Chicago
Federal Home Loan Bank 111 East Wacker Drive Chicago, Illinois 60601

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VIA FEDERAL EXPRESS
AND ELECTRONIC MAIL

Federal Housing Finance Board
1777 F Street, N.W.
Washington, D.C. 20006
Attn: Public Comments

Dear Sir or Madam:

Introduction

This letter addresses the Federal Housing Finance Board's ("FHFB") request for comments on the proposed rule No. 2003-19 ("Proposed Regulation") regarding "Registration by Each Federal Home Loan Bank of a Class of Its Securities Under the Securities Exchange Act of 1934" published in the Federal Register on September 17, 2003. The Proposed Regulation would require each Federal Home Loan Bank ("FHLB") to prepare and make public certain disclosures relating to its business and financial condition. These disclosure requirements would be satisfied by the FHLB registering its equity stock with the Securities and Exchange Commission ("SEC") under §12(g) of the Securities Exchange Act of 1934. The Federal Home Loan Bank of Chicago ("Bank") appreciates the opportunity to comment on the Proposed Regulation.

1. Accounting Treatment of FHLB Capital Stock Regarding Conditional Redemption

Registration of FHLB stock with the SEC raises several important issues. The most critical one, which must be resolved prior to a final regulation, is the accounting treatment of FHLB stock. First, a fundamental problem is created by §931.7 of the FHFB's regulations which provides that a member may request redemption of excess stock and that a FHLB "must" redeem the excess shares of Class A or Class B stock once the redemption period has expired. This language is inconsistent with §6(e)(1) of the Federal Home Loan Bank Act ("Bank Act"), which states that a FHLB, in its sole discretion, may redeem any excess shares of Class A or Class B stock issued and held by a member. The Bank Act reflects Congressional intent to provide the FHLBs with flexibility to manage their capital positions consistent with statutory standards and safe and sound practices. Moreover,

under the pre-Gramm-Leach-Bliley Act ("GLB Act") regime, because the FHLBs had the discretion as to whether to redeem excess stock, an IRS tax ruling provided tax-deferred treatment to stock dividends that many FHLBs issue to their members. Bringing the regulation into conformity with the Bank Act would ensure continued applicability of this ruling.

The inconsistency between the regulation and the statute also must be addressed because of the resulting effect on the FHLBs registering their stock with the SEC. The mandatory nature of the FHFB's regulations may cause the SEC to require the FHLBs to classify all its stock as "puttable."

The Statement of Financial Accounting Standards No. 150 ("FAS 150") discusses classifying stock as either equity or debt. FAS 150 provides that if a stock has a mandatory redemption feature, then, as soon as a request for redemption is received by an institution, the institution must reclassify that stock as debt, even if it will not be redeemed. Additionally, if dividends are paid during the notice of redemption period, we are advised that the dividends must be classified as an "interest expense." This means that a significant amount of FHLB equity could be eliminated from the financial statements of an individual FHLB and the FHLB System simply by virtue of the submission of redemption requests by members, even though the statute required such requests not be honored. This would occur if, at the end of the applicable notice period, the stock was not excess at that time or such redemption would cause the FHLB to fail to meet its minimum capital requirements.

Additional restrictions are imposed by the SEC's Accounting Series Release No. 268 ("ASR 268"). Under ASR 268, if a stock has a mandatory redemption feature, the stock must be classified as "puttable" stock in the institution's financial statements even if an institution has not received any requests for redemption of that stock. This means that the Bank would be required to classify all of its stock as "puttable" stock. However, the labeling of the Bank's stock as puttable stock would be inaccurate and misleading. By statute, the Bank is only able to redeem stock as long as its capital does not fall below its minimum regulatory capital requirement of 4%. Capital equal to 4% of assets is in fact permanent and not redeemable, let alone "puttable." Therefore, labeling all Bank stock as "puttable" stock is incorrect.

A solution to this problem is readily available. If the FHFB revises §931.7 to conform with the statute to provide that the Bank has the discretion to redeem a member's excess stock upon request by the member, all the Bank's stock would not have to be labeled "puttable," thereby resolving the SEC's concerns. We refer to the letter sent to Mr. Thomas Casey of the FHFB by Mr. Thomas Vartanian, counsel to the Bank, dated November 11, 2002.

