

July 14, 2009

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

By e-mail RegComments@fhfa.gov and Federal Express

Attention: Comments/RIN 2590-AA18

Re: Federal Home Loan Bank Membership for Community Development Financial Institutions;
RIN 2590-AA18

Dear Mr. Pollard:

The Federal Home Loan Bank of San Francisco (Bank) appreciates this opportunity to comment on the Federal Housing Finance Agency (Finance Agency) proposed rule that would implement the extension of membership eligibility in a Federal Home Loan Bank (FHLBank) to community development financial institutions (CDFIs) pursuant to Section 1206 of the Housing and Economic Recovery Act of 2008 (HERA) (amending Section 4(a)(1) of the Federal Home Loan Bank Act (Bank Act) (12 U.S.C. § 1424(a)(1))). The proposed rule would amend the Finance Agency's membership regulations to provide that non-federally insured, CDFI Fund-certified CDFIs are authorized to become members of the Bank. Per the proposed rule, the newly eligible CDFIs would include community development loan funds, venture capital funds and state-chartered credit unions without federal deposit insurance. (Proposed 12 C.F.R. §§ 1263.1 and 1263.6.) The Bank is particularly optimistic about new opportunities CDFI membership will present for enhancing the Bank's ability to help community development and increase access to financing for affordable housing.

I. General Comments

We support the proposed regulation's extension of authority giving CDFIs the opportunity to become members of the Bank. Their purpose, to offer credit and financial services to underserved populations, is consistent with our own mission to help member financial institutions expand the availability of mortgage credit and foster strong and vibrant communities through community and economic development. The Bank looks forward to promoting the success of CDFIs in their provision of loans, investments, financial services, and technical assistance to underserved populations and communities.

While we favor expanded membership opportunities for mission-compatible entities such as CDFIs, we have reservations about the expanded risks the FHLBank System (System) will face, and we ask the Finance Agency to limit membership to regulated entities. It is not clear that Congress intended HERA to require the Finance Agency to extend the right to apply for full membership in the FHLBanks to all CDFIs, including non-regulated entities. *See* HERA § 1206. Since creation of the FHLBanks, membership has been limited to regulated, examined entities. If the final rule makes non-regulated entities eligible for membership, for the first time in their history, the FHLBanks will have to manage the risks associated with extending advances to non-regulated, non-depository institutions. Non-regulated CDFIs would present the FHLBank System with significantly increased underwriting and monitoring challenges. Receipt and review of regulatory reports of examination for regulated members and any resulting enforcement actions are an integral part of the Bank's risk management framework. Examinations conducted in conformance with a CAMELS analysis and rating provide the Bank detailed information regarding a member's

financial condition. In addition, they provide an important assessment of a member's management and its ability to manage risk, which may not be evident from externally reported financial performance metrics. Regulatory examinations are a critical risk management tool in assessing member risk that will not be available for non-regulated CDFIs. The Bank is concerned that, with no actual regulator, either the Finance Agency or the FHLBanks will, by default, end up serving a *de facto* regulatory function through the credit underwriting and risk monitoring process that the FHLBanks normally follow to ensure advances can be made safely and soundly. For these reasons, the Bank supports extension of membership eligibility only to regulated CDFIs.

We also ask the Finance Agency to provide detailed guidance addressing membership, underwriting, and monitoring standards in the final rule that will ensure that all FHLBanks have a clear and uniform framework for providing CDFIs access to credit that:

- Assists the FHLBanks in identifying, analyzing, and managing the new risks associated with CDFIs (including risks associated with non-regulated CDFIs if the final rule permits their membership),
- Gives each FHLBank the information and tools needed to achieve relative consistency in the analysis of member creditworthiness and the extension of credit,
- Protects each member of an FHLBank as a participant in the FHLBank's cooperative ownership structure, and
- Preserves the safety and soundness of the FHLBank System.

