America's Community Bankers
Shaping Our Future

July 12, 2006

Federal Housing Finance Board
1625 Eye Street, N.W.
Washington, DC 20006

Attention: Public Comments

RE: Federal Housing Finance Board
Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks.
RIN Number 3069-AB30
Docket No. 2006-03
71FR 13306 (March 15, 2006)

Dear Sir or Madam:

America's Community Bankers[1] (ACB) is pleased to comment on the Federal Housing Finance Board's (Finance Board) proposed rule on excess stock restrictions and retained earnings requirements for the Federal Home Loan Banks (FHLBanks). ACB appreciates the efforts of the Finance Board to ensure a safe and sound Federal Home Loan Bank System (FHLBank System). We renew our request that the Finance Board withdraw the proposal and issue an Advance Notice of Proposed Rulemaking to address the numerous issues raised by the current proposal. We believe that an Advance Notice of Proposed Rulemaking provides a better opportunity for discussion and dialogue between the Finance Board and the stakeholders of the FHLBank System.

ACB strongly opposes the current proposed rulemaking. ACB has serious concerns about the proposal and believes that the rule, if adopted as currently proposed, could have significant negative consequences for the FHLBanks, their member institutions and the communities they serve. We believe that this rule has great potential to fundamentally alter the direction and makeup of the FHLBank System for many years to come, and limit the FHLBank System's ability to adapt to future financial challenges and demands.

[1] America's Community Bankers is a national trade association representing banks and savings institutions. ACB members are member institutions of all 12 Federal Home Loan Banks, and collectively own more than 50 percent of the equity of the Federal Home Loan Bank System.

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Summary of Proposed Rule

The Finance Board proposes three principal changes to the existing regulations implementing the capital standards provisions of the Federal Home Loan Bank Act (Bank Act).

1. Prohibition on Excess Capital Stock. The Proposed Rule would impose a limit on the amount of excess capital stock an FHLBank could have outstanding. Proposed § 934.1(a). The aggregate amount of an FHLBank's outstanding excess stock could not exceed one percent of its total assets.

To implement this provision, Proposed § 900.2 would define "excess stock" to mean the amount of an FHLBank 's capital stock held by a member in excess of the minimum investment in capital stock that is required by the FHLBank's capital plan, the Bank Act, or the Finance Board's regulations.

2. Prohibition on Stock Dividends. The Proposed Rule would prohibit the FHLBanks from paying stock dividends. Proposed § 934.1(b).

3. Mandatory Minimum Amount of Retained Earnings. Each FHLBank would be required to maintain as part of its capital a minimum amount of retained earnings, equal to $50 million plus one percent of its non-advance assets. (The retained earnings minimum or REM). Proposed § 934.2(a)-(b).

Until a Bank reaches its mandatory retained earnings minimum, it may not pay a dividend that exceeds 50 percent of its current net earnings without the prior approval of the Finance Board. Proposed § 934.3(a). If an FHLBank fails to maintain the REM after it has reached that target, it is prohibited from paying any dividend without prior approval of the Finance Board. Proposed § 934.3(b).

Position Summary

ACB strongly opposes the Proposed Rule and requests it be withdrawn and reissued as an Advance Notice of Proposed Rulemaking.

Excess Stock Limitation

ACB opposes the limits on excess stock for the following reasons:

- The excess stock provision treats Class B member stock as quick-take out capital rather than the stable source of permanent capital mandated by Congress in the Gramm-Leach-Bliley Act (GLBA)[2].

[2] Public Law 106-102, 133 Stat 1338 (November 12, 1999).

- The proposal assumes that FHLBanks' investments to ensure adequate liquidity in the FHLBank System are not mission related investments, when, in fact, the liquidity that these investments provide assures members access to ever-ready advances. The Proposed Rule implies that the acquired member assets (AMA) program is not a core mission of the FHLBanks, which is contrary to the Finance Board's own regulations.
- The excess stock restriction is a destabilizing shift in policy by the Finance Board. Having approved some FHLBank capital plans that utilize excess stock to capitalize AMA programs and other activities, the Finance Board is changing course without any factual and legal basis.
- ACB has advocated that the FHLBank System would be better served by a system that places greater reliance on membership and activity-based stock requirements to capitalize the FHLBank System, rather than on excess stock purchases. Nevertheless, the Finance Board approved a range for activity-based stock that began at zero, thus permitting excess stock in lieu of activity-based stock for the AMA programs. The Finance Board cannot now change the policy without first undertaking a rulemaking to change the capital regulations governing activity-based stock (12 CFR part 930), and permitting the FHLBanks to resubmit capital plans for approval.
- The rapidity with which FHLBanks must comply with the Proposed Rule is a grave concern. In order to meet regulatory requirements, FHLBanks may be required to liquidate assets at an imprudently quick pace or be required to substitute inferior forms of capital for excess member stock.
- The mandatory redemptions caused by the restrictions on excess stock will cause serious tax consequences for many member institutions, and impose a deadweight loss on FHLBank member institutions.

Prohibition on Stock Dividend

ACB opposes the prohibition on stock dividends for the following reasons:

- Dividends paid in the form of Class B stock arguably create the most stable form of member stock. It is not only subject to the five-year redemption requirement, but is among the last stock a member would seek to redeem because of the tax event that would be triggered.
- Stock dividends have for several decades enhanced the stability of the FHLBank System capital, while providing member institutions a valuable tax savings. Stock dividends clearly benefit both the FHLBanks and their members and should be retained as an option for FHLBanks.
- The Finance Board asked for comments on whether it would be appropriate to permit an FHLBank to pay stock dividends, as long as the FHLBank were in compliance with the excess stock restrictions. We do not believe that this is a realistic middle ground. In order not to run afoul of the excess stock limit, it is unlikely that any FHLBank would issue stock dividends.

Retained Earnings Requirement and Dividend Restriction

While ACB agrees that retained earnings are an essential component of capital for the FHLBanks, we oppose the REM requirement and the restrictions on dividends that are part of that requirement for the following reasons:

- The proposal on retained earnings fails to recognize that Class B stock is permanent capital, as provided by Congress in GLBA.
- The proposal incorrectly assumes that capital in forms other than retained earnings is not available to protect against losses.
- The methodology employed by the Finance Board in developing the REM is seriously flawed.
- Since the REM requirement fails to distinguish among the widely–varying relative risks of non-advance assets, the requirement could have the unintended consequence of encouraging the FHLBanks to hold riskier assets on their balance sheets.
- The proposal diminishes the individual cooperative owners' equity in the FHLBank System by transferring a substantial amount of earnings of the FHLBanks to the retained earnings accounts of the FHLBanks, permanently depriving the individual cooperative owners of their interest in those earnings.
- The proposal hinders the FHLBanks' ability to manage liquidity.
- The dividend restriction will result in a destabilizing increase in the cost of advances and other FHLBank services, over the intermediate term, with possibly long-term adverse consequences.
- The dividend restriction will cause large member institutions with funding choices to reduce their use of the FHLBank System, which, in turn, will reduce earnings and increase the costs of the FHLBanks.
- The reduction in dividend income and increase in costs of FHLBank services will have a disproportionately greater impact on small member institutions.
- The proposal fails to recognize that dividends are an essential component of a cooperative.

The Proposed Rule is Not Legally Supportable

ACB submits that the Proposed Rule does not comport with the laws governing the operation of the FHLBanks and the Finance Board for the following reasons:

- The Finance Board may not use its general safety and soundness authority to adopt de facto capital standards that trump the capital provisions that are explicitly set forth in statute.
- The Proposed Rule is inconsistent with the express provisions of the Bank Act, including the FHLBank capital provisions enacted in GLBA, that contain specific Congressional mandates regarding the capital structure for the FHLBanks.

- If the Proposed Rule were adopted in its current form, it would be deemed "arbitrary and capricious" under the Administrative Procedure Act[3] because they have no rational basis.
- If the Finance Board believes that the capital rules that it promulgated in 2001 to implement GLBA do not adequately protect the FHLBank System against risk, then the proper solution is for the Finance Board to initiate the process to revise those regulations in accordance with GLBA.

Background – Gramm-Leach-Bliley Capital Regime

It is important to place the Proposed Rule in its historical context. The proposal follows extensive work by both the Finance Board and the FHLBanks to put in place the new capital structure for the FHLBank System created by GLBA. That capital scheme included the development of individual capital plans for the 12 FHLBanks and the individual approval of those plans by the Finance Board.

In 1999, GLBA was enacted and made a number of changes to the structure and authorities of all entities in the financial services arena. Among the changes were fundamental organizational changes to the FHLBank System. Under Title VI of GLBA (the Federal Home Loan Bank Modernization Act), after decades in which federal savings associations were captive members, all membership in the FHLBank System became voluntary. The shift to an all-voluntary membership necessitated the development of a new capital structure. Other changes included a shift of authority for governance of the FHLBs to their boards of directors and away from their regulator, the Finance Board. An intended consequence was to make the FHLBanks more responsive to the business needs of the cooperative membership.

Because the FHLBank System is organized into 12 FHLBanks, the business of each of the FHLBanks focuses on the needs of its own members and the communities they serve. The local and regional emphasis on activities of the FHLBanks has enabled the FHLBanks and their members to provide extensive community support. The local nature of the focus of the FHLBanks led to differences in operation and business strategy. Further, although there are 12 FHLBanks, the Bank Act provides that there is joint and several liability for certain activities of the FHLBanks. This distinguishing feature of the FHLBank System leads to the result that every one of the 12 FHLBanks has an interest in the activities of each of the other FHLBanks.

As has been the case throughout its history, the FHLBank System continues today to be a critical source of funding for member institutions that are not large enough to obtain funding from other sources at prices that are affordable. As additional banks joined the FHLBank System, the GLBA capital provisions gave the FHLBank System greater flexibility to evolve to meet the needs of all members, while maintaining the cooperative structure and the critical source of liquidity. The banking supervisory agencies have

[3] 5 U.S.C. §§ 551 *et seq.*

recognized the importance of this source of liquidity for their regulated entities, both big and small.[4]

The differences in operating strategy of each of the FHLBanks was one of the reasons that rather than imposing a strict capital regime that contained the same elements for every FHLBank, the law provides that each of the FHLBanks adopt a capital plan that meets the needs of its membership, within the parameters of the statute and implementing regulations.

Another important change made as part of GLBA was the devolution of much of the organizational responsibilities for each of the FHLBanks to the FHLBanks themselves. The Finance Board retains safety and soundness oversight, but the individual FHLBanks' boards of directors are to determine the "rights, terms, and preferences" for each class of stock, consistent with 12 U.S.C. § 1426, with the regulations of the Finance Board, and with market requirements.

The board of directors of the each of the FHLBanks is comprised of elected representatives of member institutions and appointed directors representing other public interests. GLBA requires the boards of directors of the FHLBanks to adopt the capital plans within specified limits, subject to Finance Board review and approval.

In 2001, the Finance Board promulgated a capital standards rule that set forth in great detail the requirements of the risk-based capital and leverage rules to address the risks presented by the lines of business in which the FHLBanks were engaged, including the risks of investments in mortgages. That rule also established a process for Finance Board review and approval of a capital plan for each FHLBank.

Pursuant to that rule, in 2002 the Finance Board reviewed the individual capital plans by which each FHLBank would comply with the requirements of the Bank Act and the agency's implementing rule. During the development of the capital plans, each of the FHLBanks adopted plans that were within the parameters of the statute and regulations. Although the statute and regulations contain elements that are required for all FHLBanks, it also permits each of the FHLBanks some flexibility in establishing the capital structure of the FHLBank. As noted in more detail later in this comment letter, in approving the plans of the FHLBanks, the Finance Board necessarily approved each FHLBank's plan for using excess capital and retained earnings to satisfy its legal obligation to maintain "permanent capital" sufficient to meet all the FHLBanks' statutory and regulatory obligations.

The Finance Board has approved the capital plans for the 12 FHLBanks. Eleven of the 12 have implemented their plans. Despite this enormous effort, the Finance Board has proposed the current rulemaking as another layer of capital regulation on top of the

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[4] *See, for example,* Regulatory Handbook, Office of Thrift Supervision, Section 530 (December 2003), page 5. Attached as Appendix 1.

GLBA capital requirements, the regulations implementing the GLBA requirements and the 12 FHLBanks' capital plans. The proposals conflict with critical elements of GLBA, and the Finance Board has provided no explanation for its fundamental departure from the approvals it so recently granted the FHLBanks in connection with their capital plans.

ACB Opposes the Proposed Rule

Excess Stock Restriction

ACB opposes the limit on excess stock proposed in the Proposed Rule for the following reasons.

The Proposal Fails to Treat Member Class B Stock as Permanent Capital

The Finance Board's rationale for the excess stock restriction is highly speculative and ignores provisions of the law that make member stock a stable source of capital to protect the FHLBanks against losses. The Finance Board argues that excess stock is not stable because the FHLBanks have traditionally honored in a timely fashion requests of members to redeem stock before the end of the redemption period associated with the stock. The Finance Board argues that this practice could lead to capital instability, if an FHLBank were to experience large-scale requests to repurchase stock.

The Finance Board's assertion ignores several important features of the capital in the FHLBank System. In accordance with capital plans approved by the Finance Board, ten of the eleven FHLBanks that have completed the conversion process rely solely on Class B stock for member investments in the FHLBank System, and the eleventh FHLBank requires members to purchase Class B stock to meet activity-based stock requirements. GLBA provides that Class B stock is a form of permanent capital, which is redeemable in five years after redemption is requested. Although the Banks have the discretion to redeem before five years have elapsed, the five-year redemption period allows an FHLBank time to honor repurchase requests gradually and adjust its operations and balance sheet to meet the redemption requests and to minimize any impact.[5]

The Finance Board's argument assumes that the board of directors of an FHLBank would fail to utilize the full five-year redemption period in times of stress. Moreover, after the five-year redemption period, a board of directors of an FHLBank is restricted from redeeming stock under certain circumstances, which are described in more detail elsewhere in this letter.

[5] 12 U.S.C. §1426(e).

Additionally, the argument ignores the tools available to the Finance Board itself to handle cases of instability in individual FHLBanks.[6] The Finance Board has ample authority to step in and stop redemptions, in specific cases, whenever an FHLBank has incurred or is likely to incur losses that result in a charge against the capital of the FHLBank, or the FHLBank would fail to meet any capital standard after the redemption.[7] The Finance Board should not base a drastic change in policy on an assumption that the tools that Congress created to stabilize the capital of the FHLBank System will not be utilized.

The Finance Board further speculatively argues that if the board of directors of an FHLBank prudently delayed the redemption of stock as provided in the law, then member institutions' confidence in the FHLBank could be eroded. The argument ignores the fact that the members of the FHLBanks are knowledgeable investors and understand that FHLBanks have the right to delay redemption of the Class B stock for five years and that redemption is not available under the circumstances cited above. In fact, as part of each Bank's conversion to the GLBA capital regime, any member not wishing to convert its then existing stock to the new classes of stock was given the right to opt out of conversion and an opt-out deadline was set.[8] Prior to the opt-out deadline, each FHLBank was required to disclose to member institutions the terms under which the new Class A and Class B stock could be redeemed or repurchased, including the limitations on redemptions and repurchases in times of stress.[9]

The Finance Board's rationale for the excess stock restriction disregards what is obvious: (1) the vast majority of the FHLBank System capital consists of very stable Class B stock; and (2) Congress has given the boards of the FHLBanks and the Finance Board very powerful tools to stabilize FHLBank System capital in times of stress.

While the Finance Board uses as support for the proposed excess stock limitation a concern about stability, in fact the excess stock restriction itself has great potential to create capital instability in those FHLBanks with significant amounts of excess stock. The Proposed Rule potentially forces an FHLBank to repurchase any Class B excess stock over one percent of assets in 60 days, making the stock less permanent than even Class A stock, and prevents such an FHLBank from utilizing the full five-year redemption period. Moreover, while the intent of the Proposed Rule is to replace excess stock with retained earnings, the effect will be to force excess stock out quickly while retained earnings will accumulate slowly. The net effect will be to force capital out of the FHLBank System, having an immediate, direct and adverse effect on safety and soundness of the entire FHLBank System.

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[6] The Finance Board has demonstrated its willingness to use these tools. For example, in the case of the FHLBank Seattle, the Finance Board stepped in and stopped the redemption of member stock.
[7] 12 U.S.C. §1426(f).
[8] 12 CFR § 933.2(e).
[9] 12 CFR § 933.5(b)(1)(iii).

Indeed, the irony is that the overall impact of the proposal, and, particularly, the dividend restrictions on the FHLBanks that have not met the REM, is likely to shake members' confidence in the FHLBank System by increasing the overall costs of advances and other services, and lead to reduced use of the FHLBank System by members with alternative sources of funding.

About-Face in Policy

In connection with the post-GLBA capital plan approval process (and in other contexts), the Finance Board has approved the use of excess stock to capitalize investments in assets, including AMA programs. For example, the capital plan of the FHLBank of Cincinnati expressly used shared pooling of excess stock to capitalize its AMA program and a portion of its advances.[10] The Finance Board approved FHLB Cincinnati's plan on a 5-to-0 vote on November 13, 2002. The FHLBank of Cincinnati plan enhances the stability of the excess stock by paying dividends through the distribution of stock dividends. The tax benefits associated with stock dividends provide incentives to members to avoid redemption requests. Cincinnati also caps an individual member's use of pooled stock at $200 million worth of Class B stock. The FHLBank Cincinnati plan demonstrates that excess stock can be used effectively to capitalize AMA activities and advances without an adverse impact on safety and soundness. As explained more fully in our legal analysis below, the Finance Board cannot now reverse its decisions with respect to the affected FHLBanks based on some generalized, unsupported, system-wide safety and soundness concerns.

Mission Rationale is Flawed

The Finance Board cites as support for the excess stock limitation the use of excess stock to invest in not readily saleable assets (AMA assets) and money-market securities and other non-core mission assets used to earn arbitrage profits.[11] ACB disagrees with the assumptions that underlie this argument. The acquisition of money-market securities and similar highly liquid assets is fundamental to the mission of the FHLBanks. The FHLBanks provide community banks with efficient and quick access to liquidity. In order to maintain the ever-ready access to advances, the FHLBanks need the flexibility that these more liquid investments allow them. Moreover, ACB believes that the spread on such investments versus comparable FHLBank System liabilities is minimal and provides little incentive to arbitrage, contrary to the Finance Board's assertion.

The AMA programs are core mission activities under Finance Board regulations defining core mission activities.[12] In fact, the Finance Board has repeatedly argued this point, including in a lawsuit in which the legality of the AMA programs was challenged. In <u>Texas Savings and Community Bankers Ass'n v. Federal Housing Finance Board</u>, the

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[10] The capital plan of the FHLBank of Cincinnati is attached as Appendix 2.
[11] 71 Fed Reg 13308-13309.
[12] 12 CFR part 940.

federal court of appeals upheld the AMA programs based, in part, on a 1996 Finance Board Memorandum which states that the MPF program is "simply a method of empowering member institutions to channel funds into residential housing finance in a manner that is technically more sophisticated than, yet functionally similar to, that which occurs when a FHLBank makes an advance."[13]

It appears that the Finance Board has completely reversed its position, implying that the AMA programs are now to be considered non-core mission activities. The Finance Board has for more than a decade promoted AMA programs in the FHLBanks. It cannot now reverse the direction of the policy through restrictions on excess stock. If a change is warranted to the AMA program, the Finance Board must first undertake a rulemaking to propose changing its regulations defining core mission activities.

Capital Standards Should Be Amended

In the past, ACB has advocated that the FHLBank System would be better served by a system that places greater reliance on membership and activity-based stock requirements to capitalize the FHLBank System, rather than on excess stock purchases.[14] We argued that greater reliance on properly calibrated membership and activity-based stock creates a capital regime that grows and contracts organically with membership and usage of FHLB services. Members would then provide capital in a manner proportional to the risk-taking activities into which they require the FHLBank System to enter. The approach also reinforces the cooperative structure of the system by requiring ownership stakes that are proportional to usage and exposure of the FHLBank System.

The Finance Board cannot justify a draconian shift that would require a rapid adjustment to what amounts to a 180-degree reversal by the agency. Instead, having allowed the FHLBanks to hold zero activity-based stock against acquired member assets and having permitted the FHLBanks to capitalize the activity with excess stock purchases, the Finance Board cannot now change the policy without first undertaking a rulemaking to change the capital regulations governing activity-based stock[15] and permitting the FHLBanks to resubmit capital plans for approval.

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[13] *See, Texas Savings and Community Bankers Ass'n et al v. Fed. Housing Finance Bd.*, No. 98-50758, (5th Cir. 2000); *See also* Testimony of the Federal Housing Finance Board before the Subcomm. on Financial Institutions, Senate Banking Committee, September 9, 2003, "Under the AMA programs, a Bank may purchase mortgage assets from a member institution. The programs, like advances, provide member institutions liquidity for mortgage lending." Id. at 8. The testimony is attached as Appendix 3.

[14] *See, e.g.,* Letter from ACB to Ms. Elaine Baker, Board Secretary, Finance Board, dated November 17, 2000, Re: Capital Requirements for FHLBanks, 65 FR 43408 (July 13, 2000); and Letter from ACB and several state banking organizations to Ms. Elaine Baker, Board Secretary, Finance Board, dated April 16, 2001, Re: Capital Requirements for FHLBanks, 66 FR 14093, (March 9, 2001). Attached as Appendix 4. The FHLBank Cincinnati plan is consistent with this approach inasmuch as it does not rely on purchased excess stock to capitalize FHLBank assets, instead the plan relies on stock that becomes excess because an advance has been repaid or other obligation to hold activity-based stock has ended.

[15] 12 CFR part 930.

Additionally, as noted above, Class B stock requires no early redemption before its five-year redemption period ends. Therefore, any adjustments to excess stock and activity-based purchase rules as applied to AMA programs, to the extent warranted and subject to a rulemaking, should be permitted, at the discretion of the FHLBanks, over a phase-in period of five years.

Rapidity of Change in Policy is a Cause of Concern

The rapidity with which the Finance Board expects compliance with the excess stock restriction is in and of itself a concern. Notably, the Proposed Rule does not provide any period of transition. Instead, once the rule becomes effective, four of the 12 FHLBanks will immediately (or by the end of the quarter) be in non-compliance with the restriction. Those FHLBanks (and FHLBanks in the future that run afoul of the prohibition) would have 60 days to either correct the violation, or devise a plan, subject to Finance Board approval, to correct the violation.

We are concerned that the pace of correction anticipated by the proposal is likely to lead to an imprudently rapid liquidation of assets and restructuring of balance sheet assets at these four FHLBanks, and in the future, as other FHLBanks slip above the one percent mark. Additionally, the proposal could lead to the substitution of inferior forms of capital for equity in order to comply with the excess stock restriction.

Serious Tax Consequences for Member Institutions

The restrictions on excess stock will cause serious tax consequences for many member institutions. The Proposed Rule would force the early redemption of excess stock above one percent of assets, creating a taxable distribution for many members who otherwise likely would have chosen to hold the stock in anticipation of future borrowing or other FHLBank mission-related activity. The Finance Board estimated that as of December 31, 2005, there was approximately $2.44 billion in member stock at four FHLBanks in excess of the proposed limitation.[16] Although that estimate may not currently be accurate and, as a result, it is difficult to determine the extent of the tax liability for the members of the four FHLBanks, it is safe to say that the precipitous redemption of this stock will create a significant tax liability for those member institutions in the year the stock is redeemed.

Stock Dividend Prohibition

Proposed § 934.1(b) would ban the payment of dividends though the distribution of stock, or stock dividends. The Finance Board's reasoning for the prohibition as stated in the Proposed Rule is that, "Stock dividends, along with the sale of excess stock to

[16] Memorandum to the Directors of the Finance Board, from Stephen Cross and John Kennedy, dated March 1, 2006, as provided by the Finance Board on July 6, 2006, as part of the incomplete response to ACB's FOIA request. Attached as Appendix 5.

members, are the main causes of growth in excess stock on the FHLBanks' balance sheets."[17] ACB opposes the Proposed Rule because the use of stock dividends actually enhances capital stability and reduces member institutions' all-in cost of using the products of the FHLBanks.

Stock Dividends Enhance Capital Stability

Stock dividends enhance capital stability in the FHLBank System. Unlike cash dividends, stock dividends actually maintain the level of capital in an FHLBank. Stock dividends are not taxed until the stock is actually redeemed. The tax treatment associated with stock dividends provides an incentive for members to leave the stock in the FHLBank System. Moreover, the tax savings reduces members' net cost of using FHLBank advances and other services. Stock dividends clearly benefit both the FHLBanks and their members and should be retained as an option for FHLBanks.

Comment on Specific Question

The Finance Board asked for comments on whether it would be appropriate to permit an FHLBank to pay stock dividends, as long as the FHLBank were in compliance with the excess stock restrictions. We do not believe that this is a realistic middle ground. In order not to run afoul of the excess stock limit, it is unlikely that any FHLBank would issue stock dividends. ACB strongly believes the stock dividend option should be preserved, without qualification.

Proposal is an Arbitrary Change in Policy

For many years, several FHLBanks have customarily paid stock dividends to their members – with no adverse effects – in large part because of more flexible tax treatment accorded members receiving dividends in this manner. The use of stock dividends has occurred with the approval of the Finance Board and its predecessor, the Federal Home Loan Bank Board. For example, the Finance Board expressly approved the use of stock dividends in connection with the approval of capital plans after the passage of GLBA.[18] In fact, in 2005, seven of the 12 FHLBanks distributed stock dividends. It is arbitrary for the Finance Board to now prohibit stock dividends on a system-wide basis without a clearer justification for the change.

Retained Earnings Requirement

ACB agrees that retained earnings are an essential component of capital for the FHLBanks. However, ACB opposes the REM requirement and the restrictions on dividends that are part of that requirement for the reasons detailed below.

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[17] 71 Fed. Reg. at 13309.
[18] *See, e.g.,* the capital plan of the Federal Home Loan Bank of Cincinnati.

Fails to Treat Class B Stock as Permanent Capital

The Finance Board's primary policy rationale for the REM requirement is that only retained earnings can provide a cushion protecting against the risk of capital stock impairment. In part this is because the Finance Board treats Class B stock as something other than permanent capital, contrary to GLBA. As a result of the Finance Board's proposal, a manageable loss, accompanied by a "run" on Class B stock, could dramatically shrink the size and earning capacity of the FHLBank, magnifying what would be an otherwise manageable loss into one causing impairment of the remaining stock. The Finance Board's rationale does not properly take into account the tools provided under the law and regulations that protect the par value of member stock: five-year redemption period and the prohibition on redemptions in times of stress.

The five-year redemption period allows an FHLBank time to recover from losses or allows for an orderly unwinding of operations. Additionally, 12 U.S.C. § 1426(f) prohibits an FHLBank from redeeming or repurchasing stock, if the FHLBank or the Finance Board determines that the FHLBank has incurred or is likely to incur losses that result in or are expected to result in a charge against capital. Under the provision, the FHLBank cannot redeem or repurchase member stock while the situation continues, except with permission of the Finance Board. The provision absolutely prohibits any stock redemption or repurchase, if the FHLBank would fail any minimum capital requirement following the redemption. All of these provisions make Class B stock a real economic buffer against losses.

The Finance Board argues that Class B stock is not stable because the FHLBanks have traditionally honored requests to redeem stock prior to the expiration of the redemption period. The FHLBanks have the discretion to redeem stock before the end of the redemption period, and do so routinely in normal times. The Finance Board's argument is based on an assumption that an FHLBank's board of directors would ignore its duties in times of stress and redeem stock. It further assumes that the Finance Board itself would not exercise its authority to shutoff redemptions and repurchases, under the appropriate circumstances. A regulation with such far-reaching implications for the FHLBank System cannot be based on an assumption that every tool put in place by Congress to protect the capital of the FHLBank System will be ignored.

Incorrectly Assumes that Capital in Forms Other than Retained Earnings is Unavailable to Protect Against Loss

The Finance Board's proposal implies that retained earnings are the only form of capital available to protect against loss, at least with respect to risks associated with non-advance assets. The Finance Board also implies that risks of loss from the advance business can be readily absorbed if necessary by resort to collateral protection and confiscation of membership and activity-based stock purchases in the event of default on advances obligations. This idea of bifurcating different forms of capital to match against different forms of risk is faulty. Different forms of capital, while not identical, are highly fungible at the margin. It is incorrect to regard retained earnings as the only form of capital available to protect against risks arising from non-advance asset holdings, or the businesses that necessitate trading in such assets.

Unexpected losses from non-advance businesses could be absorbed against retained earnings, or could be absorbed by a reduction or suspension of dividend payments. In fact, over the history of the FHLBank System, losses have been addressed by one or both methods.

Absorbing a significant loss wholly or partly through a significant reduction in dividends requires evaluation of possible of impairment, but does not imply impairment, particularly in the case of FHLBank stock. The primary source of GAAP that should be used in accounting for FHLB stock is SOP 01-6 *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others.* SOP 01-6 provides that FHLBank and Federal Reserve Bank stock should be classified as a restricted investment security, carried at cost, and evaluated for impairment.[19] FHLBank stock is generally viewed as a long-term investment.

Accordingly, when evaluating FHLBank stock for impairment, its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The determination of whether the decline affects the ultimate recoverability is influenced by criteria such as the following:

- The significance of the decline in net assets of the FHLBanks as compared to the capital stock amount for the FHLBanks and the length of time this situation has persisted;
- Commitments by the FHLBanks to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBanks;
- The impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLBanks; and
- The liquidity position of the FHLBanks.

Despite the fact that FHLBanks have "suspended" dividend payments on occasion, member institutions historically have not had to recognize impairment on FHLBank stock, based on the above criteria. Holders of FHLBank stock historically have always recovered the par value of the stock, notwithstanding limited or suspended dividend payments for a certain time. These holders may have realized a lower return on investment, and perceived value, but based on experiences to date have not lost their initial investment. Dividends are not guaranteed, but are set quarterly based on profitability and other financial considerations.

[19]Each Federal Home Loan Bank has its own stock that is purchased by the members in its region. This stock cannot be sold to the public at large, nor can a person buy it from a stockbroker. Its classification as a restricted security should remove FHLB stock from the purview of FAS 115, and impairment analysis is determined primarily by using guidance in SOP 01-6.

The Finance Board fails to recognize the extent to which the total capital stock of the FHLBanks is available to absorb losses. This error has resulted in an excessive and erroneous focus on retained earnings as a sole means of absorbing certain potential losses, and a proposed solution that requires an unnecessarily high proportion of retained earnings in total capital.

Flawed REM Formula

In developing the REM formula in the Proposed Rule, the Office of Supervision prepared an overly simplistic analysis of the credit and market risks of FHLBank non-advance assets and then conducted a linear regression analysis based on a very limited number of observations over a short period of time (three quarters for the twelve FHLBanks, for a total of 36 observations.) In an undated memo, the Office of Supervision admits the less than precise nature of its REM formula and its scientific limitations, stating "The proposed REM formula principally reflects a *supervisory judgment* of an appropriate framework to set retained earnings levels at the 12 FHLBanks." (Emphasis added). [20]

ACB consulted an expert in economics and finance, Dr. James J. Clarke, to review the empirical analysis on which the Finance Board relied when it set the proposed REM formula. Dr. Clarke concluded as follows:[21]

> "The Finance Board is using a panel study to determine if variations in non-advance assets could account for differences in the credit and market risk exposures among the FHLBanks. In order to measure risky assets, the study uses as a proxy non-advance assets. To determine the credit risk, the study uses the Basel II Accord, which by the way, has not been implemented in the US and will not be implemented for a number years partially due to the concern over the methodology used for credit risk weighting. The study specifically uses the Internal Ratings Based Approach, which is one of the methods a bank can choose under Basel II. Under this method, the capital charge for each asset is based on maturity, credit rating or probability of default and the expected loss given default. The sum of these charges for all non-advance assets resulted in a risk-weighted measure of the credit risk exposure for each FHLBank in a given quarter.
>
> "In order to calculate the market risk, the Finance Board uses standard shock methodology based on parallel shifts in the yield curve. The three largest variations in capital are averaged and used to determine the measure of market

[20] Letter from Finance Board FOIA Officer to Patricia A. Milon, dated May 2, 2006, transmitting an undated memorandum from Finance Board Office of Supervision on the Proposed Retained Earnings Minimum. Attached as Appendix 6.

[21] Statement of Dr. James J. Clark on the Proposed Rule. Attached as Appendix 7.

> risk. Most of the FHLBanks are effectively matched on their advances, so if there is significant market risk, it is assumed to arise from the non-advance assets.
>
> "The credit and market risk exposure are summed for each FHLBank on a quarterly basis. The Finance Board performed a linear regression analysis using 12 Home Loan Banks and three quarters. Actually it appears to be a 3 by 12 panel study based on thirty-six observations. This is a relative small sample to achieve reliable results. Also, the regression itself appears flawed. The dependent variable is the risk exposure or the sum of the credit and market risk. The independent variable is the level of non-advance assets. But, the non-advance assets were used to determine the credit and market risk. The two variables are obviously going to be co-linear based on the definitions of the variables. The model's estimated coefficients are statistically significant. Well, of course they are, since the measure of risk was defined by the non-advanced assets, one would expect that the higher the amount of non-advanced assets the higher the risk. This is a tautology.
>
> "The model uses no control variables to adjust for differences between the FHLBanks, and there are large differences in the makeup of their non-advance assets; and the model has no control variables for the three time periods. The lack of control variable leads to questions concerning heteroscedasticity, which further reduces reliability of the statistical technique.
>
> "In conclusion, the model appears very naïve, and a rather simple theoretical basis for such a significant policy change. The change in policy offered by the Finance Board will have serious impacts on both the FHLBanks and member banks. One would expect a more robust analysis rather than a small sample regression analysis."

ACB concurs with this finding, and has been provided with no other information that can be used to justify the specific parameters of the REM, despite a Freedom of Information Act (FOIA) request and appeal to the Finance Board seeking whatever rationale might exist. Consequently, we conclude that those parameters, specifically the requirement that retained earnings equal $50 billion plus one percent of non-advance assets, constitute an arbitrary determination.

Proposal Diminishes the Cooperative Owners' Equity

Shareholders gain the benefits of ownership through the distribution of dividends, lower prices for FHLBank services, or a combination of both. Provided that the proposed build up of retained earnings is not intended to increase capital above statutory levels, a build up of retained earnings beyond prudent levels diminishes the value of the FHLBank shareholders' equity by transferring what would otherwise be member equity positions to the FHLBanks. The cooperative owners will never be able to recapture this equity.

Moreover, the Finance Board's proposal seeks to deprive the owners of their equity without a clearly articulated and supported rationale for doing so.

The FHLBank owners are particularly sensitive to a build up of retained earnings because of the federal government's history of expropriation of FHLBank earnings to fund the deposit insurance system. In 1987, Congress took $3 billion in retained earnings from the FHLBank System to fund the Financing Corporation. In 1989, Congress took $2.5 billion of retained earnings to fund the Resolution Funding Corporation (REFCORP).[22] Moreover, since 1989, part of the FHLBank earnings have been used to defease REFCORP bonds.[23] Currently, 20 percent of the FHLBanks earnings are used to pay REFCORP obligations. Although GLBA provides that the retained earnings of the FHLBank System belong to the Class B stockholders, a level of retained earnings beyond the statutory mandate and economic necessity could again tempt placement of an additional direct tax on the earnings of the FHLBanks.

Proposal Hinders FHLBanks' Ability to Manage Liquidity

In the past, the Finance Board has recognized the importance of managing liquidity risks, and in 2001 promulgated a rule that requires each FHLB to hold contingency liquidity in an amount sufficient to meet its liquidity needs for at least five business days without access to the consolidated obligation debt markets.[24] Most FHLBs, for prudential reasons, exceed this requirement. However, given the penalty the Proposed Rule imposes on such investments, FHLBanks will have incentives to reduce their liquidity investments to the bare minimum – a result that does not promote safety and soundness. In fact, the FHLBank of Topeka has indicated it will reduce its highly liquid money market assets to comply with the Proposed Rule.[25]

Dividend Restriction Will Result in a Destabilizing Cost Increase for Advances and Other Services

The REM requirement and the restriction on dividends will have a significant adverse impact on member institutions and will have great potential to create instability within the FHLBank System. At least one analyst estimates that the amount of forgone dividends over the first 18 to 36 months following the effective date of the Proposed Rule to be between $2 billion and $3.1 billion.[26] The FHLBanks will have to target an amount of retained earnings above the actual REM requirement because the consequences of falling out of compliance once the target is obtained. The proposal harms member institutions by decreasing member income and by increasing the all-in

[22] 71 Fed Reg 13310, footnote 9.
[23] 12 U.S.C. § 1441b.
[24] 12 CFR § 932.8.
[25] Statement of FHLBank Topeka on the Impact on Dividends of Proposed FHFB Regulation, April 10, 2006. Attached as Appendix 8.
[26] *Home Loan Capital Plan Impact Focused on Several Banks*, Jaret Seiberg,Stanford Washington Research Group, March 20, 2006. Attached as Appendix 9.

cost of advances and other FHLBank services. We estimate that the return on assets of the average member is likely to be reduced by about 3 basis points, the return on equity by about 40 basis points, and the all-in cost of advances to be increased by about 15 basis points.[27]

Impact on Large Member Institutions

The increase in cost of using the FHLBank System will lead to diminished use of the FHLBank System by large members. Large members with access to other wholesale funding sources will seek those alternatives and reduce their use of FHLBank advances and other services. Reduced use by the larger members will deprive the FHLBanks of a valuable source of earnings. The net result is that the proposal's dividend restriction frustrates the Finance Board's overall goal of increasing retained earnings. The FHLBanks with the largest retained earnings deficit under the proposal are the ones most likely to see a reduced presence of larger members. Moreover, those larger financial institutions that are eligible to borrow from more than one FHLBank may move their borrowing away from the FHLBanks with the largest retained earnings deficit to FHLBanks with no deficits or relatively smaller deficits. The shift will make it more difficult for those FHLBanks to comply with the REM requirement.

