically undercapitalized:* An Enterprise will be classified as critically undercapitalized if the Enterprise does not meet the critical capital level; and
- *Discretionary reclassification:* As is set out in more detail below, 12 U.S.C. 4614(b) authorizes OFHEO to reclassify an Enterprise into the next lower capital classification at any time, in the

<sup>21</sup> OFHEO has recently published such rules at 66 FR 47729 (Sept. 13, 2001).

<sup>22</sup> In determining whether control exists for the purposes of exercising jurisdiction over an affiliate of an Enterprise under any particular provision of the 1992 Act, OFHEO considers the nature of the particular provision and the facts and circumstances involved. Among other things, OFHEO considers whether an Enterprise or other entity exercises a controlling influence over the management and policies of a particular entity, by ownership of, or the power to vote, a substantial percentage of any class of voting securities, by the ability to elect or appoint members of the board of directors or officers of the entity, or by other means.

discretion of the Director of OFHEO. Appropriate grounds for reclassification include a finding by the Director that the Enterprise is either engaging in conduct that could result in a rapid depletion of the Enterprise's core capital, or that the value of property subject to mortgages held or securitized by the Enterprise has decreased significantly. Other reclassifications, based on other sections of subtitle B of the 1992 Act pertaining to failure to submit an acceptable capital restoration plan or implement it, are located in § 1777.7, the section addressing capital restoration plans.

Under § 1777.20(a), the minimum and critical capital levels are the determinative standards for assessing whether an Enterprise falls into the significantly undercapitalized or critically undercapitalized classification based on capital, without regard to whether the Enterprise maintains total capital at or above its risk-based capital level. Under the 1992 Act, the minimum and critical capital levels act as the "tripwires" for the prompt corrective actions specified in 12 U.S.C. 4616 and 4617. The amount of capital an Enterprise is required to hold to meet its risk-based capital level could be either less or more than the amount of the capital required to meet its minimum capital level or even its critical capital level. The rule therefore avoids a result under which an Enterprise that fails to meet its minimum capital level or critical capital level might avoid classification as significantly undercapitalized or critically undercapitalized by maintaining total capital in compliance with its risk-based capital level.

The final version of § 1777.20(a)(5) sets forth the grounds for reclassification of an Enterprise. Under section 4614(b), grounds for reclassification include a finding by the Director that the Enterprise is either engaging in action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events) that could result in a rapid depletion of the Enterprise's core capital, or that the value of property subject to mortgages held or securitized by the Enterprise has decreased significantly. In their comments, the Enterprises objected to language proposed in § 1777.20(a)(5) to the effect that OFHEO could also issue a discretionary reclassification if OFHEO deems it to be necessary to ensure that the Enterprise holds adequate capital and operates safely. OFHEO disagrees. Section 4614(b) recites that OFHEO may issue a discretionary reclassification if the

Director determines that an Enterprise is engaging in conduct that could result in a rapid depletion of core capital, or that the value of the Enterprise's mortgage collateral has decreased significantly. Notably, section 4614(b) is silent with regard to whether the statutorily recited grounds for reclassification are exclusive. Section 4513(b) empowers the Director of OFHEO to make other determinations, including those necessary to determine the capital classification of an Enterprise and those necessary for other matters that the Enterprises are adequately capitalized and operating safely.

Taken together, the above-referenced statutory provisions evidence a Congressional purpose that the Director of OFHEO have the discretionary authority to reclassify Enterprise if the Director determines that the Enterprise's capital position is not deemed by the Director to be sufficient to ensure its safety and soundness. OFHEO is therefore adopting § 1777.20 (a)(5) as proposed.

For purposes of OFHEO's discretionary authority to reclassify an Enterprise based on "conduct that could result in a rapid depletion of core capital" under 12 U.S.C. 4614(b), OFHEO interprets the term "conduct" to include action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events). In its comments, Fannie Mae objected to inclusion of this language in proposed § 1777.20(a)(5)(i). However, the regulatory language is well within the ordinary meaning of the term "conduct," and OFHEO has included it in the final version of § 1777.20(a)(5) without change. Freddie Mac also objected to OFHEO's assertion in the preamble to the proposed rule that the rapid depletion of core capital referred to in section 4614(b) and § 1777.20(a)(5) need only be a possible consequence of the conduct in question. Freddie Mac argues that OFHEO appears to be implementing too liberal a standard in light of the more extreme formulation contained in section 4614(b) itself. OFHEO reiterates the point, as stated in the preamble to the proposed rule, that the statutory language under section 4614(b) does not require OFHEO to find that the rapid depletion is underway or imminent, but requires only that OFHEO determine that such rapid depletion "could result," i.e., that it is a possible outcome or result of the conduct in question, or that the conduct could contribute significantly to deepening losses. Congress, having already established the capital classifications based on capital levels to address cases in which an Enterprise's

capital has already declined, established a broad standard for discretionary reclassification, to authorize early intervention by OFHEO when appropriate.

Section 1777.20(d) of the final rule provides that OFHEO will not reclassify an Enterprise for conduct that was previously approved by the Director of OFHEO in connection with the Director's approval of the Enterprise's capital restoration plan or of a written agreement that is enforceable in accordance with 12 U.S.C. 4631. The Enterprises argued in their comments that OFHEO proposal impermissibly would narrow section 4614(b), and that the statutory language thereunder immunizes any conduct however approved by the Director.

Section 4614(b) provides that OFHEO may reclassify an Enterprise that engages in conduct "not approved by the Director" that could result in a rapid depletion of core capital. However, the statute is silent as to what constitutes an approval for these purposes, leaving OFHEO to define the term by regulation pursuant to the authority granted by section 4513(b). An administrative agency is entitled under law to establish reasonable procedures in such manner as to enable the agency to channel and manage its approval processes.

The Enterprises suggest that the only reasonable interpretation of section 4614(b) is that it immunizes all conduct "approved by the Director" of OFHEO in any context or manner. However, such interpretation is so open-ended as to be unreasonable. In light of the significance of an approval for purposes of section 4614(b), the statute can be reasonably read to require an approval to be made through a formal mechanism, in a context in which OFHEO can evaluate the consequences thereof for purposes of capital classification. Thus, it is reasonable to define the approvals exception under section 4614(b) as referring to approvals made as part of a capital restoration plan under subtitle B and to formal supervisory agreements. The inclusion of formal written agreements serves the underlying purpose of fairness to the Enterprise, particularly since such written agreements may be used simultaneously with a capital restoration plan.

As provided in § 1777.20(b), if an Enterprise is reclassified by OFHEO on grounds that the Enterprise is engaging in action or inaction that could result in a rapid depletion of core capital, OFHEO will continue to take such conduct into account for each subsequent determination of the Enterprise's capital classification, until

OFHEO determines that the action, inaction, or condition in question has ceased and been remedied to OFHEO's satisfaction. For example, if OFHEO reclassified an Enterprise from adequately capitalized to undercapitalized based on such conduct, and during the pendency of such conduct, the Enterprise's total capital declined below the risk based capital level (which, standing alone, would result in classification in the undercapitalized category), the resulting classification could be to the significantly undercapitalized category. In addition, as provided in § 1777.20(b), nothing in 12 U.S.C. 4614(b) prohibits OFHEO from subsequently reclassifying an Enterprise again if the action, inaction or condition has not ceased or been eliminated and remedied to OFHEO's satisfaction within a reasonable time. The foregoing would also apply for a discretionary reclassification under § 1777.20(a)(5), based on a decline in collateral values.

The Enterprises also objected to proposed § 1777.20(b), on various grounds. Freddie Mac argues that once OFHEO has issued a reclassification based on conduct and the Enterprise has submitted an acceptable capital restoration plan, OFHEO may not subsequently reclassify the Enterprise for failure to eliminate the objectionable conduct within a reasonable time, so long as the Enterprise continues to make good faith reasonable efforts to comply with the capital restoration plan. However, section 4614(b) contains no explicit restriction or limitation on reasonable successive reclassifications, and such a limit could inhibit OFHEO's ability to meet its supervisory obligations under evolving circumstances. Thus, OFHEO is adopting the text of § 1777.20(b)(2) without change.

Fannie Mae suggests § 1777.20(b)(2) should be revised to ensure the Enterprises are given advance notice of what constitutes a reasonable period to remedy or eliminate conduct or conditions forming the basis of a discretionary reclassification. However, this issue is too fact-driven for OFHEO to specify by rule. The question of timing will be resolved as it arises. OFHEO would specify such timing matters reasonably and fairly, in light of relevant circumstances.

Fannie Mae further suggests that it would be unfair that OFHEO might attempt to exercise unbridled discretion over so significant a question as to when a discretionary reclassification should be terminated. Fannie Mae suggests discretionary reclassifications should be presumptively terminated fifteen days

after an executive officer certifies that the condition that led to reclassification has been corrected for at least one calendar quarter. However, given that initiation of a reclassification under section 4614(b) is vested in OFHEO's discretion, as is approval of the capital restoration plan designed to restore the Enterprise to a secure condition, OFHEO rejects Fannie Mae's assertion that OFHEO's discretion over termination of such reclassification is somehow unfair, or of such significance to be beyond the agency's supervisory authority. Moreover, the quarterly classification process gives the Enterprise formal written notice of OFHEO's intention with regard to continuation or termination of a discretionary reclassification; provides the Enterprise with an opportunity to submit information that OFHEO might take into consideration; and provides the Enterprise with the opportunity for judicial review (if the Enterprise is not classified as critically undercapitalized). The Enterprises are thus adequately insulated from possible unfair treatment by the agency.

