COUNCIL OF FEDERAL
HOME LOAN BANKS

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January 31, 2014

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN No. 3064-AE04

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW
Suite 3E–218, Mail Stop 9W–11
Washington, DC 20219
Docket ID OCC–2013–0016

Mr. Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R–1466

Re: Proposed Rule — Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring

Dears Sirs and Madams:

I am writing on behalf of the Council of Federal Home Loan Banks (Council) with respect to your notice of proposed rulemaking to establish minimum liquidity requirements for covered financial institutions. The Council is an association whose members are the twelve Federal Home Loan Banks. In order to provide context for our comment letter, I will begin by briefly reviewing the purpose and structure of the Federal Home Loan Banks.

I. The Federal Home Loan Banks

There are twelve regional Federal Home Loan Banks ("FHLBanks"). The FHLBanks were created by Congress in 1932 for the *specific purpose of providing liquidity* to the housing market through their member institutions. There are approximately 7,500 members of the FHLBanks, consisting of thrifts, commercial banks, credit unions, insurance companies, and community development financial institutions. The FHLBanks have proven to be a reliable source of liquidity throughout all economic cycles since they were established in 1932.

The FHLBanks are cooperative institutions that operate within 12 Districts covering the entire United States and its territories. Each Bank issues capital stock that can only be purchased by member institutions. Minimum stock purchases are required for membership, and the capital stock is bought and sold at par. Unless a member is holding "excess stock," when a member takes out a new advance it must purchase additional shares in the Bank in proportion to the face value of the advance. Thus, when demand for liquidity increases, the capital base of the FHLBanks increases as well. As a result, during periods of credit expansion, the cooperative structure provides additional capital to support advances growth. During periods of extreme distress, such as the recent liquidity crisis, the FHLBanks' capital structure ensured adequate capitalization: as member institutions' liquidity needs increased, the self-capitalizing nature of these borrowings enabled the FHLBanks to increase their advances while preserving the safety and soundness of each Bank. These additional advances were funded through the issuance of Federal Home Loan Bank Consolidated Debt Obligations. As will be discussed further below, these obligations are backed by the consolidated resources of all the FHLBanks, and have proven to be highly marketable throughout all economic cycles, including the recent financial disruption that began in 2008.

The ability of the FHLBanks to provide a reliable source of liquidity even during traumatic economic disruptions was clearly demonstrated during the recent financial crisis. During this crisis the FHLBanks were able to increase their lending to members in every part of the nation by $370 billion, from total outstanding advances of $650 billion in the second quarter of 2007 to over $1 trillion in the third quarter of 2008. The FHLBanks were able to carry out this essential liquidity function for their members without government direction or requiring taxpayer assistance. A Federal Reserve study found that the FHLBanks were far and away the *largest provider of liquidity* to domestic depository institutions during this critical period, with the Federal Reserve providing liquidity to other sectors of the finance industry.[1]

II. The Liquidity NPR

The FHLBanks support the goals of the recently published NPR. Sufficient liquidity is necessary to protect our financial system in times of economic stress, such as we experienced after the failure of Lehman Brothers. However, certain features of the proposed rule could have the potential of undermining the strength of the FHLBanks and reduce member institution access to FHLBank liquidity. Certain provisions of the NPR could actually increase both liquidity risks and credit risk for our nation's depository institutions. Fortunately, we do not believe that this result is mandated by the international agreement pursuant to which the NPR was issued. The FHLBanks are unique to the United States, and the Basel III Liquidity accord provides the U.S. regulators with sufficient discretion to develop a regulatory approach that takes into account the special nature of the FHLBanks, Congressional intent in establishing the FHLBanks, and the vital role the FHLBanks have played in every liquidity crisis since the Great Depression.

A. FHLBank Consolidated Obligations

[1] A. Ashcroft, M. Bech and W. Frame, "The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?", Federal Reserve Bank of New York Staff Reports, Number 357 (November 2008).

