**STATEMENT of Paul B. Héroux**
**Senior Vice President and**
**Chief Credit Officer**
**of the Federal Home Loan Bank of New York**
**before**
**the Federal Housing Finance Board**
**at the**
**Hearing on Federal Home Loan Bank Unsecured Lending**
**Business Activity Risk Management Practices**

**Washington, DC**
**March 12, 2003**

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Mr. Chairman, Directors O'Neill, Leichter, Mendelowitz, and Weicher, I am Paul Heroux, Senior Vice President and Chief Credit Officer of the Federal Home Loan Bank of New York. On behalf of management at the Bank, I thank the Federal Housing Finance Board for the opportunity to present our views. I have been an employee of the Home Loan Bank for the past 19 years and have served in several capacities. I have been involved with various elements of credit and credit risk management since 1990. Today, as Chief Credit Officer, I oversee the Credit Risk Team of the Bank and provide oversight on all credit and credit risk related matters for the organization. We appreciate the opportunity to present our thoughts on the subject of extending unsecured credit through our liquidity and money market investment activities.

This is actually not the first time that testimony on the topic of the New York Bank's investment activity in money market instruments has been provided to the Finance Board. On May 11, 1998, Alan Williams, the former Vice Chairman of the Board of Directors for the New York Bank, addressed the then current Chairman and Finance Board Directors. I believe Director O'Neill was present for that public hearing as well. (You have excellent staying power, sir!)

At the time of the 1998 testimony, the Finance Board's focus was on the asset compositions within the balance sheets of the Home Loan Banks. In particular, the interest was in promoting a preference for higher proportion of assets originated by members, and a lesser concentration in non-mortgage assets -- specifically, money market investment activity. In this regard, the New York Bank fully supported the Finance Board's efforts at that time and continues to support that concept today. In fact, the New York Bank's focus on mortgage-related assets, as well as its preference for member-generated assets, can be best demonstrated by the numbers. In 1998, our Board of Directors adopted a mortgage-related asset target of 80% - 90% of consolidated obligations. Non-mortgage assets, at that time were approximately 15% of total assets, while member-generated assets were 58% of total assets. Today, non-mortgage assets are approximately 5% of total assets, member-generated assets are in excess of 75% of total assets and mortgage-related assets are at 97% of the New York Bank's consolidated obligations. As you can see, our support and commitment to this effort and our housing mission has been consistent.

However, faced with the possibility of imposed limits on liquidity and money market investments, Vice Chairman Williams, in his 1998 testimony, raised some key concerns in support of maintaining the New York Bank's then current level of these investments. These concerns included:

- The ability to generate the necessary amounts of other asset types required to fulfill our financial and housing missions, while replacing anticipated reduced levels of money market investments;
- The need for financial flexibility to prudently manage our liquidity needs;
- The need to achieve appropriate levels of investment earnings that help produce competitive prices for advances and that are necessary to fund an active Affordable Housing Program; and
- The need to productively leverage the overabundance of capital provided through the System's statutory capital requirements.

Many of these management challenges remain today. However, I am pleased to be sitting before you, and expressing my appreciation, on behalf of the New York Bank for the work that has been accomplished since that public hearing in 1998. For example, modification of the REFCORP formula, accomplished in 1999, now eliminates the risk that the fixed annual assessment could overwhelm the Home Loan Banks' earnings. Further, the rationalization, in statute, of the Home Loan Banks' capital structure was also successfully accomplished through the direct efforts of the Finance Board and staff.

We are now only a few months away from realizing a significant reduction in capital as we move toward the implementation of the New York Bank's Capital Plan. Approved by our Board of Directors and the Finance Board last July amid great ceremony and celebration, the Plan will be implemented on October 1st of this year. With this implementation, the long-standing, mutual interest of the Finance Board and the New York Bank will be accomplished – that being the ability to maintain a balance sheet driven by the business needs of our members, rather than by the 1932 capital structure.

This will also result in a notable reduction of non-mortgage assets at the New York Bank – or in today's lexicon – the reduction of unsecured extensions of credit at the New York Bank. Upon implementation of the new capital structure, our business plan projections estimate that approximately 10% of the Bank's existing capital will be returned to members -- enabling the Bank to reduce short-term money market investments by approximately 40% from current levels. This is the direct result of having designed a more efficient and effective capital structure, made possible under the new statute.

This now brings me to the point of addressing your present concerns, as we understand them in New York.

The New York Bank uses the short-term money market investments for several key balance sheet management purposes:

- To meet its operational and contingency liquidity regulatory requirements
- To produce a reasonable return on excess cash positions; and
- To maintain a targeted leverage ratio to meet established earnings targets and balance sheet objectives.

