

BY EMAIL AND FEDERAL EXPRESS

March 17, 2011

Alfred M. Pollard, General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

**Re: Alternatives to Use of Credit Ratings in FHFA Regulations
RIN 2590—AA40**

Dear Mr. Pollard:

The 12 Federal Home Loan Banks (“FHLBanks”) are writing to comment on the Federal Housing Finance Agency’s (“FHFA’s”) advance notice of proposed rulemaking on alternatives to use of credit ratings in FHFA regulations (“Advance Notice”).¹ The Advance Notice solicits comments on how the FHFA should comply with the statutory mandate of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Section 939A”), which obligates the FHFA to review all of its regulations that require the use of an assessment of the credit-worthiness of a security or money market instrument (“Relevant Regulations”). After the FHFA conducts its required review of the Relevant Regulations,² the agency must then act to modify those regulations (a) to remove all references to or requirements of reliance on credit ratings³ and (b) to substitute for those references or requirements such replacement standards of credit-worthiness as the FHFA shall determine are appropriate for such regulations (“Replacement Standards”).

The issues presented by Section 939A’s mandate are significant, and the FHLBanks appreciate this opportunity to provide the FHFA with our comments as it reviews the Relevant Regulations and begins the process of making required changes to those regulations. In response to the questions posed in the Advance Notice, this comment letter: (A) summarizes the FHLBanks’

¹ 76 Fed Reg 5292 (Jan. 31, 2011).

² Note that there may be regulations that contain references to credit ratings but fall outside of the scope of Section 939A because they do not relate to “a security or money market instrument” within the meaning of Section 939A(a)(1). For example, to the extent the 12 CFR §932.9(a) limits on unsecured extensions of credit rely on issuer credit ratings, rather than credit ratings for particular securities or instruments, such limits arguably fall outside the scope of the Relevant Regulations. For the same reason, the requirement set forth in the FHFA’s proposed section 1270.5(c) that each FHLBank maintain a minimum issuer credit rating may also be outside the scope of Section 939A. *See* 75 Fed. Reg. 68534 (Nov. 8, 2010).

³ Section 939A does not provide a definition of “credit ratings.” We assume for purposes of this comment letter that “credit ratings” in Section 939A means credit ratings issued by a Nationally Recognized Statistical Ratings Organization (NRSRO).

recommendations to the FHFA for fulfilling Section 939A's mandate; and (B) answers certain questions from the Advance Notice on a question-by-question basis.⁴

A. Summary response to Advance Notice

The FHLBanks would support FHFA proposed rulemakings to amend FHLBank risk-based capital ("RBC") requirements (12 C.F.R. § 932.4) and FHLBank investments (12 C.F.R. § 956) that rely on NRSRO credit ratings, to implement Replacement Standards.⁵ As expressed in the comment letter submitted by certain FHLBanks on January 7, 2011, in response to the FHFA's proposed rulemaking regarding FHLBank liabilities ("Liabilities Comment"), we believe Replacement Standards could, for example, take the form of an FHLBank-specific credit ratings scale ("FHLBank Credit Scale") that substantially mirrors the definitions used by the NRSROs for each rating category. For example, the Replacement Standard for an AA rating of an unsecured security could mean the obligor has a *very strong* capacity to meet its financial commitments, an A rating could mean the obligor has a *strong* capacity to meet its financial commitments, and a BBB rating could mean the obligor has *adequate capacity*. Each FHLBank would be responsible for matching particular assets to the definitions in the FHLBank Credit Scale. Definitions in the scale could also permit the FHLBanks to look to third-party credit and liquidity assessments, including NRSRO ratings, as a significant factor in assigning an appropriate FHLBank Credit Scale rating to an asset. It may also be appropriate for an FHLBank Credit Scale to incorporate an asset-category component, particularly with respect to RBC charges. Those asset categories could be broad classes of investments and exposures that could be applied easily and without significant discretion in the form of RBC buckets or classes. Classes might include, for example, government, non-government-secured, and non-government-unsecured, with subcategories for varying maturities.

