TRANSCRIPT OF PROCEEDINGS

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FEDERAL HOUSING FINANCE BOARD

IN THE MATTER OF:)
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OPEN MEETING)

Federal Housing Finance Board
1777 F Street, N.W.
Washington, D.C.

Tuesday,
December 11, 2001

The parties met, pursuant to notice, at 3:05 a.m.

BEFORE: J. TIMOTHY O'NEILLL
Chairman, Federal Housing Finance Board

BOARD MEMBERS:

JOHN C. WEICHER
FRANZ S. LEICHTER
ALLAN I. MENDELOWITZ
JOHN T. KORSMO

STAFF:

MELISSA ALLEN
ARNOLD INTRATER
THOMAS JOSEPH
SHARON LIKE
CHARLES McLEAN
JULIE PALLER
SCOTT L. SMITH

P R O C E E D I N G S

(3:05 p.m.)

MR. O'NEILL: Welcome, all. There are two things I want to say before we start the Board meeting, one extremely sad, the other very joyous. So I guess I'll first start with the sad one. Today is the two-month anniversary of the disaster both in New York City and at the Pentagon. And I know that there have been a lot of different ceremonies this morning honoring them.

One of the people that died in New York was not only a good friend of mine but was the chairman of the Federal Home Loan Bank of New York for a while, Neil Levin. And many times I have heard Al DelliBovi, the president of the Federal Home Loan Bank of New York say that one of the people that was the strongest advocate of the Federal Home Loan Bank of New York getting out of one of the two towers was Neil Levin as chair. So in a real sense, although Neil Levin is gone, because of him, there were no deaths in the Federal Home Loan Bank of New York.

So for Neil Levin and all of those who died either in New York City or at the Pentagon, why don't we have a brief moment of silence.

(Pause)

MR. O'NEILL: Thank you very much. The other thing, many times people say to me I first came to the

Finance Board as the director of congressional affairs more than 10 years, and many times people say that I am the institutional memory of the Federal Housing Finance Board. Well, this is truly a historic moment because, as you know, within the last couple of weeks, three Board members got confirmed by the Senate, and their commissions were signed by the President.

This is the first time since the Board went full time that we have an entire roster of five Board members here present today. So because I'm the Chairman, I guess one of the prerogatives of being the Chairman, I'm going to swear in the three Board members that were recently sworn in. So if you all can stand and raise your right hand.

I -- and please state your name -- do solemnly swear that you will support and defend the Constitution of the United States against all enemies, foreign and domestic; that I will bear true faith and allegiance to the same; that I take this obligation freely, without any mental reservation or purpose of evasion; and that I will well and faithfully discharge the duties of the office on which I am about to enter. So help me God.

(Allan I. Mendelowitz, Franz S. Leichter, and John T. Korsmo repeat oath)

MR. LEICHTER: Thank you.

(Applause)

MR. O'NEILL: I worked with Franz and Allan for a while, and I've gotten to know John Korsmo. And I think it's a new chapter for the Federal Housing Finance Board, and I'm very happy that we're finally at full strength because my chosen profession is as a lobbyist because I am a stickler for what the Congress wanted us to have. And since they wanted us to have five full-time members, we finally did it.

I now turn over to the acting general counsel, who today is acting for the managing director. So, Arnie, could you give us the first issue, please.

MR. INTRATER: Yes. I'm acting in an operational role. I may try to push it for as much as I can. But on behalf of the staff and on behalf of Jim Bothwell, who is unavoidably unavailable today because of a longstanding medical appointment that he couldn't change, I want to add our congratulations to the full Board members and to the new Board member in particular.

We have three items on the agenda. The first one is a final rule on unsecured credit. The presentation will be by Julie Paller, with assistance from Tom Joseph if necessary. Julie.

MS. PALLER: Good afternoon, Mr. Chairman and Board members, and welcome. Staff is presenting today for your consideration a final rule that would amend the unsecured credit limits for the Federal Home Loan Banks in Section 932.9 of the Finance Board's regulations. This regulation initially was adopted as part of the capital rule on December 20, 2000. After several banks requested an additional opportunity to comment on these provisions, the Finance Board published for comment a proposed rule on March 7, 2000.