Smaller Institutions Hit the Hardest

The adverse impacts are significant for all users of the FHLBank System, but fall hardest on small financial institutions that rely on the dividend income that comes from FHLBank stock ownership and that are unable to access the markets directly for funding.

In an evaluation of the impact of the proposal on publicly traded financial institutions, one analyst estimated that smaller banks and savings associations could suffer a five percent reduction of net income until full dividends are restored.[28] Additionally, smaller institutions that are highly dependent on FHLBank advances have few alternatives during the period of dividend restrictions. They cannot easily raise additional deposits.

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[27] These estimates assume a dividend reduction of 50 percent, from 6 percent to 3 percent, a holding of FHLBank stock of about 1% of total assets, and that the borrowing member has to purchase additional FHLBank stock to support further advances. There are two member impacts, one reducing return on assets and equity of the member institution, and a second increasing the net cost of additional advances.

Dividend Restriction and Return on Assets: 1% of assets x 3% dividend reduction will reduce return on assets of 3 bp. Assuming a 7 percent capital ratio, return on equity is reduced approximately 40 bp.

Increase in advances cost:	6.25% = hypothetical original net advances cost
	0.15% = increased cost of advances from dividend restriction (from 5% FHLBank Stock Requirement x 3% 'give up' from dividend restriction)
Add together to get:	6.40%, Total Advances Cost

[28] *FHLB Capital Proposal Bigger Threat to Smaller Banks*, Jaret Seiberg; Stanford Washington Research Group, April 17, 2006. Attached as Appendix 10.

Moreover, they do not have the same access to wholesale funding as larger institutions. Because the dividend restriction will increase smaller banks' all-in cost of funding, they will become less competitive with their larger rivals.

The net effect is that these smaller institutions will end up bearing a relatively greater proportion of the cost of meeting the REM. The proposal could create a "free-rider" effect at the expense of the smaller banks. Once the REM requirements are met, and the dividend restrictions disappear, any larger member that previously reduced its use of the FHLBank System would be free to ramp up its use of the FHLBank System, taking advantage of the retained earnings base built up by the member institutions that stayed in the FHLBank System.

Dividends are a Fundamental Part of the Cooperative Business Model

The FHLBank System has operated as a cooperative since its inception. Cooperative owners share the net earnings of the enterprise through the distribution of patronage dividends. Patronage dividends not only allow the cooperative owners to share in the profits of the enterprise created by the owners' use of its services and products, but dividends also reduce the cost of those services and products. The distribution of patronage dividends is a fundamental part of the cooperative business model. Similar to other cooperatives, the distribution of dividends is a fundamental part of the cooperative structure of the FHLBank System. The Proposed Rule fails to recognize the role that dividends play in the FHLBank System's cooperative business model.

Impact on Affordable Housing Programs

The Proposed Rule would result in a decrease in funds available for the FHLBank affordable housing program (AHP). Under the Bank Act, each year the FHLBanks must contribute the greater of ten percent of their net earnings for the prior year or $100 million to the FHLBank AHP. Last year the FHLBanks contributed a total of $280 million to this program. As noted above, the Proposed Rule is likely to lead to reduced use of the system by larger member institutions with access to alternative sources of wholesale funding. As a result, the earnings of many of the FHLBanks would be reduced, which would reduce the funds available for the FHLBank AHP. We note that several housing groups and at least two prominent Members of Congress have raised concerns about the Proposed Rule's impact on the FHLBank AHP.[29]

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[29] *See, for example,* Comment Letter to Finance Board from the National Housing Conference, dated June 19, 2006; and Letter from House Financial Services Committee Chairman Michael G. Oxley and Ranking Member Barney Frank, dated June 30, 2006. Attached as Appendix 12.

The Proposal Is Not Legally Supportable

ACB submits that the Proposed Rule does not comport with the laws governing the operation of the FHLBanks and the Finance Board.

First, the Finance Board relies heavily on its general "safety and soundness" authority under 12 U.S.C. §§ 1422a(a)(3) and 1422b(a) as legal support for its proposals regarding retained earnings, excess stock and dividends. While safety and soundness supervision is critical to the regulation of all financial institutions, as a legal matter, we do not believe that the Finance Board's safety and soundness authority can be used to supplant or negate other sections of the Bank Act. In short, we do not believe that the Finance Board may use its general safety and soundness authority to adopt de facto capital standards that trump the capital provisions that are explicitly set forth elsewhere in the statute.

Second, ACB believes that portions of the Proposed Rule are inconsistent with the express provisions of the Bank Act that contain specific Congressional mandates regarding the capital structure for the Federal Home Loan Banks.

Finally, we believe that the Proposed Rule, if adopted in its current form, would be deemed "arbitrary and capricious" under the Administrative Procedure Act[30] because it has no rational basis.

Each of these points is discussed separately below.

The Proposed Rule Cannot Be Legally Justified under the Finance Board's General "Safety and Soundness" Authority

In attempting to justify its proposals, the Finance Board has relied primarily on the general grant of authority given by Congress in 12 U.S.C. §§ 1422a(a)(3) and 1422b(a) to ensure that the FHLBanks operate in a financially safe and sound manner. While safety and soundness is a crucial part of the Finance Board's supervision of the FHLBanks, the scope of that authority is not limitless. In particular, the specific capital standards that apply to the FHLBanks are set forth in 12 U.S.C. § 1426. Those capital standards reflect the choices made by Congress regarding capital. The Finance Board cannot properly invoke its safety and soundness authority to trump statutory capital requirements.

Congress could have, but chose not to, given the Finance Board authority to make a discretionary decision about the minimum level and composition of capital that each FHLBank should have. Instead, in GLBA, Congress decided to exercise its authority directly and to specify in detail the capital requirements with which each FHLBank must comply. It did not give the Finance Board discretionary authority to modify or ignore those rules if the agency came to believe, for policy reasons, that a different approach to capital might be preferable.

[30] 5 U.S.C. §§ 551 *et seq.*

For example, 12 U.S.C. § 1426(a)(2)(A) sets in statute the leverage requirement for each FHLBank at 5 percent total capital based on total assets. Retained earnings are used as part of the permanent capital allowed for the 5 percent calculation. The statute does not contain any other authority for the Finance Board to change make up of the leverage requirement of the FHLBanks -- which is exactly what the Proposed Rule seeks to do through use of general safety and soundness authority.

Similarly, 12 U.S.C. § 1426(a)(3) requires risk-based capital to be set by the Finance Board taking into account specific risks faced by each FHLBank. Indeed, as required by statute, the Finance Board in 2001 promulgated a capital standards rule that set forth in great detail the requirements of the risk-based capital and leverage rules to address the risks presented by the lines of business in which the FHLBanks were engaged, including the risks of investments in mortgages. In 2002, the Finance Board approved the individual capital plans under which each FHLBank would comply with the requirements of the Bank Act and the agency's implementing rule. The agency's separate approval of each capital plan was based on its review of the specific market-based risk and the leverage risk that each individual FHLBank faced and the approach that institution had developed to provide the permanent capital required to offset those risks. In approving the capital plans, the Finance Board necessarily approved each FHLBank's strategy for using excess capital and retained earnings to satisfy its legal requirement to maintain "permanent capital" sufficient to meet all its statutory and regulatory obligations.

Through the Proposed Rule, the Finance Board seeks to apply its safety and soundness authority to all FHLBanks on a system-wide, one-size-fits-all basis to require changes in the types and amounts of regulatory capital they must hold and the capital plans for each FHLBank that the Finance Board has approved.[31] These mandatory modifications to the current capital requirements for the FHLBanks are not tailored to the current capital position of an individual FHLBank, or to the lines of business in which it is engaged, or to the credit and interest rate risks it faces. The Finance Board would impose these new requirements without a particularized finding that a specific FHLBank's safety and soundness would be threatened if these changes in the composition of its regulatory capital were not required.

The Finance Board simply cannot, as a matter of law, ignore the express mandates contained in statute and use its more general "safety and soundness" authority to clear the way for a different policy approach to capital adequacy that the agency apparently prefers to the standards Congress actually enacted in GLBA.

[31] In its July 6, 2006 letter to ACB, the Finance Board released additional portions of a memorandum, dated March 1, 2006, from Finance Board staff (Stephen Cross and John Kennedy) to the Finance Board in which the staff recognizes that approval of the excess stock proposal would supersede the Federal Home Loan Bank of Chicago's approved capital plan. As discussed above, the capital plans were approved pursuant to requirements of GLBA. Attached as Appendix 12.

The Finance Board's Proposals Violate Other Explicit Statutory Provisions of the Federal Home Loan Bank Act and the Gramm-Leach-Bliley Act of 1999

ACB submits that none of the other legal rationales suggested by the Finance Board supports the substance of the proposal. In fact, the proposal is in direct conflict with the statutory capital requirements mandated by Congress.

Prohibition on Excess Capital Stock

In addition to its safety and soundness authority, the agency also relies upon its authority under the capital standards that permit the FHLBanks to issue capital stock "with such rights, terms and preferences not inconsistent with . . . [the Finance Board's] regulations." 12 U.S.C. § 1426(a)(4). Finally, the Finance Board justifies this proposal under its authority under 12 U.S.C. § 1426(a)(4) to determine the manner in which FHLBank stock may be sold or redeemed and to permit each FHLBank to issue Class A and Class B stock with various rights, terms and preferences. 71 Fed. Reg. at 13310.

Congress addressed "excess stock" in only one place in the Bank Act. 12 U.S.C. § 1426(e)(1) provides:

> A Federal home loan bank, in its sole discretion, may redeem or repurchase, as appropriate, any shares of Class A or Class B stock issued by the bank and held by a member that are in excess of the minimum stock investment required of that member. (Emphasis added).

12 U.S.C. § 1426(e)(3) further provides that an FHLBank may not redeem any excess Class B stock prior to the end of the five-year notice period, unless the member has no Class A stock outstanding that could be redeemed as excess.

By granting each FHLBank discretion to determine the amount of excess stock that it might repurchase at any time, the capital standard provision expressly authorizes each FHLBank to have "excess stock" outstanding and does not explicitly impose any limitation on its amount. If Congress had wanted to limit the excess stock outstanding for each FHLBank, it would presumably have done so in this section of the statute. Instead, Congress left the decision on redemption of any outstanding excess stock to each individual FHLBank.

Further, the excess stock proposal ignores the capital structure for the FHLBanks adopted by Congress in GLBA. In GLBA, Congress addressed capital adequacy by (1) authorizing the issuance of Class B stock, subject to a five-year redemption period; (2) establishing risk-based and leverage requirements geared to the particular investments an individual FHLBank holds; and (3) requiring individual FHLBanks to hold "permanent capital" – Class B stock or retained earnings – that Congress deemed sufficient to satisfy the capital requirements.

Thus, when the Proposed Rule asserts that some FHLBanks have relied on excess stock to capitalize balance sheet activities that are long-term in nature and not readily saleable, 71 Fed. Reg. at 13308, the Finance Board has ignored an important fact -- that through the capital standards established in 12 U.S.C. § 1426, Congress already has addressed directly the concern that an FHLBank might invest in long-term assets that would not be readily saleable.

Under the Finance Board-approved capital plans, ten of the eleven FHLBanks that have implemented their capital plans have only Class B stock outstanding, and the eleventh requires members to meet the activity-based requirement through the purchase of Class B stock. This means that the vast majority of the current capital in the FHLBank System has a degree of permanence that Congress deemed to be adequate to address the long-term risks presented by their investments.

The Finance Board's reliance on the "terms and conditions" language of 12 U.S.C. § 1426(a)(4) as authority to drastically limit excess stock is an attempt to use implementation tools to override of the explicit will of Congress as embodied in 12 U.S.C. § 1426. For example, if the Finance Board issued an across-the-board rule that purported to extend the minimum notice period for redemption of Class B stock from five to ten years under its "redemption" power or under the "rights, terms and preferences" clause, its action would clearly be contrary to the terms of GLBA. Its proposed across-the-board rule to prevent each FHLBank from exercising the "in its sole discretion" provision is no different.

Prohibition on Stock Dividends

The proposal to prohibit stock dividends is expressly tied to the limit of excess capital and necessarily falls if the excess capital proposal is not consistent with statute. See 71 Fed. Reg. at 13309 ("Stock dividends, along with the direct sale of excess stock to members, are the main causes of growth in excess stock on the FHLBanks' balance sheets.")

In any event, the Proposed Rule's proposal to prohibit all stock dividends, on a system-wide basis and under all circumstances, violates the explicit provisions of the Bank Act.

12 U.S.C. § 1426 does not expressly grant the Finance Board authority to limit the amount of stock dividends declared by the FHLBanks or to prohibit them altogether. The only provision of the capital standards addressing stock dividends is 12 U.S.C. § 1426(h)(2). It provides that a member of an FHLBank has "no right to . . . receive distribution of any portion of the retained earnings of the bank" except through "the declaration of a dividend or a capital distribution" by the FHLBank. (Emphasis added)

A stock dividend constitutes a "capital distribution" in the form of new shares of the FHLBank. Payment of stock dividends therefore is expressly authorized by 12 U.S.C. §

1426. Further, elsewhere in the capital standards, Congress adopted limitations that determine when an FHLBank may pay stock dividends. In particular:

> --the dividend must be consistent an FHLBank's capital plan approved by Finance Board; and
>
> -- an FHLBank may not distribute its retained earnings in any form if, following such a distribution, the bank would no longer meet all applicable capital requirements. Section 1426(h)(3).[32]

In light of the explicit Congressional decisions on the circumstances in which stock dividends may be paid, the Finance Board may not impose limits of its own creation on a system-wide basis without violating the capital standards. Moreover, the Finance Board has already approved the payment of stock dividends through its approval of the capital plans after the passages of GLBA. In 2005, seven of the 12 FHLBanks distributed stock dividends.

Mandatory Minimum Amount of Retained Earnings

To support its retained earnings proposal, the Finance Board relies primarily upon its authority to supervise the FHLBanks and to ensure that they are operated in a safe and sound manner. 12 U.S.C. §§ 1422a(a)(3), 1422b(a)(1). The agency states that a larger, mandatory level of retained earnings is justified under these provisions because of the safety and soundness and mission concerns that could result from the value of an FHLBank's stock falling below par value and because of the increased risks on the balance sheets of the FHLBanks since the existing rule was adopted. Id. at 13314.

As discussed above, ACB does not believe that the Finance Board's safety and soundness authority legally supports the Proposed Rule.

Moreover, the Proposed Rule directly conflicts with the express language of 12 U.S.C. § 1426. The legislative history of GLBA shows that Congress considered various ways in which to bolster the capital requirements applicable to FHLBanks, including requiring members to contribute capital that could not be withdrawn for various periods of time; creation of a risk-based capital requirement, in combination with a leverage ratio; and requiring a mandatory level of retained earnings in each FHLBank.[33] Congress

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[32] The Finance Board 's implementing rule, 12 C.F.R. § 931.4(b), tracks the statute. It provides:

> (b) *Limitation on payment of dividends.* In no event shall a Bank declare or pay any dividend on its capital stock if after doing so the Bank would fail to meet any of its minimum capital requirements, nor shall a Bank that is not in compliance with any of its minimum capital requirements declare or pay any dividend on its capital stock.

[33] See B-283453, Capital Structure of Federal Home Loan Bank System, letter from Thomas J. McCool, Director, Financial Institutions and Market Issues, GAO, to the Chairman and Ranking Member of the

ultimately decided to adopt a system with two components: (1) a new structure of permanent capital (Class B stock and retained earnings) to address the increased risks presented by the lines of business in which the FHLBanks were engaged; and (2) leverage and risk-based capital standards that were fine tuned to reflect the specific risks that each FHLBank faces.

Congress explicitly considered, but ultimately did not adopt, a requirement that the FHLBanks must maintain a minimum level of retained earnings. Congress determined instead to require that each FHLBank maintain "permanent capital" sufficient to satisfy risk-based capital and leverage standards. 12 U.S.C. § 1426(a)(3)(A).

Congress defined "permanent capital" to include the amounts paid by the FHLBank's members for its Class B stock and the retained earnings of the FHLBank. 12 U.S.C. § 1426(a)(5)(A). Rather than require a minimum level of retained earnings, Congress established a method of determining the overall level of "permanent capital" that each FHLBank must satisfy, but did not authorize the Finance Board to impose a mandatory allocation of capital between Class B stock and retained earnings on a system-wide basis. Congress instead gave each FHLBank discretion to determine, subject to Finance Board approval of its capital plan, the precise combination of Class B stock and retained earnings that it would utilize to satisfy its capital requirement.

The Proposed Rule also asserts that not all the FHLBanks have increased their retained earnings as quickly as the agency would have liked in response to an Advisory Bulletin it issued in 2003; that "there is a general lack of consistency among the FHLBanks' retained earnings policies and target retained earnings levels" under the capital plans that the Finance Board previously approved; and that the FHLBanks "manage arguably riskier balance sheets" than previously because of increased holdings of mortgage assets. 71 Fed. Reg. at 13311. As a legal matter, the Advisory Bulletin did not supplant the capital plans that the Finance Board had approved shortly before the Bulletin was issued. Moreover, 12 U.S.C. § 1426 does not require, nor envision, that there be "consistency" among the retained earnings policies of each FHLBank. 12 U.S.C. § 1426 grants each FHLBank discretion as to the combination of Class B stock and retained earnings that it will use to satisfy its capital requirements, subject to Finance Board approval through the capital plan process.

In addition to its safety and soundness authority, the Finance Board relies upon its authority under 12 U.S.C. § 1436 to justify the retained earnings requirement. That provision allows the Finance Board to direct an FHLBank "to establish such other reserves . . . as [it] shall require." The agency asserts that 12 U.S.C. § 1436 "does not limit the reasons for which it can require the FHLBanks to establish these additional reserves" and notes that historically, reserves required under this provision were included in retained earnings. 71 Fed. Reg. at 13314.

Subcommittee on Capital Markets of the House Banking and Financial Services Committee (Aug. 31, 1999) (summarizing prior GAO testimony). Attached as Appendix 13.

This assertion is not supportable, however, because the Proposed Rule does not propose the creation of a "reserve." Rather, it seeks to impose a mandatory allocation between the two statutory components of "permanent capital." If the proposal were implemented and unless the Finance Board intends to set the minimum leverage ratio at a level higher than that authorized by statute, an FHLBank would have no more permanent capital available to offset potential losses after the rule was implemented than under the current rules. There would only be a reallocation of capital between categories on the balance sheets of the FHLBanks.

The Proposed Rule Has No Rational Basis and is Therefore Arbitrary

ACB submits that the Finance Board has not provided sufficient rationale for the new limitations regarding retained earnings, excess stock and dividends. In some cases, the Proposed Rule itself undermines the Finance Board's justifications for the proposals.

In addition, the Finance Board also refuses to release information concerning the factual underpinnings and analysis of the Proposed Rule, and in one case has indicated that it has not performed any analysis at all of the impact of the Proposed Rule on the members of the Federal Home Loan Bank System.

FOIA Requests

On April 3, 2006, ACB submitted a FOIA request to the Finance Board for any documents and analyses prepared by the Finance Board that demonstrate the factual underpinnings of the numerical limitations on retained earnings and excess stock contained in the Proposed Rule.[34] The Finance Board released some documents that contained the flawed analysis discussed in the section on retained earnings above. The Finance Board withheld many more documents under the "deliberative exemption" contained in section 910.5(a)(5) of the Finance Board's regulations.[35]

ACB appealed this determination by the Finance Board on June 5, 2006, asserting that the deliberative exception does not cover factual documents. The Finance Board provided no response to the appeal request within the timeframe for response as required by the agency's own regulation at 12 CFR § 910.8. However, on July 6, 2006, the Finance Board by letter denied ACB's appeal, continuing to assert that the Finance Board would withhold responsive material under section 910.5(a)(5) of the agency's regulations.[36]

[34] ACB's original FOIA requested, dated April 3, 2006; Finance Board's second response, claiming exemptions for information, dated May 5, 2006; and ACB's Appeal of Determination, dated June 5, 2006. Attached as Appendix 14. The Finance Board's first response is found in Appendix 6, and the Finance Board's denial of ACB's appeal is found in Appendix 12.
[35] 12 CFR § 910.5(a)(5).
[36] The letter denying the appeal is found in Appendix 12.

The Analysis Released by the Finance Board Is Flawed and Does Not Support the Proposal

As discussed above, the Finance Board has released, in response to ACB's FOIA request, an undated document that sets forth a simplistic analysis of how the agency developed its retained earnings proposal. The document states that "the proposed REM formula principally reflects a supervisory judgment of an appropriate framework to set retained earnings levels at the 12 FHLBanks." This type of analysis does not support adoption of a rule that will have far-reaching consequences on the operations of the FHLBanks and their members. An agency cannot simply choose arbitrary limits to constrain the lawful operation of its regulatees.

The Proposed Rule Is Not Supported by the Finance Board's Statements

Significantly, the Finance Board admits in the Proposed Rule that all FHLBanks satisfy the capital standards and that the risk of insolvency is de minimis. Each FHLBank now operates under a capital plan approved by the Finance Board. Each FHLBank now maintains sufficient permanent capital to meet its regulatory requirements, as determined by the risk-based capital and leverage tests established by the Finance Board. The agency itself concedes that "its capital rules and the FHLBanks' overall capital levels remain adequate and the risk of capital insolvency at any FHLBank in the foreseeable future is *de minimis*." 71 Fed. Reg. at 13311. Accordingly, there is no basis for invocation of the agency's safety and soundness powers even assuming that authority could be used to change statutory capital standards.

Further, the safety and soundness rationale does not support what the Finance Board actually has proposed. The Proposed Rule does not seek to increase the amount of capital that each FHLBank holds, so it is difficult to understand why the Proposed Rule is needed at all. The Finance Board admittedly seeks only to change the composition of capital between its two permissible components. Since Congress determined that capital represented by Class B stock, with a five year notice requirement prior to redemption, was sufficient to support the long-term investments of the FHLBanks, the retained earnings proposal amounts to an agency effort to second guess the congressional policy decision reflected in Section 1426(a)(5) that either Class B stock or retained earnings could be used to support those investments.

In fact, the Proposed Rule contains provisions that would weaken the capital position of the FHLBank System as a whole. In a rule that invokes the agency's safety and soundness rationale to strengthen the capital of the FHLBanks, it is completely irrational to start with a provision that requires the FHLBanks to pay out billions of dollars to redeem excess capital stock, and then to require those FHLBanks to build up retained earning to compensate for the capital that the Finance Board required them to disperse.

Finally, the Finance Board fails to provide any explanation as to why the agency has dramatically shifted its policies regarding capital since 2001. The Proposed Rule represents a 180-degree shift from the well-crafted capital regulations adopted by the Finance Board in 2001, and the detailed process conducted in 2002, to approve the capital plans for each FHLBank. Under *Motor Vehicle Mfgrs. Ass'n v. State Farm Mut. Life Ins. Co.*, 463 U.S. 29 (1983), an agency is permitted to change its position on an issue, as long as it provides a rational explanation for its action. The Finance Board has not met this obligation in the Proposed Rule.

Conclusion

Thank you for the opportunity to comment on this important matter. As we have previously requested in our joint letter of June 16, 2006, we request that the Finance Board withdraw this proposal because of its potential significant negative impact on the FHLBank System and reissue an Advance Notice of Proposed Rulemaking that takes into consideration the policy issues and facts raised during this comment period. Should you have any questions, please contact Ike Jones at 202-857-3132 or ijones@acbankers.org.

Sincerely,

Diane Casey-Landry

Diane Casey-Landry
President & CEO

Appendices

Appendix 1. Regulatory Handbook, Office of Thrift Supervision, Section 530 (December 2003).

Appendix 2. FHLBank of Cincinnati Capital Plan approved November 13, 2002.

Appendix 3. Testimony of the Federal Housing Finance Board before the Subcommittee on Financial Institutions, Banking Committee, United States Senate, September 9, 2003.

Appendix 4. Letter from ACB to Ms. Elaine Baker, Board Secretary, Finance Board, dated November 17, 2000, Re: Capital Requirements for FHLBanks, 65 FR 43408 (July 13, 2000); and Letter from ACB and several state banking organizations to Ms. Elaine Baker, Board Secretary, Finance Board, dated April 16, 2001, Re: Capital Requirements for FHLBanks, 66 FR 14093, (March 9, 2001)

Appendix 5. Memorandum to the Directors of the Finance Board, from Stephen Cross and John Kennedy, dated, March 1, 2006, as provided to ACB by the Finance Board on July 6, 2006.

Appendix 6. Letter from Finance Board FOIA Officer to Patricia A. Milon, dated May 2, 2006, transmitting an undated memorandum from Finance Board Office of Supervision on the Proposed Retained Earnings Minimum.

Appendix 7. Statement of Dr. James J. Clark on the Proposed Rule and a description of qualifications of Dr. Clark.

Appendix 8. Statement of FHLBank Topeka on the Impact on Dividends of Proposed FHFB Regulation, April 10, 2006.

Appendix 9. Home Loan Capital Plan Impact Focused on Several Banks, Jaret Seiberg, Stanford Washington Research Group, March 20, 2006.

Appendix 10. *FHLB Capital Proposal Bigger Threat to Smaller Banks*, Jaret Seiberg, Stanford Washington Research Group, April 17, 2006.

Appendix 11. Comment Letter to Finance Board from the National Housing Conference, dated June 19, 2006; and Letter from House Financial Services Committee Chairman Michael G. Oxley and Ranking Member Barney Frank, dated June 30, 2006.

Appendix 12. Letter from Finance Board General Counsel to Patricia A. Milon, dated July 6, 2006, transmitting supplemental materials in response to ACB's FOIA appeal.

Appendix 13. Letter from Thomas J. McCool, Director, Financial Institutions and Market Issues, GAO, to the Chairman and Ranking Member of the Subcommittee on Capital Markets of the House Banking and Financial Services Committee (Aug. 31, 1999), on the Capital Structure of the Federal Home Loan Bank System.

Appendix 14. ACB's original FOIA requested, dated April 3, 2006; Finance Board's Second Response, claiming exemptions for information, dated May 5, 2006; and ACB's Appeal of Determination, dated June 5, 2006.

Appendices

Appendix 1.

Regulatory Handbook,
Office of Thrift Supervision, Section 530 (December 2003).

INTRODUCTION

Liquidity management is the ability to meet financial obligations at a reasonable cost in a timely manner. The essence of liquidity is having cash when you need it. Each association must maintain sufficient liquidity to ensure safe and sound operations.

Liquidity can be thought of as a reservoir of funds that management can readily access to meet funding requirements and business opportunities. Primary sources of liquidity include:

- Liquidity assets (surplus cash and assets that can be quickly converted into cash).
- Liquidity liabilities and unused borrowing capacity (an association's capacity to access the markets for deposits and other wholesale funds).

Liquidity risk is the risk of not having sufficient funds to meet deposit withdrawals and other financial commitments when due. As associations have become more dependent on wholesale funding to meet liquidity needs, liquidity risk has become largely synonymous with funding risk, that is, the risk of being unable to maintain or acquire funds at a reasonable price when needed.

Association-specific problems or systemic disturbances can trigger liquidity problems. Association-specific liquidity problems are usually the result of other problems within an association:

- Poor asset quality.
- Excessive interest rate risk.
- Inadequate capital.
- Operational problems.
- Inadequate cash flow planning.

Systemic liquidity problems may result from a major financial debacle, a crisis, or other catastrophic event.

Liquidity management involves balancing the trade-off between profitability and the risk of illiquidity. Although a high degree of liquidity may be a positive sign since it indicates a capacity to meet obligations and take advantage of business opportunities, too much liquidity in the form of cash and low-earning assets or expensive borrowings can reduce profitability. The key is to find the right balance between liquidity and profitability. That balance will change over time as economic and business conditions change.

Finding the right balance depends in part on management's ability to estimate and manage future cash flows. To manage liquidity, effective managers typically employ the following analytical techniques:

- Maturity gap analysis.
- Cash flow forecasting.
- Scenario planning.

Effective liquidity management, however, starts with the development of written policies and procedures, and the establishment of minimum acceptable levels of liquidity. These policies should clearly define an association's strategy for managing liquidity, delineate areas of management responsibility, and establish a process for measuring, monitoring, and managing liquidity. Each association should also have contingency plans for dealing with unanticipated cash flow disruptions or cash flow needs.

This Section provides an overview of the liquidity management process. It includes a brief description of the various sources of liquidity, a basic explanation of the various techniques for measuring liquidity and estimating future cash flow needs, and a guide for assessing the quality of risk management practices. The Section concludes with a list of early warning signals of potential liquidity problems.

SOURCES OF LIQUIDITY

Liquidity Assets

Savings associations often meet liquidity needs through the sale of liquid assets and the planned runoff of loans and investments. While in theory any asset can serve as a source of liquidity, associations must consider the length of time it takes to dispose of an asset and the price at which it can be sold. Unencumbered assets that an association can sell or borrow against with relative ease without appreciable loss are ideal sources of liquidity.

Liquid assets would generally include deposits with other financial institutions, money market instruments, and short-term, investment-grade securities. In addition, associations may consider as liquid assets other securities and loans that can easily be sold or are about to mature. Because of the time dimension of liquidity, an asset may be a source of liquidity if it matures or can be sold within the time horizon of the need for funds. But as a general rule, assets with shorter maturities or those with a higher quality are more liquid.

Cash and Deposits with Other Institutions

While cash is the essence of liquidity, the cash balances reported on an association's balance sheet are not necessarily available to meet a liquidity shortfall. While a minimum level of operating cash balances is needed for day-to-day transactions (for tellers and ATMs), other cash balances may be in the form of checks or drafts in the process of collection, and are unavailable. Typically only excess cash balances – balances over and above those needed for daily operations and scheduled payments – are considered to be a source of liquidity. However, generally associations do not hold large excess cash balances that are nonearning assets.

Money Market Instruments and Securities

As a practical matter, most associations view their portfolios of money market instruments and investment securities as a primary source of liquidity. Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Debt and Equity Securities, requires institutions to designate investment securities as either available-for-sale, trading, or held-to-maturity. Securities designated as available-for-sale or trading must be carried on the balance sheet at fair value. Securities designated as held-to-maturity are carried at amortized cost. Thrift Activities Handbook Section 540 discusses accounting for securities.

In general, associations may not sell securities in the held-to-maturity portfolio before maturity without "tainting" the entire portfolio – an event that would cause the entire portfolio of held-to-maturity securities to be reported at fair value. Management should be familiar with SFAS No. 115 and understand the circumstances when they may sell held-to-maturity securities without penalty of tainting. Moreover, management should carefully consider its liquidity needs before designating securities as either available-for-sale, trading, or held-to-maturity.

While the designation of a security as available-for-sale, trading, or held-to-maturity has certain consequences for accounting purposes, it has no bearing on whether the security is liquid in an economic sense. Whether an investment is liquid depends on how easily the holder can sell it in the market. Securities with tight bid-ask spreads are more liquid than those with wide bid-ask spreads.

Securitizations

With adequate planning and certain efficiencies, securitizations can create a more liquid balance sheet as well as leverage origination capacity. However, peculiarities related to certain transactions as well as excessive reliance on securitizations as a single funding vehicle may increase liquidity risk. For example, a concentration or over-reliance on securitizations as a funding source may increase liquidity risk if there are disruptions in the market.

Management should consider securitization's implications on its day-to-day liquidity management and on its contingency planning. Management should analyze the potential effect of securitizations on liquidity from an individual transaction perspective and on an aggregate basis. Associations should make the following determinations when contemplating a securitization transaction:

- The volume of securities scheduled to amortize during any particular period.
- The plans for meeting future funding requirements (including when such requirements may arise).
- The existence of early amortization or increased collateralization triggers.
- The alternatives available for obtaining substantial amounts of liquidity quickly.
- Operational concerns associated with reissuing securities.

In particular, associations that use securitizations to fund credit cards and other revolving credit receivables should prepare for the possible return of receivable balances to the balance sheet because of scheduled or early amortization. Such events may result in large asset pools that require balance sheet funding at unexpected or inopportune times. Management should also factor the maturity and potential funding needs of the receivables into short-term and long-term liquidity planning.

Exposure may also increase if an association minimizes securitization costs by structuring transactions at maturities offering the lowest cost, without regard to maturity concentrations or potential long-term funding requirements. Correlating maturities of incidental securitized transactions with overall planned balance sheet growth may somewhat mitigate this risk.

Associations that originate assets for securitizations may depend heavily on securitization markets to absorb its asset-backed security issues. If the association allocates only enough capital to support a "flow" of assets to the securitization market, it may experience funding difficulties if circumstances in the markets or at a specific institution were to force the association to hold assets on its books.

Associations should have adequate monitoring systems in place so that management is aware well in advance of a potential problem.

Mortgage Loans

As noted above, many savings associations view mortgage loans and other receivables that can easily be sold or are about to mature as liquid assets. In addition, associations with active loan securitization programs generally treat loans that they are about to sell as liquid assets. Because of the time dimension of liquidity, associations may consider an asset that matures or can be easily sold at a fair price within the time horizon of the need for funds as a liquid asset.

Pledged Assets

In assessing liquidity, it is important to know which assets have been pledged to secure borrowings or for other purposes. Pledged assets are not liquid. In addition, it is important to determine which assets are currently unpledged, eligible, and available as collateral to secure borrowings.

Liquidity Liabilities

As an alternative to liquid assets to satisfy liquidity needs, these needs may be met through liability sources such as wholesale borrowings and deposits. A savings association's ability to borrow or attract deposits in the markets is generally a function of its size, reputation, creditworthiness, and capital levels. Access to money markets also depends on prevailing market conditions.

Many financial institutions are increasing their use of wholesale funding, replacing lost retail deposits with funds provided by professional money managers. These funds, however, are generally more sensitive to credit risk and interest rates than retail funds, causing them to pose a greater liquidity risk to the association.

Retail Deposits

Deposits play a critical role in an association's ongoing successful operations. Management must protect deposit growth and should have an effective deposit management program. The program should regularly monitor the make-up of accounts to determine the amounts that are stable, fluctuating or seasonal, or volatile. Management should remain knowledgeable of the characteristics of the deposit structure using periodic internal reports. Lack of such knowledge could lead to the unwise use of funds and subsequent related problems.

Retail funding is supplied by the deposits a bank receives from the general public, individuals, and small businesses. Deposits are generally an association's primary (or core) funding source, and are typically a stable source of funds. These accounts usually maintain balances of $100,000 or less, to be fully insured by the FDIC. These accounts include demand deposit accounts (DDAs), negotiable order of withdrawal accounts (NOWs), money market demand accounts (MMDAs), savings accounts, and time certificates of deposit (CDs).

Historically, these accounts have not been very sensitive to an institution's credit quality or interest rates. Sensitivity may occur depending on the level of a customer's financial expertise, previous experiences, geographic location, and investment alternatives. Generally, retail and wholesale depositors behave differently under stress and changing economic conditions. A liquidity manager should distinguish between the two and track trends separately. In addition, a liquidity manager should track accounts that have balances in excess of FDIC insurance limits since those account owners will be more credit-sensitive than those with fully insured accounts.

Wholesale Funding

Borrowing sources that an association can access immediately, at a reasonable cost, and with a high degree of certainty are ideal sources of liquidity. Wholesale borrowings frequently have attractive features, and can, if properly assessed and prudently managed, facilitate the management of interest rate and liquidity risks. The initial cost of the borrowing is often low when compared to other liabilities with similar maturities. If the instrument contains embedded options, however, borrowing costs may increase under certain circumstances, and must be properly evaluated and managed.

Management should take the following actions if engaging in wholesale borrowings:

- Review borrowing concentrations. Determine whether an amount of borrowings from a single source poses an undue risk.
- Review borrowing contracts.
  - — Determine if there are any embedded options or other features that may affect the interest rate or pose liquidity risk.
  - — Review collateral agreements for fees, maintenance requirements, and triggers for increases in collateral.
- Review stress tests.
  - — Determine how to identify and monitor the risks of the various terms of each contract, including penalties and option features.
  - — Perform tests before entering into any agreement and periodically thereafter.
  - — Ensure that the stress test results depict the potential impact of contractual triggers and external events (such as interest rate changes that may result in the exercise of embedded options or the termination of the contract) on the association, as well as on its overall earnings and liquidity position.
- Review the use of complex borrowings on the association's interest rate exposure.
- Ensure that there are management processes in place to control liquidity and interest rate risks, and that they also have in place contingent funding plans.
- Fully inform the board of directors, or the asset/liability management committee about the risks of wholesale borrowing agreements prior to engaging in the transactions, as well as on an ongoing basis.
- Ensure that the instruments are consistent with the association's portfolio objectives and level of sophistication of its risk management practices. Only associations with technical knowledge and risk management systems sufficient to adequately identify, monitor, and control the risks of complex wholesale borrowings should use this type of funding.

