FEDERAL HOUSING FINANCE BOARD

[NO. 99–61A]

RIN 3069–AA88

Proposed Changes to the Financial Management Policy of the Federal Home Loan Bank System

AGENCY: Federal Housing Finance Board.

ACTION: Notice.

SUMMARY: The Federal Housing Finance Board (Finance Board) is proposing to amend its policy statement entitled ''Financial Management Policy of the Federal Home Loan Bank System'' (FMP). The proposed amendments to the FMP are being made in conjunction and conformance with proposed regulatory changes to the Finance Board's regulations regarding the Office of Finance (OF), described in detail in a Proposed Rule published elsewhere in this issue of the **Federal Register**. The proposed regulatory changes would reorganize the OF, a joint office of the Federal Home Loan Banks (Bank or Banks), and broaden its duties, functions and responsibilities in two key respects: (1) the OF would perform consolidated obligation (CO) issuance functions, including preparation of combined financial reports, for the Banks; and (2) the OF would serve as a vehicle for the Banks to carry out joint activities in a way that promotes operating efficiency and effectiveness in achieving the mission of the Banks.

DATES: The Finance Board will accept comments on the proposed changes to the FMP in writing on or before March 6, 2000.

ADDRESSES: Send comments to Elaine L. Baker, Secretary to the Board, by electronic mail at *bakere@fhfb.gov,* or by regular mail at the Federal Housing Finance Board, 1777 F Street, N.W., Washington, D.C. 20006. Comments will be available for public inspection at this address.

FOR FURTHER INFORMATION CONTACT: Joseph A. McKenzie, Deputy Chief Economist, Office of Policy, Research and Analysis, 202/408–2845, *mckenziej@fhfb.gov;* Charlotte A. Reid, Special Counsel, Office of General Counsel, 202/408–2510, *reidc@fhfb.gov;* or Eric E. Berg, Senior Attorney, Office of General Counsel, 202/408–2589, *berge@fhfb.gov.* Staff also can be reached by regular mail at the Federal Housing Finance Board, 1777 F Street, N.W., Washington, D.C. 20006.

SUPPLEMENTARY INFORMATION:

I. Background

The FMP evolved from a series of policies and guidelines initially adopted by the former Federal Home Loan Bank Board (FHLBB), predecessor agency to the Finance Board, in the 1970s and revised a number of times thereafter. The Finance Board adopted the FMP in 1991, consolidating into one document the previously separate policies on funds management, hedging, and interest-rate swaps, and adding new guidelines on the management of unsecured credit and interest-rate risks. *See* 62 FR 13146 (Mar. 19, 1997).

The FMP generally provides a framework within which the Banks may implement their financial management strategies in a prudent and responsible manner. Specifically, the FMP identifies the types of investments the Banks may purchase pursuant to their statutory investment authority and includes a series of guidelines relating to the funding and hedging practices of the Banks and the management of their credit, interest-rate, and liquidity risks. The FMP also establishes liquidity requirements in addition to those required by statute. *See* FMP secs. III–IV.

II. Analysis of the FMP amendments

Pursuant to section 11 of the Federal Home Loan Bank Act, 12 U.S.C. 1431, and the proposed changes to 12 CFR parts 900, 910 and 941 described in detail in a Proposed Rule published elsewhere in this issue of the **Federal Register**, the Finance Board and the Banks have authority to issue through the OF consolidated obligations (COs), *i.e.,* bonds, notes, or debentures on which the Banks are jointly and severally liable. Under the FMP, a Bank is authorized to participate in the proceeds from COs, so long as entering into such transactions will not cause the Bank's total COs and unsecured senior liabilities to exceed 20 times its capital. *See* FMP sec. IV.C.

The FMP also authorizes a Bank to participate in certain types of standard and non-standard debt issues. *See id.* Specifically, the FMP requires a Bank participating in non-standard debt issues to enter into a contemporaneous hedging arrangement that passes the interest-rate or basis risk through to the hedge counterparty unless the Bank is able to document that the debt will be used to fund mirror-image assets in an amount equal to the debt, offset or reduce interest-rate or basis risk in the Bank's portfolio, or otherwise assist the Bank in achieving its interest-rate or basis risk management objectives. If a Bank participates in debt denominated in a currency other than U.S. dollars, it is required to hedge the currency exchange risk. *See id.* at sec. IV.C.3.

The proposed FMP amendments would delete existing section IV, ''Funding Guidelines,'' and replace it with a new section IV titled ''Minimum Total Capital and Hedging Requirements.'' The new section would read as follows:

Minimum Total Capital and Hedging Requirements.

A. *Leverage limit.* Each Bank shall have and maintain at all times total capital in an amount equal to at least 4.76 percent of the Bank's total assets. For purposes of this section, total capital is the sum of a Bank's retained earnings and total paid-in capital stock outstanding, less the Bank's unrealized net losses on available-for-sale securities.

B. *Prohibition on foreign currency or commodity positions.* A Bank shall not take a position in any commodity or foreign currency. If a Bank participates in consolidated obligations denominated in a currency other than U.S. dollars or linked to equity or commodity prices, it must hedge the currency, equity, and commodity risks.

