FEDERAL HOUSING FINANCE BOARD

BOARD MEETING

OPEN SESSION

Wednesday, December 14, 2005

10:00 a.m.

Federal Housing Finance Board
1625 Eye Street, N.W.
Washington, D.C.

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MEMBERS PRESENT:

Ronald A. Rosenfeld, Chairman
Franz S. Leichter
Allan I. Mendelowitz
Alicia R. Castaneda
Brian Montgomery

STAFF PRESENT:

Mr. McKenzie
Mr. Cross
Mr. Sciacca
Mr. Kennedy
Mr. McLean
Ms. Like
Ms. Martinez
Ms. Willis

P R O C E E D I N G S

CHAIRMAN ROSENFELD: Good afternoon, everyone. I call this meeting of the Federal Housing Finance Board to order. Today we will have an open session followed immediately by a closed session, where the Board will receive updates on its examination and supervisory findings.

We now need to vote to approve the closing of the latter portion of today's meeting, as required by the Sunshine Act and Finance Board regulation. And since the closed portion of today's meeting will contain sensitive and confidential examination information, I would ask for a motion to seal the transcript of this portion of the meeting.

Director Castaneda?

DIRECTOR CASTANEDA: Mr. Chairman, I move to close the portion of this meeting and further, that this Board determine that the record and transcript of this closed portion of the meeting be kept confidential.

CHAIRMAN ROSENFELD: Thank you for the motion.

Is there any discussion of the motion? Any discussion?

Seeing none, the secretary will please call the roll on the motion.

MS. WILLIS: On the motion before the Board, Director Leichter, how do you vote?

DIRECTOR LEICHTER: Yes.

MS. WILLIS: Director Castaneda?

DIRECTOR CASTANEDA: Yes.

MS. WILLIS: Director Mendelowitz?

DIRECTOR MENDELOWITZ: Yes.

MS. WILLIS: Director Montgomery?

DIRECTOR MONTGOMERY: Yes.

MS. WILLIS: Chairman Rosenfeld.

CHAIRMAN ROSENFELD: Yes.

The motion is carried and the subsequent portion of our meeting will be closed and its transcript will remain closed and confidential. Thank you.

Let us now turn to the public portion of today's meeting. The first agenda item for consideration is a waiver request regarding placement of consolidated obligations. Who will be making the staff presentation? Joe, go ahead.

MR. McKENZIE: Good morning. The Office of Finance has submitted a waiver request for the direct placement of consolidated obligations with another Federal Home Loan Bank, but such a direct placement is the most expedient way to ensure the timely payment of all principal and interest due on all consolidated obligations due that day. By direct placement, we mean the purchase and issuance by one bank of a consolidated obligation that's the primary obligation of another bank.

This waiver is necessary because Section 966.8(c) of the Finance Board's regulations prohibits the direct placement of consolidated obligations. The original intent of that section was to prevent a bank from abusing its agency funding advantage by purchasing of consolidated obligations for which another bank was the primary obligor and expanding its balance sheet.

The genesis of this waiver request is a revision of the policy statement on payment systems risk of the Board of Governors of the Federal Reserve System and the resulting changes in operating procedures to be implemented by the Federal Reserve Bank of New York in July 2006. The Federal Reserve Bank of New York operates the book entry system for the debt obligations of the Federal Home Loan Banks and the other housing GSEs.

Under the new procedures, it will not make any principal or interest payments on a given consolidated obligation until it has received sufficient funds from the bank who's the obligor of the bond through the Office of Finance, which serves as that bank's fiscal agent.

A bank's failure to provide funds to the Office of Finance, which forwards funds to the Federal Reserve Bank of New York in time for the 4:00 clock wire deadline would lead to the nonpayment of principal or interest on a consolidated obligation. The market reaction to such an occurrence is likely to be swift, negative, severe and persistent.

The Office of Finance seeks a waiver of this provision in one limited circumstance. If a bank has not provided funds to the Office of Finance by the internal agreed-upon deadline for that day's principal and interest payments, the Office of Finance would invoke procedures and require another bank to purchase a consolidated obligation for which the nonpaying bank is responsible. In this way, the Office of Finance can wire funds to the Federal Reserve Bank of New York by the 4:00 deadline.

