



FEDERAL HOME LOAN BANK OF INDIANAPOLIS

*Building Partnerships. Serving Communities.*

July 2, 2010

*via Federal eRulemaking Portal and  
electronic mail to:  
RegComments@fhfa.gov*

Alfred M. Pollard, General Counsel  
Attention: Comments/RIN 2590-AA32  
Federal Housing Finance Agency  
Fourth Floor  
1700 G Street, NW  
Washington, DC 20552

**Re: Comments on Notice of Proposed Rulemaking for Federal Home Loan Bank Investments (RIN 2590-AA32)**

Dear Mr. Pollard:

The Federal Home Loan Bank of Indianapolis (“Bank”) appreciates this opportunity to comment on the Federal Housing Finance Agency (“FHFA”) notice of proposed rulemaking (“NPR”) that would re-organize and re-adopt existing investment regulations for the Federal Home Loan Banks (“FHLBanks”) that were previously adopted by the Federal Housing Finance Board (“FHFB”). The FHFA is also proposing to incorporate into the new regulation limits on FHLBanks’ investment in mortgage-backed securities (“MBS”) and certain asset-backed securities. These limits are currently set forth in the FHFB’s Financial Management Policy (“FMP”).

The FHFA is seeking comments on whether it should adopt additional restrictions, or lower the overall limit, on the FHLBanks’ investment in MBS generally, and particularly in private-label MBS (“PLMBS”). The FHFA has posed four questions to the FHLBanks pertaining to this issue. We respectfully address each of these questions below for the FHFA’s consideration.

However, initially, we note the significance of the FHLBanks’ ability to invest in MBS. In section 11 of the FHLBank Act<sup>1</sup> (the “Act”), Congress sets forth the investment authorities of the FHLBanks. Over the years, following the establishment of the Act, Congress broadened the FHLBanks’ investment authority to include not only Agency obligations but also “participations or other instruments of or issued by” the Agencies to allow the FHLBanks to indirectly contribute to housing finance, recognizing the FHLBanks as important investors in the secondary market.

The FHFA acknowledged this importance during the most recent credit crisis. On April 3, 2008, the FHFA issued Advisory Bulletin 2008-AB-01 (“2008-AB-01”), which temporarily increased the FHLBanks’ investment authority in MBS, permitting them to “purchase and hold MBS in an amount

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<sup>1</sup> 12 U.S.C. 1431(h)

up to six times its capital, but all MBS purchases must be investments in Agency MBS when existing MBS investments exceed three times capital.” This temporary authority expired on March 31, 2010. According to 2008-AB-01, by allowing the FHLBanks to purchase additional Agency MBS, “the Finance Board intends to further its statutory housing finance mission....” In addition, the FHFB stated: “[T]his action can increase the demand for Agency MBS, the added liquidity could help to restore the market for these securities and could, in turn, lead to lower liquidity premiums, lower mortgage rates, and increased home purchases.” Also in this release, former FHFB Chairman Ronald Rosenfeld stated, “The Federal Home Loan Bank System plays a vital role in helping to finance homeownership and strengthening the economy at large. Increasing the Agency MBS investment authority for the FHLBanks is another way in which the system can perform its traditional mission.” In a separate release, FHFB board member Geoff Bacino noted this quick action by the FHFB should “help alleviate the current crisis in the mortgage markets.” These various statements exemplify the reliance on and implied expectation of the FHLBanks to support the secondary mortgage market through MBS investments. This is especially important in times of market disruptions.

There is a compelling need to restart the secondary mortgage market, and the FHLBanks’ MBS investment authority may play a key role in achieving that goal. As a public policy matter, the secondary mortgage market in the United States cannot continue on a sustainable basis if it consists almost entirely of government-guaranteed loans. There must be a substantial private sector component for prudently underwritten loans, and the FHLBanks can play a critical role as part of the market for MBS. The FHLB system had \$152 billion invested in MBS at December 31, 2009 (\$104 billion Agency MBS; \$48 billion PLMBS).

For these reasons, we believe the final rule, while incorporating reasonable quantitative limits and prudential standards, should be written to preserve sufficient flexibility for the FHLBanks to invest in housing finance. These investments play a significant role for the FHLBank system as we safely and soundly exercise our housing finance mission.

## **I. Quantitative and Other Limitations on MBS**

The NPR proposes to incorporate the current provision in the FHFB’s FMP section II.C.2<sup>2</sup> that limits an FHLBank’s level of investment in MBS and eligible ABS to 300 percent of its total capital into the final rule. We support retention of this limitation. Limits on an FHLBank’s MBS investment authority ensure the FHLBank will not over-emphasize those investments at the expense of advances and, in conjunction with other restrictions on an FHLBank’s MBS investments currently implemented through the FMP, impose reasonable constraints on the amount of interest rate and credit risk an FHLBank will assume through its investment portfolio. The authority to invest in appropriately conservative MBS securities can be seen as serving an FHLBank’s need to invest its capital and excess liquidity to generate sufficient earnings and enhance achievement of the FHLBanks’ primary mission of providing credit to member institutions. MBS investments represent a source of income that enable the FHLBanks to meet REFCORP and AHP obligations, cover operating expenses, build retained earnings, provide their members a reasonable dividend on their capital stock investment, as well as

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<sup>2</sup> A Bank may enter into agreements to purchase MBS, CMOs, REMICs, and eligible asset-backed securities so long as such purchases will not cause the aggregate book value of such securities held by the Bank to exceed 300 percent of the Bank’s capital. A Bank may not increase its holdings of such securities in any one calendar quarter by more than 50 percent of its total capital at the beginning of that quarter.

support the FHLBanks' advance activity. Such investments also help provide stability of operations in the periods when a Bank's core products balances are low.

