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FHLBANKS
A NATION OF LOCAL LENDERS

August 2, 2016

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW.
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW.
Washington, DC 20429

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street SW.
Suite 3E–218 Mail Stop 9W–11
Washington, DC 20219

Re: Docket No. R–1537; RIN 7100 AE–51 (Federal Reserve Board)
RIN: 3064-AE44 (Federal Deposit Insurance Corporation)
FDIC Docket ID OCC-2014-0029 (Office of the Comptroller of the Currency)

Dear Sirs and Madams:

This comment letter is submitted by the Council of Federal Home Loan Banks (Council), a trade association, on behalf of its members, the eleven Federal Home Loan Banks (FHLBanks or FHLBank System). It is being submitted in response to the Notice of Proposed Rulemaking (NPR) published in the Federal Register on June 1, 2016 entitled "Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements." The Docket and RIN numbers are located above.

The FHLBanks are government-sponsored enterprises of the United States, organized under the authority of the Federal Home Loan Bank Act of 1932, as amended, and structured as cooperatives. Each FHLBank is independently chartered and managed, but the FHLBanks issue consolidated debt obligations for which each FHLBank is jointly and severally liable (Consolidated Obligations). The capital stock of each FHLBank is registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934. The FHLBanks serve the general public interest by providing liquidity to approximately 7,200 member financial institutions, thereby increasing the availability of credit for residential mortgages, community investments, and other services for housing and community development. The FHLBanks' member institutions, which include banks, savings institutions, credit unions, community development financial institutions, and insurance companies, are also their shareholders. The FHLBanks provide readily available, low-cost sources of funds to their member financial institutions through loans referred to as "advances." In addition, some FHLBanks also purchase and hold residential mortgage loans from their member financial institutions.

The FHLBanks' cooperative business model has enabled them to support their members' liquidity and risk management needs safely and soundly for nearly 85 years. The FHLBanks have been a reliable source of liquidity throughout all economic cycles. Their critical role as a liquidity provider has been reinforced by the governmental resources made available to them to support their own liquidity, as discussed below.

The Council appreciates the importance of adequate liquidity in our financial system, and in particular the need to assure that large and internationally active institutions have strong and reliable sources of stable funding to survive a year-long period of financial or economic stress. We therefore applaud the efforts of the U.S. banking agencies in addressing this issue, and for publishing this proposed rule. We believe that it is a step in the right direction. However, as will be explained in this letter, we believe that the NPR can be improved by more fully taking into account the role of the FHLBanks as a reliable liquidity provider during times of economic and financial stress and by recognizing that FHLBank Consolidated Obligations are a highly liquid and easily marketable asset throughout all economic cycles.

In this letter, after describing the FHLBank System and providing analytics, we will be recommending revisions to the available stable funding ("ASF") factors applied to FHLBank advances and public unit or municipal deposits in excess of FDIC insurance and backed by FHLBank letters of credit or other private insurance, and the required stable funding ("RSF") factor applied to FHLBank Consolidated Obligations.

I. Purpose of the NPR

The genesis of this NPR may be found in the 2007–2008 financial crisis, when large and internationally active banking organizations were buffeted by the sudden and dramatic withdrawal of short term funding.[1] During this market crisis, some banking organizations experienced such severe contractions in the supply of funding that their continued viability was

[1] 81 Fed. Reg. 35126 (2016).

threatened.[2] This NPR is part of several new standards developed by the Basel Committee on Bank Supervision that are designed to improve a banking organization's ability to absorb shocks that arise during periods of severe financial and economic stress.[3]

To date, the U.S. banking agencies have adopted a number of Basel proposals, and taken other actions, to improve the safety of our financial system and to strengthen the ability of financial companies to withstand sharp downturns. In 2014, the agencies implemented a liquidity standard regulation, the "Liquidity Coverage Ratio" (LCR) designed to ensure that covered banking companies can withstand a short-term (30 day) period of market turmoil.[4] This NPR, on the other hand, is designed to protect institutions from *long-term* liquidity stresses, over a one-year period. The preamble explains this concisely: "In a financial crisis, financial institutions without stable funding sources may be forced by creditors to monetize assets at the same time, driving down asset prices. The proposed rule would mitigate such risks by directly increasing the funding resilience of individual covered companies, thereby indirectly increasing the overall resilience of the U.S. financial system."