The most important premise underlying the waiver request is that the nonpayment of principal or interest on any consolidated obligation is an event to be avoided at all costs. While there may be alternatives other than direct placement of consolidated obligation that would accomplish the same end, any solution adopted by the Office of Finance needs to be effectuated in a narrow time frame and that limits the choices.

One possible alternative solution would be an interbank loan. The banks could, by prior contractual agreement, attach joint and several liability to that loan and thereby create the economic and financial equivalent of the direct placement of a consolidated obligation. There are, however, two reasons not to proceed in that fashion.

The first is that the Office of Finance is in the business of issuing consolidated obligations. It is not in the practice of originating, arranging or brokering loans. Because of the narrow time frame, the Office of Finance wants to use existing processes for what it does all the time. Invoking unfamiliar procedures to arrange a loan may run up against that deadline.

Second, the Office of Finance could not wait for any bank to make an explicit decision whether or not it wants to enter into a relatively uncommon interbank loan transaction. In short, the inexorable ticking of the clock makes any alternative other than the issuance of a consolidated obligation less attractive, as the consequences associated with missing the 4 p.m. deadline are likely to be dire.

The draft procedures developed by the Office of Finance governing such direct placement of consolidated obligations need to be modified in two respects. First, these procedures need to incorporate a notification to the Finance Board. Since the Finance Board is responsible for both ensuring the safe and sound operations of the banks and ensuring that the banks can raise funds in the capital markets, it's entirely appropriate that the Finance Board be notified by 5:00 any day the Office of Finance invokes these procedures.

Second, the draft procedures contain an interest rate to be paid by the bank in whose name the consolidated obligation is issued. The late fee in the draft procedures is 50 basis points above the federal funds rate. This fee is wholly inadequate, as the bank is likely to provide funds the next business day; thus, any financial disincentive to engage in this behavior is modest.

The resolution for your consideration contains a provision that conditions the approval of the waiver on the establishment by the Office of

Finance of an interest rate of at least 500 basis points in excess of the federal funds rate. The Office of Finance and the banks can develop procedures on how, if at all, this fee will be shared among the banks.

The notification to the Finance Board, the escalating interest rate, and the negative reaction by other banks are all incentives for the bank in question to provide funds as quickly as possible and to avoid similar situations in the future.

There is one change in the resolution from what was in your book and that change is to establish a July 1, 2006 effective date.

This waiver request complies with the Finance Board's regulations concerning waivers. The waiver request is for good cause and consistent with the Bank Act that requires the Finance Board to ensure that the banks remain able to raise funds in the capital markets.

The proposed waiver does not adversely affect any existing rights and would not adversely affect the achievement of the purposes of the Bank Act.

Therefore, we recommend that the Board of Directors adopt the waiver with the two conditions contained in the resolution dealing with notification and interest rate.

I'll be happy to answer any questions.

CHAIRMAN ROSENFELD: Thank you very much.

Is there any discussion from the Board?

DIRECTOR CASTANEDA: I have some comments, Mr. Chairman.

Thank you, Joe, for the presentation.

I just wanted to be clear that the Federal Housing Finance Board is granting this waiver in a very limited fashion and for a very specific purpose. Our action today is not meant to be a departure from our general rule prohibiting direct placement of COs.

And while I agree to this waiver because the potential consequences to the system's cost of funds would be severe were a Federal Home Loan Bank to miss the deadline, we expect this power to be used very rarely, if at all.

I also wanted to note that the Federal Reserve change simply puts the Federal Home Loan Banks on the same footing as commercial banks, which already have to operate without the benefit of deadline overdrafts.

Indeed, it would generally have raised serious questions about the management and systems at a Federal Home Loan bank if this process actually needed to be invoked on its behalf. So I hope and expect this will be a non-issue.

Nevertheless, I would like to ask Finance Board staff to promptly advise this Board whether COs had been issued under this waiver so that we may respond appropriately. Thank you.

