FEDERAL HOME LOAN BANK
OF CINCINNATI

TESTIMONY BEFORE

FEDERAL HOUSING FINANCE BOARD

MARCH 12, 2003

TESTIMONY ON MANAGEMENT OF UNSECURED CREDIT RISK

Mr. Chairman, Directors Leichter, Mendelowitz, O'Neill, and Weicher, my name is Carole Cossé and I hold the position of Senior Vice President, Treasurer of the Federal Home Loan Bank of Cincinnati (the FHLBank). I have been an employee of the FHLBank for the past 24 years, beginning as Cash Manager in 1979 and am now responsible for the investments, funding and financial modeling and analysis of the FHLBank. Thank you for providing me the opportunity to address the Federal Housing Finance Board (Finance Board) on the FHLBank's practices in managing unsecured credit in light of its need to maintain a portfolio of liquid assets.

The primary mission of the FHLBank is to serve as a consistent, readily available and reasonably priced source of funding for our 750 member institutions. This funding is used by members for their asset/liability and liquidity management as well as to finance their housing and community development related activities. The credit reserve function of the FHLBank requires the maintenance of a substantial level of liquidity at all times to meet member needs.

By definition, a liquid asset for the FHLBank is one that can be easily transformed to cash without any significant loss of value. This implies the FHLBank should hold its liquidity in the form of short-term marketable securities that will not show significant fluctuations in value as interest rates change. It is also desirable that the action of transforming a liquid asset to cash would not disrupt the FHLBank's accounting practices. The FHLBank does not view a long-term investment security such as a US Treasury note, an agency debenture or a mortgage-backed security as an effective liquid asset. These instruments have the potential for significant fluctuation in their market value. If held as liquid assets, they would also force the FHLBank to recognize them as available-for-sale securities, which can carry unfavorable accounting treatment. Given the desire to preserve both the market value and favorable accounting treatment, the FHLBank looks to short-term Treasury, agency and money market instruments to meet its liquidity requirements and needs. The decision to hold liquidity in these forms entails a classic risk/return tradeoff. Liquidity held in the form of short-term Treasury bills carries no credit risk. The decision to hold money market instruments depends, in part, on the added return relative to the modest unsecured credit risk inherent in private liquid assets.

The FHLBank's ability to maintain a sufficient amount of liquid assets is essential to providing members access to advance funding and mortgage loan sales on a daily basis in all financial environments. One primary way the FHLBank can serve at all times as a "lender of first resort" is through opportunistic debt issuance, which means the debt can be issued on terms favorable to the FHLBank's debt issuance practices rather than being dictated solely by the timing of member demand for funds. Issued debt can be warehoused in short-term liquid assets until it is needed to fund member activity. The ability conferred by liquid assets to warehouse debt maximizes the FHLBank's ability to secure debt at favorable relative funding costs, (which has obvious implications for advance and mortgage pricing). It also provides an additional cushion of liquidity that is not dependent upon the FHLBank's ability to issue debt to meet a portion of member demand for additional funding.

The FHLBank has a robust set of tools to manage the unsecured credit risk involved in its liquidity portfolio of private money market investments. To a large measure, the management of unsecured credit risk exposure has been made formulaic and transparent. Finance Board Regulations and the FHLBank's Financial Management Policy (FMP) limit the maximum permissible unsecured credit risk exposure to any individual counterparty as a percentage of the lesser amount of the FHLBank's total capital or the counterparty's Tier 1 capital based upon the level of the counterparty's long-term credit rating assigned by a nationally recognized statistical rating organization (NRSRO). In addition, the FHLBank may not have an amount of unsecured credit outstanding to any group of affiliated counterparties in excess of thirty percent of the FHLBank's total capital. Further, the FHLBank has an internal policy that it will not extend unsecured credit to any financial institution with a long-term credit rating below BBB. All of these limits are codified in databases maintained by the Credit Department with confirmation of accuracy by the Treasury Department back office.

