FHLBank
Topeka
Building Communities Together

FHLBank Topeka | P.O. Box 176 | One Security Benefit Pl, Suite 100 | Topeka, Kansas 66601-0176
PH 785.233.0507 | www.fhlbtopeka.com

ANDREW J. JETTER
President & CEO

October 19, 2006

By e-mail to comments@fhfb.gov

Federal Housing Finance Board
1625 Eye Street, NW
Washington, DC 20006

Attn: Public Comments

Re: Federal Housing Finance Board. Notice: Examination Rating System for the Federal Home Loan Banks and the Office of Finance. Docket Number 2006–N-05.

Ladies and Gentlemen:

We are pleased to have the opportunity to share our comments on the proposed examination rating system (Rating System) for the Federal Home Loan Banks (FHLBanks) and the Office of Finance (OF) published in the *Federal Register* on September 21, 2006.

The implementation of an examination rating system by the Federal Housing Finance Board (Finance Board) is a proactive step in improving the examination process and we fully support this action. We believe there are a number of positive results that are likely to come from the implementation of a rating system. They include more consistency in examinations over time as well as among the individual FHLBanks, a better understanding by the FHLBanks of examiner expectations and a fuller context in which to understand and evaluate the prudent operation and regulation of the FHLBanks.

However, we also respectfully suggest that the proposed Rating System can be significantly improved in a number of ways, both in its design as well as in its use.

Importance of Condition and Performance; Composite Ratings. We suggest that the overall design of the Rating System inappropriately minimizes the importance of current financial condition and performance. As quoted in the preamble, the FHLBank Act states that "the primary duty of the Finance Board is to ensure that the [FHLBanks] operate in a financially safe and sound manner." The preamble goes on to state that the major program of the Finance Board is the supervision of the FHLBanks "[t]o carry out [the Finance Board's] mission of ensuring that the Banks and the OF are safe and sound so the Banks can serve as a reliable source of liquidity and funding for the nation's housing finance and community investment needs…." Finally, the Rating System is "designed to reflect in a comprehensive, systematic and consistent fashion the overall condition and performance of an institution, taking into consideration all significant financial, operational, and compliance factors addressed in the Finance Board's examination." These excerpts demonstrate that the ultimate objective of the Finance Board is to ensure that the FHLBanks are in sound financial condition and are able to operate successfully now and in the future.

To be consistent with the Finance Board's primary mission, we believe that a composite safety and soundness rating should be a measure of an institution's current financial condition and its ability to operate successfully in the future. A high rating ("1" in the proposed system) should correspond to strong financial condition and performance today and a high probability that an institution will operate successfully in the future (and therefore the institution engenders little or no supervisory concern). A low rating ("4" in the proposed system) should correspond to a weak financial condition and performance today and a low probability that an institution will operate successfully in the future (and therefore the institution engenders significant supervisory concern and likely immediate intervention). The most critical factor in making these assessments is the present condition of the institution. If an institution is currently operating on a successful basis (strong earnings, strong product demand, etc.), it is more likely to operate successfully in the future. If an institution is currently not operating successfully, it is less likely to operate successfully in the future. The existing status of the institution generally falls under the Condition and Performance component. The other components included in the Rating System (governance, level and management of market, credit and operations risk) are important indicators of whether current performance will be sustained in the future (i.e., poor corporate governance, high risk levels and poor risk management practices make poor performance in the future more likely).

The Rating System does not appear to sufficiently weight current performance in the assignment of the composite rating. The introductory section of the Rating System states that "[t]he composite rating assigned to an institution is not an arithmetic average of the component ratings. Instead, the relative importance of each component is determined case-by-case within the parameters established by this rating system." It goes on to say that "the corporate governance component is given special consideration when assigning a composite rating."

We believe that the Finance Board should specifically identify and elevate the consideration of current financial condition and performance in describing how a composite rating is determined. For example, in describing the attributes of a Composite 1 rated institution, we suggest the following: "The institution has strong financial condition, performance and prospects, and exhibits no material deficiencies in corporate governance or risk management." A "1" composite rating should require more than just "no material deficiencies" in performance, as currently stated in Section II of the Rating System.