We note that the National Credit Union Administration ("NCUA") recently issued a proposed rule to implement Section 939A that would replace NRSRO credit ratings with definitions that are consistent with the general approach the FHLBanks believe the FHFA should adopt. *See* 76 Fed. Reg. 11164 (March 1, 2011) ("NCUA Proposal").

As set forth in the Liabilities Comment, we believe the FHLBanks should be permitted to use NRSRO credit ratings as a factor in determining whether a particular security meets the level of credit-worthiness reflected in any Replacement Standard the FHFA adopts. Section 939A by its terms obligates the FHFA to remove all references to credit ratings and all requirements to rely on credit ratings from the Relevant Regulations. Section 939A does not, however, bar the FHFA from permitting the FHLBanks to use NRSRO credit ratings as a factor in determining whether financial assets meet the levels of credit-worthiness reflected in Replacement Standards. Any proposed rule the FHFA issues to implement Replacement Standards should not, therefore, prohibit the FHLBanks from using NRSRO credit ratings in their internal analyses in applying any FHFA

⁴ The comments set forth herein are in addition to the comments submitted on January 7, 2011, by some of the FHLBanks in response to the FHFA's proposed rulemaking regarding FHLBank liabilities and those made by certain of the undersigned FHLBanks by separate comment letter dated December 23, 2010, regarding the application of Section 939A to the Federal Housing Finance Agency's acquired member assets regulations.

⁵ As set forth in footnote 2, changes to 12 C.F.R. § 932.9(a) may also be appropriate.

promulgated FHLBank Credit Scale. While the FHLBanks do not and should not rely mechanistically on NRSRO credit ratings to determine credit-worthiness, such ratings remain a useful tool.

The FHLBanks welcome the opportunity to provide the FHFA with additional information on our views regarding development of a framework that would include an FHLBank Credit Scale, before the agency issues any notice of proposed rulemaking to implement Replacement Standards for Parts 932 and 956.

B. Question-by-question response to Advance Notice

The following comments respond to those questions in the Advance Notice that have not been addressed in our summary response.

Question 1:

What core principles would be most important in FHFA's development of new standards of credit-worthiness? Which principles are least important to developing robust new standards? Are there principles in addition to those above that should be incorporated into new standards? Do differences in the business models, structures and core mission and activities of the Banks and the Enterprises justify or compel developing approaches that may emphasize different core principles depending on whether the rule applies to the Banks or the Enterprises?

In the Advance Notice, the FHFA states it believes that any Replacement Standard should:

- (i) Distinguish between different levels of credit risk, in an accurate and meaningful manner,
- (ii) Be a transparent approach,
- (iii) Be able to be applied consistently across regulated entities to the extent that they are subject to the same regulatory requirements,
- (iv) Be straightforward and not unduly burdensome to apply, and
- (v) Not be readily subject to manipulation.

The FHLBanks agree with the FHFA's list of core principles the agency should use in developing Replacement Standards.

The FHLBanks do not believe it is important that any Replacement Standards adopted for use by the FHLBanks be the same or consistent with those applicable to the other government sponsored enterprises. Investment limits may differ across entities. The business models and the investment activities of the FHLBanks are structured to best serve our unique cooperative structure and mission by providing readily accessible liquidity to our member institutions and facilitating housing finance, while at the same time protecting members' investment in the FHLBanks. This structure is very different from that of the Enterprises and creates different investment strategies.

Question 2:

What types of objective criteria could be used to differentiate credit exposures and apply meaningful credit risk capital charges? Should different criteria be used for different broad classes of investments or exposures? Could there be perverse incentives or other “downsides” to this approach? What might be the problems with this approach?

Addressed in Section A above.

Question 3:

What qualitative and quantitative standards would FHFA need to set to implement an approach that relied on the regulated entities to generate internal estimates of credit risk exposures? What are the strengths and weaknesses of such an approach? What would be the strengths and weaknesses of having FHFA itself set credit risk capital charges based on its own estimates of risk?