After considering comments made on that proposal, the Finance Board decided that more extensive rule changes than initially envisioned may be necessary and appropriate and thus we propose for comment additional amendments to the unsecured credit limit on August 8, 2001.

The Finance Board received seven comment letters on the proposed rule published on August 8th, all of which were from Federal Home Loan Banks. Four of the commenters requested that the Finance Board delay the effective date of the rule, normally 30 days after publication in the Federal Register, to give the banks sufficient time to conform recordkeeping and recording systems to the limits adopted by the Finance Board.

As such, staff is recommending that the final rule become effective 90 days after publication in the Federal Register. The proposed rule requires that the banks use long-term counterparty credit ratings to determine maximum capital exposure limits. Two of the commenters requested that the Finance Board allow the use of short-term credit ratings to determine such limits.

Staff is recommending that the final rule be adopted as proposed, and that except in certain limited circumstances, a counterparty's long-term credit will be used to determine the exposure limit. Reliance on long-term credit ratings is consistent with the approach prepared by the Basel Committee on Banking Supervision pursuant to this meeting on lending in the new capital accord.

The proposed rule established two limits for each counterparty. The first limit, the timeliness, applies to all extensions of credit except sales of overnight federal funds. The second limit, the overall limit, applies to all transactions with a particular counterparty, including any overnight fed funds transactions. The overall limit for a particular counterparty would equal twice the counterparty's term limit.

For example, the term limit for a counterparty with the highest credit rating is 15 percent, with an overall limit of 30 percent. One commenter requested that the Finance Board exclude all overnight fed funds from the limits. Staff is recommending that the final rule be adopted as proposed because excluding all overnight fed funds transactions from the limits could result in an imprudent amount of exposure with particular counterparties.

The proposed rule limited extensions of credit to affiliate counterparties to 30 percent of a bank's total capital. Only one commenter addressed this provisions and requested that the Finance Board raise this limit to 50 percent of a bank's total capital. Consequently, staff is recommending that this provision be adopted as proposed.

In addition, staff is recommending a change to the definition of affiliated counterparty to make it consistent with similar terms used by other banking regulators. Two commenters asked that the Finance Board add a provision to the rule to clarify the status of bonds issued by Housing Finance Agencies, or HFAs. Both commenters indicated that treating HFAs like other counterparties would severely restrict the bank's ability to invest in FHA bonds because FHAs often have low capital.

One of these commenters indicated a belief that most FHA bonds were secured by mortgage collateral, and therefore should have been exempt from the unsecured credit limits, but provided no justification or legal rationale to support such a conclusions.

One of the commenters requested that if a third party guaranteed repayment by the counterparty, the unsecured credit limit should be applied to the guarantor and not to the counterparty itself.

Staff is recommending that the final rule establish a special limit for FHA obligations, which would be calculated based only upon the bank's total capital and not the counterparty's total capital. Staff is also recommending that in cases where a third party has provided an unconditional and irrevocable guarantee, a bank would use the credit rating and capital of the third party guarantor in determining the credit limit.

Other staff recommendations include revisions to the maximum capital exposure limits to more closely calibrate them to reflect default data by credit rating category and adopting a special limit as proposed for bank exposure to GSEs equal to the lesser of 100 percent of the bank's or the GSE's total capital.

However, the rule as recommended for approval would place a lower sublimit on a bank's purchase of GSE subordinated debt and require banks to treat a GSE like any other counterparty if it's long-term credit rating is downgraded.

Also being recommended is a requirement that a bank report promptly to the Finance Board any occurrence of noncompliance with any of the unsecured credit limits, a provision to clarify that a bank is not required to unwind or liquidate any transaction due to a ratings downgrade, and a provision setting forth the method for calculating unsecured credit exposures arising from derivatives transactions.