As noted above, § 1777.20(c) contains a set of capital classifications based on an Enterprise's minimum capital level and critical capital level, reflecting the classification criteria presently used by OFHEO. These classifications apply until September 13, 2002, which is one year following the initial effective date of OFHEO's regulations establishing the risk-based test:

- *Adequately capitalized:* Until September 13, 2002, an Enterprise is deemed to be classified as adequately capitalized so long as it meets the minimum capital level, as required by 12 U.S.C. 4614(d);
- *Undercapitalized:* Until September 13, 2002, 12 U.S.C. 4614(d) provides that an Enterprise that meets the minimum capital level is to be classified as adequately classified, notwithstanding whether the Enterprise maintains an amount of total capital that equals or exceeds the risk-based capital level as otherwise required by 12 U.S.C. 4614(a)(2)(A);
- *Significantly undercapitalized:* An Enterprise will be classified as significantly undercapitalized if it meets the critical capital level but fails to meet the minimum capital level, unless OFHEO has exercised its discretion to reclassify the Enterprise as critically undercapitalized;
- *Critically undercapitalized:* An Enterprise will be classified as critically undercapitalized if it does not meet the critical capital level; and
- *Discretionary reclassification:* As set out above, 12 U.S.C. 4614(b)

authorizes OFHEO to reclassify an Enterprise into a lower capital classification in certain circumstances, in the discretion of the Director of OFHEO.

The Enterprises specifically objected to proposed § 1777.20(c)(5)(i)(A) and (B), under which OFHEO notes that the agency can reclassify an Enterprise that otherwise meets the minimum capital requirement. The Enterprises assert that, during the one-year transition period following the effective date of OFHEO's risk-based capital rules, OFHEO may not make a discretionary reclassification of an Enterprise otherwise classified as "adequately capitalized," because 12 U.S.C. 4614(d) and 4615(c) prohibit OFHEO from issuing such a reclassification.

OFHEO disagrees. Sections 4614(d) and 4615(c) are merely transition provisions designed to give the Enterprises one year to optimize their operations in light of the new risk-based capital rules before OFHEO begins periodically issuing capital classifications based on risk-based capital as well as minimum capital. Nothing in the law or its legislative history indicates a Congressional intention to make the OFHEO powerless to confront circumstances that might threaten the viability of the Enterprises during the transition period. Nor were the referenced sections intended by Congress to immunize an Enterprise engaged in conduct that might result in rapid depletion of core capital. OFHEO is therefore adopting § 1777.20(c)(5) as proposed.

The Enterprises' comments on proposed § 1777.20(a)(5)(i), concerning the scope of the conduct included therein, and on proposed § 1777.20(a)(5)(ii), concerning the scope of conduct approved by the Director, as well as OFHEO's responses to those comments as discussed above, apply equally to § 1777.20(c)(5) of the final rule. The Enterprise's comments on § 1777.20(b), concerning successive reclassifications, specification of reasonable periods to remedy conduct upon which reclassification was based, and OFHEO's discretion over termination of reclassifications, as well as OFHEO's response to these comments as discussed above, apply equally to reclassifications under § 1777.20(a)(5) as they do to reclassifications under § 1777.20(c)(5) of the final rule.

#### *Classification Procedures*

Section 1777.21, implementing 12 U.S.C. 4618, sets out the procedure by which OFHEO classifies the Enterprises. These procedures apply to routine classifications that OFHEO issues for

each Enterprise at least once a quarter based on capital reports from the Enterprise and any other additional relevant information. These procedures would also be used by OFHEO to reclassify an Enterprise pursuant to its discretionary authority to do so under subtitle B of the 1992 Act, or if OFHEO otherwise determines that a new classification would be appropriate. OFHEO's current classification procedures at 12 CFR 1750.5 are terminated as part of this rulemaking, but procedures for submitting capital reports to OFHEO will continue to be addressed in part 1750.

OFHEO may determine capital classifications using different "as of" dates for the Enterprise's risk-based capital level and minimum and critical capital levels. The respective "as of" dates will be specifically identified in the proposed and final capital classifications. Thus, OFHEO may assess compliance by an Enterprise with the minimum capital level more often than it would calculate the Enterprise's risk-based capital level.

As § 1777.21(a)(4) provides, OFHEO may initiate a capital classification proceeding at any time. If another proposed capital classification is pending at such time, OFHEO will advise the Enterprise whether the later proposed classification supersedes the pending one.

Under the classification procedure in 12 U.S.C. 4618, OFHEO is to deliver written information to the Enterprise describing the proposed capital classification and the agency's basis for such classification, as described in § 1777.21(a)(1) of the final rule. In their comments, the Enterprises argued that OFHEO's proposed procedure in § 1777.21(a)(1)(ii), for reclassifying an Enterprise for failure to file an acceptable capital plan, without additional notice, is inconsistent with 12 U.S.C. 4618(a) and (b), under which an Enterprise is entitled to additional notice when OFHEO takes new action. The Enterprises assert that OFHEO may not combine notices in this way.

OFHEO disagrees. 12 U.S.C. 4618(b) evidences Congress' express authorization that the notice required under 12 U.S.C. 4618(a) may be a combined notice. Section 4618(b) states that, in providing notice under 12 U.S.C. 4618(a), OFHEO may combine a notice of classification or reclassification under 12 U.S.C. 4614 (classifications based on capital levels or discretionary reclassification based on conduct or housing prices) with a notice of discretionary supervisory action under 12 U.S.C. 4615 (reclassification from undercapitalized

to significantly undercapitalized for failure to file an acceptable capital plan or to comply with an approved plan). The statute's language can be given meaning only if a notice of proposed classification as undercapitalized is permitted to be combined with a notice of proposing to reclassify the Enterprise as significantly undercapitalized in the event the Enterprise fails to submit an acceptable capital plan. Similarly, 12 U.S.C. 4618(b) provides that OFHEO may combine notice of discretionary supervisory action under 12 U.S.C. 4616 (issuance of certain orders to the Enterprise, as well as reclassification from significantly undercapitalized to critically undercapitalized based on failure to file an acceptable plan or comply with an approved plan) with notices of classification or reclassification under 12 U.S.C. 4614.

Contrary to Freddie Mac's comments, such a notice is also consistent with the remainder of 12 U.S.C. 4618. It satisfies the requirements of 12 U.S.C. 4618(a), since the combined notice describes both proposed actions, the reasons therefore, and the information upon which they are based. During the Enterprise's response period under 12 U.S.C. 4618(c), the Enterprise has an opportunity to submit information and arguments as to why the Enterprise should not be further reclassified. OFHEO's notice to Congress under 12 U.S.C. 4618(d) will provide all information required therein. OFHEO is therefore adopting proposed § 1777.21(a)(1)(ii), as well as § 1777.23(c)(1) and § 1777.23(c)(3), without change.

As described in § 1777.21(a)(2), an Enterprise is to have thirty days from the date it is provided notice of capital classification to submit any relevant information in response to a notice. 12 U.S.C. 4618 authorizes OFHEO to extend the response period up to an additional thirty days for good cause or to reduce the response period if the condition of the Enterprise so requires; the Enterprise may also consent to an abbreviated response period. In exigent circumstances, the response period afforded to an Enterprise may be quite brief. In its comments, Fannie Mae objected to proposed § 1777.21(a)(2)(i), to the extent the proposed rule suggests that OFHEO can shorten an Enterprise's response period to less than thirty days as OFHEO determines to be appropriate. Fannie Mae points out that the statutory standard, at 12 U.S.C. 4618(c)(3), is that the condition of the Enterprise requires the period to be shortened. OFHEO's determination as to whether an curtailment is "appropriate," as under the language of proposed

§ 1777.21(a)(2)(i), is to be made in consideration of the statutory standard under 12 U.S.C. 4618(c)(3). In light of the comment, OFHEO has changed the language of the final version of § 1777.21(a)(2)(i) to reflect the language of 12 U.S.C. 4618(c)(3).

An Enterprise's failure to respond within the applicable period waives the opportunity to comment on the proposed classification. Once the response period has closed, OFHEO will make a final determination of the Enterprise's capital classification. OFHEO will take into consideration any relevant information submitted by the Enterprise during the response period in reaching the final decision. The final capital classification is to be provided to the Enterprise in writing, including a description of OFHEO's basis for the classification.

OFHEO proposed a requirement under § 1777.21(b)(1) that the Enterprise notify OFHEO of any material event that may reasonably be expected to cause the Enterprise's minimum, critical, or risk-based capital level to fall to a point that could result in a capital classification lower than the Enterprise's existing or proposed capital classifications. In their comments, the Enterprises objected to this requirement as being overly vague. Freddie Mac suggested it be narrowed, to require notice only when the Enterprise has reason to believe it has failed to meet a capital requirement. Fannie Mae called for elimination of any such notice requirement. In response to the Enterprises' expressed concerns about vagueness, OFHEO has decided to model its standard on a similar standard successfully used by the Federal bank regulatory agencies under their PCA system. *See, e.g.*, 12 CFR 325.102(c)(1). Thus, OFHEO has revised final § 1777.21(b)(1) to require notice of any material development that would cause the Enterprise's core or total capital to fall to a point that would cause the Enterprise to be placed in a lower capital classification.

As suggested by one commenter, OFHEO has deleted the words "as appropriate" from the proposed version of § 1777.21(a)(1)(i), as unnecessary. In addition, various erroneous citations and cross-references have been corrected in the final rule.<sup>23</sup>

<sup>23</sup> Freddie Mac's comments on the prompt corrective action proposal also expressly incorporated by reference certain comments Freddie Mac made to OFHEO in a submission dated March 10, 2000, as to OFHEO's second risk-based capital proposal. Those comments addressed the proposed risk-based capital reporting procedure and other matters unrelated to the classification procedure, and have been responded to in the

### Capital Distribution Restrictions

Section 1777.22 sets forth statutory capital distribution restrictions, including those provisions of the Enterprise's respective charter acts<sup>24</sup> prohibiting, without regard to capital classification, an Enterprise from making a capital distribution that would decrease the capital of the Enterprise to an amount less than the risk-based capital level or the minimum capital level, except as explicitly approved by OFHEO. Section 1777.22(a) reflects these statutory restrictions.<sup>25</sup> Under § 1777.22(b)(1), any Enterprise that is not classified as adequately capitalized is prohibited from making a capital distribution that would result in classification into a lower capital classification as provided by 12 U.S.C. 4615(a)(2) and 4616(a)(2). Under § 1777.22(b)(2), a significantly undercapitalized Enterprise is prohibited from making a capital distribution absent OFHEO's prior approval, as provided by 12 U.S.C. 4616(a)(2). Section 1777.22(b)(2) also applies in the case of an Enterprise classified as critically undercapitalized. The final rule recites, in a manner consistent with 12 U.S.C. 4617(b) through (c), OFHEO's authority to take actions authorized by 12 U.S.C. 4616 in the case of a critically undercapitalized Enterprise. Under the same authority, § 1777.23 requires an Enterprise classified as critically undercapitalized to submit a complete and acceptable capital restoration plan to OFHEO.

