

November 20, 2000

Elaine L. Baker
Secretary to the FHFB
Federal Housing Finance FHFB
1777 F Street, N.W.
Washington, D.C 20006

RE: Docket No. 2000-23; 12 CFR Parts 917, 925, 930 – 933, 956, & 960
65 Fed. Reg. 43408-43447 (July 13, 2000); Notice of Proposed
Rulemaking – Capital Requirements for Federal Home Loan Banks
Second Comment Letter

Dear Ms. Baker:

The American Bankers Association (“ABA”) appreciates the opportunity to comment further on the Notice of Proposed Rulemaking (“NPR”) on the Capital Requirements for Federal Home Loan Banks (“FHLBanks”) issued by the Federal Housing Finance Board (“FHFB”) published in the *Federal Register* on July 13, 2000. ABA brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country. ABA members represent a significant portion of the over 7,720 members of the Federal Home Loan Bank System.

In our first comment letter, we outlined general themes that our membership has identified as essential to the final rulemaking. The purpose of this comment letter is to elaborate on some of those themes and to address issues not fully explored in our first letter. This additional comment letter addresses the following issues:

- ABA urges the FHFB to put in writing its commitment to respond promptly to an adverse accounting, tax, or regulatory capital treatment, or an unforeseen event that negatively impacts the FHLBank System or the membership.
- Membership fees, even if optional or paired with stock purchase requirements, undercut the cooperative ownership of the FHLBank System and should not be permitted in the final capital rule.
- The proposed limitation on the amount of capital that a FHLBank may raise should be removed.
- The FHFB should revise the proposed rule to clarify that a FHLBank may issue only Class B stock if it so chooses and that the current state-by-state and apportionment voting requirements of Section 7 would apply to both Class A and Class B stock.
- ABA could support redemption of activity-based stock so long as the manner chosen by the particular FHLBank does not disadvantage the financial institution members.
- The proposed capital charge for operational risk should be replaced by one that reflects the risk exposure as determined by on-site examination. A satisfactory examiner report

on operational risk management should justify lowering the 30 percent add-on capital charge.

- The capital charges for all advances should be lower than proposed – and should not rise with the maturity of advances.
- Each FHLBank should be explicitly authorized to accept a cash-flow test for interest rate risk exposure – without also having to satisfy the proposed value-at-risk stress test.
- The requirement to make up any deficiency of market value below 95 percent of book value should be eliminated.

Each of these issues is discussed below:

1. Form of Rule. A great deal of debate has centered over the technical form of the final capital regulation (whether final or interim final). ABA suggests that the important issue is not the form of the rule, but the commitment of the FHFBS to act promptly in the event of an unforeseen event that negatively impacts the FHLBank System membership or the FHLBanks such as an unfavorable tax, accounting, or regulatory capital treatment of FHLBank stock. This willingness to act promptly gives the FHLBank System as a whole the comfort to go forward cooperatively with the FHFBS as the capital plans are developed. ABA urges the FHFBS to put its commitment to act in writing, whether in the preamble of the final rule or a letter to the System membership, to give further evidence of the seriousness of the FHFBS's promise. ABA recognizes the nonbinding nature of such a commitment, but urges that placing it in writing will ease transition jitters and facilitate a successful capitalization of the System.

2. Membership Fees. ABA understands that the current debate over membership fees has shifted from allowing membership fees as an alternative to stock investment to preserving FHLBank flexibility and allowing the FHLBanks to use membership fees in combination with stock ownership. While ABA appreciates the movement on the issue, it is still ABA's position that the FHFBS should prohibit the use of membership fees. The problem with membership fees assessed in combination with stock ownership is the potential for the fee to over shadow or render meaningless the stock investment requirement. The FHLBank System is a cooperatively owned source of necessary liquidity born out of an economic depression. Part of its strength to withstand economic cycles is its cooperative ownership. Membership fees are merely user fees that undercut the cooperative nature of the System. ABA members oppose any option that permits membership fees. This includes opposition to any compromise that would grant the use of membership fees in conjunction with stock investments.

3. Opposition to Cap on Capital. Initial indications suggest that the FHFBS is willing to reconsider the need for a limit on the amount of capital that a FHLBank may raise. ABA urges the FHFBS to remove the proposed hard cap on capital. This issue works "hand-in-glove" with the issue of membership fees. If the hard cap is eliminated, there is no need for membership fees to manage capital growth. ABA strongly supports removal of the hard cap along with elimination of membership fees.

