REGULATORY INTERPRETATION 2010-RI-2

Subject: Effect of Foreign Government Guarantees on Unsecured Credit Exposure

Issue: Whether a Federal Home Loan Bank (Bank) that invests in unsecured debt instruments that are guaranteed by foreign governments under programs to promote market stability must calculate its unsecured credit limits for such instruments based on the creditworthiness of the foreign government.

Conclusion: A Bank that invests in unsecured debt instruments that are guaranteed by a foreign government under such a program may do so up to the regulatory limits applicable to the counterparty, rather than those applicable to the guarantor, provided that the Bank underwrites the extension of credit solely on the basis of the creditworthiness of the counterparty and not in reliance on the government guarantee.

Background:

A Bank is subject to regulatory limits on the amount of unsecured credit it may extend to any one counterparty. *See* 12 C.F.R. § 932.9. Under that rule, a Bank generally may extend unsecured credit to a single counterparty in an amount not to exceed the lesser of the Bank's total capital or the capital of the counterparty, multiplied by a stated percentage, which percentage is based on the long-term credit rating of the counterparty. 12 C.F.R. § 932.9(a). If a counterparty's debt is irrevocably and unconditionally guaranteed by a third party, however, the Bank must consider the guarantor to be the counterparty for purposes of calculating and applying the limits on unsecured credit to the guaranteed debt. Thus, if a third party guarantees the debt of multiple counterparties, a Bank must apply the guarantor's unsecured credit limit to all of the guaranteed debt issued by those counterparties, *i.e.*, the aggregated guaranteed debt of the several counterparties cannot exceed the unsecured credit limit applicable to the guarantor.

Those provisions apply independently and allow a Bank to extend unsecured credit to a single counterparty up to the limits of both provisions. Accordingly, a Bank may invest in unsecured debt instruments that are the sole obligation of a counterparty up to the limit that applies to the counterparty. It also may invest an additional amount in the unsecured debt instruments of that counterparty that are guaranteed by a third party, up to the amount available under the limit that applies to the guarantor.

The Banks engage in unsecured credit transactions with both domestic and foreign counterparties. In recent months, some foreign governments have established programs to promote the stability of their financial markets by guaranteeing the repayment of debt instruments issued by their financial institutions. The sovereign guarantee programs are temporary in nature and their terms vary from country to country. Some programs apply only to certain types of debt instruments issued by eligible institutions within a specified time period, while others are more expansive and cover all types of debt instruments issued by resident institutions while the program is in effect.

The unsecured credit regulation limits a Bank's ability to invest in debt instruments guaranteed by a particular sovereign to a dollar amount that may not differ significantly from the amount that a Bank could otherwise invest in the non-guaranteed debt of each of its individual counterparties. For example, the unsecured credit limit for debt guaranteed by a foreign government with a long-term credit rating of "AAA" would be 15 percent of the Bank's capital, whereas the limit for non-guaranteed debt of a counterparty with a rating of "AA" could be 14 percent of the Bank's capital. With respect to any foreign programs that guarantee all debt issued by a country's financial institutions, however, the regulation would reduce the amount of unsecured credit a Bank may extend to individual counterparties because in those circumstances the unsecured credit limits applicable to the foreign sovereign would effectively replace the individual counterparty limits, at least for the duration of the program. A strict application of the unsecured credit regulation in this situation may effectively steer the Banks towards investments in the non-guaranteed debt of their counterparties, rather than their guaranteed debt, in order to avoid exceeding the limit on the guaranteed debt – even assuming that non-guaranteed debt is available (*i.e.,* that the counterparty's debt is not guaranteed by the sovereign automatically by operation of the sovereign-guarantee program).

Those possibilities have prompted inquiries about whether the regulatory limitations that apply to guarantors generally should be applied as well to a guarantee that is provided by a foreign sovereign.

Analysis:

The purpose of the unsecured credit limits is to prevent undue concentrations of unsecured credit, which could harm a Bank if a counterparty were to come under financial stress. The Federal Housing Finance Board adopted those provisions based on its statutory duty to ensure the safety and soundness of the Banks. *See* 66 Fed. Reg. 66718 (Dec. 27, 2001) (final rule); 66 Fed. Reg. 41474 (Aug. 8, 2001) (proposed rule). The regulation exempts instruments issued or guaranteed by the United States, but does not exempt instruments guaranteed by foreign governments. When adopting the exemption the Finance Board simply noted that it paralleled the agency's existing guidance. The Finance Board did not mention guarantees provided by foreign governments.

It does not appear that the risks that the unsecured credit regulation was intended to address are present in the case of the temporary guarantee programs that foreign governments have established to stabilize their financial markets. The guarantees provided by these foreign governments are not intended to serve as a primary source of repayment for the debt issued by their financial institutions. Rather, they have been established as temporary measures to respond to the global financial crisis and are intended to restore confidence and increase liquidity in those countries' financial markets. Even as a secondary source of repayment, however, the foreign government guarantees provide additional credit enhancement to the entities investing in the guaranteed debt, and thus lessen the credit risk to which the investors are exposed. Investing in instruments that present a reduced credit risk is consistent with the safety and soundness objectives of the unsecured credit regulation.

Moreover, a strict application of the regulation could well cause Banks to forgo the benefit of the sovereign guarantee for fear of exceeding the unsecured credit limit applicable to the guarantor, and might altogether preclude lending to multiple such counterparties if it is not possible to forgo the guarantee. Given the unique circumstances surrounding these temporary programs, and the purposes of the unsecured credit regulation, staff has determined that the limits in the regulation applicable to guarantors generally need not be applied to debt that is guaranteed by foreign sovereigns under these programs, to the extent that the Bank underwrites the investment based on the counterparty's own credit risk without regard to the guarantee.

Accordingly, in the case of a foreign counterparty the debt instruments of which are guaranteed by its government under a temporary program to stabilize its financial markets, a Bank may invest in the unsecured debt of a single counterparty up to the limits applicable to that counterparty, and need not aggregate the guaranteed debt with all other debt guaranteed by the foreign government, provided that the Bank underwrites the extension of the unsecured credit solely on the basis of the creditworthiness of the counterparty, and not on the basis of the guarantee provided by the foreign government.

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By: Alfred M. Pollard
General Counsel

This Regulatory Interpretation is issued pursuant to 12 C.F.R. § 907.5 and is subject to modification or rescission by the Director of the Federal Housing Finance Agency.