While the recommended limits are more restrictive than those currently in the FMP, staff does not expect the rule to have a major effect on any bank. While some banks may have to reduce the amount of unsecured credit they extend to some of their counterparties under the new rule, there are many other counterparties of similar credit worthiness available such that no bank should experience in reallocating its unsecured credit investments to other equally credit worthy counterparties. Such reallocations will only serve to enhance the safety and soundness of an already safe and sound activity.

In addition, staff is requesting Finance Board approval of a resolution that delays the date for compliance of Section 932.9 and Section 932.8, which contains liquidity requirements for the banks until the effective date of the final rule amendments being considered today, which would be 90 days from publication of the final rule in the Federal Register.

Although the liquidity requirements contained in Section 932.8 are not being amended, they are related to the unsecured credit limits, and it was intended that they take effect at the same time. Finance Board Resolution 2001-20, dated September 26, 2001, would require the banks to comply with Sections 932.8 and 932.9 on January 28, 2002. The resolution requires that the banks continue to comply with the unsecured credit limits and the additional liquidity requirements contained in the Finance Board's financial management policy until the effective date of the final rule.

We would be happy to answer any questions.

MR. O'NEILL: I guess I'll ask the first question. Of the counterparties that are having unsecured credit, what percentage are domestic, and what percentage are foreign? And is that percentage constant, or has it changed over the last five or ten years?

MR. SMITH: I don't have those numbers in front of me. I think the answer is that most of them are domestic, by far. And I don't know -- that would be my guess.

MR. O'NEILL: Any other questions about this?

MR. MENDELOWITZ: Yeah. When you're finished.

MR. O'NEILL: I know that we have put off the final compliance. When the rule was first -- when we published the capital rule, the date that this was going to be effective was 30 days from that, so we're basically a year behind where we said we were going to be. That's about right, that this one the banks now all know what they're doing, and they have had a say in whether these make sense or not. Allan?

MR. MENDELOWITZ: I'd like to say that I am very pleased to see this rule come to the Board for review and approval. The primary responsibility of the Finance Board is to assure the safety and soundness of the System. And the approach I've always taken to risk on the balance sheet of the System is that we in effect should have a higher tolerance of risk when the assets involved are related to housing and community development.

When the assets aren't related to housing and community development and serve another function, then we need to take a very, very careful look at the risks being assumed and placed on the balance sheet.

In the case of the unsecured lending, it is clear that it is not related to housing and community development. It's necessary because of the needs on the part of the Treasury operations of the banks to manage their liquidity. And so the access to the ability of the banks to play some of their own used assets and short-term unsecured lending is really a financial management function to make good use of liquidity on the books of the banks. And therefore, we need to take a very, very careful look at the risks and the appropriate limits to be placed on those risks.

Now the old rules, as they applied, clearly were excessive. They went well beyond what appropriate limits are in financial institutions for unsecured lending. And I really want to commend the staff for what I think is an outstanding job in developing appropriate rules consistent with what are standard practices across the Board for financial institutions with respect to prudent limits on unsecured lending.

So I'm actually quite supportive of this rule. I look forward to voting for it and want to commend the staff for really an excellent job. I know the Chairman raised a question about the fact that this final rule is a year after it originally appeared in the capital rule. And I would say that a year seems like an awfully long time to adopt what is a fairly fundamental rule. But the truth of the matter is this issue probably should have been dealt with as a separate rulemaking. It shouldn't have been included in the capital rule. And because it was inserted into the capital rule, I don't think it got the level of attention and consideration that it really needed. And the year that was devoted to this over this past year I think was in effect a result of the effect that instead of trying to wrap it up with capital rule, it didn't lend the process to giving the appropriate attention and care to this particular undertaking.

There is one issue in this rule that I would like to ask the Board members to keep an open mind on going forward with respect to one possible modification. A question was asked regarding this rule about the ability of unsecured borrowers to borrow when there is no long-term credit rating. I mean, typically, we think of financial institutions or potential borrowers who are the very, very best borrowers that you would expect them to have Triple A long-term credit ratings. And hence we hang our standards in this particular rule on the long-term credit ratings.