### Capital Restoration Plans

Under § 1777.23(a)(1), an Enterprise is required to file a complete capital restoration plan with OFHEO within ten days of receiving final notice of capital classification indicating that the Enterprise is classified as undercapitalized, significantly undercapitalized, or critically undercapitalized, unless OFHEO extends the period. In its comments, Fannie Mae objected to this ten-day period as being too short. However, the time period is consistent with 12 U.S.C. 4622(b). OFHEO has set the deadline at ten days as a general rule to allow sufficient time for the Enterprise to

agency's disposition of the final risk-based capital rule at 66 FR 47730 (September 13, 2001).

<sup>24</sup> The Federal Home Loan Mortgage Corporation Act at 12 U.S.C. 1452(b)(2), and the Federal National Mortgage Association Charter Act at 12 U.S.C. 1718(c)(2).

<sup>25</sup> The proposed rule contained § 1777.22(c), implementing these statutory provisions prior to the initial date of OFHEO's risk-based capital rules. With the publication of such rules on September 13, 2001, § 1777.22(c) is unnecessary and has been dropped from the final rule.

articulate its responsive business plans, which, absent catastrophe, would likely have been developed over some time before a written submission is required. At the very least, the Enterprise and OFHEO will likely be aware of any impending threat and need for a capital restoration strategy by the time a notice of proposed classification is issued. In light of the serious implications of an adverse classification under subtitle B of the 1992 Act, swift implementation of a required capital plan is crucial. If it appears to OFHEO that additional time is appropriate under the particular circumstances, § 1777.23(a)(1) provides that OFHEO may extend the timeframe.

Under § 1777.23(a)(2), an Enterprise that is already operating under an approved capital restoration plan need not submit a new plan each time the Enterprise receives subsequent notices of capital classification, unless OFHEO notifies the Enterprise to the contrary. As a general matter, OFHEO would likely direct an Enterprise to submit a new or amended plan if subsequent notices of capital classification are on grounds different from or in addition to the grounds underlying previous notices, or if changes in circumstances underlying the original plan necessitate a revised plan, or if the original plan is not effective within a reasonable period.

Section 1777.23(b) requires an Enterprise's capital restoration plan to include the information specified in by 12 U.S.C. 4622(a) and such other information as directed by OFHEO. If the Enterprise does not submit a complete plan by the specified deadline, OFHEO may in its discretion lower the Enterprise's capital classification, as set forth in § 1777.23(c). If a complete and timely capital restoration plan is not filed by an Enterprise, OFHEO may reclassify the Enterprise under § 1777.21(a)(3) immediately upon expiration of the filing deadline, without further notice. As further provided in § 1777.23(c), an Enterprise's failure to submit a complete and timely plan may be considered in the determination of each subsequent capital classification of the Enterprise, until the Enterprise files a plan that obtains OFHEO's approval. If the Enterprise has not corrected its failure to file an acceptable plan after a reasonable period, OFHEO may reclassify the Enterprise, without further written notice.<sup>26</sup>

As specified in § 1777.23(d), OFHEO is to review the Enterprise's capital plan

<sup>26</sup> As is discussed above in connection with § 1777.21(a)(1)(ii), the Enterprises object to this combined notice under § 1777.23(c)(1) and § 1777.23(c)(3), but this approach is specifically authorized under 12 U.S.C. 4618(b).

and issue an order within thirty days either approving or disapproving the plan, subject to extension for an additional thirty days as OFHEO deems necessary. If the plan is disapproved, the Enterprise must then submit an amended plan acceptable to OFHEO within thirty days or such longer period as OFHEO specifies. Notably, the thirty-day period is longer than the ten-day period for submission of the initial plan in order to facilitate dialogue with the Enterprise as to how the Enterprise may rehabilitate a disapproved plan. However, as provided in § 1777.23(c), OFHEO may reclassify the Enterprise into a lower capital classification, without additional notice, at any time before the Enterprise files an amended capital plan and OFHEO approves it.

Once a capital plan is approved, it may be amended only with the prior written approval of OFHEO, as provided in § 1777.23(f). As that section provides, the Enterprise's obligations under an approved plan remain in place except to the extent the plan itself identifies dates, events, or conditions upon which the obligations terminate. To the extent the plan is silent in regard to a particular obligation, the obligation remains in place until OFHEO issues an order terminating the obligation. An Enterprise may seek such termination orders from OFHEO under § 1777.23(g)(2).

In its comments, Fannie Mae objected to proposed § 1777.23(g), on the grounds that leaving a decision as significant as termination of a capital plan to the unlimited discretion of OFHEO would be fundamentally unfair.<sup>27</sup> Fannie Mae asserted that the plan should terminate upon the Enterprise's certification that the measures in the plan have been fulfilled, absent specific written findings to the contrary by OFHEO.

<sup>27</sup> Fannie Mae also requested, under similar arguments of potential unfairness, that OFHEO create an ombudsman function within OFHEO, and that OFHEO also establish a formal appeals process whereby the Enterprises would have an avenue to appeal any significant supervisory decision to a senior agency official who was not involved in the original decision making process. Fannie Mae notes that the Federal bank regulatory agencies are required by the FDI Act to maintain such an appellate procedure. OFHEO has not implemented these suggestions because key differences between OFHEO and the bank regulatory agencies render such functions superfluous. Among such differences, because OFHEO supervises only two entities it lacks a large, decentralized supervisory structure, common among the banking agencies. The significantly smaller size of OFHEO makes it impracticable to provide a senior supervisory officer to act as ombudsman in such matters. The Enterprises have greater opportunities to provide input into the prompt corrective action classification and order process under the 1992 Act than is provided for insured depository institutions under the Federal Deposit Insurance Act.

OFHEO disagrees. The initial approval of the capital restoration plan (including its duration) is vested wholly in OFHEO's discretion. No reason supports a contention that OFHEO's parallel discretion over termination of a capital restoration plan is somehow otherwise unfair, or of such significance as to be beyond the agency's supervisory purview. Furthermore, an Enterprise can request that its obligations under an approved plan be terminated. In addition, as noted in § 1777.23(g)(1), to the extent particular provisions of a particular plan may be appropriately subject to termination by reference to specified dates, events, or conditions, the plan may be structured accordingly.

If an Enterprise fails to take timely action reasonably necessary to comply with an approved plan, OFHEO may exercise its authority under 12 U.S.C. 4615(b)(2) and 4616(b)(5) to reclassify the Enterprise. In their comments, the Enterprises objected to the language of proposed § 1777.23(h)(1), under which an Enterprise must make efforts reasonably necessary to comply with the capital restoration plan and to fulfill the schedule thereunder, as not being consistent with the statutory standard. OFHEO interprets the "good faith, reasonable efforts necessary to comply with the capital restoration plan and fulfill the schedule for the plan" language in sections 4615(b) and 4616(b) to mean that the Enterprise must make all reasonable efforts as are necessary to comply with the plan. OFHEO would consider it a demonstration of a lack of good faith if an Enterprise fails to attempt to carry out one or more efforts contemplated by an approved capital restoration plan. OFHEO would not deem an Enterprise's efforts to be in bad faith simply because such efforts fail to effect a desired result.

In light of the Enterprise's comments that OFHEO's proposed formulation does not adequately express the statutory standard, § 1777.23(h)(1)(i) has been revised to expressly refer to good faith, and to note that it is incumbent upon the Enterprise to make all reasonable efforts necessary to comply with an approved plan. The final rule provides that OFHEO may reclassify the Enterprise if, in the agency's discretion, the Enterprise has failed to make, in good faith, reasonable efforts necessary to comply with a capital restoration plan and to fulfill the schedule thereunder.

As is provided in § 1777.23(h)(1)(ii) through (iii), an Enterprise's failure to implement an approved capital plan may be considered in the determination of each subsequent capital classification of the Enterprise until OFHEO

determines the Enterprise is making reasonable efforts. The Enterprise may face successive reclassifications for failure to make such efforts after a reasonable period.

As is noted in § 1777.23(h)(2), a capital plan that has received an approval order by OFHEO shall be deemed an order under the 1992 Act for enforcement purposes, and an Enterprise in any capital classification, its executive officers, and directors may be subject to action by OFHEO under 12 U.S.C. 4631, 4632, and 4636 and 12 CFR part 1780 for failure to comply with an approved plan. In its comments, Fannie Mae objects to such characterization. Fannie Mae asserts that the terms of an approved capital plan are not enforceable under OFHEO's cease and desist authority or civil money penalties, and that such an action by OFHEO would exceed its authority under the 1992 Act.

OFHEO disagrees and is adopting § 1777.23(h)(2) without change. Fannie Mae improperly infers that the only "orders" susceptible to enforcement action under these statutes are OFHEO determinations that are designated as "orders" by the 1992 Act itself. However, the 1992 Act does not designate any particular OFHEO determination with respect to an Enterprise or its directors or executive officers as an "order," thereby begging the question under Fannie Mae's reasoning as to what would constitute an "order" for purposes of sections 4631, 4632, and 4636. While the 1992 Act describes OFHEO's decisions under sections 4631, 4632, and 4636 as "orders," to argue that these are the exclusive "orders" to which such sections refer is not convincing. It would be circular to interpret these sections to mean that the only order the violation of which is redressable by a cease and desist order is another cease and desist order or an order imposing civil money penalties. While circumstances may occur in which a regulatory agency that is faced with noncompliance with a formal enforcement order may appropriately resort to further administrative enforcement action, more often a judicial enforcement of the enforcement order is likely to be sought. *Cf.* 12 U.S.C. 4635(a) (judicial actions to enforce orders and notice issued under subtitles B and C of the 1992 Act). Moreover, the statutory language in section 4361(a)(3)(A) and section 4636(a)(1) broadly refers to any order under the 1992 Act or the charter acts, without restriction as to particular sections of such acts.

