FEDERAL HOME LOAN BANK
OF CINCINNATI

Alfred M. Pollard, Esq., General Counsel
Attention: Comments/RIN 2590-AA39
Federal Housing Finance Agency
400 Seventh Street SW, Eighth Floor
Washington, D.C. 20024

RE: Notice of Proposed Rulemaking; Request for Comments – Members of the Federal Home Loan Banks

Dear Mr. Pollard:

The Federal Home Loan Bank of Cincinnati ("Bank") is submitting this comment on the Federal Housing Finance Agency's ("FHFA") notice of proposed rulemaking and request for comments on "Members of the Federal Home Loan Banks" published on September 12, 2014 ("Proposal").[1]

The Bank appreciates the opportunity to comment on the Proposal and the membership rules and process. This is a very important subject for us, our members and the communities that we serve.

The Bank submitted a comment letter on the Proposal noting our general suggestions and concerns.[2] In particular, we do not believe that the FHFA should impose ongoing requirements for Federal Home Loan Bank ("FHLB") Members to meet a 1% long-term home mortgage loan ("home mortgages") test, or a 10% residential mortgage loan ("residential mortgages") test (hereinafter collectively referred to as the "Continuing Requirements").

While the Proposal does not expressly prohibit affiliates pledging collateral on behalf of Members, this comment addresses specific parts of the Proposal that would not accommodate including affiliate collateral when calculating a Member's compliance with the Continuing Requirements, if included in a final rule, and could therefore cause such a Member to be expelled from membership. As explained in further detail below, financial service organizations often originate, warehouse or hold residential mortgage loans at different corporate entities within the same organization for various business purposes which are typically unrelated to regulatory requirements or interests. Thus due to these business decisions, a Member may need to rely on an affiliate pledge of collateral. Below, we propose a modification to the Continuing Requirements that provides a logical and legally supportable way to take account of collateral pledges from a Member's affiliates to satisfy the Member's Continuing Requirements.

SUMMARY

1. Affiliate collateral pledges have occupied a safe and legitimate role in the FHLB advances landscape for over 15 years.

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1 The Proposal is published at 79 Fed. Reg. 54848 (Sept. 12, 2014).

2 *See* Letter from Carl F.Wick, Chairman of the Board, and William J. Small, Vice Chairman of the Board, FHLB Cincinnati to Alfred M. Pollard, FHFA General Counsel, October 31, 2014.

2. The Proposal does not identify any safety and soundness concerns in connection with the use of affiliate pledges.

3. The Continuing Requirements should be revised so as to not advertently or inadvertently curtail the use of pledges of collateral by affiliates ("Affiliate Collateral") of an FHLB Member.

4. We request that any final rule that contains the Continuing Requirements provide that in calculating a Member's compliance with the Continuing Requirements, an FHLB will take into account Affiliate Collateral, as discussed below ("Affiliate Collateral Calculation").

5. If the FHFA adopts a final rule that includes Continuing Requirements, but does not include the Affiliate Collateral Calculation, the FHFA should provide the public a cost-benefit analysis that would support a final rule that would expel from membership FHLB Members that utilize Affiliate Collateral for their borrowings from their FHLB.

DISCUSSION

I. Accepting Affiliate Collateral is Consistent with the Statutory and Regulatory History of the FHLB System

Congress decided in section 10 of the Federal Home Loan Bank Act ("FHLB Act") to allow an FHLB Member to borrow on the basis of collateral pledged by its affiliates.[3] The text of Section 10(e) of the FHLB Act, which gives FHLBs priority with respect to a security interest in collateral granted to the FHLB by either an FHLB Member or its affiliates, demonstrates that Congress intended for the FHLBs to accept affiliate collateral. Indeed, the FHFA's predecessor, the Federal Housing Finance Board ("FHFB"), recognized that:

> Implicit in Congress' inclusion of collateral pledged by an affiliate in the so-called "superlien provision" is the authority for the Banks to accept collateral from the members' affiliates. Accordingly, the Finance Board has determined that Congress has authorized the Banks to accept collateral not only from a wholly-owned subsidiary, but from any affiliate of a member . . . .[4]

The ability of a FHLB Member to use Affiliate Collateral to obtain FHLB advances has not only been established by the law but has also been recognized and implemented by the regulators. Regulations adopted by the FHFB in 2000 and currently codified by the FHFA in Section 1266.7(g) of its regulations implement this authorization by recognizing that Affiliate

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[3] 12 U.S.C. § 1430(e).

