March 28, 2006

I have two strong concerns about your proposed rule:

Prohibition on Payment of Stock Dividends

Proposed § 934.1(b) would prohibit a FHLBank from declaring or paying a dividend in the form of stock. The FHFB complains that stock dividends are a main cause of growth in excess stock on the FHLBanks' balance sheets. The Finance Board therefore is proposing to prohibit the issuance of stock dividends. The proposed prohibition on the issuance of stock dividends is unnecessary, especially in light of the overall limit on outstanding excess stock that is being proposed (1% of assets).

Moreover, the prohibition of stock dividends could financially destabilize one or more of the Federal Home Loan Banks. Bank shareholders are able to count stock dividends as income, therefore, while FHLBanks are increasing equity capital, they can issue stock dividends to meet the conflicting needs of their bank shareholders for income on their stock investments while growing their equity account to support growth.

If stock dividends cannot be paid and FHLBanks need to increase equity for any reason, the dividends on the stock could disappear, causing many bank shareholders to seek to redeem their stock. A first out the door is the winner syndrome could destabilize one or more of the FHLBanks.

I strongly urge you to not implement this proposed rule.

Effort to Increase Retained Earnings

Banks and members have extremely valid incentives to keep the level of retained earnings low, because they accrue no value from retained earnings and if they sell their stock they only get par value for their shares. Therefore, it is rational for the FHLBanks and their shareholder owner banks to seek a low level of retained earnings at the FHLBanks. The FHFB argues that low retained earnings are insufficient to protect the par value of Bank stock from losses and that this can have serious consequences, if those losses are realized and the par value of the stock becomes impaired. Yet, forcing FHLBanks to lower dividends permanently is a kind of tax on the shareholders and by decreasing dividends to the bank shareholders makes it more likely that banks will seek to take their excess stock out of the system, triggering a run in a first out the door is a winner syndrome. Bank shareholders bear the economic risk of loss if their par value shares are impaired but this rule guarantees that the value of the shares are permanently decreased.

Moreover holding retained earnings against investments in MPF program assets is not needed since the banks have near total recourse against shareholder banks for their assets in the event of credit problems as they do with advances.

I strongly urge you to not implement any proposed rule that seeks to increase retained earnings in a meaningful manner. ICBA estimates that the proposed rule will require $3 billion of additional retained earnings, therefore the proposed rule is essentially a $3 billion tax on the banking industry.

To illustrate the interconnectedness of my two comments, I offer the following illustration:

Bank A
Assets $1 billion
Par Equity $30 million
Retained Earnings $10 million
Earnings $3 million
Dividend $1 million
Return on Investment 3.33%
Par Value of Shares $30 million
Market Value of Shares $14.3 million (7% required return)

Bank B
Assets $1 billion
Par Equity $30 million
Retained Earnings $0
Earnings $2.6 million
Dividend $1 million cash, $1.6 million stock
Return on Investment 8.67%
Value of Shares $30 million
Market Value of Shares $37.2 million (7% required return)

The only difference between the banks is that Bank A is retaining $1 million in earnings per year to build retained earnings and has $10mm more assets (from its retained earnings) yielding 5%, or $500,000 ($400,000 after tax). The Market Value of the shares is calculated by dividing the yield by required yield times par value of the shares. Recall, that there is no appreciation possible from the shares, only dividends, and future dividends are rationally highly discounted by the bank shareholders versus the current level of dividends.

I and my bank would much rather be a shareholder of Bank B. Wouldn't you? Especially in light of the comment in the rule "[the] Board believes that its capital rules and the Banks' overall capital levels remain adequate and the risk of capital insolvency at any Bank in the foreseeable future is de minimis." If we don't need higher capital levels don't destabilize the system with rules that will greatly reduce the dividends and earnings the bank shareholders receive!

Lastly, I note that the rule would prohibit payment of dividends on estimated earnings. The FHLBanks generally are able to estimate their dividends and notify their bank shareholders before we finalize our earnings for each quarter. The proposed rule would likely shift dividend declarations away from being quarter-end results, and in essence deprive all bank shareholders of one quarter's worth of dividends on a one-time basis. Again, this is a tax on the banking industry.

Sincerely,
Stephen Lange Ranzini
President & Chairman
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