But I do know out there in the real world, occasionally, there are borrowers who don't borrow long-term because of their business model and their business strategy. And that means if they don't borrow long-term, they don't have a long-term credit rating because they have no need to establish one. And it may be that there are circumstances out there -- and I've received, quite honestly, conflicting information on whether this is a hypothetical issue or a real-world issue. But at least at the hypothetical level it is possible that there are basically the very best quality borrowers out there without long-term credit ratings, so they don't borrow long term, and should be able in effect to meet our risk standards and still borrow up to 15 percent of capital.

That's not possible under this rule because the most someone can borrow if they only have a short-term rating is up to I guess the 12 percent limit. Is that correct? The 12 percent limit, yeah.

So what I would like to ask the members of the Board to do is to keep an open mind going forward that if we can resolve whether this is a hypothetical issue or an empirically valid issue, if it turns out to be an empirically valid issue, I would like to at some point see the staff propose an amendment that establishes a process that would enable one of our Federal Home Loan Banks to come to the Board to establish the credit worthiness of an obligor without a long-term rating that would enable that borrower to borrow up to the 15 percent limit.

I realize that we have waiver rules. And as a general matter, a bank could come in and ask for a waiver because their potential borrower is so credit worthy and, you know, make the case. But the waiver rule implies that what is being asked for is in violation or nonconformance to the rule. And I would much rather see a rule that deals with safety and soundness that is complete in its entirety. And if in fact there are potential borrowers out there who are so credit worthy that they deserve that 15 percent cap, even though they don't have a long-term credit rating, I would like to see us have a process in place, a legitimately recognized process, for getting that kind of borrowing level approved.

MR. O'NEILL: I think we will all keep an open mind on that.

MR. KORSMO: Mr. Chairman, may I ask, we didn't get any comments that anticipated the situation that Dr. Mendelowitz is posing during the comment period. I can see it's a legitimate point, and I understand why.

MR. MENDELOWITZ: I can clarify. I actually got phone calls from --

MR. KORSMO: Oh, you did?

MR. MENDELOWITZ: -- board members of some of the banks. And I asked the staff to look into it. When the staff looked into it, they couldn't find them. So the problem that I -- the empirical problem that I have --

MR. KORSMO: Maybe hypothetically.

MR. MENDELOWITZ: The empirical problem that I have is that this issue was raised by a member, a fairly senior member, for example, of one of the board's directors of the Federal Home Loan Bank. The staff did not find any businesses that fell into the category yet. And because the issue was raised, I want to make absolutely sure that in fact if it is a real problem, that we step forward and have a process for dealing with it.

MR. O'NEILL: Okay. Can I have a motion on this matter from one of the Board members?

MR. MENDELOWITZ: I would very much like to move we accept this rule.

MR. O'NEILL: All those in favor say "aye."

(Chorus of ayes)

MR. O'NEILL: Any opposed?

(No audible response)

MR. O'NEILL: Adopted.

MR. INTRATER: Mr. Chairman? Actually, the waiver of the compliance with the time limits of the rule is also placed before you. I think Julie didn't want me to have very much to say, so she brought the two items together. You may want to address that as well because it was presented as part of the package.

MR. O'NEILL: Okay. Then on the --

MR. INTRATER: The resolution.

MR. O'NEILL: The waiver of the compliance, right?

MR. INTRATER: Correct.

MR. O'NEILL: A motion on that?

MR. LEICHTER: Yeah. I'll move it.

MR. O'NEILL: Okay. All those in favor say "aye."

(Chorus of ayes)

MR. O'NEILL: Any opposed?

(No audible response)

MR. O'NEILL: Adopted. Now the third item.

MR. INTRATER: The third item has to do with proposed amendments to the Affordable Housing Program Rule, presented by Charles McLean, assisted by Sharon Like and Melissa Allen.

MR. McLEAN: Good afternoon, Mr. Chairman and Directors. Staff is before you to present proposed amendments to the Finance Board's regulation governing the operation of the Affordable Housing Program, the AHP. The Finance Board's existing AHP regulation underwent a significant revision and became effective on January 1, 1998. Since 1998, various amendments have been made to the AHP regulation to clarify AHP requirements and improve the operation and effectiveness of the program.

