

October 12, 2000

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

RE: Docket No. 2000-23; 12 CFR 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

Dear Ms. Baker:

The American Bankers Association (“ABA”) appreciates this opportunity to comment on the Notice of Proposed Rulemaking (“NPR”) on the Capital Requirements for Federal Home Loan Banks (“FHLBanks” or “Banks”) issued by the Federal Housing Finance Board (“Board” or “FHFB”) published in the *Federal Register* on July 13, 2000. The American Bankers Association 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 7,500 members of the Federal Home Loan Bank System.

ABA applauds the Board’s prompt pursuit of the legislative mandates contained in Title VI of the Gramm-Leach-Bliley Financial Modernization Act (“Title VI”). The intent of the legislation was to restructure the FHLBank System in a manner that would continue the fundamental purposes of the System while providing flexibility to adjust to an evolving and fiercely competitive financial services industry. The FHLBank System has been and continues to serve as an important source of liquidity for long-term assets. ABA has strongly supported the expansion of eligible collateral for advances as a means of bringing greater liquidity to community financial institutions. The System is a key financial and planning tool for most insured financial institutions in the United States today. The continued success of the System is at the heart of ABA’s comments.

ABA also compliments the Board on its willingness to extend the comment period and to listen to the concerns of the FHLBank System members. To this end, ABA is submitting this letter as an initial comment in order to give the Board greater time to consider alternative approaches to the concerns raised. ABA anticipates filing an additional letter after further discussion among its members on issues such as voting concentration, actions requiring member vote and other issues identified as the comment period progresses.

Our comment letter is divided into three parts: general comments; comments on structure and governance; and comments on risk-based capital.

### **General Comments**

1. **Simplicity**. One of the hallmarks of the proposed rule is its plethora of choices and flexible arrangements. ABA commends the Board on this approach. Flexibility is the key to adaptation and change. However, as the System evolves to the new permanent capital scheme, it is important to keep the process simple. Unduly complex and convoluted twists and turns in this type of rulemaking benefit few. For this reason, several of the FHLBanks have communicated their desire and intention to make their capital plans simple. ABA supports this approach. Simplicity benefits the member institutions by increasing the transparency of the System's balance sheet, easing Wall Street and regulatory concerns. Confidence in the integrity of the System and, therefore in the investment in the stock are paramount. Simplicity is key to maintaining that integrity.
2. **Take the time necessary**. The Board is to be commended for its diligence in pursuing the statutory goals set for implementing the new capital structure. It is even more commendable that the Board has listened to the members and the FHLBanks and granted an additional 40 days for comment. The Board has taken several steps to advance the discussion, including its public hearing on proto-type capital plans. ABA urges the Board to take further steps to ensure that the process moves toward the best resolution and greatest certainty for all participants. Investment in FHLBank stock is a sizeable portion of the balance sheet of many financial institution members. Capital plans must be structured to maximize the value of that asset while providing predictability and stability. To achieve greater certainty concerning this asset, ABA urges the Board to require significant capital comments and detailed, proto-type capital plans from each of the twelve FHLBanks. This approach allows the members to more fully understand the ramifications of the capital proposal in the context of the member's particular FHLBank. This proposal, if implemented, should not diminish the time allowed each FHLBank to submit a capital plan once the proposed rule is finalized. Rather, the purpose is to identify difficulties presented by the proposed rule or statute in enacting a workable plan for each FHLBank. A number of issues were identified with the initial proto-types. The submission now by the FHLBanks of additional detailed proto-type plans will crystallize the issues that the final rulemaking should address from both a FHLBank viewpoint and a member perspective.

ABA supports the Board's actions that recognize the critical importance of providing a regulatory framework for the successful conversion of the System to its new capital structure.

There is only one opportunity to achieve that success. The System needs to take the time necessary without submitting to artificial pressures. Indeed, the conversion of the System from its current ownership structure to the next has been analogized to the mutual-to-stock conversion process overseen by the Office of Thrift Supervision. Even after almost three decades of experience, a single institution's conversion from mutual to stock can take more than one year to wind through the regulatory approval process let alone the actual solicitation of proxies and subscription sale. The conversion of one cooperative system to another, reflecting the voluntary and stock-based permanent capital format of Title VI, likewise needs to move deliberately and carefully. Reacting to the comments collected through November 20, 2000, ABA encourages the Board to enact any rule as an interim final rule, to allow for additional changes, should they be necessary, in the most expeditious manner possible.