#### *Orders Under Section 4616*

Section 1777.24 of the final rule implements OFHEO's discretionary authority under 12 U.S.C. 4616(b)(1) through (4), to issue orders requiring a significantly undercapitalized Enterprise to take remedial and corrective actions. OFHEO may fashion such remedy or require supervisory action as appropriate including, but not limited to, any of the following:

- Limit an increase in, or require a reduction of, any borrowings and other types of obligations of an Enterprise, including off-balance sheet obligations;
- Limit or prohibit the growth of assets of an Enterprise or require reduction of its assets;
- Require an Enterprise to obtain additional capital in such form and amount as specified by OFHEO; and
- Require an Enterprise to terminate, reduce, or modify a program or activity that entails excessive risk to the Enterprise.

As indicated by § 1777.24, OFHEO may also issue orders to an Enterprise that has been classified as critically undercapitalized under authority provided by 12 U.S.C. 4617(b) through (c).

The procedures under which such orders may be issued are similar to the procedures for issuance of capital classifications, and are set out in §§ 1777.24 through 1777.26. Similar to the treatment of approved capital plans discussed above, the provisions contained in these orders will bind the Enterprise until such provisions terminate under the terms of the order or OFHEO modifies the order, as discussed in § 1777.26(b). As indicated in § 1777.26(c), such orders constitute orders under the 1992 Act, and an Enterprise in any capital classification, its executive officers, and directors may be subject to administrative enforcement action by OFHEO under 12 U.S.C. 4631, 4632, and 4636 and 12 CFR part 1780 for failure to comply with such orders. Moreover, 12 U.S.C. 4635 provides jurisdiction in the United States District Court of the District of Columbia for direct enforcement of such orders.

#### *Administrative Exhaustion*

Section 1777.27 summarizes 12 U.S.C. 4623, which provides that an Enterprise not classified as critically undercapitalized may seek judicial review of OFHEO's final notice of its capital classification, or a final notice of order issued under 12 U.S.C. 4616(b)(1) through (4). For any issue raised by such Enterprise in connection with such review, the Enterprise must have first exhausted its administrative remedies,

by presenting its objections, arguments, and information relating to such issue for OFHEO's consideration in the Enterprise's response to OFHEO's notice of capital classification or notice of intent to issue an order. The Enterprise's judicial action will not operate as a stay of a capital classification or order by OFHEO.

In its comments, Freddie Mac asserted that OFHEO's requirement in proposed § 1777.27(b) that the Enterprise assert its objections concerning a classification to OFHEO before raising them before the D.C. Circuit would be inconsistent with applicable judicial doctrine. OFHEO disagrees. Section 1777.27 is consistent with controlling judicial precedent on exhaustion and review, and has been adopted in the final rule without change.

#### *Appointment of a Conservator for a Significantly or Critically Undercapitalized Enterprise*

Section 1777.28 addresses appointment of a conservator for a significantly undercapitalized or critically undercapitalized Enterprise.<sup>28</sup> As is described in § 1777.28(a), 12 U.S.C. 4616 empowers OFHEO to appoint a conservator for a significantly undercapitalized Enterprise, if OFHEO determines the Enterprise's core capital is less than the minimum capital level and the alternative remedies available to OFHEO under the 1992 Act are not satisfactory. As is described in § 1777.28(b), 12 U.S.C. 4617 requires the Director to appoint a conservator for a critically undercapitalized Enterprise, unless the Director makes a written determination, and the Secretary of the Treasury concurs in writing, that the appointment of a conservator is likely to have serious adverse effects on economic conditions of national financial markets or on the financial stability of the housing finance market, and that the public interest would be better served by taking some other enforcement action authorized by the 1992 Act. In response to a comment, OFHEO has revised the final version of § 1777.28(b)(2), to clarify that the written determination described therein is to be in support of the agency's determination not to appoint a conservator.

Under 12 U.S.C. 4619(e)(2), a conservatorship appointment under either § 1777.28(a) or 1777.28(b) is to be terminated by OFHEO upon determining that the Enterprise has

maintained an amount of core capital that is equal to or exceeds the minimum capital level. OFHEO is also vested with discretion, under 12 U.S.C. 4619(e)(1), to terminate such a conservatorship appointment based upon determining that such termination is in the public interest and may safely be accomplished. These termination provisions are reflected in § 1777.28(d).

#### **Regulatory Impact**

##### *Executive Order 12866, Regulatory Planning and Review*

The final rule is not classified as a significant rule under Executive Order 12866 because it will not result in an annual effect on the economy of \$100 million or more or a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or have significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or foreign markets. Accordingly, no regulatory impact assessment is required and this proposed regulation has not been submitted to the Office of Management and Budget for review.

##### *Unfunded Mandates Reform Act of 1995*

This final rule does not include a Federal mandate that could result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100,000,000 or more (adjusted annually for inflation) in any one year. As a result, the final rule does not warrant the preparation of an assessment statement in accordance with the Unfunded Mandates Reform Act of 1995.

##### *Regulatory Flexibility Act*

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) requires that a regulation that has a significant economic impact on a substantial number of small entities, small businesses, or small organizations must include an initial regulatory flexibility analysis describing the regulation's impact on small entities. Such an analysis need not be undertaken if the agency has certified that the regulation will not have a significant economic impact on a substantial number of small entities. 5 U.S.C. 605(b). OFHEO has considered the impact of the final rule under the Regulatory Flexibility Act. The General Counsel of OFHEO certifies that the final rule is not likely to have a significant economic impact on a

substantial number of small business entities because the rule only affects the Enterprises, their executive officers, and their directors.

##### *Paperwork Reduction Act of 1995*

This final rule contains no information collection requirements that require the approval of the Office of Management and Budget pursuant to the Paperwork Reduction Act, 44 U.S.C. 3501–3520.

#### **List of Subjects in 12 CFR Part 1777**

Administrative practice and procedure, Capital classification, Mortgages.

Accordingly, for the reasons set out in the preamble, OFHEO adds part 1777 to subchapter C of 12 CFR chapter XVII, to read as follows:

#### **PART 1777—PROMPT CORRECTIVE ACTION**

Sec.

- 1777.1 Authority, purpose, scope, and implementation dates.
- 1777.2 Preservation of other authority.
- 1777.3 Definitions.

##### **Subpart A—Prompt Supervisory Response**

- 1777.10 Developments prompting supervisory response.
- 1777.11 Supervisory response.
- 1777.12 Other supervisory action.

##### **Subpart B—Capital Classifications and Orders Under Section 1366 of the 1992 Act**

- 1777.20 Capital classifications.
- 1777.21 Notice of capital category, and adjustments.
- 1777.22 Limitation on capital distributions.
- 1777.23 Capital restoration plans.
- 1777.24 Notice of intent to issue an order.
- 1777.25 Response to notice.
- 1777.26 Final notice of order.
- 1777.27 Exhaustion and review.
- 1777.28 Appointment of conservator for a significantly undercapitalized or critically undercapitalized Enterprise.

**Authority:** 12 U.S.C. 1452(b)(2), 1456(c), 1718(c)(2), 1723a(k), 4513(a), 4513(b), 4514, 4517, 4611–4619, 4622, 4623, 4631, 4635.

##### **§ 1777.1 Authority, purpose, scope, and implementation dates.**

(a) *Authority.* This part is issued by the Office of Federal Housing Enterprise Oversight (OFHEO) pursuant to sections 1313, 1371, 1372, and 1376 of the Federal Housing Enterprises Financial Safety and Soundness Act (1992 Act) (12 U.S.C. 4513, 4631, 4632, and 4636). These provisions broadly authorize OFHEO to take such actions as are deemed appropriate by the Director of OFHEO to ensure that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the

<sup>28</sup> OFHEO also has authority under 12 U.S.C. 4619(a)(1) through (2) to appoint conservators on various grounds, regardless of an Enterprise's capital classification.

Enterprises) maintain adequate capital and operate in a safe and sound manner.

(b) *Authority, purpose and scope of subpart A.* In addition to the authority set forth in paragraph (a) of this section, subpart A of this part is also issued pursuant to section 1314 of the 1992 Act (12 U.S.C. 4514), section 307(c) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1456(c)), and section 309(k) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723a(k)), requiring each Enterprise to submit such reports to OFHEO as the Director of OFHEO determines, in his or her judgment, are necessary to carry out the purposes of the 1992 Act. Subpart A of this part is also issued in reliance on section 1317 of the 1992 Act (12 U.S.C. 4517) authorizing OFHEO to conduct examinations of the Enterprises. The purpose of subpart A of this part is to set forth a framework of early intervention supervisory measures, other than formal enforcement actions, that OFHEO may take to address emerging developments that merit supervisory review to ensure they do not pose a current or future threat to the safety and soundness of an Enterprise. OFHEO's initiation of procedures under subpart A does not necessarily indicate that any unsound condition exists. The supervisory responses enumerated in § 1777.11 do not constitute orders under the 1992 Act for purposes of sections 1371 and 1376 thereof (12 U.S.C. 4631 and 4636).