CHAIRMAN ROSENFELD: Any other questions or comments?

Allan?

DIRECTOR MENDELOWITZ: The discussion in both written and oral presentation by the staff says that this resolution and the waiver are conditioned upon a minimum of 500 basis point penalty, 500 basis points above the federal funds rate.

In just looking through the actual wording of the waiver, I'm having trouble finding that.

MR. McKENZIE: It's in the form of a "further resolved" paragraph.

DIRECTOR MENDELOWITZ: I don't see it.

DIRECTOR CASTANEDA: Yeah, it's there.

DIRECTOR MENDELOWITZ: Ah, okay. That's fine. I understand. The substitute page got put in the wrong place. I have it. Thank you.

I just had one other question. What are the circumstances, what type of circumstances do you believe would lead to the taking advantage of this waiver?

MR. McKENZIE: My belief is that this waiver would be invoked if there were problems with the fed wire terminal at a bank where it couldn't wire funds at 2:30 in the afternoon, or if the person in charge of making these fed wires had a heart attack and were taken out of the building.

I can't believe that there would be any financial reason, you know, given nonpayment in the chain. The Home Loan Bank gets wires in and gets wires out all day long. It's entirely possible that a member who's supposed to wire funds didn't wire the funds in time and the Home Loan Bank may have to do some adjustment. But my view is that it would probably be more of an operations risk at issue, rather than a financial risk issue that would cause this waiver to be invoked.

DIRECTOR MENDELOWITZ: So we're talking about not just an operations risk issue but an extraordinary operations risk issue.

MR. McKENZIE: Yes.

DIRECTOR MENDELOWITZ: Onset of serious illness on the part of someone handling the wire. You don't believe that it would be invoked because of any kind of financial issue at a Home Loan Bank, if I understood what you're saying.

MR. McKENZIE: The Home Loan Banks are going to have to change their operating procedures to some extent to make sure that they get inbound wires earlier in the day than they do now. It's just a management change that's going to percolate down to the members, also.

I mean it's just a question of who's getting the intraday float. The Home Loan Banks used to get intraday float. The members used to be able to benefit from some intraday float. That's not going to happen anymore.

DIRECTOR MENDELOWITZ: Do the provisions of these funding agreements have specific time periods? Like I understand in the case of the Fed, transactions have to be closed out by 4 p.m. But, for example, in advances to members, is it currently the practice on the part of the banks that repayments are due by a certain time?

MR. McKENZIE: I don't know. I don't know the answer to that question.

CHAIRMAN ROSENFELD: Director Leichter?

DIRECTOR LEICHTER: Joe, you said something which sort of struck my interest. Do we have any idea what the amount of the intrafloat benefit to the Home Loan Banks has been, say over a period of time, like a year?

MR. McKENZIE: It's a number in the hundreds of millions of dollars. On a typical day the Home Loan Banks settle at least $25 billion of securities through the Federal Reserve Bank of New York. One day's worth of interest on $25 billion is several hundred million dollars.

DIRECTOR LEICHTER: So the change in the federal rule can have a real impact on the Home Loan Banks' income?

MR. McKENZIE: It would have that hundred million dollar--multi-hundred million dollar effect if the banks had to have the money on deposit at the Federal Reserve Bank of New York the night before. That's not going to happen. They're going to start dribbling it in through the day. So it's not a multi-hundred million dollar effect at all, but it would be if they had to have the money there the night before.

CHAIRMAN ROSENFELD: Allan?

DIRECTOR MENDELOWITZ: Because working through this in the way that we anticipate requires both some operational changes at the banks themselves, as well as in OF, and because the end of daylight overdrafts kicks in in basically six months beginning July 2006, and that's when this waiver kicks in, I would like to request that the staff assess how well the banks have made these necessary adjustments and changes so that we have a level of confidence that everything in the chain that needs to be done has been done by the first of July so that, in fact, the actual use of this waiver is exactly that which you anticipate, which is a very rare and very extraordinary event precipitated by a highly unusual operations issue and not a function of anything that is either routine or the result of financial issues.