3. Tax free is paramount. The process for exchanging the current stock for the new forms of A and B stock must provide sufficient certainty that the result will not cause members to experience a taxable event. While the accounting profession is unwilling to opine in the absence of actual capital plans filed by the FHLBanks, it is important that the FHFBA reviews and approves the stock offerings ensure that, to the greatest extent possible, the stock offerings result in a tax free transaction. Otherwise, the member institutions must significantly adjust their business plans to meet the tax burden. The unintended result, less credit availability due to shrinkage of investment and available advances, could have wide-ranging, negative effects on the economy as a whole. This result will be increasingly likely as financial institutions turn to FHLBank advances as a stable and competitive source of funding. Closing or restricting the availability of advances shifts the financial services competitive landscape to the disadvantage of community financial institutions and the small businesses and families they serve. Tax consequences of the new forms of stock will have a real impact on these institutions.

In every presentation and discussion with accounting professionals and Internal Revenue Service representatives, there are certain factors that make a favorable determination on the anticipated tax treatment more likely. ABA encourages the FHFBA to use these factors in its review and to ensure that FHLBanks have favorable tax opinions in advance of the actual offering of the new stock to the members. This should be part of the plan of conversion or exchange distributed to members in advance of the actual stock offerings. For those institutions that have received stock dividends rather than cash, the need to structure the new stock carefully is particularly acute. In those instances, the initial stock offering may need to be restricted to a class of stock in order to avoid a cashing out of FHLBank investment. ABA encourages the FHFBA to permit sufficient variation among capital plans in order to recognize historical dividend differences and alternative approaches required to achieve the preferred tax result.

4. Preserve the cooperative nature of the System. The FHLBank System was created and operates as a cooperative. It has permitted institutions to thrive and has survived significant economic peaks and valleys, despite the diversion of a portion of its retained earnings. The System is a reliable source of liquidity for long-term assets that has proven its value again and again. Indeed, one of the key reasons for its success is the cooperative nature of the

System. Owners view the use of their property very differently from renters or users. Renters have no interest in making sure that preventive maintenance schedules are maintained; owners care because problems are rooted out and fixed before they become large and expensive disruptions. In the same sense that home ownership has been demonstrated to significantly contribute to the quality of life in a community, cooperative ownership of the FHLBank System has led to greater credit availability, zero advance losses, and an enviable record that returns income to the bottom line of member institutions. A cooperative responds to the needs of its members with new products while anticipating better than any governmental agency the likely sources of risk. Owners take care to use their property responsibly.

Because of the differences between owners and users, ABA opposes the use of membership fees, even as an option. Membership fees change the cooperative nature of the System. All financial institution members, no matter when they join, should be stockowners. Nothing, including the proposed caps on capitalization, should prevent members from purchasing stock. The proposed caps on capital need to be eliminated or a wider range of acceptable capital levels substituted. There are few, if any, incentives in the proposed rule for an FHLBank to be overcapitalized. Elimination of the hard cap or a substitution of a range within which capital may fluctuate provides the FHLBanks with sufficient leeway to allow each new member to be a stockowner. The possibility that any financial institution user of the System would not also be an owner is anathema to the cooperative nature of the FHLBanks.

The lifting of the cap or the substitution of a wide range of acceptable capital also provides the FHLBanks with the flexibility necessary to answer the very fundamental question, "How much does it cost to become a member?" If the cap is left as proposed, there is no easy answer to that basic question other than "it depends." It depends on the timing of the purchase; it depends on the leverage capital of the FHLBank; it depends on how much B stock is sold; it depends on nothing related to the member's commitment to the FHLBank or need for liquidity. That uncertainty erodes investor confidence at both the member and Wall Street level, resulting in higher advance rates, and less liquidity and credit availability. The business of lending is difficult enough without arbitrarily hamstringing the very tools used to manage the risks.

