Federal Home Loan Bank of Boston
Federal Home Loan Bank of Chicago
Federal Home Loan Bank of Cincinnati
Federal Home Loan Bank of Des Moines
Federal Home Loan Bank of Indianapolis
Federal Home Loan Bank of New York
Federal Home Loan Bank of Pittsburgh
Federal Home Loan Bank of Topeka

December 23, 2010

VIA EMAIL: *RegComments@FHFA.gov*

Alfred M. Pollard, General Counsel
Attention: Comments/ RIN 2590–AA36
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Re: Comments on Notice of Proposed Rulemaking Relating to Federal Home Loan Bank Liabilities (RIN 2590–AA36)

Dear Mr. Pollard:

The undersigned Federal Home Loan Banks ("FHLBanks") appreciate the opportunity to comment on that part of the Federal Housing Finance Agency ("FHFA") notice of proposed rulemaking on Federal Home Loan Bank Liabilities that concerns the replacement of references to or required use of credit ratings in Federal agency regulations, as required by Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank")[1]. We respectfully submit the following comments for your consideration. Specifically, we are commenting on this matter as related to the FHFA's regulation on Acquired Member Assets (12 CFR Part 955) (the "AMA regulation").[2]

Comment Summary

The FHLBanks understand Congress's concerns about the required use of and reliance on credit ratings, and the role that such required use and reliance may have played in the current economic downturn. Section 939A of the Dodd-Frank Act addresses those concerns by providing that references to or required reliance on credit ratings be removed from the FHFA's (and other

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203 (2010)
[2] The comments set forth herein are in addition to comments provided by the FHLBanks regarding the application of Dodd-Frank Act Section 939A to FHLBanks' investments.

Federal agencies') regulations. The Dodd-Frank Act, however, does not expressly prohibit the continued use of credit ratings by the FHLBanks and other financial institutions as part of a comprehensive risk management program. In our opinion, the FHFA's AMA regulation should be revised to remove references to and required reliance on credit ratings, and to allow the FHLBanks to utilize a variety of risk management and risk modeling tools, including third-party analytics and credit ratings, in establishing the creditworthiness of FHLBank acquired member assets ("AMA"), subject to regulatory supervision and appropriate internal policies and governance processes. Allowing the FHLBanks to use a broader range of credit risk management tools for AMA will comply with Congressional intent, and will enable the FHLBanks to more prudently manage credit risk.

Background

Section 939A of the Dodd-Frank Act states:

> (a) Agency Review.—Not later than 1 year after the date of the enactment of this subtitle, each Federal agency shall, to the extent applicable, review—
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> (1) any regulation issued by such agency that requires the use of an assessment of the creditworthiness of a security or money market instrument; and
>
> (2) any references to or requirements in such regulations regarding credit ratings.
>
> (b) Modifications Required.—Each such agency shall modify any such regulations identified by the review conducted under subsection (a) to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of creditworthiness as each respective agency shall determine as appropriate for such regulations. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of creditworthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of creditworthiness.
>
> (c) Report.—Upon conclusion of the review required under subsection (a), each Federal agency shall transmit a report to Congress containing a description of any modification of any regulation such agency made pursuant to subsection (b).

In response to this provision of the Dodd-Frank Act, the FHFA, as part of its notice of proposed rulemaking on FHLBank Liabilities, has solicited comments on what alternative standards of creditworthiness could appropriately be adopted to replace the requirements in its regulations that are based on credit ratings. More specifically, the FHFA has requested comments on potential creditworthiness standards that could be applied across regulations governing the Federal Home Loan Bank System to replace the credit ratings.

The AMA regulation governs the acquisition of AMA by an FHLBank. Section 955.3 sets forth the required risk-sharing structure for AMA, and contains several references to credit ratings. Specifically, section 955.3 currently requires an FHLBank to determine the amount of credit enhancement that is necessary to enhance the credit quality of a pool of assets to be acquired by an FHLBank so that the pool of assets obtains a credit quality equivalent to that of an instrument having at least the fourth highest credit rating from a Nationally Recognized Statistical Ratings Organization ("NRSRO"), or such higher credit rating as the FHLBank may require. The methodology used by an FHLBank to determine the credit enhancement must be confirmed in writing by a NRSRO. Section 955.3 contains several other references to "credit rating."

There are currently two asset-acquisition programs that have been approved under the AMA regulation: the Mortgage Partnership Finance® (MPF®) Program and the Mortgage Purchase Program (MPP). The undersigned FHLBanks have been approved under either or both the MPP or the MPF Program. Both AMA programs utilize the S&P LEVELS® risk modeling tool to analyze the credit risk associated with a residential mortgage loan or pool of loans to be acquired by a participating MPF or MPP FHLBank. LEVELS® also assigns a credit rating equivalent based on S&P's risk rating criteria. The FHLBanks incorporate the LEVELS® model into the methodology they use to determine the credit enhancement that is required by 12 CFR 955.3.