Given the present stress on financial institutions, we believe it is essential that no unmanageable additional risk be introduced to the FHLBank System.

II. Application and Membership Requirements

The Bank believes the final rule should incorporate the following minimum application and membership requirements, and allow the FHLBanks to identify additional standards appropriate to CDFIs as the FHLBanks develop greater expertise specific to these new membership types. Accordingly, in promulgating the final rule, we urge the Finance Agency to take the following steps:

- Incorporate the standards proposed below along with others the Finance Agency develops in consultation with parties with specific expertise in evaluating the various classes of CDFIs,
- Specify that each FHLBank has discretion to impose additional requirements that it determines appropriate for CDFIs in its district,
- Establish certain CDFI-specific thresholds for when an FHLBank must submit a notice of new business activity under 12 C.F.R. § 980.1(3) in connection with extending credit to a CDFI.

A. Requirements for Non-federally Insured Credit Union CDFIs

1. Financial Reporting Requirements: The final rule should require that, for a non-federally insured credit union CDFI to be eligible for membership, its state regulator must require the CDFI to file financial reports that are, in the opinion of the applicable FHLBank, comparable to those filed with the NCUA by federally insured credit unions. The Bank agrees with the Finance Agency that the FHLBanks should be permitted to review those reports to assess the financial condition of the applicant and that the same review criteria should be applied to all prospective credit union members.

2. Reports of Examination: State regulators are not required by statute to share reports of examination with FHLBanks. The Bank believes CDFI Credit Unions should be eligible for membership only if the applicable state regulator provides reports of examination to the district's FHLBank.

B. Requirements Applicable to All CDFIs:

The Bank believes the final rule should incorporate the following minimum application and membership requirements for credit union CDFIs and, if the Finance Agency extends membership to non-regulated CDFIs, the Bank believes these requirements should also apply to them.

1. CDFI Fund Certification: The final rule should require that the CDFI Fund certification of the applicant be dated not more than one year prior to the date of application. Applicants that do not meet this requirement must obtain re-certification under the CDFI Fund requirements and submit the new certification with the FHLBank application.

2. GAAS-Consistent Audited Financial Statements: The Finance Agency asked whether an FHLBank could accurately assess the financial condition of a CDFI applicant using an alternative to financial statements that are consistent with generally accepted auditing standards (GAAS). The Bank is not aware of any alternative auditing standards that would enable the Bank to achieve uniform review standards across all membership types and, therefore, the Bank believes the final rule should require all applicants to provide GAAS-consistent audited financial statements.

3. Financial Statements: The final rule should require all CDFI applicants to submit independent audits for the three years preceding the year in which the application is submitted and auditor-reviewed quarterly statements for six quarters preceding the submission. As noted below, the Bank also believes these financial statements should be consistent with GAAS.

4. Loan Loss Reserves: The Bank does not support the proposed use of different ratio requirements for CDFI and non-CDFI applicants for the minimum ratio of allowance for loan and lease losses (ALLL) to nonperforming loans and leases. While we recognize that delinquency rates among CDFI-originated loans have historically been lower than prime loans, the Bank is concerned that the ongoing mortgage and liquidity crisis may impose stresses on CDFIs and their home-mortgage borrowers that do not reflect historical trends. In addition, because most newly eligible CDFIs are smaller and less diversified than most federally insured financial institutions, defaults on a relatively small number of loans can have disproportionately negative impact on a CDFI. In addition, geographic concentrations can exacerbate such stresses. The Bank believes all applicants should be subject to a minimum ALLL-to-nonperforming assets ratio of 60 percent. If the final rule does not adopt the 60 percent ratio for all applicants, the Bank requests that the final rule specify that each FHLBank may, in its own discretion, adopt this uniform standard.

5. CDFI Bank Holding Companies: We agree with the proposed regulation's exclusion of CDFI bank holding companies from membership eligibility and concur with the Finance Agency's view that the appropriate vehicle for FHLBank membership would be the holding company's insured depository institution. To permit otherwise would create incentives that could distort the FHLBank System.