Wholesale fund providers are professionals who manage most wholesale funds, and operate under established investment criteria. They may be associated with large commercial and industrial corporations, other financial institutions, governmental units, or wealthy individuals. Because their responsibility is to preserve their clients' principal, they are sensitive to changes in the credit quality of the institutions where they invest, as well as to changes in interest rates.

An association can use a variety of instruments to tap the wholesale funding markets. A brief description of some of these instruments is provided below. Depending on the side of a transaction that an association takes, some of these instruments may be either a source of asset liquidity or a source of liability liquidity.

Securities Sold Under Repurchase Agreements

Securities sold under repurchase agreements are a means of financing inventories of securities. Under repurchase agreements, securities are temporarily "loaned out," for periods ranging from overnight to one year in return for borrowed funds. The vast majority mature in three months or less. A standard repurchase agreement involves the acquisition of funds through the sale of securities with a simultaneous commitment to repurchase the securities on a specified date at a specified price. The collateral most often used by savings associations is U.S. government and agency mortgage-backed securities (MBS). The repurchase agreement rate is the interest rate that the borrower pays the lender (investor) for the use of funds.

Dollar Rolls

Dollar Rolls (also called dollar repurchase agreements) provide another alternative source of liquidity. Dollar rolls are agreements to sell and repurchase "substantially similar" but not identical securities. To qualify as a financing, these agreements to return "substantially similar" securities cannot exceed 12 months from the initiation of the transaction. Primarily, the dollar roll market consists of agreements that involve mortgage-backed securities.

Federal Home Loan Bank (FHLB) Advances

FHLB advances are an important source of funds for savings associations. Advance is simply another word for a loan. FHLBs offer a wide range of advance products with maturities ranging up to 10 years or longer. These products are primarily two types: collateralized advances and uncollateralized investments.

In general, a FHLB establishes a line of credit for each of its members. A FHLB may, however, limit or deny a member's request for an advance if the member is:

- Engaging in any unsafe or unsound practice.
- Inadequately capitalized.
- Sustaining operating losses.
- Deficient with respect to financial or managerial resources.
- Otherwise deficient.

FHLB advances are generally secured by collateral. Thus, the unused borrowing capacity of an association is a function of both its eligible, unpledged collateral and its unused line of credit with its FHLB.

Some FHLB advances contain embedded options or other features that may increase funding risk. For example, some types of advances, such as putable and convertible advances, provide the FHLB with the option to increase the interest rate on the advance under specified conditions. See TB 13a-2, Structured Advances, for more on the risks associated with certain FHLB advances.

A FHLB can often react quickly, sometimes before market information is available to other funds providers, to reduce its exposure to a troubled institution by not rolling over unsecured lines of credit. Depending on the severity of a troubled institution's condition, a FHLB may discontinue or withdraw (at maturity) its collateralized funding program because of concerns about the quality or reliability of the collateral or other credit-related concerns. This may create significant liquidity problems for an institution, especially if it has large amounts of short-term FHLB funding. Associations should aggregate FHLB funds by type of program to monitor and appropriately limit short-term liability concentrations, just as with any other credit-sensitive funds provider.

For FHLB borrowings, as with all borrowings to meet liquidity needs, an association should evaluate the level of its borrowings from any one source as well as the quality of the source. Management should perform adequate due diligence in selecting funding sources, and periodically review their quality and stability. An association should have contingency plans in place should a need arise for an alternative funding source.

Lines of Credit

An unused portion of a line of credit with another financial association can be an important source of liquidity, particularly if it represents a binding legal commitment to borrow without major restrictions on its use and the borrowing rate is reasonable.

Federal Reserve Primary and Secondary Credit

The Federal Reserve Board recently revised Regulation A to provide for primary and secondary credit programs at the discount window. Reserve Banks will extend primary credit at a rate above the target Fed Funds rate on a short-term basis (typically, overnight) to eligible depository_institutions. Eligibility for primary credit is based largely on an institution's examination rating and capital status. In general, institutions with composite CAMELS ratings of 1,2, or 3 that are at least adequately capitalized are eligible for primary credit unless supplementary information indicates their condition is not generally sound. Other conditions exist to determine eligibility for 4 and 5 rated institutions.

An institution eligible for primary credit need not exhaust other sources of funds before coming to the discount window. Institutions may use primary credit to finance the sale of fed funds. However, because of the above-market price of primary credit, the Board expects institutions to mainly use the discount window as a backup source of liquidity, rather than as a routine source.

Generally, Reserve Banks extend primary credit on an overnight basis with minimal administrative requirements to eligible institutions. Reserve Banks may also extend primary credit to eligible institutions for periods of up to several weeks if funding is not available from other sources. These longer extensions of credit are subject to greater administrative oversight.

The Reserve Banks also offer secondary credit to institutions that do not qualify for primary credit. Secondary credit is typically another short-term backup source of liquidity. Long-term secondary credit would be available for the orderly resolution of a troubled institution. In such a case, there are certain limitations and a higher level of Reserve Bank administration and oversight.

Federal Funds Purchased

Federal Funds Purchased are excess reserves held at Federal Reserve Banks that depository institutions may lend to one another. The most common type of federal funds transaction is an overnight, unsecured loan. Transactions that are for a period longer than one day are called term fed funds. In some instances, lenders may require that term fed funds transactions be made on a secured basis. If the borrower's creditworthiness is questionable, lenders may require excess collateral or may choose not to lend. Federal funds that are loaned (sold) are assets. Federal funds that are borrowed (purchased) are liabilities.

Treasury Tax and Loan Funds (TT&L)

TT&L account balances typically are not significant and therefore, do not present a material factor in assessing liquidity.

Brokered Deposits and Other Rate Sensitive Deposits

Brokered deposits and other rate sensitive deposits represent a convenient source of funds for depository associations that are in good financial condition. These deposits (including Internet, certificate of deposit listing services, and other automated services) may increase the volatility of the deposit portfolio if they are rate sensitive. Section 29 of the Federal Deposit Insurance Act (FDIA) generally prohibits any association that is not well capitalized from accessing the market for brokered or high rate deposits. Adequately capitalized institutions that wish to accept renew, or rollover brokered deposits or high rate deposits must first obtain approval from the FDIC. Undercapitalized associations cannot accept brokered deposits or high rate deposits at all. See the discussion in this section under "Troubled

Institutions." See also Handbook Section 560, "Deposits and Borrowings."

Eurodollar Time Deposits

Eurodollar Time Deposits are certificates of deposit issued by banks in Europe, with interest and principal paid in dollars. Interest rates are usually tied to LIBOR. These certificates of deposit usually have minimum denominations of $100,000 and have a short-term maturity of less than two years. An association should limit the volume of Euro-dollar CDs to control the liquidity risks associated with the secondary markets in these instruments.

MEASURING LIQUIDITY

The purpose of liquidity analysis is to measure an association's current liquidity position and its ability to meet future funding needs. An analysis of an association's *current liquidity position* generally involves a review of key balance sheet ratios, while the analysis of an association's ability to meet *future funding needs* involves an analysis of projected cash inflows and outflows.

Financial Ratio Analysis

The measurement of liquidity is an inexact and highly subjective process. This is largely due to the high degree of cash flow uncertainly associated with assets, liabilities, and off-balance-sheet contracts. In practice, analysts use a variety of financial ratios to measure the current liquidity position of an institution. Some ratios that measure liquidity include the following:

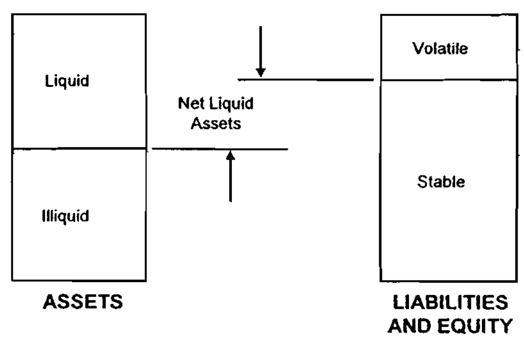
- Loans to deposits.
- Liquid assets to total assets.
- Volatile liabilities to total assets.
- Liquid assets to volatile liabilities.
- Net liquid assets to total assets.
- Unpledged eligible collateral to total assets.
- Net unused FHLB borrowing capacity to total assets.
- Unpledged collateral to net unused FHLB borrowing capacity.
- FHLB advances to FHLB Stock.
- Uninsured deposits to total deposits.

A key issue is defining liquid assets and volatile liabilities. Definitions vary depending on the objective or purpose of the analysis and data limitations. The time horizon of the analysis is particularly important in defining what is and what is not liquid. As a rule, liquid asset definitions include shorter-term assets that are readily saleable and assets that mature over the near-term. Some analysts define liquid assets to include the sum of cash, deposits with other associations, investment securities, and mortgage pool securities.

Volatile liabilities generally include wholesale and rate sensitive deposits and short-term liabilities that are likely to be withdrawn at the first hint of trouble. These forms of "hot money" include brokered deposits, uninsured deposits, federal funds purchased, securities sold under agreements to repurchase, and other borrowings with remaining maturities of less than one year.

The basic model for measuring current liquidity is shown in Figure 1. That model relates liquid assets to volatile liabilities. The difference between liquid assets and volatile liabilities represents the net liquidity position. (Liquid assets less volatile liabilities equals net liquidity position).

Figure 1. Static Balance Sheet Model



An association can improve its liquidity position in a number of different ways. For example, it can take the following actions:

- Increase holdings of high-quality liquid assets.
- Shorten the maturities of assets.
- Lengthen the maturities of liabilities.
- Diversify funding sources by maturity, geographic region, and by lender/depositor.
- Expand core deposits and other stable funding sources.
- Make loans that it can easily sell or securitize.

Successful liquidity management requires accurate measurement and control of the daily inflow and outflow of funds. Advance knowledge of liquidity shortfalls makes it possible to explore alternative ways to deal with them. Two useful techniques for monitoring cash flows are liquidity gap analysis and liquidity forecasting.

Liquidity Gap Analysis

A liquidity gap schedule provides an analytical framework for measuring future funding needs by comparing the amount of assets and liabilities maturing over specific time intervals. Table 1 below presents a sample liquidity gap schedule.

Table 1. Liquidity Gap Schedule

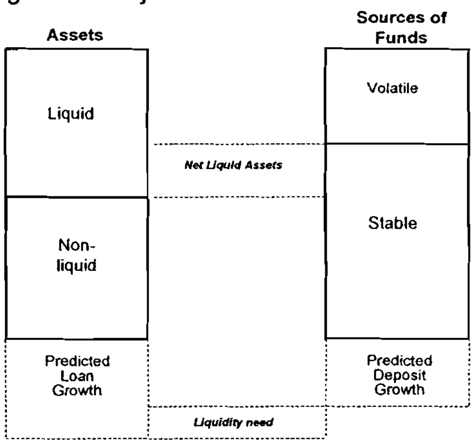
	Less than 10 days	Over 10 days but less than 3 months	Over 3 months but less 6 months	Over 6 months but less than one year	1 to 5 years	Over 5 years and capital	Total
Assets	10	10	10	5	65	0	100
Liabilities & Equity	50	30	15	0	0	5	100
Net outflow (assets minus liabilities)	(40)	(20)	(5)	5	65	(5)	0
Cumulative net outflow	(40)	(60)	(65)	(60)	5	0	0

In the liquidity gap schedule, assets and liabilities are slotted into different time intervals according to their remaining time to maturity. As a rule, the assets and liabilities are slotted according to their *effective* maturities rather than their *contractual* maturities. Nonmaturity deposits, for example, are generally treated as long-term liabilities (based on estimated run-off rates) rather than as short-term liabilities. In this example, more liabilities than assets mature in the earlier time intervals, indicating that the association is borrowing short and lending long, which is typical of most savings associations.

Negative gapping at the shorter end of the schedule (that is, borrowing short and lending long) increases the risk that the association will not be able to rollover maturing liabilities as they come due. While such a position is not favorable to liquidity, it tends to enhance profitability over the long-term – provided the association keeps the gaps within manageable bounds and the shape of the yield curve is not inverted.

One shortcoming of the liquidity gap schedule is that it does not capture projected balance sheet changes such as future loan and deposit growth. While it is important to understand the liquidity of an association's existing balance sheet, it is also important to forecast the growth of key balance sheet components, such as deposits and loans, over time. (See Figure 2.)

Figure 2. Projected Balance Sheet Model



Liquidity/Cash Flow Forecasting

Cash flow forecasting is a critical element in managing liquidity. The objective of cash flow forecasting is to project cash inflows and outflows over future periods. A common practice is to project net funds deficits for short-term (next 5-10 days) and long-term planning intervals (3-6 months, 6-12 months). By projecting cash flows for short- and long-term planning periods, management can significantly reduce the risk that sizable net funds deficits go unnoticed and unattended.

A sample forecast is presented in Table 2.

Table 2. Cash Flow Forecast

	Forecast 0-30 days	Forecast 31 –60 days	Forecast 61-90 days	Forecast 91-365 days
Cash Inflows:				
Deposits	$1,000	$1,200	$1,500	$20,000
Maturing loans and investments	600	1,200	1,800	9,000
Loan sales	0	0	0	0
Other	200	100	200	1,500
Total Inflows	$1,800	$2,500	$3,500	$30,500
Cash Outflows:				
Maturing deposits	800	900	1,000	3,500
Maturing debt	0	0	0	1,000
New Loans	900	1,500	1,600	15,000
Other	200	0	0	1,000
Total Outflows	$1,900	$2,400	$2,600	$20,500
Net Surplus (deficit)	($100)	$100	$900	$10,000
Cumulative net surplus (deficit)	($100)	0	$900	$10,900

LIQUIDITY MANAGEMENT

Each association should have a written strategy for the day-to-day management of liquidity. The liquidity strategy should define the association's general approach to managing liquidity, including various quantitative and qualitative targets. The liquidity strategy should cover specific policies on the composition of assets and liabilities, the use of wholesale funding, and strategies for addressing temporary and longer-term liquidity disruptions.

The sophistication of an association's policies, procedures, and information systems for managing liquidity should be related to the following items:

- Size and complexity of the association.
- Strength and stability of the association's core deposit base.
- The association's dependence on wholesale funding.
- Variability of the association's cash flows.
- Financial condition of the association.

Associations with deteriorating financial condition and/or declining exam ratings should increase attention to liquidity management and contingency planning.

Board and Senior Management Oversight

Effective oversight is an integral part of an effective liquidity management program. The board and senior management should understand their oversight responsibilities.

Board of Directors

The board of directors should establish the association's tolerance for liquidity risk, set liquid requirements, and approve significant policies related to liquidity management. The board should also ensure senior management takes the necessary steps to monitor and control liquidity risk. The board should understand the nature and level of the association's liquidity risk, and management should inform the board regularly of the liquidity position of the association.

Senior Management

Senior management should establish policies, procedures, and guidelines for managing and monitoring liquidity to ensure adequate liquidity at all times. Policies should include internal controls.

In addition, senior management should review the association's liquidity position on a regular basis and monitor internal and external factors and events that could have a bearing on the association's liquidity. Senior management should also prepare contingency funding plans.

Senior management should review periodically the association's liquidity strategies, policies, and procedures.

Policies and Procedures

A savings association should have clearly defined policies and procedures for managing liquidity. The board of directors has ultimate responsibility for the adequacy of policies and procedures; senior management has responsibility for their design and implementation. Polices and procedures should include the following:

- *Delineated lines of responsibility.* Identification of individuals or committees responsible for managing and monitoring liquidity risk.
- *An overall liquidity strategy.* The liquidity strategy should define the general approach the savings association will follow in managing liquidity, including various quantitative and qualitative targets. The liquidity strategy should cover specific policies on the composition of assets and liabilities, including policies on investment in illiquid securities and the use of wholesale funding. There should also be a written strategy for addressing temporary and long-term liquidity disruptions.
- *A process for measuring and monitoring liquidity.* Although associations can use a number of procedures for measuring and monitoring liquidity, the most effective pro-

cedures involve pro-forma cash flow projections. These range from simple calculations to complex models for projecting cash inflows and outflows over different planning periods (time bands) to identify cash shortfalls and surpluses in future periods. While liquidity measures based on balance sheet ratios are useful in measuring an association's current liquidity position and in monitoring trends in liquidity, management should focus its attention on forward looking, pro-forma measures of liquidity.

- *Quantitative guidelines and limits to ensure adequate liquidity.* Guidelines and limits will vary depending on the nature of an association's operations and circumstances. Associations could set guidelines, for example, on the size of cash flow mismatches over specified time horizons. Because of the subjective nature of the numbers in pro-forma cash flow projections, associations may find it impractical to establish precise risk limits or precise rules for addressing cash flow mismatches projected to occur in future periods. Nevertheless, an association should make an effort to define its tolerance for cash flow mismatches and should establish strategies for addressing them. Associations can also tie limits to balance sheet ratios. Examples include the following ratios:
  - Maximum projected cash flow shortfall tolerated for specified time (for example, one week ahead, one month ahead, one quarter ahead) as a percentage of liquid assets and unused borrowing facilities.
  - Minimum ratio of liquid assets to total assets.
  - Maximum overnight borrowings to total assets.
  - Maximum ratio of FHLB advances to total assets.
  - Maximum ratio of brokered deposits to total assets.
  - Maximum ratio of total wholesale borrowings to total assets.
  - Maximum ratio of pledged assets to total assets.
  - Maximum ratio of loans to deposits.
  - Maximum ratio of managed assets to total assets if the association securitizes assets.
- *Internal control procedures* to ensure adherence to policies and procedures that address the integrity of the liquidity risk management process. An effective system of internal control should promote effective operations, reliable financial and regulatory reporting, and compliance with relevant laws and institutional policies. Internal control systems should provide appropriate approval processes, limits, and ensure regular and independent evaluation and review of the liquidity risk management process. Such reviews should address any significant changes in the nature of the instruments acquired, limits, and controls since the last review. Internal control should include the following activities:
  - Procedures for approvals of exceptions to policies, limits, and authorizations. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to the process described in approved policies.
  - A schedule for the periodic review of the liquidity policies and procedures. Periodic reviews of the liquidity management process and related procedures should address any significant changes in liquidity risk limits, liquidity strategy, information systems, and internal controls since the last review.
  - Contingency Planning. Management should assess its responses to liquidity events in the context of their implications for an association's short-term, intermediate-term, and long-term liquidity profile. Contingency Plans are further discussed in this handbook section.

Management Information Systems

Each savings association should have adequate information systems for measuring, monitoring, and controlling liquidity risk:

- A management information system should provide timely information on the association's current and prospective liquidity position.
- Management should be able to project its liquidity position and liquidity requirements over various time horizons and scenarios.
- Management should clearly define assumptions used in projections so it can evaluate the appropriateness and validity of the projections.
- The information system should provide the data needed by management to determine compliance with the association's liquidity policies, procedures, and limits.

Measuring and Monitoring Liquidity

Each association should have a process for measuring and monitoring its existing liquidity position as well as its net funding requirements. Liquidity measurement involves forecasting cash inflows and outflows over various time horizons to identify potential cash imbalances. A cash flow forecast is a useful device to compare cash inflows and outflows on a daily basis and over future periods. Management should take steps to address projected net funding deficits in a timely manner.

Management and other staff responsible for managing overall liquidity should be aware of any information, such as a pending decline in earnings, an impending legal action, or a downgrade by a rating agency that could have an adverse impact on perceptions about the financial condition of the association.

Management should also consider conducting scenario analysis in estimating liquidity requirements. In conducting an analysis of liquidity, management should consider the following scenarios:

- Range of possible future scenarios, such as optimistic, pessimistic, and most likely. In estimating normal funding needs, some associations use historical data and account for seasonal and other effects believed to determine loan demand and deposit flows. Alternatively, some associations rely on judgmental business projections, or undertake a customer-by-customer assessment for larger customers and apply historical relationships to the remainder.
- Stressful events such as a loss of wholesale funding, a significant run-off of deposits, a sharp increase in funding costs, or a sharp increase in loan demand.
- Cash flow timing differences and the related assumptions among scenarios. For example, in a general market crisis, the capacity to sell assets may deteriorate significantly.
- The potential for unanticipated cash outflows and reduced cash inflows associated with embedded options in various assets, liabilities, and off-balance-sheet contacts. Potential cash outflows include loan commitments; calls on loans sold with recourse and financial guarantees; payments on swap contracts and other financial derivatives; margin calls; early termination agreements; and so forth.

Contingency Planning

Each association should have a contingency plan for handling unanticipated stressful scenarios that could result in a significant erosion of association-specific or general-market liquidity. Management should update the plan on a regular basis. A contingency plan should accomplish the following:

- Consistently planned use of liquidity sources with the association's stated purposes and objectives of its liquidity program.
- Identify and assess the adequacy of financial resources (source of funds) for contingent needs. The plan should identify all back-up facilities (equity lines of credit), the conditions related to their use, and the circumstances where the association might use them. Periodically, management should test all sources of its contingency funding with the goal of ensuring that there are no unexpected impediments or complications in case the association needs to use its contingency lines. Management should understand the various conditions, such as notice periods, that could affect access to back-up funding sources.

- Define responsibilities and decision-making authority so that all personnel understand their role during a problem situation.
- Identify the sequence that the association will mobilize and commit key sources of funds for contingent needs. The degree of uncertainty as to the magnitude and timing of availability of resources may call for different priorities in different situations.
- Address implementation issues such as procedures by which resources are committed for emergency use or released from one use and transferred to another.
- Identify other actions necessary in the event of an unexpected contingency.
- Assess the potential for funding erosion (magnitude and rate of outflow) by source of funds under different scenarios.
- Assess the potential liquidity risk posed by other activities such as asset sales and securitization programs.

A fundamental principle in designing contingency plans for liquidity purposes is to ensure adequate diversification in the potential sources of funds. Such diversification should not only focus on the number of potential funds providers but on the underlying stability, availability, and flexibility of funds sources in the context of the type of potential liquidity event.

Managing Access to Funding Sources

Savings associations should carefully manage their access to available sources of funding and understand their funding options:

- An association should build and maintain relationships with a broad range of depositors and other funding sources. An association should understand how much funding might be available from various sources under normal and adverse circumstances.
- Senior management should be aware of the composition, characteristics, and diversification of its funding sources.
- Management should consider developing or expanding markets for asset sales or exploring arrangements for borrowing against assets.

Liquidity Support Between Affiliates

An association within a holding company structure should be able to rely on liquidity support from other affiliates within the company. Transfers can usually be made quickly and easily, and typically include buying or selling Fed Funds, granting or repaying debt, or selling or participating in loans or other assets. Limitations on transactions with affiliates is an additional consideration.

Liquidity Risk of the Holding Company

The funding structure of a holding company may expose it to more liquidity risk than its subsidiary insured institution. A holding company cannot accept deposits, offer FDIC insurance to its funds providers, or rely on discount window liquidity support. Typically, it has no independent source of revenue, no liquid assets, and a leveraged balance sheet.

In some instances, liquidity may flow from the parent holding company to the subsidiary. Examples include a parent holding company placing excess cash in its subsidiaries or participating in certain loans.

A holding company in a liquidity crisis may not look to its subsidiaries for relief, and any upstreaming of value by a subsidiary to its parent holding company is highly regulated by federal statues and implementing regulations.

An association may not be insulated from its parent holding company's liquidity risks, particularly when both have similar names. If a parent holding company goes bankrupt, it will reflect on the association because depositors probably do not understand the legal distinctions between the two. See also Sections 300 and 600 of the Holding Company Handbook.

SUPERVISORY CONCERNS

OTS requires savings associations to maintain sufficient liquidity to ensure safe and sound operations (12 CFR § 563.161).

Early Warning Signals

Liquidity problems are often symptomatic of other more fundamental problems at an association such as excessive credit risk, excessive interest rate risk, inadequate capital, operational problems, and so forth. Factors that could indicate or precipitate liquidity problems include:

- Over-reliance on wholesale funding.
- A significant increase in the level of wholesale funding.
- Excessive borrowing concentrations.
- A sharp rise in funding costs.
- A ratings downgrade by credit rating agency.
- A sharp drop in earnings.
- An increase in nonperforming assets.
- A decline in capital adequacy category.
- Management problems.
- Adverse publicity.

Mortgage Banking and Loan Sale Activities

Associations engaged in mortgage banking activities and loan origination and sale activities must ensure that adequate lines of credit are available to meet warehousing needs and that there are adequate forward commitments to sell the loans in the pipeline. The association's liquidity planning should consider the effect of recourse and other credit enhancements from loans sold. You should review loan sale and servicing agreements to determine how credit enhancements and recourse obligations affect liquidity.

Federal Home Loan Bank Membership and Liquidity

Federal savings associations are no longer required to maintain membership in a FHLB pursuant to Section 5(f) of the Home Owners Loan Act (12 USC § 1464(f)). An association that voluntarily withdraws from FHLB membership is, however, subject to a prohibition on re-entry into membership for five years.

When examining a savings association that is not a FHLB member, you should determine if the association's existing liquidity position and its ability to borrow funds adequately address any liquidity concerns. As part of this determination you should review written plans, analyze the association's access to sources of funds, and assess management's evaluation of near-term and longer-term anticipated funding needs.

If the savings association is a member of a FHLB you should determine the size of its line of credit with the FHLB and how much unused credit is available under that line. See also discussion of FHLB advances in this handbook section.

Troubled Associations

There are restrictions on funding sources for troubled and undercapitalized insured institutions. These restrictions serve to reduce the ability of troubled or undercapitalized associations to obtain credit. Two of the restrictions include limited access to brokered deposits (12 CFR § 337.6) and restrictions on the amount of permissible credit exposure to a correspondent association (12 USC § 1831o(f)(2)(G). In addition, there are certain restrictions on borrowing programs available at the Federal Reserve discount window (12 CFR § 201.4).

Brokered Deposits

Section 29 of the FDIA significantly reduced the availability of brokered deposits as a source of liquidity by mandating restrictions on such deposits. The FDIC's implementing regulations, at 12 CFR § 337.6, set forth the following provisions:

- Well-capitalized institutions may accept brokered deposits without restriction.
- Adequately capitalized institutions must receive prior FDIC approval.
- Undercapitalized institutions may not accept brokered deposits.

See Handbook Section 560, Deposits/Borrowed Funds, for a detailed discussion of brokered deposit restrictions.

Limitations on Interbank Liabilities

Under FRB regulation 12 CFR Part 206, Limitations on Interbank Liabilities (Regulation F), insured institutions must establish and maintain written policies and procedures to prevent excessive exposure to any individual correspondent. The prevention of excessive risk exposure relates to the condition of the correspondent. Specifically, the regulation requires institutions to establish policies and procedures that take into account credit and liquidity risks, including operational risks, in selecting correspondents and terminating those relationships.

REFERENCES

Statutes

12 USC 1831f	Federal Deposit Insurance Act
12 USC 1831o	Prompt Corrective Action
12 USC 1467a	Regulation of Holding Companies
12 USC 371c	Banking Affiliates

Code of Federal Regulations (12 CFR)

Part 201	Extensions of Credit by Federal Reserve Banks
Part 206	Limitations on Interbank Liabilities
§ 337.6	Brokered Deposits
§ 561.31	Nonwithdrawable Account
§ 563.80	Borrowing Limitations
§563.140	Capital Distributions
§ 563.161	Management and Financial Policies
§ 563.172	Financial Derivatives
§ 563.176	Interest Rate Risk Management Procedures
§ 563b.520	Post Conversion Dividends
§ 563c.102	Financial Statement Presentation
§ 563d.1	Requirements Under Certain Sections of the Securities Exchange Act of 1934
Part 563g	Securities Offerings

Office of Thrift Supervision Bulletins

RB 34	Examiner Guidance on Wholesale Borrowings
TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivative Activities
TB 13a-2	Structured Advances

Interagency Guidance

CEO Letter No. 141 (July 13, 2001) – Joint Agency Advisory on Brokered and Rate-Sensitive Deposits (May 10, 2001)

Statement of Financial Accounting Standards

SFAS No. 115	Accounting for Certain Debt & Equity Securities

Appendix 2.

FHLBank of Cincinnati Capital Plan,
approved November 13, 2002.

FEDERAL HOME LOAN BANK
OF CINCINNATI

CAPITAL PLAN

Amended Capital Plan Approved by the Federal Housing Finance Board on November 13, 2002.

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Capital Plan of the
Federal Home Loan Bank of Cincinnati

ARTICLE I

PURPOSE

The purpose of this Capital Plan is to provide for the governance and the regulation of the capital structure of the Federal Home Loan Bank of Cincinnati, consistent with the requirements of the Federal Home Loan Bank Act, as amended, and the Regulations of the Federal Housing Finance Board under that Act.

ARTICLE II

DEFINITIONS

"Act" means the Federal Home Loan Bank Act, as amended, 12 U.S.C. § 1421, et seq.

"Activity Stock" means the actual number of shares of Class B Stock owned by a Member and used to capitalize, as applicable, the Member's three types of Mission Asset Activity with the FHLBank.

"Activity Stock Account" means the account maintained by the FHLBank on the FHLBank's books and records for each Member, which account reflects the actual number of shares of Activity Stock owned by the Member.

"Cancellation Fee" means the fee the FHLBank charges a Member when the Member cancels a Redemption Notice pursuant to Section VI.7.d. or a Withdrawal Notice pursuant to Section 8.b. or when a Redemption Notice automatically is cancelled pursuant to Section VI.7.e. of this Capital Plan.

"Cancellation Notice" means the written notice, substantially in the appropriate form prescribed by the FHLBank from time to time, given to the FHLBank by any Member to cancel a Redemption Notice or a Withdrawal Notice, as the case may be.

"Capital Plan" means this Capital Plan.

"Capital Requirements" means the minimum permissible capital to asset ratios to be maintained by the FHLBank under the Finance Board's capital rule.

"Charges Against the Capital of the FHLBank" means an other than temporary decline in the FHLBank's total equity that causes the value of the total equity to fall below the FHLBank's aggregate capital stock amount.

"Class B Stock" means the Class B Stock issued under this Capital Plan to the Members of the FHLBank.

"Effective Date" means December 30, 2002 (or such other date selected by the FHLBank which is not more than 12 months from the date this Capital Plan is approved by the Finance Board), on which date each Member's stock shall be converted on the books and records of the FHLBank into shares of Class B Stock.

"Excluded Mission Asset Activity" means the aggregate of the current unpaid principal balance and the current dollar amount of mandatory delivery contracts under the Mortgage Purchase Program purchased or traded, and recorded on the books and records of the FHLBank, as of the earlier of (i) the Effective Date; or (ii) a date determined by the FHLBank in its sole discretion. Notwithstanding any other provision of this Capital Plan, a Member's Excluded Mission Asset Activity shall be disregarded in all allocations of shares of Class B Stock to that Member's Membership Stock, Activity Stock and Member Excess Stock Accounts and in any calculation of that Member's Required Shares of Membership Stock and Activity Stock. No Member shall be required to purchase any shares of the FHLBank's capital stock to capitalize its Excluded Mission Asset Activity.

"FHLBank" means the Federal Home Loan Bank of Cincinnati.

"FHLBank Excess Stock" means the total par value (or resulting number of shares) of Class B Stock owned by all Members minus the sum of (i) the par value of Class B Stock allocated by the FHLBank to the Members' Membership Stock Accounts, (ii) the total of the par value of Class B Stock resulting from multiplying each type of Members' Mission Asset Activity by its applicable Maximum Allocation Percentage, (iii) the par value of shares of Member Excess Stock which are reserved for Members' exclusive use as provided in <u>Section VI.5.c.</u> and (iv) the par value of shares of Member Excess Stock which are the subject of outstanding Redemption and Withdrawal Notices.

"FHLBank's Board" means the Board of Directors of the Federal Home Loan Bank of Cincinnati.

"Finance Board" means the Federal Housing Finance Board.

"Maximum Allocation Percentage" means for each Member and for each type of Mission Asset Activity, the highest permissible percentage (as established pursuant to <u>Section VI.4.a.iii.</u>) of the Member's par value of Class B Stock in its Activity Stock Account allocated to support that type of Mission Asset Activity.

"Maximum Dollar Amount" means the maximum par value of FHLBank Excess Stock that may be designated by the FHLBank to capitalize the total of all types of a single Member's Mission Asset Activity.

"Member" means an institution that has been approved for membership in the FHLBank and has purchased the requisite number of shares of Class B Stock to satisfy such institution's Membership Stock Account.

"Member Excess Stock" means the total par value (or resulting number of shares) of Class B Stock owned by any Member minus the sum of (i) the par value of Class B Stock allocated by the FHLBank to the Member's Membership Stock Account; and (ii) the total of the par value of Class B Stock resulting from multiplying each type of the Member's Mission Asset Activity by its applicable Maximum Allocation Percentage. If this calculation results in a negative number, the FHLBank shall, for internal bookkeeping purposes only, show a negative number of shares of Excess Stock for the Member; however, the Member's Member Excess Stock Account shall reflect that the Member actually owns no shares of Member Excess Stock.

"Member Excess Stock Account" means the account maintained by the FHLBank on the FHLBank's books and records for each Member, which account reflects the actual number of shares of Member Excess Stock owned by the Member.

"Membership Stock" means the actual number of shares of Class B Stock owned by each Member as is required to become a Member or to maintain membership status with the FHLBank.

"Membership Stock Account" means the account maintained by the FHLBank on the FHLBank's books and records for each Member, which account reflects the number of shares of Membership Stock owned by the Member.

"Minimum Allocation Percentage" means for each Member and for each type of Mission Asset Activity, the lowest permissible percentage (as established pursuant to Section VI.4.a.iii.) of the Member's par value of Class B Stock owned and in its Activity Stock Account allocated to support that type of Mission Asset Activity.

"Mission Asset Activity" means the following three types of Member activity: (i) the unpaid principal balance of advances, (ii) funds and rate advance commitments and (iii) the unpaid principal balance of purchases of mortgage loans and mandatory delivery contracts under the

Mortgage Purchase Program, in each case as held on the books and records of the FHLBank. Mission Asset Activity does not include Excluded Mission Asset Activity.

"Opt-Out Date" means October 31, 2002 (or, if the Effective Date is a date other than December 30, 2002, the date which is 60 days prior to the Effective Date), which shall be the last date by which a Member's Opt-Out Withdrawal Notice must be received by the Finance Board and the FHLBank in order for the Member's existing shares of FHLBank capital stock not to be converted to Class B Stock on the Effective Date.

"Opt-Out Withdrawal Notice" means the written notice, substantially in the form prescribed by the FHLBank, required to be submitted to the Finance Board and the FHLBank by a Member to withdraw as a Member of the FHLBank and to have its shares of FHLBank capital stock redeemed on the Effective Date in accordance with this Capital Plan, the Act and the Regulations.

"Permanent Capital" means the retained earnings of the FHLBank, determined in accordance with accounting principles generally accepted in the United States (GAAP), plus the amount paid-in for the FHLBank's Class B Stock.

"Redemption Notice" means the written notice, substantially in the form prescribed by the FHLBank from time to time, required to be submitted by a Member intending to redeem shares of its Class B Stock. Unless it has been cancelled, a Redemption Notice shall become effective at the end of its Redemption Period.

"Redemption Period" means the five- (5-) year period beginning on the date a Redemption Notice is received by the FHLBank.

"Regulations" means the Code of Federal Regulations Title 12 - Banks and Banking Chapter IX - Federal Housing Finance Board. Reference to any particular Section of the Regulations means that Section as it may be amended from time to time or such other applicable successor Section, rule, order or procedure then in effect.

"Required Shares" means the total number of shares of Class B Stock actually owned by a Member pursuant to this Capital Plan in the Member's Membership Stock Account and Activity Stock Account and shall not include any shares of Member Excess Stock or FHLBank Excess Stock.

"Risk-Based Capital Requirement" means the dollar-amount sum of the FHLBank's credit risk, market risk, and operations risk, to be measured by the FHLBank in accordance with the rules and Regulations of the Finance Board.

"Stock Dividend" means the dividends declared by the FHLBank's Board and paid to Members in the form of additional shares of Class B Stock.

"Total Assets" means a Member's total assets as disclosed by the Member pursuant to applicable industry standard regulatory reporting requirements.

"Withdrawal Notice" means the written notice, substantially in the form prescribed by the FHLBank from time to time, required to be submitted by a Member intending to withdraw as a Member of the FHLBank. Unless it has been cancelled, a Withdrawal Notice shall become effective at the end of its Withdrawal Period.

"Withdrawal Period" means the five- (5-) year period beginning on the date a Withdrawal Notice is received by the FHLBank.

ARTICLE III

FHLBANK DIRECTORS' ELIGIBILITY, APPOINTMENT, AND ELECTIONS

1. Designation of Elective Directorships. There shall be at least fourteen (14) directors on the FHLBank's Board. Of that number, at least eight (8) will be elective directors. The Finance Board shall conduct the annual designation of directorships for the FHLBank based upon the number of Required Shares determined by the FHLBank to be owned by the Members in each state based upon each Member's position as of December 31 of the preceding calendar year. Each Member shall be entitled to vote with respect to those elective directorships designated by the Finance Board to represent the state in which the Member is organized and/or located.

2. Number of Votes. For each directorship that is to be filled in an election, each Member located in the state to be represented by such directorship shall be entitled to cast one vote for each Required Share of Class B Stock determined by the FHLBank to be owned by the Member based upon its position as of December 31 of the preceding calendar year; provided, however, that the number of votes any Member may cast for any one directorship shall not exceed the average number of the Required Shares determined by the FHLBank to be owned by all Members located in that state, based upon each Member's position as of December 31 of the preceding calendar year.

