FHLBank San Francisco

October 23, 2006

Federal Housing Finance Board
1625 Eye St., N.W.
Washington, D.C. 20006
Attention: Public Comments

VIA E-MAIL: **comments@fhfb.gov**

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

Greetings:

The Federal Home Loan Bank of San Francisco ("Bank") appreciates the opportunity to comment on the Federal Housing Finance Board's ("Finance Board's") notice with request for comments on its examination rating system for the Federal Home Loan Banks ("FHLBanks") and the Office of Finance (71 Fed. Reg. 55181, September 21, 2006) ("Notice" or "Rating System").

The Bank supports the Finance Board's objectives of executing an effective risk-based supervisory program that promptly identifies and addresses current and emerging risks to the FHLBanks and of enhancing communication and transparency between the Office of Supervision and the FHLBanks. The Bank is particularly supportive of the Finance Board's effort to identify, in the Rating System, all significant financial, operational, and compliance factors to be considered during an examination.

We agree with the Finance Board that the Rating System's specificity in detailing the factors applied in examinations will bring a systematic focus to exams. We anticipate that this focus will enhance the benefits to the FHLBanks of the examination process by keeping the attention of management, directors, and examiners alike directed toward the significant financial, operational, and compliance factors both during an exam and throughout the year. We are also hopeful that this focus will bring added direction and clarity to communication between the FHLBanks and the Finance Board. This will be especially true to the extent that the Rating System is used to put exam report language in the appropriate context by providing a measure for comparison to a standard of performance. Combined, these benefits can be expected to foster examinations that are educational, open, and cooperative in tone.

While we generally support the proposed Rating System and its objectives, we are concerned that some of the prescribed standards appear to have more relevance in evaluating commercial banks than FHLBanks. The Rating System has significant policy implications to the extent it pushes the FHLBanks toward a commercial bank model. If left unchanged, these standards could result in rewarding FHLBanks that conform to measures that best serve neither the mission of the FHLBanks nor their special status as government-sponsored enterprises. Some standards are simply foreign to the business model appropriate for an FHLBank. We offer the following examples:

- Earnings & Profitability: We support the Finance Board's statement that an assessment of an FHLBank's earnings and profitability must take into account the cooperative ownership structure and the attendant relationship between product pricing and dividends. We are concerned, however, that the Ratings System appears to measure the adequacy of retained earnings only against an FHLBank's earnings stability and future prospects. We believe that, for an FHLBank, other factors, including risk management history, earnings stability relative to a benchmark, the FHLBank's business model, and its risk profile have more concrete relevance in evaluating the adequacy of retained earnings. We nevertheless strongly agree with the Rating System's implication that the adequacy of retained earnings should be measured based on a multiplicity of factors rather than by a single mathematical formula that does not consider all relevant variables.

  The emphasis the Rating System places on the stability of earnings and capital could be viewed as requiring a business model that demands an ever-increasing asset base and relatively large advance margins to support that stability. We believe an FHLBank needs a more dynamic business model that can achieve other strategic objectives and that allows for expansion and contraction based on member credit demand and the market factors that affect member credit demand. We recognize that the Rating System makes reference to the relationship of earnings and capital to market factors, but believe the Rating System does not incorporate standards that adequately consider this relationship.

- Credit Risk from Concentration: Concentration risk, while relevant to any credit risk analysis, must be viewed differently when evaluating an FHLBank than when considering concentration risk at other types of lending institutions. Having large outstanding advance amounts to members is not necessarily indicative of unsafe or unsound concentration risk. We believe, for example, that the amount and diversification of the underlying collateral and the risk management process is more relevant to a credit risk analysis than is the amount of the extensions of credit to a single member. We ask that the Finance Board incorporate into the Rating System specific mechanisms for examiners to take into account the effectiveness of countervailing factors, such as credit and collateral risk management processes, and sources of repayment, such as regulated financial institutions and collateral.

  We also note that the Rating System assumes that retained earnings and capital levels affect credit risk. We believe instead that retained earnings and capital can absorb credit losses, but do not increase or decrease credit risk.

- Measuring Operational Risk: Operational errors at an FHLBank are generally unique in nature. The FHLBanks do not experience regular or routine operational errors from any particular operational function as do commercial banks. It is unclear, therefore, how an FHLBank could demonstrate that it is measuring operational risk and, therefore, how this standard applies to the FHLBanks. We believe that more specificity would be helpful.

The examples above are intended to give the Finance Board our sense of how the Rating System, as proposed, has assumptions embedded in its standards that will tend to push the FHLBanks towards policies and practices more appropriate for commercial banks than FHLBanks. The Bank therefore urges the Finance Board, when finalizing the Rating System, to give careful consideration to the policy implications that each of the standards carries.

Thank you for your consideration of our comments. The Bank believes that, if the Finance Board is able to further tailor the Rating System to a business model more appropriate for an FHLBank, the Rating System will be a positive addition to the Finance Board's supervisory approach.

Sincerely,

Dean Schultz

Dean Schultz
President and Chief Executive Officer