C. Requirements for Non-Regulated CDFIs:

If the Finance Agency extends membership to non-regulated CDFIs, the Bank believes the final rule should incorporate the following minimum application and membership requirements.

1. Resolution: All current FHLBank members are subject to rigorous, well-defined regulatory structures incorporating comparatively predictable resolution processes with which the FHLBanks have experience. The relative certainty of the rules governing the failure of current member types helps us isolate and manage risk from member to member. Non-credit union CDFIs are not subject to these well-defined regulatory resolution processes. As a secured

creditor making advances to members, the Bank has not previously had to manage risks associated with a member's bankruptcy, thereby presenting new risk management challenges. Imposition of an automatic stay in a CDFI bankruptcy could, for example, result in a significant time delay in the CDFI's resolution and in the repayment of the CDFI's advances obligations to the Bank. It is possible that, during the pendency of an automatic stay, the Bank would not be repaid for any advances due. Additionally, the Bank's ability to realize on cash collateral and to redirect payments received by loan servicers on loan collateral might be subject to challenge under bankruptcy rules.

Given the uncertainties presented by bankruptcy proceedings, we believe the Finance Agency should establish minimum standards for the resolution of any CDFI. We suggest that only CDFIs subject to resolution or liquidation by a federal or state regulatory agency should be eligible for FHLBank membership, necessitating legislative action before some CDFI-types could be eligible for membership.

2. CARS Rating: The final rule should require that non-regulated CDFI applicants submit a CDFI Assessment and Ratings System (CARS) report performed by the Opportunity Finance Network (OFN) (or similar analysis and report conducted by another CDFI group network determined acceptable by the Finance Agency) that is dated no more than three years prior to the date of application and that the CARS report be the most recent obtained from the OFN. The final rule should also specify that the FHLBank may, in its discretion, require a more recent CARS report on a case-by-case basis prior to acceptance for membership.

3. Definitions: The Bank generally supports the definitions of the proposed rule. The final rule should, however, change the proposed definition of *Gross revenues* to exclude all restricted funds and grants, and to include in gross earned revenues only unrestricted donor contributions and grants. Exclusion of restricted grants and other monies from the definition will ensure an appropriate measurement of gross revenues available to cover all expenses since restricted grants and donations are subject to donor-imposed stipulations as to their usage.

4. De Novo CDFIs: The final rule should (a) specify that any non-credit union CDFI is not eligible for membership until the CDFI has completed at least three full years of operations; or (b) give the FHLBanks discretion to determine whether a CDFI that has completed fewer than three full years of operations is eligible for membership in that FHLBank. The Bank believes this standard is appropriate because FHLBanks will not have the benefit of the assurances provided by a report of examination and the accompanying regulatory supervision.

5. Net Asset Ratio: We support the proposed rule's requirement that all non-credit union CDFI applicants have a minimum ratio of net assets to total assets of at least 20 percent. The Bank believes this standard is appropriate, particularly if restricted assets are included in the calculation of the ratio. This minimum equity requirement is conservative and necessary to absorb losses, and will ensure the CDFI has greater flexibility in its lending and investment operations. Further, we believe the final rule should include a statement regarding the ability of the FHLBanks to require submission of an acceptable third-party valuation of any asset the FHLBank, in its discretion, believes may be impaired.

6. Earnings: The Bank supports the proposed rule's requirement that non-credit union CDFIs show a positive net income for any two of the three most recent years. The Bank believes this standard is appropriate as a minimum requirement and is consistent with the Bank's view that non-regulated CDFIs have completed at least three years of operations prior to applying for membership. However, if a CDFI obtains a GAAS-compliant audit of its financial statements on a quarterly basis, to be consistent with the treatment of other Bank members, the Bank believes it would be appropriate to require that earnings be positive for four of the six most recent calendar quarters.

