Building Blocks
FEDERAL HOUSING FINANCE BOARD

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Ruling Expected Soon

Chairman Addresses "Commonality" Issue in Capital Standards Rule

(Federal Housing Finance Board Chairman Allan I. Mendelowitz addressed the America's Community Bankers 2001 Government Affairs Conference April 3 in Washington, DC. The following is an edited text of his remarks.)

It is an honor for me to be speaking on the same program with distinguished guests like Senator Gramm, Secretary Martinez, Director Seidman and Dr. Malmgren. Besides being a personal honor, my presence is also a very clear signal about how important *your* Federal Home Loan Banks are to your business. I say, "*your*" Banks very deliberately. I have not been at this job long, but it did not take long to realize what a sense of ownership and pride ACB has with regard to the Federal Home Loan Banks.

The Federal Home Loan Banks are remarkable institutions. They're a cooperative source of liquidity for mortgage and community lending. Additionally, last year the FHLBanks provided over $240 million in Affordable Housing Program grant money. Congress has also recently expanded the role of the FHLBanks to help small community bank-members support agricultural and small business lending. We are beginning to see increasing activity in those sectors and I look forward to seeing more.

I also quickly became aware of how important Federal Home Loan Bank funding has become, particularly for small depository institutions. Our grandchildren may one day wonder what savings accounts were. OTS recently did a study which showed that as deposits have run off to mutual funds and to Wall Street…those funds have been replaced… almost dollar-for-dollar…by wholesale funding in the form of Federal Home Loan Bank advances.

Fueled by that demand for funds, the FHLBank System has expanded to over 7,700 members. You represent over 1,200 of those members who collectively hold 51 percent of the FHLBank System's stock. ACB's devotion of resources and expertise to Federal Home Loan Bank issues and Federal

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New Features Posted To FHFB Web Site

The Finance Board has added to its web site two new features to provide visitors with increased transparency of Finance Board operations.

In January, the agency added links to all board meeting agendas in 2000, and provided links to transcripts of those meetings. That data can be located on the web site at http://www.fhfb.gov/PressRoom/PressRoom_BDTrans.htm. The data is accessible also from the home page by clicking on "Press and Reading Rooms" then clicking on "Board of Director Meetings."

In early February, the board began adding to its web site public documents concerning an on-going issue regarding a bank having membership in two or more FHLBank districts. Those documents can be accessed from the "News" box on the agency's home page. **BB**

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Housing Finance Board regulations is truly impressive. Diane Casey and the ACB staff here in Washington certainly serve their members well.

I want to especially mention the conference that ACB put together last year to discuss what was at the time, the Finance Board's proposed capital rule. I'd like to point to it as a great example of what national trade associations are supposed to do for their members. Just after the legislation passed, discussions began within the FHLBank System about what future Federal Home Loan Bank capital should look like. As many of you may remember, things got pretty contentious.

It's understandable. The proposed rule was some 140 pages long and delved into the most technical and important subjects that exist in the FHLBank System. Your representatives at ACB decided to pull all the parties together in one room to discuss the issues, clarify any misunderstandings and provide a forum for all involved to be heard and to become better informed. The Finance Board learned from the experience, the members learned from the experience and the FHLBanks learned from the experience. It really set the stage for the ultimate crafting of the rule and the conference fits well with the dynamic outreach for Finance Board deliberations to which I am committed.

You've also demonstrated your expertise in FHLBank issues by choosing to title my speech: " Federal Home Loan Banks' Capital Plans: Maintaining Commonality." The industry should give due credit to ACB for coining the term "commonality." It's become a very useful description of what many in the industry, at the FHLBanks, and we at the Finance Board would like to see as the capital plans develop. Before I get to the heart of this subject, it may be useful to define just what a "Federal Home Loan Bank Capital Plan" is.

The process of modernizing Federal Home Loan Bank capital has been underway since Gramm-Leach-Bliley passed in November 1999. That legislation assigned the Finance Board the task of creating a new, state-of-the-art, risk-based, permanent capital structure for the Federal Home Loan Banks. It is the single most dramatic change to the FHLBank System in a decade. And, for those not directly involved on a day-to-day basis, the various statutory requirements and deadlines can appear pretty confusing.