The proposed FMP amendments would eliminate the Funding Guidelines, with one exception, as unnecessary in light of the proposed comprehensive regulatory amendments published elsewhere in this issue of the **Federal Register**. The one exception concerns the leverage limit. Currently, Finance Board regulations (12 CFR 910.1(b)) and the FMP provide that, on a Bank System-wide and Bank-by-Bank basis, respectively, liabilities cannot exceed 20 times paid-in capital stock, retained earnings, and reserves. As discussed in detail in the proposed rulemaking, the Finance Board is proposing to remove the System-wide liability-based leverage limit from Finance Board regulations as unnecessary, and is here proposing to replace the current Bank-by-Bank liability-based leverage limit in the FMP with a minimum total capital requirement that would, in effect, recast the leverage limit as a percentage of assets, that is, that a Bank's total assets cannot exceed 21 times its capital, or inversely, capital must be at least 4.76 percent of assets. The Bank System had an average capital-to-assets ratio of 5.1 percent at September 30, 1999.

Neither the elimination of the Bank System-wide leverage limit from the Finance Board regulations, nor the proposed revision to the Bank-by-Bank leverage limit contained in the FMP, would have any practical effect on the Bank System or its bondholders. The Finance Board, as the regulator of the Banks, would continue to monitor each Bank for compliance with the individual leverage limit included in the FMP. The current FMP prohibits a Bank from participating in COs if such transactions would cause the Bank's liabilities to exceed 20 times the Bank's total capital. The proposed revision to the FMP would establish an equivalent leverage standard stated as a percentage of assets that would require each Bank to maintain capital of at least 4.76 percent of its total assets. Imposition of the 4.76 percent standard on each Bank will ensure that the Bank System itself stays within the leverage limit, rendering retention of a Bank System-wide leverage limit unnecessary. Further, the Finance Board notes that with the recent passage of Title VI of the Gramm-Leach-Bliley Act, the Federal Home Loan Bank System Modernization Act of 1999, Pub. L. 106–102, 113 Stat. 1338 (Nov. 12, 1999), the Banks will be subject to statutory leverage limits and risk-based capital requirements. When implemented in regulations, the new risk-based capital regime will provide an additional safeguard to the Bank System and its bondholders by requiring Banks to hold capital in proportion to the risks they assume.

The changes reflected in proposed section IV.B of the FMP do not draw the distinction between standard and non-standard debt issues contained in the current FMP. Instead, the changes require the Banks to hedge some types of debt issues previously defined as non-standard. The types of debt issues that must be hedged under the proposed amendments to the FMP are those linked to equity or commodity prices or those denominated in foreign currencies.

The Finance Board also is taking this opportunity to propose a change in the FMP unrelated to the issuance of debt or the OF reorganization. Section VII of the FMP contains guidelines for the Banks on the management of interest-rate risk. The Finance Board uses duration of equity as its primary measure of interest-rate risk. The current FMP gives the Banks an option on how to calculate their duration of equity. The option deals with the inclusion or exclusion of the cash flows associated with the Bank's Affordable Housing Program (AHP) and Resolution Funding Corporation (REFCorp) obligations. Since 1995, each Bank has to contribute a minimum of 10 percent of its annual income (net of its REFCorp obligation) for the AHP, with a Bank System-wide minimum of $100 million. *See* 12 U.S.C. 1430(j)(5)(C). In addition, the Banks, in the aggregate, formerly were required annually to contribute $300 million towards the Bank System's REFCorp obligation. *Id.* 1441b(f)(2)(c) (superseded).

The Gramm-Leach-Bliley Act changed the REFCorp obligation for years 2000 and beyond from a fixed annual payment of $300 million to the payment of 20 percent of the Banks' net earnings (net of AHP and operating expenses), with the payment period extended or shortened as necessary to ensure full payment of the present value of the obligation. Since the AHP has not been a fixed dollar obligation since 1994 and the REFCorp obligation will no longer be a fixed dollar amount, the Finance Board proposes to prohibit the Banks from managing their assets and liabilities as if these items are fixed dollar obligations. Instead, under the revised FMP, a Bank would treat these obligations as typical variable expenses (like operating expenses) for purposes of asset-liability management. Because the Banks' AHP and REFCorp obligations are variable expenses, the Finance Board believes that it would not be appropriate for the Banks to include AHP and REFCorp-related cash flows in their duration of equity calculations. The Finance Board originally proposed this change to the FMP in 1997. *See* 62 FR 13146 (Mar. 19, 1997). The proposed language would read as follows:

> Each Bank is required to report its cash flows and calculate its duration and market value of equity without projected cash flows which represent the Bank's share of the System's REFCorp and AHP obligations.

The Finance Board is expressly proposing this language again as even more appropriate in light of the Gramm-Leach-Bliley Act change to the REFCorp payment methodology.

The Finance Board will accept comments on the proposed FMP amendments for the same 60-day comment period as the proposed regulatory amendments to parts 900, 910, and 941.

By the Board of Directors of the Federal Housing Finance Board.

Dated: December 14, 1999.

Bruce A. Morrison,

Chairman.

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