FHLBANKS
A NATION OF LOCAL LENDERS

September 18, 2023

Mr. Clinton Jones
General Counsel
Federal Housing Finance Agency
Attention: Comments/RIN 2590-AB23
400 Seventh Street, SW
Washington, D.C. 20219

Re: Comments on Notice of Proposed Rulemaking amending the Suspended Counterparty Program

Dear Mr. Jones:

The Council of Federal Home Loan Banks (*Council*), a trade association that represents the views and positions of the 11 Federal Home Loan Banks (each an *FHLBank,* and collectively, *FHLBanks*) respectfully submits this comment letter regarding the Federal Housing Finance Agency's (*FHFA*) Notice of Proposed Rulemaking amending the Suspended Counterparties Program (*Proposed Rule*). The purpose of the Suspended Counterparties Program (*Program or the SCP*) is to, "mitigate the risk that a regulated entity will be harmed by an individual or institution with which it is doing or has done business that has committed fraud or other financial misconduct during a specified time period."[1] The Council appreciates FHFA's review of the Program in furtherance of the safe and sound operations of the FHLBanks. Likewise, the FHLBanks are continuously committed to safe and sound operations in every facet of the organization and look forward to continuing their engagement with FHFA on the Program. To facilitate that engagement, and in response to the Proposed Rule, this comment letter raises several significant concerns, identifies key items for further clarification as outlined below, and provides input in response to the questions as specifically requested by FHFA.

I. Without additional information, we are unable to fully comment on whether the Proposed Rule is tailored to address any particular problem.

Without additional information on how the Program may not be achieving FHFA's objectives, we are unable to fully comment on whether the Proposed Rule would provide benefits that exceed the costs the Proposed Rule imposes on the FHLBanks.[2] The Administrative Procedure Act (*APA*) requires that an agency provide the reasons for a proposed rule to avoid acting in an arbitrary and capricious manner.[3] However, the Proposed Rule does not include FHFA's reasoning for expanding the SCP, rather the Proposed Rule states only that, "in FHFA's experience of administering the SCP, it has

[1] 78 Fed. Reg. 63007 (Oct. 23, 2013).
[2] *See* Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983) (holding that there must be a rational connection between the facts found and the choices made in the promulgation of regulations).
[3] *See* Am. Radio Relay League, Inc. v. F.C.C., 524 F.3d 227, 236 (D.C. Cir. 2008); Portland Cement Ass'n v. Ruckelshaus, 486 F.2d 375, 393 (D.C. Cir. 1973).

determined that this [criminal conviction] standard is too narrow."[4] Furthermore, the Proposed Rule does not include any data or discussion of potential problems with the Program to support the expansion of the SCP. Without these reasons, it is difficult for us to fully comment on the Proposed Rule. Accordingly, the Council respectfully requests that FHFA either withdraw the Proposed Rule in its entirety or re-propose the rule providing its reasons for the new proposal.

II. The expansion of the Program inadvertently creates prudential management concerns for the FHLBanks, and is operationally burdensome.

A. The expansion of the Program causes prudential management concerns for the FHLBanks.

The FHLBanks collectively manage over 10,000 different counterparty relationships, including vendor relationships, broker-dealer relationships, insurance providers, trade associations, legal advisors, consultants, information technology providers, banking services providers, accountants, mortgage originators and servicers, members and participants in Community Investment Programs. Depending on how broadly FHFA intends to expand the Program, critical FHLBank counterparties may be suspended under the Program for actions that did not increase risk to the FHLBanks; these counterparties are categorized as critical by the FHLBanks due to the importance of the service provided, or because those counterparties are extremely time-consuming or expensive to replace. For those critical counterparties, placement on the final suspension list – thereby requiring an FHLBank to cease current business with the suspended counterparty and source a new counterparty – would have an immediate negative impact on the safe operations of the FHLBanks. In certain instances, such as switching counterparties mid-project or from counterparties that are industry leaders, can result in greater financial expense and poorer work product, thus increasing, rather than mitigating, the risk to an FHLBank.

If FHFA finalizes the Proposed Rule, the Council requests that FHFA include a procedure outlining the right for an FHLBank's senior management to determine to continue business operations with a suspended counterparty, subject to a written strategy detailing the FHLBank's plan to disengage with the suspended counterparty in the natural course, similar to the discretion afforded agency directors under the Federal Acquisition Regulations (*FAR*). In the alternative, the Council suggests that FHFA revise 12 C.F.R. §1227.10(c) to clearly define when the FHFA will respond to an FHLBank's exception request (we respectfully suggest that FHFA respond within ten days of an FHLBank's exception request), and clarify that the FHLBanks may continue to conduct business with a suspended counterparty while waiting on a decision from FHFA. As the FHLBanks may be in the middle of contracting with a suspended counterparty, these revisions to 12 C.F.R. § 1227.10 are critical to ensuring that the FHLBanks remain in compliance with the Program.