7. Liquidity Ratio: The Bank supports the proposed rule's liquidity ratio requirement as a minimum standard for non-credit union CDFIs. Prospective CDFI members should have unrestricted cash and cash equivalents sufficient to cover quarterly operating expenses, because operating with inadequate liquidity could significantly restrict operations and expose the member to losses. We believe this requirement is essential for entities whose liquidity management is not subject to regulatory oversight.

8. Self-Sufficiency or Sustainability Ratio: The final rule should incorporate a self-sufficiency ratio requirement for non-credit union CDFI applicants as described in the preamble to the proposed rule. The Bank believes the minimum required self-sufficiency ratio should be 1.0. This is an important measure of a CDFI's ability to cover its expenses from earned revenue and an important indicator of a CDFI's ability to operate without loans and grants. Some CDFIs operate with grants, unsecured debt, and equity-equivalent capital instruments that give the grantors rights to accelerate payment. A required ratio of 1.0 or higher would ensure the CDFI could sustain operations in the event large or important grants or loans were not renewed.

9. Nonperforming Assets Limit as Percent of Total Loans: The final rule should add a requirement that the nonperforming loans and leases of a non-credit union CDFI applicant do not exceed 10 percent of the applicant's total loans and leases to match the requirement in proposed § 1263.11(b)(3)(B) applicable to depository institutions and CDFI credit unions. The Bank has identified no reason why this standard should not apply in the same manner to all applicants.

10. Off-Balance Sheet Transactions: Because CDFIs sometimes engage in off-balance sheet transactions and facilities and such transactions and facilities may be material to the CDFI's financial condition, the final rule should require each CDFI applicant to provide an opinion letter from its independent auditor identifying all off-balance sheet transactions and facilities.

11. Character of Management: Proposed § 1263.17(e)(2)(ii) allows an applicant to submit a written analysis to seek to overcome the rebuttable presumption that the applicant does not meet the character of management requirement of proposed § 1263.12 if the applicant or one of its directors or senior officers has been the subject of a criminal proceeding. For regulated financial institutions, the written analysis must demonstrate that the proceedings will not likely result in an enforcement action. Pursuant to Section § 19(a)(1) of the Federal Deposit Insurance Act (12 U.S.C. § 1829(a)(1)), any criminal conviction of an individual involving dishonesty or a breach of trust or money laundering (or an agreement by an individual to enter into a pretrial diversion or similar program in connection with a prosecution for such offense) will result in permanent debarment of such individual from working at a financial institution, making it extraordinarily difficult to overcome the presumption following a criminal conviction (or pre-trial agreement) involving dishonesty, a breach of trust, or money laundering. For CDFIs the proposal requires only that the applicant demonstrate that the proceedings will not "likely have a significantly deleterious effect on the applicant's operations." We believe this standard is vague and may be difficult to apply in practice. We believe the final rule should provide that the Finance Agency will determine whether an applicant's written analysis overcomes a rebuttable presumption. Alternatively, the Bank believes the standard for overcoming the rebuttable presumption should be higher and, therefore, urges the Finance Agency to replace the word "significantly" with the word "potentially" or some similar phrase or word.

III. Ongoing Underwriting and Monitoring

The Bank believes that, prior to issuing the final rule, the Finance Agency should issue a notice of proposed rulemaking that would add a new subsection to 12 C.F.R. § 950.4 addressing limitations on access to advances specific to CDFIs.

A. Standards for Underwriting and Monitoring Regulated CDFIs

For regulated CDFIs, the Bank believes the CDFI's state regulator must continue to provide reports of examination to the FHLBank for the member to obtain additional advances or extensions of credit or to roll existing advances.

B. Standards for Underwriting and Monitoring Non-Regulated CDFIs

If the Finance Agency extends membership eligibility to non-regulated CDFIs, the Bank believes a new subsection of 12 C.F.R. § 950.4 should be added to incorporate bright-line standards applicable to non-regulated CDFIs, which might include the following, for example:

1. CDFI Fund Recertification: CDFI members must obtain recertification by the CDFI Fund every three years to obtain additional advances or extensions of credit or to roll existing advances.