The preamble above indicates that this NPR is designed to address at a macroeconomic level that the nation's largest financial institutions will have ample liquidity during periods of market stress. At a microeconomic level, this rule is not designed to assure that a financially troubled institution will in fact have adequate liquidity in all situations. Thus, whether a FHLBank reduces liquidity to a troubled bank due to poor quality assets, mismanagement, fraud, or other particular safety and soundness concerns is not the relevant consideration for this proposal. Rather, the issue presented by the NPR is whether the FHLBank System is a reliable provider of liquidity when such liquidity is necessary due to a systemic stress, such as the market panic that began in 2007. As explained and documented below, we believe the answer is an emphatic "yes."

II. <u>FHLBanks' Financial Reliability and Stability</u>

Several factors make the FHLBanks a far more reliable source of liquidity than other wholesale funders. Key differences include: the Congressional mandate given the FHLBank System; the breadth of having over 7,200 financial institution member investors; the role and history of the FHLBanks as a liquidity provider in times of economic stress; the various special resources the FHLBanks have, including robust underwriting and statutory access to Federal banking exam reports, that ensure their continued ability to provide funding even in dire economic times; the demonstrated ability of the FHLBanks to raise funds through the issuance of Consolidated Obligations during a financial or economic crisis; the special statutory lien priority

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[2] Id. "As access to funding became limited and asset prices fell, many banking organizations faced the possibility of default and failure. The threat this presented to the financial system caused governments and central banks around the world to provide significant levels of support to these institutions to maintain global financial stability."
[3] Id.
[4] Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 FR 61440 (October 10, 2014).

given the FHLBank advances; and the close Federal safety and soundness supervision of the Banks. As discussed below, because of these differences, we recommend that FHLBank advances, public unit or municipal deposits in excess of FDIC insurance and backed by FHLBank letters of credit or other private insurance, and FHLBank Consolidated Obligations be assigned more favorable ASF and RSF factors than those proposed by the NPR.

A. Congressional Mandate

Congress established the FHLBank System in order to provide a reliable source of liquidity to housing lenders. The Federal Home Loan Bank Act was passed in 1932 for the very purpose of providing liquidity in the midst of a severe financial and economic crisis, the Great Depression. In the accompanying Presidential signing statement Herbert Hoover explained the purpose of the Act: "Its purpose is to establish a series of discount banks for home mortgages, performing a function for homeowners *somewhat similar to that performed in the commercial field by the Federal Reserve banks through their discount facilities*." Since 1932, the FHLBank System has fulfilled this Congressional mandate by providing liquidity to its members, especially when needed due to financial or economic stress. Most recently, during the height of the financial crisis that began in 2007, the FHLBank System became the largest provider of liquidity for the domestic banking sector.

B. FHLBanks Provide Liquidity During Economic Stress

The ability of the FHLBank System to provide low-cost liquidity during financial and economic crises was clearly demonstrated during the 2007-08 financial crisis. Beginning in the second quarter of 2007 and continuing to the end of the third quarter of 2008, the FHLBank System increased lending to its members from approximately $650 billion to over $1 trillion. The FHLBank System's cash infusion into the U.S. banking sector helped numerous banks, generally across the curve, remain solvent and avoid failure. This not only served to relieve pressure on the U.S. Treasury, Federal Reserve, and Federal Deposit Insurance Corporation—it likely saved U.S. taxpayers billions of dollars.