For these reasons, ABA opposes the use of membership fees. We also strongly urge the FHFB to either eliminate the fixed capital caps or substitute a wide range of acceptable capital levels.

### **Structure and Governance**

Using the above general principles of simplicity, preservation of the cooperative nature of the System, and minimization of the tax effect of the structure as overarching goals, ABA has the following more specific comments on the structural elements of the proposed capital rule.

1. State representation is important. State representation recognizes the local nature of the System. Elected directors are currently selected and voted upon on a state-by-state basis. It is a system that attracts the best and the brightest among the membership. It is an honor and vote of confidence of members' peers to be elected a director of an FHLBank. The responsibility of representing the members is keenly and deeply felt. To abandon this functioning, existing infrastructure (particularly for nominations) gains little and loses much. The current system works and delivers effective member representation and quality directors. ABA urges the FHFBS not to alter the existing state-by-state representation established by each Federal Home Loan Bank.
2. Size diversity is the goal of each FHLBank. ABA understands and supports the need for boards to reflect all sizes of institutions. The median member institution of ABA is \$69 million in assets. The FHLBanks have worked to have representation of all members on their boards. Size diversity is a goal each FHLBank takes seriously and actively works to achieve. ABA supports these efforts at the FHLBank level and encourages the FHFBS to devolve these types of governance issues to the individual FHLBanks. Adding more size categories to a state-by-state representational system creates complexity when simplicity is called for. The current method for electing FHLBank directors works and results in diverse representation from the membership. Until there is a change in the membership, use of the existing state system achieves the underlying goals of the FHFBS for FHLBank directors without additional layers of requirements. Complexity in voting frustrates the very ideals the FHFBS is seeking to achieve. ABA strongly urges the FHFBS to provide a simple approach that allows the existing state-by-state method to continue while encouraging each individual FHLBank to achieve diverse representation on its particular board of directors.
3. Tradability is problematic. ABA supports redemption of both A and B stock at par value. To allow the stock to fluctuate and reflect a market value would almost certainly lead to fair value treatment of the stock, and 100 percent risk weighting for risk-based capital purposes. This is too much of a shock to the balance sheets of System members. The volatility associated with such a mark-to-market approach may cause the stock of several different FHLBanks to be valued differently. This poses too great a risk to the System, particularly when coupled with joint and several liability. Additionally, ABA believes that tradeability starts the System on the path to privatization. Accordingly, ABA urges the FHFBS to require redemption at par with the FHLBanks acting as their own stock transfer agents.

One related issue, forced redemption by the FHLBank, should be addressed by the final rule. ABA urges the FHFBS to require FHLBanks to give three months notice to members whose stock holdings are subject to a forced redemption. This notice period allows the affected member to adjust holdings and balance sheet items to reflect the changed investment. This is the flip side of the member institution redemption issue and merits inclusion in the final rule.

