

October 23, 2006

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

On behalf of the Federal Home Loan Bank of Seattle (Seattle Bank) we thank you for the opportunity to comment on the proposed Examination Rating System (ERS) for the Federal Home Loan Banks (FHLBanks). The Seattle Bank is supportive of the development of a rating system and we believe that a well constructed ERS will ultimately improve the examination process; however, we believe the Finance Board must establish a proper foundation prior to the implementation of such system. We offer the following comments for your consideration:

There is a need to establish a proper foundation for the examination process prior to the establishment of a ratings system.

As an overall comment, we believe that in order for the ERS to meet the stated objective of providing for a comprehensive, systematic, and consistent assessment of an FHLBank's condition, the Finance Board should first develop a proper foundation for the examination staff. The Finance Board has yet to develop comprehensive examination guidance (such as manuals and/or handbooks) to provide examiners with the necessary road map to ensure consistent examination procedures. In our view, this has led to a lack of consistency in the supervisory process. If the Finance Board decides to implement a formal ratings system of this magnitude, they should first ensure the examination staff has the necessary tools to allow them to meet the objectives stated in the proposal.

The examination guidance noted above should be provided to FHLBanks and would provide direction to FHLBank management regarding the expectations of the Finance Board as they are related to the proposed ratings. This would help to ensure that the banks are fully aware of the issues deemed critical by the Finance Board for the safe and sound operation of an FHLBank and would provide meaningful benchmarks for FHLBank management teams.

For the reasons stated above, we believe it is an important first step for the Finance Board to develop comprehensive examination guidelines prior to implementing the proposed ERS.

We would also like to make the following specific comments on the proposal:

There is a lack of clarity in certain parts of the proposal

If and when the ERS is adopted, certain aspects should be better defined and clarified to ensure both those responsible for establishing the ratings and the FHLBanks fully understand the expectations of the Finance Board. Some examples are as follows:

- Many of the terms in the proposal are undefined. For example, what does the Finance Board mean when it uses terms such as substantial compliance, moderate deficiencies, severe deficiencies and minor control deficiencies? We understand that there is a necessary subjective component to the rating process, but failure to provide clarity on significant terms will likely result in inconsistent ratings.
- The proposal lacks benchmarks for certain components of the ERS. For example, what does a “well administered AHP Program” mean? Is there an error rate that is acceptable, or is a zero percent error rate necessary for a program to be considered well administered? This is a significant issue and requires consistent application since the examiners’ opinion of AHP administration will have a direct and potentially significant impact on the corporate governance and operations risk components of the ERS.

Certain rating components are too conservative

Several of the ratings components in the proposal are overly conservative. We offer the following examples:

- It appears that to achieve a corporate governance rating of two, a FHLBank would have to promote compliance and have only minor compliance exceptions. Does this mean that to achieve a one rating an FHLBank could have no compliance exceptions? This may be an unrealistic expectation and make it impossible for even an institution with an exceptional corporate governance function to consistently achieve a one rating.
- A credit risk component of one could only be achieved if there are no losses or minimal losses. This appears to ignore the big picture, i.e., the ability of an FHLBank to absorb losses through current and retained earnings.

There are potentially significant inconsistencies in the application of assessment methodologies

The assessment methodologies, which are based on three measurement points and use a four point scale, are highly complex and could result in inconsistent application of the ratings. For example, two FHLBanks could each receive market risk ratings of “moderate risk” (using the measurement points low, moderate, or high risk) and have “adequate” market risk management practices (using the measurement points strong, adequate, or weak), and one institution could receive a rating of two and the other three. This is potentially significant since the proposal indicates that the general policy is that supervisory actions will be taken to address identified deficiencies or weaknesses of three-rated institutions.

Furthermore, the composite rating is likely to result in inconsistencies between examination results at different FHLBanks and between examination years at the same FHLBank because it is not to be derived arithmetically from the ratings of the five key components, but rather the relative importance of each component is to be determined on a case-by-case basis.

There is not sufficient differentiation in the ratings on the market risk component

There appears to be little difference in the definition of “strong market risk management” and “adequate market risk management”. However, an FHLBank receiving an assessment of strong could be rated a one and an institution receiving an assessment of adequate could receive a rating of four. This seems to be too wide of a disparity given the similarity in the definitions.

The affordable housing and community investment functions should have a separate ratings system

The proposal indicates that the Finance Board may consider the need for a separate ratings system for affordable housing and community investments. We agree with the Finance Board that this is an important component of an FHLBank’s mission, and we encourage the implementation of a separate and distinct rating system from the safety and soundness rating. This approach would be consistent with the approach taken by other financial institution regulators that provide both a rating to reflect safety and soundness and a rating to reflect the level of performance related to community reinvestment activities.

Comprehensive examination guidance, as discussed above, would be useful in the AHP area for the reasons previously stated. Several comment letters received by the Finance Board in response to the new AHP regulation requested that the Finance Board more clearly define certain requirements, such as acceptable sampling plans, initial monitoring and long-term monitoring. Presumably, the purpose of these requests was to clarify potentially differing opinions between the FHLBanks and Finance Board examiners. The Finance Board’s response to the comments was that these sections would be reviewed during the examination. An examination manual would greatly enhance the Banks’ ability to meet the Finance Board’s expectations in these types of situations.

We appreciate the opportunity to comment on the proposed ERS. Please let us know if you have any questions or would like to discuss any of the comments.

Sincerely,



James E. Gilleran
President and Chief Executive Officer



Richard M. Riccobono
Executive Vice President and Chief Operating Officer