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FEDERAL HOUSING FINANCE AGENCY

12 CFR Parts 1267, 1269, and 1270

RIN 2590-AA40

Removal of References to Credit Ratings in Certain Regulations Governing the Federal Home Loan Banks

AGENCIES: Federal Housing Finance Agency.

ACTION: Notice of proposed rulemaking; request for comment.

SUMMARY: Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires Federal agencies to review regulations that require the use of an assessment of the credit-worthiness of a security or money market instrument and any references to, or requirements in, such regulations regarding credit ratings issued by credit rating organizations registered with the Securities and Exchange Commission (SEC) as nationally recognized statistical rating organizations (NRSROs), and to remove such references or requirements. To implement this provision, the Federal Housing Finance Agency (FHFA) is proposing to remove a number of references and requirements in certain safety and soundness regulations affecting the Federal Home Loan Banks (Banks) and to adopt new provisions that would require the Banks to apply internal analytic standards and criteria to determine the credit quality of a security or obligation, subject to FHFA oversight and review through the examination and supervisory process. FHFA will undertake separate rulemakings to remove NRSRO

references and requirements contained in the capital regulations applicable to the Banks and in the regulations governing the Banks' acquired member asset (AMA) programs.

DATES: Comments on the proposed rule must be received on or before [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit your comments on the proposed rule, identified by regulatory information number (RIN) 2590-AA40 by any of the following methods:

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments. If you submit your comments to the Federal eRulemaking Portal, please also send it by e-mail to FHFA at RegComments@FHFA.gov to ensure timely receipt by the agency. Please include "RIN 2590-AA40" in the subject line of the message.
- E-mail: Comments to Alfred M. Pollard, General Counsel may be sent by e-mail to RegComments@FHFA.gov. Please include "RIN 2590-AA40" in the subject line of the message.
- Hand Delivery/Courier: The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA40 , Federal Housing Finance Agency, Constitution Center, (OGC) Eighth Floor, 400 Seventh Street, SW, Washington, DC 20024. The package should be logged at the Seventh Street entrance Guard Desk, First Floor, on business days between 9 a.m. and 5 p.m.
- U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service: The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA40, Federal Housing Finance Agency, Constitution Center, (OGC) Eighth Floor, 400 Seventh Street, SW, Washington, DC 20024.

FOR FURTHER INFORMATION CONTACT: Amy Bogdon, Associate Director for Regulatory Policy and Programs, Amy.Bogdon@FHFA.gov, 202-649-3320, Division of Federal Home Loan Bank Regulation, Federal Housing Finance Agency; or Thomas E. Joseph, Associate General Counsel, Thomas.Joseph@FHFA.gov, 202-649-3076 (these are not toll-free numbers), Office of General Counsel (OGC), Federal Housing Finance Agency, Constitution Center, Eighth Floor, 400 Seventh Street, SW, Washington, DC 20024. The telephone number for the Telecommunications Device for the Hearing Impaired is 800-877-8339.

SUPPLEMENTARY INFORMATION:

I. Comments

FHFA invites comments on all aspects of the Notice of Proposed Rulemaking (NPR), and will develop final regulations after taking all comments into consideration. Copies of all comments will be posted without change, including any personal information you may provide such as your name and address (mailing or email) and telephone numbers, on the internet web site at https://www.fhfa.gov. In addition, copies of all comments received will be available for examination by the public on business days between the hours of 10 a.m. and 3 p.m., at the Federal Housing Finance Agency, Constitution Center, (OGC) Eighth Floor, 400 Seventh Street, SW, Washington, DC 20024. To make an appointment to inspect comments, please call the Office of General Counsel at 202-649-3804.

II. Background

A. Dodd-Frank Act Provisions

Section 939A of the Dodd-Frank Act requires federal agencies to: (i) review regulations that require the use of an assessment of the creditworthiness of a security or money market instrument; and (ii) to the extent those regulations contain any references to, or requirements regarding credit ratings, remove such references or requirements. See section 939A, Public Law No. 111-203, 124 Stat. 1887 (July 21, 2010). In place of such credit-rating based requirements, agencies are instructed to substitute appropriate standards for determining creditworthiness. The new law further provides that, to the extent feasible, an agency should adopt a uniform standard of creditworthiness for use in its regulations, taking into account the entities regulated by it and the purposes for which such regulated entities would rely on the creditworthiness standard.