4. Consolidation and the need for a transition. ABA suggests that the FHFBS add to the final rule a transition period and process to deal with member institutions consolidating across FHLBanks. A transition period would allow the FHLBanks to minimize the disruption that a sizeable consolidation could have on the availability of advances or capital levels. Additionally, this gives predictability to the process and allows sound management of the balance sheets of the FHLBanks and their members. There are examples of transitions provided throughout banking (including consolidation of deposit accounts and availability of FDIC insurance), and ABA suggests that this is an even more appropriate area to provide a transition. While ABA recognizes that the FHFBS has the authority to order a transition on a case-by-case basis if safety and soundness were impacted, a general rule providing an orderly transition process of up to one year (with no requirement to take the full year if less time is needed) would benefit all System members.
5. Stock certificates are unnecessary. In this age of digital signatures, wire transfers, and electronic commerce, the production of actual stock certificates is unnecessary and even a burden. Most members are quite comfortable with allowing their stock ownership to be maintained on the books of their FHLBank without the need for a physical reminder, i.e., a certificate. Accordingly, ABA suggests that the FHFBS not require maintenance of actual certificates.
6. Manipulation of Class A dividend is unlikely. The proposal suggests that the Class B stockowners may be motivated to manipulate the Class A dividend in a manner that would disadvantage the Class A owners. ABA respectfully suggests that this is a self-correcting problem if and when it arises. Simply put, if Class A shareholders believe that they are being disadvantaged, they can redeem their stock in a relatively short time frame (six months). As Class A is more like preferred stock, the rights and returns of Class A stock are more likely to reflect investment desires and preferences of its holders and are more likely to be stated in greater detail in any offering prospectus or circular. These holders will quickly abandon the stock if it fails to meet expectations. The more likely result will be significant efforts by the FHLBanks to ensure that the Class A stock receives the dividends promised.
7. Subclasses. The proposal permits the FHLBanks to split the A and B stocks into subclasses and to create activity-based stock. ABA appreciates the creativity and flexibility this approach provides; however, it is important for the cooperative nature of the System that the subclass and activity-based stock benefit not just the holders of those stocks, but the particular FHLBank membership as a whole. Selective benefits restricted to a particular subclass could cause the cooperative approach to fracture along subclass lines. If, for instance, a member is a large user of a particular product supported by activity-based stock, it is easy to anticipate that the owner of that stock would prefer that the benefits gained flow directly to the holders of that subclass of stock. The cooperative nature of the System means that the members benefit as the FHLBank benefits as a whole. The System should allow for special advantages provided only to those able to

invest in product specific subclasses. The ability to “cherry pick” gains via subclass offerings needs to be carefully monitored.

8. Regulatory treatment for capital purposes. It is clear from discussions with the federal banking regulators that the issue of risk weighting for FHLBank stock will not be resolved in the near term. Delay is unfortunate, and ABA urges the FHFb to take all steps possible to assist the agencies in their deliberations. The issue, whether the stock will continue to merit its 20 percent risk weighting or whether the stock will move to the one hundred 100 percent risk weighting, has enormous implications for FHLBank System members. The importance of this issue cannot be stated strongly enough. Member financial institutions need the assurance that their FHLBank holdings will continue to receive the favorable, 20 percent risk based capital treatment. There are characteristics identified by risk-based capital experts that make a favorable treatment of the FHLBank stock more likely than not. These characteristics are important features to be included in the FHLBank capital plans and stock offerings. While nothing is certain, if the FHFb, the FHLBanks and the industry members work together, it is possible to maintain the current risk weighting. ABA encourages the FHFb to maintain an open dialogue with all parties in order to achieve this desired result, and ABA is committed to work with all parties to achieve the lower risk-based capital treatment.

### **Risk-Based Capital**

The risk-based capital standards being developed are intended to promote the safety and soundness of the FHLBanks. ABA is concerned that the proposed standards may be excessive to the point of being at odds with this goal. If too much capital is required relative to the risk exposure, then the FHLBanks will not be able to offer their services competitively and pay attractive dividends to keep members. If members leave the System, now that membership is voluntary, the FHLBanks’ capital bases and soundness will be undermined.

The financial health of each of the twelve FHLBanks is of as much concern to ABA and the System members as it is to the FHFb. System members rely heavily on the FHLBanks for advances and other products to support liquidity and risk management. Therefore, it is essential that the capital standards be rigorous, but not onerous. We feel that the proposed standards can be altered in certain ways to promote the soundness of the FHLBanks as well as help them serve their member banks. Specifically, we suggest that:

1. The risk-based capital rule should take account of the tendency for market and credit risk to offset one another in mortgage and other assets.
2. Regulatory oversight of operational risk should be based on strict supervision, not the proposed capital charge.
3. The credit risk charges for advances should reflect the conservative collateral requirements and should not rise with maturity.

4. Letters of credit to System members should be treated as “contingent advances” for capital purposes.
5. The capital requirements should explicitly accept a cash-flow test, with no preference for a market value stress test.
6. There should not be a requirement for capital to cover any deficiency between market value and 95 percent of book value.
7. Requiring 100 percent capital backing is excessive for non-mortgage, non-advance assets where there is a realistic chance that the asset will not default, or that there will be, at worst, partial recovery in case of default.
8. FHLBank borrowing should not be limited based on a member institution’s capital.

These suggestions are more fully explored below.

