FEDERAL HOUSING FINANCE BOARD

[NO. 2000–25]

RIN 3069–AA88

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 amending its policy statement entitled ''Financial Management Policy of the Federal Home Loan Bank System'' (''FMP'') to: (1) delete the ''Funding Guidelines'' in section IV; (2) insert a new section IV titled ''Hedging Requirements''; and (3) revise the ''Interest Rate Risk Limitations'' in section VII. These FMP amendments are being made in conjunction with changes to the Finance Board's regulations governing the issuance of consolidated obligations (COs) under section 11 of the Federal Home Loan Bank Act (Act) (12 U.S.C. 1431) and the authority and operations of the Office of Finance (OF), described in detail in a Final Rule published elsewhere in this issue of the **Federal Register** (OF Final Rule).

DATES: The FMP amendments are effective June 7, 2000.

FOR FURTHER INFORMATION CONTACT: Joseph A. McKenzie, Deputy Chief Economist, Office of Policy, Research and Analysis, 202/408–2845, *mckenziej@fhfb.gov;* or Charlotte A. Reid, Special Counsel, Office of General Counsel, 202/408–2510, *reidc@fhfb.gov.* Staff also can be reached by regular mail at the Federal Housing Finance Board, 1777 F Street, NW, Washington, DC 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.[1]

The FMP governs how the Banks may implement their financial management strategies by specifying the types of investments the Banks may purchase pursuant to their statutory investment authority. The FMP also establishes mandatory guidelines relating to the funding and hedging practices of the Banks, the management of their credit, interest-rate, and liquidity risks, and the liquidity requirements for the Banks in addition to those required by statute. *See* FMP secs. III–IV.[2]

II. Proposed FMP Amendments

On January 4, 2000, the Finance Board published for comment a notice of proposed amendments to the FMP, in conjunction and conformance with proposed regulatory changes to the Finance Board's regulations regarding the OF (Proposed OF Rule). *See* 64 FR 339 (Jan. 4, 2000) (Proposed FMP Amendments). The Proposed FMP Amendments would have deleted FMP sec. IV. C. ''Funding Guidelines,'' as unnecessary in light of the Proposed OF Rule, with the exception that the current Bank-by-Bank, liability-based leverage limit would have been replaced with a minimum total capital requirement recast as a percentage of assets. The Proposed FMP Amendments would have required that a Bank's capital must be at least 4.76 percent of assets, or, inversely, that a Bank's total assets could not exceed 21 times its capital. The Proposed FMP Amendments also would have amended section IV.C.3 of the FMP to eliminate the distinction between standard and non-standard debt issues and require the Banks to hedge debt issues linked to equity or commodity prices or those denominated in foreign currencies.

Finally, the Proposed FMP Amendments would have amended section VII[3] of the FMP, which currently permits the Banks to include the cash flows associated with their REFCorp and Affordable Housing Program (AHP) payment obligations in their duration of equity calculations, to restrict the Banks from treating the REFCorp obligation as if it were a fixed dollar obligation. In light of the Gramm-Leach-Bliley Act,[4] changes to the Banks' REFCorp obligation the Proposed FMP Amendments would have required the Banks to treat these obligations as typical variable expenses (similar to operating expenses) for purposes of the Banks' asset-liability management.

The sixty-day public comment period closed on March 6, 2000. The Finance Board received seven comment letters: six from Banks and one from a Bank trade association. Generally, the commenters opposed the proposed change to the leverage limit as more restrictive than the current allowance and premature in advance of the new statutory leverage limit and risk-based capital requirements imposed by the Gramm-Leach-Bliley Act.[5] The commenters offered no objection to the revisions to the hedging requirements or the duration of equity calculation.

III. Comments on the Proposed Amendments and Analysis of Changes Made in the FMP Amendments

A. Leverage Limit

The Proposed FMP Amendments, and corresponding Proposed OF Rule, did not include the 20-to-1 Bank System-wide leverage limit from the Finance Board's regulations, or the 20-to-1 liability-based leverage limit on each Bank contained in the FMP. Instead, the Proposed FMP Amendments recast the leverage limit applicable to each Bank from a liability-based limit to an asset-based limit, and required that each Bank maintain capital in an amount equal to at least 4.76 percent of the Bank's total assets. *See* 65 FR at 328, 339. This limit required that the assets of a Bank not exceed 21 times its capital.

The Finance Board did not believe that either the elimination of the Bank System-wide leverage limit from the Finance Board's regulations, or the proposed revision to the 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 existing FMP provision prohibits a Bank from participating in COs if such transactions would cause the Bank's liabilities to exceed 20 times the Bank's capital. The Proposed FMP Amendments established an equivalent leverage standard, stated as a percentage of assets, which would require each Bank to maintain capital of

[1] *See* Fin. Bd. Res. No. 96–45 (July 3, 1996), as amended by Fin. Bd. Res. No. 96–90 (Dec. 6, 1996), Fin. Bd. Res. No. 97–05 (Jan. 14, 1997), and Fin. Bd. Res. No. 97–86 (Dec. 17, 1997). *See also* 62 FR 13146 (Mar. 19, 1997)).