CHAIRMAN ROSENFELD: If there's nothing else, I'll accept a motion to approve the resolution.

DIRECTOR MENDELOWITZ: I so move. I didn't know--you were nodding.

CHAIRMAN ROSENFELD: Would the secretary please call the roll?

MS. WILLIS: On the item before the Board, Director Leichter, how do you vote?

DIRECTOR LEICHTER: Yes.

MS. WILLIS: Director Castaneda?

DIRECTOR CASTANEDA: Yes.

MS. WILLIS: Director Mendelowitz?

DIRECTOR MENDELOWITZ: Yes.

MS. WILLIS: Director Montgomery?

DIRECTOR MONTGOMERY: Yes.

MS. WILLIS: Chairman Rosenfeld?

CHAIRMAN ROSENFELD: Yes.

The motion is adopted.

Before we go on, let me acknowledge the many folks in the audience. I want to particularly welcome Director Leichter's friends and relatives.

The next agenda for consideration is the proposed rule to amend the Affordable Housing Program regulations.

Who'll be making the staff presentation?

MR. CROSS: I'll make the presentation. I'll be joined by Sharon Like and Charles McLean and Sylvia Martinez will be available, also, to assist in answering any questions that might arise.

We are presenting today for your consideration a proposal to amend 12 CFR 951, the Finance Board's Affordable Housing Program, or AHP regulation. The proposed changes are intended to streamline and reorganize the regulation in a number of ways.

First, they add some definitions and add some clarity to certain definitions. Second, they remove procedural requirements from certain definitions. Third, the changes provide guidance on the calculation of the net earnings of the banks on which AHP contributions are to be determined. Fourth, the changes place operational provisions of the competitive application program and the set-aside program in separate sections of the regulation to make the regulation and those programs easier for sponsors and users of the program to understand.

Fifth, the changes would combine the standard and first-time home ownership set-aside programs. Sixth, would permit the use of AHP subsidies under the competitive application program to be used by loan pools and revolving loan funds. Seventh, the changes would remove preferences which currently can be exercised at a bank's discretion to either restrict or prohibit the use of AHP funds in projects that are located outside a Home Loan Bank's district boundaries.

Next, it would expand the scoring for disaster areas to include not just projects that are located in federally declared disaster areas but also assistance provided to lower and moderate income households that are displaced from federally declared disaster areas.

And finally, the proposed changes would establish monitoring requirements that are based on outcome standards, rather than on the prescribed processes of the existing regulation.

The recommendation is for this to be issued in the Federal Register with a 120-day comment period. I'd be happy to address any questions, with the assistance of my colleagues.

CHAIRMAN ROSENFELD: Thank you, Mr. Cross.

Is there any discussion from the Board?

DIRECTOR LEICHTER: Mr. Chairman, this has been a major undertaking to improve and streamline the AHP regulation. As you can tell, any proposed rule that has a preamble of 51 pages and a rule of 32 pages requires a great deal of work and labor and I think it's very appropriate for me to thank the staff who worked on this and worked very diligently and deciduously.

So I want to thank what has been really a team effort and my gratitude goes to Steve Cross and his staff in the Office of Supervision, including Sylvia Martinez, Charles McLean, Melissa Allen, as well as John Kennedy and his staff in the Office of General Counsel, particularly Sharon Like, Neil Crowley for really what is, I think, superb work.

I also want to thank you, Mr. Chairman, Secretary Jackson, Commissioner Montgomery, my colleagues Alicia Castaneda and Allan Mendelowitz for their involvement and participation and support.

As we know, since the passage of the Financial Institution Reform Recovery and Enforcement Act, the bank system's public mission has included a requirement that at least 10 percent or $100 million of the system's annual net income go in support of affordable housing.

I think what's remarkable is that this is a government program that has worked exceedingly well, that there are no scandals, there's been no bad publicity, there's been no charge of misuse of funds. Nobody has ever accused this of being a slush fund and since the inception of the Affordable Housing Program, the system has awarded more than $2 billion to member banks and project sponsors subsidizing over 430,000 affordable housing units for very low, low and moderate income individuals and families. In 2004 alone, the bank granted $229 million to subsidize over 39,000 housing units in urban and rural communities.