B. The Bank System

The twelve Banks are wholesale financial institutions organized under the Federal Home Loan Bank Act (Bank Act).[1] The Banks are cooperatives; only members of a Bank may purchase the capital stock of a Bank, and only members or certain eligible housing associates (such as state housing finance agencies) may obtain access to secured loans, known as advances, or other products provided by a Bank.[2] Each Bank is managed by its own board of directors and serves the public interest by enhancing the availability of residential credit through its member institutions.[3] Any eligible institution (generally a federally insured depository institution or state-regulated insurance company) may become a member of a Bank if it satisfies certain criteria and purchases a specified amount of the Bank's capital stock.[4]

As government-sponsored enterprises, the Banks are granted certain privileges

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[1] See 12 U.S.C. 1423, 1432(a).
[2] See 12 U.S.C. 1426(a)(4), 1430(a), 1430b.
[3] See 12 U.S.C. 1427.
[4] See 12 U.S.C. 1424; 12 CFR part 1263.

under federal law. In light of those privileges, the Banks typically can borrow funds at spreads over the rates on U.S. Treasury securities of comparable maturity lower than most other entities. The Banks pass along a portion of their funding advantage to their members – and ultimately to consumers – by providing advances and other financial services at rates that would not otherwise be available to their members. Consolidated obligations (COs), consisting of bonds and discount notes, are the principal funding source for the Banks. The Bank System's Office of Finance (OF) issues all COs on behalf of the twelve Banks. Although each Bank is primarily liable for the portion of COs corresponding to the proceeds received by that Bank, each Bank is also jointly and severally liable with the other eleven Banks for the payment of principal and interest on all COs.[5]

C. Advance Notice of Proposed Rulemaking

On January 31, 2011, FHFA published an advance notice of proposed rulemaking (ANPR) in which it solicited comments from the public on potential alternatives to the use of NRSRO credit ratings in its regulations applicable to the Banks, as well as in its regulations applicable to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the Enterprises).[6] Prior to issuing the ANPR, FHFA also had issued a proposed rule on Bank liabilities and COs, which, among other things, would have combined and re-designated a number of existing regulations as

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[5] See 12 U.S.C. 1431(c); 12 CFR 1270.10.
[6] See Advance Notice of Proposed Rulemaking, Alternatives to Use of Credit Ratings in Regulations Governing the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Banks, 76 FR 5292 (Jan. 31, 2011).

new part 1270 of the FHFA rules.[7] In the preamble for the proposed rule on Bank Liabilities, FHFA asked for comments on implementing section 939A of the Dodd-Frank Act with regard to certain provisions addressed in that rulemaking but did not propose specific amendments related to section 939A at that time. FHFA ultimately decided to adopt the Bank Liability Rule without amending those provisions that referenced credit ratings but noted that it would propose changes to those provisions as part of a future rulemaking.[8] It also stated that it would consider relevant comments made on the part 1270 rules, along with the comments received on the ANPR, as part of such rulemaking.

FHFA received nine comment letters on the ANPR. It also received five comment letters on the proposed Bank Liability Rule, all but one of which addressed issues related to the implementation of section 939A of the Dodd-Frank Act.[9] These comments generally supported an approach to implementing section 939A of the Dodd-Frank Act that would allow the Banks and the Enterprises flexibility to develop internal processes and procedures for measuring, monitoring, and controlling the credit risk of specific assets and obligations. Many of the comments also stated that the Dodd-Frank Act did not prohibit use of NRSRO or other third party credit analytics as part of any internal process as long as such use was not mandated by FHFA and the entity undertook its own analysis of the appropriateness of any rating or third party analytics. A number of commenters believed that any proposed new credit standards should not be unduly burdensome or costly to implement and should recognize difference in risk profiles

[7] See Proposed Rule: Federal Home Loan Bank Liabilities, 75 FR 68534, 68536-38 (Nov. 8, 2010) (Bank Liability Rule).
[8] See Final Rule: Federal Home Loan Bank Liabilities, 76 FR 18366, 18368 (Apr. 4, 2011) (adopting 12 CFR part 1270).
[9] In addition, FHFA staff met with an outside party who provided comments concerning certain minimum credit rating requirements for insurance companies in the AMA regulation.

among different counterparties, assets or obligations. The comments received are discussed in more detail below to the extent that they are relevant to the specific provisions being addressed in this notice of proposed rulemaking.

While the ANPR addressed all FHFA regulations that referenced or otherwise applied requirements based on credit ratings, this proposed rulemaking only addresses Bank safety and soundness regulations that reference or contain requirements based on credit ratings found in parts 1267 (Federal Home Loan Bank Investments), 1269 (Standby Letters of Credit), and 1270 (Liabilities) of the FHFA regulations. FHFA intends to undertake separate rulemakings to remove references to and requirements based on NRSRO credit ratings in the Bank AMA regulations as well as to revise and remove NRSRO rating related references and requirements in the Bank capital and related rules found at part 932 of the former Federal Housing Finance Board regulations.[10]

Finally, FHFA has determined not to amend part 1273 of its regulations to remove references to NRSROs found in § 1273.6(d) of its rules.[11] As FHFA noted in the ANPR, this provision assigns to OF the responsibility to manage the Bank System's relationship with NRSROs, if NRSRO ratings are considered necessary or desirable in connection

