

July 6, 2010

By email to: RegComments@fhfa.gov

Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
1700 G Street, NW Fourth Floor
Washington, DC 20552
Attention: Comments/RIN 2590-AA32

VIA FEDERAL EXPRESS AND EMAIL

Re: Notice of Proposed Rulemaking; Request for Comment (Investment Regulation)

Dear Mr. Pollard:

The Federal Home Loan Bank of San Francisco (the "San Francisco Bank") appreciates this opportunity to comment on the Federal Housing Finance Agency ("FHFA") Notice of Proposed Rulemaking ("NPR") that would reorganize and readopt existing investment regulations for the FHLBanks that were previously adopted by the Federal Housing Finance Board ("FHFB"). The FHFA also proposes incorporating into the new regulation existing limits on the FHLBanks' investment in mortgage-backed securities ("MBS") and certain asset-backed securities. These limits are currently set forth in the FHFB's Financial Management Policy ("FMP").

The FHFA is seeking comments on several questions relating to whether it should adopt additional restrictions, or lower the overall limit, on the FHLBanks' investment in MBS generally, and particularly in private-label MBS ("PLMBS"). The San Francisco Bank's comments on these questions are set forth below.

Before commenting, however, we note the significance of the FHLBanks' ability to invest in MBS. In Section 11 of the FHLBank Act, 12 U.S.C. §1431(h) (the "Act"), Congress sets forth the investment authorities of the FHLBanks. Over the years following the establishment of the Act, Congress has expanded the FHLBanks' investment authority to include not only Agency obligations, but also "participations or other instruments of or issued by" the Agencies, allowing the FHLBanks to indirectly contribute to housing finance and recognizing the FHLBanks as important investors in the secondary market.

The FHFB acknowledged this importance during the most recent credit crisis. On March 24, 2008, the FHFB issued Resolution 2008-08, which temporarily increased the FHLBanks' investment authority in MBS and permitted them to purchase and hold MBS in an amount up to six times capital, as long as purchases in excess of the existing three times capital limitation were Agency MBS. This temporary authority was granted until March 31, 2010. In a statement released with the Resolution, former FHFB board member Geoff Bacino noted that this quick action by the FHFB should "help alleviate the current crisis in the mortgage markets." At the same time, former FHFB Chairman Ronald Rosenfeld noted, "The Federal Home Loan Bank System plays a vital role in helping to finance homeownership and strengthening the economy at large. Increasing the Agency MBS investment authority for the FHLBanks is another way in which the system can perform its traditional mission." On April 3, 2008, the FHFB issued Advisory Bulletin 2008-AB-01 ("2008-AB-01"), which provided implementation guidance for the Resolution. According to 2008-AB-01, by allowing the FHLBanks to purchase additional Agency MBS, "the Finance Board intends to further its statutory housing finance mission . . ." In addition, the FHFB stated: "To the extent that this

action can increase the demand for Agency MBS, the added liquidity could help to restore the market for these securities and could, in turn, lead to lower liquidity premiums, lower mortgage rates, and increased home purchases.” These various statements exemplify the reliance on and implied expectation of the FHLBanks to provide liquidity to the secondary market through MBS investments. This is especially important in times of market disruptions.

There is a compelling need to restart the secondary mortgage market, and the FHLBanks’ MBS investment authority may play a key role in achieving that goal. As a public policy matter, the secondary mortgage market in the United States cannot continue on a sustainable basis if it consists almost entirely of government-guaranteed loans. There must be a functional and efficient private sector component for prudently underwritten loans that serve certain needs in the housing finance market that cannot be met through the guaranteed securitization market. The FHLBanks should be permitted to continue to play a role in supporting that private securitization market. The FHLBank system had \$152 billion invested in MBS at December 31, 2009 (\$104 billion Agency MBS; \$48 billion PLMBS).

For these reasons, the San Francisco Bank believes that the final rule, while incorporating reasonable quantitative limits and prudential standards, should be written to preserve sufficient flexibility for the FHLBanks to invest in non-government guaranteed housing finance instruments as well as guaranteed instruments. These investments play a significant role for the FHLBank System as we safely and soundly exercise our housing finance mission.