B. The Proposed Rule does not address FHLBank reporting requirements under 12 C.F.R. §1227.4.

FHFA does not address impact to the FHLBank's reporting requirement under 12 C.F.R. §1227.4 in the Proposed Rule. The Council requests that FHFA clarify whether it is FHFA's intention that the FHLBanks prepare and submit reports regarding a counterparty's breaches of contract or other civil enforcement actions. Specifically, if it is FHFA's intent that the FHLBanks submit reports regarding a counterparty's breach of contract, the Council requests that FHFA explicitly limit such reports to those breaches of contract where an FHLBank is a direct party to the breached contract. This clarification will ensure that the FHLBanks do not prepare and submit speculative reports.

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[4] 88 Fed. Reg. 47078 (July 21, 2023).

C. The Proposed Rule should clarify the implications to other applicable regulatory guidance.

To the extent FHFA has already adopted applicable regulatory guidance for the suspension of FHLBank business relationships, the Council requests that FHFA clarify that the existing regulations and/or guidance supersedes the regulations provided under the Program. For example, 12 C.F.R. §1291.63(b) of the Affordable Housing Program regulation outlines suspension or debarment requirements for participants from the Affordable Housing Program. (*AHP*). To avoid conflict between the regulations and promote operational efficiency for the FHLBanks, FHFA should specifically exclude FHLBank member relationships and AHP Participant relationships from the Program.

III. The Proposed Rule dramatically expands the definition of conviction to include breaches of contract and civil enforcement actions.

A. Expanding the definition of "conviction" by including breach of contract is overly broad.

1. Public Policy Considerations

Although it is possible that a counterparty could breach a contract for reasons related to fraud or other financial misconduct, it is more likely that a contract is materially and knowingly breached due to an inability to perform or other overwhelmingly compelling business reasons. The parties enter the contract fully aware of the possibility of breach by either party, and mitigate that risk by including mutually agreed-upon remedies for breach in the contract. The FHLBanks diligently manage vendor and other counterparty risks, including the possibility of contract breach through proper underwriting, vendor watch lists, tabletops, and through the identification of replacement counterparties.

If FHFA retains breach of contract as a "conviction," FHFA may penalize counterparties for contract breaches, without any financial or similar misconduct, and not presenting any additional risks to the FHLBanks. This penalty does not align with established public policy,[5] which defers the right to businesses to make the most economically efficient decisions for their company, nor to standards of other federal entities, such as the FAR standards for suspension or debarment.[6] Moreover, there may be reasonable circumstances why a counterparty cannot comply with contractual provisions such as a change in business operations or market conditions (e.g. the COVID-19 pandemic), technological advancement or downstream considerations. In such cases, there would be no reason to disqualify such counterparty from doing business with the FHLBanks. The FHLBanks are sophisticated institutions with a long history of proper vendor management practices. Each FHLBank must retain its ability to do business with the counterparties of its choosing, while considering whether, and under what circumstances, the counterparty was a breaching party to a contract.

Accordingly, the Council respectfully requests that FHFA remove breach of contract from the definition of "conviction" because its inclusion is overly broad and is not in the furtherance of public policy.

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[5] *See,* Aaron Xavier Fellmeth, Civil and Criminal Sanctions in the Constitution and Courts, 94 Geo. L.J. 1, 58–59 (2005).
[6] The FAR standard for suspension or debarment for a breach applies generally as to a willful or ongoing performance breaches and is intended and applied to severe circumstances.

2. If FHFA will not remove breach of contract from the Proposed Rule, FHFA should clarify the scope for qualifying breaches of contract.

i. Threshold requirements for breaches of contract

The Council recommends FHFA specifically limit the scope of breaches of contract to the same threshold requirements as the other offenses (*e.g.*, criminal judgements or administrative sanctions) identified in the definition of "conviction." At a minimum, breach of contract as a suspension trigger should be limited to situations in which: (i) the federal or state government is a party to the contract, and (ii) the breach of contract involves an act of "fraud, embezzlement, theft, conversion, forgery, bribery, perjury, making false statements or claims, tax evasion, obstruction of justice, or any similar offense," in each case in connection with a mortgage, mortgage business, mortgage securities or other lending product related to mortgages. By limiting the scope to the situations identified above, FHFA will help the FHLBanks target the breaches of contract that pose the most risk to the FHLBanks and operationalize the Program.