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[10] See 12 CFR part 955 (AMA rules); 12 CFR part 932 (Bank capital and related rules). Effective July 30, 2008, the Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289, 122 Stat. 2654, created FHFA as a new independent agency of the Federal Government, and transferred to FHFA the supervisory and oversight responsibilities of the Office of Federal Housing Enterprise Oversight (OFHEO) over the Enterprises, and the supervisory and oversight responsibilities of the Federal Housing Finance Board over the Banks and the OF. See id. at section 1101, 122 Stat. 2661-62. The Enterprises, the Banks, and the OF continue to operate under regulations promulgated by OFHEO and the Finance Board until FHFA issues regulations that supersede those regulations. See id. at sections 1302, 1312, 122 Stat. 2795, 2798.

[11] 12 CFR 1273.6(d).

with the issuance and sale of COs.[12] The provision does not prohibit any action or mandate any particular action be taken by the Banks or OF based on NRSRO ratings. Therefore, FHFA believes this provision is outside the scope of the requirements in section 939A of the Dodd-Frank Act and need not be changed.[13]

D. Actions of Other Regulators

In formulating this proposed rule, FHFA also considered actions taken by other regulators to implement section 939A of Dodd-Frank with respect to similar regulations, including actions by SEC, the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB).

The FHFA recognizes, as have the other federal regulatory agencies, that existing references to credit ratings generally serve several regulatory purposes including those related to capital adequacy, investment acceptability, risk assessment, and disclosure. Agencies that have proposed or finalized regulations in line with the requirements of section 939A of the Dodd-Frank Act have taken one or more of the following actions: (i) removed and not replaced references to credit ratings; (ii) prohibited certain high risk

[12] See 76 FR at 5295.

[13] No commenters disagreed with FHFA's statement in the ANPR that § 1273.6(d) appeared outside the scope of section 939A of the Dodd-Frank Act.

FHFA is not undertaking as part of these Bank-related rulemakings the removal of specific references to NRSRO ratings in safety and soundness or capital regulations applicable to the Enterprises. As FHFA noted in the ANPR, the references to NRSRO ratings in the Enterprise safety and soundness regulations do not require the Enterprises to take or refrain from specific actions based on those ratings and therefore appear outside the scope of section 939A of the Dodd-Frank Act. See 76 FR at 5294. FHFA also noted that the Enterprise statutory and regulatory capital requirements, including those regulatory requirements that referenced NRSRO ratings, were not binding on the Enterprises for the duration of the current conservatorships, although FHFA recognized that it might have to develop and adopt new risk-based capital requirements for the Enterprises or their successors in a post-conservatorship environment. Id.

activities altogether; (iii) established new definitions for minimum credit standards with an emphasis on repayment capacity and risk of default; (iv) replaced creditworthiness standards that previously referenced credit ratings with standards that evaluate other common credit criteria; (v) eliminated any undue reliance on third-party credit ratings; and/or (vi) re-emphasized and promoted sound and effective governance, (credit) risk management, due diligence, and documentation practices.

The final rules that the NCUA, FDIC, and OCC adopted regarding investments are most relevant to this rulemaking.[14] In their rulemakings, the FDIC and OCC redefined an ''investment grade'' security as one where the issuer has an adequate capacity to meet all financial commitments under the security for the projected life of the security. To meet this new standard, national banks and federal and state savings associations must determine that the risk of default by the obligor is low and that the full and timely repayment of principal and interest is expected. Both agencies also published guidance to assist their regulated institutions in complying with the new regulations.[15] Similarly, the NCUA replaced minimum rating requirements with a requirement that the federal credit union or corporate credit union conduct and document a credit analysis demonstrating that the issuer of the security has a certain, specified capacity to meet its financial commitments. For regulations pertaining to counterparty transactions, the NCUA's final rule replaced minimum rating requirements with a requirement that the

[14] See Final Rule: Alternatives to the Use of Credit Ratings, 77 FR 74103 (Dec. 13, 2012) (NCUA); Final Rule: Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities, 77 FR 43151 (Jul. 24, 2012) (FDIC); and Final Rule: Alternatives to the Use of External Credit Ratings in the Regulations of the OCC, 77 FR 35253 (Jun. 13, 2012) (OCC).
[15] See Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security Is Eligible for Investment, 77 FR 43155 (Jul. 24, 2012) (FDIC); and Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment, 77 FR 35259 (Jun. 13, 2012) (OCC).

credit union conduct a credit analysis of the counterparty based on a standard approved by the credit union's board of directors.