Under the prior legislation governing the FHLBank System, the capital of an FHLBank was not determined by the needs of the FHLBank's book of business. It was calculated according to a subscription formula under which members bought stock based on how big *they* were. Additionally, until just a short time ago, most of you here were *mandatory* members of the FHLBank System and had no choice but to put up the required capital.

At the same time, the asset side of the FHLBanks' balance sheets are about as safe as they can be. The primary assets of the Federal Home Loan Banks are advances, which are fully collateralized by mortgages, with an extra 15-25 percent of collateral tacked on for good measure.

So, a situation developed in which the FHLBank System had loads of capital supporting very little risk. Currently, the FHLBank System has about five times as much capital as it needs on a risk-weighted basis. It is obviously not efficient. Gramm-Leach-Bliley has given us the opportunity to make the FHLBank System more effective and efficient by developing a capital plan that aligns the size of the FHLBank System's capital with the size of and risks on the balance sheets of the FHLBanks.

It's been a long road to get to this point. Last July, the Finance Board unanimously voted to propose the capital rule. We actively sought comments from the banking industry, Congress, and other government departments and agencies. ACB sponsored the conference I mentioned earlier to discuss capital issues.

Last Fall, the Finance Board held a special meeting with the intention of further assisting the FHLBanks and their members in their efforts to better understand the proposed capital changes. As a result of these outreach efforts, the Finance Board was able to develop a capital rule that gained the support of the FHLBanks and their members. In December the Finance Board unanimously voted to approve its final capital rule. We also subsequently issued an Advanced Notice of Proposed Rulemaking (ANPR) to solicit even more commentary concerning potential unforeseen consequences of the new rule. The comment period on that ANPR closes on April 9th and I look forward to ACB's comments.

Now, what is a "Capital Plan?" Publication of the final rule started the 270-day period imposed by statute during which the Federal Home Loan Banks must prepare their specific individual capital plans and submit them to the Finance Board for approval.

The statute provides the framework for those plans. FHLBanks can capitalize themselves by issuing Class B stock, which is considered permanent, and can only be redeemed on five years notice. If the FHLBanks so choose, they may also issue Class A stock, which is similar to the current stock and can be redeemed on six months notice if a member requests it. Class B stock and any retained earnings count as permanent risk-based capital. In recognition of this, it gets additional weight in the leverage calculation. Class A stock can be used to meet the statutory leverage requirement of 5 percent, as long as there's enough permanent capital to support the risk on the balance sheet.

With those statutory guidelines, it sounds like "commonality" should be a cinch. Well, Congress deliberately wrote the statute broadly to allow for the unique characteristics and opportunities within each FHLBank district. Also, there is enough room in the statute to allow FHLBanks to innovate and for their capital plans to evolve over time with the needs of the particular region.

The Finance Board now has to evaluate these capital plans as they are presented over the next seven months. Obviously and without question our first priority will be safety and soundness. Because each FHLBank is part of the FHLBank System as a whole, and they are all jointly and severally liable for each other's obligations, this cannot be done in isolation. This is where commonality comes in. I think of "commonality" as

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New Deadline is July 2

Board Extends Deadline on Rule For Unsecured Credit Limits

On February 28 the Finance Board approved a short-term waiver to allow the FHLBanks until July 2, 2001 to come into compliance with revised limits on extensions of unsecured credit to a single counterparty or group of affiliated counterparties. The Finance Board took this action in response to requests from several FHLBanks. In a separate action, the Finance Board has proposed to amend the unsecured credit regulation as it applies to credit extended by the FHLBanks to government-sponsored enterprises (GSEs). The deadline for submitting comments on the proposed rule is April 23, 2001.

As part of its new capital rule, the Finance Board approved new limits (12 CFR 932.9) on the amounts of unsecured credit that a FHLBank may extend to a single counterparty or group of affiliated counterparties. These new unsecured limits revised and codified the unsecured credit guidelines set forth in the Finance Board's Financial Management Policy (FMP). The Finance Board is proposing to amend the unsecured credit provisions of the capital rule to increase the limit on a FHLBank's unsecured credit exposure to a GSE.

