Federal Home Loan Bank of New York

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VIA FEDERAL EXPRESS

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Federal Housing Finance Agency
1700 G Street, N.W.
Washington DC 20552

Attention: Comments/RIN 2590–AA21

Re: Interim Final Rule on Capital Classifications and Critical Capital Levels for the Federal Home Loan Banks

To the Federal Housing Finance Agency:

The following represent the views of the Board of Directors of the Federal Home Loan Bank of New York ("FHLBNY") regarding the Federal Housing Finance Agency's ("FHFA" or "Finance Agency") interim final rule ("Rule") on capital classifications and critical capital levels for the Federal Home Loan Banks ("FHLBanks") published in the Federal Register on January 30, 2009. In general, the FHLBNY believes that the Rule as published is consistent with the framework of a safety and soundness regulator.

Among other things, the Rule invited comments on whether adopting a fifth capital classification category of "well-capitalized" would be a useful and appropriate way to encourage the FHLBanks to hold more than the minimum amounts of capital. The FHFA suggests that the criteria for a well-capitalized category could be specified as a percentage of a Bank's minimum leverage and risk-based capital requirements, such as 110 percent of these requirements, and/or incorporate specific retained earnings or market value of equity/par value of capital stock ("MVE/PVCS") targets. The FHLBNY agrees that adopting a well-capitalized category is consistent with the banking regulators' approach.

The FHFA specifically posed a number of questions in the Rule regarding the adoption of the classification category of "well-capitalized". Those questions, and our comments, are set forth below.

1. Would a well capitalized classification category provide incentives to the FHLBanks to hold more than the minimum amount of capital and increase retained earnings as a percentage of capital? The FHLBNY believes that there are strong incentives for a FHLBank to achieve this category if the requirements are

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reasonable and attaining the category provides more operational and balance sheet flexibilities. We also suggest that consideration be given to rating the capital adequacy of the whole FHLBank System in addition to individual FHLBanks. Because the FHLBanks are jointly and severally liable, adequacy of capital on a Systemwide basis is an important factor to consider.

2. What criteria may be appropriate to define such a category? And would a MVE/PVCS or a retained earnings target be appropriate in defining a well-capitalized category, and if so, what should the target be?

Retained earnings The FHLBNY believes the level of retained earnings is the most important aspect of an individual FHLBank's capital because of the cooperative structure of the FHLBank System and the fact that capital stock is required to be redeemed or repurchased at par. Recognizing this requirement, the Federal Home Loan Bank Act prohibits a Bank from redeeming or repurchasing stock without the written permission of the Director of the Finance Agency ("Director") if the FHLBank is experiencing, or is likely to experience, losses that will result in charges against capital. Current regulations define the phrase "charges against capital" to mean losses that would cause a FHLBank's total equity to fall below the par value of outstanding Bank stock on an other than temporary basis.

The requirement that redemption and repurchase of the capital stock be at par is the single most important distinction between the Home Loan Banks and Fannie Mae and Freddie Mac and other privately owned financial institutions. One logical interpretation of the intent of the requirement is to protect members' investment. This sets the debate on how much cushion or buffer a FHLBank needs to avoid the impairment of members' stock.

In general, most financial institutions keep their capital above the minimum capital requirements, which is commonly known as 'buffer capital'. Financial institutions hold buffer capital to avoid costs related to market discipline and supervisory intervention if the institution is approaching or falling below the regulatory minimum capital-ratio. Buffer capital acts as insurance against costs that may occur due to unexpected losses and difficulties in attracting new capital. The buffer allows management to have more flexibility in pursuing their strategies; however, the buffer is not viewed as protection for the stockholders.

Regulators of the Federal Home Loan Banks have to contend with the protection of the members' stock investment in addition to the protection of taxpayers. The capital invested by FHLBank members is there to protect the bondholders and taxpayers. In general, the FHLBanks require total stock purchase substantially above the regulatory requirements. For example, the FHLBNY requires membership stock purchase equal to 20 basis points of its members' mortgage related assets and activity stock purchase equal to 4.5% of their outstanding advances. Arguably, this level of capital stock provides significant protection to the bondholders and taxpayers due to the fact that the capital stock level in the

FHLBNY is significantly higher than risk-based capital requirements, for example, FHLBNY total capital exceeded risk-based capital requirement ($0.7 billion) by approximately $5 billion.

However, the buffer the FHLBanks have maintained in excess of the minimum capital requirements does not necessarily protect the members against capital stock impairment. The only effective buffer is operating earnings and retained earnings. The question is how much is adequate to protect the par value of capital stock against losses that are other than temporary.

We suggest that a good starting point is to combine annual earnings and retained earnings and, if the total is equal to or exceeds credit and market risk, a FHLBank should be categorized as well-capitalized.