E. Considerations of Differences between the Banks and the Enterprises

When promulgating regulations relating to the Banks, section 1313(f) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act), as amended by section 1201 of HERA, requires the Director of FHFA (Director) to consider the differences between the Banks and the Enterprises with respect to the Banks' cooperative ownership structure; mission of providing liquidity to members; affordable housing and community development mission; capital structure; and joint and several liability.[16] The Director also may consider any other differences that are deemed appropriate. The changes proposed in this rulemaking apply exclusively to the Banks. FHFA, in preparing this proposed rule, considered the differences between the Banks and the Enterprises as they relate to the above factors. FHFA, however, requests comments from the public about whether these differences should result in any revisions to the proposed rules.

III. Proposed Amendments to Parts 1267, 1269, and 1270 of the FHFA Regulations

As noted in the ANPR and above, a number of requirements in FHFA regulations impose limits on Bank activity or investments or otherwise require the Banks to take certain actions based on NRSRO credit ratings. To remove these requirements, FHFA is proposing to require the Banks to base determinations about the appropriateness of specific investments or activities on their own documented analyses of credit and other risks. FHFA has a long standing expectation that Banks apply, demonstrate and

[16] See 12 U.S.C. 4513 (as amended by section 1201 Pub. L. 110-289, 122 Stat. 2782-83).

document appropriate risk management in the assumption and extension of credit risk. The analyses required will be subject to FHFA oversight and review through the examination and supervisory process. FHFA's expectations with respect to appropriate standards for assessing creditworthiness under this proposal are described in more detail below.

A. Part 1267 Rules --Investments.

A number of provisions in the investment regulation limit Bank investments by reference to the rating issued by an NRSRO for a particular instrument. First, the Banks are prohibited from investing in any debt instrument that is rated below investment grade by an NRSRO at the time the investment is made.[17] Another provision, which sets forth exceptions to a general prohibition on a Bank's investment in mortgages or other whole loans, specifically allows for investment in marketable direct obligations of state, local, or tribal government units or agencies, having at least the second highest credit rating from an NRSRO where the purchase would generate customized terms, necessary liquidity, or favorable pricing for the issuer's funding of housing or community lending.[18]

To remove references to NRSRO credit ratings from these provisions, FHFA is proposing to add a new defined term "investment quality" to § 1267.1 of its rules while removing the current definitions for "investment grade" and "NRSRO" from that provision. FHFA would then substitute the term "investment quality" for the two references to "investment grade" in § 1267.3(a) and for the reference to "second highest credit rating from an NRSRO" in § 1267.3(a)(4)(iii).

Under the proposed rule, "investment quality" would be defined as a

[17] See 12 CFR 1267.3(a)(3).
[18] See 12 CFR 1267.3(a)(4)(iii).

determination made by a Bank that there is adequate financial backing for any security or obligation so that full and timely payment of principal and interest is expected, and there is only minimal risk that such timely payment would not occur because of adverse changes in financial or economic conditions over the life of the instrument. This Bank determination must be based on well documented internal analysis that would include consideration of the sources for repayment on a particular security or obligation.

FHFA believes that the proposed definition would allow Banks to build upon their current internal credit risk assessment and management practices and provide flexibility to consider differences in credit quality of different investments – considerations which were supported by many commenters to the ANPR. By requiring the Banks to consider sources of repayment for a particular instrument, the proposed definition also would allow the Banks to consider guarantees or other credit enhancements when determining the credit quality of a particular investment. FHFA emphasizes that under the proposed definition a Bank must document its analysis as to the credit quality of a particular instrument so FHFA would be able to review these decisions as part of its supervisory and examination process and thereby help ensure consistency and rigor in the analysis across all Banks.

Factors the Banks may consider in evaluating the creditworthiness of a security or other obligation include, but are not limited to, internal or external credit risk assessments, including scenario analysis; security or asset-class related research; credit analysis of cash flow and debt service projections; credit spreads for like financial instruments; loss distributions, default rates, and other statistics; relevant market data, for example, bid-ask spreads, most recent sales price, and historical price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the investment; local and regional economic conditions; legal or other contractual implications to credit and repayment risk; underwriting, performance measures and triggers; and other financial instrument covenants and considerations. FHFA notes that some commenters to the ANPR believed that FHFA should not eliminate references to credit ratings in its rules but should instead adopt specific standards that would help ensure an NRSRO would be independent from an issuer of a security or would meet other specific qualifications. Other commenters believed that any proposal should not prevent the Banks from using NRSRO ratings as part of any credit analysis. While FHFA believes that mandating any use or reliance on NRSRO credit ratings in the investment regulation would be inconsistent with the Dodd-Frank Act provisions, the proposed definition of "investment quality" would not prevent a Bank from using NRSRO ratings or other third party analytics in its credit determination so long as the Bank does not rely principally on such rating or third party analysis. Instead, FHFA expects that such determination will be driven primarily by the Bank's own internal analysis of market and other external data and relevant financial information, including the size and complexity of the financial instrument and the Bank's own risk appetite and risk assessment framework. This approach is consistent with the existing FHFA supervisory expectation that the Banks have in place appropriate credit risk management and due diligence review processes.