The proposed amendments before you today are based on discussions held at the Finance Board's workshop this past June. At that time, representatives from the Federal Home Loan Banks, their members and advisory councils and from private sponsors and national housing groups provided the agency with information about circumstances they were encountering that could not be readily addressed in provisions of the regulation.

As a result of that forum, as well as additional feedback from the community investment officers and advisory councils of the banks, the staff is proposing a number of additional regulatory amendments intended to further improve the operation of the AHP. These proposed changes would give the banks more flexibility to manage their programs in order to meet the affordable housing needs of low and moderate-income households in their districts.

The staff recommends that the Board adopt and publish the proposed amendments contained in your Board books for a 60-day public comment period. The key amendments are the following: making the standards for approving modification of a project at the completion the same as those currently applicable for approving the modifications of a project prior to completion. This includes allowing the banks to increase the amount of AHP subsidy previously awarded for a completed project.

The amendment would provide the banks with more flexibility to participate with other funding sources and work out arrangements to help troubled projects retain their affordable housing units. It is within each bank's discretion whether to approve a modification of a particular project.

Second, eliminating the current definition of homeless households for purpose of scoring applications that reserve units to homeless households and presenting each bank to define this term in its AHP implementation plan. The proposed amendment would allow the bank to take into consideration regional characteristics of homelessness, particularly in rural areas and in areas with subzero temperatures, where there may be few if any organized shelters. The proposed change would allow projects serving those households to be more productive in applying for AHP funds.

Three, amending the scoring criteria for conveying properties to permit each bank to award points for properties conveyed by -- an amount that is significantly below their fair market values, as defined by the bank in its AHP implementation plan. The proposed change would allow the banks to be more responsive in dealing with these types of projects by removing the nominal price requirement that is in the current regulation.

In addition, the staff recommends amending the scoring criteria to provide that a bank may award scoring points for a property conveyed by the federal government, regardless of the amount charged for such conveyance. This change would be consistent with the statutory priority for such properties and would allow the banks to be more responsive in dealing with foreclosed housing units owned by HUD or other federal government agencies.

Four, permitting the banks to allocate up to the greater of 3 million or 25 percent from the next year's required annual AHP contribution to the current year's competitive application program, as needed to address special market conditions or other circumstances.

The banks currently have the same option, up to the same limits, under the AHP home ownership set aside program. Allowing the same authority under the competitive program would give each bank greater flexibility to make unusual current demands, such as those arising from natural disasters, to take advantage of special funding opportunities from other housing sources, or to mitigate the effects of the FAS 133 accounting rule on the annual AHP contribution.

As with the set aside programs, the allocation of funds for the following year to the current year's competitive program will be at each bank's discretion.

Five, permitting the banks in their discretion to allow sponsors of home ownership projects to recapture AHP direct subsidies used for downpayment, closing costs, rehabilitation and interest rate buydowns to assist additional eligible households in an approved project. The proposed change would allow a sponsor to assist an additional household in accordance with the sponsor's approved AHP application when a household sells or refinances the house prior to the end of the retention period instead of requiring repayment of the subsidy to the Federal Home Loan Bank.

The proposed change could allow for more efficient use of AHP subsidies since the sponsor receives no additional subsidy from the bank and the recent used subsidy continues to assist households in accordance with the original AHP application commitments.

The staff also recommends additional proposed technical amendments aimed at giving the banks more administrative flexibility in operating their programs, including the processing of applications and the managing of funding grants.

The staff stands ready to respond to any questions you might have.

MR. LEICHTER: Yeah. I'm very pleased to see these changes to the AHP regulations. When we had our workshop on June 6th, we said at that time that we were really looking to the participants to guide us and help us in making changes to the regulations which would make the program more efficient and more user friendly. And we said this was not a cosmetic exercise we were involved in, but we were really listening, and we were going to act on the suggestions. And we showed today that we've done this. And I want to express my appreciation, first of all, to the staff, to Charles, and to Melissa, and to Sharon Like, and also to my special assistant, Linda Fleming McGhee, who worked very hard on making these changes.