All of these activities are quite normal and essential uses of short-term money market investments for any financial institution. The New York Bank's views expressed in 1998 on the matter of determining the level of liquidity and investments, remain largely the same today – it is fundamentally a management issue, to be determined by the Board of Directors and management, consistent with safe and sound operations and the pursuit of strategic business objectives.

At this time, the New York Bank limits its money market investments to overnight and term Federal Funds activities, and domestic and foreign bank Certificate of Deposits. While permitted by regulation, the Bank does not currently invest in commercial paper.

It should be noted that, while investments in money market instruments do entail extensions of unsecured credit, this activity is viewed by the Bank as first and foremost an investment activity – <u>not</u> a lending business.

The New York Bank fully recognizes that this short-term investment activity is not without risks -- however limited such risks may be. As such, the application of sound and conservative risk management practices is a cornerstone to our efforts in constructing and maintaining a secure money market portfolio. Once again the Finance Board has provided significant guidance in this effort through the issuance of updated regulations and conservative exposure limits. The New York Bank has adopted this regulatory framework and has gone one step further in establishing its own, more conservative, credit policies and tolerance levels, that satisfy our internal business objectives while also remaining in full compliance with existing regulations. In all cases we have taken a more conservative approach than allowed for in the Regulation. For instance:

- The Finance Board's regulation does allow for investments with counterparts rated "triple B" by a Nationally Recognized Statistical Rating Organization, while our internally established risk tolerances prohibits any new investment activity with counterparties rated below "single A", including any counterparty rated "A minus" that has been placed on negative watch for a possible rating downgrade.
- In addition, the minimum capital required for eligible counterparties at the New York Bank is set at $500 million -- $250 million above the regulatory allowed minimum capital level.
- The New York Bank does not invest with "mono-line" banks – such as credit card banks -- nor with counterparties domiciled in countries judged to be subject to political instability or greater than normal economic uncertainty. Currently the Bank predominantly invests in money market instruments with U.K., German, and Canadian Banks.
- Besides the established "hard" policy limits, the Bank also operates under a current internally established "desk limit" that places a cap on total short-term investments with any one counterparty, or group of affiliated counterparties, at $500 million. As a percentage of current Bank capital, this fixed-dollar "desk limit" cap is currently at 11%.

Finally, the Bank maintains a general practice of not lending to its own members in the unsecured markets – However, an exception may be made from time to time for a member that was an unsecured counterparty with the Bank prior to becoming a member. In these exception cases, the exposure limit is capped at $50 million.

At one time, the Bank had a more active unsecured lending relationship with some of our larger member institutions that had access to the money markets. However, several years ago, the Bank developed an advance product that would provide the same pricing opportunity available in the Fed Funds market. The impetus of this product was to satisfy the borrowing needs of larger members who were actively borrowing in the unsecured money markets, including borrowing actively from other Home Loan Banks. This product has been very successful in converting money market borrowings by members into secured advances with the Bank. We always feel better when we have collateral!

The New York Bank also places funds with other Home Loan Bank System members. These are generally banks with whom such relationships with the New York Bank pre-dated their FHLBank membership. These HLB System member counterparties must also meet the New York Bank's internal capital and rating minimum requirements cited earlier. It is clear that for these members of other Home Loan Banks and for the banking system as a whole, that the Home Loan Banks' money market activities serve as an important bridge between institutional sources of funds and the banks across the nation. Although it should not be a prime focus of policy, this fact should be taken into account as a policy consideration, perhaps in consultation with the Federal banking regulators.

Consistent with the New York Bank's conservative approach to this investment activity, over 55% of the counterparties with whom the Bank currently invests have long-term debt ratings of "double A minus" or better. The remaining active counterparties carry long-term debt ratings of "single A". We understand that the regulatory focus on long-term debt ratings, as opposed to short-term debt ratings, is another of the Finance Board's methods of ensuring the existence of conservative limits. However, from a risk management perspective, a more appropriate indication of true risk in short-term money market investments is the short-term debt rating of the counterparty. The short-term rating indicates the degree to which the counterparty has the capacity to meet its financial commitments over a 12-month horizon. By this indicator, all but one of our active money market investment counterparties are rated at the highest short-term ratings – A1/P1 – and in fact, half are rated A1+ by Standard & Poors! This indicates that the counterparty's capacity to meet its financial commitments on these short-term obligations is "extremely strong".

According to Standard and Poors, the probability of default for short-term investments, up to the one-year horizon, with counterparties rated A1+ or A1, is two tenths of one basis point -- or two one hundred thousandths of one percent. By way of comparison, assets of the same nature as the Home Loan Banks' money market portfolios are held by money market mutual funds. Although never guaranteed or even stipulated, the expectation of money market mutual fund investors is that their net asset values will remain stable at $1 per share – an empirical observation that suggests that the risks associated with high-quality short-term investments are also judged, by the marketplace, to be extremely low.