Under the new language proposed for § 1267.3(a), a Bank would need to make its determination concerning the credit quality of a debt instrument prior to purchasing such instrument. If the Bank determined that the instrument did not meet its criteria to be considered "investment quality" consistent with the proposed definition of that term discussed above the Bank would be prohibited from purchasing the debt instrument. If the Bank determined that the instrument is "investment quality," the Bank would be permitted to purchase it.

As part of its risk management and monitoring process, FHFA expects a Bank to periodically update its analysis with regard to any debt instruments purchased to determine whether they continue to meet criteria to be considered "investment quality" as well as to meet other safety, soundness, and business objectives. The Bank would also be expected to develop appropriate strategies to respond to a decline in the credit quality of its investments, consistent with then-current market and financial conditions and considerations. Under proposed § 1267.(3)(a)(ii), however, the Bank would not be required to sell a debt instrument if subsequent analysis indicated the instrument became less than "investment quality" after the initial purchase. This approach is consistent with current § 1267.3(a), which provides that a Bank cannot buy debt instruments that are rated less than investment grade by an NRSRO at the time of purchase, but that the Bank does not have to sell any such instrument if it is downgraded to below investment grade after acquisition. FHFA is proposing no other changes to current § 1267.3(a) beyond replacing the current references to "investment grade" with references to "investment quality."

Similarly, under proposed § 1267.3(a)(4)(iii), a Bank would be permitted to purchase a marketable direct obligation of a state, local or tribal government agency or unit, as an exception to the general prohibition on the purchases of mortgages or interest in mortgages, only after determining that the obligation would meet the "investment quality" criteria (as well as meeting all the other conditions set forth in the provision).[19] As with the debt investments, a Bank would be expected to periodically update its credit analysis to determine whether the obligation in question continues to meet the "investment quality" criteria. The "investment quality" standard would replace the current requirement that the instrument have "the second highest rating from an NRSRO." No other change to the provision is being proposed.

The proposed change may appear to extend somewhat the ability of the Banks to invest in certain marketable direct obligations of a state, local or tribal government agencies or units as such investments would not be limited to instruments rated by an NRSRO in the second highest rating category or better. Before making a purchase, however, a Bank would first need to determine, based on rigorous analysis, that there will be sufficient financial backing so that full and timely repayment of principal and interest on such obligations is expected, and only minimal risk that adverse changes would alter this likelihood. FHFA believes that requiring the Banks to undertake this affirmative analysis should help ensure that the proposed change would not alter substantially the risk a Bank may face from this class of investments and could help improve the quality of a Bank's investment decisions in this area. FHFA also believes that it would be complex and unduly burdensome to develop and apply a standard that would more closely approximate the current requirement than that proposed.

Finally, FHFA proposes to remove current § 1267.5 because it no longer applies to any Bank. This provision establishes interim capital requirements for investments, but

[19] Specifically, the Bank's purchase of the marketable direct obligation of a state, local or tribal government unit or agency would have to provide the issuer the customized terms, necessary liquidity, or favorable pricing required to generate needed funding for housing or community lending. These conditions are being carried over from the current rule without change as part of the proposed amendments.

by its terms applies only to those Banks that have not yet converted to the capital stock structure mandated by the Gramm-Leach-Bliley Act[20] (GLB Act) and are not subject to the more rigorous risk-based and leverage capital requirements mandated by the GLB Act and implemented by the capital regulations found at 12 CFR part 932. Because all Banks have now converted to the GLB Act capital stock structure, none remain subject to the requirements of § 1267.5,[21] and FHFA proposes to delete it from its regulations.

B. Part 1269 Rules – Standby Letters of Credit

Section 1269.2(c)(2) of FHFA regulations provides that a standby letter of credit issued or confirmed by a Bank on behalf of a member to assist the member in facilitating residential housing finance or community lending may be collateralized by obligations of a state or local government unit or agency, if the obligation is rated investment grade by an NRSRO.[22] FHFA proposes to eliminate this reference to an NRSRO investment grade rating in § 1269.2(c)(2) and replace it with a requirement that the obligation of the state or local government unit or agency have a readily ascertainable value, can be reliably discounted to account for liquidation and other risks, and can be liquidated in due course. FHFA also proposes to remove the current definitions for "investment grade" and "NRSRO" from § 1269.1.[23]

FHFA considered replacing the investment grade rating requirement in § 1269.2(c)(2) with the same "investment quality" standard that is being proposed in the part 1267 Investment Regulations. However, FHFA believes that it would not be realistic and would be unnecessarily onerous for a Bank to perform the same type of in- depth