MVE/PVCS The Rule defines market value of equity ("MVE") as the economic value of a Bank's equity. We assume that the term market value is similar to fair value, which is a market-based measurement. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is also commonly referred to as the liquidation value. There are a number of issues associated with the fair/market value concept; some are technical while others are conceptual. However, we believe that value derived from "market" only tells part of the story and reliance on this number as an indicator of capital level can be problematic and potentially misleading.

Conceptually, it is important for investors and regulators to have a reasonable estimate of the market value of an institution's assets and liabilities and the resulting MVE in a consistent and transparent manner. It may be an important indicator of the institution's health but it is easy to misinterpret the MVE without careful analysis and a thorough understanding of the market value process.

When a FHLBank reports a MVE/PVCS that is less than par, that figure does not necessarily indicate poor financial health, and reporting above par does not necessarily indicate a healthy FHLBank. For example, assume that two FHLBanks reported similar MVE/PVCS ratios of 0.95, and FHLBank A's below par ratio is due to a markup of the liabilities because Bank A improves its credit and its liabilities can be transferred at a lower rate and a resulting higher price. In this case, the financial health of FHLBank A improves but the MVE/PVCS ratio declines. In contrast, FHLBank B's lower ratio is due to credit deterioration in its investments resulting in lower prices. This illustrates the difficulties in applying the MVE/PVCS ratio.

On the technical side, the recent market stress has revealed a number of issues related to the valuation of complex products. As liquidity evaporates quickly in the markets for many complex structured products and primary and secondary transaction prices became unavailable, some market participants responded by switching from valuation methods based on observable prices (or indices) to methods that relied more on modeled valuations. In other cases, model-based valuations required more extensive use of unobservable inputs, reducing the reliability of final value.

3. What restrictions on adequately capitalized FHLBanks may be appropriate to create an incentive to FHLBanks to achieve and maintain a well-capitalized rating? The FHLBanks are already operating under very restrictive rules when compared to other regulated financial institutions. In particular, the regulatory requirements on capital, operations and risk management of the FHLBanks are very stringent. Supervision by the FHFA is very strict which has resulted in the FHLBanks remaining financially strong through the current crisis. The FHLBNY is able to provide and will continue to provide much needed liquidity to our members in this unprecedented market.

   All the Federal Home Loan Banks follow very conservative and consistent risk management policies when compared with other financial institutions. Their policy restricts investment purchases to no more than 3 times their capital in mortgage related assets which must be "AAA" rated at purchase. Loans to members, commonly referred to as 'advances', are collateralized with significant 'haircuts' and have experienced no losses for 76 years. Market risk is also conservatively managed: no FHLBanks mismatch their assets duration from liabilities duration by more than 2 months. This conservative risk profile is reflected in very low risk-based capital requirements as stated in 12 CFR 932.3, and the FHLBanks' capital exceeds risk-based capital requirements by a large margin.

   Because of their low risk profile, placing additional restrictions on an adequately capitalized FHLBank is unnecessary. It would be more appropriate to incentivize well-capitalized FHLBanks in the form of operational flexibility.

4. 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 that the FHFA should view the risk-based capital requirements as minimum regulatory requirements that reflect as accurately as possible the FHLBanks' risk profile. Requirements for a "well-capitalized" category should be established in a separate rule and should not be part of risk-based capital rules.

5. Are there changes to the current risk-based capital requirements that should be considered in light of the PCA provisions that are being added by this interim final rule? Should MVE/PVCS or retained earnings target be adopted other than as part of the risk-based capital structure? As stated earlier, a retained earnings target should be used as a measure of the category of "well-capitalized" and should not be

part of risk-based capital. We believe that the current risk-based capital requirements in § 932.5 do not reflect the current market condition.

In this regard, there are two specific issues that the FHFA should address:

- The current risk-based requirements significantly underestimated the risk of highly rated investments. The statistical data that underpins the risk-based requirements should be revisited.

- FHFA regulations regarding the market risk capital requirement located at 12 CFR 932.5 (a) (1) provide that "*Each Bank's market risk capital requirement shall equal the sum of: (i) The market value of the Bank's portfolio at risk from movements in interest rates, foreign exchange rates, commodity prices, and equity prices that could occur during periods of market stress, where the market value of the Bank's portfolio at risk is determined using an internal market risk model that fulfills the requirements of paragraph (b) of this section and that has been approved by the Finance Board; and (ii) The amount, if any, by which the Bank's current market value of total capital is less than 85 percent of the Bank's book value of total capital....*"

  This requirement that the amount by which the current market value of equity is less than 85% of the book value of equity is added to the market risk component of the risk-based requirement is too severe because of the stressed and illiquid market today. More importantly, the cause of the lower value is due primarily to factors related to credit, liquidity and market dislocation rather than market or interest rate risk.

Thank you for consideration of these comments and observations.

Very truly yours,

Michael M. Horn

Michael M. Horn
Chair of the Board of Directors of the
Federal Home Loan Bank of New York