The NPR requires covered companies and depository institutions to hold sufficient high quality liquid assets to meet the cash needs that would be faced during a 30 day period of economic distress. High quality liquid assets are divided into three levels. Level 1 assets can be used to meet the liquidity test without limit. Level 2A assets can be counted for liquidity purposes, but are subject to a 15 percent haircut. Level 2B assets are subject to a 50 percent haircut. In addition, the aggregate amount of Level 2A and 2B assets cannot equal more than 40 percent of the total required high quality liquid assets, and Level 2B assets cannot count towards more than 15 percent of the total required amount.

Level 1 assets include cash, reserves at a Federal Reserve Bank that can be drawn down, Treasury securities, and liquid and readily marketable securities issued or guaranteed by a sovereign entity, provided the security has a 0 risk weight under the Basel capital rules, and the issuer's obligations have a proven track record as a reliable source of liquidity during stressed conditions. The consolidated debt obligations issued by the FHLBanks are categorized as Level 2A assets, and are therefore subject to both a 15 percent haircut, and an overall cap of 40 percent when combined with all other Level 2 assets.

As mentioned previously, the Consolidated Debt Obligations of the FHLBanks are highly liquid and readily marketable. These obligations have maintained the same ratings as U.S. government obligations and are viewed in the markets as low-risk, high-quality investments. Even in the most dire economic times FHLBank Consolidated Obligations have found a ready market, and have been able to reliably fund FHLBank advances.

In our view, it makes little sense to treat FHLBank Consolidated Debt Obligations as Level 2A assets, when the NPR would permit more speculative securities issued by foreign governments to be treated as Level 1 assets. Given the fact that foreign debt will often carry a higher interest rate than FHLBank Consolidated Obligations, the likely result would be to push covered companies to meet their liquidity mandate through investments in higher yielding foreign debt. This will have two negative consequences. Risk will increase in our financial system as covered companies hold more foreign debt that has been shown to be less liquid than FHLBank obligations in times of stress, and second it will result in our institutions providing funds for foreign economic growth at the expense of our domestic housing market.

We recommend that FHLBank Consolidated Obligations be treated as Level 1 assets. If this outcome is not possible, then FHLBank Consolidated Obligations should be subject to a Level 2 cap that is greater than 40 percent and a haircut that is less than 15 percent.

B. Residential Mortgages and Residential Mortgage-Backed Securities

Under the NPR, the definition of high quality liquid assets excludes whole mortgages and private label mortgage-backed securities. At the same time, the NPR allows both corporate debt and corporate equities to be included as high quality liquid assets included in Level 2B. This will make it more expensive for covered companies to hold mortgage assets, thereby lowering the availability of mortgages or increasing the cost of mortgage credit, or both.

The proposed treatment of mortgage-backed securities is not consistent with the international accord on liquidity, which permits a covered company to count these assets towards its liquidity requirement, subject to a 25 percent haircut, rating requirement, and aggregate cap.

We understand that the agencies may be reluctant to allow mortgages and mortgage-backed assets to be used for liquidity purposes in light of the dramatic decline in the value of these instruments during the financial crisis. However, since the financial crisis the market has imposed much tougher underwriting standards on mortgage originations. In addition, beginning in January of this year, all mortgage originations are subject to the "ability to repay" test promulgated by the CFPB. Under this regulation, mortgages that meet very high underwriting standards are defined as "qualified mortgages" or "QM." These mortgages, and securities backed by QM mortgages, are likely to perform very well under any economic condition. Certainly QM and QM-backed instruments can be expected to perform as well as corporate debt and equity securities.

We suggest that, at a minimum, QM mortgages and QM-backed securities should be allowed to be considered as high quality liquid assets, subject to an appropriate haircut.

C. <u>Assets That Can Support FHLBank Advances</u>

The NPR provides that Level 1 or Level 2 assets that are pledged to secure future FHLBank Advances can be used to satisfy an institution's liquidity requirement, so long as the pledged assets are not currently being used to support a FHLBank advance.