Historically, 70 percent of the units receiving AHP subsidies have served very low income households. AHP subsidies have proven to be extremely important in financing projects that present underwriting challenges, such as projects for the homeless and special needs populations, including persons with disabilities and the elderly.

The AHP also has been used effectively with low income housing tax credits by filling financial gaps, thereby enabling a larger percentage of very low income households to be served.

You may ask if this is such a good program, has worked so well, why do you have to make such a significant revision of the AHP rules? The reason is that we want to improve the system. We can make it even better. We can make it more efficient. And these rules or the proposed rule has the purpose of making the program leaner, stronger, more effective, and more efficient.

It's based on the experience that we've had with the program over these years and from 2003 to 2005 the Finance Board staff conducted a horizontal review or audit of the bank system's AHP program, finding that to no one's surprise, the AHP has contributed substantially to the provision of affordable housing in the United States.

But we saw areas where we could make improvement. One of the things that we found over the years is as the banks have become more comfortable with the programs, their administration has become better, more secure, and the very prescriptive rules that were first written when the program was initiated are really no longer appropriate.

So we're making significant changes, for instance, in the monitoring, placing greater responsibilities on the banks to do the monitoring, to do this based on the risk involved and factors that the banks are familiar with.

So we've made some changes over the years and these are maybe the most major changes that have been made and they're probably not the last changes. We will continue to look at this program and see where we can make it more effective and more efficient. We'll look at the competitive program, see if there's some things that can be done there that could increase, in effect, the value and the benefit of these AHP grants in the districts that the banks serve.

So I think that we have a rule here which serves the purpose of making this program, as I've said, more effective and efficient, but we will have a 90-day comment period. We will certainly look at the comments and urge all of the participants in this program to look very carefully at this rule and give us their comments and we will, of course, in adopting a final rule, have in mind the various comments that we receive.

But I think we're making a significant step forward today and I'm pleased that we've reached this point, Mr. Chairman.

CHAIRMAN ROSENFELD: Director Leichter, on behalf of the Board, I wanted to commend you for your leadership in this very important endeavor, as well as your colleague Chris Morton. We really appreciate your effort.

I noticed a shaking of the head when you said 90 days. Is it 90 days?

MR. CROSS: It's a significant rule and we want to make sure everyone gets an opportunity to give us their comments, their best comments, so it's 120 days.

DIRECTOR LEICHTER: Thanks.

CHAIRMAN ROSENFELD: Is there any further discussion from the Board?

DIRECTOR CASTANEDA: I do have some comments, Mr. Chairman. I also would like to thank the staff for their hard work in preparing this proposal.

AHP is clearly an important area for the Federal Home Loan Banks under the statute and the Finance Board has an obligation to revisit, as Director Leichter just mentioned, from time to time whether our regulation is and continues to be appropriate to the proper discharge of our responsibilities.

As a regulator and a former banker, I firmly believe in the goals of both reducing regulatory burden and of eliminating administrative waste to the greatest extent possible. Every dollar spent on unnecessary administrative costs means more money that is not spent on advancing the mission, whether it's affordable housing or any other program, for that matter.

Plus, our emphasis should primarily be on outcomes, rather than dictating precise procedures to be followed, especially when we have no reason to believe that we, as regulators, have a better idea as to how this operation should be run. We need to get out of the way and let the banks figure that out while we rededicate ourselves to ensuring that the outcomes produced by these operations fulfill the banks' mandate.

So I'm pleased that the staff has prepared this proposal with a view to streamlining what currently is, in my view, and I agree with Director Leichter and Steve Cross's comments, that this is a very cumbersome regulation and overly prescriptive regulation and a regulation that imposes lots of administrative and procedural requirements without any clear sense of the trade-off between costs and benefits.

We are providing a healthy comment period, again 120 days, and I am confidant that we will get good and constructive feedback to consider as we move forward finalizing the new AHP regulation. Thank you.

CHAIRMAN ROSENFELD: Any other questions?