Condition and performance is a fundamentally different attribute than the other components. Each of the other components relates to risks of a future deterioration in condition and performance. They are not independent objectives. They are factors which will contribute to or detract from the future successful operation of an FHLBank. Consider two institutions, one that rates extremely poorly on corporate governance but is outstanding in terms of current condition and performance, and the other which scores high on corporate governance but has severe financial problems and is insolvent. Clearly the second institution warrants a much higher level of supervisory concern, if not warranting immediate regulatory intervention. Some may dislike this example because they believe that the institution with strong corporate governance is much more likely to be successful than is an institution that does not. This is precisely the point. The condition and performance of an institution is the ultimate objective. Corporate governance and the level of and the degree of management effectiveness relative to market risk, credit risk and operations risk are important because they are likely to have a direct and material impact on the future condition and performance of an FHLBank.

Market Risk Component. The Rating System defines market risk as "the degree to which changes in interest rates and other market risk factors can adversely affect an institution's economic capital (market value of equity) or earnings." We believe this statement does not appropriately define market risk in the context of an FHLBank's operations. The ultimate measure of safety and soundness is an FHLBank's ability to operate over the long-term at a level of profitability sufficient to absorb operating expenses, retain advance balances and pay a neutral dividend to members. A "neutral dividend" is one that does not provide undue incentive for a member to reduce advance balances, redeem stock or withdraw from membership. So the critical factor is not the degree to which changes in interest rates can adversely affect an institution's economic capital or earnings, but how the result of those changes affect the FHLBank's ability to continue to operate successfully. For example, volatility of earnings in the abstract tells little about the risk inherent in an FHLBank's operations. The degree to which that volatility is correlated with changes in interest rate levels does. If a 100 b.p. parallel drop in interest rates leads to a decline in earnings at an FHLBank, the level of supervisory concern should depend on how the lower earnings stream impacts the FHLBank's ability to operate and pay a neutral dividend (a neutral dividend being lower in a lower interest rate environment). In other words, earnings streams, and the affect of changes in earnings streams, are relevant only to the extent they ultimately impact the FHLBank's future ability to operate and pay a neutral dividend.

Market value of equity (MVE) is a more direct measure of future earnings streams relative to market rates, at least in theory. This would clearly be the case if market value of equity for an FHLBank was derived by projecting future earnings and then discounting those earnings at the neutral dividend rate. However, the calculation of market value of equity used by the FHLBanks is derived through discounting income/expense streams on individual assets and liabilities at what is determined to be the most appropriate discount rate for each asset and liability. This can produce some counterintuitive results. For example, the value of an outstanding debt instrument issued by the FHLBank is determined by discounting the debt by the current market rates on newly issued debt. Assume that the demand for the FHLBanks' debt significantly increases for whatever reason (increased foreign demand, enhanced marketing of FHLBank debt, etc.), causing the relative rates on the new debt to be lower than the rates on the debt issued in the past. Clearly, this would be a very positive development for the FHLBanks as it significantly enhances their relative profitability going forward. However, on a MVE basis, this appears to be a negative development. The improved issuance rates will be used to set the appropriate discount rate to value existing debt, leading to that debt having a higher market value (using lower discount rates to value a fixed stream of payments results in higher present values), and consequently the FHLBank will have a lower market value of equity. This situation occurs because MVE as currently determined for FHLBanks ignores the franchise value of the FHLBank (the positive earnings caused by the difference between asset yields and debt yields).

These comments are not meant to suggest that measures such as the level or volatility of MVE or earnings are not critically important to understanding and evaluating the market risk to which an FHLBank is exposed. However, such measures must be interpreted in the overarching context of risk to the long-term successful operation of the institution which is, at its core, the ability to generate an acceptable stream of earnings over the long term.

Credit Risk Component. We believe the ratings for this component are too conservative. A "1" rating should not require that there are no losses or only minimal losses, but that losses are managed to acceptable limits. The ability to manage losses will be a function of the level of possible/likely losses from credit exposures and the ability to withstand a loss in terms of earnings streams (primary) and retained earnings (secondary). To the extent a loss can readily be absorbed in terms of current earnings without negatively impacting retained earnings or dividends, the incurrence of losses should not prevent a "1" rating.

Operational Risk Component. We are concerned with the references in this section to severity and frequency of accounting, financial and regulatory reporting errors. There should be a qualitative analysis of whether errors are understandable given the changing landscape and often extreme complexity of accounting rules, such that a thorough and reasonable analysis can reach a result that is ultimately determined to be incorrect.

Condition and Performance Component. As discussed above, we believe this component should be given the most weight in determining the composite rating.