The FHLBank liquidity support during the financial crisis was extensively documented in a New York Federal Reserve Bank study. This paper concluded that the FHLB System, ". . . by far, was the largest lender to U.S. depository institutions until December, 2007, while most of the Federal Reserve's liquidity operations until then were for the benefit of non-depository institutions or foreign financial institutions."[5] The growth in advances during the initial stages of the 2007-08 financial crisis is illustrated in this chart:

[5] Federal Reserve Bank of New York, Staff Report No. 357 at pages 28 – 29 (Nov. 2008).

Figure 1: FHLBank Advances
Source: Office of Finance

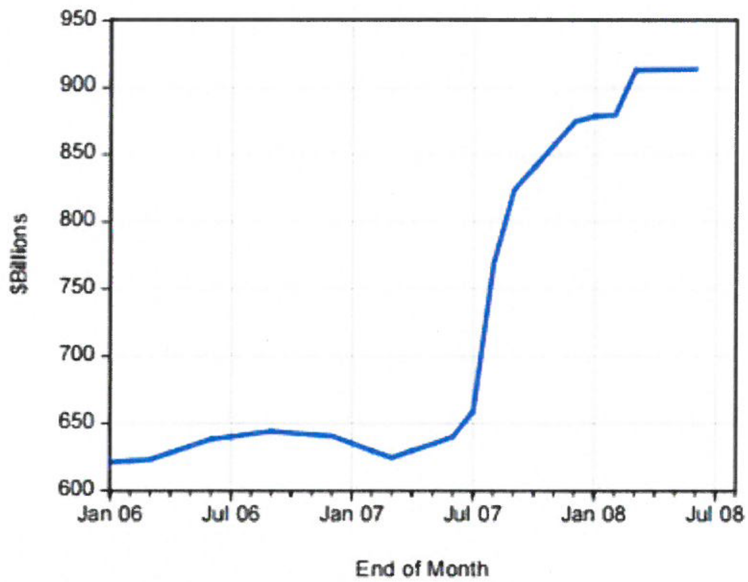
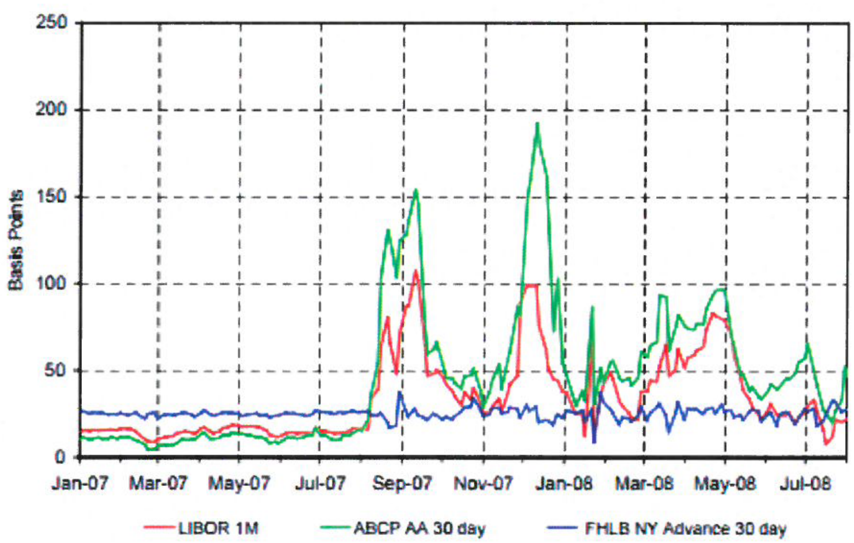
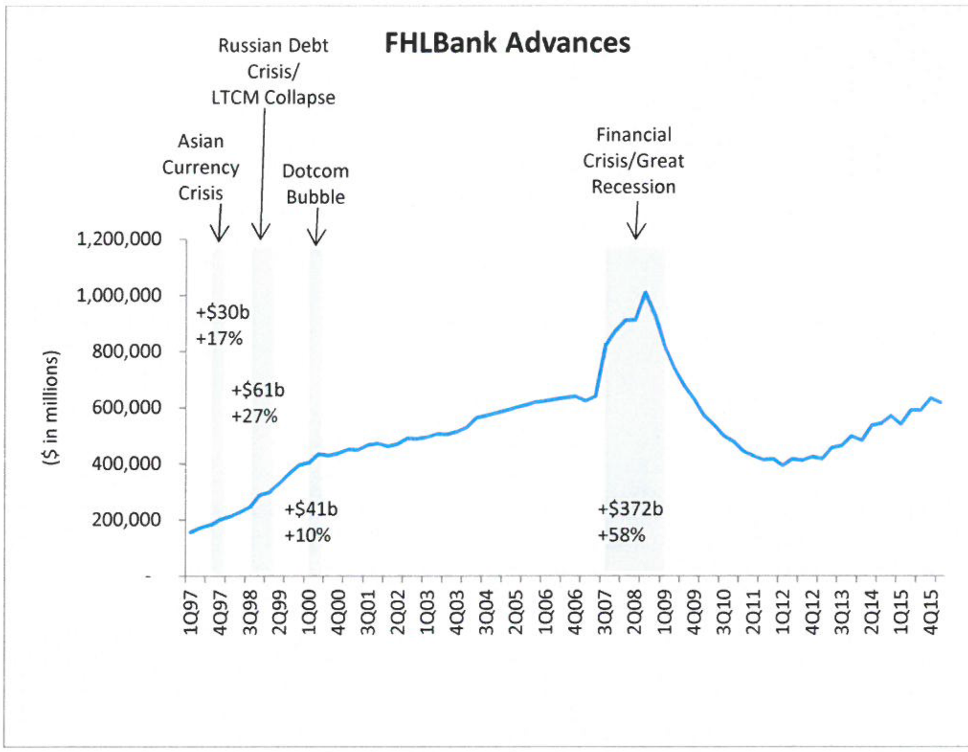


