FHLBank
San Francisco

Dean Schultz
President and
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May 15, 2009

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Federal Housing Finance Agency
1700 G Street, N.W., Fourth Floor
Washington, D.C. 20552
Attention: Comments/RIN 2590-AA21

VIA FEDERAL EXPRESS
AND EMAIL

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

The Federal Home Loan Bank of San Francisco ("Bank") submits this comment in response to the publication on January 30, 2009 by the Federal Housing Finance Agency ("FHFA") of an interim final rule ("Rule") establishing new capital classifications and critical capital levels for the Federal Home Loan Banks ("FHLBanks") pursuant to Section 1141 et seq. of the Housing and Economic Recovery Act of 2008 ("HERA"). In addition to requesting comments on the Rule itself, you have also requested comments on whether or not to include an additional, "well capitalized" classification. Thank you for the opportunity to comment on these issues.

The first section of this letter comments on the Regulations contained in the Rule, and the second section responds to the specific questions posed in the Rule with respect to a proposed "well-capitalized" classification.

I. The Regulations

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

1. 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 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. Even where a member has sufficient excess stock to support the new advances, so that no additional capital stock is issued, the new advances help stabilize the FHLBank's capital structure, since that excess stock becomes activity-based stock that must be retained by the member and is not eligible for repurchase by the FHLBank as long as the advance remains outstanding. 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 FHFA modify Section 1229.6(a)(4) to exclude advance assets from the quarterly asset growth cap.

2. Increase Time Period for Submission of Capital Restoration Plan. 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] While we acknowledge that the Rule allows the Director to extend this deadline within his or her discretion, we believe that the initial 10 calendar days to which a FHLBank is entitled is likely not a long enough period of time to permit it to create a truly effective capital restoration plan. We suggest that Section 1229.11(b) be amended to extend this time period from 10 calendar days to 30 calendar days. Furthermore, we believe that it is appropriate for the FHLBanks to receive a longer period than the Enterprises for completing such a plan because of the different capital structures of the FHLBanks and the Enterprises; while Fannie Mae and Freddie Mac are publicly traded and, therefore, have access to a broad pool of potential investors, the FHLBanks have a multi-faceted and ongoing relationship with a limited pool of shareholders. Any increase in the minimum stock purchase requirement or change to the Banks' capital plans could have significant consequences for the Bank's shareholders and would need to be managed carefully taking their interests into account.

3. 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 as follows:

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

   b) 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.

II. Well-Capitalized Classification

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

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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.

1. <u>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?</u>

   We believe that the current regulatory framework is sufficient to ensure that the FHLBanks are sufficiently capitalized, and do not believe that the FHFA should implement an additional, well capitalized category, which may have the practical effect of raising the minimum capital standards for the FHLBanks beyond what is required to adequately support their statutory mission.

   A definition of well capitalized based on holding more than the current minimum levels of capital could induce 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 could induce an FHLBank to reduce or, in some cases, eliminate the dividends that it might otherwise pay its members. In either case, an individual FHLBank is unlikely to seek such well capitalized status unless it is offered clear incentives that enable it to offset any lost earnings from decreased leverage or to forego the benefit to its members of higher dividends. We are doubtful that either higher capital levels or the accumulation of more retained earnings will provide any meaningful market benefits for individual FHLBanks in their dealings with capital market counterparties (e.g., swap and Fed funds counterparties), since they typically rely primarily on external credit ratings and (in the case of interest rate swaps counterparties) posted collateral.

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

2. <u>What criteria may be appropriate to define such a category?</u>

   As noted above, we believe that the current regulatory framework ensures that the FHLBanks have sufficient total capital to support their business models. While we do not believe that the creation of a well capitalized category is appropriate, we believe that any such category, if it is created, should focus on the composition rather than the amount of capital. Under one possible 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 earnings. Under this 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 are used as an element of the definition of well capitalized, the Rule should clarify that Other Comprehensive Income would not be considered in determining well capitalized status.

3. <u>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?</u>

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

   HERA establishes four capital classifications, and we do not believe that it is appropriate to impose <u>restrictions</u> on an adequately capitalized FHLBank as a lever to force it to raise its total capital level beyond what is statutorily required. Rather, implementation of a well capitalized category, if established at all, should be encouraged by <u>incentives</u> that reward an FHLBank for achieving that status.

   As noted above, we do not believe that any meaningful market benefits will accrue to a FHLBank for meeting the requirements of a well capitalized category. 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, or add appropriate new permitted investment categories.

   The Rule might also offer regulatory incentives for an FHLBank to become well capitalized. For example, a well capitalized FHLBank might be granted a presumption that a new business activity notice will be approved, 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.

5. <u>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?</u>

   As noted above, using MVE measures to establish any capital requirement is problematic. These problems are illustrated by current market 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.

Any retained earnings requirement that is used to define a capital category or to provide an incentive to achieve well capitalized status should be based on clearly articulated risk factors and how increased retained earnings mitigate those risk factors.

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

For the reasons mentioned above regarding MVE, we believe the Finance Agency 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% of its book value of total capital.

We do not believe that there is a strong correlation between operational risks (such as the risk of unauthorized transactions or clerical error by employees) and credit risk or market risk. Instead, we believe that operational risk is best measured against a FHLBank's training and supervision programs, compliance history, custodial and other vendor relationships, and overall management supervision of operations. For this reason, we encourage the FHFA to revisit the operational risk capital requirement and decouple it from the market risk requirement generated by any MVE deficit.

Thank you for your consideration of our comments.

Sincerely,

Dean Schultz
President and Chief Executive Officer