[4] Federal Home Loan Bank Advances, Eligible Collateral, New Business Activities and Related Matters, 65 Fed. Reg. 44414, 44422 (Jul. 18, 2000) ("Affiliate Collateral Rule").

Collateral is functionally equivalent to a Member's own collateral. This is the case so long as the FHLB has obtained and maintains "a legally enforceable security interest pursuant to which the Bank's legal rights and privileges with respect to the collateral are functionally equivalent in all material respects to those that the Bank would possess if the member were to pledge the same collateral directly . . . ."[5]

The FHFB recognized that if Affiliate Collateral is pledged to secure the Member's obligation to repay advances or if the affiliate enters into a surety arrangement and "assumes a primary joint and several co-obligation to repay the advance" and "fully secures this primary surety obligation with eligible collateral," then the pledging of the collateral would be fully consistent with the statutory requirements of the FHLB Act.[6] Thus, a pledge of Affiliate Collateral was clearly considered to be the functional equivalent of collateral pledged by the Member itself.

FHFB regulatory precedent demonstrates that Affiliate Collateral pledges have never been viewed or treated as significant risks or as inherently unsafe and unsound situations. On the contrary, even before the adoption of the Affiliate Collateral Rule, the FHFB and its staff viewed an FHLB's acceptance of Affiliate Collateral as being consistent with safe and sound lending practices. On two occasions prior to the adoption of the Affiliate Collateral Rule, the FHFB and its staff stated that there were no legal objections nor were there any safety and soundness concerns regarding the use of Affiliate Collateral to secure advances. Each such occasion involved the use of the assets of the Member's non-member subsidiary real estate investment trust as eligible collateral pursuant to hypothecation agreements coupled with safeguards that were consistent with the conditions of the future Affiliate Collateral Rule. On each occasion, the FHFB staff indicated that it had "no safety and soundness concerns regarding the proposed transaction."[7] In addition, we are not aware of any enforcement actions involving affiliate pledges and there is no evidence that any loss has ever been incurred by an FHLB because of the use of an affiliate pledge.

Based on this body of evidence, we urge the FHFA not to reverse itself without public comment on the analytic materials that might support such a reversal of its historical acceptance of Affiliate Collateral. In the absence of such input from the public, we recommend that as suggested below, the FHFA include Affiliate Collateral for purposes of calculating the Member's Continuing Requirements.

II. The Continuing Requirements Do Not Properly Take Into Account How Financial Services Organizations Are Often Structured

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5 12 C.F.R. § 1266.7(g)(2).

6 65 Fed. Reg. at 4422.

7 *See* FHFB 1998-RI-01, Whether Mortgage Assets Held By a Member's Real Estate Investment Trust Subsidiary Are Eligible Collateral for Advances Under Section 19(a) of the Federal Home Loan Bank Act; FHFB 1999-RI-08, Federal Home Loan Bank Authority to Accept Eligible Collateral From a Member's Real Estate Investment Trust Subsidiary.

The Continuing Requirements would penalize financial services organizations that may hold mortgages and mortgage securities in various entities within their corporate organization for a range of business reasons. For example, as recognized in the Proposal, when an institution "originates loans for resale rather than for portfolio," that institution's dedication to the housing finance mission may not be properly reflected on its balance sheet at the year end.[8]

Instead, the housing finance mission of an organization should be evaluated according to the demonstrated dedication of the organization as a whole, not just a single subsidiary, because the corporate lines of demarcation may be driven by factors entirely unrelated to the securing of FHLB advances. A subsidiary Member may not directly hold enough home mortgages or residential mortgages to meet the Continuing Requirements, but other parts of the corporate organization may. Allowing a pledge from such affiliates has never and should not in the future be restricted either as inconsistent with the housing finance mission or the safety and soundness requirements of the FHLB Act, without the development of a significant record to support doing so. As described in depth below, there are ample precedents where laws, regulations and regulators have ignored corporate lines of demarcation and looked at the overall regulatory standing of an organization, including its subsidiaries and affiliates.

