



REGULATORY INTERPRETATION 2002-RI-06

Date: November 5, 2002

Subject: Application of the Interim Capital Requirements Under 12 C.F.R. § 956.4

Request Summary:

The Capital and Financial Management Policy Subcommittee of the Federal Home Loan Bank System Financial Officers Committee (Subcommittee) has requested that the risk-based capital requirement of section 956.4 of the Federal Housing Finance Board (Finance Board) rules, which requires a Federal Home Loan Bank (Bank) to hold retained earnings and general allowances for losses as support for the credit risk of all investments that are rated by a Nationally Recognized Statistical Rating Organization (NRSRO) lower than the second highest credit rating, be interpreted as not applying to existing short-term investments authorized under Section II.B of the Financial Management Policy (FMP) and applying only to investment activities not previously approved under the FMP.

Conclusion:

Section 956.4 of the Finance Board rules applies to all investments undertaken by a Bank and not just to new investments. For each Bank, these requirements will continue to apply until the Bank implements its capital structure plan and complies with the capital requirements set forth in part 932 of the Finance Board rules. 12 C.F.R. part 932.

Background:

Section 956.4 of the Finance Board rules state that:

Each Bank shall hold retained earnings plus general allowance for losses as support for the credit risk of all investments that are not rated by a NRSRO, or are rated or have a putative rating below the second highest credit rating, in an amount equal to or greater than the outstanding balance of the investment multiplied by:

- (a) A factor associated with the credit rating of the investments as determined by the Finance Board on a case-by-case basis for rated assets to be sufficient to raise the credit quality of the asset to the second highest credit rating category; and
- (b) 0.08 for assets having neither a putative nor actual rating.

12 C.F.R. § 956.4. More generally, part 956 of the Finance Board rules, 12 C.F.R. part 956, along with parts 950 and 955 of the Finance Board rules, 12 C.F.R. parts 950 and 955, provide the authority for certain of the Bank's investment activities. This authority is subject to limitations set forth in section 956.3 of the Finance Board rules, 12 C.F.R. § 956.3, in the FMP, and in part 980 of the Finance Board rules, 12 C.F.R. part 980. *See* 12 C.F.R. § 956.2.

Discussion:

The Subcommittee acknowledges that section 956.4 on its face does not distinguish between existing short-term investments and new types of investments, but nonetheless contends that the provision's requirement for a case-by-case determination of the capital charge supports its contention that section 956.4 was intended to apply only to new types of investments. The Subcommittee further argues that its position is consistent with the fact that the part 956 rules generally were intended to expand the authorized investment activity of the Banks, subject to the Banks' compliance with the new business activities requirements of part 980.¹ Finally, the Subcommittee points out that application of the section 956.4 capital requirement potentially could have a detrimental effect on the Banks' net earnings and their ability to maintain their current level of dividend payments.

Under the plain language of section 956.4, however, the risk-based capital requirement of that section applies to "all investments that are not rated by an NRSRO or that are rated or have a putative rating below the second highest credit rating," and not just to new types of investments. The preamble of the *Federal Register* release adopting the part 956 rules similarly makes clear that section 956.4 requires a Bank to hold retained earnings plus specific loan loss reserves as support for the credit risk of all investments that are not rated by an NRSRO or that are rated below the second highest credit rating. *See* 65 Fed. Reg. 43969 at 43980 (July 17, 2000). The Finance Board made a similar point when it adopted the unsecured credit limits in section 932.9 of its rules. At that time, the Finance Board stated that "a Bank will be subject to the capital requirements set forth in section 956.4 of the Finance Board rules ... if the Bank undertakes unsecured transactions with any counterparty rated below the second highest credit rating by an NRSRO." 66 Fed. Reg. 66718 at 66720 (Dec. 27, 2001). These statements do not suggest that the Finance Board intended section 956.4 to apply only to new types of investments.

In adopting the part 956 rules, the Finance Board also noted that it was "expected that ... section 956.4 [would] be superseded at the time that a final capital rule is promulgated, to be replaced by specific requirements set forth in the capital regulation relating to each credit rating category." 65 Fed. Reg. at 43980 (emphasis added). Once adopted, however, the new capital regulations made clear that the "specific requirements" imposing capital charges based on the credit rating of the investment or counterparty would not be applied to a Bank until such time as the Bank first issues stock under its capital structure plan. *See* 12 C.F.R. § 931.9(a). *See also* 12 C.F.R. §§ 932.3 and 932.4. Thus, the interim risk-based capital requirements of section 956.4 will

¹ The Subcommittee also states that section 932.9 of the Finance Board rules, which was proposed just a few days prior to the adoption of the part 956 rules, "allows a Bank to invest in other types of previously ineligible assets ..., all subject to the New Business Activities notice requirements of part 980 ..." and thus, provides further support to the contention that section 956.4 was meant to apply to new types of investments and not short-term unsecured investments already permitted under the FMP. Contrary to the Subcommittee's assertion, however, section 932.9 is not a source of investment authority for the Banks. Instead, this rule establishes limits on the Banks' extension of unsecured credit. Authority to invest in particular assets or undertake particular transactions is found in part 956 (along with parts 950 and 955) of the Finance Board rules. *See* 12 C.F.R. §§ 956.2 and 956.5.

continue to be applied to each Bank's investments, including its short-term investments, until the Bank has implemented its capital structure plan and has come into compliance with the leverage and risk-based capital requirements of part 932. See 12 C.F.R. §§ 932.2 and 932.3.

During this interim period, in order for a Bank to determine the "factor associated with the credit rating of the investments ... sufficient to raise the credit quality of the asset to the second highest credit rating category," as required by section 956.4(a), the Bank should use the capital requirements set forth in Table 1.3 of section 932.4 of the Finance Board rules. 12 C.F.R. § 932.4. The Banks, therefore, must hold retained earnings, loan loss reserves, or some combination of both equal to the difference between the amount of capital that would be required under Table 1.3 for a specific asset and the amount of capital that is required for rated assets of the second highest investment grade with remaining maturities similar to that specific asset. For example, based on Table 1.3, the interim capital requirement for investments with a remaining maturity of one year or less of the third highest investment grade will be 0.50 percent (*i.e.*, 0.70 percent less 0.20 percent), and the requirement for investments with a remaining maturity of one year or less of the fourth highest investment grade will be 2.30 percent (*i.e.*, 2.50 percent less 0.20 percent). No capital is required to be held on an interim basis under section 956.4 for investments of the highest or second-highest investment grade.²

The Finance Board may require a Bank to hold capital in an amount greater than that indicated above to support the credit risk on a particular investment. A Bank could also for any reason hold additional capital against particular assets, should it so decide.

A <u>Regulatory Interpretation</u> applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 C.F.R. part 907.

² Once a Bank implements its capital plan and is subject to the capital requirements of part 932, risk-based capital is required to be held against the credit risk of all assets including those rated in the two highest investment grade categories. See 12 C.F.R. §§ 932.3 and 932.4.