In certain respects, the new unsecured credit limits in 12 CFR 932.9, which are based in part on the credit rating of the counterparty, are more restrictive than those applied under the FMP. In other respects, however, the new rules allow the FHLBanks greater latitude, such as by allowing an extension of unsecured credit to lower-rated counterparties than is allowed under the FMP and by removing maturity constraints on extensions of unsecured credit that apply under the FMP.

Before a FHLBank may extend unsecured credit to any counterparty (or affiliated counterparties) to which a FHLBank could not lend under the credit rating restrictions or maturity limits in the FMP, the FHLBank must obtain the Finance Board's approval under the new business activity provisions of 12 CFR Part 980.

The proposed rule makes clear that the new limits on unsecured credit do not apply to obligations that are backed by the full faith and credit of the United States government, which is the case under the unsecured credit guidelines of the FMP, and that they do not require a FHLBank to unwind extensions of credit that were made in accordance with the FMP before the effective date of the new rule.

The Finance Board adopted the regulatory limits on unsecured credit because the diversification of risk, particularly with regard to unsecured credit, promotes the safety and soundness of the FHLBanks. The specific limits adopted in 12 CFR 932.9 address the increase in credit risk associated with concentrations of credit exposures within the FHLBank System, and generally are consistent with those applicable to commercial banks and savings associations.

Some in the banking industry have suggested, however, that as applied to debt issued by the GSEs, the new limits on unsecured credit may present problems for some FHLBanks. Under the FMP, a FHLBank could maintain an unsecured credit exposure to a single GSE in an amount equal to 100 percent of the capital of the FHLBank. Under the new unsecured credit regulation, an extension of unsecured credit to a GSE would be treated in the same manner as an extension of unsecured credit to any other private counterparty, and as such would be determined based on the long- or short-term ratings assigned to the GSE by a Nationally Recognized Statistical Rating Organization (NRSRO). Generally speaking, GSEs currently receive the highest investment grade rating assigned by an NRSRO which, under Sec. 932.9, means that the maximum amount of unsecured credit that any FHLBank may have outstanding to a GSE cannot exceed 15 percent of the total capital of the FHLBank or of the regulatory capital of the GSE, whichever amount is lower.

Some FHLBanks have indicated that the reduction in the amount of unsecured credit that a FHLBank may extend to a GSE under Sec. 932.9 will cause some difficulty for the FHLBanks in developing new investment strategies that conform to these new limits. Certain of the FHLBanks have indicated that an extension of unsecured credit to a GSE offers a more attractive risk-return profile than other investments, and that a GSE is a better credit risk than other counterparties, even counterparties with an equivalent NRSRO rating, as is evidenced by the premium over corporate debt at which GSE debt trades in the markets. Certain FHLBanks also have expressed concern

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Further Comments Sought on Capital Standards Rule

The Federal Housing Finance Board approved on March 2 an Advanced Notice of Proposed Rulemaking (ANPR) intended to be a vehicle for responding to unforeseen issues or problems that may arise as the FHLBanks implement the new capital rule.

On January 30, the Finance Board published a final rule on the new capital standards, which began a 270-day time period within which the FHLBanks must submit their capital plans to the Finance Board for approval. The ANPR will have a 30-day comment period and does not change that statutorily established deadline. It asks for comment on any issues that arise during the development of capital plans, on actions by other regulatory agencies, or on any other circumstances that could affect the process and require appropriate Finance Board action.

"We want to provide the FHLBanks with all the tools they need to develop optimal capital plans," said Finance Board Chairman Allan I. Mendelowitz. "The final capital rule was designed with that in mind, but we recognize that there may be some unforeseen issues that may require the Board to amend its regulations."

Comments on this issue should be addressed to Elaine L. Baker, Secretary to the Board, 1777 F Street, Washington DC 20006, or emailed to bakere@fhfb.gov. **BB**

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referring to the system-wide impacts that may be inherent in an individual FHLBank's capital plan. In other words, it is important to evaluate each capital plan in terms of possible undesirable consequences for the FHLBank System as a whole.