Figure 2: Spread of Selected Funding Rates to 4 Week FHLBank Discount Note
Source: Office of Finance



The use of FHLBank advances to meet liquidity needs of member depository institutions in times of economic or financial stress is not new. In prior financial crises, the FHLBank System has likewise provided, not withdrawn, necessary liquidity. Below is a chart showing some of the more significant financial crises since 1997 and the percentage increase in FHLBank advances that occurred.

Figure 3: FHLBank Advances During Significant Financial Crises
Source: Office of Finance



As can be seen by this chart, the FHLBanks are a reliable source of liquidity, especially during periods of economic stress.

C. Special Nature of the FHLBanks

Unlike other wholesale lenders, the FHLBanks' unique nature supports their continued ability to fund advances. First, the U.S. Treasury is explicitly authorized to purchase up to $4 billion of FHLBank System debt securities. Second, FHLBank debt securities are considered government securities under the Securities and Exchange Act of 1934. Among other things, this status means that the securities can be used as collateral for public deposits, can be bought and sold by the Federal Reserve in open-market operations, and may be held in unlimited amounts by federally insured depository institutions. Third, FHLBank debt securities are eligible for issuance and transfer through the Federal Reserve System's book-entry system, which is also used by the U.S. Treasury. Fourth, by statute, under certain circumstances, the FHLBanks are given a priority over other creditors in the event that a borrowing institution becomes insolvent (sometimes called a "super-lien"). Fifth, the FHLBanks are supervised and regulated by a Federal agency that mandates capital and liquidity standards. Finally, and most notably, no FHLBank has ever suffered a loss on an advance, even in cases of significant banking failures, mergers, and acquisitions.

All of these factors illustrate the special nature of the FHLBanks and the importance that Congress attributes to their mission to provide liquidity to financial institutions. Also, the FHLBanks' various connections with several Federal agencies demonstrate that the FHLBanks have the support to be able to continue accessing funds necessary to make advances in troubled times.