ARTICLE IV

MEMBERS OF THE FHLBANK

1. In General. Any building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, savings bank, or any insured depository institution (as defined in Section 1422 of the Act) shall be eligible to be or become a Member of the FHLBank, provided such institution:

a. is already a Member of the FHLBank in good standing; or

b. is duly organized under the laws of (i) the United States, (ii) the states of Kentucky, Ohio or Tennessee or (iii) such other states as are located within the FHLBank's district; and

c. is subject to inspection and regulation under the banking laws, or under similar laws, of the state in which it is organized and/or located or of the United States; and

d. makes such home mortgage loans as, in the judgment of the Finance Board, are long-term loans (except that in the case of a savings bank, this Section IV.1.d. shall apply only if, in the judgment of the Finance Board, such savings bank's time deposits, as defined in Section 19 of the Federal Reserve Act, warrant making such loans); and

e. has a financial condition such that advances may be safely made to such institution; and

f. the character of its management and its home-financing policy are consistent with sound and economical home financing.

2. Additional Eligibility Requirement for Insured and Non-Insured Depository Institutions. An insured depository institution other than a community financial institution must have at least ten percent (10%) of its Total Assets in residential mortgage loans. A non-insured depository institution must have mortgage-related assets that reflect a commitment to housing finance as determined by the Finance Board in its discretion.

3. Ownership Rights. The FHLBank's retained earnings, surplus, undivided profits, and equity reserves are owned by the holders of the FHLBank's Class B Stock. Each such item is allocated to those holders according to each holder's proportionate share of total Class B Stock. The holders' interest in such items will be realized at the time the FHLBank is liquidated, or periodically as declared by the FHLBank through dividend (pursuant to Section VI.5.b.) and/or capital distributions, and then only to such holders as are currently holding shares of Class B Stock in proportion to each holder's then current Class B Stock holdings.

ARTICLE V

FHLBANK CAPITAL REQUIREMENTS

1. Risk Management. Before this Capital Plan may take effect, the FHLBank shall obtain Finance Board approval of the market risk model to be used by the FHLBank to calculate the market risk component of its risk-based capital requirement, and for the risk assessment

procedures and controls (whether established as part of its risk management policy or otherwise) to be used to manage the FHLBank's credit risk, market risk, and operations risk.

2. Total Capital Requirements. The FHLBank shall maintain at all times: (a) total capital in an amount at least equal to four percent (4%) of the FHLBank's total assets; and (b) a leverage ratio of total capital to total assets of at least five percent (5%) of the FHLBank's total assets. For purposes of determining the leverage ratio, total capital shall be computed by multiplying the FHLBank's Permanent Capital by one hundred fifty percent (150%) and adding to the product thereof all other components of capital. The FHLBank acknowledges the Finance Board may from time to time adjust the Capital Requirements, and if it does so, this Section V.2. shall be deemed to automatically be amended to reflect the same.

3. Risk-Based Capital Requirement. The FHLBank shall maintain at all times Permanent Capital in an amount at least equal to the sum of its credit risk capital requirement, its market risk capital requirement, and its operations risk capital requirement, calculated in accordance with the rules and Regulations of the Finance Board.

4. Credit Risk Capital Requirement. The FHLBank's credit risk capital requirement shall be equal to the sum of the FHLBank's credit risk capital charges for all assets, off-balance sheet items and derivative contracts in compliance with the rules and Regulations of the Finance Board.

5. Market Risk Capital Requirement. The FHLBank's market risk capital requirement shall equal the sum of: (i) the market value of the FHLBank's portfolio at risk from movements in interest rates, foreign exchange rates, commodity prices, and equity prices that could occur during periods of market stress, where such market value of the FHLBank's portfolio at risk is determined using an internal market risk model that shall be approved by the Finance Board; and (ii) the amount, if any, by which the FHLBank's current market value of total capital is less than eighty-five percent (85%) of the FHLBank's book value of total capital, where: (A) the current market value of the total capital is calculated by the FHLBank using the internal market risk model approved by the Finance Board; and (B) the book value of total capital is the same as the amount of total capital reported by the FHLBank to the Finance Board under §932.7 of the Regulations.

6. Operations Risk Capital Requirement. Except as approved by the Finance Board, the FHLBank's operations risk capital requirement shall at all times equal thirty percent (30%) of the sum of the FHLBank's credit risk capital requirement and market risk capital requirement.

ARTICLE VI

CAPITAL STOCK

1. Issuance of Stock. The capital stock of the FHLBank may be issued only in accordance with Section 931.2 of the Regulations and only to Members of the FHLBank and may be held only by Members and, as provided in Section VI.8.d., former Members of the FHLBank. The FHLBank shall initially issue one class of capital stock, Class B Stock, as such stock is defined by the Act. There shall be no Class A Stock, as such stock is defined in the Act, or subclasses of Class B Stock issued. Subject to Section III.2, all shares of Class B Stock shall have the same rights and preferences. Each share of Class B Stock shall be issued at a par value of One Hundred Dollars ($100) per share. The FHLBank shall be entitled to issue an unlimited number of shares of Class B Stock. Any shares of Class B Stock which are repurchased, redeemed or otherwise reacquired by the FHLBank shall be deemed cancelled and subsequently may be reissued. The FHLBank reserves the right to authorize the issuance of Class A Stock and/or subclasses of Class B Stock, subject to Finance Board approval. A Member shall not be permitted to purchase shares of Class B Stock other than as set forth in this Capital Plan. Shares of the FHLBank's capital stock shall not be certificated, but rather held in book entry form on the records of the FHLBank. The FHLBank shall serve as transfer agent for all shares of its capital stock on its capital stock register. Any transactions affecting the FHLBank's capital stock register shall be made and deemed effective at the end of the applicable business day.

2. Allocation of Class B Stock. Each Member's Class B Stock shall be allocated by the FHLBank to one (1) of three (3) distinct accounts: a Membership Stock Account, an Activity Stock Account, and a Member Excess Stock Account. Each share of Class B Stock may be allocated to only one (1) of the three (3) distinct accounts at a time; and a Member's total number of shares of Class B Stock shall be determined by adding the number of shares of Class B Stock in each of the Member's three (3) distinct accounts. Additionally, each share of Class B Stock allocated to a Member's Activity Stock Account may be allocated to only one (1) of the three (3) distinct types of Mission Asset Activity at a time. Shares may be reallocated from time to time among the types of Mission Asset Activity as the Member's activity changes. A Member's shares of Class B Stock (whether acquired on the Effective Date or later acquired through purchase or by Stock Dividend) shall be first allocated to its Membership Stock Account. Once a Member's Membership Stock Account requirement is satisfied, the Member's remaining Class B Stock shall be next allocated to its Activity Stock Account, and then to its Member Excess Stock Account. Transfers made between and among the accounts for any particular Member shall be made by the FHLBank based upon the following rules:

a. Membership Stock Account. Membership Stock is the actual number of shares of Class B Stock owned by a Member as required to become a Member of or to retain membership status in the FHLBank. The number of shares of a Member's Class B Stock allocated to the Member's Membership Stock Account shall be calculated as a percentage, or range of percentages, of the Member's Total Assets and shall be determined by the FHLBank yearly or more frequently as directed by the FHLBank's Board, in accordance with Section VI.4.a.

b. Activity Stock Account. Activity Stock is the actual number of shares of Class B Stock owned by a Member and used to capitalize (in whole or in part) the Member's Mission Asset Activity with the FHLBank. The number of shares of Class B Stock allocated to a Member's Activity Stock Account at any time shall ensure that, for each type of Mission Asset Activity, the ratio of the par value of the Member's Activity Stock to that type of Member's Mission Asset Activity is at least as large as its applicable Minimum Allocation Percentage, and no larger than its applicable Maximum Allocation Percentage. For each type of Mission Asset Activity, the Minimum Allocation Percentage and the Maximum Allocation Percentage may be adjusted by the FHLBank's Board to facilitate compliance with the FHLBank's Capital Requirements as specified in the Act and the Regulations or as directed by the Finance Board.

c. Member Excess Stock Account. A Member's Member Excess Stock is the total par value of Class B Stock owned by the Member minus the sum of (i) the par value of Class B Stock allocated by the FHLBank to the Member's Membership Stock Account, and (ii) the total of the par values of Class B Stock that results from multiplying each type of the Member's Mission Asset Activity by its applicable Maximum Allocation Percentage. If a Member's Member Excess Stock is a positive number, the Member actually owns Member Excess Stock equal to such positive number. If a Member's Member Excess Stock is a negative number, the Member actually owns no excess stock and is, by definition, utilizing some portion of the FHLBank's Excess Stock to capitalize its Mission Asset Activity.

d. Timing of Transactions. All transactions made on the books and records of the FHLBank shall be made and deemed effective at the end of the applicable business day.

3. Implementation of Capital Plan.

a. Election to Opt-Out of Capital Plan. A Member that does not wish to have its existing FHLBank capital stock converted into Class B Stock on the Effective Date must determine to withdraw as a member of the FHLBank and must file an Opt-Out Withdrawal Notice with the Finance Board and the FHLBank on or before the Opt-Out Date. If a Member's Opt-Out Withdrawal Notice is timely filed, and has not for any reason been rejected by the Finance Board, the Member's membership in the FHLBank shall terminate on the Effective Date. Thereafter, subject to Section VI.8.d., such institution (1) shall be deemed to have surrendered all its existing capital stock to the FHLBank against receipt of payment by the FHLBank of the par value of those shares of stock in immediately available funds (less any shares representing obligations due and owing by the institution to the FHLBank, which shall be liquidated in an orderly manner in accordance with the FHLBank's practice for shares held by an institution which has withdrawn from membership in the FHLBank as provided in Section VI.8.d.), and (ii) shall not be entitled to any other rights or privileges accorded to Members; provided, however, that the institution may receive dividends earned pursuant to Section VI.5.b., to the extent that those dividend payments exceed any such obligations due and owing to the FHLBank.

Any Member that is in the process of withdrawing on the Effective Date but did not file its Opt-Out Withdrawal Notice on or before the Opt-Out-Date shall have its existing capital stock converted into Class B Stock on the Effective Date, and the effective date of withdrawal of the Member shall be established in accordance with the requirements of Sections 925.26(b) and (c) of the Regulations, as implemented by the withdrawal and redemption provisions of this Capital Plan, except that the applicable stock redemption period calculated pursuant to Section 925.26(c) of the Regulations shall commence on the date the Member first submitted the Opt-Out Withdrawal Notice to the Finance Board.

b. Conversion of Existing Stock. The initial issuance of Class B Stock under this Capital Plan shall be consummated by a book entry exchange, by the FHLBank on behalf of each of the Members, of all of the Members' existing capital stock (carried on the FHLBank's books as of the Effective Date) for Class B Stock (also to be carried on the FHLBank's books) on an equal share-for-share basis. The conversion shall be completed after the close of business on the Effective Date. There shall be no transition period for conversion or implementation. On the Effective Date, each Member's Class B Stock shall be designated by the FHLBank to the Member's Membership Stock Account, Activity Stock Account, and Member Excess Stock Account, as provided for herein.

c. Procedure.

i. *Approval by the Finance Board*. Implementation of the Capital Plan is subject to Finance Board approval.

ii. *Effective Date*. Each Member having on the Effective Date an insufficient number of shares of Class B Stock to satisfy the Member's required Membership Stock Account, as determined by the FHLBank, shall be required immediately to purchase additional shares of Class B Stock in an amount sufficient to satisfy the Member's Membership Stock Account. After a Member has the number of shares of Class B Stock necessary to satisfy its Membership Stock Account, the Member shall satisfy its Activity Stock Account. Each Member having on the Effective Date a number of shares of Class B Stock (not including Membership Stock) that does not satisfy the applicable Minimum Allocation Percentages applied to each type of the Member's Mission Asset Activity shall be required immediately to purchase additional shares of Class B Stock sufficient to satisfy the Minimum Allocation Percentage for each type of Mission Asset Activity. Each Member having on the Effective Date a total number of shares of Class B Stock (not including Membership Stock) that satisfies the applicable Minimum Allocation Percentage, but that does not satisfy the Maximum Allocation Percentage for each type of Mission Asset Activity, shall be required to utilize a par value amount of the FHLBank's Excess Stock (subject to Section VI.4.b.) such that the sum of the Member's par value of Activity Stock and the par value the Member utilizes of the FHLBank's Excess Stock divided by the specific type of Member's Mission Asset Activity satisfies each applicable Maximum Allocation Percentage. Each Member's Member Excess Stock Account shall be determined in accordance with Section VI.2.c.

iii. *Estimate of Class B Stock Accounts*. Between thirty (30) and sixty (60) calendar days before the Opt-Out Date, the FHLBank shall notify each Member of the estimated number of shares of Class B Stock that will be allocated by the FHLBank to the Member's three (3) stock accounts, and inform each Member if there is a likelihood the Member may be required to purchase additional shares of Class B Stock and of the method by which a Member should calculate the number of shares of Class B Stock which it will be required to hold upon implementation of the Capital Plan.

iv. *Purchase of Additional Shares*. On or before the Effective Date, each Member which will, or is likely to, be required to purchase additional shares of Class B Stock upon implementation of the Capital Plan shall place sufficient immediately available funds in its demand deposit account with the FHLBank to cover any share purchase that will or may be required. On the Effective Date, the FHLBank shall be entitled to complete any share purchase which a Member is required to make by drawing down the funds in the Member's demand deposit account.

4. Minimum Investment by Members.

a. Required Shares. Each Member shall own at all times its Required Shares of Class B Stock. There are two components to Required Shares: Membership Stock and Activity Stock.

i. *Required Shares of Membership Stock*. The sum of the Membership Stock of all Members shall capitalize the FHLBank's investment securities and minimum liquidity (as determined by the FHLBank). The number of shares of a Member's Class B Stock allocated to the Member's Membership Stock Account shall be calculated as a range of percentages of the Member's Total Assets. Such percentages shall vary from three-hundredths of one percent (0.03%) to three-tenths of one percent (0.30%), inclusive, and may vary inversely with the dollar amount of the Member's Total Assets. The determination of the percentages shall be based upon the methods as set forth on Schedule A to this Capital Plan. Such percentages, including the initial percentages established at the Effective Date of the Capital Plan, shall be subject to periodic review and to adjustment as determined by the FHLBank's Board. Any change to such percentages shall be announced with at least thirty (30) days prior written notice to all Members before implementation of the change. If the number of shares of Class B Stock a Member is required to hold in its Membership Stock Account decreases, such shares shall be first allocated to the Member's Activity Stock Account, up to the applicable Maximum Allocation Percentages as applied to each type of the Member's Mission Asset Activity. Any remaining shares of Class B Stock shall then be allocated to the Member's Excess Stock Account. If the number of shares of Class B Stock a Member is required to hold in its Membership Stock Account increases, such additional shares shall be allocated from the Member's Excess Stock Account to the Member's Membership Stock Account. If, at the time of such increase, the Member has no or an insufficient amount of Member Excess Stock to satisfy its Membership Stock Account requirement or there is insufficient amount of FHLBank Excess Stock, or the FHLBank is not then in compliance with the requirements of this Capital Plan, the Act or the Regulations, the Member shall be required to purchase (on the effective date of the change specified in the notice) additional shares of Class B Stock to satisfy its Membership Stock Account requirement. A Member may not utilize any other Member's portion of FHLBank Excess Stock or its own Activity Stock to satisfy its Membership Stock Account requirement.

ii. *New Member Membership Stock Purchase Requirement*. From the date of approval of an institution's membership application by the FHLBank, the institution shall be granted sixty (60) calendar days in which to purchase the number of shares of Class B Stock necessary to satisfy its Membership Stock Account. The institution may not, however, engage in any Mission Asset Activity with the FHLBank until the institution has purchased all of its Required Shares.

iii. *Required Shares of Activity Stock* The number of shares of Class B Stock allocated to a Member's Activity Stock Account at any time shall ensure that, for each type of Mission Asset Activity, the ratio of the par value of the Member's Activity Stock to that type of the Member's Mission Asset Activity is at least as large as its applicable Minimum Allocation Percentage and no larger than its applicable Maximum Allocation Percentage. Initially upon the Effective Date, for types i and ii of a Member's Mission Asset Activity, the Minimum Allocation Percentage shall be two percent (2%) and the Maximum Allocation Percentage shall be four percent (4%); and for type iii of a Member's Mission Asset Activity, the Minimum Allocation Percentage shall be zero percent (0%) and the Maximum Allocation Percentage shall be four percent (4%). Such percentages may be periodically adjusted between one percent (1%) and six percent (6%), inclusive, for types i and ii of the Member's Mission Asset Activity, and between zero percent (0%) and six percent (6%), inclusive, for type iii of the Member's Mission Asset Activity as determined by the FHLBank's Board, with at least thirty (30) days prior written notice to all members.

The number of shares of Class B Stock a Member shall hold in its Activity Stock Account may fluctuate with the Member's Mission Asset Activity. An increase in any type of a Member's Mission Asset Activity first shall be capitalized, pursuant to Section VI.4.b., by a reallocation of the Member's Member Excess Stock (to the extent the Member holds a sufficient number of shares of Member Excess Stock and provided there are sufficient shares of FHLBank Excess Stock available) to the Member's Activity Stock Account at the appropriate Maximum Allocation Percentage for that type of Mission Asset Activity. In such an event, the Member shall not be permitted to purchase additional shares of Class B Stock; and the Member's Member Excess Stock Account shall be reduced by the number of shares of Member Excess Stock reallocated to its Activity Stock Account. To the extent a Member has an insufficient number of shares of Member Excess Stock to capitalize all of an increase to its Mission Asset Activity, the portion of the incremental Mission Asset Activity not so capitalized by the Member's Activity Stock shall be capitalized by FHLBank Excess Stock at the appropriate Maximum Allocation Percentage for that type of Mission Asset Activity pursuant to Section VI.4.b. In such an event, the Member shall not be permitted to purchase additional shares of Class B Stock, and the amount of FHLBank Excess Stock shall be reduced by the number of shares allocated from the Member's Member Excess Stock and by the number of additional shares of other Members' portion of the FHLBank Excess Stock used to capitalize the incremental Mission Asset Activity. If the FHLBank has insufficient FHLBank Excess Stock, in the FHLBank's sole discretion, to permit utilization of the FHLBank Excess Stock to capitalize all or a portion of a Member's incremental Mission Asset Activity, the Member, regardless of whether it holds Member Excess Stock, shall be required to purchase (on the effective date of the change specified in the notice) additional shares of Class B Stock, at the appropriate Maximum Allocation Percentage for that type of Mission Asset Activity, to capitalize the portion of the incremental Mission Asset Activity not capitalized with FHLBank Excess Stock.

If, after a decrease in a Member's Mission Asset Activity, the number of shares of Class B Stock in the Member's Activity Stock Account is less than the number required to capitalize the Member's remaining Mission Asset Activity at the applicable Maximum Allocation Percentages for the different types of Mission Asset Activity, the number of shares of Class B Stock in the Member's Activity Stock Account shall not change. If, after a decrease in a Member's Mission Asset Activity, the number of shares in the Member's Activity Stock Account is greater than the number required to capitalize the Member's remaining Mission Asset Activity at the applicable Maximum Allocation Percentages for the different types of Mission Asset Activity, the extra shares shall be allocated to the Member's Member Excess Stock Account.

b. <u>FHLBank Excess Stock</u>. FHLBank Excess Stock is the total par value of Class B Stock owned by all Members minus the sum of (i) the par value of Class B Stock allocated by the FHLBank to the Members' Membership Stock Accounts, (ii) the total of the par values of Class B Stock resulting from multiplying each type of Members' Mission Asset Activity by its applicable Maximum Allocation Percentage, (iii) the par value of shares of Member Excess Stock which are reserved for Members' exclusive use as provided in <u>Section VI.5.c.</u> and (iv) the par value of shares of Member Excess Stock which are the subject of outstanding Redemption and Withdrawal Notices. Other Members' portions of FHLBank Excess Stock may not be utilized, under any circumstances, to satisfy a Member's Membership Stock Account. Each Member's Member Excess Stock (not otherwise reserved for its exclusive use or excluded from FHLBank Excess Stock because it is the subject of an outstanding Redemption or Withdrawal Notice), shall be pooled into FHLBank Excess Stock and made available to all Members to capitalize Mission Asset Activity at a rate equal to the applicable Maximum Allocation Percentage for each type of Mission Asset Activity. If at any time the FHLBank, in its sole discretion, has determined that FHLBank Excess Stock may not be used to capitalize incremental Mission Asset Activity, or if any of the FHLBank's Capital Requirements are not satisfied, a Member (regardless of whether the Member has shares of Class B Stock allocated to its Member Excess Stock Account) seeking to capitalize an increase in its Mission Asset Activity shall be required to purchase an additional amount of Class B Stock at a rate at least equal to the applicable Maximum Allocation Percentage of the type of Member's incremental Mission Asset Activity. With respect to utilization of FHLBank Excess Stock by the Members, the following shall apply:

i. <u>*Percentage Limitation*</u>. Each Member must at all times retain in its own Activity Stock Account a number of shares of Class B Stock sufficient to satisfy the Minimum Allocation Percentages for each type of Mission Asset Activity then engaged in by the Member. If a Member is at the Minimum Allocation Percentage for a type of Mission Asset Activity and desires to increase that type of Mission Asset Activity and is not at the applicable Minimum Allocation Percentage for the other type(s) of Mission Asset Activity, the Member's Activity Stock will be reallocated from the other type(s) of Mission Asset Activity to the respective Minimum Allocation Percentage(s). If such reallocation does not provide sufficient Class B Stock to support the Member's increased Mission Asset Activity, the Member shall be required to purchase additional shares of Class B Stock in an amount that will maintain the applicable Minimum Allocation Percentage.

ii. <u>*Maximum Dollar Amount*</u>. Initially, no Member may use more than Two Hundred Million Dollars ($200,000,000) (exclusive of the par value of the Member's Member Excess Stock Account) of available FHLBank Excess Stock as the Maximum Dollar Amount. If a Member reaches the Maximum Dollar Amount and desires to increase its Mission Asset Activity, the Member shall be required to purchase additional shares of Class B Stock, at the applicable Maximum Allocation

Percentage for the specific type of Mission Asset Activity, to capitalize that type of incremental Mission Asset Activity. The FHLBank shall retain sole discretion to adjust the Maximum Dollar Amount from time to time.

5. Dividends.

a. In General. The FHLBank may pay dividends on its capital stock only out of previously retained earnings or current net earnings (as determined by the FHLBank in accordance with Generally Accepted Accounting Principles). The FHLBank's Board shall determine the dividend rate.

b. Scheduled Dividend Payments. Dividends shall be paid at the FHLBank's discretion to Members based upon the average total number of shares of Class B Stock actually owned by a Member during the period for which the distribution is to be made. The number of shares of Class B Stock actually owned by a Member in such period shall be determined based upon the number of days or the percentage of the period each share of Class B Stock was owned by the Member (regardless of whether the Member holds such share on the date the dividend is paid). Dividends, if declared and paid, shall be paid quarterly, except as otherwise declared by the FHLBank's Board, and shall be noncumulative. Dividends earned in any given period shall be paid on or about the last calendar day of such period. Dividends may be made in the form of additional shares of Class B Stock, in cash, in any combination thereof, or in such other form as the FHLBank may determine at the time of such dividend distribution.

c. Period of Exclusive Use. Stock Dividends paid shall be first allocated to a Member's Membership Stock Account. If, after a Member's Membership Stock Account is satisfied, the Member has additional shares of Class B Stock resulting from a Stock Dividend, the FHLBank shall allocate such additional shares to the Member's Activity Stock Account to the extent the Member's Mission Asset Activity is capitalized by the Member's Activity Stock at less than the Maximum Allocation Percentage. If, after a Member's Membership Stock Account is satisfied and the total number of shares in its Activity Stock Account satisfies the Maximum Allocation Percentages for each type of the Member's Mission Asset Activity, the Member has additional shares of Class B Stock resulting from a Stock Dividend, such shares shall be allocated to the Member's Member Excess Stock Account. A Member receiving such Stock Dividends, and having incremental shares of Class B Stock in its Member Excess Stock Account as a result of such Stock Dividends, shall have, for the three- (3-) month period immediately following the Stock Dividend payment, exclusive rights to utilize such Stock Dividends to capitalize the Member's (and only the Member's) incremental Mission Asset Activity.

d. Limitation of Issuance. The FHLBank shall not, under any circumstances, declare or pay any dividends on its capital stock if in doing so (and taking into account the effect of any such dividend) the FHLBank would fail to meet any of its Capital

Requirements. Nor shall the FHLBank declare any dividend on its capital stock if (i) the FHLBank is not then in compliance with any one or more of its Capital Requirements; or (ii) the FHLBank determines that to do so would create a safety and soundness issue for the FHLBank.

e. Dividends Made In Error. If any dividends are paid in error by the FHLBank in contravention of Section VI.5.d., the Members receiving such dividends shall return to the FHLBank all such dividends paid within thirty (30) calendar days of written notification by the FHLBank. In requiring the return of such distributions, the FHLBank shall incur no liability to its Members.

6. Transfer of Capital Stock. Any stock issued by the FHLBank shall be tradable and transferable only between the FHLBank and its Members. Any transfer shall be undertaken only in accordance with Section 931.6 of the Regulations. Upon application of the Member as set forth below and the approval of the FHLBank, a Member may transfer any number of shares of Class B Stock actually held in the Member's Excess Stock Account to another Member of the FHLBank or to an institution that has been approved for and has satisfied all the conditions of membership in the FHLBank other than the purchase of Required Shares. Such transfers shall be made at the par value of One Hundred Dollars ($100) per share. The FHLBank shall serve as transfer agent for the Class B Stock. Any such transfer shall be effective at the end of the business day on which the transfer is recorded in the register of the FHLBank.

A Member wishing to transfer all or a portion of its Member Excess Stock to another Member must submit a request in writing to the FHLBank at least thirty (30) days prior to the date the transfer is desired to take place ("Transfer Request"). The Transfer Request shall include: (1) the names of the Members wishing to consummate the transfer; (2) the number of shares of Class B Stock to be transferred; (3) the desired date of transfer; (4) a brief statement as to the reason(s) for the transfer; and (5) the authorized signature of each party to the proposed transaction indicating its respective desire to execute the transfer. Upon receipt of the Transfer Request, the FHLBank shall evaluate the request and, no later than the third business day prior to the date of transfer, in its sole discretion, either approve or disapprove the transfer.

7. Redemption and Repurchase of Capital Stock.

a. Redemption of Member Excess Stock. A Member may request that the FHLBank redeem all or any portion of the Member's shares of Class B Stock, without affecting the Member's membership status, by submitting a Redemption Notice to the FHLBank. The Redemption Notice shall state the number of shares of Class B Stock targeted for redemption, and a Member may not have more than one Redemption Notice outstanding at any time covering the same shares of Class B Stock. Until the shares are redeemed, or earlier repurchased pursuant to Section VI.7.b., a Member shall continue to receive dividends on the shares of Class B Stock targeted for redemption. Subject to Sections VI.10., 11. and 12., at the end of the Redemption Period (unless the Redemption

Notice has been cancelled), the FHLBank shall redeem, in accordance with Section VI.7.c., all of the shares of Class B Stock covered by the Redemption Notice that are Member Excess Stock on the date the Redemption Notice becomes effective. If the FHLBank is unable to redeem all or any portion of those shares of Class B Stock at the end of the Redemption Period because of restrictions set forth in this Capital Plan, the Act or the Regulations, the FHLBank may redeem the shares, without further notice or waiting period, when and as permitted by this Capital Plan and, if applicable, permitted or required by the Finance Board. If at any time the FHLBank is able to redeem some, but not all, of the shares of Class B Stock that are covered by effective Redemption Notices, the FHLBank shall honor the redemption requests on a first come/first served basis, based upon the date and time such Redemption Notices were marked received by the FHLBank.

b. Repurchase of Member Excess Stock. Subject to Sections VI.10., 11. and 12., the FHLBank shall have the right at any time to repurchase, in accordance with Section VI.7.c., all or any portion of its Members' Member Excess Stock. Any such repurchase shall be at the sole discretion of the FHLBank and shall be initiated by giving each affected Member no less than five (5) calendar days' prior written notice. If and when the FHLBank determines to repurchase Member Excess Stock, the FHLBank shall first purchase any shares of Class B Stock for which Redemption Notices have become effective but have not been fully honored, in the order in which those Notices became effective. To the extent the FHLBank has determined to repurchase more shares of Class B Stock, it then shall repurchase those shares for which Redemption Notices have been filed but not yet become effective, in the order in which those Notices were filed. In the event the FHLBank determines to repurchase more shares of Class B Stock than are currently covered by outstanding Redemption Notices, the FHLBank shall repurchase the additional shares from each Member having a positive number of shares in its Member Excess Stock Account in proportion to the total number of shares of Class B Stock then allocated to each Member's Excess Stock Account.

c. Redemption and Repurchase Price. All redemptions and repurchases of shares of Class B Stock shall be made by the FHLBank in immediately available funds at the par value of One Hundred Dollars ($100) per share. Once a share is redeemed or repurchased, pursuant to Sections VI.7.a. and VI.7.b. and subject to Section VI.5.b., the Member's rights and privileges and the FHLBank's obligations with respect to such share shall immediately terminate and the Member shall be deemed to have surrendered the share to the FHLBank.

d. Cancellation of Redemption Notice. A Member shall have five (5) calendar days from the date the FHLBank receives a Redemption Notice from the Member to submit a Cancellation Notice to the FHLBank and to cancel that Redemption Notice without penalty or fee. If a Member desires to cancel a Redemption Notice after the five (5) calendar day grace period has expired, the Member may do so by providing a Cancellation Notice to the FHLBank, but the FHLBank shall charge a Cancellation Fee, as a percent of the par value of the Class B Stock referenced in the Redemption Notice, based upon the year in which the Redemption Notice is cancelled according to the following schedule: two percent (2%) in the first year, three percent (3%) in the second year, four percent (4%) in the third year, five percent (5%) in the fourth year, and six percent (6%) in the fifth year. To be effective, the Cancellation Notice must be received by the FHLBank before the Redemption Notice to which it relates becomes effective and before the FHLBank repurchases the shares of stock referenced in the Redemption Notice. From time to time, the FHLBank's Board, in its sole discretion, may waive the Cancellation Fee if it has a bona fide business purpose for doing so and the waiver is consistent with Section 7(j) of the Act or may change the Cancellation Fee schedule to reduce all or any portion of the Fee.

e. Automatic Cancellation of Redemption. A Member's Redemption Notice shall automatically be cancelled to the extent the FHLBank is prevented from redeeming any Class B Stock which is the subject of the Notice within five (5) business days after the end of the Redemption Period because the Member would fail to maintain its minimum investment in the stock of the FHLBank after such redemption. The automatic cancellation of a Member's Redemption Notice shall have the same effect as if the Member had cancelled its Redemption Notice pursuant to Section VI.7.d., including the applicability of the Cancellation Fee specified therein.

8. Termination of Membership.

a. Voluntary Withdrawal. Any Member may initiate its withdrawal from membership in the FHLBank by filing a Withdrawal Notice with the FHLBank. Within ten (10) calendar days of receiving such Withdrawal Notice, the FHLBank shall forward a copy of the Withdrawal Notice to the Finance Board. During the Withdrawal Period, the Member shall be entitled to dividends, voting rights, and other membership rights commensurate with continuing stock ownership. Subject to Section VI.8.d. and Sections VI.10., 11. and 12., and provided that the Withdrawal Notice has not been cancelled in accordance with Section VI.8.b., at the expiration of the Withdrawal Period, (a) the institution's membership in the FHLBank shall terminate, (b) the FHLBank shall redeem, in immediately available funds at their par value (less any obligations due and owing by the institution to the FHLBank), the shares of Class B Stock owned by the institution on the date the Withdrawal Notice was filed and (c) the institution shall not be entitled to any other rights or privileges accorded to Members; provided, however, that the institution may receive dividends earned pursuant to Section VI.5.b., to the extent that those dividend payments exceed any such obligations due and owing to the FHLBank. If the FHLBank is unable to redeem the shares of Class B Stock at the end of the Withdrawal Period because of restrictions set forth in this Capital Plan, the Act or the Regulations, the FHLBank may redeem the shares, without further notice or waiting period, when and as permitted by this Capital Plan and, if applicable, permitted or required by the Finance Board. If at any time the FHLBank is able to redeem some, but not all, of the shares of Class B Stock subject to

Withdrawal Notices, the FHLBank shall honor the Withdrawal Notices on a first come/first served basis, based upon the date and time such Withdrawal Notices became effective. The Withdrawal Period shall automatically commence for any additional shares of Class B Stock acquired by the institution (by purchase or in the form of Stock Dividends) after the date the Withdrawal Notice initially was filed on the date the additional shares are received. In its sole discretion, the FHLBank may repurchase such after-acquired shares from time to time, provided that they are not required to support any indebtedness of the institution to, or business transaction of the institution with, the FHLBank.

b. Cancellation of Withdrawal Notice. A Member shall have thirty (30) calendar days from the date the FHLBank receives the Member's Withdrawal Notice to submit a Cancellation Notice to the FHLBank and to cancel the Withdrawal Notice without penalty or fee. If a Member desires to cancel a Withdrawal Notice after the thirty (30) calendar day grace period has expired, the Member may do so by providing a Cancellation Notice to the FHLBank, but the FHLBank shall charge a Cancellation Fee, as a percent of the par value of the Class B Stock referenced in the Withdrawal Notice, based upon the year in which the Withdrawal Notice is cancelled according to the following initial schedule: two percent (2%) in the first year, three percent (3%) in the second year, four percent (4%) in the third year, five percent (5%) in the fourth year, and six percent (6%) in the fifth year. To be effective, the Cancellation Notice must be received by the FHLBank before the Withdrawal Notice becomes effective. From time to time, the FHLBank's Board, in its sole discretion, may waive the Cancellation Fee if it has a bona fide business purpose for doing so and the waiver is consistent with Section 7(j) of the Act or may change the Cancellation Fee schedule to reduce all or any portion of the Fee. The FHLBank's Board may, in its sole discretion, establish a Cancellation Fee applicable to Withdrawal Notices that is different than the Cancellation Fee applicable to Redemption Notices.

c. Involuntary Withdrawal. The FHLBank's Board may terminate the membership of any institution that (i) fails to comply with any requirement of this Capital Plan, the Act or any Regulation prescribed under the Act, in effect from time to time, (ii) becomes insolvent or otherwise subject to the appointment of a conservator, receiver, or other legal custodian under federal law or state law applicable to the institution, or (iii) would jeopardize the safety or soundness of the FHLBank if it were to remain a Member. The institution's membership in the FHLBank shall terminate as of the date the FHLBank's Board acts, at which time a five- (5-) year redemption period for the shares of Class B Stock owned by the institution on that date shall commence and after which the institution shall not be entitled to any rights or privileges accorded to Members; provided, however, the institution may receive dividends earned pursuant to Section VI.5.b. until its Class B Stock is redeemed. At the end of the redemption period provided for in this Section VI.8.c., and subject to Section VI.8.d., the FHLBank shall redeem, in immediately available funds at their par value (less any obligations due and owing by the institution to the FHLBank), the shares of Class B Stock owned by the institution on the date the institution's membership in the FHLBank terminated. A five- (5-) year redemption period shall automatically commence for any shares of Class B Stock acquired by the institution as Stock Dividends after the date on which the institution's membership in the FHLBank terminated. In its sole discretion, the FHLBank may repurchase such after-acquired shares from time to time, provided that they are not required to support any indebtedness of the institution to, or business transaction of the institution with, the FHLBank.

d. Additional Conditions Relating to Withdrawal. A Member's voluntary withdrawal pursuant to Section VI.3.a. or Section VI.8.a., or involuntary withdrawal pursuant to Section VI.8.c., as a Member of the FHLBank shall be effective as of the applicable date specified in each such Section and, thereafter, regardless of any shares of the FHLBank's capital stock still held (as contemplated by the following sentence), the Member shall no longer be a Member and shall have no rights accorded to Members other than as are specified in the applicable Section. Notwithstanding the provisions of those Sections or any other provision of this Capital Plan, the FHLBank shall not redeem or repurchase shares of Class B Stock from an institution that has withdrawn from membership in the FHLBank, or that otherwise has had its membership in the FHLBank terminated, to the extent that those shares are required to support, at up to the Maximum Allocation Percentage in effect from time to time and applicable to the type of Mission Asset Activity, any indebtedness of the institution to, or business transaction of the institution with, the FHLBank until after such indebtedness or business transaction has been extinguished or settled. For purposes of determining the number of shares of Class B Stock required to support an institution's remaining indebtedness to or business transactions with the FHLBank, all shares of Membership Stock held by the institution on the effective date of withdrawal, as well as all shares subsequently received as Stock Dividends, shall be classified as Activity Stock.

e. Rejoining After Divestiture of All Shares of Stock. Except as provided herein, and notwithstanding any other provision of the Act, an institution that divests all shares of stock in the FHLBank or any other Federal Home Loan Bank may not, after such divestiture, acquire shares of the FHLBank before the end of a five- (5-) year period beginning on the date of the completion of such divestiture, except as provided in Section VI.9; provided, however, that if the divestiture was made prior to December 31, 1997, such institution may acquire shares of the FHLBank at any time after that date, subject to the Act and approval by the FHLBank and the Finance Board.

