Testimony of

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Mr. Chairman and Federal Housing Finance Board (FHFB) directors, thank you for this opportunity to testify this afternoon. While the preliminary study I will discuss with you today was prepared for the Bank Presidents' Conference, I would like to emphasize I am here only on behalf of the management of the Boston Bank and cannot speak for the other Banks.

In September 2002, the Research and Planning Committee of the Bank Presidents' Conference commissioned a study of credit concentrations in the Federal Home Loan Bank System. The study examined the Bank System's credit exposures to members from secured advances and to non-members from unsecured extensions of credit – primarily in the Federal Funds market – and derivatives contracts. The study looked not only at the level of those exposures but how the 12 Banks manage them.

The Committee appointed Michael Wilson, Chief Operating Officer of the Boston Bank, to coordinate the study. Mr. Wilson then appointed a working group at the Boston Bank to prepare the study, with assistance from the credit officers and other personnel at all twelve Federal Home Loan Banks, as well as personnel from the Office of Finance.

The working group is currently in the process of finalizing the report. I would like to summarize for you three key preliminary findings that are relevant to today's hearing, specifically the Bank System's counterparty underwriting policies, monitoring of unsecured exposures, and distribution of unsecured extensions of credit. I will begin by defining "unsecured extensions of credit" and commenting on why a Federal Home Loan Bank makes these types of investments.

Background

When we use the phrase "unsecured extensions of credit," we mean money market investments such as Federal Funds and holdings of debt securities issued by other government-sponsored enterprises (GSEs). Internally, we refer to these as "unsecured" extensions of credit to distinguish them from our "secured" or "collateralized" extensions of credit such as advances.

Why does a Bank hold money market investments? There are several reasons. First, the short-term nature of the money market, or unsecured credit market, allows a Bank to maintain a liquidity position sufficient to meet its daily obligations and anticipated and unanticipated member demand for advances and loan purchases. Second, member deposits, which are largely overnight rollovers, can fluctuate significantly and that dictates investing those funds on a short-term basis. Third, money market investments provide a Bank with opportunities for capital leverage and asset-liability and duration of equity management. For example, a Bank might invest in debentures issued by U.S. government agencies and instrumentalities to generate spread income and as a means of lengthening or shortening the asset sensitivity profile of the Bank without using derivatives.

System Counterparty Underwriting Policies

As part of the study for the Bank Presidents' Conference, the working group surveyed the Banks regarding their underwriting practices with regard to counterparties for unsecured investments. The findings indicate that the Banks have broadly similar underwriting processes. All of the Banks require that non-member counterparties for new unsecured investment be rated by at least one of the three Nationally Recognized Statistical Rating Organizations, or NRSROs. Many of the Banks require that counterparties have a certain minimum rating. Some Banks also require that the counterparty have a minimum level of Tier I capital to be considered as a counterparty for unsecured investment. A few of the Banks do differentiate their underwriting standards between domestic and foreign counterparties. For example, one of the Banks requires that foreign counterparties have a minimum rating of A, while requiring only a BBB minimum rating for domestic counterparties. All of the Banks include an analysis of counterparty financial condition in their evaluation of counterparties, in accordance with FHFB Advisory Bulletin 98-10.

The Federal Home Loan Banks also regularly monitor concentrations in their investment portfolios. Some of the Banks use this specific data to diversify their investments further, and thereby decrease the credit risk in their investment portfolios.

System-wide Monitoring of Unsecured Exposures

The working group surveyed the Banks regarding any formal proposals that have been made to a Systemwide forum, such as the Bank Presidents' Conference, to establish Systemwide limits on investments that would be tracked on a real-time basis. A few Banks made such proposals prior to the implementation of the new investment limitations in March 2002. Some of their proposals were incorporated into the new regulation. To our knowledge, there have been no formal proposals since that time. Many of the Federal Home Loan Banks now believe that the current limitations as noted in the regulations are sufficiently conservative to prevent significant concentration risk in the Banks' (and the System's) investment portfolios. This position recognizes the fact that these are short-term investments in large, sophisticated, highly rated counterparties. The Banks recognize that there is some risk, albeit a manageable and reasonable risk, in participating in this market.

