FEDERAL HOME LOAN BANK OF CINCINNATI

David H. Hehman
President & CEO

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By e-mail and Federal Express

Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street, N.W.
Washington, D.C. 20552

Re: Alternatives to Use of Credit Ratings in Finance Agency Regulations RIN 2590—AA40

Dear Mr. Pollard:

The Federal Home Loan Bank of Cincinnati ("Cincinnati Bank") appreciates the opportunity to comment on the Federal Housing Finance Agency's ("Finance Agency") advance notice of proposed rulemaking on alternatives to the use of credit ratings in Finance Agency regulations ("Advance Notice") as published in the *Federal Register* January 31, 2011. In addition to signing a joint response letter developed by all the Federal Home Loan Banks, the Cincinnati Bank respectfully submits the following comments. Specifically, we are commenting on this matter as related to the Finance Agency regulation on Acquired Member Assets (12 CFR Part 955) (the "AMA regulation").

Comment Summary

The Cincinnati Bank proposes that the AMA regulation permit the use of alternative risk management approaches, analyses, and models to determine the amount of credit enhancement required for the mortgage loans to be purchased in lieu of being required to deploy a NRSRO model used since the inception of the MPP Program.

Background

12 CFR Part 955 governs the acquisition of member assets by a Federal Home Loan Bank ("Bank"). Section 955.3 sets forth the required risk-sharing structure for acquired assets, and contains several references to credit ratings. Specifically, section 955.3 requires a Bank to determine the amount of credit enhancement that is necessary to enhance the credit quality of a pool of assets to be acquired by a Bank so that the pool of assets obtains a credit quality equivalent to that of an instrument having at least the fourth highest credit rating from an NRSRO, or such higher credit rating as the Bank may require. The methodology used by a Bank

to determine the credit enhancement must be confirmed in writing by an NRSRO. Section 955.3 contains several other references to "credit rating." The Cincinnati Bank currently utilizes an NRSRO risk model to analyze the credit risk associated with a residential mortgage loan or pool of loans to be acquired. This NRSRO model also assigns a credit rating based on risk rating criteria. This analysis and ranking is used to determine the credit enhancement required by 12 CFR 955.3.

On December 23, 2010, the Cincinnati Bank signed a joint response from eight AMA Banks (Comments on Notice of Proposed Rulemaking Relating to Federal Home Loan Bank Liabilities RIN 2590–AA36) regarding this issue ("Joint Comment Letter"). This joint response stressed the importance of the Finance Agency moving from requiring one creditworthiness standard (i.e., a specific NRSRO credit rating) to a *principles-based* approach to credit risk management in the AMA regulation and included the following key points:

"Suggested elements of a principles-based approach to credit risk management for AMA assets are set forth below:

(1) An FHLBank should have the flexibility to develop its own policies and processes for determining creditworthiness and AMA credit enhancements (including the use of LEVELS® and NRSRO credit ratings to the extent deemed appropriate by each FHLBank);
(2) An FHLBank's creditworthiness standards and credit risk management policies and processes should comport with established governance standards and should be reviewed for adequacy by the Finance Agency;
(3) The total credit enhancement necessary for AMA assets would be the amount necessary to enhance the asset or pool of assets to a credit quality that meets the investment grade or credit rating established in the FHLBank's credit risk and investment policies; and
(4) The party responsible for determining the total credit enhancement necessary to enhance the asset or pool of assets to an appropriate level would be the FHLBank using models adopted or developed by an FHLBank, rather than the NRSROs exclusively, subject to regulatory guidance."

Discussion
In light of our continuing support for the considerations outlined above, the Cincinnati Bank proposes to use a principles-based approach, including the use of an alternative model to assess the credit risk of AMA loans that would provide a more accurate evaluation of such risk than relying solely on the current regulatory required model. As stated in the "Joint Comment Letter": *"The risk management program and creditworthiness standard outlined above would require the FHLBanks to document, through their own credit analysis and assessment, that the AMA assets and AMA credit enhancement process meet specified internal credit and risk analysis standards. The credit and risk analysis process for AMA assets would be part of an FHLBank's existing overall risk management policy and processes. The use of models and related controls in connection with the AMA credit and risk analysis process would fully conform to the requirements of Finance Agency Advisory Bulletin 2009-AB-03, and would be subject to supervisory review."*

The Cincinnati Bank believes it has the appropriate tools needed to develop and apply the principles-based approach to evaluating and determining credit enhancements for the MPP within our risk management program. We have been using an industry-recognized third-party credit default model since 2009 to evaluate credit risk in our MPP; this model is also an integral part of the MPP loan loss reserve process. This model was validated by independent third-party consultants in 2010, and we submitted the validation report to the Finance Agency for final approval of our New Business Activity filing originally submitted on September 25, 2009. Both we and the consultants believe that the model is less subjective and may be more theoretically robust than the currently required model in the way loan defaults are utilized within the risk management of the MPP. This model also provides substantially more flexibility and opportunity for user analytics (such as sensitivity analysis, drill down, decomposition, and attribution), which would offer additional benefits when implementing the principles-based approach to credit risk management in accordance with the principles-based approach suggested in the "Joint Comment Letter." Although this model is not based on credit ratings, we believe it is feasible to formulate an approach to effectively calibrate the results of the model to a ratings equivalent terminology; this approach can preserve establishing credit enhancements to continue achieving an investment grade rating within the Cincinnati Bank's internal credit risk policies and practices. There are also other third-party industry credit default models that could be considered to achieve an objective of continuing to determine credit enhancements within a ratings framework.

We appreciate your consideration of our comments as the Finance Agency develops its response to Section 939A of the Dodd-Frank Act and considers revisions to the AMA regulation.

Sincerely,

David H. Hehman
President & CEO