9. Consolidation of Members.

a. Consolidation of Members of the FHLBank. Upon consolidation of two or more Members of the FHLBank into one institution operating under the charter of one of the consolidating institutions, the transfer of Class B Stock owned by the disappearing institution(s) to the consolidated institution shall be deemed approved by the FHLBank. All shares of Class B Stock shall be allocated to the consolidated institution's stock accounts pursuant to Section VI.2. hereof and any share of Class B Stock thereby in such consolidated institution's Member Excess Stock Account may be redeemed in a manner consistent with the terms and conditions of this Capital Plan.

b. Consolidation of a Member into a Member of Another Federal Home Loan Bank. If a Member is consolidated with and into a Member of a Federal Home Loan Bank other than the FHLBank, and, after the consolidation, the Member is to operate under the charter of the consolidated institution, the Member's membership in the FHLBank shall terminate upon cancellation of its charter; provided, however, that if more than eighty percent (80%) of the assets of the consolidated institution are derived from the assets of the disappearing Member, then the consolidated institution shall continue to be a Member of the FHLBank. In the event of a termination as provided in this Section VI.9.b., liquidation of the Member's shares of Class B Stock shall be in accordance with the Act and Section 925.29 of the Regulations.

c. Consolidation of a Member into a Non-Member. If a Member is consolidated with and into an institution that is not a Member, the Member's membership in the FHLBank shall terminate upon cancellation of the Member's charter. In the event that the consolidated institution has its principal place of business within the District of the FHLBank, the consolidated institution shall have sixty (60) calendar days after the cancellation of the Member's charter to notify the FHLBank that the consolidated institution intends to apply for membership in the FHLBank. The consolidated institution shall then have sixty (60) calendar days from the aforementioned notice to apply for membership in the FHLBank. Prior to membership approval for the consolidated institution, the disappearing institution may continue to hold any outstanding FHLBank advances and shares of Class B Stock, and the consolidated institution shall have the rights associated with such shares of Class B Stock. The consolidated institution shall, within sixty (60) calendar days of its approval for membership status, purchase shares of Class B Stock as necessary to satisfy the Member's Membership Stock Account and Activity Stock Account requirements. If the consolidated institution does not apply for membership, or if its application for membership is denied, then the liquidation of any outstanding indebtedness owed to the FHLBank and the redemption of the Member's shares of Class B Stock shall be carried out in accordance with the Act and Section 925.29 of the Regulations.

10. Failure to Meet Capital Requirements. Notwithstanding any other provision of this Capital Plan, the FHLBank may not redeem or repurchase any shares of its capital stock if the FHLBank is not then in compliance with any one or more of its Capital Requirements or if, as provided in Section 931.7(c) of the Regulations, following the redemption or repurchase, the FHLBank would fail to meet any of its Capital Requirements or the Member would fail to maintain its minimum investment in the capital stock of the FHLBank as required by the Regulations and this Capital Plan.

11. Capital Impairment. In accordance with Section 931.8(a) of the Regulations, the FHLBank may not and shall not redeem or repurchase any capital stock without the prior written approval of the Finance Board, if the Finance Board or the FHLBank's Board has determined that the FHLBank has at the time of such proposed redemption or repurchase incurred, or is likely to incur, losses that result in, or are likely to result in, Charges Against the Capital of the FHLBank. This prohibition shall apply even if the FHLBank is in compliance with its Capital Requirements, and shall remain in effect for however long the FHLBank continues to incur such Charges, or until the Finance Board determines such Charges are not expected to continue, or otherwise in accordance with Finance Board Regulations and rulings.

12. FHLBank's Discretion to Suspend Redemption. In accordance with Section 931.8(b) of the Regulations, the FHLBank, upon the approval of the FHLBank's Board, or a subcommittee thereof, may suspend the redemption of any of the FHLBank's stock if the FHLBank reasonably believes that the continued redemption of stock would cause the FHLBank to fail to meet its Capital Requirements, would prevent the FHLBank from maintaining adequate capital against potential risk that may not be adequately reflected in its Capital Requirements, or would otherwise prevent the FHLBank from operating in a safe and sound manner. The FHLBank shall notify the Finance Board within two business days of the date of its decision to suspend the redemption of stock, informing the Finance Board of the reasons for the suspension and of the FHLBank's strategies and timeframes for addressing the conditions that led to the suspension. The Finance Board may require the FHLBank to re-institute the redemption of stock. The FHLBank shall not repurchase any stock without the written permission of the Finance Board during any period in which the FHLBank has suspended redemption of stock under this Section VI.12.

13. Transition Provision. The FHLBank shall comply with the minimum leverage and risk-based capital requirements specified in Sections 932.2 and 932.3 of the Regulations, respectively, and each Member shall comply with the minimum stock investment established in this Capital Plan, as of the Effective Date of this Capital Plan. Any Member who immediately prior to the Effective Date does not have sufficient FHLBank stock to exchange for new Class B Stock on the Effective Date to meet its minimum stock investment requirements as set forth in this Capital Plan shall, pursuant to Section VI.3., of this Capital Plan, bring itself into compliance with such requirements as of the Effective Date.

ARTICLE VII

LIQUIDATION OR MERGER OF THE FHLBANK

In the event that the FHLBank is liquidated, or is merged or otherwise consolidated with another Federal Home Loan Bank, the rights and obligations of the Members shall be as follows: (A) If the FHLBank is merged or otherwise consolidated into another Federal Home Loan Bank (an "FHLB"), the Members shall have the option (after reasonable notice) to (1) receive par value for each share of Class B Stock then owned by the Members; provided, however, that (i) the

FHLBank first meets its financial obligations to all non-Member creditors of the FHLBank (excluding the purchasing FHLB and/or the FHLB into which the FHLBank is to be merged); (ii) the FHLBank retains sufficient reserve funds to accommodate reasonable debts that may arise or accrue after the date of the merger or consolidation (excluding debts related to the merger); (2) remain Members of the FHLB into which the FHLBank is merged by converting or exchanging shares of Class B Stock for the stock of the surviving FHLB and by satisfying the terms and conditions set by the surviving FHLB and the FHLBank for such conversion or exchange, subject to the rights and obligations of Members of such surviving FHLB; or (3) accept other terms and conditions as may be presented to the Members at the time of the merger and/or consolidation. (B) If another FHLB is merged or consolidated into the FHLBank, Members' rights and obligations with respect to their Class B Stock shall continue to be as outlined in this Capital Plan as such Capital Plan may be modified and/or restated from time to time. (C) If the FHLBank is liquidated, the assets of the FHLBank shall be distributed as then directed by the FHLBank's Board in compliance with this Capital Plan, the Act, the Regulations and any applicable rulings made by the Finance Board.

The provisions of this Article VII are subject to the right of the Finance Board otherwise to liquidate, merge or consolidate the FHLBank in accordance with the authority granted to the Finance Board by the Act and the Regulations.

ARTICLE VIII

PERIODIC REVIEW AND AMENDMENT

1. Periodic Review. The FHLBank's Board shall monitor and adjust, as necessary, the numbers of shares of Class B Stock required to be held in Members' Membership Stock Accounts and Activity Stock Accounts to ensure that the amounts invested are sufficient to allow the FHLBank to comply with its Capital Requirements. In addition, to maintain prudent capitalization and ongoing compliance with the Act and the Regulations, the FHLBank's Board shall review the FHLBank's Capital Plan at least once every calendar year to determine whether any amendments are required. Pursuant to and consistent with the Act and the Regulations of the Finance Board, the FHLBank shall amend this Capital Plan as set forth in Section VIII.2. herein to effectuate any changes deemed necessary.

2. Amendment. The FHLBank's Board may, from time to time, adopt amendments to this Capital Plan. All amendments shall be submitted to and approved by the Finance Board before such amendments will be effective. After receipt of approval from the Finance Board, such amendments shall be effective fifteen (15) days after the mailing or electronic posting of notice to the Members, unless another date is specified in the notice.

ARTICLE IX

MISCELLANEOUS

1. Prompt Compliance: Use of Member Demand Deposit Accounts. Each Member shall comply promptly with the terms and conditions of this Capital Plan and with any changes thereto that may be adopted by the FHLBank from time to time, including any changes that may lead to an increase in the number of a Member's Required Shares. On or before the effective date of any such change, the Member shall place sufficient immediately available funds in its demand deposit account with the FHLBank to cover any necessary purchase of additional Required Shares. In order to effectuate prompt compliance, the FHLBank is authorized to issue stock in the name of a Member and to withdraw appropriate payment from the Member's demand deposit account.

2. Maintenance and Interpretation of the Plan. The President of the FHLBank and/or his designees shall have the right and the responsibility to (a) establish operating procedures for implementation and maintenance of this Capital Plan and (b) interpret any issues that may arise with respect to the application of the Capital Plan and its effect on any one or more Members of the FHLBank in a manner consistent with the Act and the Regulations.

3. Errors Discovered in Capital Stock Calculations. In the event that any inadvertent error(s) are discovered regarding calculations made in reference to a Member's Required Shares and/or its Member Excess Stock, the FHLBank shall immediately correct such errors and make such adjustments as are warranted to remedy the discovered error(s).

4. Liquidation of Claims Against a Member. Claims of the FHLBank against a Member, including claims for any applicable prepayment fees or penalties resulting from prepayment of advances prior to stated maturity, shall be liquidated in an orderly manner, as determined by the FHLBank.

5. Calculation of Time Periods. Except for time periods related to the calculation and payment of dividends, whenever any time period specified in this Capital Plan ends on a day on which the FHLBank is not open for business, the time period shall be deemed to end on the following business day.

6. Limitation on Discretion. Any discretion granted to the FHLBank's Board under this Capital Plan shall be limited by applicable authority accorded to the Finance Board pursuant to the Act and the Regulations.

7. Good Faith Determination. The Board of Directors of the FHLBank certifies that it has made a good faith determination that the FHLBank will be able to implement this Capital Plan and that the FHLBank will be in compliance with its regulatory total capital requirement and its regulatory risk-based capital requirement after this Capital Plan is implemented.

Capital Plan of the Federal Home Loan Bank of Cincinnati
Schedule A Relating to Section VI.4.a.i.: Membership Stock

Illustrative Allocation of Membership Stock Among Members

- The total amount of required Membership Stock shall be determined by the FHLBank and shall be allocated among Members based on a range of percentages applied to each Member's Total Assets.

- The range of percentages shall vary inversely with the amount of each Members' Total Assets. Such percentages shall vary from three-hundredths of one percent (0.03%) to three-tenths of one percent (0.30%).

- An illustrative range of percentages follows:

Total Amount of Member's Assets (Dollars in Billions)	Percentage for Membership Stock Allocation
\$0 - \$25	0.15 percent
Greater than \$25 to \$50	0.10 percent
Greater than \$50 to \$75	0.07 percent
Greater than \$75 to \$100	0.05 percent
Greater than \$100	0.03 percent

- The amount of Membership Stock computed from applying the range of percentages is cumulative. For example, a Member with Total Assets of \$60.000 billion shall be required to hold Membership Stock as the sum of (i) the first \$25.000 billion of Total Assets at a rate of 0.15 percent, (ii) the next \$25.000 billion Total Assets at a rate of 0.10 percent, and (iii) the last \$10.000 billion of Total Assets at a rate of 0.07 percent. Such member would be required to hold \$69.500 million of Membership Stock.

Provision for Determination of Range of Percentages

The range of percentages is illustrative only. As specified in Article VI, Section 4.a.i., the actual range of percentages, including such initially in place at the Effective Date of the Capital Plan, shall be announced by the FHLBank's Board of Directors with at least one (1) calendar month's prior written notice to all Members.

Appendix 3.

Testimony of the Federal Housing Finance Board
before the Subcommittee on Financial Institutions,
Banking Committee, United States Senate, September 9, 2003.

Prepared testimony of John T. Korsmo,
Chairman, Federal Housing Finance Board,
Before the Subcommittee on Financial Institutions,
Senate Committee on Banking, Housing, and Urban Affairs
Washington, D.C.
September 9, 2003

Thank you, Chairman Bennett, Ranking Member Johnson, and distinguished members of the Subcommittee on Financial Institutions. I appreciate the opportunity to speak with you today about the Federal Housing Finance Board (Finance Board) and the Federal Home Loan Bank System.

Many important issues are facing the nation's government sponsored enterprises (GSEs), including, certainly, the Federal Home Loan Banks (Banks). I highlight today the aggressive steps we have taken at the Federal Housing Finance Board, the System's regulator, first, to strengthen the agency's oversight capabilities; and second, to improve financial disclosures by the Federal Home Loan Banks through voluntary registration with the Securities and Exchange Commission (SEC).

These initiatives will benefit not just the Federal Home Loan Banks and their member institutions, but also the investors that purchase the Banks' debt, the taxpayers, and ultimately, the home-buying public who are served by the housing finance mission of the Banks.

As requested in Chairman Bennett's invitation to this oversight hearing, I will also address the issues of multidistrict memberships in Federal Home Loan Banks and the Banks' various Acquired Member Asset programs (AMA).

Allow me to begin by providing a brief overview of both the Federal Housing Finance Board and the entities we regulate, the 12 Federal Home Loan Banks and the Office of Finance.

The Federal Housing Finance Board is an independent agency in the executive branch of the U.S. government, with a five-member Board of Directors, four appointed by the President and one ex-officio member, the Secretary of Housing and Urban Development. Created to take over certain duties of the Federal Home Loan Bank Board by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Finance Board's primary duty is to ensure that the 12 Federal Home Loan Banks and the Office of Finance operate in a financially safe and sound manner.

In addition, the Finance Board ensures that the Federal Home Loan Banks carry out their housing finance and community lending mission and remain adequately capitalized and able to raise funds in the capital markets. The Federal Home Loan Bank Act requires the Finance Board to examine and report on the condition of each Federal

Home Loan Bank at least annually. Finally, the Finance Board is a non-appropriated agency that enacts its own budget; it assesses the Banks for the costs of its operation.

The 12 Federal Home Loan Banks and their joint office, the Office of Finance, serve the public by promoting the availability of housing finance, including community lending credit, through 8000-plus member institutions. The 12 Banks provide a readily available, low-cost source of funds to members and a secondary market facility for home mortgages originated or acquired by their members. The Banks are cooperatives; only members may own the stock of each Federal Home Loan Bank, and the members receive dividends on their investment. Insured banks, thrifts, and credit unions and insurance companies engaged in housing finance can apply for membership.

The Federal Home Loan Banks play a unique role in housing finance. They make loans, called advances, to their members and eligible housing associates (principally state housing finance agencies) on the security of mortgages and other collateral pledged by those members and housing associates. Advances generally support mortgage originations, provide term funding for portfolio lending, and may be used to provide funds to any member "community financial institution" (an FDIC-insured institution with assets of $538 million or less) for loans to small business, small farms, and small agribusiness. Because portfolio lenders may originate loans they are unwilling or unable to sell in the secondary mortgage market, Federal Home Loan Bank advances serve as a funding source for a variety of mortgages. This flexibility allows these advances to support important housing markets, including those focused on low- and moderate-income households.

Federal Home Loan Bank advances can provide funding to smaller lenders that lack diverse funding sources. Smaller community lenders often do not have access to funding alternatives available to larger financial entities, including repurchase agreements, commercial paper, and brokered deposits. The Federal Home Loan Banks give these lenders access to competitively priced wholesale funding.

The Federal Home Loan Banks principally fund themselves by issuing consolidated obligations, which are the primary obligation of a sponsoring Bank or Banks, backed by a joint-and-several liability guarantee of all Banks. Consolidated obligations outstanding at June 30, 2003, totaled $712.4 billion. This includes bonds (original maturity of one year or longer) of $556.2 billion and discount notes (original maturity of less than one year) of $156.2 billion.

Finally, a few more key figures: Total assets of the Federal Home Loan Banks stood at $812 billion as of June 30, 2003. Advances totaled $506.3 billion, which is 7.6 percent greater than one year ago. Viewed collectively, the Federal Home Loan Banks represent the third largest domestic banking organization.

Institutions of this size and importance to the nation's housing market and economy in general clearly require a robust and capable regulator, and since President

Bush named me Chairman in December 2001, I have sought to establish the Finance Board as just that.

IMPROVEMENTS IN SAFETY AND SOUNDNESS OVERSIGHT

Soon after I became Chairman, my Finance Board colleagues and I determined that the Finance Board lacked the necessary resources to effectively carry out its primary responsibility, that of overseeing the Federal Home Loan Banks and the Office of Finance for safety and soundness. Just one example demonstrates this point: The Finance Board had only eight bank examiners on staff to review and supervise a dozen financial institutions with, at the time, more than $700 billion in assets, more than $30 billion in capital, and some $650 billion in outstanding debt. Yet the agency also had an Office of Public Affairs with the same number of staff, eight. The relative allocation of resources simply did not meet the agency's statutory mandates.

In addition to being understaffed, the examination function was also insufficiently focused on the Banks' risk assessment processes and the Banks' internal control systems. Such shortcomings had been identified in a 1998 General Accounting Office (GAO) report of the Finance Board's examination program, but had not by that time been addressed and corrected.

I immediately set out to respond to these problems, beginning with the recruitment of new leadership for the agency's Office of Supervision. After a national search, the Finance Board hired a new director and a new deputy director of supervision, who between them have 40 years of regulatory experience with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC).

My Finance Board colleagues and I increased the resources available for supervision, expanding the agency's examination staff to 17 full-time bank examiners. Our goal is to have 24 in place by the end of this calendar year, and 30 by the end of the next budget year.

The Finance Board is now conducting more thorough, risk-focused examinations, and communicating the results of those examinations more effectively to the Banks.

Examinations now recognize that banking – including AAA-rated, GSE banking – is a business of managing risks, and the responsibility of bank supervisors is to ensure that the institutions they regulate understand those risks and monitor and control them through prudent risk management practices.

To enhance analysis and oversight in the risk management area, we have established two risk units – a Risk Modeling Division and a Risk Monitoring Division. The Risk Modeling Division is responsible for the development of our asset/liability modeling and for monitoring the Bank's internal interest rate risk models. The Risk Monitoring Division pulls together all our data and the Banks' own financial reporting into a risk-monitoring framework.

We have hired an Associate Director for Examinations who oversees all our safety and soundness examiners. She has more than 15 years of bank regulatory experience with the FDIC. We also have hired a Senior Advisor to the Director of Supervision to provide support to the Risk Modeling and Risk Monitoring Divisions. That Senior Advisor possesses some 30 years of bank supervision, capital markets, and capital regulation experience with the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision.

While on-site examinations remain the primary tool of supervisors, the agency now complements exams with off-site monitoring and regular communication with the Banks. Our new "Bank Analyst Program" charges a member of our Office of Supervision with following an individual Bank and reviewing monthly and quarterly financial reports for trends and changes, while also keeping abreast of issues in the financial and housing industries to determine their effect on each Bank.

Our Office of General Counsel has also assigned attorneys who serve as points of contact for the examiners on particular Bank issues.

In short, the Finance Board's safety-and-soundness oversight of the Federal Home Loan Banks has improved dramatically. We have more work ahead of us, to be sure, but the Finance Board is a much stronger and more capable regulatory agency than it was as recently as 12 months ago.

The 1998 GAO report also found that Finance Board examinations neglected the critical area of board governance at the Federal Home Loan Banks. To address this shortcoming, and as another element of our safety and soundness supervision, the Finance Board has undertaken a thorough assessment of corporate governance at each of the Banks. This effort included the first-ever horizontal review – that is, a systemwide supervisory review of a single issue at each of the 12 Banks – which addressed the Banks' effectiveness relative to eight indicators of effective board governance.

Those indicators are:

- Engaged Board of Directors
- Skilled Senior Management
- Thorough Strategic Planning
- Sound Risk Management
- Robust Internal Control
- Effective Audit Program
- Strong Ethical Culture
- Timely, Accurate, and Complete Communications

The Finance Board's final report on this review includes a variety of general recommendations for improving corporate governance. The agency also provided specific, confidential feedback to each of the 12 Banks.

The next step with respect to bank governance is a public hearing, tentatively scheduled for October 15. The Finance Board will solicit from the Banks, their member institutions, experts, and interested members of the public any ideas for reform in this important area. Input generated may be used in the design of proposals aimed at making the Federal Home Loan Banks role models in corporate governance.

Earlier this year, the Finance Board undertook a second systemwide horizontal review – that of the Federal Home Loan Banks' implementation of the statutorily mandated Affordable Housing Program (AHP). The AHP is a highly successful program that warrants a separate discussion and some background.

THE AFFORDABLE HOUSING PROGRAM (AHP)

The Federal Home Loan Bank Act requires each Bank to establish and fund an Affordable Housing Program. Under the AHP, each Bank must annually contribute the greater of 10 percent of its net earnings for the previous year, or such prorated sums as may be required to ensure that the aggregate contribution of the Banks is at least $100 million. Actual contributions to the program were $199 million for 2002, and the contributions have exceeded $100 million each year since 1994.

AHP subsidies must be used to fund the purchase, construction, or rehabilitation of:

- Owner-occupied housing for very low-income, or low- or moderate-income (no greater than 80 percent of area median income) households; or
- Rental housing in which at least 20 percent of the units will be occupied by and affordable for very low-income (no greater than 50 percent of area median income) households.

In 2002, the Finance Board adopted a regulation enabling Banks to allocate annually the greater of $4.5 million or 35 percent of each Bank's AHP contribution to homeownership set-asides. Part of this increased funding authority helps Banks combine AHP subsidies with HUD initiatives benefiting minority, immigrant, and other first-time homebuyer families.

Since the inception of the AHP in 1990, the Federal Home Loan Banks have contributed $1.7 billion to the program, funding 236,596 rental units and 122,126 owner-occupied units. In 2002, the Banks committed $286 million to AHP projects.

The Finance Board appropriately devolved operation of the AHP program to the individual Banks in the late 1990s, a valuable development because the Banks are best equipped to assess local affordable housing needs and build partnerships with local community groups and housing agencies.

Correspondingly, the Finance Board's oversight responsibility has grown with respect to the AHP to ensure proper and effective program operation. As such, we are following up the horizontal review with a new practice of examining each Bank's AHP program once a year. These exams are performed by examiners and analysts whose specialized training has specifically equipped them for this task.

We are also preparing regulatory language intended to enhance the effectiveness of the AHP by permitting Banks more latitude in establishing the criteria to score applications. The goal is for Banks to be more responsive to local housing conditions. We also plan to streamline the application process to permit projects to proceed more quickly and with lower administrative costs.

AHP is truly one of the Federal Home Loan Banks' great success stories, and with rigorous oversight at the Federal Housing Finance Board, I am confident it will be even more successful in the years ahead.

ENHANCED DISCLOSURES

The other key initiative I wish to discuss today is enhancing the quarterly and annual corporate disclosures of the Federal Home Loan Banks.

In July of 2002, the Administration called on all government sponsored enterprises to comply with the corporate disclosure requirements of the Securities Exchange Act of 1934, as interpreted and enforced by the SEC.

Fannie Mae and Freddie Mac, the other two housing-related GSEs, answered this call. Fannie Mae has already filed its first disclosures under the new SEC regime.

As Chairman of the Federal Housing Finance Board, I too am determined to hold the Federal Home Loan Banks to the highest standard of disclosure. Accordingly, I formed a working group from the Finance Board and the Federal Home Loan Banks to review the implications of acceding to the Administration's request.

Early this year, I concluded that voluntary registration with the SEC was indeed the best approach to providing enhanced public disclosure of the operations and finances of the Federal Home Loan Banks. I reached this conclusion based on two premises.

First, the Banks' long-term access to global capital markets will be enhanced by providing investors in consolidated obligations with maximum reliable transparency into the finances and governance of each of the 12 Banks. Markets function best, especially in times of stress, when needed information is readily available and reliable.

Second, as public trusts, these 12 GSEs have a duty to contribute both to the smooth functioning of capital and mortgage finance markets and to public confidence that the benefits of GSE status are used wisely.

At my urging, Federal Home Loan Banks and the staff of the SEC have held numerous meetings to address the process for voluntary registration, including methods for resolving several key disclosure and accounting questions.

The Board of Directors of the Federal Home Loan Bank of Cincinnati actively embraced the disclosure initiative as in the best interest of its members, voting in February to pursue voluntary registration. Last month, the Cincinnati board resolved to "actively engage, effective immediately, in the process of voluntary registration with the SEC of its member-held stock."

This summer, too, the boards of the Federal Home Loan Bank of San Francisco and the Federal Home Loan Bank of Atlanta resolved that if SEC registration was the determined course of action, it is their request that the Finance Board adopt a regulation requiring it.

In response to those requests, at its regularly scheduled meeting tomorrow the Finance Board will consider a proposed regulation requiring each Bank to register a class of securities with the SEC under section 12(g) of the Securities Exchange Act of 1934.

The proposed rule provides for a lengthy, 120-day comment period, during which, I hope, the Banks will each meet with the SEC to work out the necessary details to effectuate registration and begin meeting the periodic financial reporting requirements of the '34 Act.

The focus of the enhanced disclosure effort from the start has been to ensure that the Federal Home Loan Banks play their part, as government sponsored enterprises, in contributing to the smooth functioning of the capital and mortgage finance markets. In the end, consistent and full disclosures of these institutions' finances and corporate governance also serve the public, who stand behind their charters as government sponsored enterprises.

ACQUIRED MEMBER ASSETS (AMA)

I have been asked to address two other issues in my testimony today. The first of these concerns regulations governing the Acquired Member Assets programs, or AMA, of the Federal Home Loan Banks.

The 12 Federal Home Loan Banks are authorized to purchase single-family mortgages that do not exceed the conforming loan limit applicable to Fannie Mae and Freddie Mac, currently $322,700. The authority granted under the current rule (12 C.F.R. Part 955) is an expansion and refinement of previous authority that had been granted to the Banks by a Finance Board resolution in 1996. That authority was challenged in 1997, a challenge rejected by a U. S. District Court in 1998. The U.S. Court of Appeals for the Fifth Circuit upheld the District Court's ruling in 2000, affirming the Finance Board's authority in this area.

There are currently two AMA programs – Mortgage Partnership Finance ™ (MPF) and Mortgage Purchase Program (MPP). MPF is the older and larger program. Under the current AMA programs, a Bank may purchase mortgage assets from a member institution. The programs, like advances, provide member institutions liquidity for mortgage lending. In AMA programs, the member manages and bears a material portion of the credit risk. Since the programs' inception in 1996, the Banks have purchased more than 600,000 loans. Approximately 75 percent of those loans were purchased under MPF and 25 percent under MPP. More than 95 percent of the total loan acquisition has occurred since 2000, the current AMA regulation having become effective on July 17, 2000.

On July 1 of this year, the Finance Board unanimously adopted and published for comment a proposed revision to the current AMA regulation. The Finance Board's intent is clearly stated in the preamble to the regulation, that is, to make the regulation more "effective and efficient in regulating the Banks' mortgage purchase programs." In the rule, the Finance Board also seeks to clarify and simplify the language of the current rule. The proposed regulation does not expand or alter the fundamental structure of the AMA programs.

The proposed regulatory changes also maintain or strengthen many appropriate safety and soundness provisions of the current rule, again reflecting the Finance Board's continued emphasis on improving its safety and soundness oversight of the Federal Home Loan Banks.

Safety and soundness provisions maintained or strengthened under the proposed rule include requirements that:

- All AMA must be at least investment grade when acquired by the Bank.
- The Bank must have in place a process and methodology to determine the required credit enhancement prior to acquisition of any asset and throughout the life of the asset on the Bank's books.
- The Bank must take remedial action by requiring the member to provide additional credit enhancement or hold additional capital if the estimated credit rating of the asset declines to below the rating required at time of acquisition.
- Insurers must be rated AA or better to provide a portion of the credit enhancement to the member institution selling assets to the Bank.
- Banks without risk-based capital structures in place must hold retained earnings for losses as support for the credit risk associated with any AMA estimated to be rated below AA.

In addition, the proposed regulation incorporates Finance Board criteria previously set forth in the preamble of the July 2000 final AMA rule outlining the circumstances under which Banks are permitted to acquire from members highly rated interests in pools of mortgages as an alternative to acquiring whole loans. Among the criteria is a requirement that all loans backing such interests must themselves be eligible for purchase by the Bank as AMA. As with any new AMA product, a Bank is only allowed to acquire such interests after its proposed program has been reviewed and approved under the Finance Board's New Business Activity regulation.

The proposal further seeks comment on whether the Finance Board should take measures to prevent a Bank from acquiring loans or assets backed by loans, through its AMA program, where the loans have features or were made under circumstances that may be considered predatory or abusive. The proposal also asks for comment on whether and how to limit Banks' authority to acquire such loans or assets backed by such loans.

The text of the proposed regulation maintains the current prohibition on purchases directly from affiliates of member institutions. In response to numerous requests from members using affiliates and subsidiaries for mortgage origination activities, the preamble does invite comment on changing current policy to allow affiliates owned and controlled by members to directly sell assets to Federal Home Loan Banks.

The importance of revising Finance Board regulations to better reflect the agency's supervision approach argues for a constructive exchange among the interested public, Federal Home Loan Banks, and the Finance Board. It appears, however, that some may have misunderstood the intention of this proposed regulation.

As a result, in agreement with my fellow Directors, I will ask the Finance Board to vote at its regular Board meeting tomorrow to withdraw the present rulemaking. The proposed text will be revised and clarified to more clearly enunciate the principles I listed above, and the resulting proposed regulation will be voted on in a subsequent meeting. If approved by the Finance Board, the revised proposed regulation will be published for a 90-day comment period.

MULTIDISTRICT MEMBERSHIP

When I became Chairman of the Finance Board in December 2001, the multidistrict membership debate was already over a year old, having been prompted by regulatory requests filed in 2000 and 2001 by four Federal Home Loan Banks that had lost large members to mergers with institutions headquartered in other Federal Home Loan Bank districts. A Solicitation for Comments on the issue was pending and remained open until March 2002.

When Congress created the 12 Federal Home Loan Banks 71 years ago, it anticipated that each member thrift institution would operate where its collateral was located, and at that time, that meant in its home state alone. The financial world, of course, has fundamentally changed since 1932, as has the membership base of the

Federal Home Loan Banks now that membership is voluntary for all and open to commercial banks and credit unions, as well as thrifts and insurance companies.

With the advent of interstate banking and national holding companies, the Federal Home Loan Banks are operating in a different competitive environment than existed through most of their history. For Bank member institutions organized under certain holding company structures, multidistrict membership already exists. One hundred three holding companies, doing business in more than one Federal Home Loan Bank district through separately chartered subsidiaries, currently account for 451 distinct Bank memberships. Institutions that operate in multiple regions through a single charter, however, are precluded by Finance Board regulations from establishing similar operating arrangements with more than one Federal Home Loan Bank.

Let me make clear that, while it is my view that the Federal Home Loan Bank Act both empowers and obligates the Finance Board to continue regulating the terms of Bank membership to the extent necessary to ensure safe and sound operation of Banks, access by Banks to capital markets, and achievement of the Banks' housing finance mission, I am neither an advocate nor an opponent of expanding multidistrict membership in the Federal Home Loan Bank System.

When I became Chairman, I asked the four Banks seeking regulatory approval for multidistrict membership to withdraw their requests to permit a thorough, comprehensive review of the changed financial services industry and mortgage market circumstances that give rise to the multidistrict issue. That review has occurred without producing any compelling reason for the Finance Board to address the question of expanded multidistrict membership on its own initiative.

My commitment to those Banks that withdrew their pending regulatory requests, however, was that, when the review was complete, any Bank seeking authority to admit as a full member an institution doing business in that Bank's district but maintaining a charter and membership in another Federal Home Loan Bank district would be afforded an opportunity to make its case to the Finance Board and present its recommended solutions to the various operational challenges its proposal would raise. In June, in fulfillment of my commitment to those Banks, I requested the Office of Supervision and the Office of General Counsel to draft a proposed regulation establishing a process by which the Finance Board could receive, review, and accept or reject such applications, should any Bank choose to make one. No Bank, however, has made any request to the Finance Board to proceed on multidistrict membership, the draft proposal was never completed, and no further Finance Board action establishing a procedure is planned.

CONCLUSION

Chairman Bennett, distinguished members of the subcommittee, I close by returning to the very reason the Federal Housing Finance Board exists: to ensure that

Federal Home Loan Banks operate in a financially safe and sound manner, carry out their housing-finance mission, and remain adequately capitalized and able to raise funds in the capital markets.

Since 2002, the Finance Board has dramatically improved its ability to perform these statutorily mandated responsibilities. The agency's supervision function is stronger, more thorough, and more effective. Taken in conjunction with the initiative to enhance the financial disclosures filed by the Federal Home Loan Banks, I believe the Finance Board is capably representing the interests of the public and taxpayers who stand behind the Federal Home Loan Banks and who benefit from the successful performance of the Federal Home Loan Banks' important role in housing finance.

Appendix 4.

Letter from ACB to Ms. Elaine Baker, Board Secretary,
Finance Board, dated November 17, 2000, Re: Capital Requirements for
FHLBanks, 65 FR 43408 (July 13, 2000);
and Letter from ACB and several state banking organizations
to Ms. Elaine Baker, Board Secretary, Finance Board, dated April 16, 2001,
Re: Capital Requirements for FHLBanks, 66 FR 14093, (March 9, 2001)

April 16, 2001

Ms. Elaine L. Baker
Secretary to the Board
Federal Housing Finance Board
1777 F Street, NW
Washington, DC 20006

Re: Capital Requirements for Federal Home Loan Banks
66 FR 14093, March 9, 2001

Dear Ms. Baker:

America's Community Bankers (ACB)[1] and the undersigned state trade associations are pleased to offer their comments on the Federal Housing Finance Board's ("Finance Board") Advance Notice of Proposed Rulemaking No. 2001-05: Capital Requirements for Federal Home Loan Banks ("FHLBanks").[2]

On December 20, 2000 the Finance Board approved the final rule implementing a new capital structure for the FHLBanks. In approving the final rule the Finance Board indicated that it would later issue an advanced notice of proposed rulemaking to afford interested parties the opportunity to address any remaining issues either not handled in the final rule or that required further consideration. We appreciate this opportunity provided by the Finance Board.

Virtually all of ACB's and the state associations' members are FHLBank System ("System") members, and they collectively hold the majority of the stock in the System. As a result, the proper development and implementation of the FHLBanks' new capital plans is of vital importance. We were appreciative that the Finance Board was responsive to the concerns of the System's members in crafting the final capital rule. While the final rule gave the FHLBanks the necessary flexibility to develop capital plans appropriate for their stockholders and provides the basis to ensure that a suitable degree of commonality exists among the plans of the twelve FHLBanks, we request the Finance Board make several modest, but important changes.

Activity Based Capital Requirements

We were pleased that the Finance Board agreed with us on the importance of maintaining the System as a cooperative. It is the cooperative nature of the System that sets it apart from other government sponsored entities and allows it to effectively serve the wholesale capital market access needs of its members. To continue to serve its community bank members as one of the most important sources of wholesale funding, the FHLBanks must be able to respond to dramatic shifts in funding demand. To accomplish this, the FHLBanks must be able to access the capital markets; effectively manage market risk; and maintain the necessary level of capital to meet applicable minimum capital requirements. Traditionally the FHLBank members' funding needs have been met through System advances. To acquire an advance, members must collateralize and capitalize the advance.

The FHLBanks have never experienced a loss associated with the extension of advances to their members. The risk of losses has been minimized because FHLBank System members seeking advances are required to post high quality loans as collateral. A risk-averse approach to the extension of advances, or other functionally equivalent program, is important in a cooperative system where each of the FHLBanks and their member-owners are jointly and severally liable. Requiring an activity based stock purchase requirement further indemnifies the system against losses, and of equal importance it helps ensure that the FHLBank meets its minimum capital requirements and provides additional capital to the FHLBank when members require new funding.

Activity based stock purchase requirements can help ensure the continued cooperative nature of the FHLBank System. If each FHLBank member is required to capitalize its own activities, the FHLBank's programs should not require additional capitalization by non-participating FHLBank members. The combination of minimum capital requirements for membership coupled with activity based requirements can also prevent creation of separate classes of membership with some gaming the FHLBank for lower interest rates on advances while others game the FHLBank for higher dividends.

The final capital rule adopted by the Finance Board mandated that, when activity based stock purchases are required, the FHLBank member engaged in the activity must maintain the stock for the life of the activity. This sound policy is based on the principle that the member generating the activity provides the capital to support the activity. The Finance Board has recognized that new activities of the FHLBanks, acquired member assets ("AMA") that include products like the mortgage partnership programs, are the functional equivalent of advances. However activity based stock purchase requirements are only recommended. The Finance Board's requirement to hold the stock for the life of the activity is a sound and prudent policy. ACB and the state associations strongly request that the policy be expanded to require activity based stock purchases for advances and AMA programs like the mortgage partnership programs as part of the FHLBanks' capital rules.

FHLBank Capital Plan Approval and Disclosure

The Finance Board has recognized in its meetings, speeches, and final capital rules the importance of ensuring that adequate commonality exists among the 12 FHLBanks' capital plans. The FHLBanks have until October 29, 2001 to submit their proposed capital plans to the Finance Board for approval. The Finance Board's approval process is where commonality can be ensured.

As part of that process, we believe it is important that the FHLBanks' capital plans be approved based both on the merits of each individual plan and the affinity of all the plans. The process must also make sure there is adequate financial transparency for the joint and severally liable members across the twelve-FHLBank cooperative System. To accomplish this and to avoid any potential arbitraging of the FHLBank plans, we request the Finance Board adopt, and disclose, a process in which no FHLBank capital plan will be approved until all plans have been submitted, and that as plans are submitted that they be made readily and immediately available to the public with an opportunity for a 30-day public comment period.

