January 12, 2015

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

Re: Notice of Proposed Rulemaking and Request for Comments – Members of Federal Home Loan Banks (RIN 2590-AA39)

We appreciate the opportunity to comment on the proposed rule changes. Our response is written from our perspective as a community bank serving a defined geographic area with our core banking business. We are proud of our long history of active engagement in our local consumer mortgage markets - as well as our longstanding membership in the FHLB system - and we intend to remain a viable and an active participant in those markets going forward. It is with this in mind that we support the intent behind the proposed changes, but are compelled to voice our deep concern for what we believe would be their counterproductive, albeit unintended, consequences.

At 1st Source Bank, we use the FHLB as a prominent source of contingent liquidity, which we incorporate into our overall plan for mitigating any potential financial instability. This access to liquidity supports the safety and soundness of our institution and helps to further our efforts within the communities we serve. In this manner, we are both guided by and helping to fulfill the FHLB's mission, and we share a mutual objective that all stakeholders adhere to practices that ensure a strong and stable FHLB system well into the future.

However, we find the proposed rule changes quite troubling. We established our housing commitment when we applied for membership at the FHLB and continually demonstrate this initiative through our operations. Indeed, we would not be able to function as a successful bank without the continued focus on our community, which includes supporting the housing market. The rule changes at issue include the *ongoing* compliance tests of the 1% "makes test" for long-term residential mortgage loans ("1% test") and the 10% residential mortgage test ("10% test"). These changes will have far-reaching consequences that potentially affect product pricing for consumers in a negative manner, restrict strategic balance-sheet management and unnecessarily increase resources.

Impact on Prudent Balance-Sheet Management

The events of the recent Great Recession clearly teach us that financial institutions allowed to proactively manage their individual balance sheets to mitigate the risks of those environments are critical to the safety of the system as a whole. The proposed ongoing compliance test will add restrictions that could arbitrarily force FHLB member institutions to carry risk exposure beyond what they would prudently take otherwise.

The proposed ongoing 1% and 10% tests will create conflicting dynamics for balance sheet management. The underlying assets that support both tests have inherent risks that increase in certain interest rate

cycles. For example, the 10% test requires that financial institutions prove that they have at least 10 percent of assets in residential mortgage loans. The mortgage loans and securities that support this test are considered risky assets from an interest rate risk perspective. These loans and securities have an inherent extension of cash flow timing in a rising rate environment (i.e. duration and convexity risks). In other words, as these loans and securities extend in duration during an upward move in interest rates, they create more interest rate risk on a bank's balance sheet. Accordingly, bank management may seek to reduce mortgage holdings to prudently mitigate this risk during certain interest rate cycles. The proposed tests, however, could conceivably create a situation where bank management may be forced into deciding between managing interest rate risk versus maintaining access to contingent liquidity at the FHLB.

Another consideration as it relates to the 1% test is the relationship between mortgage originations and interest rates. Mortgage originations are negatively correlated to movements in interest rates: The number of mortgage applications reduces as rates rise. This macro dynamic is an external factor over which banks have little control. Considering the current interest rate environment, the amount of mortgage applications is likely to decrease significantly when rates rise. Banks could conceivably be penalized with FHLB membership cancellation under the new 1% test requirement despite best efforts to continue supporting their local mortgage markets.

The proposed ongoing tests will limit banks from prudently managing their balance sheets. As noted above, these restrictions will create dilemmas for bank management when having to decide between access to liquidity or reducing interest rate risk. Furthermore, external factors will now have a significant role in determining membership eligibility to the FHLB. Overall, the unintended consequences of the proposed tests will significantly weaken the FHLB member banks.

Negative Consequences for Consumers and their Communities

The cascading effect of these proposed rules ultimately would reach consumers, whose access to affordable mortgage products would be severely restricted. Currently, banks are free to manage their portfolio of mortgage-related products in a manner that appropriately mitigates risk exposures. This allows banks to offer such beneficial and desirable products as 15- and 30-year fixed-rate mortgages – even in today's low interest rate environment – because they are not *forced* to absorb the significant interest rate risk inherent in holding such instruments on the balance sheet long-term. The proposed rules would short-circuit this effective system.

If banks cannot prudently manage their mortgage holdings to mitigate the risk exposure inherent in a given rate environment, they will have no choice but to compensate for the additional risk by adjusting the structure of their product offerings. Indeed, they may find themselves under significant regulatory pressure to do so. During various points in the rate cycle, banks will either have to offer fewer products or increase their price to offset the exposure of being forced to hold them. It is crucial to understand that the market forces created by these rules would be in play across *all* FHLB member institutions simultaneously, affecting a broad swath of borrowers.

In addition, the restrictions imposed by the proposed rules changes could result in fewer institutions qualified to – or even *opting* to – remain members of the FHLB. This could severely impact the Affordable Housing Program (AHP), which is dependent on FHLB profitability and income for its funding. Decreased AHP funds will, in turn, negatively impact all communities that have benefitted greatly from the millions of dollars made available annually through FHLB members.

AHP-funded programs have assisted with developing affordable rental housing and housing for the homeless, provided down payment assistance for income-qualified first-time homebuyers, and funded programs enabling income-qualified homeowners to rehabilitate their homes. Funding has also allowed qualified homeowners to make much-needed modifications to their homes to accommodate family members with disabilities, or to help older homeowners to safely age in place.

These programs also help member banks achieve strong Community Reinvestment Act (CRA) ratings, as federal financial regulatory agencies view participation in FHLB's AHP programs as positive CRA activity.

In summary, the additional impact on consumer accessibility to affordable home financing terms and reduced subsidy programs for first-time homebuyers and lower-income homeowners would be jeopardized as an unintended consequence of the proposed membership rules.

Unnecessary Increase in Resources

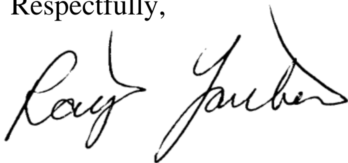
The proposed ongoing tests would add to the already growing compliance burden within the banking industry. In a recent American Banker article, *"Janet Yellen and Me,"* Ms. Yellen even acknowledged this concern when she told a community banker that "she hears almost daily how the Dodd-Frank Act and the Consumer Financial Protection Bureau are making it difficult for community banks to survive." The ongoing tests would add to this growing issue, but are the tests necessary?

We possess the assets needed to satisfy the tests as a result of our continued commitment to our communities. Our business model would not be successful without providing mortgage products to our customers. Proving our compliance, however, would require dedicating valuable resources to ensure our asset mix is satisfactory at the end of the year, and to analyzing and reporting our results. With our already established commitment to the housing market, the only result of the tests from this perspective would be unnecessary reporting requirements that serve no added benefit.

Conclusion

We appreciate this opportunity to voice our concerns about these proposed rules changes, and ask that you please take them under sincere consideration as you deliberate the future of the FHLB. We share your goal of ensuring a strong and viable program capable of fulfilling its stated mission, and of supporting the missions of its member institutions. However, we implore you to reassess the potential impact these proposed changes would have on the FHLB and its member banks, and strongly encourage you to consider a more surgical approach to address what we all agree to be the core issue.

Respectfully,



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