(c) *Authority, purpose, and scope of subpart B.* In addition to the authority set forth in paragraph (a) of this section, subpart B of this part is also issued pursuant to subtitle B of the 1992 Act (12 U.S.C. 4611 through 4623), section 303(b)(2) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1452(b)(2)), and section 303(c)(2) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1718(c)(2)). These provisions authorize OFHEO to administer certain capital requirements for the Enterprises, to classify the capital of the Enterprises based on capital levels specified in the 1992 Act, and, in appropriate circumstances, to exercise discretion to reclassify an Enterprise into a lower capital category. Under these provisions, there are also automatic consequences for an Enterprise that is not classified as adequately capitalized, as well as discretionary authority for OFHEO to require an Enterprise to take remedial actions. Subpart B implements the provisions of sections 1364 through 1368, 1369(b) through (e), 1369C, and 1369D of the 1992 Act as they apply to the Enterprises (12 U.S.C. 4614 through

4618, 4619(b) through (e), 4622 and 4623). The principal purposes of subpart B are to identify the capital measures and capital levels that OFHEO uses in determining the capital classification of an Enterprise; to set out the procedures OFHEO uses in determining such capital classifications; to establish procedures for submission and review of capital restoration plans of an Enterprise that is not classified as adequately capitalized; and to establish procedures under which OFHEO issues orders pursuant to section 1366(b)(1) through (4) of the 1992 Act (12 U.S.C. 4616(b)(1) through (4)).

(d) *Effective dates of capital classifications.* Section 1364 of the 1992 Act (12 U.S.C. 4614(d)) directs OFHEO to determine capital classifications for the Enterprises by reference to two capital standards, consisting of the minimum or critical capital level on the one hand, and the risk-based capital level on the other. Section 1364(d) of the 1992 Act (12 U.S.C. 4614(d)) excludes consideration of whether the Enterprises meet the risk-based capital level in determining capital classifications or reclassifications under 1364, until one year after the effective date of OFHEO's regulation implementing OFHEO's risk-based capital test (issued under section 1361(e) of the 1992 Act (12 U.S.C. 4611(e)), until such time, section 1364(d) provides that an Enterprise is to be classified as adequately capitalized so long as it meets the minimum capital level. Subpart B contains a currently effective set of capital classifications omitting consideration of the risk-based capital level, as well as another set of capital classifications which will take effect, and displace the current set of capital classifications, on September 13, 2002 that is, one year after the effective date of OFHEO's risk-based capital rule published at 66 FR 47730, September 13, 2001.

#### § 1777.2 Preservation of other authority.

(a) *Supervisory standards.* Notwithstanding the existence of procedures in § 1777.10 for the Director of OFHEO to designate certain developments for supervisory response under subpart A of this part, nothing in this part in any way limits the authority of OFHEO otherwise to take such actions with respect to any issue as is deemed appropriate by the Director of OFHEO to ensure that the Enterprises maintain adequate capital, operate in a safe and sound manner, and comply with the 1992 Act and regulations, orders, and agreements thereunder.

(b) *Capital floor.* Classification of an Enterprise as adequately capitalized in

accordance with subtitle B of the 1992 Act and subpart B of this part indicates that the Enterprise meets the capital levels under sections 1361 and 1362 of the 1992 Act (12 U.S.C. 4611 and 4612) and regulations promulgated thereunder as of the times specified in the classification determination. Nothing in subpart B of this part or subtitle B of the 1992 Act limits OFHEO's authority otherwise to address circumstances that would require additional capital through regulations, orders, notices, guidance, or other actions.

(c) *Form of supervisory action or response.* In addition to the supervisory responses contemplated under subpart A of this part, and the authority to classify and reclassify the Enterprises, to issue orders, and to appoint conservators under subpart B of this part, the 1992 Act grants OFHEO broad discretion to take such other supervisory actions as may be deemed by OFHEO to be appropriate, including issuing temporary and permanent cease and desist orders, imposing civil money penalties, appointing a conservator under section 1369(a)(1) through (2) of the 1992 Act (12 U.S.C. 4619(a)(1) through (2)), entering into a written agreement the violation of which is actionable through enforcement proceedings, or entering into any other formal or informal agreement with an Enterprise. Neither the 1992 Act nor this part in any way limit OFHEO's discretion over the selection of the type of these actions, and the selection of one type of action under this part or under these other statutory authorities, or a combination thereof, does not foreclose OFHEO from pursuing any other action.

#### § 1777.3 Definitions.

For purposes of this part, the following definitions will apply:

*1992 Act* means the Federal Housing Enterprises Financial Safety and Soundness Act, 12 U.S.C. 4501 *et seq.*

*Affiliate* means an entity that controls an Enterprise, is controlled by an Enterprise, or is under common control with an Enterprise.

*Capital distribution* means:

(1) Any dividend or other distribution in cash or in kind made with respect to any shares of, or other ownership interest in, an Enterprise, except a dividend consisting only of shares of the Enterprise; and

(2) Any payment made by an Enterprise to repurchase, redeem, retire, or otherwise acquire any of its shares or other ownership interests, including any extension of credit made to finance an acquisition by the Enterprise of such shares or other ownership interests, except to the extent the Enterprise

makes a payment to repurchase its shares for the purpose of fulfilling an obligation of the Enterprise under an employee stock ownership plan that is qualified under section 401 of the Internal Revenue Code of 1986 (26 U.S.C. 401 *et seq.*) or any substantially equivalent plan as determined by the Director of OFHEO in writing in advance.

*Core capital* has the same meaning as provided in 12 CFR 1750.2.

*Critical capital level* means the amount of core capital that is equal to the sum of one half of the amount determined under 12 CFR 1750.4(a)(1) and five-ninths of the amounts determined under 12 CFR 1750.4(a)(2) through 1750.4(a)(7).

*Enterprise* means the Federal National Mortgage Association and any affiliate thereof, and the Federal Home Loan Mortgage Corporation and any affiliate thereof.

*Minimum capital level* means the minimum amount of core capital specified for an Enterprise pursuant to section 1362 of the 1992 Act (12 U.S.C. 4612), as determined under 12 CFR 1750.4.

*OFHEO* means the Office of Federal Housing Enterprise Oversight.

*Risk-based capital level* means the amount of total capital specified for an Enterprise pursuant to section 1361 of the 1992 Act (12 U.S.C. 4611), as determined under OFHEO's regulations implementing section 1361.

*Total capital* has the same meaning as provided at 12 CFR 1750.11(n).

## Subpart A—Prompt Supervisory Response

### § 1777.10 Developments prompting supervisory response.

In the event of any of the following developments, OFHEO shall undertake one of the supervisory responses enumerated in § 1777.11, or a combination thereof:

(a) OFHEO's national House Price Index (HPI) for the most recent quarter is more than two percent less than the national HPI four quarters previously, or for any Census Division or Divisions in which are located properties securing more than 25 percent of single-family mortgages owned or securing securities guaranteed by an enterprise, the HPI for the most recent quarter for such Division or Divisions is more than five percent less than the HPI for that Division or Divisions four quarters previously;

(b) An Enterprise's publicly reported net income for the most recent calendar quarter is less than one-half of its average quarterly net income for any

four-quarter period during the prior eight quarters;

(c) An Enterprise's publicly reported net interest margin (NIM) for the most recent quarter is less than one-half of its average NIM for any four-quarter period during the prior eight quarters;

(d) For single-family mortgage loans owned or securities by an Enterprise that are delinquent ninety days or more or in foreclosure, the proportion of such loans in the most recent quarter has increased more than one percentage point compared to the lowest proportion of such loans in any of the prior four quarters; or

(e) Any other development, including conduct of an activity by an Enterprise, that OFHEO determines in its discretion presents a risk to the safety and soundness of the Enterprise or a possible violation of applicable law, regulation, or order.

### § 1777.11 Supervisory response.

(a) *Level I supervisory response*—(1) *Supervisory letter*. Not later than five business days after OFHEO determines that a development enumerated in § 1777.10 has transpired, OFHEO shall deliver a supervisory letter alerting the chief executive officer or the board of directors of the Enterprise to OFHEO's determination.

(2) *Contents of supervisory letter*. The supervisory letter shall notify the Enterprise that, pursuant to this subpart, OFHEO is commencing review of a potentially adverse development. As is appropriate under the particular circumstances and the nature of the potentially adverse development, the letter may direct the Enterprise to undertake one or more of the following actions, as of such time as OFHEO directs:

(i) Provide OFHEO with any relevant information known to the Enterprise about the potentially adverse development, in such format as OFHEO directs;

(ii) Respond to specific questions and concerns that OFHEO poses about the potentially adverse development; and

(iii) Take appropriate action.

(3) *Review; further action*. Based on the Enterprise's response to the supervisory letter and consideration of other relevant factors, OFHEO shall promptly determine whether the Level I supervisory response is adequate to resolve any supervisory issues implicated by the potentially adverse development, or whether additional supervisory response under this section is warranted.

(4) *Sequence of supervisory responses*. The Level II through Level IV supervisory responses in paragraphs (b)

through (d) of this section may be carried out in any sequence, including simultaneous performance of two or more such responses. OFHEO may also carry out one or more such responses simultaneously with a Level I supervisory response pursuant to this paragraph (a).

(b) *Level II supervisory response*—(1) *Special review*. In addition to any other supervisory response described in this section, OFHEO may conduct a special review of an Enterprise in order to assess the impact of the potentially adverse development on the Enterprise.

(2) *Review; further action*. Based on the results of the special review and consideration of other factors deemed by OFHEO to be relevant, OFHEO shall promptly determine whether additional supervisory response under this section is warranted.

(c) *Level III supervisory response*—(1) *Action plan*. In addition to any other supervisory response described in this section, OFHEO may direct the Enterprise to prepare and submit an action plan to OFHEO, in such format and at such time as OFHEO directs.

(2) *Contents of action plan*. Such action plan shall include, subject to additional direction by OFHEO, the following:

(i) In the case of any potentially adverse development arising from conditions or practices internal to the Enterprise, any relevant information known to the Enterprise about the circumstances that led to the potentially adverse development;

(ii) An assessment of likely consequences that the potentially adverse development may have for the Enterprise; and

(iii) The proposed course of action the Enterprise will undertake in response to the potentially adverse development, including an explanation as to why such approach is preferred to any other alternative actions by the Enterprise and how such approach will address the concerns of OFHEO.