ii. Definition of "material" breach of contract

FHFA restricts the inclusion of breaches of contract to breaches that are "material" and "knowing." While the Council appreciates FHFA's qualifiers, FHFA does not provide a definition of "material." Although the Council acknowledges that FHFA references the standard provided by HUD, codified at 42 U.S.C. §1437-z1, to support the use of "material" and "knowing" (*HUD Standard*), neither the HUD Standard nor FHFA provide a comprehensive definition of what constitutes a "material" breach of contract under the Proposed Rule. As such, the Council respectfully requests that, if FHFA continues to include breach of contract in the final rule, FHFA either provide a standard definition for what is considered a material breach of contract or provide examples of what FHFA considers a material breach of contract under the Proposed Rule.

iii. Patterns of misconduct

The current Proposed Rule may subject a counterparty to suspension for any one breach of contract that is material and knowing; however, as stated above, the Council notes that there are valid and acceptable reasons to materially and knowingly breach a contract without creating additional fraud risk to the FHLBanks. As such, we suggest that FHFA consider adopting a standard similar to the standard for suspension or debarment of community investment participants under 12 C.F.R. § 1291.63 and update the Final Rule to provide that counterparties may only be subject to suspension if there is an established pattern of material and knowing breaches. This change will ensure that counterparties who commit one material and knowing breach of contract are not penalized under the Final Rule.

iv. Affiliate considerations for breach of contract

As stated in the 2023 Regulatory Review comment letter (*Regulatory Review Comments*), submitted to FHFA on June 13, 2023, the Council recommended FHFA consider, "revising the definition of 'Affiliate' [for Program purposes] to more closely align with entities to which the FHLBanks have a

direct nexus."[7] *Affiliate* is currently defined to mean "a party that either controls or is controlled by another person, whether directly or indirectly, including one or more persons that are controlled by the same third person."[8] The Council requests that FHFA should revise the definition of Affiliate as suggested in the Regulatory Review Comments.

The revision of Affiliate is particularly important given the proposed expansion to the definition of "conviction." FHFA does not discuss how or if breaches of contract will be imputed to Affiliates in the Proposed Rule, however, due to the organizational structure of some of the FHLBanks' counterparties, the FHLBanks may have a contract or other covered transaction with an entity that is under the same common control as a convicted entity through a parent company.[9] FHFA should limit breaches of contract to those counterparties who have actually breached the contract to ensure that a single breach of contract by a large parent company or one of its subsidiaries does not preclude the FHLBanks from conducting business with the relevant subsidiary or parent company that has not breached a contract.

B. *The Proposed Rule expands the definition of "conviction" to include civil and administrative orders and judgments by federal and state courts and agencies, causing the Program to have inconsistent standards of review and inequitable results.*

Under the current Program, a final suspension order arising out of a criminal conviction is based on facts proven beyond a reasonable doubt, or plea agreements that include an admission of misconduct. Under the Proposed Rule, however, FHFA will issue a suspension order based on the standard that has been adopted or applied by the court or administrative agency in a civil or administrative proceeding[10], which includes lesser standards such as preponderance of the evidence, clear and convincing evidence, probable cause, substantial evidence, not arbitrary and capricious, and adequate evidence. As the standards of review in civil enforcement actions are not applied consistently[11] by the courts and administrative agencies, counterparties who have committed the same action may or may not be placed on the FHFA's final suspension list depending on the standard of review utilized. This disparity causes unequal treatment to potential counterparties, and does not achieve FHFA's objectives to mitigate the risk to the FHLBanks because certain counterparties who have committed the same activity will not be placed on the Final Suspension List. As such, the Council respectfully requests that FHFA withdraw the civil enforcement action suspension trigger from the Proposed Rule. Furthermore, as the resolution in settlements or consent orders are negotiated by the parties to spare themselves the time and expense of litigation, there is essentially no standard of review at all. The Proposed Rule would include consent orders and similar resolutions such as settlements among the bases for covered misconduct even where there is no admission of misconduct. As there is no standard of review in settlements, the Council respectfully requests that FHFA remove the settlement or consent order requirement from the Proposed Rule. Otherwise, the Council requests that FHFA

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[7] 2023 Regulatory Review Comment Letter, submitted June 13, 2023

[8] 12 C.F.R. §1227.2

[9] 2023 Regulatory Review Comment Letter, submitted June 13, 2023

[10] It would be helpful for FHFA to clarify what "State legal and administrative agencies and local courts and authorities are in scope. The definition of state appears to be overly broad.