Also, the description of condition and performance contains the following statement: "An assessment of a Bank's earnings and profitability takes into account the cooperative ownership structure of the Banks and the interplay in a cooperative between product pricing and dividends." While clearly an FHLBank may determine that it prefers to charge less for its products and services and thereby earn less money, this does not make an FHLBank which chooses to do so, and therefore has a history of lower earnings, equal in credit quality to an FHLBank that has higher earnings. The ability of an institution to withstand a hit to earnings will be function of the level of those earnings, regardless of whether those existing earnings levels are a result of poor performance or a conscious decision to charge less for its products and services. While this practice may arguably engender a higher score in terms of mission achievement, it has negative implications in terms of safety and soundness.

Current and future earnings should focus on core pre-FAS 133 earnings. One-time events or the timing issues that come from FAS 133 do not represent a good prediction of the ability to operate successfully in the future.

A "1" rating under this component indicates that "[t]rends of most key measures are positive." It would be better to say that there are no negative trends. An FHLBank with strong earnings should not need to show a "positive" trend in earnings to receive a "1" rating.

Capital and leverage ratios should be evaluated based on what is driving those ratios. Maintaining higher liquidity ratios at the expense of a capital ratio that is close to the minimum required represents a prudent practice. Examiners should evaluate the underlying factors producing a capital ratio rather than just looking at the ratio itself. Primary focus in terms of an institution's ability to absorb loss should be the level and quality of current earnings stream (primary) and retained earnings (secondary). Leverage ratio (which includes capital stock) is not as significant a factor given that it represents the third layer of protection (behind current earnings and retained earnings).

This component should also address business prospects going forward, such as growth in products, stability of membership, and diversification of borrowers.

One of the factors under "Capital and Retained Earnings" is "[t]he relative stability of capital." If this is a reference to voluntary or excess stock, it needs to be analyzed in the context of the institution's ability to respond to redemptions of excess stock as well as the probability of such stock being redeemed. An FHLBank can more readily respond to redemptions of excess stock if that stock is supporting money market assets than it can if the stock is supporting long-term mortgage assets.

Use of Ratings. We believe that individual FHLBank composite and component ratings should be shared with all of the FHLBanks. The FHLBanks are jointly and severally liable for consolidated obligations, making each FHLBank a guarantor of the debt of every other FHLBank. In those circumstances, it is appropriate that the board of directors and senior management of the FHLBanks have a clear understanding of the Finance Board's view of the level of risk and management ability exhibited at each of the FHLBanks. With respect to the OF, all FHLBanks have a direct interest in the operations of the OF and should be entitled to see a copy of the OF's examination in its entirety.

Currently, pursuant to the regulations of the Finance Board, two FHLBank presidents as well as a public interest director, each appointed by the Finance Board, sit on the OF's board of directors and therefore have access to the OF's examination report. Since the OF acts as the agent of each of the FHLBanks, it would be desirable and appropriate for representatives of all of the FHLBanks to sit on the board of directors of the OF. Short of this, however, each FHLBank should have access to the examination report of the OF to assess the risks and quality of management at the organization overseeing the issuance of system debt.

Separate Rating for Safety/Soundness and Mission. The Rating System addresses both safety and soundness and mission compliance. The preamble notes that "the Office of Supervision may consider the need for a separate rating system or separate ratings component to evaluate and rate the affordable housing and community investment programs of each Bank after gaining experience with the proposed Rating System." Section I of the Rating System also notes that "the administration of a Bank's affordable housing and community investment activities is of critical importance in carrying out a Bank's housing finance mission, and it is taken into account in assigning component ratings for corporate governance and operational risk."

We urge the Finance Board to adopt a dedicated rating system for mission compliance, including administration of the AHP/CIP, separate and distinct from the safety and soundness rating system. This would be similar to the rating system used for banks and thrifts, which receive a safety and soundness rating as well as a Community Reinvestment Act (CRA) rating. Incorporating mission achievement in the component and the composite ratings creates significant ambiguity as qualitative aspects of mission achievement are juxtaposed against safety and soundness considerations. We believe it would produce a much better evaluation system to use different ratings for safety and soundness and mission achievement. There may be a number of areas in which safety and soundness and mission are arguably at odds. Trying to combine both into a single rating will obscure the results and inject substantial discretion and uncertainty into the component and composite ratings.

We appreciate the opportunity to comment on the proposed Rating System. If you have any questions or would like to discuss any of our comments, please call me at (785) 438-6001.

Sincerely,

Andrew J. Jetter