(3) *Review; further action*. If OFHEO in its discretion determines that the information, assessment, or proposed course of action contained in the action plan is incomplete or inadequate, OFHEO shall promptly direct the Enterprise to correct such deficiencies to the extent OFHEO determines such corrections will aid in resolving supervisory issues implicated by the potentially adverse development, and will promptly determine whether additional supervisory response under this section is warranted.

(d) *Level IV supervisory response*—(1) *Notice to show cause*. In addition to any other supervisory response described in

this section, OFHEO may issue written notice to the chief executive officer or the board of directors of the Enterprise directing the Enterprise to show cause, on or before the date specified in the notice, why OFHEO should not issue one or more of the following:

(i) A notice of charges to the Enterprise under section 1371 of the 1992 Act (12 U.S.C. 4631) and the procedures in 12 CFR part 1780 commencing an action to order the Enterprise to cease and desist conduct, conditions, or violations specified in the notice to show cause;

(ii) A temporary order to the Enterprise under section 1372 of the 1992 Act (12 U.S.C. 4632) and the procedures in 12 CFR part 1780 to cease and desist from, and take affirmative actions to prevent or remedy harm from, conduct, conditions, or violations specified in the notice to show cause;

(iii) A notice of charges under section 1376 of the 1992 Act (12 U.S.C. 4636) and the procedures in 12 CFR part 1780 commencing imposition of a civil money penalty against the Enterprise; or

(iv) A notice of discretionary reclassification of the Enterprise's capital classification under section 1364(b) of the 1992 Act (12 U.S.C. 4614(b)) and subpart B of this part.

(2) *Review; further action.* Based on the Enterprise's response to the notice to show cause and consideration of other relevant factors, OFHEO shall promptly determine whether to commence the actions described in the notice, and whether additional supervisory response under this section is warranted.

#### **§ 1777.12 Other supervisory action.**

Notwithstanding the pendency or completion of one or more supervisory responses described in § 1777.11, OFHEO may at any time undertake additional supervisory steps and actions in the form of any informal or formal supervisory tool available to OFHEO under the 1992 Act, including, but not limited to, issuing guidance or directives under section 1313 (12 U.S.C. 4513), requiring reports under section 1314 (12 U.S.C. 4514), conducting other examinations under section 1317 (12 U.S.C. 4517), issuing discretionary reclassification under section 1364 (12 U.S.C. 4614), initiating discretionary action under section 1366(b) (12 U.S.C. 4616(b)), appointing a conservator under section 1369(a) (12 U.S.C. 4619(a)), or initiating administrative enforcement action under sections 1371, 1372, and 1376 (12 U.S.C. 4631, 4632 and 4636). In addition, OFHEO may take any such steps or actions with respect to an Enterprise that fails to

make a submission or comply with a directive as required by § 1777.11, or to address an Enterprise's failure to implement an appropriate action in response to a supervisory letter or under an action plan under § 1777.11.

### **Subpart B—Capital Classifications and Orders Under Section 1366 of the 1992 Act**

#### **§ 1777.20 Capital classifications.**

(a) *Capital classifications after the effective date of section 1365 of the 1992 Act.* The capital classification of an Enterprise for purposes of subpart B of this part is as follows:

(1) *Adequately capitalized.* Except as otherwise provided under paragraph (a)(5) of this section, an Enterprise will be classified as adequately capitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, holds total capital equaling or exceeding the risk-based capital level; and

(ii) As of the date specified in the notice of proposed capital classification, holds core capital equaling or exceeding the minimum capital level.

(2) *Undercapitalized.* Except as otherwise provided under paragraph (a)(5) of this section or § 1777.23(c) or § 1777.23(h), an Enterprise will be classified as undercapitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, holds total capital less than the risk-based capital level; and

(ii) As of the date specified in the notice of proposed capital classification, holds core capital equaling or exceeding the minimum capital level.

(3) *Significantly undercapitalized.* Except as otherwise provided under paragraph (a)(5) of this section or § 1777.23(c) or § 1777.23(h), an Enterprise will be classified as significantly undercapitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, holds core capital less than the minimum capital level; and

(ii) As of the date specified in the notice of proposed capital classification, holds core capital equaling or exceeding the critical capital level.

(4) *Critically undercapitalized.* An Enterprise will be classified as critically undercapitalized if, as of the date specified in the notice of proposed capital classification, the Enterprise holds core capital less than the critical capital level.

(5) *Discretionary reclassification—determination to reclassify.* If OFHEO determines in writing that an Enterprise

is engaging in action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events) that could result in a rapid depletion of core capital, or that the value of property subject to mortgages held or securitized by the Enterprise has decreased significantly, or that reclassification is otherwise deemed necessary to ensure that the Enterprise holds adequate capital and operates safely, OFHEO may reclassify the Enterprise as:

(i) Undercapitalized if the Enterprise is otherwise classified as adequately capitalized;

(ii) Significantly undercapitalized if the Enterprise is otherwise classified as undercapitalized; or

(iii) Critically undercapitalized if the Enterprise is otherwise classified as significantly undercapitalized.

(b) *Duration of reclassification; successive reclassifications.* (1) A reclassification of an Enterprise based on action, inaction, or conditions under paragraph (a)(5) or (c)(5) of this section shall be considered in the determination of each subsequent capital classification of the Enterprise, and shall only cease being considered in the determination of the Enterprise's capital classification after OFHEO determines that the action, inaction or condition upon which the reclassification was based has ceased or been eliminated and remedied to OFHEO's satisfaction.

(2) If the action, inaction, or condition upon which a reclassification was based under paragraph (a)(5) or (c)(5) of this section has not ceased or been eliminated and remedied to OFHEO's satisfaction within such reasonable time as is determined by OFHEO to be appropriate, OFHEO may consider such failure to be the basis for additional reclassification under such paragraph (a)(5) or (c)(5) of this section into a lower capital classification.

(c) *Capital classifications before the effective date of section 1365 of the 1992 Act.* Notwithstanding paragraph (a) of this section, until September 13, 2002, the capital classification of an Enterprise for purposes of subpart B of this part is as follows:

(1) *Adequately capitalized.* Except as otherwise provided in paragraph (c)(5) of this section, an Enterprise will be classified as adequately capitalized if the Enterprise, as of the date specified in the notice of proposed capital classification, holds core capital equaling or exceeding the minimum capital level.

(2) *Undercapitalized.* An Enterprise will be classified as undercapitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, holds core capital equaling or exceeding the minimum capital level; and

(ii) Is reclassified as undercapitalized by OFHEO under paragraph (c)(5) of this section.

(3) *Significantly undercapitalized.* Except as otherwise provided under paragraph (c)(5) of this section or § 1777.23(c) or § 1777.23(h), an Enterprise will be classified as significantly undercapitalized if the Enterprise:

(i) As of the date specified in the notice of proposed capital classification, held core capital less than the minimum capital level; and

(ii) As of the date specified in the notice of proposed capital classification, held core capital equaling or exceeding the critical capital level.

(4) *Critically undercapitalized.* An Enterprise will be classified as critically undercapitalized if, as of the date specified in the notice of proposed capital classification, the Enterprise held core capital less than the critical capital level.

(5) *Discretionary reclassification.* If OFHEO determines in writing that an Enterprise is engaging in action or inaction (including a failure to respond appropriately to changes in circumstances or unforeseen events) that could result a rapid depletion of core capital, or that the value of the property subject to mortgages held or securitized by the Enterprise has decreased significantly or that reclassification is deemed necessary to ensure that the Enterprise holds adequate capital and operates safely, OFHEO may reclassify the Enterprise as:

(i) Undercapitalized if the Enterprise is otherwise classified as adequately capitalized:

(ii) Significantly undercapitalized if the Enterprise is otherwise classified as undercapitalized; or

(iii) Critically undercapitalized if the Enterprise is otherwise classified as significantly undercapitalized.

(d) *Prior approvals.* In making a determination to reclassify an Enterprise under paragraph (a)(5) or (c)(5) of this section, OFHEO will not base its decision to reclassify solely on action or inaction that previously was given specific approval by the Director of OFHEO in connection with the Director's approval of the Enterprise's capital restoration plan under section 1369C of the 1992 Act (12 U.S.C. 4622), or of a written agreement with the Enterprise that is enforceable in accordance with section 1371 of the 1992 Act.

#### § 1777.21 Notice of capital category, and adjustments.

(a) *Notice of capital classification.* OFHEO will classify each Enterprise according to the capital classifications in § 1777.20(a) or § 1777.20(c) on at least a quarterly basis. OFHEO may classify an Enterprise according to the capital classifications in § 1777.20(a) or § 1777.20(c), or reclassify an Enterprise as set out in § 1777.20(a)(5), § 1777.20(c)(5), § 1777.23(c), or § 1777.23(h), at such other times as OFHEO deems appropriate.

(1) *Notice of proposed capital classification.*—(i) Before OFHEO classifies or reclassifies an Enterprise, OFHEO will provide the Enterprise with written notice containing the proposed capital classification, the information upon which the proposed classification is based, and the reason for the proposed classification.

(ii) Notices proposing to classify or reclassify an Enterprise as undercapitalized or significantly undercapitalized may be combined with a notice that OFHEO may further reclassify the Enterprise under § 1777.23(c), without additional notice.

(iii) Notices proposing to classify or reclassify an Enterprise as significantly undercapitalized or critically undercapitalized may be combined with a notice under § 1777.24 that OFHEO intends to issue an order under section 1366 of the 1992 Act (12 U.S.C. 4616).

(iv) Notices proposing to classify an Enterprise as undercapitalized or significantly undercapitalized may be combined with a notice proposing to simultaneously reclassify the Enterprise under § 1777.20(a)(5) or § 1777.20(c)(5).

(2) *Response by the Enterprise.* The Enterprise may submit a response to OFHEO containing information for OFHEO's consideration in classifying or reclassifying the Enterprise.

(i) The Enterprise may, within thirty calendar days from receipt of a notice of proposed capital classification, submit a response to OFHEO, unless OFHEO determines the condition of the Enterprise requires a shorter period or the Enterprise consents to a shorter period.