The FHLBank has segregated the credit risk analysis and the unsecured credit risk management functions and housed them in two separate departments. Thus, the Unsecured Credit Risk

Analyst and the Credit Officers independently look at the "bigger picture" look. The Treasury Department is closely involved with management of unsecured credit risk in two ways. Its Trading Room staff, two of whom are FHLBank officers, implement the relevant provisions of the FMP. They also have responsibility for responding on a "real time" basis to contemporaneous monitoring of relevant news about the economy, political situations, financial markets, individual counterparties and the changing tone of the market, in general or regarding specific financial institutions and entities. All of this information is obtained from various brokers and dealers, news wires, the NRSROs, and sometimes from individual counterparties themselves. Based upon this current news, the Trading Room staff can and will instantaneously suspend new activity with individual counterparties, put them on a Trading Room "watch list" (which per FHLBank policy mandates an overnight-only maturity status), apply tighter maturity or dollar limits than permitted by the FMP, or even liquidate securities holdings. They can also steer investment priorities away from particular counterparties or market segments. Currently, out of 170 counterparties, there are 18 on suspension and 10 on the Trading Room "watch list". Several others are subject to more informal limitations on maturity.

The Unsecured Credit Risk Analyst provides the Trading Room staff with daily written and/or oral briefings on news that could affect unsecured credit counterparties. These briefings include news articles, reports generated by the NRSROs regarding specific individual counterparties and the market segments in which the counterparties operate. Any ratings changes are immediately communicated to the Trading Room staff and all applicable databases are immediately updated.

A request to add a new counterparty is made by the Treasury Department to the Credit Department. Requests consider, among other things, the counterparty's degree of presence in the short-term money market and the extent to which lending funds to the counterparty would enhance the diversity of the FHLBank's unsecured credit portfolio. If the Credit Department determines that the institution is an eligible counterparty in terms of credit ratings and capitalization, it will perform a detailed written review of the counterparty's business and finances. There are five financial areas that are addressed: asset quality, profitability, liquidity, capitalization, and stock price performance. The review includes a recommendation of whether the proposed counterparty should be added to the list of approved counterparties and whether there should be investment restrictions beyond those in the FMP. The Senior Vice President, Credit Officer presents the findings of the review to the Asset/Liability Management Committee (ALCO). ALCO is responsible, by majority vote, to approve or not approve the proposed counterparty. Since the end of 1998, the FHLBank has added dozens of new counterparties.

The Credit Department also performs periodic reviews of all counterparties. These reviews include updating the counterparties' financial information and compiling, reading, analyzing and communicating the latest reports from the NRSROs. Historical stock price trends are also analyzed.

Selecting the measure to determine the amount of liquidity that is truly sufficient is very problematic. Finance Board Regulations require the FHLBank to maintain operational liquidity ["sources of cash from both the Bank's ongoing access to the capital markets and its holding of liquid assets" (FHFB Regulations, § 917.1)] and contingency liquidity "sufficient to enable the Bank to meet its liquidity needs, which shall, at a minimum, cover five business days of inability to access the consolidated obligation debt markets" (FHFB Regulations, § 932.8). In addition to these regulatory requirements, the FHLBank can consider several other factors to determine an optimal level of liquidity. The FHLBank can look at the amount of unused credit lines for advances, the amount of master commitments under the Mortgage Purchase Program (MPP), and the amount of upcoming maturities and calls of debt. Also, the amount of asset liquidity should increase as the total amount of assets increase. It should also increase with expansion of the MPP because MPP loans typically have relatively long commitment periods that cannot always be efficiently hedged with derivatives. An increased amount of volatility in asset balances (measured over a short-term period such as daily or weekly) should also increase the amount of asset liquidity. There is no doubt that asset volatility has been increasing in recent years as members have become more sophisticated users of FHLBank advances and as the Federal Home Loan Bank System has increasingly come to be seen as a lender of first resort. All these factors point to a need for the FHLBank to have more asset liquidity today than in the past.