ACB and the undersigned state associations appreciate the opportunity to comment on this important matter. If you have any questions, please contact Eric Mondres at (202) 857-5577.

Sincerely,

America's Community Bankers
Community Bank League of New England
Community Bankers Association of New York State
Iowa's Community Bankers
Michigan League of Community Banks
Minnesota League of Savings & Community Bankers
Missouri League of Financial Institutions
New Jersey League of Community & Savings Bankers
Ohio League of Financial Institutions
Texas Savings & Community Bankers Association
Western League of Savings Associations

[1] ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

[2] 66 Fed. Reg. 14093 (March 9, 2001).

America's Community Bankers
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November 17, 2000

Ms. Elaine L. Baker
Secretary to the Board
Federal Housing Finance Board
1777 F Street, NW
Washington, DC 20006

Re: Capital Requirements for Federal Home Loan Banks
65 FR 43408 (July 13, 2000)

Dear Ms. Baker:

America's Community Bankers (ACB) is pleased to offer its comments on the Federal Housing Finance Board's (FHFB) proposed regulations for a new capital structure for the Federal Home Loan Banks (FHLBanks). ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

Virtually, all of ACB's members are members of the Federal Home Loan Bank System (System) and they hold half of the nearly $32 billion of stock in the System. Our members have been vested in the cooperative-based System since its creation in 1932 and are the community banks that first formed the cooperative partnership that continues to help finance our country's urban and rural housing and community development needs. This cooperative partnership supports our nation's community-based financial institutions and facilitates their access to credit. Restructuring the capital requirements and the capital stock and maintaining the cooperative nature of the System are of great importance and of the highest interest to ACB.

ACB would like to thank the Finance Board for extending the deadline for filing comment letters on this proposal. The extension has enabled more thorough examination of the important issues involved. We are aware that the Board itself has been effectively using this time in reviewing its range of options within the confines of the revised statute. ACB has also devoted considerable resources and time to reviewing the capital restructuring options and the long-lasting and significant ramifications such changes may have on America's community banks. ACB has great appreciation for the Board's efforts to objectively assess how much change, especially in the dimensions of voting and FHLBank board of directors' representation, can be effected under the new law. *It is vital that we as an industry, the FHLBanks, and the Federal Housing Finance Board take the time necessary to get the regulations right the first time.*

Additional Comment Opportunity Requested

As a threshold issue, ACB urges the Board to either issue a revised proposed rule or, at the least, promulgate a rule in interim final form with an additional sixty-day comment period. This will be especially important if the language of the final rule contains significant changes from that of the proposal. As part of any subsequent rulemaking ACB urges the Board to stipulate that, while encouraging early submissions of FHLBank capital plans, no submitted capital plan will be approved until the Board has reviewed all FHLBank capital plans. ACB believes that such an approach will help ensure that appropriate "commonality" exists among the 12 FHLBank capital plans, and that such deferral of approval would not impose any undue delay in the work of the individual FHLBanks in moving towards the implementation of their capital plan.

Approval Timing for Capital Plan

Preserving the cooperative nature and coordination of the 12 Bank, FHLBank System is essential to continuing the access to credit that facilitates the ability of America's community banks to finance our country's urban and rural housing and community development needs. Having all the Banks' capital plan submissions in hand before approving any one will enable the Board to meet its charge to assure adequate safety and soundness regulation and coordination of the entire System as a whole rather than as individual components. One of the concerns that ACB has raised consistently about the new capital structure is that it should have enough commonality across the FHLBanks to avoid destabilizing incentives for certain large members doing business across more than one FHLBank district, permitting them to "arbitrage" their operations in search of particular configurations of capital and activity requirements. It is essential that the final capital rule provide the foundation for a system that is fair to all FHLBank members, allowing them to continue their mission of meeting their community's credit needs.

Commonality and Flexibility

Commonality is a term that ACB has used to describe the context in which the new capital rules should be considered and developed. ACB strongly supports a capital regulation that ensures sufficient coordination of the final capital plans across the entire System to avoid destabilizing competition and arbitrage of membership and to preserve the cooperative nature of the System. Commonality does not mean that all FHLBank capital plans should be identical. ACB strongly believes that System governance should be devolved to the FHLBanks. *Properly applying the concept of commonality will provide necessary flexibility for the FHLBanks to develop the best capital plans for their members and regions, while ensuring a strong, stable cooperative System.*

Conversion Procedures for Existing Stock

ACB strongly urges the Board as well as the FHLBanks to take all necessary steps to ensure that regulations and capital plans avoid triggering tax recognition events and adverse accounting and regulatory capital treatments. Toward this end, ACB understands that almost all of the FHLBanks are currently contemplating the automatic conversion of all existing FHLBank stock to Class B form. This is expected to avoid tax recognition of the conversion event. ACB supports the flexibility for each

FHLBank to decide whether to convert automatically to Class A, Class B, or a choice/combination of Classes A and B.

ACB understands that the decision to convert existing stock to all Class B need not foreclose the option of issuing Class A later. Similarly, decision to have both Class A and B available at the time of the initial move to the new regime need not foreclose the option of moving to an all Class B approach subsequently. The statutory risk-based requirements may necessitate the issuance of some Class B stock by FHLBanks so that Class B is likely the only viable "single-stock" format.

Tax and Accounting Dimensions

ACB supports the general architecture of treating any Class A stock that is issued as akin to senior or preferred stock, with the Class B stock playing the role of the common equity. *However, ACB cannot emphasize too strongly the serious tax and financial accounting complexities involved, and appreciates the willingness of the Board and the FHLBanks to discuss these topics openly.* ACB also agrees that it is necessary to move ahead with some concrete specifications for Class A and B stock in order to get a better fix on how these tax and accounting issues may be resolved. ACB is confident that the Board will continue to allow the FHLBanks adequate flexibility to secure the equity classification of their capital instruments under evolving GAAP and the best feasible risk-weighting of FHLBank stockholdings for the members under federal banking rules. While these issues may be beyond the total control of the FHLBank System or its regulator, a coordinated effort to favorably resolve these issues can ensure a low-risk approach to avoid an unfavorable result.

Elective Director Allocation and Voting Rights

ACB urges the Board to apply a strict interpretation of the statute to avoid legal challenges that could delay and complicate the transition to a new FHLBank System capital structure. Perhaps the most divisive issue within the ambit of the proposal is its treatment of elective directorship allocation and the voting rights of members/shareholders. ACB is concerned about possible conflict and legal challenge to the Board's interpretation of Sections 6 and 7 of the Gramm-Leach-Bliley Act. In the preamble to the proposal, the Board asserts, "it is not possible to reconcile" certain aspects of sections 6 and 7 of the FHLBank Act and, as a result, significant elements of Section 7(b) and (c) "must be considered to have been impliedly repealed."

ACB believes the Board's interpretation of the Gramm-Leach-Bliley Act changes affecting FHLBank director allocations and member voting is wrong. There are inconsistencies in the amended FHLBank Act. The new language contained in section 6 clearly indicates congressional intent to allow the FHLBanks to provide additional preferences for Class B voting rights. Section 6 also states that those preferences must not be "inconsistent with this Act." The Board's proposal to limit individual members' voting rights to no more than 20 percent of the votes eligible to be cast (or such lower level established by a FHLBank) appears to be inconsistent with the state average number of shares limits contained in Section 7 of the Act. However, providing additional weight to the votes of Class B shares of stock without changing the state average weighting given to both Class A and B stock that can be voted may not be inconsistent with the Act. Under this approach, where both Class A and B stock are outstanding, the two could be converted into a "common currency." This could be done, for example, by treating each share of Class B as equal to 1.5 shares of Class A.

After weighing the options on voting rights for members, *ACB supports, consistent with the FHLBank Act, a rule allowing the individual FHLBanks to designate director seats for the System's members by stockowner/user size, better ensuring small, medium and large System user representation in each state.*

ACB strongly opposes using the "one member one vote" approach mentioned in the preamble of the proposal. This is the equivalent of further tightening the current voting limits on director elections to allowing only one share per member to vote. This would represent a move in the wrong direction and would disenfranchise the major System users with the proportionately larger investment in FHLBank stock

ACB notes that if there is a decision to maintain the current apparatus of the average holdings per in-state member, the Board will have to provide guidance on the continued allocation of the elective director positions by state. It might be minimally disruptive by using the common currency approach of putting both Class A and B into a single standardized measure to scrap the distinction between total and required holdings of FHLBank stock in that allocation formula. The difference in the allocations of director slots by state would be marginal.

ACB opposes the addition of advisory directors to the boards of the FHLBanks. New non-voting positions would not be acceptable substitutes for full voting positions and would be an added expense and distraction. Access to a range of outside perspectives is the function of the appointed, public interest directors.

No Need for Ownership Limit

ACB opposes the proposal's 40 percent ownership limit. Since the constraint on voting FHLBank stock will occur well below the value of 40 percent suggested in the proposal as the upper limit on ownership, ACB does not see any purpose in including such an ownership limit. Unless ownership can be converted into control, which is impossible given the voting limits and the other restrictions on FHLBanks under the basic charter as government-sponsored enterprises, the ownership limit is unnecessary. Such a limit could be counterproductive by cutting off the source of capitalization provided by large, heavy-user members of the FHLBank. If the ownership limit is eliminated, there is also less need to expand the use of fees to cover what would normally be capitalized by additional activity-based stock purchases.

Dividend Priority and Subclasses of Stock

ACB supports providing additional flexibility for the FHLBanks in setting the priorities and dividends for Class A and B stock. The Gramm-Leach-Bliley Act shifted the System's governance from the Board to the individual FHLBanks. The Board should accord the FHLBanks the maximum flexibility possible in establishing the priorities and dividends for Class A and Class B stock. The proposal gives the dividend on the Class A stock priority over dividends on Class B stock and requires that the Class A dividend be set in advance pursuant to some formula/indexation. It also appears to permit the formula/index to include a floor and a ceiling, and for Class A to receive supplemental dividends before or after the declaration of dividends on Class B. In that case, the exceptions to pre-computation of Class A dividends could ultimately render the indexation requirement meaningless. *If the Board finds that it must accord priority to Class A dividends, ACB strongly urges the Board to leave other details to the FHLBanks.*

ACB opposes the authorization of subclasses of Class A and Class B stock. Multiple classes of A and B stock is not consistent with statutory language that contemplates only two types of stock. Also, the creation of subclasses will add an unnecessary dimension of complexity to the FHLBank System. For example, in creating a subclass of "tracking stock" to mimic the returns of the Mortgage Partnership Finance program (or other acquired member asset initiative), complex questions of how much of that stock can be offered without diluting the benefits of the program to shareholders at large would inevitably arise.

In addition, as stated earlier, ACB supports a regulation that promotes commonality between the FHLBank capital plans. Allowing FHLBanks to issue subclasses of stock could create significant differences between FHLBank capital plans resulting in potentially destabilizing incentives for large institutions located in multiple Bank districts to arbitrage the System. *The Board should avoid potentially destabilizing incentives and seek to promulgate regulations that will simplify the System members' conversion to a new capital structure.*

Importance of 'User-Stock' Capitalization

ACB supports activity-based stock purchase requirements. As a cooperative System, FHLBank System members should be required to capitalize the activities in which they engage through stock purchase requirements. ACB urges the Board to adopt a regulatory approach that continues the "user stock" tradition by requiring members that use the FHLBank as counterparty in a transaction to provide the capitalization for the position. While advances usage will and should continue to be the major program purpose of the System, new activities and programs such as the Mortgage Partnership Finance (MPF) program (or other acquired member asset initiatives) are growing as significant components of the FHLBanks balance sheets. It would make sense to extend an activity-based requirement to MPF and other positions.

ACB recognizes that, in some circumstances, such as stand-by letters of credit, it is reasonable for the counterparty to offer or be assessed a fee rather than a stockholding requirement for the service. Nonetheless, it is appropriate to establish a rebuttable presumption of an activity-based stockholding requirement for member-counterparties to capitalize the major lines of business of the FHLBanks. *Because ACB opposes secondary market trading of FHLBank stock, we suggest that the FHLBank be authorized to require the holding of user stock as long as the counterparty position is maintained, not just its initial purchase to capitalize that position. Conversely, we support authorizing the FHLBanks to redeem individual members' excess stock without regard to notice requirements.* For example, it serves no purpose to require a member to hold stock in support of advances that have been repaid. Allowing such redemption of excess stock will help prevent the unnecessary over-capitalization of a FHLBank.

Membership Fees and Joint Stock

ACB strongly opposes any substitution of annual membership fees for the statutorily mandated minimum stock purchase requirements for System members. Stock ownership is essential to maintain the cooperative nature of the System. As noted above, fees can have a useful auxiliary role for some minor, "member accommodation" lines of business, as current practice provides. However, an accommodation fee is distinct and different from an annual membership fee. Further more, there is no express statutory authority for the annual membership fee option, though there is an explicit requirement for a (meaningful) minimum stockholding.

In an October 16, 2000 letter to the Board, U.S. Representative Richard Baker, chairman of the House Banking Committee's Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises and primary author of the FHLBank Modernization Act, made similar points. As Chairman Baker writes, "... during the legislative process the issue of membership fee in lieu of a minimum stock purchase requirement was considered and rejected. The Finance Board's interpretation in developing this provision of the proposed capital rule is contrary to the Act and Congress' legislative intent." *We request the Board to delete this provision from the final rule.*

ACB opposes joint stock or joint issuance of stock by more than one FHLBank. Such issuance would be a major step, unsanctioned by any statutory revision. The pooling of stock across more than one FHLBank, for example, to capitalize a participation interest sold by one FHLBank (where the user stock capitalization is provided) to another, would be less of a departure, but would still represent a breach in the separation of the FHLBanks within their System. It would be more sensible to explore other capitalization and service compensation arrangements among the FHLBanks concerned.

Issue/Redemption at Par and Tradability

ACB opposes the proposal's provision allowing a FHLBank to issue Class B stock at a price other than par. ACB urges the Board to maintain the familiar and workable approach of issuing and redeeming Class B stock only at par. The statute requires the equality of issuance and redemption price at par for Class A. It seems likely that the omission of this requirement for Class B stock was a drafting oversight rather than an invitation by the Congress to allow the "back door" creation of the "permanent paid-in" Class C stock that had been specifically considered, but rejected well before moving to the final language of the amendments.

ACB opposes active tradability of any class of FHLBank stock and requests the elimination of the language that repurchase transactions between the FHLBank and a member be conducted at a negotiated price. These deals should be done at par, the member-expected price for all sales/purchases, and regulations should reflect that sentiment. ACB supports maintaining the current approach of conducting substantially all purchases and sales of FHLBank stock with the FHLBank itself, with all sales and purchases at par. Because the cooperative nature of the System implies little upside potential in the open market value of FHLBank stock, tradability is unnecessary and would add additional mark-to-market risk to the financial statements of FHLBank shareholders. FHLBank facilitation of occasional between-member sales – also at par – should be allowed if needed to maintain the current option of tax deferral on dividends paid in additional FHLBank stock.

Redemption at *Pro Forma* Book Value

Despite real appreciation for its ingenuity, *ACB opposes the pro forma book value redemption approach*. The book value price would have the redemption price for Class B stock increase over time to incorporate the *pro rata* ownership of the retained earnings of the FHLBank.

ACB does not see any substantial advantage to this concept that could not be derived from paying out retained earnings as dividends in the form of Class B stock. If the book value approach is to afford the alleged advantage of dealing truly equitably with the ownership of those retained earnings, fairness requires the reflection of how long each share of Class B has been outstanding to support the operations of the FHLBank. Thus the approach would eventually have to include tranches of added value to each "vintage" of Class B stock. Not all Class B stock would have the same book value. This would be operationally burdensome and an accounting distraction.

More significantly, value added to the Class B stock in this manner would not currently be included in the most important measure of income under GAAP. Under Statement of Financial Accounting Standards (SFAS) No. 115, fluctuations in the value of equity securities flow into other comprehensive income and to the capital account, bypassing the regular income statement. On the other hand, dividends paid in additional shares of Class B stock would be included in GAAP income. In addition, the members' ownership interest in those shares would be truly unquestionable and would automatically reflect the performance of the FHLBank over the reporting and dividend period. Thus, the complexity of tranches of added book value per vintage of Class B stock would be completely unnecessary. *ACB further suggests that the clarification under the statutory amendments that Class B stockholders are the owners of any retained earnings not hitherto distributed as dividends, should be reflected in the final regulation.*

It is also important to recognize that the FHLBanks will need to maintain some level of retained earnings to absorb potential charges from the asymmetry of treatment of hedging instruments and on-balance-sheet hedge "targets" under SFAS No. 133. As discussed below, unless some revisions are secured in the market risk component, it appears that the new regime would require even tighter financial management than the current Financial Management Policy. In addition to the impact on earnings and dividends, that added stringency could require a higher level of hedging activity, with additional risk of asymmetric accounting treatment, with the result being a need for a retained earnings cushion to protect against losses on the derivative hedge position.

Higher Operating Capital Ratios

ACB opposes the proposed requirement for formal operating capital ratios over and above the regulatory capital requirements for both leverage and risk-based capital ratios. We request the Board eliminate these provisions from the final rule. ACB certainly concurs that each FHLBank will, in the course of regular and prudent financial management, seek to maintain a safety margin above the minimum regulatory capital requirement. ACB does not object to the FHLBanks being asked to set such a target margin as part of its capital plan, but we strongly oppose the restrictions that are contemplated if the FHLBank goes either above or below those operating capital ratios. Such restrictions could create inequities in System usage by members and would constrict the FHLBanks ability to manage its capital and operations. If it is above the proposed operating capital ratio, the FHLBank would not be able to impose activity-based stock purchase requirements. If it is below that ratio, its operating flexibility would also be restricted.

Presumably, the prohibition on requiring additional capital purchases is to avoid overcapitalization of the FHLBanks and the need for arbitrage investments to earn a return on the excess capital. But the weaknesses of the current system do not flow from activity-based requirements. They result from the inflexibility of the subscription requirement from non-borrowers and from the limitation of the activity base to advances only. The Gramm-Leach-Bliley Act has removed these weaknesses, and the FHLBanks will be able to set their capital levels with more discrimination. The operating capital ratios are an unnecessary complication.

Operational Risk Add-On

ACB believes that the proposal takes a reasonable approach to the operational risk component of the risk-based capital requirements. It appears that the Board is applying this operational risk add-on based on its interpretation of the Gramm-Leach-Bliley provisions requiring the Board to take "due consideration of any risk-based capital test established" by the Office of Federal Housing Enterprise Oversight (OFHEO) for Fannie Mae and Freddie Mac. OFHEO is statutorily required to impose a 30 percent operational risk add-on for Fannie Mae and Freddie Mac.

ACB commends the Board for its analysis that enabled it to propose a more flexible approach to operational risk. The proposal allows FHLBanks to use insurance coverage and documentation of the range of operating risk factors to reduce the regulatory 30 percent add-on imposed to a floor of 10 percent.

Credit Risk Components

In general, the Board's proposal shows commendable sophistication in its treatment of credit risk and the attempted linkage to credit ratings. *ACB suggests that the regime being developed by the Board be linked more closely to the credit risk weights being applied by OFHEO to the other housing sector GSEs.*

ACB cannot suggest a more comprehensive dataset to permit the default rates on mortgages to be more accurately linked to security ratings. The available mortgage default data are somewhat patchwork in nature and their relevance to the present, still less the future, is debatable. By contrast, OFHEO has been conscientiously modeling the stress test prescribed in detail by its governing statute and has arrived at risk weights for mortgage-related assets that are lower than those suggested by the proposal.

The Board's proposed risk weight for Fannie Mae /Freddie Mac mortgage-backed securities should be lower than the 45 basis points charge that appears to apply to both direct positions in mortgages (as under the MPF program where the FHLBank has the same -- or greater -- exposure as the other GSEs in their MBS guarantor/investor business) and to MBS holdings of the FHLBanks.

If those MBS holdings are Fannie/Freddie guaranteed, however, the FHLBank has the added credit support of the GSE guarantee in comparison with MPF positions and has thus greater protection from the risks embedded in equivalent credit quality underlying mortgage pools.

As a general matter, it would seem reasonable for the FHLBank capital requirement for MPF to be about equal to the required GSE capital support for their issuance of MBS. Thus, the absolute credit risk weight for MPF positions is itself arguably too high, since the 45 basis points charge is 5 to 7 basis points higher than the level assessed by OFHEO. The risk weight for GSE-issued MBS is far too high.

It is possible to take the view that the OFHEO risk weight for straight mortgage credit risk is too low and that the "correct" capital support for MPF is 45 basis points. But the identical risk weighting of MBS and MPF, both of which are of conforming quality but one of which has an added layer of protection before the FHLBank is exposed to loss, seems misguided. Further analysis of the proposal and consultation with OFHEO might be helpful.

Advances Risk Weight

ACB believes that the Board's proposed risk weights for advances are higher than justified and requests the Board reexamine the proposed weighting to support advances. The problem is particularly acute at the long end of the spectrum where the risk weight rises to 45 basis points for high quality mortgage-related advances. At the short end of the advances maturity spectrum, the risk weight is more reasonable (at 7 basis points it is slightly less than 1% of the regular depository institution capital support requirement of 8%).

It is important to recognize that advances are not the equivalent of the mortgage position: the advance is over collateralized by 20 percent, and is also supported by the FHLBank stock purchased and pledged as additional protection that supports the advance. If the mortgage position (see above) should be recalibrated down to 40 basis points, the long advance should be set even lower, perhaps around 25 basis points.

ACB appreciates the decision of the Board to treat advances independently of the underlying collateral, indicating that the Board is committed to appropriate differential over collateralization depending on the type of collateral offered as support of advances. This approach will help to ensure that the FHLBanks' zero-risk tolerance for advances remains unchanged with the introduction of new eligible collateral

Diane M. Casey
President & CEO

America's Community Bankers
900 Nineteenth Street, NW, Suite 400,Washington, D.C. 20006
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Appendix 5.

Memorandum to the Directors of the Finance Board,
from Stephen Cross and John Kennedy, dated, March 1, 2006,
as provided to ACB by the Finance Board on July 6, 2006.

Federal Housing Finance Board

TO: Chairman Ronald A. Rosenfeld
HUD Secretary Alphonso Jackson
Director Alicia R. Castaneda
Director Franz S. Leichter
Director Allan I. Mendelowitz

FROM: Stephen M. Cross, Director, Office of Supervision
John P. Kennedy, General Counsel

SUBJECT: Proposed Regulations Concerning Excess Stock and Retained Earnings

DATE: March 1, 2006

I. Overview

We are proposing to amend Parts 917, 925, 930, and 931 of the Rules and Regulations of the Federal Housing Finance Board (Finance Board) and to add a new Part 934. These proposals would establish a regulatory limit for excess stock in a Federal Home Loan Bank (FHLBank or Bank) and establish a regulatory minimum retained earnings requirement for each FHLBank. If the proposed amendments are adopted, a Bank would no longer (i) be permitted to pay stock dividends or (ii) sell capital stock to members if the stock would be excess stock at the time of purchase. A Bank's dividends would be constrained if the Bank had less than its regulatory minimum retained earnings. These proposed regulatory amendments are intended to prevent recurrence of supervisory concerns regarding capital composition, capital management, and retained earnings that have given rise to formal and informal enforcement actions taken by the Finance Board in recent years. There is no question of capital solvency of any FHLBank; it is the composition of the capital that gives rise to these proposals.

II. Excess Stock Limitation

FHLBank capital stock that members hold in excess of the amount they are required to purchase as a condition of membership or to support their activities with the Bank is referred to as "excess stock." Excess stock presents two principal supervisory issues for the Finance Board. First, member institutions can redeem their excess stock at its par value without curtailing activities with the Bank or withdrawing from membership. Many of the Banks have commonly repurchased member stock on request,

notwithstanding the provisions in the Federal Home Loan Bank Act that establish six-month to five-year statutory redemption periods.[1] Repurchasing excess stock "on demand" can create capital management difficulties for the Bank if the Bank relies on excess stock to fulfill any part of its regulatory capital requirements, particularly if multiple, large redemption requests were to be submitted in a short period of time. Second, advances are normally supported by required "activity" stock. Any excess stock will typically be used to capitalize non-advance assets, such as mortgages (Acquired Member Assets or AMA), mortgage-backed securities (MBS), and other investments. Although a Bank may impose an "activity" charge to support AMA, only six of the 12 FHLBanks do so. Using excess stock to capitalize mortgages or other long-term assets is undesirable from a supervisory perspective to the extent that members expect the stock to be repurchased at par and virtually upon notice. Using excess stock to capitalize investment securities beyond an amount needed for liquidity is also undesirable from a public policy perspective to the extent that the Government Sponsored Enterprise (GSE) borrowing privilege is being used to fund activities that are not related to the GSE's core mission.

The proposed regulatory amendments should serve to reduce the risks of capital instability associated with relying on excess stock to meet regulatory capital requirements. It would also limit the use of excess stock as a way of funding mortgages or investments. Specifically, we are recommending that the board of directors of the Finance Board amend or introduce the aforementioned regulations to:

1. Limit excess capital stock in any FHLBank to no more than one percent of the Bank's assets;

2. Prohibit members from purchasing capital stock in excess of their required stock investment; and

3. Prohibit the payment of stock dividends.

With these regulatory changes, excess stock would arise only when stock is not redeemed or repurchased following a reduction in a member's required stock investment.

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[1] An FHLBank may buy back excess stock from a member either through repurchase or redemption. A repurchase transaction occurs at the discretion of the FHLBank, and the FHLBank may repurchase excess stock at any time, after providing members with notice of its intent to do so. FHLBanks generally repurchase excess stock either upon the request of a member or in accordance with an established schedule. Redemptions are initiated by the member. Under the regulations that pertain to the Chicago Bank, which has not yet implemented the capital provisions of the Gramm-Leach-Bliley Act (GLB Act), a member may withdraw from membership in an FHLBank six months after filing a written notice of intent to withdraw and, "upon surrender and cancellation of its capital stock, the member shall receive a sum equal to its cash paid subscriptions for the capital stock surrendered." Under the capital provisions of the GLB Act, a redemption transaction is initiated by a member's filing of a written request to have stock redeemed and occurs at the end of a notice period established by the FHLBank Act. The FHLBank, subject to certain exceptions, is required to redeem a member's excess stock at the end of this statutory redemption period. The statutory redemption periods are six months for Class A stock and five years for Class B stock.

Discussion

As of December 31, 2005, the FHLBanks held $7.4 billion in excess stock, or approximately 17 percent of the FHLBank System's total capital stock of $43.5 billion. The Banks had retained earnings of $2.5 billion and, therefore, total capital of $46.0 billion. Required capital totaled $36.1 billion

Under current Finance Board regulations, a member's investment in excess stock may arise from any of three sources: (i) a purchase of FHLBank stock in excess of the amount required as a condition for membership or to support certain activities, such as advances from the Bank; (ii) a payment of dividends by the FHLBank to its members in the form of stock rather than cash; or (iii) a reduction in a member's required stock holdings – such as through the repayment of an outstanding advance – without a commensurate reduction in the FHLBank stock held by that member.

The FHLBank of Chicago has the largest concentration of excess stock. In recent years, only the Chicago Bank has made direct sales of excess stock to members. Much of the stock was sold to members for "investment" purposes at a time during which the dividend yield on the Bank's stock significantly exceeded yields on alternative short-term investments. At one point, more than 60 percent of the FHLBank of Chicago's capital was in the form of excess stock, and excess stock was more than three times greater than the limit proposed by these regulatory amendments. However, other FHLBanks have capital plans that will allow such direct sales. If the proposed amendment to the regulations is adopted, the regulatory restrictions on excess stock would supersede any capital plan provisions that allow direct sale. The proposed amendments are intended to prevent the sale of FHLBank stock for investment purposes and to prevent undue reliance on excess stock by any FHLBank in the future.

redacted in prior package

The FHLBank of Cincinnati has the second largest concentration of excess stock. Its excess stock is largely the result of the Bank paying stock, rather than cash, dividends to its members. Stock dividends allow a member to defer payment of taxes until any stock is redeemed – and for tax management purposes many FHLBank members have chosen to hold the excess stock created by stock dividends.

Seven of the FHLBanks have paid stock dividends since 1995. As shown in the table below, those seven Banks also paid out stock dividends in 2005.[2] Four of those seven Banks have excess stock exceeding the proposed limitation.

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[2] The data reflect dividends actually paid to members in a particular quarter. Dividend policies vary among the FHLBanks. In some cases, dividends are paid in a quarter based on actual and projected earnings for the quarter. In other cases dividends are paid based on actual earnings from the preceding quarter. In still other cases, dividends are paid based on actual earnings from one or more months in the preceding quarter as well as one or more months from the current quarter.

Stock Dividend Payments by FHLBanks
Payments Made in Each Quarter of 2005
(Dollars in Millions)

Bank	1Q05	2Q05	3Q05	4Q05
Boston	0	0	0	0
New York	0	0	0	0
Pittsburgh	0	0	0	0
Atlanta	0	0	0	0
Cincinnati	42	45	42	50
Indianapolis	21	21	0	0
Chicago	60	58	52	38
Des Moines	0	0	0	0
Dallas	18	22	25	25
Topeka	19	21	21	23
San Francisco	82	87	101	107
Seattle	9	0*	0*	0*

*Did not pay any dividends.

The proposed amendments would prohibit any FHLBank from paying stock dividends to its members, thereby preventing the buildup of excess stock resulting from them.

Rationale for Proposed Changes

An FHLBank's reliance on excess stock raises safety and soundness and public policy concerns. Since FHLBanks often repurchase excess stock from a member promptly upon request, a Bank's reliance on excess stock can leave the Bank vulnerable to capital management problems if it were to experience substantial requests for repurchase over a relatively short timeframe. Furthermore, if excess stock is needed to meet an FHLBank's regulatory capital requirements, the Bank must refuse to honor a member's request for repurchase as such a repurchase would result in noncompliance with Finance Board regulations. Such refusals could undermine members' confidence in the FHLBank to the extent that the members had believed or expected that the Bank would repurchase their investments in excess stock upon demand.

Public policy concerns arise as the FHLBanks use excess stock to arbitrage the capital markets to generate earnings. The Banks' GSE status permits them to borrow funds at favorable rates and invest proceeds in non-mission related assets, most notably mortgage-backed securities and money market investments. While these activities increase FHLBank income, they do not directly further the FHLBank System's public purpose. Critics of this practice maintain that the GSE borrowing privilege should be restricted to housing finance mission-related activities and should not be used to arbitrage the capital markets. In the 1990s, the Finance Board set regulatory limits for mortgage-backed securities investments to address public policy concerns; however, no limits have been set for investments in money market instruments.

A limit on excess stock serves to reduce the potential for capital instability at the FHLBanks and limit the use of excess stock as a funding vehicle for non-mission related assets. Our recommendations would limit excess stock holdings by an FHLBank to one percent of assets and prohibit stock dividends altogether. The regulatory limits would allow for sufficient liquidity at the FHLBanks while promoting a stronger and more stable capital structure.

As of December 31, 2005 excess stock held by the FHLBanks of Chicago, Cincinnati, Seattle and Indianapolis was in excess of one percent of total assets as shown in the table below. As shown in the preceding table, each of those four Banks paid stock dividends in 2005.

Excess Stock as Percentage of Total Assets
As of December 31, 2005

Bank	Excess Stock ($ in millions)	Excess Stock/ Total Assets (as percentage)	Stock in Excess of Limitation ($ in million)
Boston	353	0.61	0
New York	0	0.00	0
Pittsburgh	85	0.12	0
Atlanta	12	0.01	0
Cincinnati	1,492	1.93	720
Indianapolis	686	1.43	205
Chicago	2,331	2.73	1,478
Des Moines	91	0.20	0
Dallas	370	0.57	0
Topeka	386	0.82	0
San Francisco	1069	0.48	0
Seattle	563	1.07	38

With the proposed amendments, we are also recommending that any FHLBank that exceeds the one percent of total assets limit as of the last business day of a quarter be required to notify the Finance Board. Within 60 days following that quarter-end, the FHLBank would have to certify, in writing, that it has corrected the deficiency or develop a compliance plan acceptable to the Finance Board.

III. Minimum Retained Earnings Requirement

An FHLBank's net income that is not distributed to shareholders as dividends is known as "retained earnings." Retained earnings can serve several functions, including to:

1. Provide a cushion to absorb losses and protect the par value of capital stock;
2. Enable payment of dividends in the event of a shortfall in earnings;
3. Allow relative stability in dividends when accounting income is not stable; and
4. Provide a source of capital for growth.

The level of an FHLBank's retained earnings critically affects a Bank's ability to absorb fluctuations in earnings and pay dividends to its members. Retained earnings are a particularly important component of capital for the FHLBanks because of the statutory, regulatory, and supervisory priority the Finance Board places on maintaining the par value of member stock. In response to supervisory guidance and increased earnings volatility, the FHLBanks have made progress in increasing their retained earnings over the past three years. Although the FHLBanks have increased retained earnings since the Finance Board issued Advisory Bulletin 03-08 in August 2003, progress has been modest and uneven among the Banks. The proposed regulatory amendments should ensure greater consistency among the FHLBanks in establishing and maintaining an adequate level of retained earnings.

An important factor contributing to earnings volatility at the FHLBanks has been the implementation of Statement of Financial Accounting Standards Number 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities,* which contributes to higher earnings volatility due to its asymmetric accounting of derivative instruments and held-to-maturity hedged items. Increased holdings of mortgage assets, with long contractual lives coupled with borrower prepayment options have also contributed to higher market risk exposure and greater earnings fluctuations among the FHLBanks.[3]

By establishing a minimum retained earnings requirement, each FHLBank should have in place a sufficient cushion for potential losses in order to avoid impairment to the par value of members' capital stock. Specifically, we are recommending that Parts 917, 930, and 931 be amended and a new Part 934 be added to state that:

1. Each FHLBank shall achieve and maintain minimum retained earnings totaling $50 million plus one percent of non-advance assets. The calculation would be performed quarterly using the FHLBank's average daily balances of non-advance assets during the preceding quarter.

2. For reasons of safety and soundness, the Finance Board may require an FHLBank to achieve and maintain retained earnings in excess of the minimum requirement of this regulation.

3. Until an FHLBank achieves compliance with its minimum retained earnings requirement, it may not declare or pay dividends in excess of 50 percent of its current net earnings without prior written approval from the Finance Board.[4]

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[3] On January 25, 2006, the Financial Accounting Standards Board (FASB) released an exposure draft, "The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115." The changes proposed in the exposure draft would allow an FHLBank to designate certain hedged assets to be carried at fair value and thereby eliminate much of the asymmetric accounting of derivative instruments and held-to-maturity hedged items. The proposed changes would allow entities to re-designate the carrying status of existing assets.

[4] "Current net earnings" are defined under the proposed amendments as the net income of a FHLBank for a calendar quarter in accordance with generally accepted accounting principles (GAAP) after deducting the FHLBank's required contributions for that quarter to the Resolution Funding Corporation under Sections 21A and 21B of the Bank Act (12 U.S.C. 1441a, 1441b) and to the Banks' Affordable Housing Program

4. An FHLBank that subsequently falls below its minimum retained earnings requirement would be prohibited from declaring or paying a dividend without prior written approval from the Finance Board.

5. Dividends for a quarter shall be declared only after the FHLBank's net earnings for the quarter have been recorded. Dividends shall not be based on projected or anticipated earnings.

Discussion

When retained earnings are negative, the par value of an FHLBank's capital stock is considered "impaired." When "other than temporarily impaired," the FHLBank capital stock held by member institutions would be reported on the members' balance sheets at a value that is less than its par value under generally accepted accounting principles (GAAP).

Capital stock impairment, particularly in the FHLBank context, is not synonymous with either capital insolvency or capital inadequacy. A Bank can exceed its minimum capital requirements by a substantial amount, but still have the par value of its capital stock impaired if retained earnings have been exhausted and the members' capital stock has absorbed losses.[5]

An "other than temporary" impairment of the par value of an FHLBank's capital stock carries significant negative consequences. First, an FHLBank is prohibited from redeeming or repurchasing members' capital stock without the prior approval of the Finance Board, when the Finance Board or the Bank's board of directors has determined that the Bank has incurred or is likely to incur other than temporary losses that result or are expected to result, in negative retained earnings. *See* 12 U.S.C. § 1426(f) and 12 C.F.R. § 931.8. Second, an FHLBank may not pay dividends if the par value of its capital stock is impaired. *See* 12 U.S.C § 1436 and 12 C.F.R. § 917.9. Third, market participants (members, bondholders, rating agencies, other banking regulators, and others) may respond negatively to impairment of FHLBank stock. Such reactions could include unwillingness on the part of members to acquire additional Bank stock, a slowdown in new advance business, an increase in the risk-based capital requirement by members' regulators, or a downgrade in an FHLBank's counterparty credit ratings. Any one of these reactions could increase the FHLBank's costs.

By regulation (12 C.F.R. §931.1(a)(2) and (b)(2)), new Class A or Class B FHLBank stock must be purchased at par value ($100 per share) even when the capital stock on a

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under Section 10(j) of the Bank Act (12 U.S.C. 1430(j)) and Section 951.2 [of the Finance Board's rules], but before declaring any dividend under Section 16 of the Bank Act (12 U.S.C. 1436).