At this time, the FHLBanks believe establishment of an FHLBank Credit Scale that mirrors the definitions used by the NRSROs, with each FHLBank having responsibility to match particular assets to the definitions in the FHLBank Credit Scale, is the best approach. The Replacement Standards should require the FHLBanks to develop and implement appropriate policies and procedures to ensure their credit assessment processes are consistent with safety and soundness standards, including policies and procedures regarding the extent to which those processes may make use of NRSRO credit ratings and other third-party analytics. Those credit assessment processes would continue to be subject to FHFA oversight.

Question 4:

In order to apply a meaningful risk-based capital charge, FHFA needs to set forth requirements for the regulated entities to estimate the credit risk of their various exposures. Could an approach be developed that estimates a meaningful risk-based capital charge that avoids requiring a specific credit risk charge or specifying criteria to estimate credit risk? What might such an approach be?

The FHLBanks have not identified an alternative to risk-based capital charges at this time; however, the FHLBanks would welcome the opportunity to provide the FHFA with additional information to help it identify such a framework. In addition, as noted in Section A above, any FHLBank Credit Scale that serves as a Replacement Standard for RBC charges could incorporate an asset-category component based on broad classes of investments and exposures. Classes might include, for example, government, non-government-secured, and non-government-unsecured, with subcategories for varying maturities.

Question 5:

What are the strengths and weaknesses of these various approaches? Are there any existing, objective tools or approaches that could readily replace references to ratings issued by NRSROs in the regulations discussed in this ANPR? Are there other approaches not discussed above that may be appropriate?

As discussed in Section A above, for prudential regulations that the FHFA determines fall within the scope of Section 939A, the FHLBanks believe a prudent approach would be for the FHFA to develop an FHLBank Credit Scale that is responsive to the unique mission and purpose of the FHLBanks, adopt that scale for use in Relevant Regulations, and require each FHLBank to apply that scale using appropriate judgment. At this time, the FHLBanks have not identified any existing purely objective tool or approach that could readily replace references to ratings issued by NRSROs, without FHFA adoption of an FHLBank Credit Scale.

Question 6:

What specific credit-worthiness or investment criteria should FHFA incorporate into a new regulation, if it decided to adopt such a regulation? For example, should FHFA limit investments by regulated entities to securities that would be eligible investments for money market funds, or to securities with original maturities of one-year or less, or based on other objective criteria? What principles would FHFA need to incorporate into any regulation or policy that was meant to govern a regulated entity's internal credit assessment process?

The FHLBanks should not be limited to investing in securities that would be eligible for money market funds or securities with maturities of one-year or less. Imposition of such highly restrictive objective criteria would unnecessarily limit the FHLBanks' ability to implement effective liquidity planning strategies and our ability to respond effectively to market changes and other external factors. In addition, we reiterate the comments expressed in the Liabilities Comment: the FHLBanks believe our existing regulatory authority to acquire investment grade assets should be preserved, by implementation of appropriate Replacement Standards in the form of an FHLBank Credit Scale that defines investment grade. The FHLBanks' authority to acquire investment grade assets should not be removed. The FHLBanks are special entities that serve unique functions in facilitating housing finance and providing financial institution liquidity. The FHLBanks' current investment authority furthers the FHLBanks' ability to fulfill the core mission of the FHLBank System by providing the FHLBanks with sufficient liquidity to support the FHLBanks' advance business. Limiting the investment criteria could have a negative impact on the FHLBanks' ability to fulfill their core mission.

Question 7:

Can any of the current prudential requirements that reference NRSROs or credit ratings be eliminated without compromising FHFA's ability to monitor and promote the safe or sound operations of the regulated entities?

The FHLBanks do not believe that Section 939A mandates that the FHFA remove all references to NRSRO ratings or requirements from its regulations. To the extent the FHFA determines any NRSRO ratings references or requirements must be replaced, the FHLBanks believe replacing those requirements with Replacement Standards in the form of an FHLBank Credit Scale will enable the FHFA to continue to monitor and promote the safe and sound operations of the FHLBanks.