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[20] Pub. L. 106-102, 133 Stat. 1338 (1999).
[21] See 76 FR at 5295, n.5.
[22] See 12 CFR 1269.2(c)(2).
[23] 12 CFR 1269.1.

credit analysis, as discussed above, for a security that will be accepted as collateral as for one in which the Bank intends to invest. This is especially true given that the amounts of likely collateral covered by this requirement are not large. Instead, FHFA is proposing a standard that is more appropriate for collateral and is similar to one already applied in other FHFA collateral regulations.[24] FHFA also believes the proposed standard is consistent with the original intent of the investment grade requirement in this regulation, given that the rating was meant to serve as a proxy for securities that had "an established secondary market . . . [that] . . . can be easily valued and, if necessary, liquidated by a [Bank]."[25]

Under the new language proposed for § 1269.2(c)(2), a Bank would be expected to incorporate criteria into its collateral policies to assure that any state or local government obligation accepted as collateral for a standby letter of credit under this provision would have a readily ascertainable value, can be reliably discounted to account for liquidation and other risks, and can be liquidated by the Bank in due course. FHFA also would expect the Bank to meet other requirements applicable to collateral more generally, including having a policy and procedures in place to ensure that the Bank accurately values the collateral and applies realistic haircuts that reflect the market for the instrument and existing economic conditions.

C. Part 1270 Rules – Liabilities

Part 1270 contains a number of provisions that reference NRSRO credit ratings or

[24] See 12 CFR 1266.7(a)(4).
[25] Proposed Rule: Federal Home Loan Bank Standby Letters of Credit, 63 FR 25726, 25729 (May 8, 1998).

require the Banks to seek a rating from an NRSRO. First, § 1270.4(b)(6)[26] references assets that have been assigned a rating or assessment by an NRSRO that is equivalent to, or higher than, the rating or assessment assigned by the NRSRO to outstanding COs. This provision is contained in the "negative pledge requirement," which states that a Bank must maintain certain specific assets free of any lien or pledge in an amount equal to the Bank's pro rata share of total outstanding COs. FHFA proposes to remove § 1270.4(b)(6) because the provision does not appear to expand the type of assets that can be used to fulfill negative pledge requirement beyond those already identified in paragraphs (b)(1) through (b)(5) of the regulation.

The negative pledge requirement was first adopted in 1946. It has been amended only once to any significant degree, in 1992, at which time the Finance Board added the provisions currently found at § 1270.4(b)(5) and at § 1270.4(b)(6) of FHFA regulations.[27] While § 1270.4(b)(6) allows certain securities to be used to fulfill the negative pledge requirement based on their NRSRO rating based on their NRSRO ratings, § 1270.4(b)(5) allows a Bank to rely on investments authorized under section 16(a) of the Bank Act[28] to fulfill this requirement. Among the investment authorized by section 16(a) of the Bank Act are "such securities as fiduciary and trust funds may be invested in under the laws of the State in which the . . . Bank is located." The type of securities that would be included within the broad authority provided by this "fiduciary" language would appear to include the assets that are also authorized for use in meeting the negative pledge requirement by

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[26] 12 CFR 1270.4(b)(6).
[27] See Proposed Rule: Leverage Ratio on Consolidated Federal Home Loan Bank Debt, 57 FR 20061, 20062 (May 11, 1992); Final Rule: Leverage Ratio on Consolidated Federal Home Loan Bank Debt, 57 FR 62183, 62185 (Dec. 30, 1992).
[28] 12 U.S.C. 1436(a).

§ 1270.4(b)(6). Moreover, FHFA is not aware of any asset that the Banks currently use to fulfill the negative pledge requirement that would be exclusively authorized by § 1270.4(b)(6). Nor did the Finance Board, in adding current § 1270.4(b)(6), indicate any specific instrument or class of instruments that would be covered by the provision.[29] Thus, FHFA is proposing to delete this provision as duplicative and unnecessary.

FHFA considered replacing the current reference to NRSRO credit ratings in § 1270.4(b)(6) with a requirement that a Bank determine that a security has a level of credit risk that is equivalent to or less than that of outstanding COs before the security can be used to fulfill the negative pledge requirement. Under this alternative approach, the determination would have been based on credit standards collectively developed by the Banks in consultation with OF. Use of a collectively developed standard would be warranted in this case because all Banks are jointly and severally liable on outstanding COs, and FHFA believed that each Bank would have a strong interest in seeing that the other Banks maintain the conservative risk profile of assets used to fulfill the negative pledge requirement. FHFA viewed this alternative approach as overly complex, however, especially in light of the fact that § 1270.4(b)(6) appears not to expand the pool of assets already authorized for use to meet the negative pledge requirement elsewhere in the regulation.