[5] A member would classify or write down its capital stock in an FHLBank, however, only if the impairment was "other than temporary." That determination would be made based on a number of factors influencing the ultimate recoverability of the par value of the stock. "Other than temporary" impairment would not reflect a temporary decline in value, but would be influenced by the size of the impairment relative to par value and the permanence of factors that have contributed to the impairment.

book value basis is less than par value, *e.g.*, $90 per share.[6] Consequently, any stock purchased at par value when the book value of capital stock is below par is an immediate economic loss to the acquirer. In such situations, existing members would be reluctant to purchase new stock to expand their activity-based relationship with the FHLBank and potential new members would likely defer joining the Bank. As a result, a Bank's ability to provide mission-related services to its members could be severely curtailed.

Rationale for Proposed Changes

At present, all twelve of the FHLBanks exceed their minimum capital requirements and the risk of capital insolvency for any FHLBank is extremely remote. However, one or more of the Banks reasonably could incur sufficient losses that could deplete retained earnings and result in the impairment, at least temporarily, of the par value of capital stock.

The capital stock of an FHLBank has characteristics that require its par value to be fully protected. By statute or regulation, FHLBank stock is purchased and redeemed at par. In many respects, and with the exception of capital stock supporting advances, an FHLBank's retained earnings function as the Bank's operating capital.

In an effort to encourage the FHLBanks to bolster their retained earnings, the Office of Supervision issued Advisory Bulletin 03-08, *Capital Management and Retained Earnings*, in August 2003. That advisory bulletin required that each FHLBank adopt a capital management and retained earnings policy that includes a retained earnings target commensurate with the Bank's risk profile under a variety of economic and financial scenarios. However, in our examinations and in a supplemental review of the Banks' retained earnings polices, we found broad differences among the Banks' policies and in their approaches to establishing their retained earnings targets.[7] [redacted]

Ex 8

Under the proposed amendments, each FHLBank would be required to achieve and maintain a minimum amount of retained earnings equal to $50 million plus one percent of the FHLBank's non-advance assets. We considered several alternative measurements tied explicitly to risk-based capital requirements or measures of income volatility, but concluded that the proposed measure, which uses non-advance assets as a proxy for risk,

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[6] The cited regulation does not apply to the FHLBank of Chicago, which has not yet converted to it new capital structure as set forth in the Gramm-Leach-Bliley Act of 1999. *See* 12 C.F.R. §925.19, which applies to the FHLBank of Chicago until the time of its capital plan conversion.

[7] *Review of Federal Home Loan Bank Retained Earnings Policies*, Regulations and Research Division, Office of Supervision, Federal Housing Finance Board, February 10, 2005.

captures an FHLBank's exposure to risk in a transparent, straightforward, and easily calculable manner. Our estimates also indicated that the formula is a reasonable approximation of alternative measurements we considered. In addition, the most significant risks faced by the FHLBanks generally are associated with non-advance assets, such as mortgages and mortgage-related securities and the hedging and funding instruments associated with those assets. Further, advances differ from other FHLBank assets in that members normally must purchase capital stock, known as "activity stock," in support of advances. Stock in the FHLBank held by the member is available to absorb credit losses incurred from advances and other indebtedness of a member to the FHLBank.

Implications of the Proposed Rule

If the proposed rule had been in place at year-end 2005, the FHLBanks' minimum retained earnings requirement at year end 2005 would have ranged from a low of $218 million at the FHLBank of Topeka to a high of $672 million at the FHLBank of Chicago. As shown in the following table, eleven FHLBanks, the exception being the FHLBank of New York, would have fallen short of the proposed requirement. The estimated retained earnings shortfalls would have ranged from zero for the FHLBank of New York to $393 million at the FHLBank of San Francisco.

Minimum Retained Earnings (MRE)
As of December 31, 2005
($ in millions)

	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
MRE	226	255	265	383	399	245	672	275	224	218	525	378
Actual RE	139	291	182	343	208	149	523	161	174	138	132	69
MRE Shortfall	87	0	83	40	191	96	149	114	50	80	393	309

We are also recommending that dividends be restricted to 50 percent of net current earnings until the FHLBank reaches its minimum retained earnings requirement. As the following table indicates, nine of the FHLBanks would likely be able to meet their minimum retained earnings requirement in two years or less and, except for Seattle, each of the FHLBanks would likely meet its minimum retained earnings requirement in less than three years if the proposal were to be adopted. The table also shows the length of time for each FHLBank to reach its minimum retained earnings requirement at various dividend payout rates above 50 percent.[8]

[8] These timeframe estimates are based on the assumption that 2005 net current earnings are representative of income; however, if 2005 earnings are not representative, these estimated timeframes will expand or contract.

Years to Meet Minimum Retained Earnings Requirement
Under Alternative Dividend Payout Limitations*

Payout Rate	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
50%	1.3	n/a	1.0	.2	1.7	1.3	1.2	2.5	.8	1.2	2.1	**
60%	1.6	n/a	1.3	.3	2.2	1.6	1.5	3.2	1.0	1.4	2.7	**
70%	2.1	n/a	1.7	.4	2.9	2.1	2.1	4.2	1.4	1.9	3.5	**
80%	3.1	n/a	2.5	.6	4.3	3.2	3.1	6.3	2.1	2.9	5.3	**

* Estimated using net current earnings in 2005.
**Not meaningful because of negligible net earnings in 2005.

Generally, we would expect the FHLBanks to hold retained earnings at least modestly above their minimum requirement as protection against an unforeseen quarterly loss or accounting volatility. Under the proposed amendments, if a Bank were to fall below its minimum retained earnings requirement after initially satisfying the standard, the FHLBank would be prohibited from declaring or paying a dividend without the prior written approval of the Finance Board. This restriction would likely arise in only extreme circumstances, principally as a result of substantial losses in one or more quarters, which would reduce retained earnings to a level below the required minimum. Indeed, the proposed dividend restriction would provide an incentive for an FHLBank to maintain retained earnings above the minimum requirements, much like FHLBanks and other financial institutions regularly maintain capital in excess of regulatory requirements.

IV. Conclusion

The proposed amendments would address conditions among the FHLBanks that have given rise to formal and informal supervisory actions in the past two years. The proposed amendments would limit an FHLBank's reliance on "excess stock" as a source of capitalization and increase retained earnings at eleven of the twelve FHLBanks. Reliance on excess stock can make an FHLBank's capitalization vulnerable to redemptions, particularly at times when that capital is needed to absorb losses or support longer-term investments. Higher retained earnings would permit FHLBanks to absorb losses with a lower likelihood that the losses would impair, even temporarily, the value of the members' capital stock. As such, the proposed changes would enhance the overall safety and soundness of the FHLBanks and the FHLBank System.

V. Further Information

Principal staff work was done by Scott Smith and Tony Cornyn in the Office of Supervision and Tom Joseph in the Office of the General Counsel. Questions or comments on the proposal may be sent directly to their attention.

Appendix 6.

Letter from Finance Board FOIA Officer to Patricia A. Milon, dated May 2, 2006, transmitting an undated memorandum from Finance Board Office of Supervision on the Proposed Retained Earnings Minimum.

FEDERAL HOUSING FINANCE BOARD
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May 2, 2005

Patricia A. Milon
Chief Legal Officer and Senior Vice President,
Regulatory Affairs
America's Community Bankers
900 19th Street NW, Suite 400
Washington, DC 20006

Dear Ms. Milon:

As per our telephone conversation, attached to this e-mail is a partial response to your Freedom of Information Act (FOIA) request dated April 3, 2006, for all records relating to the drafting, formulation, and approval of Resolution Number 2006-03, Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks. I expect to be able to complete our response by the end of this week.

Please feel free to contact me with any questions.

Sincerely,

/s/

Janice A. Kaye
FOIA Officer

2006-017_ACB1

OFFICE OF SUPERVISION

Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks (Resolution Number 2006-03)

The Proposed Retained Earnings Minimum (REM)

Background

The composition of a Federal Home Loan Bank's (FHLBank's) capital, not just the amount of its capital, is important for its continued safe and sound operation. Retained earnings are particularly critical because of the statutory priority placed on maintaining the par value of FHLBank stock. In particular, all transactions in FHLBank stock must take place at par value. Retained earnings are the final line of defense, or protective cushion, which shield the par value of an FHLBank's stock against impairment in the event of FHLBank losses. Any failure to maintain par value could have serious consequences for an FHLBank and the FHLBank System.

Rationale for Proposed Changes

At present, all 12 of the FHLBanks exceed their minimum capital requirements and the risk of capital insolvency for any FHLBank is extremely remote. The risk of capital stock impairment, however, is a matter of significant supervisory concern.

The retained earnings of the FHLBanks may need to be strengthened to protect against the risk of capital stock impairment. To encourage the FHLBanks to bolster their retained earnings, the Office of Supervision issued Advisory Bulletin 2003-AB-08, *Capital Management and Retained Earnings*, in August 2003. That Advisory Bulletin required each FHLBank to adopt a capital management and retained earnings policy and to set a retained earnings target commensurate with its risk exposures.

We have found broad differences among the FHLBanks in their retained earnings policies and practices. Examinations in both 2004 and in 2005 included critical findings regarding the capital management and retained earnings policies at a number of the FHLBanks. We also found that the methodologies used to determine retained earnings targets often lacked analytical support and justification. We concluded that many of the retained earnings policies lack clarity and fail to address key risk elements cited in Advisory Bulletin 2003-AB-08. We also concluded that the retained earnings targets of most the FHLBanks were low relative to their risk exposures and that the FHLBanks were unlikely to make significant progress in strengthening their retained earnings absent a regulation prescribing a minimum retained earnings standard.

A number of the FHLBanks have encountered significant difficulties over the last several years. Of particular note were quarterly losses reported at the Atlanta, New York, Pittsburgh, and Seattle FHLBanks; supervisory Written Agreements with the Seattle and Chicago FHLBanks; financial restatements at five of the FHLBanks; and market value fluctuations among the FHLBanks associated with mortgage holdings, mortgage-backed-securities portfolio, other investment securities, and their associated derivatives.

Under the proposed regulation, each FHLBank would be required to achieve and maintain a minimum amount of retained earnings equal to $50 million plus 1 percent of the FHLBank's non-advance assets. We arrived at that formulation after consideration of the risk exposures of the FHLBanks in relation to their retained earnings and a supervisory judgment that most of the FHLBanks need to increase their retained earnings to protect against the risk of capital stock impairment.

The use of non-advance assets in the proposed regulation reflects the view that non-advance assets are a transparent, straightforward, and readily available proxy for an FHLBank's "risk assets," and hence its exposure to risks, which could be applied consistently across the FHLBanks. Advances are deducted from total assets because of the minimal credit risk associated with advances.[1]

Analysis

As mentioned above, we believe that non-advance assets held by an FHLBank can serve as a reasonable proxy for the risk exposure of an FHLBank, in the sense that the risk exposure would generally rise and fall with the level of the FHLBank's non-advance assets. To test this view, we first constructed measures of the market and credit risks facing each FHLBank. We then used a simple linear regression to determine if variations in non-advance assets could account for differences in the credit and market risk exposures among the FHLBanks.

The first step in the analysis was to measure the credit risk exposures of each FHLBank. We estimated exposure to credit risk using the Internal Ratings-Based Approach from the Basel II Accord,[2] which assigns a capital charge to credit exposures associated with specific types of instruments. The capital charge is based on the instrument's maturity, credit rating or probability of default, and the expected loss given default. Those capital charges assume a credit risk horizon of one year and can vary depending on the desired target rating for the institution holding those instruments. The analysis assumed that each FHLBank would be required to maintain a target rating of AA/Aa.

[1] The FHLBanks have never experienced a credit loss on an advance to a member. The market risk of advances can be minimized through prepayment penalties and matched funding programs.

[2] *See* Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Nov. 2005) at 48-139; and Basel Committee on Banking Supervision, "Consultative Document: The New Basel Capital Accord" (Apr. 2003) at 38-120.

We applied this methodology to all FHLBank assets except advances. We excluded advances since no FHLBank has ever had a credit loss associated with an advance to a member.[3] For each FHLBank, we segregated its non-advance assets into categories based on asset type, credit rating, and maturity. We then multiplied the dollar value of each asset/credit-rating/maturity category by the credit risk charge for that category. The sum of these charges for all non-advance assets resulted in a risk-weighted measure of the credit risk exposure for each FHLBank in a given quarter.

The second step in the analysis was to measure the market risk exposures of each FHLBank. We estimated exposure to market risk by using estimates of the market value of equity losses that each FHLBank would encounter given three pairs of parallel interest rate shocks, including both plus and minus shocks of 50, 100, and 200 basis points. To calculate exposure to market risk for an FHLBank, we first selected the largest equity loss estimates from each of the three pairs of shocks as of a given date. For example, the 3 selected equity losses might come from the plus 50 shock, the minus 100 shock, and the minus 200 shock, assuming the estimated equity loss was larger for the plus 50 shock than the minus 50 shock, and so on. We took a simple average of the three selected equity loss measures to arrive at the measure of the market risk exposure for each FHLBank in a given quarter.

Regression Analysis

After summing the measures for the market and credit risk exposures for each FHLBank in a given calendar quarter, we performed a linear regression analysis. The sum of the market and credit risk exposures for a given FHLBank in a particular quarter served as the dependent variable. The FHLBank's non-advance assets in the corresponding quarter served as the independent variable. The regression analysis covered 3 quarters (from the 4^{th} quarter of 2004 through the 2^{nd} quarter of 2005) for each of the 12 FHLBanks, a total of 36 observations. Therefore, for FHLBank i during quarter t, the regression equation was:

$$\text{Risk Exposure}_{i,t} = \alpha + \beta^*(\text{Non-Advance Assets}_{i,t}) + \varepsilon_{i,t}.$$

The regression results are listed in the table below.

Regression Results

Variable	Coefficient	Standard Error	t-statistic
Constant	62.82	14.86	4.23
Non-Advance Assets	0.0102	0.00046	22.42

Adjusted R-Square	0.935
F-statistic	502.5
Observations	36

Both estimated coefficients are statistically significant (different from zero) at the one percent confidence level, and the adjusted R-Square suggests the model provides a good fit of the data.

[3] There are also provisions in the Federal Home Loan Bank Act that protect the FHLBanks against credit losses from advances. *See* 12 U.S.C. § 1430(a), (c), and (e).

The Retained Earnings Minimum (REM) Formula

The proposed REM formula principally reflects a supervisory judgment of an appropriate framework to set retained earnings levels at the 12 FHLBanks. That framework relates the REM to an FHLBank's non-advance assets. The linear regression described above indicates that an FHLBank's non-advance assets are correlated with measures of its credit and market risk exposures. In addition, the regression coefficients were factors considered in the calibration of the REM formula.

Appendix 7.

Statement of Dr. James J. Clark on the Proposed Rule
and a description of qualifications of Dr. Clark.

Comments on Federal Housing Finance Board's Proposal on Federal Home Loan Bank Capital

Current Capital Requirements

The capital regulations for the FHLBanks were created under the Federal Home Loan Bank Act and were relatively straightforward before 1999. All Banks issued one class of stock, and most transactions in this stock were at par value. Bank members were required to purchase and retain a minimum amount of stock based on a fixed formula and there were no minimum capital requirements on the Banks individually; although the Finance Board did establish such requirements by regulation.

This regime changed in 1999 under the Gramm-Leach-Bliley Act (GLB). GLB made a number of key changes to policy, but the essence of the Law required each Bank to adopt and implement a capital plan consistent with provisions of the GLB Act and Finance Board regulations. Over the last three years most of the twelve Federal Home Loan Banks have met the stipulations of GLB by creating capital plans.

After Congress acted through GLB and eleven of the twelve FHLBanks made a significant effort to develop their capital plans, the Finance Board in March 2006 proposed new regulations that are substantial in both scope and depth. The regulations proposed will not only be disruptive to the operation of each FHLBank, but also to the individual member banks. This new proposal is offered even though the Finance Board believes the FHLBanks are in sound condition. To quote the Finance Board: "At present, all 12 of the FHLBanks exceed their minimum capital requirements and the risk of capital insolvency for any FHLBank is extremely remote."

Proposed Regulatory Provisions

The new regulations involve two changes:

1. Restriction on the amount of excess stock. Excess stock would be limited to 1 percent of total assets and Banks would not be allowed to use stock dividends. This provision has significant implications.

2. A required minimum level of retained earnings for each Bank. Under the proposed legislation each FHLBank would be required to achieve and maintain a minimum amount of retained earnings equal to $50 million plus 1 percent of the FHLBank's non advance assets.

Rationale for Proposed Changes

1. Excess Stock – Undue reliance on excess stock to meet minimum capital requirements and to capitalize its balance sheet activities can raise both safety and soundness and public policy issues.

2. Minimum Level of Retained Earnings – A Bank's retained earnings serve a variety of related functions. Most significantly they provide a cushion to absorb losses, help prevent capital stock impairment by protecting the par value of Bank stock, act as a source of funds to make dividend payments in the event of temporary shortfalls in Bank earnings and provide a source of capital to fund growth.

Evaluation of the Proposed Regulatory Provisions

After reviewing the proposal and the rationale for the changes I would offer the following comments.

Basis for Capital Levels

1. A $50 million minimum plus 1 percent of non-advance assets. The assets in the FHLBank system totaled approximately $966 billion at the end 2005. This is an average of $81 billion per bank. But there is a substantial deviation around the average. For example the Topeka bank was $42 billion, Indianapolis was $47 billion, and the Seattle bank was $48 billion in asset size. Whereas the Atlanta FHLBank was $143 billion and San Francisco was $212 billion. One could assume this discrepancy is handled by the 1 percent of non-advance assets to be required; that is the larger banks have proportionally more non- advance assets. But that assumption would be wrong. At the San Francisco Bank 72 percent of assets are advances, 70 percent of Atlanta's assets are advances, but only 62 percent of Topeka's asset are advances. Given the comparative analysis of the individual banks a $50 million base requirement for each Bank makes no logical sense. What is the basis for the $50 million requirement?

2. The proposed regulation imposes a 1 percent capital requirement on non-advance assets. To quote the Finance Board: "The use of non-advance assets in the proposed regulation reflects the view that non-advance assets are a transparent, straightforward, and readily available proxy for a FHLBank's 'risky assets,' and hence its exposure to risks which could be applied across the FHLBanks." To justify this conclusion the Finance Board uses a regression analysis which I will discuss next. But first let's examine the proposed rule. Non-advance assets are a proxy for risk, but not all non-advance assets have the same risk profile. A leverage strategy using mortgage backed securities could have dramatically different risk depending on the duration mismatch. T o treat all non-advance assets the same is similar to the same mistake made under Basal 1. Assigning 1 percent to all non-advance assets appear naïve.

3. Regression Analysis - The Finance Board is using a panel study to determine if variations in non-advance assets could account for differences in the credit and market risk exposures among the FHLBanks. In order to measure risky assets the study uses as a proxy non-advance assets. To determine the credit risk the study uses the Basel II Accord, which by the way, has not been implemented in the US and will not implemented for a number years partially due to the concern over the methodology used for credit risk weighting. The study specifically uses the Internal Ratings Based Approach which is one of the methods a bank can choose under Basel II. Under this method the capital charge for each asset is based on maturity, credit rating or probability of default and the expected loss given default. The sum of these charges for all non-advance assets resulted in a risk-weighted measure of the credit risk exposure for each FHLBank in a given quarter.

In order to calculate the market risk the Finance Board uses standard shock methodology based on parallel shifts in the yield curve. The three largest variations in capital are averaged and used to determine the measure of market risk. Most of the FHLBanks are effectively matched on their advances so if there is significant market risk it is assumed to arise from the non-advance assets.

The credit and market risk exposure are summed for each FHLBank on a quarterly basis. The Finance Board performed a linear regression analysis using 12 Home Loan Banks and three quarters. Actually it appears to be a 3 by 12 panel study based on thirty – six observations. This is a relative small sample to achieve reliable results. Also the regression itself appears flawed. The dependent variable is the risk exposure or the sum of the credit and market risk. The independent variable is the level of non-advance assets. But the non-advance assets were used to determine the credit and market risk. The two variables are obviously going to be co-linear based on the definitions of the variables. The model's estimated coefficients are statistically significant. Well of course they are, since the measure of risk was defined by the non-advanced assets, one would expect that the higher the amount of non-advanced assets the higher the risk. This is a tautology.

The model uses no control variables to adjust for differences between the FHLBanks, and there are large differences in the makeup of their non-advance assets; and the model has no control variables for the three time periods. The lack of control variable leads to questions concerning heteroscedasticity, which further reduces reliability of the statistical technique.

In conclusion the model appears very naïve, and a rather simple theoretical basis for such a significant policy change. The change in policy offered by the Finance Board will have serious impacts on both the FHLBanks and member banks. One would expect a more robust analysis rather than a small sample regression analysis.

Impact on Community Banks

Banks are required to purchase and retain a minimum amount of stock in the system based on condition of membership plus an amount related to the level of business conducted with the FHLBank generally related to advances. The member banks receive a dividend on their investment. It has been estimated that the Finance Board proposal would force the system to reduce dividends by $2.5 to $3.5 billion. In analyzing data in terms of membership one could easily conclude that the major impact of this dividend restriction would affect a few relatively large banks, but this would be a misguided conclusion. A dividend reduction will affect all member banks and the impact is relative. Many smaller community banks will feel the effect of the reduced dividend. Many member banks rely on the dividends to support earnings, and for the Finance Board to propose policies that simply gloss over this reality is unfair.

Conclusion

In reading through the Finance Board's proposed rule changes one is struck by the continual references to the FHLBank's mission or public purpose, and the growth in non-advance assets. It would appear that the Finance Board is concerned with the growth in non-advance assets. If this is the intent of the new rules why not approach the issue more directly instead of through regulations creating a disproportional impact on dividend policy.

In its haste to develop new regulations the Finance Board has not conducted a thorough analysis to support the rationale for the rule changes. A stronger analysis of the risk issues and the need for additional capital should result in modifications of the proposal that might achieve greater support among all parties. Consultation with the principal parties, the FHLBanks and the member banks, should occur before substantial policy changes are offered. The Finance Board proposals will have a substantial impact not only on the twelve FHLBanks, but also thousands of community banks.

Recommendations:

1. Recognizing the differences between individual FHLBanks – Before going forward with the policy changes the Finance Board should revisit its analysis of credit and market risk, and the difference between the individual FHLBanks.

2. Extending the Time Horizons – The implementation period for any policy changes effecting retained earning should lengthened. The longer time horizons would reduce the impact of potential dividend reductions on member bank earnings

3. Guideline on Growth – The Finance Board is obviously concerned with the growth in non-advance assets, which partially results from the FHLBanks ability to borrow in the capital markets at favorable interest rates. Why not tie the growth of non-advance assets to the growth of mission assets or member advances. For example, member advances could be pegged at a given percentage of total assets thereby constraining the growth of non-advance assets.

4. Recognition of Impact of Policy Changes – The proposed policy changes come after eleven of the twelve FHLBanks had responded to the capital requirements of GLB Act. In responding to GLB the Banks expended substantial time and resources to develop and implement capital policies, and then with no advance notice or consultation they are faced with new regulations. The Finance Board should have been more sensitive to the changing regulatory environment post GLB and discussed possible refinements before publicly announce a significant policy changes which will be disruptive to both the FHLBanks and member banks.

James Clarke, Ph.D.
Clarke Consulting
Villanova, Pennsylvania
June 1, 2006

Background and Qualifications

James J. Clarke holds a Ph.D. in Economics from the University of Notre Dame. Dr. Clarke is a retire professor of finance from Villanova University. At the University, Dr. Clarke taught fixed income securities (Money market, bonds, and mortgage and asset backed securities) at the graduate level, and money and capital markets and financial institution management at the undergraduate level. He serves or has served on the faculty of eleven bank management schools (including the Stonier School and America's Community Bankers National School of Banking), lecturing on asset/liability management. Dr. Clarke has taught the fixed income valuation and derivative sections of the CFA examination preparation courses, and has trained bank financial analysts and other corporate managers in financial topics.

Dr. Clarke conducts the elementary and advanced ALM seminars for America's Community Bankers. Jim also conducts ALM seminars for the Financial Managers Society (FMS) and the Risk Management Association (RMA). Dr. Clarke conducts a yearly seminar entitled "Current Issues in ALM" for the Connecticut, Illinois, Indiana, Massachusetts, Maryland, Michigan, New York, Ohio, Pennsylvania and West Virginia Bankers Associations. Jim has also conducted ALM related programs for Bank Administration Institute (BAI), and Association for Management Information Financial Services (AMIFS).

He has written numerous articles on interest rates, and bank strategic planning. Dr. Clarke has recently written a book for the American Management Association on corporate finance, and is co-author of *Bank Financial Management* published by ACB and used as the principal text in the Graduate School of Banking.

Jim has served on the boards of a number of community banks where has chaired the board ALCO. Dr. Clarke has been an expert witness on many cases, and has testified in Federal Tax Court for the IRS (IRS v FNMA-Hedging Interest Rate Risk- 1992).

Appendix 8.

Statement of FHLBank Topeka
on the Impact on Dividends of
Proposed FHFB Regulation, April 10, 2006.

FHLBank Topeka

Building Communities Together

Impact on Dividends of Proposed FHFB Regulation

April 10, 2006 - The regulator of the Federal Home Loan Banks, the Federal Housing Finance Board (FHFB), issued a proposed regulation on March 15, 2006, entitled *Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks*. The proposed rule, if put into effect, would:

1. limit the amount of excess capital stock an FHLBank may have outstanding to 1 percent of its total assets;
2. prohibit the payment of stock dividends;
3. establish a minimum retained earnings requirement equal to $50 million plus 1 percent of non-advance assets; and
4. restrict dividends to 50 percent of quarterly income when the FHLBank is not in compliance with its minimum retained earnings requirement.

We have received a number of inquiries asking what this proposal means for future dividends at FHLBank Topeka. This communication provides our analysis of the proposed regulation and our current thinking regarding the impact it may have on future dividends. As discussed below, our preliminary analysis suggests that the regulation, even if adopted in its current form, would not negatively impact the general level of our dividends (although it would prohibit stock dividends). That being said, we believe the proposed regulation is unnecessary, misguided and harmful to the FHLBanks and their members. We encourage you to share your thoughts on the proposed regulation with the FHFB. We will send you a thorough critique of the proposed regulation in a few weeks which will assist you in preparing your comments to the FHFB.

Analysis of the Impact on Dividends

The proposed regulation, if adopted, would potentially impact dividends in two ways:

1. Stock dividends are prohibited;
2. Quarterly dividends are limited to 50 percent of the prior quarter's income if the FHLBank is not in compliance with its minimum retained earnings requirement at the end of the prior quarter.

Loss of the ability to pay stock dividends is significant and we do not agree with this change. However, the choice to pay cash dividends or stock dividends does not impact the overall level of dividends the FHLBank can pay, nor does it affect the level of the

FHLBank's retained earnings.

Clearly, the more significant risk of the proposed regulation is the possibility that dividends would be limited to 50 percent of prior quarter's income. Limiting the FHLBank to a 50 percent payout ratio compares to our current payout ratio (based on projected quarterly income rather than prior quarter's income) over the last few quarters of approximately 71 percent. Dropping the level of dividends from a 71 percent payout ratio to a 50 percent payout ratio represents a 30 percent reduction in the level of dividends (21/71 = 30 percent). However, this reduction will only be applied if FHLBank Topeka is not in compliance with its retained earnings requirement at the end of the first quarter the regulation becomes effective.

If the FHFB adopts the regulation as proposed, will FHLBank Topeka's level of retained earnings satisfy the minimum requirement when the regulation becomes effective?

If the proposed regulation was in effect today, FHLBank Topeka would not be in compliance. We currently hold approximately $150 million in retained earnings. Our retained earnings requirement, based on our current level of non-advance assets, would be approximately $239 million. This would leave us $89 million short of the required minimum.

The good news is that it is highly unlikely that the regulation will be effective before the first quarter of 2007. The FHFB is accepting comments on the proposal through July 13, 2006. At that point, a formal process will begin, starting with an extensive review and analysis by FHFB staff of all of the comment letters. It seems unrealistic that the supporting analysis could be completed, action taken by the FHFB and the regulation become effective prior to the end of this year.

If we assume that the earliest the regulation is in effect is the first quarter of 2007 (meaning that FHLBanks must have sufficient retained earnings as of March 31, 2007, based on average assets over the first quarter of 2007), we need to take into account that our balance of retained earnings will likely continue to grow through the rest of this year and through the first quarter of 2007. With our current payout ratio at around 71 percent, we have been growing retained earnings at a healthy pace. We project that we will have around $187 million in retained earnings by March 31, 2007, and result in the gap falling from around $89 million to around $52 million.

Besides the expected growth in retained earnings throughout the year, the other primary tool to achieve compliance is to shrink our non-advance assets. Currently we utilize maximum leverage in operating the FHLBank. This allows us to obtain the full earnings benefit from our members' invested capital. However, in the event this proposed regulation is issued as a final rule, we have the ability to reduce the amount of these investments and thereby reduce the required level of retained earnings.

Based on our analysis, it is feasible for us to reduce our non-advance assets sufficiently so that we satisfy a requirement to hold retained earnings equal to $50 million plus 1 percent of non-advance assets.

The reduction of assets will come principally from the runoff of highly liquid money market assets. While the reduction in these assets would need to be large (likely in excess of $6 billion), the reduction in earnings is not proportionate to the reduction in assets because the spreads we earn on these assets are the lowest in our investment portfolio. While income will be reduced, meeting the retained earnings requirement will allow us to declare dividends without any restriction on the payout ratio. By increasing our payout ratio from 71 percent to 80 percent or even higher, we can pay dividends comparable to or higher than what we are paying today while still increasing retained earnings at a steady rate.

Bottom line, I firmly believe, should this proposed rule become effective in its current form, we have the ability to manage the FHLBank's balance sheet such that current level of dividends can be maintained or even increased.

In closing, please note that this analysis assumes that the proposed regulation will be adopted in its current form. I fully expect that the FHFB will significantly modify this proposal in response to the outpouring of comments I foresee coming from the FHLBanks, FHLBank members and trade organizations. Nevertheless, I wanted to give our members some assurance that we strongly believe that we could manage the FHLBank Topekasuch that dividends are not reduced even if this proposed regulation is adopted in its current form.

Andrew J. Jetter
President & CEO

Close Window

Appendix 9.

Home Loan Capital Plan Impact Focused on Several Banks,
Jaret Seiberg, Stanford Washington Research Group, March 20, 2006.

Financial Services Policy Bulletin
Jaret Seiberg
202-298-6226
March 20, 2006

Home Loan Capital Plan Impact Focused on Several Banks

Summary:

- We find Federal Home Loan Bank (FHLB) capital proposal would disproportionately affect Washington Mutual and Golden West as San Francisco and Seattle home loan banks have largest shortfall in retained earnings and they are the largest holders of the stock in these home loan banks.
- Analyses relying on bank SEC disclosures of the FHLB stocking holdings tend to either overstate or understate an institution's exposure to lost dividend income.
- Industry is expected to fight capital plan, though our odds favor it taking effect largely as proposed.

The Federal Housing Finance Board (FHFB) is proposing a new capital regime for the 12 Federal Home Loan Banks (FHLB). The intent is to bolster retained earnings, which means the Federal Home Loan Banks will need to slash dividend payments.

Our report analyzes the impact of the dividend cuts on the banks and thrifts which own Federal Home Loan Bank stock.

We first issued this note on March 15, 2006. This version was updated on March 20, 2006, to incorporate the Federal Home Loan Bank of Atlanta's filing of a Form 10 with the Securities and Exchange Commission (SEC).

Banks Most at Risk of Losing Dividend Income

	No-growth	growth-adjusted
Washington Mutual	$283,777,648	$378,673,022
Golden West	$83,685,436	$116,614,476
Citigroup	$81,487,679	$113,689,333
Citizens Financial (Charter One)	$40,526,378	$59,610,199
Bank of America	$34,036,380	$44,681,265
Sovereign/Santander	$33,951,028	$63,308,080

Source: SEC, FHFB filings

In our analysis, we break down the results on a home loan bank-by-home loan bank basis, which allows us to more precisely estimate the effect on banks and thrifts. We also offer two estimates for lost dividends. The first looks at how much a home loan bank must raise dividends if it does not grow its assets or advances. The second assumes the home loan banks will grow assets and advances at their historic rate.

Our analysis finds that banks and thrifts will receive between $2 billion and $3.1 billion less in dividend payments from the home loan banks in the 18 months to 36 months after the rule takes effect.

We also conclude that banks and thrifts which own stock in the Seattle and San Francisco home loan banks will likely face the largest impacts since these home loan banks have the largest shortfalls in retained earnings. The two biggest holders of stock in those banks are **Washington Mutual** and **Golden West**. We estimate that home loan bank dividend payments to Washington Mutual could drop by between $284 million and $397 million, while payments to Golden West could drop by between $84 million and $117 million.

Understanding SEC Filings

Banks that own stock in home loan banks often disclose this in their SEC filings. We pulled the data for the two largest holders of home loan bank system stock, which are Washington Mutual and Golden West. We present it below.

Potential Losses Using Bank-Provided Data			
	Stock Owned	% of System Stock	Dividends at Risk
Washington Mutual	$4,257,000,000	9.254%	$187,476,237.57
Golden West	$1,857,580,000	4.038%	$81,806,931.97

Source: SEC filings, FHFB reports

This bank-provided data, however, has a major shortcoming. Banks do not break out their FHLB stock holdings by home loan banks. So one only knows the value of the home loan bank system's stock that a particular bank owns. One does not know the value of their holdings in specific home loan banks. As a result, this type of analysis is deceptive. Institutions such as Washington Mutual and Golden West own shares in home loan banks with some of the largest retained earnings shortfalls. That means they are more exposed to lost dividends than a bank which owns shares in a FHLB with a much smaller shortfall. Still, even this understated analysis finds dividend payments by the FHLBs to Washington Mutual would drop by $187 million and to Golden West by $82 million from the policy change.

FHFB Proposal

The Federal Housing Finance Board (FHFB) proposed March 8 to require the 12 home loan banks to bolster retained earnings. The proposed minimum requirement would be $50 million plus 1% of total assets minus advances. FHLBs would pay only 50% of dividends until they met the minimum retained earnings requirements. We see the system's shortfall as being between $2 billion and $3.1 billion.

Also proposed was eliminating the ability of home loan banks to pay dividends in stock. They also would be restricted in the amount of excess stock they may issue. Such excess stock is a way that home loan banks used to finance the purchase of mortgages.

Estimated Lost Dividends from FHFB Capital Plan		
	no-growth	growth-adjusted
Minimum RE	$4,250,951,930	$5,349,512,798
Existing RE	$2,238,764,000	$2,238,764,000
Shortfall	**$2,012,187,930**	**$3,110,748,798**

Source: Computed from SEC, FHFB filings

Negative Industry Reaction

Initial reaction from the banking industry was negative. Banks and thrifts own all of the home loan bank stock. (The public may not own this stock.) So they will suffer financially if home loan banks are forced to cut dividends to bolster retained earnings.

We expect a vigorous industry effort to moderate the proposal. Industry groups such as America's Community Bankers already have focused on this as a key Washington issue. We expect the industry to push for a lower retained earnings requirement. They also will fight to extend the retained earnings build-up over several years rather than in the 18 months to 36 months being suggested. This would not change the total amount of lost dividends. But it would lessen the amount is any one year.

It is very early in the process, but we continue to see the odds favoring enactment without substantive changes. It does not matter if the threat from low retained earnings is real. The Federal Housing Finance Board already has made that call. Given this, we do not see how the regulator could back down.

Rosenfeld Speaks

We do not envy Rosenfeld. Less than a week after publishing the proposal, Rosenfeld stood before America's Community Bankers and explained the agency's rationale for the reform. He said higher retained earnings would ensure that a home loan bank would never have to tap into shareholder equity in the event of a loss. This would ensure home loan bank stock would continue to be worth par value. Rosenfeld also suggested the board may be open to extending the build up of retained earnings over a longer time frame. That would not reduce the total lost dividends, but would limit the pain in any particular quarter. Industry representatives at the ACB event appeared very skeptical of the need for the plan. Some feared this would create a pool of money that the government could later seize for a different purpose, which is what happened during the S&L debacle of the early 1990s.

Data Troubles

Given the threat, we have done a series of analyses to measure the impact on banks and thrifts. Our biggest challenge is obtaining accurate data. Two of the home loan banks – Topeka and Des Moines – have yet to register with the Securities and Exchange Commission. The Federal Housing Finance Board does collect some system-wide data, including a list of the tope five holders of each bank's stock. But the data are for Dec. 31, 2003.

Better data are available for the other home loan banks as they have filed Form 10s with the SEC. Some of those filings are less than a month old. Even here, however, there are problems. The banks do not follow a consistent policy in disclosing top stock holders. Some list the top five, some the top 10 and others only those that hold at least 5% of outstanding shares. Also, some of the Form 10s have been withdrawn. Still, we are relying on them as they give the most accurate information available about total capital, advances, retained earnings and stock ownership.

Our Data Solution

We present the data in two formats.

- Static. We calculate the new retained earnings requirement for each home loan bank based on their total assets and advances. We use the most current data available. That works great for nine banks. Data for Topeka, Des Moines, and Atlanta, however, are more than two years old. This analysis does not account for any growth in assets or advances between the time that data was collected until today. As such, this represents the low-end of our estimate.
- Adjusted. This is our effort to account for growth in total assets and advances. The FHFB publishes system-wide data. We use the most recent five-year period available – 1999 to 2003 – and calculate the average growth rate, which was 13.3%. We then assume that it will take a bank two years to meet the retained earnings requirement. So we grow assets and advances by the five-year average. We do not adjust retained earnings. This produces the upward bound of our estimate.