Question 8:

Is it important that FHFA’s approach to replacing requirements in its regulations that reference credit ratings issued by NRSROs be consistent with that of other financial regulators, especially federal banking agencies?

No. The FHLBanks differ significantly from other types of financial institutions. Investment security standards promulgated by the Office of the Comptroller of the Currency (“OCC”), for example, are designed specifically for the entities regulated by the OCC and are not necessarily directly transferable to the FHLBanks. The FHFA should not necessarily adopt Replacement Standards that duplicate replacement standards adopted by other agencies. However, as noted in Section A above, components of the NCUA Proposal may be useful in the development of an FHLBank Credit Scale. We also note that the OCC is currently engaged in a rulemaking addressing alternatives to credit ratings in connection with securities permissible for investment by national banks, and the federal banking agencies are engaged in a joint rulemaking on alternatives to credit ratings in connection with risk-based capital charges.⁶ The FHLBanks believe the FHLBank System would benefit from considering standards those agencies propose before the FHFA proceeds to issue final rules to implement Section 939A.

Question 9:

What are some other safeguards or requirements (not necessarily based on credit-worthiness standards) that might provide protections similar to those afforded under FHFA’s current regulations that reference ratings issued by NRSROs?

In addition to application of an FHLBank Credit Scale, the FHFA could look to benchmarking assets rated using an FHLBank Credit Scale against NRSRO ratings or other credit evaluation scale and could consider evaluations of each individual FHLBank’s credit underwriting and standards to help ensure investments are made only in conformance with regulatory requirements.

C. Other Comments

The FHLBanks ask that any rulemaking to implement Replacement Standards incorporate a phase-in period for implementation with an effective date of no earlier than one year after issuance of the final rule. This would allow the FHLBanks time to prepare and implement policies and procedures necessary for compliance with the Replacement Standards.

Thank you for your consideration of our comments.

Sincerely,

Signatures on following pages

⁶ See Advance notice of proposed rulemaking regarding alternatives to the use of external credit ratings in the regulations of the OCC. 75 Fed. Reg. 49423 (Aug. 13, 2010). See also Joint advance notice of proposed rulemaking regarding alternatives to the use of credit ratings in the risk-based capital guidelines of the Federal banking agencies. 75 Fed. Reg. 52283 (Aug. 25, 2010).

Federal Home Loan Bank of Atlanta



W. Wesley McMullan
President and Chief Executive Officer

Federal Home Loan Bank of Boston



Edward A. Hjerpe III
President and Chief Executive Officer

Federal Home Loan Bank of Chicago



Roger D. Lundstrom
Executive Vice President and
Chief Financial Officer

Federal Home Loan Bank of Cincinnati



David H. Hehman
President and Chief Executive Officer

Federal Home Loan Bank of Dallas



Terry Smith
President and Chief Executive Officer

Federal Home Loan Bank of Des Moines



Richard S. Swanson
President and Chief Executive Officer

Federal Home Loan Bank of Indianapolis



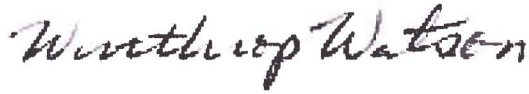
Milton J. Miller
President and Chief Executive Officer

Federal Home Loan Bank of New York



John F. Edelen
Senior Vice President and Chief Risk Officer

Federal Home Loan Bank of Pittsburgh



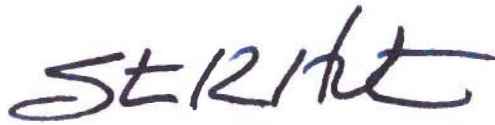
Winthrop Watson
President and Chief Executive Officer

Federal Home Loan Bank of San Francisco



Dean Schultz
President and Chief Executive Officer

Federal Home Loan Bank of Seattle



Steven R. Horton
Acting President and Chief Executive Officer

Federal Home Loan Bank of Topeka



Andrew J. Jetter
President and Chief Executive Officer