FEDERAL HOME LOAN BANK
OF CINCINNATI

David H. Hehman
President

May 15, 2009

BY FEDERAL EXPRESS AND EMAIL

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

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 Cincinnati (the Bank) with respect to the Rule. We thank you for the opportunity to be heard on this important matter.

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, the 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, while the second addresses the potential "well capitalized" category and related issues.

I. The Regulations

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

- Exclude Advances from Section 1229.6(a)(4) Quarterly Asset Growth Cap. Section 1229.6(a)(4) of the Regulations 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

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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 such an FHLBank's total assets is not then increasing at a rate sufficient to enable the FHLBank 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] We request that the 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.

- <u>Increase Time Period for Submission of Capital Restoration Plan</u>. Section 1229.11(b) of the Regulations 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] That is likely not a long enough period of 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 30 calendar days. Furthermore, we believe that the FHLBanks should receive a longer period than the Enterprises as a result of the different capital structures of the FHLBanks and the Enterprises. 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.

- <u>Clarify Scope of Section 1229.6(a)(5) Prohibition on Acquisitions</u>. 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 or CICA funding, issuing standby letters of credit, or purchasing authorized investments.

- <u>Modify Definition of "Executive Officer"</u>. 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 the 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.

advance 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 chairman of the board of directors, the vice chairman of the board of directors, the president, or the chief executive officer.

▪ Clarify Application of Executive Compensation Limits to Pre-existing Contracts. 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.

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 FHLBanks have sufficient total capital requirements under the current regulatory framework 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. A definition of "well capitalized" that is based on increases in retained earnings as a percentage of capital requires an FHLBank to pay less in dividends than it might otherwise pay. In either case, FHLBanks are unlikely to seek such well-capitalized status unless offered clear incentives that enable it to offset the lost earnings from decreased leverage or for its members to forego the benefits of higher dividends. In addition, we strongly believe the current limitation on the payment of stock dividends limits the ability of the FHLBanks to effectively raise equity in the form of capital stock. Given the tax-advantaged nature of these dividends, an FHLBank should not be limited in its ability to raise capital in the most effective manner. Prohibiting and/or limiting stock dividends effectively raises the cost of equity capital from member institutions.

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. Therefore, we believe that any definition of well capitalized is unnecessary and may suggest that an FHLBank at a less than a well-capitalized status is not sufficiently capitalized. However, in the event a well-capitalized status is to be considered, it should 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 percent) 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 percent total capital ratio (e.g., 4.5 percent) but with retained earnings computed in such calculation as a multiple (e.g., 2.0 times) of actual retained earnings. 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. -In addition, a well-capitalized category, if implemented, should continue to maintain that Other Comprehensive Income is not part of regulatory capital.

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, we do not believe a well-capitalized status is necessary or directly beneficial to an individual FHLBank given the joint and several nature of the System. However, some element of retained earnings might be an appropriate component of the definition of well capitalized. Any such element 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 we believe that the MVE/PVCS is meaningful measurement of potential risk, we do not believe that MVE/PVCS targets 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.

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?**

   While we have noted our concerns with any of the proposed provisions described above, we do believe that any requirement that incorporates a minimum level of retained earnings or MVE should be undertaken through a separate rulemaking process with robust analysis, appropriate notice and adequate opportunity for comment.

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

   For the reasons mentioned above regarding MVE, we believe the FHFA should eliminate the incremental market risk capital requirement imposed by 12 C.F.R. §932.5(a)(ii) to the extent that an FHLBank's MVE is less than 85 percent of its book value of total capital.

   We believe the FHFA should revisit the operations risk capital requirement which is an amount equal to 30 percent of the sum of the FHLBank's credit risk capital requirement and market risk capital requirement. At a minimum, the operations risk capital requirement should be decoupled from the component of the market risk requirement generated by the MVE deficit (if that component is retained). The operations risk requirement should be determined based on some measurement of actual risks arising from operational failures rather than expressed as merely a function of credit and market risks. One potential alternative would be an internal assessment process consistent with the approaches developed under Basel II.

Thank you for your consideration of our comments.

Sincerely,

David H. Hehman
President and Chief Executive Officer