(ii) The Enterprise's response period may be extended for up to an additional thirty calendar days if OFHEO determines there is good cause for such extension.

(iii) The Enterprise's failure to submit a response during the response period (as extended or shortened, if applicable) shall waive any right of the Enterprise to comment on or object to the proposed capital classification.

(3) *Classification determination and written notice of capital classification.*

After the Enterprise has submitted its response under paragraph (a)(2) of this section or the response period (as extended or shortened, if applicable) has expired, whichever occurs first, OFHEO will make its determination of the Enterprise's capital classification, taking into consideration such relevant information as is provided by the Enterprise in its response, if any, under paragraph (a)(2) of this section. OFHEO will provide the Enterprise with a written notice of capital classification, which shall include a description of the basis for OFHEO's determination.

(4) *Timing.* OFHEO may, in its discretion, issue a notice of proposed capital classification to an Enterprise at any time. If a notice of proposed classification is pending (under the process set out in paragraphs (a)(1) through (3) of this section) at that time, OFHEO may, in its discretion, specify whether the subsequent notice of proposed capital classification supersedes the pending notice.

(b) *Developments warranting possible change to capital classification*—(1) *Notice to OFHEO.* An Enterprise shall promptly provide OFHEO with written notice of any material development that would result in the Enterprise's core or total capital to fall to a point causing the Enterprise to be placed in a lower capital classification than the capital classification assigned to the Enterprise in its most recent notice of capital classification from OFHEO, or that is proposed to be assigned in the Enterprise's most recent notice of proposed capital classification from OFHEO. The Enterprise shall deliver such notice to OFHEO no later than ten calendar days after the Enterprise becomes aware of such development.

(2) OFHEO, in its discretion, will determine whether to issue a new notice of proposed capital classification under paragraph (a) of this section, based on OFHEO's review of the notice under paragraph (b)(1) of this section from the Enterprise and any other information deemed relevant by OFHEO.

#### § 1777.22 Limitation on capital distributions.

(a) *Capital distributions in general.* An Enterprise shall make no capital distribution that would decrease the total capital of the Enterprise to an amount less than the risk-based capital level or the core capital of the Enterprise to an amount less than the minimum capital level without the prior written approval of OFHEO.

(b) *Capital distributions by an Enterprise that is not adequately capitalized*—(1) *Prohibited distributions.* An Enterprise that is not

classified as adequately capitalized shall make no capital distribution that would result in the Enterprise being classified into a lower capital classification than the one to which it is classified at the time of such distribution.

(2) *Restricted distributions.* An Enterprise classified as significantly or critically undercapitalized shall make no capital distribution without the prior written approval of OFHEO. OFHEO may grant a request for such a capital distribution only if OFHEO determines, in its discretion, that the distribution:

(i) Will enhance the ability of the Enterprise to meet the risk-based capital level and the minimum capital level promptly;

(ii) Will contribute to the long-term financial safety and soundness of the Enterprise; or

(iii) Is otherwise in the public interest.

### § 1777.23 Capital restoration plans.

(a) *Schedule for filing plans*—(1) *In general.* An Enterprise shall file a capital restoration plan in writing with OFHEO within ten days of receiving a notice of capital classification under § 1777.21(a)(3) stating that the Enterprise is classified as undercapitalized, significantly undercapitalized, or critically undercapitalized, unless OFHEO in its discretion determines an extension of the ten-day period is necessary and provides the Enterprise with written notice of the date the plan is due.

(2) *Successive capital classifications.* Notwithstanding paragraph (a)(1) of this section, an Enterprise that has already submitted and is operating under a capital restoration plan approved by OFHEO under this part is not required to submit an additional capital restoration plan based on a subsequent notice of capital classification, unless OFHEO notifies the Enterprise that it must submit a new or amended capital restoration plan. An Enterprise that receives such a notice to submit a new or amended capital restoration plan shall file in writing with OFHEO a complete plan that is responsive to the terms of and within the deadline specified in such notice.

(b) *Contents of capital restoration plan.* (1) The capital restoration plan submitted under paragraph (a)(1) or (2) of this section shall:

(i) Specify the level of capital the Enterprise will achieve and maintain;

(ii) Describe the actions that the Enterprise will take to become classified as adequately capitalized;

(iii) Establish a schedule for completing the actions set forth in the plan;

(iv) Specify the types and levels of activities (including existing and new programs) in which the Enterprise will engage during the term of the plan;

(v) Describe the actions that the Enterprise will take to comply with any mandatory or discretionary requirements to be imposed under Subtitle B of the 1992 Act (12 U.S.C. 4611 through 4623) or subpart B of this part;

(vi) To the extent the Enterprise is required to submit or revise a capital restoration plan as the result of a reclassification of the Enterprise under § 1777.20(a)(5) or § 1777.20(c)(5), describe the steps the Enterprise will take to cease or eliminate and remedy the action, inaction, or conditions that caused the reclassification; and

(vii) Provide any other information or discuss any other issues as instructed by OFHEO.

(2) The plan shall include a declaration by the chief executive officer, treasurer, or other officer designated by the Board of Directors of the Enterprise to make such declaration, that the material contained in the plan is true and correct to the best of such officer's knowledge and belief.

(c) *Failure to submit*—(1) *Failure to submit; submission of unacceptable plan.* If, upon the expiration of the period provided in paragraph (a)(1) or (2) of this section for an Enterprise to submit a capital restoration plan, an Enterprise fails to comply with the requirement to file a complete capital restoration plan, or if the capital restoration plan is disapproved after review under paragraph (d) of this section, OFHEO may, in accordance with § 1777.21(a)(1)(ii) without additional notice, reclassify the Enterprise:

(i) As significantly undercapitalized if it is otherwise classified as undercapitalized; or

(ii) As critically undercapitalized if it is otherwise classified as significantly undercapitalized.

(2) *Duration of reclassification.* An Enterprise's failure to submit an approved capital restoration plan as described in paragraph (c)(1) of this section shall continue to be grounds for reclassification at each subsequent capital classification of the Enterprise, and shall only cease being considered grounds for reclassification after the Enterprise files a capital restoration plan that receives OFHEO's approval under paragraph (d) of this section.

(3) *Successive reclassifications.* If an Enterprise has not remedied its failure to file a complete capital restoration plan or an acceptable capital restoration plan within such period as is

determined by OFHEO to be appropriate, OFHEO may consider such failure to be the basis for additional reclassification under paragraph (c)(1) of this section into a lower capital classification. Such reclassification may be made without additional notice in accordance with § 1777.21(a)(1)(ii).

(d) *Order approving or disapproving plan.* Not later than thirty calendar days after receipt of the Enterprise's complete or amended capital restoration plan under this section (subject to extension upon written notice to the Enterprise for an additional thirty calendar days as OFHEO deems necessary), OFHEO shall issue an order to the Enterprise approving or disapproving the plan. An order disapproving a plan shall include the reasons therefore.

(e) *Resubmission.* An Enterprise that receives an order disapproving its capital restoration plan shall submit an amended capital plan acceptable to OFHEO within thirty calendar days of the date of such order, or a longer period if OFHEO determines an extension is in the public interest.

(f) *Amendment.* An Enterprise that has received an order approving its capital restoration plan may amend the capital restoration plan only after written notice to OFHEO and OFHEO's written approval of the modification. Pending OFHEO's review and approval of the amendment in OFHEO's discretion, the Enterprise shall continue to implement the capital restoration plan under the original approval order.

(g) *Termination*—(1) *Termination under the terms of the plan.* An Enterprise that has received an order approving its capital restoration plan remains bound by each of its obligations under the plan until each such obligation terminates under express terms of the plan itself identifying a date, event, or condition upon which such obligation shall terminate.

(2) *Termination orders.* To the extent the plan does not include such express terms for any obligation thereunder, the Enterprise's obligation continues until OFHEO issues an order terminating such obligation under the plan. The Enterprise may also submit a written request to OFHEO seeking termination of such obligations. OFHEO will approve termination of such obligation to the extent that OFHEO determines, in its discretion, that the obligation's purpose under the plan has been fulfilled and that termination of the obligation is consistent with the overall safety and soundness of the Enterprise.

(h) *Implementation*—(1) An Enterprise that has received an order approving its capital restoration plan is required to implement the plan.

(i) If OFHEO determines, in its discretion, that an Enterprise has failed to make, in good faith, reasonable efforts necessary to comply with the capital restoration plan and fulfill the schedule thereunder, OFHEO may reclassify the Enterprise:

(A) As significantly undercapitalized if it is otherwise classified as undercapitalized; or

(B) As critically undercapitalized if it is otherwise classified as significantly undercapitalized.

(ii) *Duration of reclassification.* An Enterprise's failure to implement an approved capital restoration plan as described in paragraph (h)(1)(i) of this section shall continue to be grounds for reclassification at each subsequent capital classification of the Enterprise, and shall only cease being considered grounds for reclassification after OFHEO determines, in its discretion, that the Enterprise is making such efforts as are reasonably necessary to comply with the capital restoration plan and fulfill the schedule thereunder.

(iii) *Successive reclassifications.* If an Enterprise has not remedied its failure to implement an approved capital restoration plan within such period as is determined by OFHEO to be appropriate, OFHEO may consider such failure to be the basis for additional reclassification under paragraph (h)(1)(i) of this section into a lower capital classification.

(2) *Administrative enforcement action.* A capital plan that has received an approval order from OFHEO under this section shall constitute an order under the 1992 Act. An Enterprise, regardless of its capital classification, as well as its executive officers, and directors may be subject to action by OFHEO under sections 1371, 1372, and 1376 of the 1992 Act (12 U.S.C. 4631, 4632, and 4636) and 12 CFR part 1780 for failure to comply with such plan.

