FEDERAL HOME LOAN BANK OF INDIANAPOLIS
Building Partnerships. Serving Communities.

Milton J. Miller
President & CEO

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BY FEDERAL EXPRESS AND EMAIL

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Christopher T. Curtis, Senior Deputy General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street, N.W.
Washington, DC 20552
Attention: Comments/RIN 2590-AA21

RE: Capital Classifications and Critical Capital Levels for the Federal Home Loan Banks

Gentlemen:

On January 30, 2009, the Federal Housing Finance Agency (FHFA) issued an interim final rule (the Rule) with respect to capital classifications and critical capital levels for the Federal Home Loan Banks (FHLBanks). This letter sets forth the comments of the Federal Home Loan Bank of Indianapolis (the Bank) with respect to the Rule. We thank you for the opportunity to comment.

The Rule established new capital classification and prompt corrective action regulations set forth in 12 C.F.R. Part 1229 (the Regulations). In the preamble to the Rule, FHFA also discussed the possibility that the agency might issue additional regulations relating to a potential fifth "well capitalized" capital classification, and solicited specific comment on both that possibility and a series of related questions.

Following the structure of the Rule, this comment letter is divided into two parts. The first sets forth comments on the Regulations as promulgated, together with a comment on a related FHLBank capital rule issue, while the second addresses the potential "well capitalized" category and related issues.

We offer the following comments, suggestions, and requests for clarification in respect of the Regulations:

I. The Regulations

- Exclude Advances from Section 1229.6(a)(4) Quarterly Asset Growth Cap. Section 1229.6(a)(4) provides that an undercapitalized FHLBank may not permit its average total assets in any calendar quarter to exceed its average total assets during the preceding quarter, unless certain requirements are met. In light of both the safety of advance assets and their generally self-capitalizing nature, we believe that this cap on quarterly asset growth should not restrict growth in advance balances, as such growth generally results in an improvement (not a worsening) of an FHLBank's capital position. This is true even if the ratio of tangible

equity to the bank's total assets is not then increasing at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time (as Section 1229.6(a)(4)(ii)(B) requires). Furthermore, advances are the FHLBanks' primary business and are central to the fulfillment of the FHLBanks' public purposes and their mission to provide liquidity to their members.[1] Other regulatory and safety-soundness safeguards, such as 12 C.F.R. § 950.4, are in place to ensure that an FHLBank does not take a credit loss on an advance. We request that FHFA modify Section 1229.6(a)(4) to exclude advance assets from the quarterly asset growth cap, or, in the alternative, otherwise amend the cap requirement in a way that does not limit the making of capital-enhancing advances.

- Increase Time Period for Submission of Capital Restoration Plan. Section 1229.11(b) requires an FHLBank to submit a proposed capital restoration plan no later than 10 calendar days after receiving notice from the Director of the FHFA. Depending on when the notice is received, the FHLBank could have as few as 5 business days to formulate and submit the plan,[2] and that is very likely not sufficient time to permit an FHLBank to create a truly effective capital restoration plan. We ask that Section 1229.11(b) be amended to extend this time period from 10 calendar days to 45 calendar days, as authorized by 12 U.S.C. § 4622(b). The FHLBanks should receive a longer period than the Enterprises, due to the FHLBanks' significantly different cooperative capital structure. To implement a capital restoration plan, the FHLBanks may need to amend their capital plans or take other actions that would not be applicable to the Enterprises.[3] This is particularly critical when the affected FHLBank is cooperating fully in the capital restoration process and the Director believes there is a reasonable chance of successful recapitalization. Further, the FHLBank must be given adequate time and forbearance to successfully execute its capital restoration plan. In the long run, if an FHLBank can successfully recapitalize with private investment, both the government and the industry benefit.

- Clarify Scope of Section 1229.6(a)(5) Prohibition on Acquisitions. Section 1229.6(a)(5) of the Regulations provides that an undercapitalized FHLBank may not "acquire, directly or indirectly, *any interest* in any entity [emphasis added]" unless certain requirements are met. Please clarify that this prohibition would not prohibit an FHLBank from conducting ordinary course transactions, such as making advances, acquiring member assets, providing AHP, CIP or CICA funding, issuing standby letters of credit, or purchasing authorized investments.