#### Overall Risk Measure

The proposed risk-based capital requirements are based on a peculiar measurement of total risk. The measurement adds up measures of credit risk and market risk, and then imposes an add-on for operational risk as a multiple of the combined credit and market risks. This basic approach substantially overstates and misstates risk in a number of ways.

First, credit, market, and operational risk are not simply additive. Credit and market risk, in particular, can largely offset one another for certain assets. For example, for home mortgage assets, declining interest rates tend to increase prepayments, thereby lowering credit risk but increasing market risk (and *vice versa* for increasing rates). If the risk measure fails to take into consideration this kind of negative covariance then it is inaccurate and biased toward overstating risk.

Importantly, the risk overstatement will hinder the development of FHLBank activities. In particular, it will discourage extension of the Mortgage Partnership Finance programs by increasing the capital charge for mortgages taken into portfolio by the FHLBanks.

Second, ABA adamantly disagrees with the operational risk measure. The proposed standard would simply apply a 30 percent surcharge for credit and market risk; the 30 percent could be lowered to, at best, 10 percent with appropriate modeling and insurance. However, there is no logic to assuming that operational risk is directly related to credit or market risk. In fact, a challenge for operational risk is that it has not been explicitly defined in the proposal or elsewhere. This risk will be difficult to quantify until it is defined. The general notions of such risk, however, are that it is event-specific, for events that are not linked to credit or market risk.

Since operational risk has not been reasonably defined or measured, the surcharge really accomplishes nothing except for unjustifiably raising capital requirements.

It is, nonetheless, important for the FHFb to assure the safety and soundness of the FHLBanks against operational risks. Since a capital charge will not be functional until these risks are closely defined and then submitted to measurement, a better way to assure that the FHLBanks manage these risks is through careful supervision. It is essential that the examiners pay careful attention to the plans that the FHLBanks have in place in case an unexpected, catastrophic event occurs.

### Advances

Given that no FHLBank has ever lost a cent on advances in the 68-year history of the System, the FHFb is justified in setting lower capital charges for this asset than for any other, aside from cash and Treasury securities. However, the capital charges are still too high. The matter is important because unduly high capital charges undermine the FHLBanks' primary function of extending advances to finance bank lending for mortgages and consumer, small business, and community development loans. This is a particular problem for advances to fund longer-term home mortgages because the proposed capital charges escalate for longer term advances.

The capital charge for advances should be lower than proposed because advances are already well protected by collateral and capital investments by member banks. The FHFb has always imposed conservative collateral requirements for advances to finance mortgages and has recently adopted similar conservative collateral requirements for advances for small business and farm lending. Collateral and capital have the same function: to protect against credit risk. Therefore, consideration should be given to the interplay between the collateral requirements set by each FHLBank and the credit risk capital standards.

As proposed, the capital charge for the credit risk of advances rises with maturity. However, it is not clear that credit risk rises with maturity. As an example, suppose that a bank borrows from a FHLBank through two advances, one for three years and another for fifteen years. From one quarter to the next (when a FHLBank must reconcile its capital), the chance of a default on the fifteen-year advance is no higher than on the three-year advance. Therefore, while a longer-term exposure on an advance justifies that capital backing be held for longer, it should not require more capital. Certainly, there is more interest rate risk for longer exposures, but this risk should be handled by the interest rate (or "market") risk capital requirements, and not doubly penalized by a higher credit risk capital charge as well.

Moreover, advances are also directly backed by stock investments in the FHLBanks. If an institution defaults on an advance, the FHLBank completely offsets the loss by writing down the institution's stock investment in the FHLBank. Since advances are limited by the amount of stock held in a FHLBank, it is unlikely for a default to yield a net loss. The combined conservative collateral and capital investment backing of advances should be factored into the capital charges, justifying a lower or even zero charge.

By the same principle, the proposed capital charge is too high for off-balance-sheet exposures of letters of credit (“L/Cs”) to FHLBank member institutions. The FHLBanks call such L/Cs “contingent advances” and impose the same collateral and capital-investment requirements on them as advances. Therefore the capital requirement for L/Cs should be changed to that of advances, adjusted by a “credit conversion factor.”

