DECISION MEMORANDUM OF THE BOARD OF DIRECTORS
ACTING WITHOUT A QUORUM

Date: January 11, 1995
No. 95-DM-03

ISSUE: Revision of Office of Finance 1995 Business Plan.

FACTORS CONSIDERED:

0 The Office of Finance Board of Directors (Office of Finance Board) has submitted a business plan to the Finance Board which serves as support for its 1995 budget recommendations and as a foundation for Office of Finance operating strategies in 1995.

0 The Finance Board's Office of Finance Oversight Task Force (Oversight Task Force) has reviewed the business plan and has submitted to the Finance Board a Report on the Office of Finance 1995 business plan, dated December 21, 1994.

DECISION: The Finance Board hereby directs the Office of Finance Board to revise its 1995 business plan, taking into consideration the December 21, 1994 Report on the Office of Finance 1995 business plan, and to resubmit the business plan by February 28, 1995.

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OVERSIGHT TASK FORCE REPORT
ON THE OFFICE OF FINANCE 1995 BUSINESS PLAN
December 21, 1994

These comments are not meant to be all inclusive or exclusive. There may be additional areas not covered by this Report that the Office of Finance may wish to address in a revised business plan.

General Comments

0 The business plan would benefit from a non-technical executive summary.

0 The business plan should have an expanded discussion of the OF's obligation to and relationship with the Finance Board. It mentions the Finance Board only briefly and then with an emphasis on how the lack of a quorum impedes the OF's ability to effectively serve the System.

0 The System is the OF's only client, yet the business plan discusses new products (e.g., master note agreement, global debt issuance) and operating strategies primarily in the context of investment community demands and requirements. The plan should. explain how new products benefit the Banks and help them carry out their housing finance mission.

0 The plan should discuss how the OF Board will determine whether the OF has met its 1995 goals and objectives.

0 The plan needs greater clarification of technical terms and transactions. For example, the discussion of the repo market on p. 9 is unclear (is the term "conforming" being used in two different ways?), as is the discussion of the cost of calls in a bear market on p. 10 (the plan could explain why calls are more expensive in a bear market and why dealers need to be compensated for the risk of positioning bonds during a bear market).

o The tone is unduly negative in certain places (references to regulatory "posturing" on p.10 and regulatory "ignorance" on p.31). In addition, the discussion on p. 43 on expanding the list of eligible indices gives the impression that the OF is seeking ways to circumvent Finance Board policy.

o It would be helpful if Section IV (Divisional Plans) became an appendix, since the divisional plans are operationally specific and highly technical.

0 The OF may want to use the Boston and Pittsburgh business plans as models for organizational clarity and format.

Section I -- Introduction

0 There is little discussion of the System's mission of providing funds for housing finance, which could be included in the discussion of the OF mission.

0 Given the increased importance of structured transactions in Bank funding activities over the past few years and regulatory interest in such transactions, it would be useful to have a discussion of structured debt in the Activities Review subsection, including how structured debt helps the Banks carry out their mission and expected trends in this market in 1995. The key role played by GSEs in the structured transactions market should also be discussed.

0 The major OF themes for 1995 -- diversification of funding sources and infrastructure developments -- need to be more comprehensively developed and explained.

0 The OF's major weaknesses are represented as its sub-standard analytic capabilities, mediocre market information, and low compensation for professional staff. How are these weaknesses being addressed? What professionals are underpaid, by how much, and what compensation studies have been performed? Is the System at risk due to these weaknesses?

Section II - Business Environment

0 A discussion of trends in the housing and mortgage markets and their expected impact on the Banks could be included in the Business Environment subsection.

0 Page 7 in subsection A (Potential Growth in Advances) states that the "System's public purpose is housing finance but members may borrow against eligible collateral for general business purposes." This statement contradicts statute and should be eliminated.

0 The suggestion on p. 7 that members borrow through advances as a way to avoid paying deposit insurance premiums should be eliminated, since that is one of the FDIC's arguments for considering the assessment of collateralized borrowings.