And I wanted to thank the banks, particularly the community investment officers who participated with us, and also the Housing Advisory Councils. And I want to say that we're continuing to look at this program and to make such changes as will make the program more effective and more efficient. I think we're all very proud of the AHP program. But that doesn't mean that we can't make it a better program.

I think it's one of the best things that the Federal Home Loan Bank System does, and we want to make sure that it provides the most extensive service and is used by as many of our members as possible.

So this is an ongoing process. This is not the end, but it's a continuing effort on our part to try to help you, the banks, and the community investment officers, the people who administer this program, to make sure that we make your job more effective and easier. So thank you very much.

MR. O'NEILL: I have one statement that I want to make. Obviously, the intent of the Affordable Housing Program is to work with other programs. And keeping with that thought, the staff is researching how to solve the problem that some of our statutory income standards are not consistent with those of other housing programs like the low income housing tax credits.

This inconsistency hinders easy application of the third party monitoring provisions of the current affordable housing program regulation. Consequently, the staff will be pursuing how to reconcile this inconsistency and continue the goal of making this program more user friendly. I think that the staff has gone a long way in that regard.

Obviously, there are some things that are in the statute, and we cannot do as much with as we would like. But I think we have done a good job in opening it up to third party monitoring, but we can do more in that regard. So I really want to compliment the staff on what they have done so far, and we'll continue to work on that effort.

One other thing. One of the proposals is to eliminate the concept of nominal price in the scoring criterion for donated properties and allow the banks to determine how properties should be conveyed at below market values in order to see the scoring points. I have come to consider this the Costiglio amendment.

My former colleague on the Board, Larry Costiglio, firmly opposed the current requirement that properties must be conveyed for a nominal amount, most often $1. He strongly believed the provision would be too restrictive to allow many good affordable housing projects to get AHP funds. His experience taught him that in many metropolitan areas, free properties are often available only if the purchaser could pay back taxes or extinguish other liens.

I guess the Federal Home Loan Banks and the sponsors have persuaded our staff and the Board members that Mr. Costiglio's concerns were well-placed. So this is a really good thing that we are finally addressing a problem that has been around for a very long time, and I wanted to make mention of that.

Any other items for -- yes?

MR. MENDELOWITZ: Yeah. Everybody has been frankly recognized, I think, except Director Leichter. In the time I have been on the Board and during the time when I was Chairman of the Finance Board, Director Leichter took great initiative and devoted time and great energy to looking into the AHP program and providing leadership from the Board level to the staff and to the community at large to try to take timely action to improve the program.

So I not only want to thank and congratulate the staff. But I really want to thank and congratulate Franz because these are the first tangible fruits of your efforts, and they have borne good fruit.

MR. LEICHTER: Thank you.

MR. O'NEILL: And I know that the staff will still be working with the banks because I always call the program the crown jewel of the Federal Home Loan Bank System. But I'm sure that we can polish the jewel a little further. So if you work with us, we will do more in that regard as well.

Can I have a motion on this issue? Okay. All those in favor of approving this proposed rule, signify by saying aye.

(Chorus of ayes)

MR. O'NEILL: Those opposed?

(No audible response)

MR. O'NEILL: The issue is agreed to. Before we close the Board meeting, I think I can speak for all the Board members when I say that I think that these holidays will be special holidays. And I hope that for all of you in the audience as well as the staff of the Finance Board, that the holidays truly convey the true message of the season, which is peace on earth and good will to all. Arnie?

MR. INTRATER: I wanted to give up my short stint as an -- the record by putting on my hat as acting general counsel, I ask you to please make technical and conforming corrections to any of the documents to comply with Federal Register requirements.

MR. O'NEILL: Without objection, so ordered. With no other issues to be coming before the Board, this Board meeting is adjourned.

(Whereupon, at 3:45 p.m., the meeting was adjourned.)

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REPORTER'S CERTIFICATE

DOCKET NO.: N/A
CASE TITLE: Open Meeting
HEARING DATE: December 11, 2001
LOCATION: Washington, D.C.

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the

Date: December 11, 2001

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