Distribution of Unsecured Credit

The implementation of the new Section 932.9 investment limitations in March 2002 had a significant effect on the distribution of unsecured credit extended by the System. The change in the ratings regime from emphasis on the Fitch Individual Rating to the long-term credit ratings provided by NRSROs has caused a migration of these investments away from regional domestic banks towards GSEs such as Fannie Mae and Freddie Mac and larger foreign banking organizations.

The study notes that some of the foreign banking organizations in which the Bank System now invests would not have been eligible for investment under the previous regulation due to their low Fitch Individual Ratings. Some of these foreign banking organizations rely on explicit or implicit outside support for their long-term credit ratings. Sources of potential outside support factored into these ratings include support from a corporate parent, an implied expectation of support from a government and, in a few cases, an explicit guarantee of a counterparty's obligations from a government.

A key finding of the study is that the new regulation's use of the long-term ratings to set investment limitations has resulted in a change in the distribution of unsecured credit in the System, based on the long-term ratings of counterparties. Counterparties with long-term ratings in the BBB-range constitute a much smaller portion of System unsecured investment since the implementation of the new regulations in March of last year. Correspondingly, the portion of the System's total investments in AA rated counterparties has grown. This is due to the fact that additional capacity has been created for System investments in AA rated foreign counterparties that either were not eligible for investment at all under the previous regulation, or had much lower investment limitations due to their low Fitch Individual Ratings relative to their long-term credit ratings.

The study notes that the term-to-maturity structure of System investments has not been materially impacted by the new investment regulations. The decision to invest on an overnight versus term basis is driven more by financial management considerations at the Federal Home Loan Banks than by changes in the investment limitations.

The overall level of unsecured investment by the Bank System remained relatively stable on an absolute dollar basis between December 1997 and September 2002, ranging between $80 billion and $120 billion, depending on market conditions. However, due to the fact that System assets have more than doubled over this period, from $358 billion to $765 billion, the level of unsecured investments relative to the size of the System has declined substantially. Unsecured investments accounted for almost 25 percent of System assets in December 1997. These investments have declined steadily on a relative basis in the years since, accounting for approximately 14 percent of System assets in September 2002.

In December 2001, investment in foreign banks totaled $29.2 billion, or 33 percent of total System unsecured investments. Under the new regulation, in September 2002, investment in foreign banks totaled $45.8 billion, or 43 percent of System unsecured investments. Therefore, the investment in foreign counterparties increased by almost $17 billion during this time period. At the same time, unsecured investments in domestic institutions declined from $42.1 billion, or 49 percent of System unsecured investments in December 2001, to $34.8 billion, or 34 percent of System unsecured investments in September 2002. This represents a decline in domestic investments of approximately $7 billion. Meanwhile, investments in GSEs and supranationals increased from $15.9 billion, or 18 percent of total unsecured investments, as of December 31, 2001, to $23.9 billion, or 23 percent of total unsecured investments, as of September 30, 2002.

Regarding diversification in System unsecured investments, our findings indicate that roughly half of System unsecured investment is with twenty counterparty affiliate groups, with the System investing in 113 counterparties in total. There has been little effect on the level of diversification at the top as a result of the new investment regulation. In December 2001 and September 2002, investment in the top twenty counterparties accounted for 53 percent of System unsecured investment. This amounted to $37.5 billion in December 2001, and $43.0 billion in September 2002. Eight counterparties appear in the top twenty in September 2002 that were not in this group in December 2001. Of these, seven are foreign counterparties.

As part of the study, our working group identified twenty counterparty affiliate groups that have a credit concentration with the System. The group defined a concentration on the basis of System borrowings by the counterparty greater than 25 percent of the counterparty’s total borrowings and 7.25 percent of System capital and/or 30 percent of the counterparty’s capital. The credit reviews on these counterparties indicate that they are in satisfactory financial condition. The reviews found that the credit ratings of the counterparties accurately reflect the level of credit risk that the System is exposed to by investment in these counterparties.

Thank you again for the opportunity to testify this afternoon. I would be pleased to take any questions you may have.