4. Voting. As our previous comment letter stated, ABA supports continuation of the Section 7 voting requirements including state-by-state representation. It is also important to modify the proposal in the final rule to permit explicitly the issuance of only Class B stock. As the FHFBS

has heard from a number of sources, several FHLBanks intend to issue only Class B stock. The ability to do so will facilitate the ease of transition from the current, all-six-month stock to the new capital framework developed under the final rule. An all-Class B stock achieves the goal of more permanent capital for the FHLBank System. If a FHLBank does choose to issue both Class A and Class B stock, it will also be important to extend the current state-by-state and apportionment voting requirements of Section 7 for both classes of stock. To the extent that the FHFB has issued contrary advice or opinions, ABA urges the FHFB to rescind those positions.

5. Redemption Clarification. In our letter of October 12, ABA urged the FHFB to address in the final rule a FHLBank's right to force redemption of stock. After further discussions with our members, ABA could accept redemption of activity-based stock in a manner that does not disadvantage FHLBank members. Redemption of activity-based stock in excess of the amount required to participate in the activity can improve dividend performance. Dividends are an important source of investment income for many members. Thus, permitting stock redemption can enhance the attractiveness of a FHLBank's stock and thereby increase its capital base. Several of the FHLBanks do this quarterly, and we understand that some are considering a more frequent and automatic process. Most do not redeem if the member institution anticipates further activity that would require maintaining the level of stock investment. We recommend that each FHLBank should work with its member institutions to develop a policy on stock redemption.

6. Operational Risk. ABA continues to oppose application of the proposed capital charge for operational risk (30 percent of the capital for credit-plus-market risk). The proposed charge does not reflect the risk for which it is designed to address. Thus, it would neither encourage good risk management nor provide proper capital backing.

The most effective supervisory control of operational risk is strict review during on-site examinations of a FHLBank's preparation for unanticipated problems. If the concept of an "add-on" capital charge for operational risk is not improved substantially in the final rule, then ABA urges the FHFB to amend the proposal to allow the 30 percent add-on to be lowered based on a satisfactory examiner report on a FHLBank's operational risk management. This provides the FHLBanks with an incentive to address operational risk in order to achieve the lower capital charge.

7. Capital Charges for Advances. ABA continues to support lower capital charges for the credit risk of advances than is proposed. In particular, we request that the charge should not rise with the maturity of the advance. Conversations with staff suggest that the FHFB does not expect the proposed capital charges to impact advance pricing; however, good business sense would dictate that any institution would charge more for a service that costs more to provide. Higher capital charges encourage a FHLBank to make fewer longer-term advances or else price them higher. This result conflicts with the primary, historic mission of the FHLBanks to fund long-term home mortgages. No FHLBank has lost a single cent on advances in the 68-year history of the program, there are substantial haircuts on the collateral backing advances, and every advance is additionally backed by the borrower's capital in the FHLBank. For all of these reasons, ABA believes that the capital charges for all advances should be lower and urges the

FHFB to amend the rule to reflect the facts of the FHLBank System, not the theory proposed by Wall Street.

8. Cash Flow Alternative. The proposed rule does not allow a FHLBank to base its management of interest rate risk on the most credible approach to measuring this risk, a cash flow approach. Conversations with the FHFB staff indicate that they believe that any approach a FHLBank uses must be measured against the proposed mark-to-market value-at-risk model, making this the *de facto* standard. As ABA urged in our earlier comment letter, the rule needs to provide the cash flow model as a true alternative. ABA suggests that a cash flow alternative that is thoroughly reviewed during on-site examinations should serve as the primary vehicle to measure and manage rate risk. A FHLBank should not be required to run the proposed value-at-risk model in parallel.

9. 95 Percent Standard. ABA urges deletion of this proposed requirement. Only a small part of any of the FHLBank's portfolios can be readily marked to market. Thus, as we wrote on October 12, the FHFB should delete the proposal to require each FHLBank to hold additional capital in case the market value of its assets falls below 95 percent of book value.

Conclusion

As noted at the outset, the FHFB is to be commended for its significant accomplishment reflected in the proposed capital rules. The development of these rules and the capital plans require all interested participants to work together to make implementation of Title VI of the Gramm-Leach-Bliley Act a success. There will be unexpected issues, yet together we can ensure the successful conversion of an existing, sound Federal Home Loan Bank System to a new, all-voluntary capital basis that meets the primary goals of its members. We look forward to working with the FHFB to achieve these results. If you have any questions please do not hesitate to contact Joseph Pigg (202/663-5480), Dawn Causey (202/663-5434), Keith Leggett (202/663-5506), or Rob Strand (202/663-5350).

Sincerely,

Edward L. Yingling
Executive Director, Government Relations