I. Quantitative and Other Limitations on MBS

The NPR proposes to incorporate into the final rule the current provision in the FHFB’s FMP section II.C.2¹ that limits a Bank’s level of investment in MBS and eligible ABS to 300 percent of its total capital. The San Francisco Bank supports retention of this limitation at this time. Limits on a Bank’s MBS investment authority ensure that the FHLBanks will not over-emphasize those investments at the expense of advances and, in conjunction with other restrictions on an FHLBank’s MBS investments currently implemented through the FMP, impose reasonable constraints on the amount of interest rate and credit risk an FHLBank will assume through its investment portfolio. The authority to invest in appropriately structured and underwritten MBS securities serves an FHLBank’s need to invest its capital and liquidity to generate sufficient earnings and enhance achievement of the FHLBanks’ primary mission of providing credit to member institutions. MBS investments can represent a source of income that enable the FHLBanks to meet REFCORP and AHP obligations, cover operating expenses, build retained earnings, and provide their members a reasonable dividend on their capital stock investment, as well as support FHLBank advance activity. Such investments also can help provide stability of operations in the periods when an FHLBank’s core products’ balances may be low.

In this regard, the San Francisco Bank requests that the method for calculating the 300 percent of total capital requirement be clarified and specified in terms of changes to GAAP. Specifically, the numerator should include amortized historical cost for HTM and AFS securities and fair value for trading securities. The denominator should include total capital as defined by FHFA regulation §1229.1.²

¹ “A Bank may enter into agreements to purchase MBS, CMOs, REMICs, and eligible asset-backed securities so long as such purchases will not cause the aggregate book value of such securities held by the Bank to exceed 300 percent of the Bank’s capital. A Bank may not increase its holdings of such securities in any one calendar quarter by more than 50 percent of its total capital at the beginning of that quarter.”

² “*Total capital* means the sum of the Bank’s permanent capital, the amount paid-in for its Class A stock, the amount of any general allowances for losses, and the amount of any other instruments identified in a Bank’s capital plan that the Director has determined to be available to absorb losses incurred by such Bank. For a Bank that has issued neither Class A nor Class B stock, the Bank’s total capital shall be the measure of capital used to determine compliance with its minimum capital requirement.”

II. Limits or Restrictions on the Purchase of PLMBS

With respect to PLMBS, in view of the extensive regulatory and market changes that are underway with respect to this market and the current uncertainty surrounding these efforts, we believe that establishing specific PLMBS limits or restrictions at this time is premature.

Once the new legislative and regulatory requirements for issuance of PLMBS transactions have been established, the FHLBanks, like other investors in this market, will have a clearer understanding of the issues they will face as investors in such newly-issued PLMBS. At that point, each FHLBank will be able to establish its risk parameters and limits with respect to its PLMBS portfolio in its Board-approved investment policy. These risk parameters and policy limits, like other aspects of an FHLBank's credit and investment policies, would be subject to review by the FHFA as part of the supervisory process.

III. Investment Grade Ratings for PLMBS

The San Francisco Bank supports a requirement that all PLMBS purchased by a FHLBank be limited to securities with the highest investment grade rating at the time of purchase by an FHLBank in an effort to limit the potential risks to the FHLBanks from their MBS portfolios. As a practical matter, historically, the FHLBanks have operated in compliance with this standard in limiting its PLMBS purchases to the highest investment grade rating. Therefore, we are supportive of its incorporation into the final rule. As is currently the case, an FHLBank should not be required to divest a PLMBS if the investment rating of that PLMBS falls subsequent to its purchase by an FHLBank.

If under the pending financial reform legislation the use of investment grade ratings is no longer permitted in FHFA rulemakings, other standards based on expected losses and credit enhancements could be established in future rulemakings.

Again, we thank you for the opportunity to provide our comments on the Proposed Rule.

Very truly yours,



Dean Schultz
President and Chief Executive Officer

cc: L. B. MacMillen
S. Titus-Johnson