- Modify Definition of "Executive Officer". In order to provide both more clarity as to which employees constitute "executive officers" and a more appropriate scope to that definition, we ask that the definition of "executive officer" under Section 1229.1 be amended to reflect the following three comments:

    - clause (3)(i) of the definition should be modified to include only those individuals in charge of a principal business unit, division or function who have been notified in

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[1] 12 U.S.C. § 4513(f)(1)(B).

[2] For example, if the FHLBank received the notice on Friday, May 15, 2009, the submission would be due no later than Monday, May 25, 2009. However, since that latter date is a federal holiday, Friday, May 22 would be the last business day prior to the deadline, effectively giving the FHLBank only 5 business days to develop and propose the plan.

[3] Moreover, to allow an FHLBank only 10 days following receipt of notice from the Director runs counter to the broader framework for capital restoration plans set forth in the statute. *See, e.g.*, 12 U.S.C. § 4622(d), which establishes a *minimum* 30 days for the submission of an amended capital restoration plan in the event the Director disapproves the initial plan.

advance in writing by FHFA that they constitute "executive officers" for purposes of the Regulations (this is consistent with the treatment of the Enterprises);

- clause (3)(ii) of the definition should be modified by changing "chief operating officer" to "chief executive officer;" and

- clause (3)(ii) of the definition should provide a carve out for administrative support staff reporting to the board of directors, the president, or the chief executive officer.

- Clarify Application of Executive Compensation Limits to Pre-existing Contracts and Vested Benefits. Please clarify whether, in light of contractual and constitutional concerns, employment agreements entered into prior to the effective date of the Rule are subject to the restrictions set forth in Section 1229.8(e) and (f) of the Regulations.

- Clarify Related Capital Rule Concerning Other Comprehensive Income (Loss). In a preamble to a prior proposed rulemaking, FHFA's predecessor, the FHFB, indicated that Other Comprehensive Income and Loss (OCI) is not included in the calculation of permanent and total capital, as those terms are defined in the Bank Act and related regulations.[4] The Bank believes this pronouncement is correct, and urges, for clarification purposes, that this position be incorporated into the regulatory capital definitions.[5]

II. Potential "Well Capitalized" Classification and Related Issues

We offer the following comments on the six specific questions posed by FHFA in the preamble to the Rule:

1. Would a well-capitalized classification category provide incentives to the Banks to hold more than the minimum amounts of capital and increase retained earnings as a percentage of capital?

We believe that the current regulatory framework establishes sufficient capital requirements for the safe and sound operations of the FHLBanks, and do not believe that the FHFA should implement a well capitalized category that will have the practical effect of raising the minimum capital standards for the FHLBanks above the amounts provided for under current regulations.

A definition of well capitalized based on holding more than the minimum levels of capital requires an FHLBank to decrease its leverage thereby reducing its earnings assets and net income. An FHLBank is unlikely to seek such well capitalized status unless offered clear incentives to offset the cost of lost earnings from decreased leverage or the benefits of paying higher dividends. We are doubtful that either higher capital levels or the accumulation of more retained earnings will provide any market benefits for individual FHLBanks in their dealings with capital market counterparties (e.g., swap counterparties and fed funds counterparties). We believe these counterparties rely significantly on external credit ratings and, in the case of interest rate swaps documented on ISDA forms, on the collateral provided by counterparties.

Examples of regulatory incentives that might sufficiently motivate FHLBanks to become well capitalized are discussed below under question 4.

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[4] 66 Fed. Reg. 41471 (August 8, 2001).
[5] See 12 C.F.R. Parts 930 and 932.

2. What criteria may be appropriate to define such a category?

As noted above, we believe the FHLBanks have sufficient total capital under the current regulations to support their businesses and any increment added to existing capital standards should be accompanied by an incentive for exceeding the elevated threshold. Alternatively, the definition of well capitalized could focus on the composition of capital. We suggest two possible formulations to implement this approach. Under the first approach, a well capitalized FHLBank would be any FHLBank that is adequately capitalized and has at least a specified percentage (e.g., 10%) of its total regulatory capital in the form of retained earnings. Under the second approach, well capitalized would be defined as a capital ratio above the 4% total capital ratio (e.g., 4.5%) but with retained earnings computed in such calculation as a multiple (e.g., 2.0 times) of actual retained earning. Under this second approach, an FHLBank with modest retained earnings that did not wish to sharply accelerate its accumulation of retained earnings could still meet the well capitalized standard simply by having a higher amount of capital stock.