Nevertheless, FHFA specifically requests comments on whether § 1270.4(b)(6) should be removed as proposed or if there would be benefits to amending rather than deleting the provision. If commenters believe the provision should be amended, FHFA requests comments on the alternative approach described above, which would require the

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[29] See 57 FR at 20062, and 57 FR at 62185.

Banks to collectively develop a credit standard in consultation with OF to replace use of NRSRO ratings and on whether such an approach would be overly complex to implement.

In addition to the references in § 1270.4(b)(6), §§ 1270.5(b) and (c)[30] require Banks collectively to maintain the highest NRSRO rating for COs and each Bank individually to maintain a rating of at least the second highest from an NRSRO. These requirements were adopted as a means of enhancing protections afforded holders of COs by requiring Banks either collectively or individually to take actions to maintain the required ratings.[31] The Finance Board believed that these requirements provided more effective on-going protections to bond holders than the provision that they replaced, which had required a written statement from a rating agency or an investment bank that a change in the leverage limit applicable to the Banks would not adversely affect the ratings or creditworthiness of COs, prior to the change becoming effective.[32]

FHFA proposes to delete current §§ 1270.5(b) and (c) and replace them with new § 1270.5. This new requirement would provide that the Banks, individually and collectively, should operate in such manner and take any actions necessary, including reducing leverage, to ensure that COs maintain the highest level of acceptance by financial markets and are generally perceived by investors as presenting a very low level of credit risk. FHFA believes that the proposed provision captures the intent of the current rules and helps protect holders of COs while upholding the spirit of the Dodd-Frank Act requirements by not mandating through regulation that NRSROs effectively

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[30] 12 CFR 1270.5(b) and (c).
[31] See Final Rule: Office of Finance; Authority of Federal Home Loan Banks to Issue Consolidated Obligations, 65 FR 36290, 36294 (June 7, 2000).
[32] Id.

provide an imprimatur of Bank actions through the rating process.[33] Nothing in the language as proposed, however, would prohibit the Banks collectively from seeking NRSRO ratings for COs or an individual Bank from maintaining an individual NRSRO rating if such ratings were found to be desirable or helpful for either business or other reasons.

FHFA also is proposing to delete current § 1270.5(a) of its regulations because no Bank remains subject to it.[34] This provision established leverage requirements which were applicable only to Banks that had not yet converted to the capital stock structure mandated by the GLB Act and had not become subject to the part 932 capital requirements. As already discussed, all Banks have now converted to the GLB Act capital stock structure and are subject to the part 932 capital requirements. Therefore § 1270.5(a) no longer applies to any Bank and can be removed from FHFA regulations. The proposed amendments also would delete the definition of "NRSRO" from § 1270.1, given that the term would no longer be used in part 1270 if the other proposed changes are adopted.

D. Phase-in Period

In comments to the ANPR, the Banks requested that FHFA provide a phase-in period of no less than one year for any amendments that would implement section 939A of the Dodd-Frank Act. FHFA disagrees and believes that a phase-in period of one year or more is too long, especially as the Banks should be able to leverage their current

[33] In comments to the ANPR, the Banks stated that because the individual Bank rating requirement in § 1270.5(c) did not involve the rating of a security or a money market instrument, it was outside the scope of section 939A of the Dodd-Frank Act. FHFA disagrees and believes that requiring the Banks to maintain a specific credit rating from an NRSRO would be a violation of the spirit of the Dodd-Frank provision by requiring the Banks to rely on NRSROs to review and essentially opine on Bank actions.
[34] 12 CFR 1270.5(a).

governance, risk selection, and credit risk management policies, processes, and practices to meet the proposed requirements. Nevertheless, FHFA may consider a delayed implementation date for any final requirements, and requests comments on what time frame may be necessary for the Banks to implement the proposal. FHFA further requests that any comments on this issue specifically identify and describe the actions that would need to be taken to implement these proposed amendments.

IV. Paperwork Reduction Act

The proposed rule amendments do not contain any collections of information pursuant to the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 et seq.). Therefore, FHFA has not submitted any information to the Office of Management and Budget for review.

V. Regulatory Flexibility Act

The proposed rule amendments apply only to the Banks, which do not come within the meaning of small entities as defined in the Regulatory Flexibility Act (RFA). See 5 U.S.C. 601(6). Therefore in accordance with section 605(b) of the RFA, FHFA certifies that this proposed rule, if promulgated as a final rule, will not have significant economic impact on a substantial number of small entities.

List of Subjects

12 CFR Parts 1267 and 1269

Community development, Credit, Federal home loan bank, Housing, Reporting and recordkeeping requirements.

12 CFR Part 1270

Accounting, Federal home loan banks, Government securities.

