



March 21, 2007

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551
Docket No. R-1238

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance:
Domestic Capital Modifications 71 Fed. Reg. 77446 (December 26, 2006)

Dear Sir or Madam:

The Federal Home Loan Bank of New York is submitting this comment letter to bring to your attention an important issue raised by the Basel I-A notice of proposed rulemaking.

Under the existing risk-based capital framework (Basel I), the risk weight assigned to exposures issued or guaranteed by a Government Sponsored Enterprise (GSE), such as a Federal Home Loan Bank, is 20 percent. The preamble in the Basel I-A notice of proposed rulemaking¹ notes that two GSEs – Fannie Mae and Freddie Mac – as part of an agreement with their regulator, obtain and disclose credit ratings issued by a Nationally Recognized Statistical Rating Organization (NRSRO) that assesses the “independent financial strength” (“IFS”) of these institutions without consideration of any “implied Government backing.”

The preamble states that the banking agencies are considering the use of IFS ratings to determine risk weights for all GSE exposures, and solicits comments on various ways to implement this requirement, including the question of how to treat GSEs that currently do not have IFS ratings. We believe that for a number of important policy and practical reasons the final regulation should not link capital risk weight assignments to independent financial strength assessments.

As a preliminary matter, we note that the Federal Home Loan Banks issue consolidated debt that is backed by the combined financial resources of the entire system. Individual Bank stock is not publicly traded, but rather is held only by member institutions and has a statutorily determined and fixed sale and redemption price. The Federal Housing Finance Board has extensive

¹ 71 Fed. Reg. 77446 (December 26, 2006).

supervisory authority over the Banks, including the authority to approve new activities, establish risk-based capital standards, and approve each Bank's capital plans. In light of these and other factors, there is little, if any actual risk to investors holding consolidated debt instruments.

I. Inconsistency with the Goals of the Basel I-A Rulemaking

The use of IFS ratings for setting risk weights is inconsistent with one of the fundamental purposes of Basel I-A, to better align capital to the risks in a depository institution's portfolio. The IFS is not a measure of risk to the depository institution holding the asset. Rather, it is an attempt to measure the theoretical risk to the Government that is posed by the GSE's activities. The potential risk to the Government is not equivalent to the potential risk to holders of GSE securities, which is reflected in the normal credit rating assigned by the NRSRO (the "investor rating"). Put simply, the risk to the Government is not an appropriate basis for assigning risk weights to bank assets.

The proposal is also inconsistent with the agencies' goal of alleviating some of the competitive concerns that have been raised by some non-Basel II banks. These smaller banks are concerned that the potentially reduced capital requirements under Basel II may create competitive inequalities for non-Basel II banks holding similar assets. As noted in the preamble, one of the five principles guiding the Basel I-A issuance is to "minimize differences in capital requirements that may give rise to competitive imbalances between large and small banking organizations."

Under the advanced approaches authorized by Basel II, a bank holding GSE securities would not be required to align the holdings with an artificial IFS rating, but instead would use the *investor* credit rating, which appropriately relates to the risk to the bank holding the security. Under the Basel II advanced approach, the risk weight for GSE securities that have a rating of highest or second highest investment grade would be considerably *lower* than the 20 percent risk weight proposed for GSE securities in the Basel I-A NPR.²

Under the alternative discussed in the preamble to the NPR, the risk weight under Basel I-A could increase even further based on a downgrade in the IFS rating, even if the actual NRSRO investor credit rating remains unchanged, thus creating an even greater disparity between Basel I-A and Basel II, to the disadvantage of the smaller banks.

II. Adverse Impact on Housing Finance

If the agencies go forward with tying IFS ratings on GSE securities to their risk weight, the market will demand an additional premium to hold such securities. The additional premium will be required whenever the IFS rating translates into a risk weight in excess of 20 percent. However, even if the IFS rating does not result in a higher risk weight, the fact that the risk weight *may* suddenly change in the future creates an uncertainty that will be reflected in market

² Depending on the investor credit rating, the risk weight for GSE securities with the first or second best ratings would be between 7 percent and 15 percent.

price. For example, a banking institution today can manage its portfolio of GSE securities with the assumption that the risk weight for that portfolio will remain at 20 percent. Under the IFS

proposal, the risk weight for that portfolio could change dramatically through an IFS downgrade, and the institution will either be required to increase its capital or reduce its portfolio by selling into a market suddenly flooded with GSE issuances. This new uncertainty will result in investors demanding an additional premium to purchase GSE securities. These additional costs will result in higher funding costs for the GSE, which will in turn raise the costs to the consumer of housing finance.

III. Inconsistent with Congressional Intent

The proposed IFS alternative also undermines the long-standing public policy instituted by Congress to assist the housing finance market by encouraging investments in GSE securities. Thus, for example, Congress specifically authorized national banks and Federal thrifts to invest in obligations of the housing GSEs. See, e.g., 12 U.S.C. § 24(Seventh). This Congressional policy of favoring investment in housing GSE obligations that support housing finance and affordable housing would be undermined by a regulatory policy to make such investments more costly.

IV. Conclusion

The Federal Home Loan Bank of New York believes that the use of an IFS rating for purposes of risk weighting Federal Home Loan Bank System and other GSE obligations is inconsistent with the goals of the Basel I-A proposal, the best interests of housing finance, Congressional intent, and would not be in the public interest.

Sincerely,

A handwritten signature in black ink, appearing to be 'G. Engelke, Jr.', with a long horizontal flourish extending to the right.

George L. Engelke, Jr.
Chairman
Federal Home Loan Bank of New York

Cc: Eric Amig, FHLB