In June of 2000, the Federal Home Loan Bank of New York implemented a new risk management-focused organizational structure. After 2 ½ years of experience with this new structure, Bank Management is convinced of its effectiveness at managing risks, and the positive impact that this new risk management structure has had in helping the Bank meet its mission as well as enabling successful achievement of high shareholder value.

A good example of how this risk team structure has been effective in controlling risks is in the management of the unsecured credit exposure stemming from the Bank's money market investment activity. The Credit Risk Team has established Credit Policies, approved by the Board of Directors, as well as certain Operating Standards that stipulate the standards and risk tolerances by which this activity will be conducted.

As mentioned earlier, all of these risk tolerances have been set at more conservative levels than those allowed for by the Finance Board regulation. The Credit Risk Team has obtained the necessary tools to properly monitor, analyze, and control levels of credit exposure with approved counterparties. With our own subscriptions and access to various Rating Agency services, as well as access to published quarterly financials on the Bank's counterparties, the Credit Risk Team has significantly reduced its reliance on counterparty data from the Office of Finance. In addition, more in-depth financial analyses are conducted on counterparties as determined by risk events identified through news and industry channels or due to identified concentrations that may lead to higher risks. As always, improvements can be made and the Credit Risk Team continues to explore new methods of assessing, managing, and reporting on credit risk, including the review of additional analytical models to supplement existing resources. The New York Bank Board of Directors is kept well informed through various management reports on a regular basis.

It has come to our attention that concerns relating to the level of investment activity with foreign counterparties have surfaced. It should be noted that the Home Loan Bank of New York generally prefers to invest in short-term money market instruments that are readily marketable – i.e., liquid. The New York Bank has a particular preference for Domestic and Yankee certificates of deposits due to the presence of an active secondary market for these instruments. Yankee CDs are deposit certificates issued in US dollars by US branches of foreign banks. The use of foreign banks enables the Home Loan Banks to diversify its credit risk throughout the markets. The fact that the wholesale CD market is predominantly foreign means that foreign banks are generally the most efficient and effective counterparts to use when managing short-term assets and liabilities.

Our ability to place funds with foreign banks provides the corresponding ability to liquefy these assets through repurchase agreements, or liquidate then in the secondary market, should it become necessary. Term Federal Funds on the other hand, because they are not certificated, are not able to be pledged or transferred in the secondary market, and therefore would not offer as much liquidity flexibility as CDs. The New York Bank therefore invests in CDs predominantly with foreign Banks and invests in Term Fed Funds predominantly with domestic counterparts. This enables the Bank to make the most efficient use of available markets while also adding much needed diversity to its investment portfolio.

As mentioned earlier, the New York Bank predominantly does money market investments with U.K., German, and Canadian Banks. Of the Bank's 12 foreign counterparties with whom we actively invest, 9 are rated A1+/P1 by S & P and Moodys, while the remaining 3 are rated A1/P1. These are the highest ratings that can be achieved and they represent a very low risk due to the financial strength of the issuers and the short-term maturity of the investments. Reducing the Home Loan Bank's activity with foreign banks may have the unintended consequence of hampering the Bank's ability to properly manage its liquidity compliance requirements – specifically in terms of Contingency Liquidity. This will be even more important upon the implementation of the Bank's new capital plan, under which we expect the level of short-term investments, on average, to be lower than current levels, driven mainly by liquidity needs.

We believe the regulatory structure promulgated by the Finance Board to address unsecured credit exposures is conservative, and somewhat more so as applied by the New York Bank. One might conjecture that, if the Finance Board's policies are conservative at the individual Bank level, the same must be true when the policies are applied across all 12 Banks. But it is my understanding that the Finance Board has a particular interest in the issue of credit exposure with individual counteparties commonly used across the Home Loan Banks, including system member counterparties. The New York Bank shares that interest and has been working with other Home Loan Banks on several fronts to understand the implications for the System of its money market investment activity. Efforts are currently underway among all of the Home Loan Banks, at the Bank Presidents level, within the Financial Officers group, and within the Credit Officers group.

First of all, the New York Bank is in full support of achieving a reasonable and viable approach that would enhance the Banks' capacity for regular and timely monitoring of collective exposure levels with individual counterparties. With rapidly improving and accessible communication technology, it may be possible to coordinate "end-of-day" or "next-day" activity and exposure reporting across the 12 Banks. We are fully prepared to contribute to this effort with the incentive of receiving more timely and comprehensive information that can be incorporated into our own internal risk analysis and decision making process.