As previously stated, the Congressional intent was for the FHLBs to have discretion with respect to the redemption of excess stock. The Bank Act contains several sections under which a FHLB is conditionally required, subject to maintaining at all times its 4% minimum capital requirement, to redeem a member's stock, such as when a member withdraws its membership. Section 6(e)(1), however, expressly grants the FHLB the sole discretion as to whether to redeem excess stock following the expiration of the applicable notice period. Accordingly, the FHFB should amend its regulation to be consistent with the express language of the statute and resolve this accounting issue. We believe this is a sine qua non of proceeding towards SEC registration.

2. Related Party Transactions

The second issue for organizations in a cooperative structure is the SEC requirement that an institution disclose all transactions over $60,000 with a "related party." Related party includes shareholders that hold more than 10% of any class of equity securities. This would mean that the Bank would have to disclose every transaction over $60,000 it has with any members that hold more than 10% of Bank stock, since they would be considered related parties. This requirement could entail a FHLB disclosing almost all of its transactions with its members that are classified as a "related party." Nine of the twelve FHLBs have members holding more than 10% of their stock.

The SEC and the Bank have discussed an alternative to address this requirement since requiring the FHLBs to disclose all transactions with certain members seems obviously unworkable and is not necessary to achieve the purpose of the rule. The approach being discussed is that the FHLBs would provide a summary table showing the total amounts for various products (i.e., advances, mortgages). This appears to be an acceptable approach.

3. Joint and Several Liability

Another issue raised by requiring FHLB registration with the SEC is the treatment of the joint and several liability of the FHLB System's consolidated obligation ("CO") bonds. Under FASB Interpretation No. 45 ("FIN 45"), guarantees are required to be recorded on a company's financial statement as a liability, although FIN 45 waives this requirement for entities under common control. Originally, the SEC staff took the position that the FHLBs' joint and several liability met the definition of a guarantee and therefore the FHLBs must record as a liability the "fair value" of the joint and several liability of the CO bonds.

The FHLBs have had discussions with the SEC staff regarding its position on this issue. The FHLBs have maintained that in the event of one FHLB's default on CO bonds, the FHFB would be required to step in and administer the obligations of the other FHLBs, thus creating an element of common control under any situation where joint and several liability would be operative. The SEC has indicated that it would defer to external auditors on this interpretation of an element of common control. The FHLB System's external auditor has agreed with the FHLBs interpretation of common control. Therefore, it appears that the FHLBs will not have to report their joint and several liability on CO bonds as a "fair value" liability on the balance sheet. The FHLBs should, however, disclose the relevant joint and several liability information in a footnote in their financial statements.

4. Timing Issues

Another issue that must be addressed is reporting deadlines. The SEC has adopted regulations shortening the filing deadlines for the periodic reports filed by most public companies. The regulations provide that public companies that meet the SEC's definition of "accelerated filer" must file their quarterly and annual reports on an accelerated basis beginning with their first fiscal year ending after December 15, 2003. An "accelerated filer" is a company that has aggregate market value of common equity held by non-affiliates of $75 million or more and is subject to the Securities Exchange Act of 1934 reporting requirements for at least one year. The FHLBs believe that since they are not subject to the 1934 Act and are not public companies, they should not be subject to the accelerated filing deadlines. This issue should be resolved before an informed decision to register can be made.

5. Individual FHLBs Would Be the Registrants

It is clear that only the FHLBs individually may register with the SEC and that the FHLB System, as a whole, cannot register with the SEC since there is no entity which is the "System" and there is no common management or common ownership. Under the Sarbanes-Oxley legislation, the chief executive officer and chief financial officer are required to certify as to the validity of financial statements filed. The FHLB System does not have a chief executive officer or chief financial officer, or any other managers or directors, and therefore would be unable to comply with this requirement. Therefore, only individual FHLBs would be registering with the SEC. This has been verbally agreed to by the SEC staff.

6. Meetings between Bank and SEC Staff

The Bank has had several productive meetings and conversations with the SEC staff regarding the registration of Bank stock. The Bank first offered to meet with the SEC in 2002 and met with the SEC staff in Washington, D.C. on March 22, 2003 to discuss some of the issues raised in this letter. Since that time, the Bank has participated in four conference calls and exchanged correspondence with the SEC staff. The latest call, on December 9, 2003, was to discuss the SEC staff's comments on the Bank's 2002 Management Discussion & Analysis contained in its annual report. The progress made by the Bank and the SEC staff in defining and addressing the issues created by the statutory structure of the FHLBs is reflected throughout this letter. They should be resolved before a final regulation is adopted.

Thank you for the opportunity to comment on this proposal. We would be pleased to provide such additional information or comments which would be helpful.

Sincerely yours,

Peter E. Gutzmer
Executive Vice President
General Counsel &
Corporate Secretary

PEG:sck