Consequently, I feel we need to have some critical mass of plans, maybe half, in-house and under evaluation before we approve the first plan and allow a FHLBank to begin implementing it. Also, I think the industry would be best served if the Finance Board's review process were as transparent as possible. We will be providing clear guidance on the process the Finance Board will follow when evaluating plans. Furthermore, I think that each plan that is approved by a Federal Home Loan Bank's Board of Directors and submitted to the Finance Board for approval should be made available on the Finance Board's web site. As with our latest ANPR, which seeks comment on any issue of lingering concern, I think the Finance Board can only benefit from more sunshine and more information.

I would also like to spend a little time and talk about trends in the banking industry. I will not be commenting about any specific applications that are under review or that are expected, just the broader concepts. The way I see it, consolidation in the banking industry is like a snowball rolling downhill. It is picking up speed and growing larger and larger as it rolls. Each Federal Home Loan Bank will eventually be touched by the consolidation that is taking place.

The Federal Home Loan Banks will see large members, and the business that they bring, appear and disappear very rapidly. Some FHLBanks will gain, some FHLBanks will lose, and then the cycle could reverse with the next acquisition. I am not saying that there is a crisis pending. Luckily, due to the relatively long-term duration of advances, the impact of the loss of a large member can be spread over several years. As the advances are paid off and capital is redeemed, the FHLBank's balance sheet will shrink in an orderly and predictable way. Nevertheless, it is prudent to begin now to assess the effects of consolidation. What if a Federal Home Loan Bank loses its two largest members in rapid succession? How about losing three large members? At what point does that FHLBank become too small? How will big nationwide banks interact with the FHLBank System when they have branches, and could probably even get chartered, in each and every Federal Home Loan Bank district?

I look forward to studying questions like this in the coming year. Events have made it unavoidable. The Finance Board has recently assembled a top-notch research department made up of a team of economists with particular expertise in the mortgage market. We now have the capacity to take on these issues and, in consultation with Congress, come up with some predictions and suggestions for the FHLBank System of the future.

I consider a public solicitation of comments to be a useful tool to begin this discussion. I look forward to requesting public comments as we try to develop answers to the question: "What does growing consolidation in the underlying industry mean for the FHLBank System?" It's not an easy issue. We will propose a number of questions and issues that we know should be raised and, we are very interested to hear about concerns that we have not thought about. I encourage every member's participation in this discussion. We're not going into this with a preconceived answer or outcome in mind. Hence, we look forward to your comments and your help.

A great strength of the FHLBanks is their cooperative structure. This structure makes it possible for the FHLBanks to focus their energies and attention on supporting housing finance and community lending by their members in a safe and sound manner. Because the vast majority of members are small institutions with less than $500 million in assets (more than 6,400 of the system's 7,777 members are small), the Federal Home Loan Banks are truly the Main Street GSEs. And, I believe the Federal Home Loan Bank System always wins when members' voices are heard and arguments are judged on their merits.

At the end of the day, and at the end of this speech, I see it as my job to insure that the Federal Home Loan Bank System remains a safe, competitive source of funding for its members well into the 21st Century. Again, it's been my honor to address you today and I thank you for the opportunity.

BB

(**DEADLINE**, from page 3)

that immediate compliance with the new limitations on unsecured credit may cause them to decrease their credit exposure to GSEs while increasing their exposure to counterparties with a lesser credit quality.

Because of those concerns, the Finance Board is proposing to amend 12 CFR 932.9 to raise the limit on a FHLBank's unsecured extensions of credit to a GSE and is requesting comment and supporting analysis concerning the appropriate level for this new limit.

The Finance Board also has requested comment on whether it should amend 12 CFR 932.9 to exclude from the unsecured credit limits the sale of Federal funds with a maturity of one day or less, or Federal funds sold under a continuing contract, which is consistent with the practice of the federal banking regulators with regard to the limits on the amount of credit that a bank or thrift may have outstanding to a single borrower.

Interested parties may send comments on the proposed rule to: Elaine L. Baker, Secretary to the Board, 1777 F Street NW, Washington DC 20006, or by email to bakere@fhfb.gov.

The full text of the proposed rule can be found at http://www.access.gpo.gov/su_docs/fedreg/a010307c.html. Scroll down to Federal Housing Finance Board and click on "Text." **BB**

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