**§ 1777.24 Notice of intent to issue an order.**

(a) *Orders under section 1366 of the 1992 Act (12 U.S.C. 4616).* In addition to any other action taken under this part, part 1780 of this chapter, or any other applicable authority, OFHEO may, in its discretion, issue an order to an Enterprise that is classified as significantly undercapitalized or critically undercapitalized, or is in conservatorship, directing the Enterprise to take one or more of the following actions:

(1) Limit any increase in, or reduce, any obligations of the Enterprise, including off-balance sheet obligations;

(2) Limit or eliminate growth of the Enterprise's assets or reduce the amount of the Enterprise's assets;

(3) Acquire new capital, in such form and amount as determined by OFHEO; or

(4) Terminate, reduce, or modify any activity of the Enterprise that OFHEO determines creates excessive risk to the Enterprise.

(b) *Notice of intent to issue an order.* Before OFHEO issues an order to an Enterprise pursuant to section 1366 of the 1992 Act (12 U.S.C. 4616), OFHEO will provide the Enterprise with written notice containing the proposed order.

(c) *Contents of notice.* A notice of intent to issue an order under this subpart shall include:

(1) A statement of the Enterprise's capital classification and its minimum capital level or critical capital level, and its risk-based capital level;

(2) A description of the restrictions, prohibitions, or affirmative actions that OFHEO proposes to impose or require; and

(3) The proposed date when such restrictions or prohibitions would become effective or the proposed date for the commencement and/or completion of the affirmative actions.

**§ 1777.25 Response to notice.**

(a) *Content of response.* The Enterprise may submit a response to OFHEO containing information for OFHEO's consideration in connection with the proposed order. The response should include, but is in no way limited to, the following:

(1) Any relevant information, mitigating circumstances, documentation, or other information the Enterprise wishes OFHEO to consider in support of the Enterprise's position regarding the proposed order; and

(2) Any recommended modification to the proposed order, and justification thereof.

(b) *Time to respond.* The Enterprise may, within thirty calendar days after receipt of the notice of proposed order, submit a response to OFHEO, unless OFHEO determines a shorter period to be appropriate or the Enterprise consents to a shorter period. OFHEO may extend the Enterprise's response period for up to an additional thirty calendar days if OFHEO determines, in its discretion, that there is good cause for such extension.

(c) *Waiver and consent.* The Enterprise's failure to submit a response during the response period (as extended or shortened, if applicable) shall waive any right of the Enterprise to comment on or object to the proposed order.

**§ 1777.26 Final notice of order.**

(a) *Determination and notice.* After the Enterprise has submitted its response under § 1777.25 or the response period (as extended or shortened, if applicable) has expired, whichever occurs first, OFHEO will determine, in its discretion, whether to take into consideration such relevant information as is provided by the Enterprise in its response, if any, under § 1777.25. OFHEO will provide the Enterprise with a written final notice of any order issued by OFHEO under this subpart, which is to include a description of the basis for OFHEO's determination.

(b) *Termination or modification.* An Enterprise that has received an order under paragraph (a) of this section remains subject to each provision of the order until each such provision terminates under the express terms of the order. The Enterprise may submit a written request to OFHEO seeking modification or termination of one or more provisions of the order. Pending OFHEO's review and approval, in OFHEO's discretion of the Enterprise's request, the Enterprise shall remain subject to the provisions of the order.

(c) *Enforcement of order—(1) Judicial enforcement.* An order issued under paragraph (a) of this section is an order for purposes of section 1375 of the 1992 Act (12 U.S.C. 4635). An Enterprise in any capital classification may be subject to enforcement of such order in the United States District Court for the District of Columbia pursuant to such section.

(2) *Administrative enforcement.* An order issued under paragraph (a) of this section constitutes an order under the 1992 Act. An Enterprise, regardless of its capital classification, as well as its executive officers and directors may be subject to action by OFHEO under sections 1371, 1372, and 1376 of the 1992 Act (12 U.S.C. 4631, 4632, and 4636) and 12 CFR part 1780 for failure to comply with such order.

**§ 1777.27 Exhaustion and review.**

(a) *Judicial review—(1) Review of certain actions.* An Enterprise that is not classified as critically undercapitalized may seek judicial review of a final notice of capital classification issued pursuant to § 1777.21(a)(3) or a final notice of order issued pursuant to § 1777.26(a) in accordance with section 1369D of the 1992 Act (12 U.S.C. 4623)

(2) *Other review barred.* Except as set out in paragraph (a)(1) of this section, or review of conservatorship appointments to the limited extent provided in section 1369(b) of the 1992 Act (12 U.S.C. 4619(b)) and § 1777.28(c), no court shall

have jurisdiction to affect, by injunction or otherwise, the issuance or effectiveness of a capital classification or any other action of OFHEO pursuant to this subpart B, as provided in section 1369D of the 1992 Act (12 U.S.C. 4623).

(b) *Exhaustion of administrative remedies.* In connection with any issue for which an Enterprise seeks judicial review in connection with an action described in paragraph (a)(1) of this section, the Enterprise must have first exhausted its administrative remedies, by presenting all its objections, arguments, and information relating to such issue for OFHEO's consideration pursuant to § 1777.21(a)(2), as part of the Enterprise's response to OFHEO's notice of capital classification, or pursuant to § 1777.25, as part of the Enterprise's response to OFHEO's notice of intent to issue an order.

(c) *No stay pending review.* The commencement of proceedings for judicial review of a final capital classification or order as described in paragraph (a)(1) of this section shall not operate as a stay thereof.

**§ 1777.28 Appointment of conservator for a significantly undercapitalized or critically undercapitalized Enterprise.**

(a) *Significantly undercapitalized Enterprise.* At any time after an Enterprise is classified as significantly undercapitalized, OFHEO may issue an order appointing a conservator for the Enterprise upon determining that:

(1) The amount of core capital of the Enterprise is less than the minimum capital level; and

(2) The alternative remedies available to OFHEO under the 1992 Act are not satisfactory.

(b) *Critically undercapitalized Enterprise—(1) Appointment upon classification.* Not later than thirty days after issuing a final notice of capital classification pursuant to § 1777.21(a)(3) classifying an Enterprise as significantly undercapitalized, OFHEO shall issue an order appointing a conservator for the Enterprise.

(2) *Exception.* Notwithstanding paragraph (b)(1) of this section, OFHEO may determine not to appoint a conservator if OFHEO makes a written finding, with the written concurrence of the Secretary of the Treasury, that:

(i) The appointment of a conservator would have serious adverse effects on economic conditions of national financial markets or on the financial stability of the housing finance market; and

(ii) The public interest would be better served by taking some other enforcement action authorized under this title.

(c) *Judicial review.* An Enterprise for which a conservator has been appointed pursuant to paragraph (a) or (b) of this section may seek judicial review of the appointment in accordance with section 1369(b) of the 1992 Act (12 U.S.C. 4619(b)). Except as provided therein, no court may take any action regarding the removal of a conservator or otherwise restrain or affect the exercise of the powers or functions of a conservator.

(d) *Termination—(1) Upon reaching the minimum capital level.* OFHEO will issue an order terminating a conservatorship appointment under paragraph (a) or (b) of this section upon a determination that the Enterprise has maintained an amount of core capital that is equal to or exceeds the minimum capital level.

(2) *In OFHEO's discretion.* OFHEO may, in its discretion, issue an order terminating a conservatorship appointment under paragraph (a) or (b) of this section upon a determination that such termination order is in the public interest and may safely be accomplished.

Dated: January 18, 2002.

**Armando Falcon, Jr.,**

*Director, Office of Federal Housing Enterprise Oversight.*

[FR Doc. 02-1842 Filed 1-24-02; 8:45 am]

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**DEPARTMENT OF TRANSPORTATION**

**Federal Aviation Administration**

**14 CFR Part 39**

**[Docket No. 2001-NM-198-AD; Amendment 39-12607; AD 2002-01-13]**

**RIN 2120-AA64**

**Airworthiness Directives; Boeing Model 767 Series Airplanes**

**AGENCY:** Federal Aviation Administration, DOT.

**ACTION:** Final rule.

**SUMMARY:** This amendment supersedes an existing airworthiness directive (AD), applicable to certain Boeing Model 767 series airplanes, that currently requires inspections to detect cracking and corrosion of the aft trunnion of the outer cylinder of the main landing gear (MLG) and various follow-on actions. That AD also currently requires termination of the inspections by repairing the outer cylinder and installing new aft trunnion bushings. This amendment prohibits the use of a particular corrosion inhibiting compound during accomplishment of the terminating action. This action is necessary to prevent the collapse of the

MLG due to stress corrosion cracking of the aft trunnion of the outer cylinder. This action is intended to address the identified unsafe condition.

**DATES:** Effective March 1, 2002.

The incorporation by reference of Boeing Service Bulletin 767-32A0148, Revision 2, dated November 30, 2000, as listed in the regulations, is approved by the Director of the Federal Register as of March 1, 2002.

The incorporation by reference of a certain publication, as listed in the regulations, was approved previously by the Director of the Federal Register as of February 16, 1996 (61 FR 3552, February 1, 1996).

The incorporation by reference of a certain other publication, as listed in the regulations, was approved previously by the Director of the Federal Register as of November 29, 1996 (61 FR 55080, October 24, 1996).

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

**FOR FURTHER INFORMATION CONTACT:** John Craycraft, Aerospace Engineer, Airframe Branch, ANM-120S, FAA, Seattle Aircraft Certification Office, 1601 Lind Avenue, SW., Renton, Washington 98055-4056; telephone (425) 227-2782; fax (425) 227-1181.

**SUPPLEMENTARY INFORMATION:** A proposal to amend part 39 of the Federal Aviation Regulations (14 CFR part 39) by superseding AD 96-21-06, amendment 39-9783 (61 FR 55080, October 24, 1996), which is applicable to certain Boeing Model 767 series airplanes, was published in the **Federal Register** on August 24, 2001 (66 FR 44553). The action proposed to continue to require inspections and various follow-on actions to detect cracking and corrosion of the aft trunnion of the outer cylinder of the main landing gear (MLG). The action also proposed to continue to require termination of the inspections by repairing the outer cylinder and installing new aft trunnion bushings. Finally, the action proposed to prohibit the use of a particular corrosion inhibiting compound during accomplishment of the terminating action.