0 The plan states on p. 8 that there is definite potential for advances to commercial banks to reach $40 billion in 1995, a 66% increase from October 1994. This estimate assumes the same penetration of commercial bank liabilities (currently 0.6 percent) as thrifts (8.29 percent). Is this realistic and is

it consistent with the Banks' estimates?

0 The plan could explain why restrictive monetary policy stimulates demand for advances and how it complicates the funding process (see p. 9).

0 The first paragraph of subsection D (Regulation) on p. 10 should 'be rewritten in a more neutral tone, or eliminated entirely since the key point (the uncertain impact of regulatory response to the structured debt market) is discussed on the next page.

0 Table 2 on p. 12 (subsection E - Agency Market Practices) refers to selected agency term debt sales. How were these sales selected? Do the figures represent total term debt issued?

0 What are the pricing differentials between bonds sold through selling groups and those sold competitively? (see p. 13)

0 Subsection F (The Finance Board) implies that if there were a quorum, the Finance Board would approve putable debt and debt tied to non-financial indices. Is this a realistic presumption? What are these indices and how do they work to hedge against inflation? Are there any political risks the Finance Board should be aware of before considering these indices? The plan discusses elsewhere why puts are important. That rationale should be included here, as well as a discussion of the risk associated with such imbedded options.

0 The information on investors in agency securities (subsection G) is interesting, but what is the bottom line impact on debt issuance? If no conclusions can be drawn, it may be preferable to drop this subsection since the casual reader may infer that households are the second largest investors in Bank System structured notes.

Section III - FHLBank System

0 The CO projections (p. 19) were based on estimates provided to the OF by the Banks for the purpose of determining each Bank's SAA (special asset account) balance. Has the OF verified with the FHLBank presidents or CFOs that the projections provided for SAA compliance are identical with the official balance sheet forecasts used by the FHLBanks for budget and incentive compensation purposes?

0 The second paragraph on p. 24 suggests that the Bank System's primary function is lending for liquidity. It refers to the Bank System as a central credit facility and compares the Banks to J.P. Morgan. The discussion suggests the business

plan. should be oriented to short-term funding as the driving force for Bank System operations. A discussion regarding how an emphasis on short-term funding by the Bank System's fiscal agent is consistent with the Banks' mission to support housing finance might lessen the non-housing orientation of this discussion.

Section IV - Divisional Plans

0 Regarding the global debt program (discussed on p. 28), how did the Banks benefit in terms of pricing? What were the costs associated with program implementation?

0 The second sentence in the paragraph on regulator education (p. 31) is overly negative.

0 On p. 43, the plan discusses using structured bonds in conjunction with municipal revenue bonds when a municipality suffers liquidity problems due to an adverse credit event. The discussion suggests that the idea had been previously proposed by OF management and that the OF Board objected, suggesting it would appear that the System was seeking to benefit from municipal credit woes. Incomprehensibly, the discussion then goes on to suggest that OF management will seek to gain Finance Board authority to enter into such transactions. Has the OF Board agreed to this proposal and what do the Banks think? How would such transactions be structured? What are the risks associated with such transactions and how could they be managed?

0 The need for and use of a Master Note Agreement is explained in the plan (p. 41), however, it is unclear whether it has been determined that such an agreement is within the OF's current authority. 'Will the OF discuss the MNA with the Banks or the Finance Hoard prior to utilization?

0 The plan mentions but does not explain recuts (p. 41). Is the OF continuing to do recuts and, if so, how do the Banks benefit? If not, why not?

0 The plan suggests (p. 43) that the list of eligible indices to which Bank principal and interest payments can be tied, and thus the Banks' supply of funds, could be broadened without a change in current policy if "compelling arguments" could be made that indices such as 'measures‘ of aggregate economic performance and prices, commodity prices, and prices of groups of stocks and credit ratings are financial. What are the compelling arguments, have the Banks requested that debt tied to such indices be issued, and what are the risks associated with such debt?

0 The discussion of new product development (p. 43) does not mention the Banks. Do the Banks suggest what types of products are needed, and are they involved in the development process? If so, how?