We request that the 300 percent of total capital calculation be clarified. Specifically, the numerator should include amortized historical cost for HTM and AFS securities and fair value for trading securities. The denominator should include total capital as defined by FHFA regulation §1229.1<sup>3</sup>.

## **II. Limits or Restrictions on the Purchase of PLMBS**

In view of the extensive regulatory and market changes that are underway with respect to any future PLMBS, we believe that establishing specific limits or restrictions with respect to such purchases by the FHLBanks is premature at this time. We are supportive of the PLMBS regulatory and market enhancement principles currently under consideration by the Congress, SEC and federal banking regulators, including:

- Clear regulatory definitions and underwriting standards for traditional prime credit mortgage loans and the requirements applicable to PLMBS backed by such mortgages;
- Additional due diligence requirements for sponsors, servicers, master servicers and trustees participating in a PLMBS transaction;
- Allowing significantly more time for investors to conduct a careful analysis before purchasing PLMBS;
- Increasing transparency by requiring that loan level data regarding a PLMBS transaction that an investor is considering for purchase be provided in a format and manner that is easily accessible by the investor; and
- Requirements for meaningful, detailed ongoing disclosure (including without limitation loan level disclosure) about PLMBS issued.

After these new legislative and regulatory requirements have been finalized, the FHLBanks, like other investors in this market, will have a clearer understanding of the issues they will face as investors in such newly-issued PLMBS. At that point, the FHLBanks will be able to establish prudent risk parameters, limitations and procedures with respect to any future PLMBS purchases through investment policies approved by their board of directors. These risk parameters and policy limits, like other aspects of an FHLBank's credit and investment policies, would be subject to review by the FHFA as part of the supervisory process.

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<sup>3</sup> *Total capital* means the sum of the Bank's permanent capital, the amount paid-in for its Class A stock, the amount of any general allowances for losses, and the amount of any other instruments identified in a Bank's capital plan that the Director has determined to be available to absorb losses incurred by such Bank. For a Bank that has issued neither Class A nor Class B stock, the Bank's total capital shall be the measure of capital used to determine compliance with its minimum capital requirement.

### **III. Characteristics and Restrictions on Collateral of PLMBS Purchases**

On April 12, 2007, the Office of Supervision issued Advisory Bulletin 2007-AB-01, which established expectations for the FHLBanks' pre-purchase analysis and periodic reviews of MBS investments. Subsequently, on July 1, 2008, the Office of Supervision issued Advisory Bulletin 2008-AB-02 that expressed the expectation that the FHLBanks' purchases of private-label MBS will be limited to securities in which the underlying mortgage loans comply with all aspects of the federal banking agencies' *Interagency Guidance on Nontraditional Mortgage Product Risks*<sup>4</sup> and *Statement on Subprime Mortgage Lending*<sup>5</sup>. We are in agreement with the FHFA's proposal that the principles outlined in the interagency guidance and the 2007 Advisory Bulletin, many of which are being expanded in the recent policy changes described in the preceding section, be incorporated into the final rule in keeping with the objective of reorganizing existing guidance that is dispersed over several sources. However, the standards enumerated in these Advisory Bulletins (i.e., representations and warranties) should not be applied retroactively to PLMBS purchases. The mortgage originator should not be held to a retroactive standard through the request to make representations and warranties as to the kinds of mortgages that were placed in the mortgage security, when such legal requirements were not in place at the time the security was created.

Furthermore, collateral-specific restrictions are ineffective due to varying enhancement features found in PLMBS securities. As the most recent crisis has proven, collateral performance has not been highly correlated to security performance. In fact, there are many examples of securities with highly delinquent collateral pools that have outperformed securities with better performing collateral pools due predominantly to structural differences between such securities.

### **IV. Investment Grade Ratings for PLMBS**

We would support a requirement that all PLMBS purchased by an FHLBank be limited to securities with the highest investment grade rating at the time of purchase by an FHLBank in an effort to limit the potential risks to the FHLBanks from their MBS portfolios. As a practical matter, historically, the FHLBanks have operated in compliance with this standard. Therefore, we are supportive of its incorporation into the final rule. As is currently the case, an FHLBank should not be required to divest a PLMBS if the investment rating of the PLMBS falls subsequent to its purchase by an FHLBank.

If under the pending financial reform legislation the use of investment grade ratings are no longer permitted in FHFA rulemakings, other standards based on expected losses and credit enhancements could be established in future rulemakings.

We thank the FHFA for its consideration of these comments.

Respectfully submitted,



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<sup>4</sup> Issued on October 4, 2006 (71 FR 58609)

<sup>5</sup> Issued on July 10, 2007 (72 FR 27569)