To prevent such adverse effects on an organization, the Continuing Requirements should include eligible collateral pledged by a Member's affiliates, as described below.

III. Taking Into Account an Entire Organization's Dedication to the Housing Finance Mission is Not Inconsistent With Current Financial Services Law, Regulations and Agency Policy

The regulation of financial services companies has routinely and customarily relied upon the profile, structure, activities, asset composition and size of an entire organization or particular units within the organization for purposes of assessing regulatory compliance and determining regulatory treatment. In the context of clear Congressional authorization for a Member's use of Affiliate Collateral, the FHFA should similarly apply a flexible approach to accommodate Affiliate Collateral for purposes of measuring a Member's compliance with the Continuing Requirements. Allowing Affiliate Collateral to secure advances, but not to be evidence of a financial services organization's dedication to housing finance that may satisfy a Member's Continuing Requirements, would stand in contrast to the ways in which financial services law and regulation look beyond individual company lines of demarcation to achieve an appropriate outcome. For example:

- Under Community Reinvestment Act ("CRA") regulations, a federal banking agency, at the option of an insured depository institution, may take the activity of the ***institution's affiliates*** into account for purposes of the lending, investment and services tests under the CRA regulations, provided that no such lending,

[8] Proposal at 54858.

investment or services may be claimed for CRA performance evaluation by any other institution.[9]

- The FRB's regulation implementing debit card interchange fee provisions of the Dodd-Frank Act applies to issuers that ***together with their affiliates*** have assets of $10 billion or more.[10]

- The FRB's enhanced prudential standards regulation generally applies to bank holding companies with ***consolidated assets*** of $50 billion or more, and in other certain circumstances, to bank holding companies with ***consolidated assets*** of $10 billion or more.[11]

- The OCC ***consolidates*** a national bank and a federal savings institution with their respective operating subsidiaries for various regulatory purposes.[12]

- Consumer Financial Protection Bureau ("CFPB") regulations ***aggregate affiliate operations*** with those of the primary company for purposes of determining whether that company is subject to enhanced CFPB supervision in the areas of (i) consumer debt collection;[13] (ii) student loan servicing;[14] and (iii) international money transfers.[15]

- The FDIC may impose ***sister bank*** liability on one insured depository institution for losses incurred by the FDIC in connection with the failure of its commonly-controlled insured depository institution.[16]

The quantitative and collateral restrictions of section 23A of the Federal Reserve Act generally do not apply to transactions between certain ***sister banks***.[17]

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9 12 C.F.R. §§ 25.22(c), .23(c), .24(c) (Office of the Comptroller of the Currency ("OCC") CRA regulations for national banks); 12 C.F.R. §§ 196.22(c), .23(c), .24(c) (OCC CRA regulations for federal savings institutions); 12 C.F.R. §§ 228.22(c), .23(c), .24(c) (Federal Reserve Board ("FRB") CRA regulations for state member banks); 12 C.F.R. §§ 345.22(c), .23(c), .24(c) (Federal Deposit Insurance Corporation ("FDIC") CRA regulations for nonmember banks).

10 15 U.S.C. § 1693o-2(a)(6); 12 C.F.R. § 235.5(a).

11 12 U.S.C. § 5365(a)(1); Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17240 (March 27, 2014) (to be codified at 12 C.F.R. Part 252).

12 12 C.F.R. § 5.34 (national bank operating subsidiaries); 12 C.F.R. Part 159 (federal savings institution operating subsidiaries).

13 12 C.F.R. § 1090.105.

14 12 C.F.R. § 1090.106.

15 Defining Larger Participants of the International Money Transfer Market, 79 Fed. Reg. 56631 (Sept. 23, 2014) (to be codified at 12 C.F.R. § 1090.107).

16 12 U.S.C. § 1815(e); 12 C.F.R. §§ 308.165-.168.