The FHLBanks can accept high quality assets as collateral to support advances in addition to the assets designed Level 1 or Level 2 in the NPR. However, only assets approved by the Federal Housing Finance Agency may serve as collateral for advances. Since these assets qualify as collateral, they can be immediately liquefied by using them to draw down an additional advance from a FHLBank. And as noted previously, the FHLBanks have a proven record of providing liquidity through advances even during the most turbulent economic times. Thus, it makes eminent sense, and would further the goals of the NPR, to recognize that any asset that qualifies as permissible collateral and is pledged for a future FHLBank advance should also be viewed as a high quality liquid asset under the NPR.

Alternatively, if the agencies choose not to allow these assets to be counted as high quality liquid assets, we would urge that the final rule permit covered companies to consider their available collateralized lines of credit with a Federal Home Loan Bank as a "cash inflow." This would recognize that the covered company has available collateral to support additional advances, and that the FHLBank is willing and available to provide such advances notwithstanding market stress that is disrupting the normal provision of liquidity.

D. <u>FHLBank Advance Run-Off Rate</u>

The NPR references certain parameters for the stress scenario, including, among other items, an assumed net outflow of cash resulting from a run-off of deposits, unsecured funding, and secured funding. The explanatory materials in the NPR state that secured funding outflow rates would generally be based on the nature of the collateral securing the funding, rather than the identity of the counterparty.[2] This is

[2] 78 Fed. Reg. 71842.

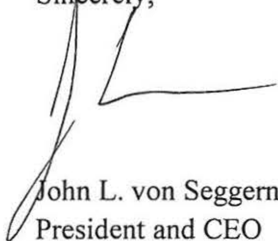
the treatment that applies to borrowing from a Federal Reserve Bank.[3] The NPR regulatory text prescribes outflow rates for secured loans that range from 0 percent for loans secured by Level 1 assets, 15 percent for loans secured by Level 2A assets, 50 percent for loans secured by Level 2B assets, and 100 percent for loans secured by assets that are not considered to be high quality liquid assets. The regulatory text also provides that there will be a 25 percent outflow rate for secured loans from government-sponsored enterprises (such as the FHLBanks) and for secured lending transactions with sovereign, multilateral development banks, that are not secured with Level 1 or Level 2A assets.

The proposed regulation is not clear if the 25 percent run-off rate applies to all secured advances by the Federal Home Loan Banks, or only for secured advances that are backed by Level 2B assets. If the NPR intends to apply the 25 percent run- off rate only to advances secured by Level 2B assets, it would significantly increase the cost of Federal Home Loan Bank advances to our member institutions, since typically Bank advances are secured by mortgages and mortgage-related securities that are neither Level I or Level 2 assets. As a result, a member covered by the liquidity rule would have to hold additional "high quality liquidity" notwithstanding the liquidity provided by the FHLBank.

Further, a 25 percent run-off rate is not consistent with the record of the FHLBanks in providing liquidity for member institutions in times of stress, as well as the unique nature of the FHLBanks' cooperative organization. It ignores the outstanding role the Banks had in providing liquidity during the last fiscal crisis. In fact, the involuntary outflow rate for FHLBank advances has been virtually zero historically.[4] The financial system has relied on the FHLBanks to renew advances in times of stress, and the Banks have done so. That is the purpose of the FHLBanks, as designed by Congress and as implemented in practice. When promulgating the liquidity rules applicable to U.S. depository institutions, the agencies should not discount this long history of providing liquidity in times of stress, and the agencies certainly should not disregard the clear intent of Congress that the FHLBanks are a stable and reliable source of emergency liquidity in normal and stressed environments. [5] We therefore suggest that the outflow rate for FHLBank advances be reduced from 25 percent to 3 percent, which is consistent with the outflow rate for stable retail deposit balances.

Thank you for providing us the opportunity to comment on your liquidity proposal. If you have any follow up questions, please feel free to contact me at 202 955-0002.

Sincerely,



John L. von Seggern
President and CEO

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[3] Id.

[4] The FHLBanks' ability to accept less liquid forms of collateral based on their statutory perfection priority has allowed them to roll over advances so that member institutions are able to receive continuous funding without any requirement to substitute the posted collateral with assets representing Level 1 liquid assets.

[5] See, Senate Rep. No. 100-19, at page 54 (1987).