Discussion

Before proceeding to a discussion of a specific alternative standard of creditworthiness that could be adopted to replace the "credit rating" references in and requirements of the FHFA's AMA regulation, we think it is important to stress that Dodd-Frank does not prohibit the use of credit ratings by the FHLBanks. Dodd-Frank requires that regulations be revised to omit references to and required reliance on credit ratings. Permissive, non-mandatory <u>use</u> of credit ratings is not prohibited by the express language of Section 939A, and there is legislative history that supports the conclusion that Congress did not intend to establish an outright prohibition on the use of credit ratings and associated analytical tools.[3] The Dodd-Frank Act does not prohibit the FHFA from permitting the FHLBanks to use creditworthiness standards for AMA assets that utilize credit ratings as part of well-founded, disciplined credit-risk assessment. External ratings, when properly utilized, can be an important part of a comprehensive credit-risk assessment methodology that regulators should continue to recognize.

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[3] The language of Section 939A is based on a provision in the financial regulatory reform bill that was passed by the House of Representatives on December 11, 2009. The wording of the House bill is almost identical to that found in Section 939A. By comparison, the financial regulatory reform bill reported out of the Senate Banking Committee on April 15, 2010 required federal agencies to both remove references to credit ratings from regulations <u>and</u> substitute replacement standards that "[are] not related to credit ratings." The substitute replacement standard requiring that the new standards be unrelated to credit ratings was removed before the full bill was passed by the Senate on May 20, 2010, and does not appear in the final legislation.

Given the requirements of Dodd-Frank, and the constantly-changing set of specific risk management tools available to regulators and the industry, we think it is important that the FHFA move away from requiring one creditworthiness standard (i.e., a specific NRSRO credit rating) to a *principles-based* approach to credit risk management in the AMA regulation. The use of risk management program principles to manage risk, instead of a single, required credit rating-based standard, would allow the FHLBanks to utilize a variety of current risk management tools and processes that can be adapted as necessary to account for changes in the market and risk management environments and best practices.

Suggested elements of a principles-based approach to credit risk management for AMA assets are set forth below:

(1) An FHLBank should have the flexibility to develop its own policies and processes for determining creditworthiness and AMA credit enhancements (including the use of LEVELS® and NRSRO credit ratings to the extent deemed appropriate by each FHLBank);
(2) An FHLBank's creditworthiness standards and credit risk management policies and processes should comport with established governance standards and should be reviewed for adequacy by the FHFA;
(3) The total credit enhancement necessary for AMA assets would be the amount necessary to enhance the asset or pool of assets to a credit quality that meets the investment grade or credit rating established in the FHLBank's credit risk and investment policies; and
(4) The party responsible for determining the total credit enhancement necessary to enhance the asset or pool of assets to an appropriate level would be the FHLBank using models adopted or developed by an FHLBank, rather than the NRSROs exclusively, subject to regulatory guidance.

In addition, we believe that it is no longer appropriate to require the use of external credit ratings as the sole method to determine the total credit enhancement necessary for AMA assets. Requiring the exclusive use of external credit ratings could lead to inconsistent and unwarranted amounts of credit enhancement, which could negatively impact the FHLBanks and their members who use the MPF Program and MPP. For these assets, an FHLBank should be permitted to develop and implement a comprehensive internal risk management program, subject to review by the FHFA in the course of its normal supervisory role. The FHLBanks should be permitted to utilize the full range of credit risk management tools that are available to the industry in order to obtain a reliable, consistent, and accurate assessment of the amount of credit enhancement needed for AMA assets. We believe this constitutes a creditworthiness standard and risk management program that is prudent and appropriate for the MPP and MPP Program.

The risk management program and creditworthiness standard outlined above would require the FHLBanks to document, through their own credit analysis and assessment, that the AMA assets and AMA credit enhancement process meet specified internal credit and risk analysis standards. The credit and risk analysis process for AMA assets would be part of an FHLBank's existing overall risk management policy and processes. The use of models and related controls in connection with the AMA credit and risk analysis process would fully conform to the requirements of FHFA Advisory Bulletin 2009-AB-03, and would be subject to supervisory review.

The principles-based creditworthiness standards and risk management process set forth above could be applied across regulations governing the Federal Home Loan Bank System to replace references to or required use of external credit ratings.

We have a few additional comments that relate to this matter.

First, in light of the credit risk capital requirements of 12 CFR 932.4, we think it unnecessary to include a risk-based capital requirement in the AMA regulation and, consequently, section 955.6 should be omitted from the AMA regulation.

Second, all previously-approved risk management models for the MPP and MPF Program should be grandfathered and not be subject to additional regulatory approval.

Third, the actual changes to the various FHFA regulations that reference or require the use of NRSRO ratings should be subject to a separate notice of proposed rulemaking, so that the Banks are given an opportunity to respond to the FHFA's specific proposals.

Finally, any final rule relating to revisions to the AMA regulation should have a phased-in implementation, with an effective date of no earlier than one year after issuance of the final rule.

We appreciate your consideration of our comments as the FHFA develops its response to Section 939A of the Dodd-Frank Act and considers revisions to the AMA regulation.

Sincerely,

[Signatures on following pages]

Federal Home Loan Bank of Boston

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