17 12 U.S.C. § 371c(d)(1).

IV. The Continuing Requirements Should Use the Affiliate Collateral Calculation to Look Across Internal Corporate Lines and Take Into Account the Entire Organization's Dedication to the Housing Finance Mission

Consistent with other areas of financial services law discussed above, and in the absence of any demonstration of risk created by the use of Affiliate Collateral, we request that if the FHFA decides to include the Continuing Requirements in a final rule, it incorporate the Affiliate Collateral Calculation to determine a Member's compliance with the Continuing Requirements. Accordingly, the following provisions should apply to the calculation of the Continuing Requirements in sections 1263.9 and 1263.10:

- Home mortgages and residential mortgages[18] that are Affiliate Collateral should qualify as the Member's for purposes of calculating the numerators of required ratios, and all pledged assets that are Affiliate Collateral would similarly be treated as the Member's for purposes of calculating the denominators of the required ratios.

- Such Affiliate Collateral would not be included in the calculation of the numerators and denominators, as applicable, of an affiliate that is an FHLB Member for purposes of assessing its compliance with the Continuing Requirements.[19]

V. The Affiliate Collateral Calculation Is Consistent with the Recognized Role of Affiliate Collateral and Supports the FHLB System's Housing Finance Mission

The Affiliate Collateral Calculation approach set forth above will (i) not increase the risk to the FHLBs, (ii) not penalize financial services organizations that support housing finance through various subsidiaries, (iii) not violate applicable statutory requirements, (iv) not reduce mortgage lending and (iii) avoid double counting of Affiliate Collateral used to secure FHLB advances.

This approach is consistent with Congress's decision in Section 10 of the FHLB Act to allow a Member to borrow on the basis of collateral pledged by its affiliates, as well as current FHFA requirements for FHLB acceptance of affiliate collateral in section 1266.7(g) of the FHFA's regulations. Indeed, it is also consistent with the well-recognized concept in financial

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[18] For purposes of section 1263.9 of the Proposal, home mortgages refers to all instruments that qualify as long-term home mortgage loans as defined in section 1263.1 of the Proposal. For purposes of section 1263.10 of the Proposal residential mortgages refers to all instruments that qualify as residential mortgage loans as defined in section 1263.1. The Affiliate Collateral Calculation would not apply to institutions that are not a member of an FHLB that are seeking to qualify for membership.

[19] Similar to the approach taken by the FRB, OCC, and FDIC in their CRA regulations in regard to affiliate lending, investment and services, this will prevent double counting of collateral for purposes of calculating compliance with the Continuing Requirements.

services regulation of functional equivalency,[20] which the FHFB itself has expressly relied upon in developing regulatory policies.[21] Where Affiliate Collateral is pledged to support the borrowing of a Member in accordance with FHFA regulations, it is the functional equivalent of those loans having been made or purchased by the Member.

To the extent that the FHFA decides to adopt the Continuing Requirements, but does not include the Affiliate Collateral Calculation, we believe that it would be important for the FHFA to publish a cost-benefit analysis of the agency's evaluation of the benefits associated with prohibiting Affiliate Collateral from being used to evaluate a Member's compliance with the Continuing Requirements, and the costs that would be imposed by the expulsion of current members that could not meet the Continuing Requirements absent the Affiliate Collateral Calculation.

The Bank appreciates the FHFA's consideration of these comments.

Sincerely,

Andrew S. Howell
President & CEO
Federal Home Loan Bank of Cincinnati

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20 *See M&M Leasing v. Seattle First National Bank,* 563 F.2d 1377, 1383 (9th Cir. 1977) (upholding OCC authorization for national banks to engage in motor vehicle leasing, finding a functional interchangeability between leases and secured lending).

21 *Texas Savings & Community Bankers Ass'n v. FHFB,* 1998 WL 842181 (W.D. Tex. 1998) (where the FHFB argued that an FHLB's purchase of mortgage loans from Members under the Mortgage Partnership Finance program creates a financing vehicle functionally indistinguishable from advances), *affirmed,* 201 F.3d 551 (5th Cir. 2000).