[2] *See* Fin. Bd. Res. No. 96–45, pp. 5–8.

[3] *See* Fin. Bd. Res. No. 96–45. p. 7.

[4] 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) (Gramm-Leach-Bliley) changed the Banks' annual REF Corp. payment from a fixed, aggregate payment of $300 million to a payment of 20 percent of each Bank's net earnings (net of AHP and operating expenses). The Finance Board uses duration of equity as its primary measure of interest rate risk. Additionally, since 1995, each Bank has been required to contribute a minimum of 10 percent of its annual income (net of its REFCorp obligation) to the AHP, with a Bank System-wide minimum of $100 million.

[5] The Gramm-Leach-Bliley Act provides for a five-year phase-in for new statutory leverage limits and risk-based capital requirements for the Banks.

at least 4.76 percent of its total assets. The imposition of the proposed standard on each Bank would ensure that the Bank System itself stays within the leverage limit, rendering any retention of a Bank System-wide leverage limit unnecessary. Further, the Finance Board noted that with the recent passage of the Gramm-Leach-Bliley Act, the Banks would be subject to asset-based statutory leverage limits and risk-based capital requirements. When implemented, the new risk-based capital regime would 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 commenters uniformly opposed the proposed 4.76 percent asset-based, Bank-by-Bank, capital requirement. A number of commenters objected to the proposed change on the basis that secured liabilities, principally repurchase agreements, are not now subject to a capital requirement. Under the Proposed FMP Amendments, however, assets funded by repurchase agreements and other secured liabilities would be subject to capital charges. Repurchase agreements represent a *de minimis* portion of Bank funding. At December 31, 1999, repurchase agreements were less than one-tenth of one percent of the total funding of the Banks, eight of the Banks had no repurchase agreements, and one Bank accounted for a majority of the Bank System's repurchase agreements. The Finance Board finds these arguments unpersuasive.

Several commenters recommended providing the Banks with a level of asset/liability management flexibility similar to that provided under a resolution adopted by Finance Board to assist the Banks in meeting member demand for Year 2000 liquidity. *See* Finance Board Res. No. 99–33 (May 28, 1999) [6] (1999 Resolution). One commenter argued in favor of retaining the 25:1 leverage limit established in the 1999 Resolution, stating that the flexibility provided therein should not be forfeited. A majority of the commenters opposed eliminating the Bank System-wide leverage limit in the current regulations, and urged deferral of a new leverage limit until after the new capital regulations required under the Gramm-Leach-Bliley Act have been adopted and the Banks' capital plans have been reviewed and approved.

The Finance Board agrees with the recommendation that the leverage requirement should be included in the Finance Board's regulations rather than in the FMP. The OF Final Rule, published elsewhere in this issue of the **Federal Register** incorporates into § 966.3(a) of the Finance Board's regulations the leverage provision that was originally proposed in the notice of Proposed FMP Amendments. In addition, in response to the comments received, the OF Final rule extends and makes permanent the leverage authority provided to the Banks in the 1999 Resolution. In particular, the OF Final Rule allows a Bank to have asset-based leverage of up to 25 to 1 if that Bank's non-mortgage assets do not exceed 11 percent of that Bank's total assets that are not funded by deposits or capital. For the purpose of the OF Final Rule, non-mortgage assets equal the total assets after deducting core mission activity assets and assets described in sections II.B. 8 through II.B. 11 of the FMP.[7]

The Finance Board believes that, when implemented, the new risk-based capital regime would 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 FMP Amendments, and the OF Final Rule published elsewhere in this issue of the **Federal Register**, are consistent with the requirements of the Gramm-Leach-Bliley Act.

Accordingly, the Finance Board is deleting existing section VI, ''Funding Guidelines'' from the FMP, as proposed.

B. Hedging Requirement

The Finance Board is replacing section IV of the FMP with a new section IV titled ''Hedging Requirements.'' The ''Hedging Requirements'' provision is adopted as proposed, without change, to read as follows:

IV. Hedging Requirements

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.

C. Duration of Equity Calculation

The Finance Board is revising section VII of the FMP, which sets forth guidelines for the Banks on the management of interest-rate risk, including certain interest rate risk limitations. New section VII.B.4 is adopted as proposed, without change, to 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 that represent the Bank's share of the System's REFCorp and AHP obligations.

Dated: June 2, 2000.

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

Bruce A. Morrison,

Chairman.

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[6] By resolution of its board of directors, the Finance Board directed that, through June 30, 2000, a Bank may have leverage up to 25 to 1 as long as that Bank's ratio of non-mortgage investments to COs does not exceed 12 percent. The Finance Board adopted this additional leverage flexibility on an interim basis to allow the Banks to provide Year 2000 funding to their members. *See* Fin. Bd. Res. No. 99–33 (May 28, 1999).

[7] On May 3, 2000, the Finance Board published for notice and comment a proposed rule that included a listing of activities that would qualify as core mission activities. *See* 65 FR 25676 at 25688 (May 3, 2000).