2. CARS Rating: Non-credit union CDFI members must maintain a CARS rating on an ongoing basis to have access to new extensions of credit.

3. Capital Adequacy: Non-credit union CDFI members must maintain a minimum ratio of net assets to total assets of at least 20 percent to have access to new extensions of credit.

4. Liquidity Ratio: Non-credit union CDFIs must maintain a minimum liquidity ratio of 1.0 to have access to new extensions of credit. Because these entities do not have a regulator and the Bank cannot rely on regulatory supervision or the monitoring of the Federal Deposit Insurance Corporation (FDIC) or NCUA for certain information critical to determining when to limit extensions of credit, a mandatory minimum liquidity ratio is necessary.

5. Self-Sufficiency or Sustainability Ratio: For the same reasons a mandatory liquidity ratio is appropriate, non-credit union CDFIs must maintain a minimum self-sufficiency ratio of 1.0 to have access to new extensions of credit.

C. Factors for Underwriting and Monitoring Non-Regulated CDFIs

If the Finance Agency grants membership eligibility to non-regulated CDFIs, the Bank believes each FHLBank should also be required to consider the following factors on an ongoing basis as a condition of making and renewing advances to non-regulated CDFIs:

1. Whether the member's CARS rating has been lowered
2. The nature of any off-balance sheet activities of the member and any affiliates
3. The likelihood of renewal of grants and the extent of reliance on restricted grants to measure revenue growth
4. Loan delinquency reports

IV. Director Eligibility

A. Officers and Directors of CDFI Affiliate: We believe that the Federal Home Loan Bank Act, as amended, permits an officer or director of a CDFI that is a member of a FHLBank to be a member director on the board of directors of a FHLBank. 12 U.S.C. § 1427(a)(4)(B). The FHLB Act would also seem to preclude a director or officer of a CDFI that is a member of a FHLBank from serving as an "independent director" of any FHLBank. 12 U.S.C. § 1427(a)(3)(B)(iii). What is not clear to us is whether a person who is an officer of an organization that is related to a CDFI that is a member of a FHLBank, but is not technically an officer or director of such CDFI itself, would be eligible to be an independent director. Except where the CDFI is a wholly owned subsidiary of the organization of which the person is an officer or director, we believe that the FHLB Act should be construed as permitting such person to serve as an independent director of a FHLBank. We would appreciate clarification of this question.

B. Capital Standard: The current regulation on director eligibility also contains a requirement that a member director be from a member "that was a member of the Bank as of the record date, and that meets all minimum capital requirements established by its appropriate Federal banking agency or appropriate state regulator."

12 C.F.R. §1261.4. We would appreciate clarification regarding the application of that standard to a member that is not subject to any express capital standard by a federal or state regulatory agency.

V. Technical Comments

If the Finance Agency grants membership eligibility to non-regulated CDFIs, the Bank asks the Finance Agency to consider the following additional comments.

A. The Finance Agency should clarify in 12 C.F.R. § 1263.27(a)(2) of the final rule (Involuntary termination of membership) that an FHLBank's board of directors may terminate the membership of a CDFI upon commencement of any proceeding relating to bankruptcy of the CDFI.

B. Prior to issuing the final rule, the Finance Agency may wish to issue a notice of proposed rulemaking to conform 12 C.F.R. § 950.4(f) (Limitations on access to advances – *Members without federal regulators*) and the subsections it cross-references to address CDFI types with no regulator.

C. Prior to issuing the final rule, the Finance Agency may wish to issue a notice of proposed rulemaking that would amend 12 C.F.R. Part 960 to specify permissible uses of standby letters of credit for CDFIs.

We thank you very much for your consideration of our comments.

Sincerely,



Dean Schultz
President and
Chief Executive Officer