“Awareness” is a fundamental and critical component of any prudent risk management effort. This is as important for the Home Loan Banks in managing counterparty and portfolio risks as it is for the Finance Board in promulgating an appropriate safety and soundness regulatory framework. Armed with heightened awareness of actual current risk exposures across the Home Loan Banks, prudent investment and credit risk managers can implement appropriate business strategies that reduce risk levels, while supporting the independent business objectives of individual Home Loan Banks.

While on the surface, the idea of imposing exposure limits on individual counterparties across all Home Loan Banks seems logical, we urge the Finance Board to continue conducting a careful and comprehensive examination of all possible implications to this course of action. The imposition of such limits that would apply across the12 Banks necessitates the development of an allocation methodology – a complicated and potentially unwieldy endeavor to say the least. However, more importantly, applying an allocation process to this liquidity and investment management tool for individual banks, will likely result in unintended but very real negative consequences. Allocation of a scarce resource will result in an inefficient utilization of that resource. In particular, pricing regimes could be compromised and increased competition among Home Loan Banks could be introduced. Both are undesirable conditions that could introduce safety and soundness issues for individual Banks and the system.

A clear understanding of the true level of risk inherent in short-term money market investments to highly rated financial institutions, needs to be understood before making determinations that will lead to individual counterparty limits across all Home Loan Banks. The various inquiries received from Finance Board staff, and this public hearing, are evidence that the Finance Board is dedicated to gaining comprehensive understanding of this subject. We appreciate your diligence in this regard. It would certainly be appropriate to devote some effort in re-assessing the current limits as set forth in the regulations.

The New York Bank generally considers regulatory limits as a framework within which we establish our own appropriate limits -- that do not exceed the regulatory limits, but that are directly responsive to internal business objectives and risk management principals of the New York Bank. Prudent changes contemplated to current limits on unsecured extensions of credit, that also take into consideration FHFB-imposed liquidity requirements, should have no material impact on the New York Bank's ability to conduct its business. As stated earlier, lower levels of money market investments are part of our business plan for later this year – upon implementation of our new Capital Plan.

A subcommittee of the Credit Officers group is currently exploring the possibility of a shared practice for not only monitoring nominal levels level of credit exposure, but also using credit analytical models, and statistically derived default probabilities of individual counterparties, to perform portfolio analytics at the Home Loan Banks' collective portfolio level -- and at the individual Home Loan Bank's portfolio level. Having this information would enable Banks to identify and quantify the sources of portfolio risk within their pool of active counterparties, and it would provide knowledgeable opportunities to choose other counterparties that would add diversification to the portfolio – resulting in lower overall portfolio risk levels. These analytical tools and the data needed to feed into the models are sophisticated and costly to implement. Resource sharing among the Home Loan Banks can lead to several positive outcomes including – lower costs, free exchange of ideas and solutions to common challenges, and continuity of best practices. However, we do realize that this is a regional system and the independence of the individual Home Loan Banks is real, needs to be recognized, and taken into account.
The New York Bank supports further study of this approach toward enhanced monitoring, and views cooperative joint ventures among Home Loan Banks as an example of good inter-Home Loan Bank practice.

We remain open to other alternatives and suggestions. However, we maintain a strong preference for creating an appropriate set of practices that clearly <u>raises the level of</u> <u>awareness</u> for all Home Loan Banks. Awareness of risk exposure across the System and at individual Home Loan Banks – both at the individual counterparty level and at the portfolio level. We support a cost-effective approach that provides opportunities to identify sources of credit risk within individual bank portfolios and within the collective portfolios of the Home Loan Banks. We support an approach that identifies options for risk mitigation strategies and that allows each individual Home

Loan Bank to implement the appropriate risk mitigation strategies that are consistent with its respective independent balance sheet management policies and practices, while also contributing to prudent risk management among the Home Loan Banks.

The New York Bank does not support a centralized money market portfolio manager approach, or any similar approach that would lead to prescriptive portfolio management directives from a centralized source. Prior to considering that as an alternative, we should first work to resolve the issue of timely gathering and dissemination of Home Loan Bank money market investment activity, and we should strive to establish "best practices" that will serve as a guide for each Bank to follow, in contributing to the prudent management of risks within, and among, Home Loan Banks.

We at the Home Loan Bank of New York are confident that the Home Loan Banks and the Finance Board can work productively together in the development of policies and practices that will best serve and protect the System, while enabling each independent Home Loan Bank to continue fulfilling its mission and meeting the unique needs of its respective district.

On behalf of the New York Bank management and staff, thank you once again for allowing us to share our views on this important subject.