D. FHLBank Consolidated Obligations Can Continue to Fund Advances in Stress Periods

The FHLBanks primarily fund advances through the issuance of Consolidated Obligations, which are debt instruments issued by the FHLBank System's Office of Finance. These obligations represent joint and several liabilities of the FHLBanks. Thus, the principal and interest from Consolidated Obligations are backed by the financial strength of the entire FHLBank System. FHLBank Consolidated Obligations are rated by Moody's (AAA) and S&P (AA+) and are exempt from state and local income tax. These factors make FHLBank Consolidated Obligations a highly desirable investment, especially in times of financial stress.

This can be illustrated again by the market reaction to the financial crisis that began in 2007. As a result of the market turmoil, investors turned to the safest possible investments, looking worldwide for safe havens. One of the chief "safe haven" investments benefiting from this flight to safety were Consolidated Obligations. Thus, at the very time the market for other assets began to seize up, demand for FHLBank Consolidated Obligations soared. In their 85-year history, the FHLBanks have always been able to raise sufficient funds in the capital markets to readily meet members' liquidity needs.

Figure 4: FHLBank Consolidated Obligations Outstanding at Month-End
Source: FHLBanks

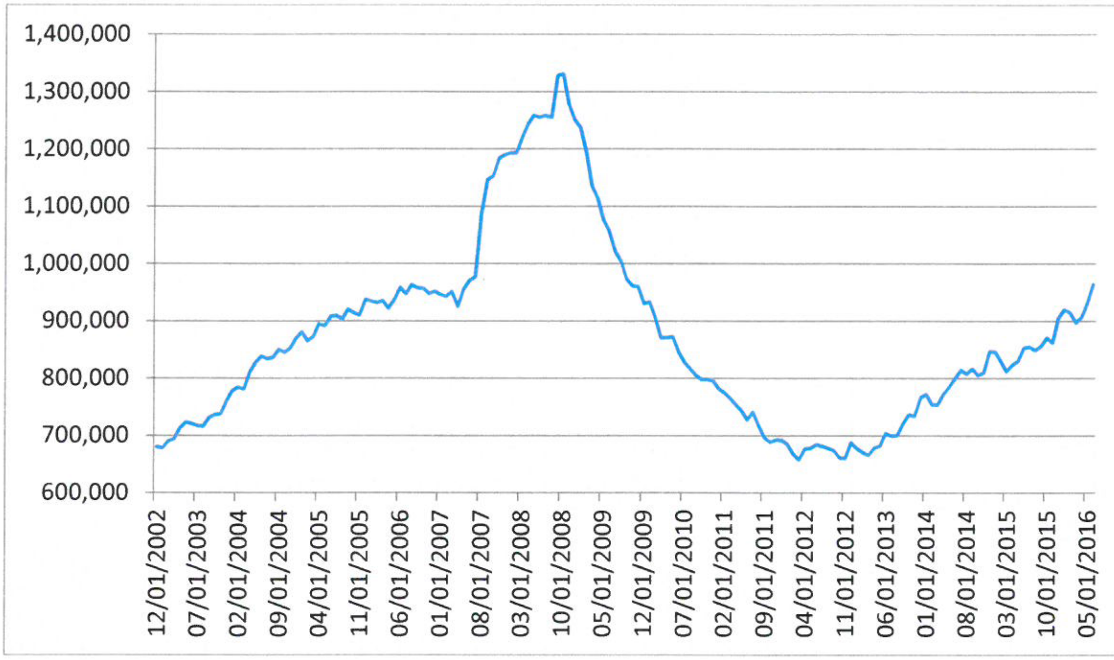
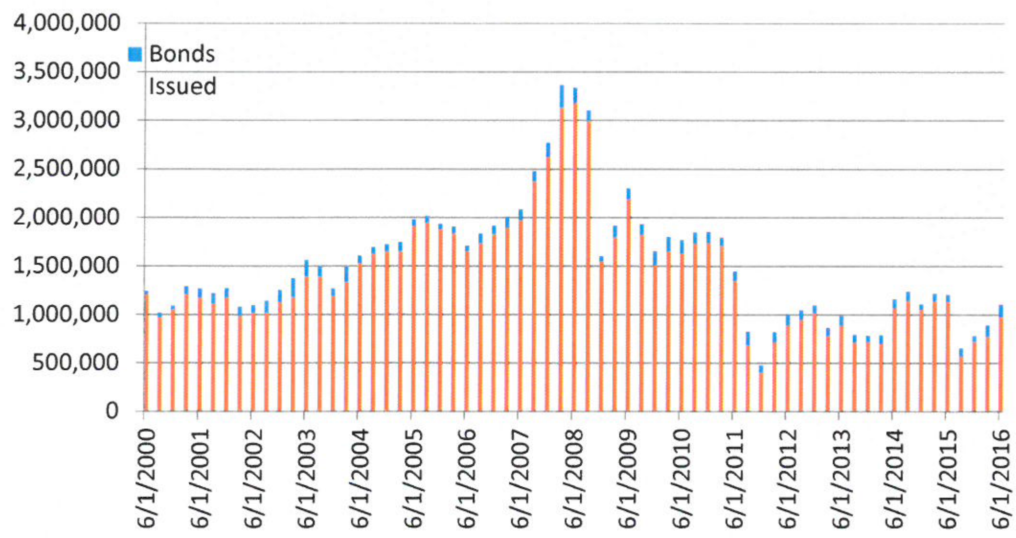