Recent and valuable initiatives by the FHLBanks have elevated the import of the capital charge for L/Cs. These L/Cs now provide credit enhancement for banks’ asset-backed bonds and protect banks’ municipal deposits, activities that further the FHLBanks’ primary mission to enhance bank funding and liquidity. Therefore, it is critical that they are not impeded by disproportionately high capital charges.

### Market Risk

The proposal sets a capital standard for market risk (essentially interest rate risk) that could fit the FHLBanks’ portfolios if there were active secondary markets for the assets therein. However, since no more than a quarter of the assets of any of the FHLBanks fill this profile, this approach is not workable. The proposal needs to be amended to explicitly accept a cash-flow test – without preference for the proposed value-at-risk (“VAR”) test and without a requirement to make up any deficiency of market value below 95 percent of book value.

The proposed market value capital requirement is based on a VAR stress test. In fact, the largest commercial banks with significant holdings of trading securities use VAR tests – but only for the “trading book” of assets that can be traded in active secondary markets. No institution uses a VAR model to measure a risk exposure for its illiquid “bank book.” The advances that comprise most of every FHLBank’s portfolio resemble “bank book” assets in that they are not traded. Since there is therefore no way to reliably establish a current market value for such assets, the uniform VAR stress test should not be the standard. Instead, a cash-flow model that is verified by on-site examination is more appropriate to the positions of the FHLBanks.

Even more troublesome is the proposed requirement that each FHLBank hold capital to cover any deficiency of its market value below 95 percent of book value. The mostly illiquid portfolios of the FHLBanks’ cannot be reliably marked to market value. There could therefore be constant disagreements with examiners over whether a FHLBank is in compliance with this standard. Moreover, while such a standard can be appropriate for an institution that is subject to being liquidated at face value at any time (such as a mutual fund), it is not appropriate to the FHLBanks. The explicit purpose of the Gramm-Leach-Bliley reforms was to create a FHLBank System with long-term, stable capital that cannot be suddenly liquidated.

### Unrated or B-or-Lower Rated

Under the proposal, banks would have to hold capital dollar-for-dollar with assets that are not advances or residential mortgages if such assets are not rated by a national rating agency or are rated B or lower. The presumption of this treatment is that every cent invested is expected to be lost. While conservative treatment is warranted, one hundred percent capital backing is excessive for many non-mortgage, non-advance assets where the bank can demonstrate that there is a realistic chance that the asset will not default, or that there will be, at worst, partial recovery in case of default.

The issue is important because excessive capital charges will discourage some worthwhile new programs of the FHLBanks. For example, some of the FHLBanks have initiated programs to purchase portions of loans to community economic projects or to fund community development. Other programs that have been discussed include investment in Small Business Investment Companies (SBICs). This prohibitive capital charge will preclude such constructive programs.

### Limit on Federal Funds Transactions

The proposal would limit a FHLBank's borrowing to fifteen percent of the lender's capital. This provision can be removed without any impact on the soundness of the FHLBanks, as there is no risk to a FHLBank if a lender were to lend a larger amount. A FHLBank will not be financially affected by default of a bank lender, no matter how much is loaned by the bank, because the FHLBanks have ample alternative sources of funding.

This restriction would, however, impede FHLBank activities in the Federal funds market, where the FHLBanks are now active participants. This limit would most likely come into play in Federal funds transactions with large, regional banks. Interestingly, there are no restrictions in bank regulation for a bank lending to another in the Federal funds market. Therefore, it is not clear why the provision should be imposed on FHLBanks either.

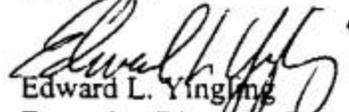
### Conclusion

As noted at the outset, the FHFBI is to be commended for its significant accomplishment reflected in the proposed capital rules. There are several areas where no answers are yet to be found or where further work is warranted. ABA urges the Board to take the time needed to give greater certainty to the process and ensure the conversion of an existing, successful Federal

Elaine L. Baker  
October 10, 2000  
Page No. 12

Home Loan Bank System to a new, all-voluntary, stock, capital basis that is also successful and 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