[11] The Council also notes that the rights and protections afforded to defendants are also not applied consistently across different federal agencies. For example, the Securities and Exchanges Commission (*SEC*) and Department of Housing and Urban (*HUD*) do not always apply the Federal Rules of Civil Procedure and Evidence, may not afford jury trials and may use hearsay in a manner that is not allowed in federal courts and without the safeguards provided by federal courts (*Hill v. Sec. and Exch. Comm'n*, 825 F.3d 1236, 1238 (11th Cir. 2016); *See* 24 C.F.R. § 26.24.)

clearly define the scope and the intention of "any other resolution that is the functional equivalent of such a judgment or order[12]."

C. Responses to FHFA Questions 1 and 2

Question 1: Should the scope of misconduct included in the definition of "covered misconduct" be expanded beyond what is being proposed? If so, what additional forms of misconduct should be included?

For the reasons addressed above, the Council believes that the scope of misconduct should not be expanded beyond what is being proposed. Rather, the proposed expansions of the definitions of "conviction" and "covered misconduct" in the Proposed Rule should be reconsidered.

Question 2: Should the illustrative list of forms of misconduct – e.g. fraud, embezzlement, etc. – provided in the definition of "covered misconduct" be otherwise changed? If so, what should be added or removed?

The Council appreciates FHFA's recognition that certain forms of misconduct pose greater risk to the FHLBanks' operations than others. In our view, the current list adequately captures the forms of misconduct that pose the most risk to the FHLBanks and as such, the Council recommends that the illustrative list remain as is. However, when considering the overall definition of "covered misconduct," the Council asks FHFA to consider the clarifying comments provided in the Regulatory Review Comments. Specifically, we asked FHFA to consider clarifying the definition of "covered misconduct" to specify that: "it is not the FHFA's intent that the FHLBanks submit reports where a conviction is based on fraud that occurs in connection with 'other lending product[s]' unrelated to mortgages."[13] As discussed in the Regulatory Review Comments, the Council still believes that this clarification will reduce the ambiguity in the regulation and promote consistent reporting among the FHLBanks.

IV. The Proposed Rule would authorize FHFA to issue immediate suspension orders.

A. Immediate suspension orders may have a significant impact on the FHLBanks and may violate a counterparty's due process rights.

1. Due process considerations

FHFA has previously acknowledged the need to consider due process under the Program, stating in the 2013 Interim Final Rule that:

> *"…because a suspension order under the Suspended Counterparty Program could have a significant impact on the regulated entities and the individual or institution that is the subject of the order, the procedures under part 1227 provide that all affected parties shall receive notice of a proposed suspension order and an opportunity to respond before issuance of any final suspension order."*[14]

The Council agrees that proposed suspension orders and opportunity to respond to the proposed suspension order is instrumental in mitigating due process concerns. Immediate suspension orders bypass these protections and revive the due process concerns originally raised in 2013. As such, the

[12] 88 Fed. Reg. 47079 (July 21, 2023).
[13] 2023 Regulatory Review Comment Letter, submitted June 13, 2023
[14] 78 Fed. Reg. 63008 (Oct. 23, 2013).

Council respectfully requests that FHFA remove immediate suspension orders from the final rule. In the alternative, if FHFA retains the right to issue immediate suspensions, the Council encourages FHFA to revise proposed 12 C.F.R. §1227.12(a) (request to vacate) to remove the requirement that the underlying administrative order be out of effect before FHFA will consider the request to vacate an immediate suspension order. We recommend the removal of this requirement to give suspended counterparties the opportunity to seek redress from FHFA from an immediate suspension order without prohibitive requirements.

Another due process consideration is that FHFA may issue an immediate suspension order based on facts and evidence that are not in the record of the administrative agency issuing the administrative sanction. Federal courts have become critical of administrative agencies making suspension or debarment decisions based upon facts or evidence not clearly in the record.[15] Given the FHFA is proposing to issue immediate suspensions based solely on the administrative agency order, and without conducting its own due diligence, counterparties may claim that the Proposed Rule is fundamentally unfair as FHFA may immediately suspend them based on facts and evidence not in the record; this is particularly unfair where a counterparty has not had an opportunity to challenge the immediate suspension order.

FHFA states that the "amendment would…not preclude FHFA from adhering to the current procedures and issuing a proposed suspension order where an immediate suspension order is authorized."[16] The Council would like further clarification from FHFA on how it will operationalize immediate suspension orders. As FHFA notes, "such an [immediate] effective date would be unduly disruptive to the regulated entities who may require additional time to wind down operations with the relevant counterparties"[17] Given the impact of immediate suspension orders on the operations of the FHLBanks, FHFA should clearly define when it will issue immediate suspension orders and when it will follow the proposed suspension path.