Figure 5: FHLBank Consolidated Obligations Issuance
Source: FHLBanks



As the data establishes, demand for FHLBank Consolidated Obligations grew, rather than declined, during the 2007-2008 financial crisis. This demonstrated the ability of the FHLBank System to raise the funds necessary to continue funding its advances during a stress period.

III. Proposed Net Stable Funding Ratio

As proposed, the new rule would apply to bank and savings and loan holding companies that have $250 billion or more in consolidated assets or $10 billion or more in foreign on-balance sheet positions. It would also apply to the depository institution subsidiaries of these organizations if the institution has at least $10 billion or more in consolidated assets. A modified standard would be applied to banking organizations that have between $50 billion and $250 billion in consolidated assets, provided these companies do not have $10 billion or more in foreign on-balance exposures. Under the proposed modified rule, banking companies with between $50 billion and $250 billion in assets would have to maintain sufficient liquidity to meet 70 percent of its cash needs as such needs are calculated under the available stable funding proposal equal to at least 70 percent of the company's estimated required stable funding.

The proposed rule requires a covered company to compute a "net stable funding ratio" which is simply the ratio of "available stable funding" (ASF) to "required stable funding" (RSF). Put another way, the proposal requires a covered company to have an amount of stable funding that is at least equal to its projected funding requirements over a one-year period of financial distress.

A. ASF Calculation

A covered company's ASF amount is a weighted measure of the stability of the company's funding over a one-year time horizon, beginning on the computation date. The ASF is computed by applying prescribed standard weights (ASF factors) to the company's equity and liabilities. A zero percent weight is for funding with the lowest stability, that is funds that would be expected to be withdrawn almost immediately. A 100 percent weight is for the most stable funding, funding that would be expected to remain with the covered company for at least a year after the onset of the financial stress. Weights between these two extremes are for funding that would likely experience some degree of flight, but as a class would not be totally withdrawn from the covered company's balance sheet.