DIRECTOR MONTGOMERY: Yes, Mr. Chairman. I have a question for Steve or one of his colleagues.

At the bottom of page 4 on our hand-out, the last sentence. This is more for my edification but the second word of the sentence is "restrictions" and the last word of that sentence is "permissible." I wonder if you can just clarify that for me a little. Assuming I'm reading this correctly, has this been an issue with one bank or some banks more than others?

MR. CROSS: Under the existing regulation, a bank may at its discretion choose to make projects that are outside of the boundaries of its district, even though it might be a market area served by one of its members ineligible for the competitive program. This proposed rule would eliminate that discretion, would prohibit them from prohibiting out-of-district projects.

DIRECTOR MONTGOMERY: So the restrictions would no longer be allowed.

MR. CROSS: The restrictions would no longer be allowed. Currently a bank may establish that out-of-district projects are ineligible or alternatively under one of the scoring criteria, they can award extra points or preferences for in-district projects. So they either can prohibit out-of-district projects or they may provide a preference for in-district projects. Both of those permissions would be prohibited under the proposed rule.

DIRECTOR LEICHTER: If I may just add, what we're really trying to respond to is all of the mergers and acquisitions that have occurred in the financial industry, where a bank may find that a member has been acquired by a member of another financial institution and this may cause a disallocation in the AHP funding.

We don't want to disadvantage a community that's been served by a member which has now been acquired and is in another bank district and therefore might, under a prohibition that a bank would now be allowed to, until we change this rule, would be allowed to impose of not having its AHP application considered.

MR. KENNEDY: It would permit a truly outstanding project that happens to be located out of the district not to be disqualified. So in a sense it makes it a more competitive process. There will be able to be competition even outside the district, and that's a good thing.

DIRECTOR MONTGOMERY: Did I read somewhere that perhaps a certain high-ranking member of Congress was objecting to this provision?

MR. CROSS: This has been an issue that has been raised at times by members of Congress in response to mergers of large or mid-sized institutions with other institutions that are headquartered outside of that particular state or region, yes.

DIRECTOR MONTGOMERY: Thank you for your clarification. Thank you.

CHAIRMAN ROSENFELD: Director Mendelowitz?

DIRECTOR MENDELOWITZ: I'm happy to see the good improvements in reducing regulatory burden and addressing the effectiveness of the program in ways that are quite good.

I do want to note with respect to the issue that you raised that over the past five years the issue of multi-district membership has come and gone on several occasions and it was, for the most part, tied to acquisitions of financial institutions in one district by a financial institution in a second district. And on more than one occasion a justification for trying to stretch our statute beyond what just a simple reading would permit was tied to questions related to misallocation of AHP funding related to the acquisition.

I think good public policy is to address a problem directly. Don't try to use the problem to totally distort or change something else in the public arena. And I think that removing the ability of one Home Loan Bank to restrict funding of AHP projects outside of its district is the appropriate, direct way to deal with a public policy challenge relating to allocation, appropriate allocation of affordable housing funds, rather than trying to use that as the lever to try to stretch the interpretation of what the statute permits into entirely different areas. But this is really a good thing, I think.

CHAIRMAN ROSENFELD: If there's nothing else, I'll accept a motion to approve the resolution and to allow staff to make technical and conforming changes to the rules.

DIRECTOR LEICHTER: I so move.

CHAIRMAN ROSENFELD: Secretary, please call the role.

MS. WILLIS: On the item before the Board, Director Leichter, how do you vote?

DIRECTOR LEICHTER: Yes.

MS. WILLIS: Director Castaneda?

DIRECTOR CASTANEDA: Yes.

MS. WILLIS: Director Mendelowitz?

DIRECTOR MENDELOWITZ: Yes.

MS. WILLIS: Director Montgomery?

DIRECTOR MONTGOMERY: Yes.

MS. WILLIS: Chairman Rosenfeld?

CHAIRMAN ROSENFELD: Yes.

The motion's adopted.

This ends the open session of the meeting. We will reconvene in closed session in three minutes.

[Whereupon, at 10:35 a.m., the open session was adjourned.]