2. Affiliate considerations for immediate suspension orders

The Proposed Rule is not clear on whether a counterparty's covered misconduct that results in an administrative sanction would be imputed to such party's Affiliates for purposes of issuing an immediate suspension order against the party's Affiliates. If an Affiliate is not a party to an administrative sanction or was not afforded notice or an opportunity to participate in any hearing related to the administrative sanction, FHFA will make the decision to issue an immediate suspension order against the Affiliate based on facts and evidence not in any record. Such a determination could have severe consequences for all involved. The final rule should either clarify that the provisions governing immediate suspension orders would not apply to covered misconduct imputed to an Affiliate or make clear that any Affiliate not a party to the original administrative sanction will have notice and opportunity for a hearing to challenge any proposed immediate suspension before such suspension is issued.

B. FHFA's Proposed Rule regarding immediate suspension orders is broader than other federal suspension/debarment rules.

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[15] *See e.g.* International Exports, Inc. v. Mattis, 265 F.Supp.3d 35, 44-50 (D.D.C. 2017).
[16] 88 Fed. Reg. 47079 (July 21, 2023).
[17] 88 Fed. Reg. 47079 (July 21, 2023).

One of the main differences between the Proposed Rule and the suspension and debarment rules of other federal agencies and FHFA's Proposed Rule is that the suspension orders of other federal agencies are clearly based on exigent circumstances as articulated under such agencies' rules. Under the *FAR*, suspension orders may be issued where immediate action is required to protect the government's interest.[18] The Office of the Comptroller of the Currency's (*OCC)* rules governing the suspension of accounting firms and accountants provide that an immediate suspension order may be granted where immediate suspension is necessary to avoid immediate harm to an insured depository institution or its depositors.[19] The Federal Deposit Insurance Corporation (*FDIC*) may suspend parties where such action is necessary to protect an insured depository institution or the interests of depositors.[20] By contrast, the Proposed Rule lacks any language suggesting that the immediate suspension order should be issued due to some exigent circumstances or to immediately protect the interests of the regulated entities. FHFA should consider strengthening the Proposed Rule by providing clear guidance with respect to the types of circumstances under which FHFA may issue an immediate suspension order and the level of exigency or immediacy justifying such order.

C. Responses to Questions 3 and 4

Question 3: Should the regulation be amended to allow for suspension based on specific additional sanctions imposed by other Federal Agencies, including but not limited to sanctions that restrict a counterparty's rights to participate in mortgage insurance programs under Title I or Title II of the National Housing Act – regardless of whether the underlying misconduct was related to fraud, embezzlement, etc?

For the reasons stated in this letter, and particularly because FHFA does not conduct independent investigations,[21] the Council does not recommend FHFA adjust the regulation to allow for suspension based on specific additional sanctions imposed by other Federal Agencies.

Question 4: Should FHFA be authorized to issue immediate suspension orders only with a prospective effective date (e.g. 10 days after signature by the suspending official)? If so, how long after signature by the suspending official?

If FHFA retains the right to issue immediate suspension orders in the Final Rule, the Council supports the development of a procedure that would allow each FHLBank's senior management to determine that it is in the FHLBank's best interest to continue conducting business with the suspended counterparty subject to a written plan outlining the FHLBank's disengagement with the counterparty in the natural course. As stated earlier in this comment letter, we also request proposed revisions to 12 C.F.R. 1227.10(c) (detailing FHFA's timeframe for responding to an exception request and clarifying that the FHLBanks may continue to conduct business with suspended counterparties while FHFA is responding to the request), particularly for immediate suspension orders where the FHLBanks will not have prior notice of an impending suspension. Notwithstanding the implementation of either of those options, the Council suggests a prospective effective date of no less than 30 days after signature by the suspending official, in alignment with the current regulation. A thirty-day period gives the FHLBanks enough time to investigate whether they have a relationship with the suspended counterparty and take any relevant next steps to remain in compliance.

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[18] 48 C.F.R. § 9.407-1(b)(1).
[19] 12 C.F.R. §19.243(c)(1)(ii).
[20] Section 8(e)(3)(A)(i) of the Federal Deposit Insurance Act.
[21] 88 Fed. Reg. 47080 (July 21, 2023).

For the reasons stated in this letter, the Council respectfully requests that FHFA withdraw the Proposed Rule in its entirety or re-propose the rule including or addressing our above requests and clarifications, with an opportunity for the FHLBanks to comment on the updates.

We look forward to continuing our engagement with FHFA to determine the best path forward for the Program and appreciate the opportunity to comment on the Proposed Rule.

Sincerely,

Ryan Donovan
President and Chief Executive Officer
Council of Federal Home Loan Banks