If retained earnings were used as an element of the definition of well capitalized, the Rule should clarify that Other Comprehensive Income would not be added to or subtracted from retained earnings for the purpose of determining well capitalized status.

3. Would a MVE/PVCS or a retained earnings target be appropriate in defining a well-capitalized category, and if so, what should the targets be?

As discussed above, some element of retained earnings might be an appropriate component of the definition of well capitalized. Any such element, however, should be developed in the context of an incentive for an FHLBank to become well capitalized rather than as effectively an additional requirement to be adequately capitalized.

While MVE/PVCS targets have a certain surface appeal, they do not provide a sound basis for defining well capitalized, in part because such measurements look to liquidation values rather than going concern values. Recent market conditions show the distortions that can result from using MVE as a measurement of capital adequacy.

4. What restrictions on adequately capitalized Banks may be appropriate to create an incentive to Banks to achieve and maintain a well-capitalized rating?

The Housing and Economic Recovery Act established four capital classifications which do not include a well capitalized category. Therefore, we do not think it is appropriate to use restrictions on an adequately capitalized FHLBank as a lever to force or entice it to comply with a higher capital standard not contemplated by the statute. Rather, implementation of a well capitalized category should be driven by incentives that encourage and reward an FHLBank for achieving that status.

As noted above, we do not believe that any market benefits will accrue to well capitalized FHLBanks. Thus financial incentives would likely have to be in the areas of expanded investment authority. For example, the Rule might make permanent the recent temporarily expanded MBS authority; explicitly expand the scope of authorized MBS investments to include, for instance, private-label MBS currently trading at substantial discounts; or add new permitted investment categories, such as certain government-guaranteed student loans.

In the same vein, the Rule might offer regulatory incentives for an FHLBank to become well capitalized. For example, a well capitalized FHLBank might receive expedited consideration of a new business activity notice or a waiver of the requirement to file such a notice with respect to specified activities that are new for the well capitalized FHLBank but that have previously been approved for other FHLBanks. Certain aspects of the annual examination of a well capitalized FHLBank might be more limited in scope (either in every year or in alternate years) than is the case with an FHLBank that is only adequately capitalized.

5. Alternatively, should the FHFA adopt a MVE/PVCS and/or retained earnings requirement as a separate risk-based capital rule that would be applied to the Banks in addition to the current risk-based capital requirement in 12 CFR 932.3, and incorporate this new requirement into the criteria for defining either the adequately capitalized category or a new well-capitalized category? Should MVE/PVCS or retained-earnings targets be adopted other than as part of the risk-based capital structure?

We believe the MVE metric used as a component of the current risk-based capital requirement is generally appropriate. As noted above, we consider using MVE measures to be problematic as the basis for establishing any new capital requirement revising existing requirements. These problems are illustrated by current events in which MVEs have been driven lower by discounts in securities prices that do not reflect real interest rate risk and that overstate credit risk.

We recognize that long-term impairment of the value of member stock at one or several FHLBanks could lead to unfavorable consequences on a System-wide basis. We support promotion of building retained earnings through positive incentives whereby an FHLBank's level of retained earnings contributes significantly to attainment of the well capitalized status. Our reply to question 2 provides a sample framework that links increasing retained earnings to achieving well capitalized status.

6. Are there any changes that should be made to the RBC framework?

We believe that a broad re-evaluation of RBC standards would be beneficial to the FHLBank System. Of a more immediate concern, we believe the FHFA should revisit the operations risk capital requirement which is an amount equal to 30% of the sum of the FHLBank's credit risk capital requirement and market risk capital requirement. Recently, the volatility of the operations risk component has been high when compared to the relatively stable level of operational risks facing the FHLBanks. At a minimum, the operations risk capital requirement should be decoupled from the component of the market risk requirement generated by the MVE deficit. The operations risk requirement should be determined based on some measurement of operational risk factors or actual loss experience from operational failures rather than expressed as merely a function of credit and market risks.

Thank you for your consideration of our comments.

Sincerely,

Milton J. Miller
President – Chief Executive Officer