Accordingly, for reasons stated in the preamble and under authority in 12 U.S.C. 4511, 4513, and 4526, FHFA proposes to amend chapter XII of title 12 of the Code of Federal Regulations as follows:

PART 1267 – FEDERAL HOME LOAN BANK INVESTMENTS

1. The authority citation for part 1267 continues to read as follows:

Authority: 12 U.S.C. 1429, 1430, 1430b, 1431, 1436, 4511, 4513, 4526.

2. Amend § 1267.1 by removing the definitions for "Investment grade" and "NRSRO" and adding in correct alphabetical order a definition for "Investment quality" to read as follows:

§ 1267.1 Definitions.

* * * * *

<u>Investment quality</u> means a determination made by the Bank with respect to a security or obligation that based on documented analysis, including consideration of the sources for repayment on the security or obligation:

(1) There is adequate financial backing so that full and timely payment of principal and interest on such security or obligation is expected; and

(2) There is minimal risk that that timely payment of principal or interest would not occur because of adverse changes in economic and financial conditions during the projected life of the security or obligation.

* * * * *

3. Amend § 1267.3 by revising paragraphs (a)(3) and (a)(4) to read as follows:

§ 1267.3 Prohibited investments and prudential rules.

(a) * * *

(3) Debt instruments that are not investment quality, except:

(i) Investments described in § 1265.3(e) of this chapter; and

(ii) Debt instruments that a Bank determined became less than investment quality because of developments or events that occurred after acquisition of the instrument by the Bank;

(4) Whole mortgages or other whole loans, or interests in mortgages or loans, except:

(i) Acquired member assets;

(ii) Investments described in § 1265.3(e) of this chapter;

(iii) Marketable direct obligations of state, local, or Tribal government units or agencies, that are investment quality, where the purchase of such obligations by the Bank provides to the issuer the customized terms, necessary liquidity, or favorable pricing required to generate needed funding for housing or community lending;

(iv) Mortgage-backed securities, or asset-backed securities collateralized by manufactured housing loans or home equity loans, that meet the definition of the term "securities" under 15 U.S.C. 77b(a)(1) and are not otherwise prohibited under paragraphs (a)(5) through (a)(7) of this section, and

(v) Loans held or acquired pursuant to section 12(b) of the Bank Act (12 U.S.C. 1432(b)).

* * *

* * * * *

§ 1267.5 [Removed]

4. Remove § 1267.5.

PART 1269 – STANDBY LETTERS OF CREDIT

5. The authority citation for part 1269 continues to read as follows:

Authority: 12 U.S.C. 1429, 1430, 1430b, 1431, 4511, 4513, 4526.

6. Amend § 1269.1 by removing the definitions for "Investment grade" and "NRSRO."

7. Amend § 1269.2 by revising paragraph (c)(2) to read as follows:

§ 1269.2 Standby letters of credit on behalf of members.

* * * * *

(c) * * *

(2) A standby letter of credit issued or confirmed on behalf of a member for a purpose described in paragraphs (a)(1) or (a)(2) of this section may, in addition to the collateral described in paragraph (c)(1) of this section, be secured by obligations of state or local government units or agencies, where such obligations have a readily ascertainable value, can be reliably discounted to account for liquidation and other risks, and can be liquidated in due course.

PART 1270 – LIABILITIES

8. The authority citation for part 1270 continues to read as follows:

Authority: 12 U.S.C. 1431, 1432, 1435, 4511, 4512, 4513, 4526.

§ 1270.1 Definitions.

9. Amend § 1270.1 by removing the definition of "NRSRO."

10. Amend § 1270.4 by revising paragraph (b) to read as follows:

§ 1270.4 Issuance of consolidated obligations.

* * * * *

(b) Negative pledge requirement. Each Bank shall at all times maintain assets described in paragraphs (b)(1) through (b)(5) of this section free from any lien or pledge, in an amount at least equal to a pro rata share of the total amount of currently outstanding consolidated obligations and equal to such Bank's participation in all such consolidated obligations outstanding, provided that any assets that are subject to a lien or pledge for the benefit of the holders of any issue of consolidated obligations shall be treated as if they were assets free from any lien or pledge for purposes of compliance with this paragraph (b). Eligible assets are:

(1) Cash;

(2) Obligations of or fully guaranteed by the United States;

(3) Secured advances;

(4) Mortgages as to which one or more Banks have any guaranty or insurance, or commitment therefor, by the United States or any agency thereof; and

(5) Investments described in section 16(a) of the Bank Act (12 U.S.C. 1436(a)).

11. Amend § 1270.5 by revising this section in its entirety to read as follows:

§ 1270.5 Bank operations.

The Banks, individually and collectively, shall operate in such manner and take any actions necessary, including without limitation reducing leverage, to ensure that consolidated obligations maintain a high level of acceptance by financial markets and are generally perceived by investors as presenting a low level of credit risk.

______________________________________ Dated: May 17, 2013.

Edward J. DeMarco
Acting Director, Federal Housing Finance Agency.

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