As proposed, ASF factors would be set at five precise percentages ranging from zero to 100 percent (i.e. 0%, 50%, 90%, 95%, 100%). Based on the NPR's categorizations, the ASF factor for FHLBank advances with a remaining maturity between six months and one year is 50 percent, meaning that 50 percent of these outstanding advances would be presumed to run off. This is the same ASF factor proposed for *unsecured* wholesale funding provided by a nonfinancial company that matures within one year. It is also the same ASF factor as *unsecured* wholesale funding provided by a financial sector entity that matures between six months and one year. By applying the same ASF factor to *fully secured* FHLBank advances as to unsecured funding provided by private sector companies, the NPR fails to take into consideration the FHLBanks' track record of financial stability and reliability and the fact that advances are fully secured.

Instead, we recommend that the final ASF factor for FHLBanks advances be appropriately scaled to other forms of wholesale funding and how those liabilities perform in adverse liquidity scenarios. To accomplish this, we recommend that the final rule include greater diversification or differentiation based on the type of funding and the anticipated likelihood of withdrawal. For instance, the agencies can establish percentage ranges based on the stability of the funding. The creation of a more robust framework that specifically acknowledges, incorporates, and relies on the FHLBanks' wholesale funding during a time of stress or crisis is crucial, as confirmed by our submitted historical data and analyses.

Our analysis shows that an ASF factor of 80 percent is appropriate for FHLBanks advances with maturities between six months to one year and an ASF factor of 20 percent for FHLBanks advances with maturities less than six months. Additionally, we believe that public unit or municipal deposits in excess of the FDIC deposit limits, which are privately insured or fully collateralized by an FHLBank letter of credit (where it is backed by the strength of an NRSRO rated FHLBank) should be assigned an ASF factor of 95 percent or slightly below the percentage for FDIC-insured deposits. The presence of stabilizing features such as FDIC insurance and FHLBank letters of credit or other private credit support should reduce the likelihood of withdrawal of these deposits during times of market disruptions.

B. <u>RSF Calculation</u>

The ASF estimates the available liquidity of the covered company during a year of stress. It is the amount of cash that would be left after some funding "runs off" during the one-year period. The "required stable funding" amount (RSF), on the other hand, is designed to be a measure of how much cash will be needed during this period. It does this by looking at the assets of the covered company, and predicting how much could be raised through the sale of these assets during the stress period. If all of a covered company's assets could be sold for full value, there would be no need for any cash reserves. Since that is not a realistic possibility during a financial or economic crisis, some assets will only be able to be sold at a discount, and there may not be a market for other assets. The gap between the book value of the assets and the amount that can be sold for cash quickly and at full value must be filled in with cash.

The NPR assigns specific discounts (RSF factors) for various types of assets commonly held by a financial company. For GSE-issued or guaranteed obligations, the RSF factor is 15 percent. This means that under the proposed rule a covered company would have to assume that FHLBank Consolidated Obligations would have to be sold at a 15 percent discount to book value. The explanation given is that the 15 percent discount is based on the "relatively high level of liquidity of these assets compared to most other asset classes." However, despite acknowledging the high level of liquidity of FHLBank Consolidated Obligations, the proposal still assigns an RSF factor of 15 percent.

As explained above in Section II.D, the 15 percent RSF factor is not consistent with historic experience. Based on historic and recent experience, demand for Consolidated Obligations should expand as a reaction to market turmoil.

We recognize that the Liquidity Coverage Ratio (LCR) applies a 15 percent discount to FHLBank Consolidated Obligations, and that this may be seen as a justification for using the 15 percent RSF factor in this proposal.[6] However, unlike the short timeframe used in the LCR, this proposal deals with a one-year period. This is a significantly longer time to liquidate assets and negates the impact of any short-term market disruption. Thus, even if one were to view a 15 percent discount appropriate in the LCR rule, it should not therefore be simply carried forward in this proposal dealing with a one-year time frame.