Putting aside all of these various measures that can be discussed, dissected and debated as to which combination or which one in particular would provide the FHLBank with the most favorable level of liquidity, actual experience is the best measure. September 11, 2001 began as a normal day with the execution of very routine overnight discount notes sales and advance demand and standard liquidity transactions. However, that day and the rest of that week turned into what could be considered an extreme test of the FHLBank's ability to meet its members' needs as well as assist its sister Banks in meeting their liquidity needs.

During the mid-morning hours, the FHLBank evacuated its downtown Cincinnati offices to its off-site facilities. The Office of Finance lost communication with various trading desks, thus overnight discount note sales from earlier in the morning could not be confirmed. These unconfirmed notes were cancelled, resulting in less funding available for the System. Approximately 58 percent of the overnight discount notes posted for sale by the District Banks were actually traded and settled that day.

With the severe disruption to the financial markets, the FHLBank only offered overnight advance funding and was able to provide $1.4 billion in new advances to its members and assist four District Banks in meeting their liquidity needs with another $1.4 billion. By the end of the day, the FHLBank had invested $4.3 billion in overnight Federal funds. The funding for the Federal Home Loan Bank of New York continued until September 16th. For the remainder of September, a period of time during which it was difficult to consistently access the debt markets, the FHLBank lent $23.0 billion in new funds to its members. This was an incredible test of the depth of the FHLBank's liquidity position and its liquidity management.

The FHLBank applauds the seriousness of the Finance Board in fulfilling its mission to ensure the System's safety and soundness. There has been discussion about the merits of establishing additional limits on the System's exposure to unsecured credit risk beyond the sum of each District Bank's limit. While the FHLBank understands the Finance Board's concern with aggregate System credit risk, it does have several concerns about establishing additional, more restrictive, Systemwide limits. In general the FHLBank worries that Systemwide limits could have unintended consequences. First, the number of eligible and approved counterparties actually in the market on a daily basis is limited, so that further reductions in the twelve Banks' ability to invest with any counterparty could decrease their abilities to have a sufficient amount of asset liquidity. Second, implementing Systemwide limits could actually increase unsecured credit risk exposure if the additional limits forced Banks to migrate toward lower-rated counterparties. Third, if each Bank's investment limits were tied to those of all other Banks, the harmonious coordination among the investment and funding activities of the Banks would likely suffer. Finally, the issue of Systemwide monitoring of unsecured credit is of great importance to both the individual Banks as well as the Finance Board. Currently, the Office of Finance collects credit exposure data from each District Bank on a monthly basis to produce a Systemwide Unsecured Credit Report. It has been suggested that such a report be completed on a weekly or daily basis. In fact, there has been some discussion of developing an online real-time basis. Such a system, while theoretically desirable, may cause disruption within the money market investment arena. Currently 12 District Banks, with their individual investment restrictions, could be (and sometimes are) competing for an eligible counterparty's financing need. With an on-line, real-time system and Systemwide limits that would be less than the sum of the 12 individual District Bank limits, two (or more) District Banks could easily be trying to execute the same trade at the exact same time. In a moving market, it is totally impractical to have to wait for a system response before executing a trade AND it could be disastrous to commit to a trade before it is posted to a system, then discover that a System limit has been exceeded. The result would inevitably be broken trades (investment transactions executed that a District Bank would have to cancel). One broken trade is not looked upon kindly within the money market investment community and its participants; several will cause significant reputational damage. More than the monetary consequences (either the District Bank making "whole" the counterparty with whom the trade was broken, or the District Bank not being able to replace the investment at a comparable interest rate, maturity date etc.), the reputational damage will be considerable. Further, it cannot and should not be assumed that the System's reputational risk would remain only within the money market investment arena and would not find its way over to the System's debt issuance, resulting in higher debt costs for the System and ultimately, its members. The potential costs to the System far outweigh the potential benefits that may be realized.

It appears to me that an end of day or weekly reporting system with limits maintained at the individual District Bank level would provide sufficient monitoring capabilities to both the 12

District Banks and the Finance Board without causing undesired market disruptions for each Bank as they manage their liquidity.

Thank you again. I would be happy to answer any questions you might have.