We also note that the proposal would apply a five percent RSF factor to the debt of most OECD foreign governments.[7] Recent experience has shown that the demand for foreign government debt can vary widely. Further, a recent Federal Reserve Board study found a cyclical correlation between economic and financial crises and sovereign debt crises.[8] In other words, it is not unusual for a financial crisis to immediately precede or coincide with a sovereign debt crisis. FHLBank Consolidated Obligations, on the other hand, correlate *inversely* with financial stress. Therefore, given the FHLBanks' unique liquidity provider status, we suggest that the RSF factor for Consolidated Obligations should be five percent as well.

The market attributes of FHLBank Consolidated Obligations support the five percent RSF factor. FHLBank Consolidated Obligations are highly liquid with many active and diverse market makers. In all market environments, FHLBank Consolidated Obligations have experienced robust and narrow bid-ask spreads and high trading volumes. With these multiple committed market makers and large number of non-market maker buyers and sellers, FHLBank Consolidated Obligations also experience timely market prices. During the 2007-2008 financial crisis, the FHLBank Consolidated Obligations bid-ask spreads did not significantly widen above normal.

We also want to bring to your attention that the proposed RSF highly favors agency mortgage-backed securities (MBS) over whole mortgage loans held in portfolio. Under the proposal, a banking company holding agency MBS applies a 15 percent RSF factor to those assets while a covered company holding whole mortgage loans in portfolio (that qualify as prudently underwritten) must apply a 65 percent RSF factor to those assets. Other mortgage loans held in portfolio are subject to an 85 percent RSF factor. The result could make portfolio lending more expensive and encourage banking companies that originate mortgages to sell them into a securitization rather than to hold them in portfolio. We question whether the agencies should be taking actions that penalize portfolio lending. There are strong public policy reasons

[6] 81 Fed. Reg. 35143 (2016).
[7] Id. at 35142.
[8] Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 1104 (May 2014) at 3.

that encourage our nation's banking companies to continue to finance home mortgages and hold them in portfolio.

IV. Conclusion

The proposed net stable funding ratio would require covered companies to maintain sufficient cash or assets readily convertible to cash to withstand the liquidity demands that the Federal banking agencies estimate would be necessary during a one-year financial crisis. We support this goal and believe that this NPR is a step in the right direction. However, we believe that the proposed regulation fails to take into account the stability of the liquidity provided by the FHLBank System and the demonstrated marketability of FHLBank Consolidated Obligations throughout the economic cycle.

With respect to the FHLBanks, the proposal appears to disregard both the public policy purposes that guide the FHLBanks' provision of liquidity, and the track record of the FHLBanks in providing liquidity during financial crises, including the recent financial crisis that began in 2007. Thus, the proposed rule assumes a run off rate for FHLBank advances that is the same rate as assumed for private wholesale counterparties. As explained above, there does not appear to be an easily seen rational basis for this assumption.

We recommend adopting a final rule that includes more diversification and accurately categorizes ASF factors based on the type of funding and the anticipated likelihood of withdrawal. For FHLBank advances with remaining maturities of six months to one year, we recommend an ASF factor of 80 percent, which would still be a conservative assumption. For FHLBank advances with remaining maturities of less than six months we recommend an ASF factor of 20 percent. For public unit or municipal deposits in excess of FDIC insurance and that are privately insured or fully collateralized by an FHLBank letter of credit, we recommend an ASF factor of 95 percent or slightly below the percentage for FDIC-insured deposits.

We also believe that the application of a 15 percent RSF factor on FHLBank Consolidation Obligations is inappropriate. Historic experience demonstrates that the demand for FHLBank Consolidated Obligations increases during periods of financial stress, and the 15 percent RSF factor is not supported by market realities. We would urge that the final rule use a RSF factor that is not in excess of five percent. Finally, we note that the proposed rule penalizes mortgage portfolio lenders by subjecting prudently underwritten whole mortgage loans a 65 percent RSF factor. We urge the agencies to consider whether this is an appropriate outcome for this regulation.

We thank you for the opportunity to provide comments.

Sincerely,

John L. von Seggern
President & CEO
Council of FHLBanks