For the non-SEC registered home loan banks – Topeka and Des Moines – we do not attempt to adjust their Dec. 31, 2003 results into something more current. Rather we assume they have the same retained earnings shortfall today that they did then. Odds favor the shortfall being larger today than in 2003. We took, however, the more conservative approach and left the data unchanged for the static estimate. Then we applied our growth factor to the adjusted estimate.

Home Loan Bank-by-Home Loan Bank Analysis

The rest of this note analyzes the potential effect of the proposal on each of the 12 Federal Home Loan Banks. Data for each of the 12 banks is presented on a separate page.

The FHLB break down allows investors who know that a particular commercial bank or thrift belongs to a specific home loan bank to see how at risk the institution is for losing dividend income.

FHLB Pittsburgh

Retained Earnings Shortfall: $154.2 Million
Shortfall Adjusted for Growth: $273.8 Million

Largest Holders: *Sovereign Bank, ING Bank*

Results in Brief

Overall, the FHLB Pittsburgh would have to more than double retained earnings to comply with the proposed standard. As a result, we would expect it to have to cut dividends for as long as three years.

Top Holders of Stock			
Amount of dividends major FHLB Pittsburgh members could lose			
	% of stock	lost dividends	growth-adjusted
Sovereign Bank	0.2160	$33,326,076	$59,141,782
ING Bank	0.1130	$17,434,475	$30,939,914
Citicorp	0.0810	$12,497,279	$22,178,168
GMAC Bank	0.0480	$7,405,795	$13,142,618
Wilmington Savings	0.0200	$3,085,748	$5,476,091
Harleysville Savings	0.0170	$2,622,886	$4,654,677

Source: Form 10, July 16, 2005

Sovereign Bank has the highest level of stock ownership of the Federal Home Loan Bank of Pittsburgh. It owns 21.6% of FHLB Pittsburgh shares. Assuming growth, that means Pittsburgh's dividend payment to Sovereign could drop by up to $59 million. Without the growth assumption, it could drop by $33 million.

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
59,835,645,000	37,766,906,000	270,687,390	116,400,000	154,287,390

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
76,810,359,294	42,789,904,498	390,204,548	116,400,000	273,804,548

Difference between Scenario 1 and Scenario 2: **$119,517,158**

Data Quality

We rank the quality of the data as good. The source is Form 10, which the bank filed July 16, 2005.

FHLB New York

Retained Earnings Shortfall: $11.5 Million
Shortfall Adjusted for Growth: $76.3 Million

Largest Holders: *HSBC, North Fork*

Results in Brief

No bank owns more than 10% of New York FHLB stock. As a result, the individual exposure to dividend cuts is much less. As importantly, the New York bank has a very small shortfall in mandatory retained earnings. This means it has to do much less in order to meet proposed minimum requirements.

Top Holders of Stock			
Amount of dividends major FHLB New York members could lose			
	% of stock	lost dividends	adjusted
HSBC	0.0962	$1,101,105	$7,340,620
North Fork Bank	0.0776	$888,210	$5,033,122
NY Community Bank	0.0761	$871,041	$5,806,873
Hudson Savings	0.0482	$551,697	$3,677,940
Independence Community Bank	0.0446	$510,492	$3,403,239
Astoria Federal	0.0330	$377,718	$2,518,092
Banco Santander	0.0100	$114,460	$763,058
Community Bank NA	0.0095	$108,737	$724,905

Source: Form 10, Aug. 26, 2005

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
87,429,000,000	64,566,000,000	278,630,000	267,184,000	11,446,000

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
112,231,645,581	82,882,663,974	343,489,816	267,184,000	76,305,816

Difference between Scenario 1 and Scenario 2: **$ 64,859,816**

Data Quality.

We rank the quality of the data as good. The source is Form 10, which the bank filed Aug. 26, 2005.

FHLB Cincinnati

Retained Earnings Shortfall: $179.6 Million
Shortfall Adjusted for Growth: $271.6 Million

Largest Holders: *Charter One, U.S. Bank*

Results in Brief

Overall, the FHLB Cincinnati needs to bolster retained earnings by about 75%. That puts it in the middle, with about an equal number of FHLBs either closer or further from the new regulatory minimum.

As a result, we would expect it to have to cut dividends for between 24 and 30 months.

Top Holders of Stock			
Amount of dividends major FHLB Cincinnati members could lose			
	% of stock	lost dividends	growth-adjusted
Charter One*	0.1400	$25,147,158	$38,030,724
U.S. Bank	0.1260	$22,632,443	$34,227,651
Fifth Third	0.0890	$15,986,408	$24,176,674
Ohio Savings Bank	0.0510	$9,160,751	$13,854,049
Park National Corp.	0.0130	$2,335,093	$3,531,424
Liberty Savings	0.0080	$1,436,980	$2,173,184

* Charter One is part of Citizens Financial Group, which itself is a unit of Royal Bank of Scotland.

Source: Form 10, Feb. 7, 2006

Both Charter One and U.S. Bank own more than 10% of FHLB Cincinnati stock. Dividend payments to these two institutions by Cincinnati could drop by between $22 million and $38 million.

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
75,848,282,000	43,409,426,000	374,388,560	194,766,000	179,622,560

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
97,365,605,272	55,724,202,653	466,414,026	194,766,000	271,648,026

Difference between Scenario 1 and Scenario 2: **$92,025,466**

Data Quality.

We rank the quality of the data as excellent. The source is Form 10, which the bank filed Feb. 7, 2006.

FHLB Boston

Retained Earnings Shortfall: $145.1 Million
Shortfall Adjusted for Growth: $203.6 Million

Largest Holders: *Bank of America, Citizens Bank*

Results in Brief

The Boston FHLB must boost retained earnings at least 130%, according to our analysis. Those lost dividends will come at the expense of Bank of America and Citizens Bank, which is a unit of Citizens Financial Group.

Top Holders of Stock			
Amount of dividends major FHLB Boston members could lose			
	% of stock	**lost dividends**	**growth-adjusted**
Bank of America	0.1200	$17,410,438	$24,429,595
Citizens Bank*	0.1060	$15,379,220	$21,579,476
Webster Bank	0.0630	$9,140,480	$12,825,537
Union Savings Bank	0.0077	$1,117,170	$1,567,566
Bank of Newport	0.0048	$696,418	$977,184
South Shore Savings	0.0045	$652,891	$916,110

* Part of Citizens Financial Group, which is a unit of Royal Bank of Scotland
Source: Form 10, Dec. 22, 2005

Overall, the FHLB Boston would have to more than double retained earnings to comply with the proposed standard. As a result, we would expect it to have to cut dividends for as long as three years.

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
54,015,094,000	33,396,396,000	256,186,980	111,100,000	$145,086,980

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
69,338,582,002	42,870,586,185	314,679,958	111,100,000	$203,579,958

Difference between Scenario 1 and Scenario 2: **$58,492,978**

Data Quality.

We rank the quality of the data as excellent. The source is Form 10, which the bank filed Dec. 22, 2005.

FHLB Chicago

Retained Earnings Shortfall: $129.8 Million
Shortfall Adjusted for Growth: $296.6 Million

Largest Holders: *LaSalle Bank, One Mortgage Partners Group*

Results in Brief

The Chicago FHLB is notable because its ownership is highly diversified. No single bank has even 8% of the FHLB's shares.

Top Holders of Stock			
Amount of dividends major FHLB Chicago members could lose			
	% of stock	lost dividends	growth-adjusted
LaSalle Bank	0.0790	$10,250,825	$23,433,526
One Mortgage Partners Group	0.0780	$10,121,068	$23,136,900
Associated Bank Green Bay	0.0460	$5,968,835	$13,644,838
State Farm Financial	0.0430	$5,579,563	$12,754,957
Mid America Bank	0.0420	$5,449,806	$12,458,331
Private Bank & Trust	0.0370	$4,801,019	$10,975,196
M&I Marshall and Ilsley Bank	0.0310	$4,022,476	$9,195,434
Citizens Equity CU	0.0180	$2,335,631	$5,339,285
Northern Trust Co.	0.0170	$2,205,874	$5,042,658
Self-Reliance FCU	0.0160	$2,076,116	$4,746,031

Source: Form 10, Feb. 10, 2006

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
83,054,343,000	24,233,015,000	638,213,280	508,456,000	129,757,280

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
106,615,946,511	31,107,654,792	805,082,917	508,456,000	296,626,917

Difference between Scenario 1 and Scenario 2: **$166,869,637**

Data Quality.

We rank the quality of the data as excellent. The source is Form 10, which the bank filed Feb. 10, 2006.

FHLB Dallas

Retained Earnings Shortfall: $75.1 Million
Shortfall Adjusted for Growth: $130.5 Million

Largest Holders: *Golden West, Washington Mutual*

Results in Brief

This home loan bank appears in pretty good shape and we would expect it to need less than two years to build up retained earnings to the proposed levels.

Golden West has 18% of the stock. Washington Mutual is second with 10.9%.

Top Holders of Stock

Amount of dividends major FHLB Dallas members could lose

	% of stock	lost dividends	growth-adjusted
Golden West	0.1820	$13,672,956	$23,747,591
Washington Mutual	0.1090	$8,188,748	$14,222,458
Guaranty Bank	0.0990	$7,437,487	$12,917,645
Hibernia Bank	0.3800	$28,547,929	$49,582,881
Franklin Bank	0.0310	$2,328,910	$4,044,919
International Bank of Commerce	0.0300	$2,253,784	$3,914,438
Trustmark National	0.0160	$1,202,018	$2,087,700
Amegy Bank	0.0110	$826,387	$1,435,294
Sterling Bank	0.0100	$751,261	$1,304,813
Southside Bank	0.0100	$751,261	$1,304,813

Source: Form 10, Feb. 15, 2006

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
69,243,488,000	49,730,875,000	245,126,130	170,000,000	75,126,130

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
88,887,103,867	63,838,977,198	300,481,267	170,000,000	130,481,267

Difference between Scenario 1 and Scenario 2: **$55,355,137**

Data Quality.

We rank the quality of the data as excellent. The source is Form 10, which the bank filed Feb. 15, 2006.

FHLB Indianapolis

Retained Earnings Shortfall: $97.3 Million
Shortfall Adjusted for Growth: $151.1 Million

Largest Holders: *LaSalle Bank, Flagstar Bank*

Results in Brief

The Indianapolis FHLB has a smaller shortfall in retained earnings than many of its peers. As a result, the reductions in dividends will be less. LaSalle and Flagstar are the biggest holders.

We would expect the Indianapolis FHLB to take between 24 and 30 months to build up retained earnings to the proposed level.

Top Holders of Stock

Amount of dividends major FHLB Indianapolis members could lose

	% of stock	lost dividends	growth-adjusted
LaSalle Bank	0.1626	$15,827,743	$24,568,948
Flagstar Bank	0.1328	$12,926,963	$20,066,152
Fifth Third Bank	0.0956	$9,305,856	$14,445,212
Union Federal Bank of Indianapolis	0.0289	$2,813,172	$4,366,806
Irwin Union Bank	0.0249	$2,423,806	$3,762,403
Firstbank	0.0029	$282,291	$438,192

Source: Form 10, July 16, 2005

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
47,226,939,000	28,276,980,000	239,499,590	142,158,000	97,341,590

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
60,624,702,098	36,298,848,179	293,258,539	142,158,000	151,100,539

Difference between Scenario 1 and Scenario 2: **$53,758,949**

Data Quality.

We rank the quality of the data as excellent. The source is Form 10, which the bank filed Feb. 14, 2006.

FHLB San Francisco

Retained Earnings Shortfall: $511 Million
Shortfall Adjusted for Growth: $677.9 Million

Largest Holders: *Washington Mutual, Golden West*

Results in Brief

The San Francisco bank has the largest shortfall in retained earnings of any of the Federal Home Loan Banks. As a result, we would expect the bank to take at least 36 months to meet the minimum retained earnings requirement.

San Francisco is where it's at for Washington Mutual and Golden West. Both lose the bulk of their dividend income at this bank.

Top Holders of Stock			
Amount of dividends major FHLB San Francisco members could lose			
	% of stock	lost dividends	growth-adjusted
Washington Mutual	0.3820	$195,217,280	$258,942,703
Golden West	0.1370	$70,012,480	$92,866,886
Citibank	0.1350	$68,990,400	$91,511,165
IndyMac Bank	0.0550	$28,107,200	$37,282,326
First Federal Bank	0.0190	$9,709,760	$12,879,349
Provident Savings	0.0040	$2,044,160	$2,711,442

Source: Form 10, Aug. 25, 2005

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
211,760,000,000	152,956,000,000	638,040,000	127,000,000	511,040,000

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
271,833,982,640	196,347,934,684	804,860,480	127,000,000	677,860,480

Difference between Scenario 1 and Scenario 2: **$166,820,480**

Data Quality.

We rank the quality of the data as excellent. The source for the top stock holders is Form 10, which the bank filed Aug. 25, 2005. The data on total assets and advances is from the Nov. 14, 2006, 10Q.

FHLB Seattle

Retained Earnings Shortfall: $286 Million
Shortfall Adjusted for Growth: $375.5 Million

Largest Holders: *Washington Mutual, Bank of America*

Results in Brief

The Seattle Federal Home Loan Bank has a significant shortfall in retained earnings and we would expect it to need up to 36 months to meet the new minimum requirement.

Washington Mutual is also the largest owner of stock of the Seattle bank. A distant second is Bank of America, which has about 12% of the stock.

Top Holders of Stock			
Amount of dividends major FHLB Seattle members could lose			
	% of stock	lost dividends	growth-adjusted
Washington Mutual	0.2810	$80,371,620	$105,507,861
Bank of America	0.1190	$34,036,380	$44,681,265
Merrill Lynch Bank	0.0580	$16,589,160	$21,777,423
Washington Federal Savings	0.0390	$11,154,780	$14,643,440
Sterling Savings Bank	0.0360	$10,296,720	$13,517,021
Glacier Bancorp	0.0210	$6,006,420	$7,884,929
Zions First National	0.0180	$5,148,360	$6,758,511
Bank of Hawaii	0.0170	$4,862,340	$6,383,038

Source: Form 10, July 16, 2005

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
48,085,000,000	16,553,000,000	365,320,000	79,300,000	286,020,000

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
61,726,185,565	21,248,904,017	454,772,815	79,300,000	375,472,815

Difference between Scenario 1 and Scenario 2: **$89,452,815**

Data Quality.

We rank the quality of the data as good. The source is Form 10, which the bank filed June 30, 2005.

FHLB Atlanta

Retained Earnings Shortfall: $140.6 Million
Shortfall Adjusted for Growth: $259.5 Million

Largest Holders: *Countrywide, Sun Trust Bank*

Results in Brief

The Federal Home Loan Bank of Atlanta filed a Form 10 with the Securities and Exchange Commission on March 17, 2006. As a result, we now have current data. Our prior estimates were based on Federal Housing Finance Board data from 2003. The new data indicate that Countrywide has nearly tripled its holding of FHLB Atlanta stock.

Top Holders of Stock			
Amount of dividends major FHLB Atlanta members could lose			
	% of stock	lost dividends	growth-adjusted
Countrywide	0.2120	$29,807,200	$55,006,726
SunTrust Bank	0.0660	$9,279,600	$17,124,736
AmSouth	0.0190	$2,671,400	$4,929,848

source: Form 10, filed March 17, 2006

Given that the shortfall in retained earnings is smaller for the FHLB Atlanta than for other home loan banks, we would expect it to need 12 to 18 months to meet the proposed minimum retained earnings requirement. Once it becomes compliant, it would resume making full dividend payments.

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

Total Assets	Advances	Minimum RE	Existing RE	Shortfall
143,200,000,000	101,300,000,000	469,000,000	328,400,000	140,600,000

Scenario 2: Adjusted for Growth

Total Assets	Advances	Minimum RE	Existing RE	Shortfall
183,824,264,800	130,037,695,700	587,865,691	328,400,000	259,465,691

Difference between Scenario 1 and Scenario 2: **$118,865,691**

Data Quality.

We rank the quality of the data as excellent. It comes from a Form 10, which the FHLB Atlanta filed on March 17, 2006, with the Securities and Exchange Commission.

FHLB Topeka

Retained Earnings Shortfall: $154.2 Million
Shortfall Adjusted for Growth: $273.8 Million

Largest Holders: *MidFirst Bank, Commercial Federal Bank*

Results in Brief

As with Atlanta and Des Moines, the Topeka FHLB has not filed a form 10 with the SEC. As a result, we are relying on outdated information compiled by the Federal Housing Finance Board. This provides us with an indication of what the proposal will mean to dividend payments. But it is less precise than the other estimates.

Top Holders of Stock

Amount of dividends major FHLB Topeka members could lose

	% of stock	lost dividends	growth-adjusted
MidFirst Bank	0.1850	$23,511,650	$31,546,191
Commercial Federal Bank	0.1400	$17,792,600	$23,872,793
Capitol FSB	0.0980	$12,454,820	$16,710,955
Security Life of Denver Insurance	0.0420	$5,337,780	$7,161,838
US Central Credit Union	0.0290	$3,685,610	$4,945,079

Source: FHFB Report for period ending Dec. 31, 2003

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
42,087,000,000	26,778,000,000	203,090,000	76,000,000	127,090,000

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
54,026,618,943	34,374,624,042	246,519,949	76,000,000	170,519,949

Difference between Scenario 1 and Scenario 2: **$43,429,949**

Data Quality.

We rank the quality of the data as poor. The bank does not post any financial data. We pulled the information from FHFB reports, including the report for the period ending Dec. 31, 2003 and the report date Aug. 10, 2004.

FHLB Des Moines

Retained Earnings Shortfall: $154.7 Million
Shortfall Adjusted for Growth: $223.9 Million

Largest Holders: *Superior Guaranty Insurance Co., Wells Fargo*

Results in Brief

Des Moines is the final of the three banks which have not filed with the SEC. As a result, we rely on Federal Housing Finance Board data. That information is much less current than the SEC filings made by the other nine banks.

Top Holders of Stock			
Amount of dividends major FHLB Topeka members could lose			
	% of stock	lost dividends	growth-adjusted
Superior Guaranty Insurance Co.	0.3090	$47,823,930	$69,179,783
Wells Fargo Bank	0.1000	$15,477,000	$22,388,279
Transamerica Life Insurance Co.	0.0320	$4,952,640	$7,164,249
AmerUS Life Insurance Co.	0.0240	$3,714,480	$5,373,187
TCF National Bank	0.0210	$3,250,170	$4,701,539

Source: FHFB Report for period ending Dec. 31, 2003

We see this data an indicative of what the proposal will mean for dividend income, though it is less concrete than the information provided for the SEC-filing banks.

The Details

Regulators propose to set minimum retained earnings at $50 million plus 1% of total assets minus advances. The two charts play that out below for the current situation and a growth scenario, which assumes two year's of growth at historical levels.

Scenario 1: Current Situation

total assets	advances	Minimum RE	Existing RE	Shortfall
48,382,000,000	26,105,000,000	272,770,000	118,000,000	154,770,000

Scenario 2: Adjusted for Growth

total assets	advances	Minimum RE	Existing RE	Shortfall
62,107,441,198	32,919,162,045	341,882,792	118,000,000	223,882,792

Difference between Scenario 1 and Scenario 2: **$69,112,792**

Data Quality.

We rank the quality of the data as poor. The bank does not post any financial data. We pulled the information from FHFB reports, including the report for the period ending Dec. 31, 2003 and the report date Aug. 10, 2004.

* * *

Appendix 10.

FHLB Capital Proposal Bigger Threat to Smaller Banks,
Jaret Seiberg; Stanford Washington Research Group, April 17, 2006.

Financial Services Policy Bulletin
Jaret Seiberg
202-298-6226
April 17, 2006

FHLB Capital Proposal Bigger Threat to Smaller Banks

Summary:

- Many small cap banks disproportionately rely on the Federal Home Loan Banks (FHLBs) for funding.
- FHLB capital plan exposes small-cap banks to lost dividend income and higher funding costs.
- Tougher competitive environment as small caps pick between losing loans or absorbing higher costs.
- Odds remain strongly in favor of Federal Housing Finance Board adopting proposed capital plan.

Our prior three reports (March 9, March 15, and March 17) on the capital proposal for the Federal Home Loan Bank system have focused on the impact to larger banks and thrifts. This is because we linked the effect to bank and thrift ownership of FHLB stock.

Left unaddressed has been what this proposal means for small- and mid-cap banks and thrifts. Today we address that question by using call report and other public data to identify which group of institutions is most dependent on Federal Home Loan Bank advances to finance their business. That list is attached at the end of this report. We then look generally at how these institutions would respond to the proposal.

We draw several conclusions:

1. **Small-Cap Problem**. The proposal overwhelmingly effects publicly traded banks and thrifts with less than $10 billion of assets. Of the 20 banks with the highest ratios of FHLB borrowings to total liabilities, only two had more than $20 billion of assets and only four had more than $10 billion.

2. **Double Whammy**. Smaller banks suffer twice under the proposal. Not only do they lose the dividend income on their FHLB stock, but most also are unable to limit their downside by switching to other funding sources. Big banks, by contrast, can tap Wall Street directly for financing.

3. **Lost Business**. Smaller banks compete in a national mortgage market. As a result, they cannot necessarily pass along the higher FHLB financing costs to customers. That means either absorbing the losses – which would reduce profitability – or accepting the loss of business that would come from having a loan product that costs more than what rivals are charging.

Banks with Highest Ratio of FHLB Borrowings to Total Liabilities
source: SNL DataSource

Pacific Premier Bancorp, Inc.	45.5%
Capitol Federal Financial	45.4%
Franklin Bank Corp.	44.5%
FedFirst Financial Corp.	44.4%
Rainier Pacific Financial Group, Inc.	43.3%

4. **Housing Market**. We do not subscribe to the theory that this proposal could damage the housing market. That is too simplistic an analysis. Yet academic research has shown that FHLB advances drive down mortgage costs. As a result, this proposal could drive down housing prices, though we would expect only a subtle impact.

In the rest of this note, we will briefly summarize the status of the FHLB capital proposal. Then we will discuss these four conclusions in greater detail.

Proposed Capital Rule

Congress created the Federal Home Loan Bank system to inject liquidity into the mortgage market. The 12 FHLBs raise money on Wall Street by issuing debt. They then loan this money to member banks in the form of advances. To obtain an advance, a member bank must own stock in a specific FHLB. The stock does not trade publicly. It is bought and sold at par. The stock pays dividends, often around $4 per share, which serve to offset the cost of advances.

The Federal Housing Finance Board regulates the 12 Federal Home Loan Banks. It proposed in March a capital rule aimed at bolstering retained earnings. The plan would require each FHLB to maintain retained earnings equal to $50 million plus 1% of total assets minus advances. On March 15 we published a report detailing how far each of the 12 home loan banks were from meeting the proposed requirement. We estimated that each home loan bank would need to slash dividend payments in half for between 18 and 42 months in order to build sufficient retained earnings.

Small-Cap Impact

We believe the proposal will hurt many small- and mid-cap banks. These banks are heavily reliant on the FHLB system for advances. They cannot easily raise additional deposits. They also cannot tap Wall Street directly as their larger rivals are able. We list these banks at the end of this note.

Smaller banks that are reliant on FHLB advances are likely to also need dividend income that comes with the stock ownership. Those dividends can be viewed two ways. First, they are income to the bank. Their loss will reduce profits. But they also can be seen as reducing the overall cost of FHLB advances. That means a bank's real cost of tapping FHLB advances may be several basis points lower. This allows smaller banks to be competitive with rivals that tap the capital markets directly for funds.

Methodology for the Analysis

For our analysis, we pulled call report and other public data from SNL DataSource. We then calculated the ratio of FHLB borrowings to total liabilities for each publicly traded bank and thrift. Attached at the end of this report is a list of all banks and thrifts with at least 20% of their total liabilities in the form of FHLB borrowings. This is not a perfect formula. It provides only a snap-shot in time. Banks can adjust the amount of advances they take. They also have the ability to sell back FHLB stock, though a different capital rule prevents banks from selling back much of their stock until after holding it for five years.

Our prior reports looked at stock ownership in the FHLBs in order to determine how much banks and thrifts would lose in dividend income. The home loan banks only report the stock holdings of their largest holders. So we could not conduct a similar analysis for the other banks.

The results of today's analysis attempts to get around this data shortage. We cannot accurately calculate how much stock a bank may hold in each FHLB as banks may belong to multiple FHLBs, each of which may have different stock-to-advance ratios. Also, banks may hold more stock than required for their advances.

Still, this provides the best proxy for the impact of the retained earnings proposal on small cap banks. Those with the highest ratios of FHLB advances to total liabilities have the most to lose from the proposal. That means our list provides a starting point to identify banks that warrant further examination.

What Does this Mean for Banks?

We did two analyses to try to answer this question:

1. **Dividend Income.** To gauge impact on the industry, we looked at how important FHLB dividend income was to these highly dependent banks by examining their most recent 10Ks. We did this

for the first 10 banks which – on our highly dependent list – also separated out FHLB dividend income. We excluded any bank that was a member of the Seattle FHLB as that institution already was forced to temporarily suspend dividend income. On average, FHLB dividends accounted for 8.8% of net income. The high was 14.31% of net income and the low was 5.46% of net income. The FHFB is proposing a 50% dividend cut. Applied to this universe of banks, that would mean an average reduction of 4.4% in net income.

2. **New York FHLB Experience**. The FHLB of New York got into trouble in 2003 for manufactured housing loans. To replenish retained earnings, it was forced to suspend the third quarter dividend payment. We reviewed press accounts to gauge effect of dividend suspension. As an example of this coverage, *American Banker* predicted major users of the FHLB of New York would see third quarter earnings-per-share fall between 4% and 5%.

These two examples are only intended to provide a rough estimate of what the proposal would mean for banks and thrifts. Each institution will react differently. Still, we see the exercise as useful as it shows there would be an impact on smaller banks, which could suffer about a 5% reduction of net income until full dividend payments are restored.

Our analysis also does not account for lost business. If bigger rivals compensate for lost dividend income by tapping alternative funding sources, then they could take business from our small-cap banks, which may lack the same access to Wall Street funding. That would further hurt the bottom line.

Next Step for FHFB

We have no doubt that banks, thrifts and their trade groups are preparing similar analyses to present to the Federal Housing Finance Board. The question becomes whether the board will amend its proposal to lessen the financial impact.

In our view, meaningful changes are unlikely. The board appears to believe strongly in protecting the par value of FHLB stock. That means requiring higher retained earnings. The FHFB's plan is amazingly simple. Unlike Basel II, we are not talking about complex formulas. Anyone can do this level of math. As a result, it is easier to defend to Capitol Hill. Plus there have been more than enough FHLB financial stumbles for the finance board to cite as justifications.

At best, the industry could hope to spread the pain out over a longer duration by getting the board to allow dividend payments at more than the 50% level called for in the proposal. Such a change would help smaller banks as it would limit the size of their funding disadvantage. Yet it also would extend this disadvantage for a longer time period.

Housing Crisis

We expect to hear an argument that the retained earnings proposal could impair the housing market by making mortgages more expensive. Academic studies have shown that institutions which use the FHLB system are disproportionately active in the home financing market. These studies also indicate that the system reduces mortgage costs. We expect critics will argue that changing the system now could be the proverbial straw that broke the camel's back. We disagree. There are still plenty of lenders vying for this business and the impact of the retained earnings plan is much less relevant than the Federal Reserve's interest rate decisions.

Conclusion

We see the odds strongly favoring adoption of the rule and expect it to take effect late in the year.

Banks Most Dependent on FHLB Borrowings

Banks and thrifts where Federal Home Loan Bank borrowing accounts for at least 15% of total liabilities.

Company Name	Ticker	State	Size of Bank (total assets) 12/05 Q ($000)	FHLB Borrowings 12/05 Q ($000)	Total Liabilities 12/05 ($000)	Ratio of FHLB Borrowings to Total Liabilities
Pacific Premier Bancorp, Inc.	PPBI	CA	699,379	296,835	652,154	**45.5%**
Capitol Federal Financial (MHC)	CFFN	KS	8,346,933	3,385,502	7,456,598	**45.4%**
Franklin Bank Corp.	FBTX	TX	4,467,281	1,842,394	4,138,421	**44.5%**
FedFirst Financial Corp. (MHC)	FFCO	PA	276,468	102,404	230,710	**44.4%**
Rainier Pacific Financial Group, Inc.	RPFG	WA	871,686	340,240	786,133	**43.3%**
Beverly Hills Bancorp Inc.	BHBC	CA	1,407,179	530,837	1,229,869	**43.2%**
FirstFed Financial Corp.	FED	CA	10,455,725	4,155,500	9,886,110	**42.0%**
WVS Financial Corp.	WVFC	PA	445,252	167,536	415,327	**40.3%**
ESB Financial Corporation	ESBF	PA	1,793,593	693,927	1,725,902	**40.2%**
Harleysville Savings Financial Corporation	HARL	PA	766,733	283,791	718,459	**39.5%**
BankUnited Financial Corporation	BKUNA	FL	11,248,098	4,070,350	10,736,939	**37.9%**
WSFS Financial Corporation	WSFS	DE	2,842,794	1,008,721	2,664,571	**37.9%**
Hingham Institution for Savings	HIFS	MA	628,244	211,816	579,793	**36.5%**
IndyMac Bancorp, Inc.	NDE	CA	20,329,938	6,953,000	19,926,198	**34.9%**
Charter Financial Corp. (MHC)	CHFN	GA	970,580	288,800	827,852	**34.9%**
NASB Financial, Inc.	NASB	MO	1,537,114	488,771	1,403,308	**34.8%**
Golden West Financial Corporation	GDW	CA	NA	38,961,165	115,944,198	**33.6%**
Commercial Capital Bancorp, Inc.	CCBI	CA	5,397,227	1,597,806	4,756,537	**33.6%**
Bofl Holding, Inc.	BOFI	CA	681,176	205,620	612,530	**33.6%**
ITLA Capital Corporation	ITLA	CA	3,061,140	931,957	2,846,715	**32.7%**
Matrix Bancorp, Inc.	MTXC	CO	2,026,202	615,028	1,898,660	**32.4%**
Provident Financial Holdings, Inc.	PROV	CA	1,579,037	467,228	1,445,419	**32.3%**
Bar Harbor Bankshares	BHB	ME	747,945	223,258	691,841	**32.3%**
LSB Corporation	LSBX	MA	521,800	148,861	461,878	**32.2%**
Camco Financial Corporation	CAFI	OH	1,074,019	307,223	980,485	**31.3%**
Southside Bancshares, Inc.	SBSI	TX	1,783,396	520,684	1,674,172	**31.1%**
Royal Bancshares of Pennsylvania, Inc.	RBPAA	PA	1,301,065	354,000	1,143,024	**31.0%**
Synergy Financial Group, Inc.	SYNF	NJ	968,259	266,600	878,637	**30.3%**
Flagstar Bancorp, Inc.	FBC	MI	15,054,001	4,225,000	14,303,547	**29.5%**
Harrington West Financial Group, Inc.	HWFG	CA	1,138,877	319,000	1,080,613	**29.5%**
NetBank, Inc.	NTBK	GA	4,753,483	1,285,500	4,370,764	**29.4%**
Gouverneur Bancorp Inc. (MHC)	GOV	NY	123,027	30,500	103,915	**29.4%**
Home Federal Bancorp, Inc. (MHC)	HOME	ID	682,554	171,788	592,561	**29.0%**
OptimumBank Holdings, Inc.	OPHC	FL	205,890	52,950	187,634	**28.2%**
Atlantic Liberty Financial	ALFC	NY	174,819	41,550	148,601	**28.0%**

Company Name	Ticker	State	Size of Bank (total assets) 12/05 Q ($000)	FHLB Borrowings 12/05 Q ($000)	Total Liabilities 12/05 ($000)	Ratio of FHLB Borrowings to Total Liabilities
Corp						
CVB Financial Corp.	CVBF	CA	5,422,971	1,410,000	5,080,094	**27.8%**
Abington Community Bancorp, Inc. (MHC)	ABBC	PA	844,390	201,445	726,841	**27.7%**
Pacific Mercantile Bancorp	PMBC	CA	981,155	249,000	902,639	**27.6%**
K-Fed Bancorp (MHC)	KFED	CA	729,636	179,869	655,167	**27.5%**
Home City Financial Corporation	HCFC	OH	149,413	36,337	136,147	**26.7%**
Bank Mutual Corporation	BKMU	WI	3,431,383	765,796	2,884,660	**26.5%**
Pulaski Financial Corp.	PULB	MO	803,040	200,000	756,024	**26.5%**
KNBT Bancorp, Inc.	KNBT	PA	3,084,968	705,125	2,705,257	**26.1%**
MAF Bancorp, Inc.	MAFB	IL	10,417,886	2,471,000	9,509,325	**26.0%**
TierOne Corporation	TONE	NE	3,218,381	747,125	2,913,408	**25.6%**
Brookline Bancorp, Inc.	BRKL	MA	2,031,278	411,507	1,612,254	**25.5%**
Central Bancorp, Inc.	CEBK	MA	536,997	126,500	497,712	**25.4%**
Kentucky First Federal Bancorp (MHC)	KFFB	KY	121,941	50,261	198,351	**25.3%**
Yardville National Bancorp	YANB	NJ	2,956,731	704,000	2,779,273	**25.3%**
First Bancorp of Indiana, Inc.	FBEI	IN	284,956	65,000	256,723	**25.3%**
Monarch Community Bancorp, Inc.	MCBF	MI	273,671	59,562	236,492	**25.2%**
First Niles Financial, Inc.	FNFI	OH	97,355	20,500	82,120	**25.0%**
Penns Woods Bancorp, Inc.	PWOD	PA	568,668	123,218	494,749	**24.9%**
Epic Bancorp	EPIK	CA	459,908	107,812	434,994	**24.8%**
Partners Trust Financial Group, Inc.	PRTR	NY	3,787,987	801,783	3,251,020	**24.7%**
River Valley Bancorp	RIVR	IN	328,459	75,000	305,730	**24.5%**
Washington Trust Bancorp, Inc.	WASH	RI	2,402,380	545,323	2,243,557	**24.3%**
First PacTrust Bancorp, Inc.	FPTB	CA	754,978	164,200	677,408	**24.2%**
Harbor Florida Bancshares, Inc.	HARB	FL	3,055,776	645,468	2,722,369	**23.7%**
FirstBank NW Corp.	FBNW	WA	822,644	176,992	747,568	**23.7%**
New York Community Bancorp, Inc.	NYB	NY	26,285,042	5,409,458	22,958,828	**23.6%**
Britton & Koontz Capital Corporation	BKBK	MS	389,260	84,196	358,000	**23.5%**
CFS Bancorp, Inc.	CITZ	IN	1,241,147	256,771	1,100,521	**23.3%**
Citizens First Bancorp, Inc.	CTZN	MI	1,664,910	346,500	1,485,653	**23.3%**
North Central Bancshares, Inc.	FFFD	IA	486,479	102,435	440,912	**23.2%**
Legacy Bancorp, Inc.	LEGC	MA	741,823	145,923	632,164	**23.1%**
Sovereign Bancorp, Inc.	SOV	PA	63,658,270	13,295,493	57,662,367	**23.1%**
Coastal Financial Corporation	CFCP	SC	1,582,485	341,357	1,481,846	**23.0%**
Guaranty Federal Bancshares, Inc.	GFED	MO	481,000	100,000	438,909	**22.8%**
NewAlliance Bancshares	NAL	CT	6,571,567	1,191,280	5,250,534	**22.7%**
Willow Grove Bancorp, Inc.	WGBC	PA	1,572,051	312,117	1,376,768	**22.7%**
Flushing Financial Corporation	FFIC	NY	2,345,703	490,191	2,176,741	**22.5%**

Company Name	Ticker	State	Size of Bank (total assets) 12/05 Q ($000)	FHLB Borrowings 12/05 Q ($000)	Total Liabilities 12/05 ($000)	Ratio of FHLB Borrowings to Total Liabilities
Downey Financial Corp.	DSL	CA	17,094,008	3,557,515	15,886,130	**22.4%**
MFB Corp.	MFBC	IN	530,098	110,216	492,241	**22.4%**
Republic Bancorp, Inc.	RBCAA	KY	2,735,556	561,133	2,521,982	**22.2%**
Berkshire Hills Bancorp, Inc.	BHLB	MA	2,037,270	397,453	1,789,487	**22.2%**
Investors Bancorp, Inc. (MHC)	ISBC	NJ	5,132,549	940,255	4,238,894	**22.2%**
PennFed Financial Services, Inc.	PFSB	NJ	2,159,287	450,465	2,037,093	**22.1%**
First Mutual Bancshares, Inc.	FMSB	WA	1,086,165	225,705	1,026,138	**22.0%**
Capital Crossing Bank	CAPX	MA	1,106,158	211,896	964,188	**22.0%**
Union Financial Bancshares, Incorporated	UFBS	SC	371,054	75,715	345,709	**21.9%**
First Federal Banc of the Southwest, Inc.	FFSW	NM	548,324	109,173	498,727	**21.9%**
Washington Mutual, Inc.	WM	WA	NA	68,771,000	316,223,000	**21.7%**
First Keystone Financial, Inc.	FKFS	PA	512,522	105,700	486,958	**21.7%**
BankAtlantic Bancorp, Inc.	BBX	FL	5,976,036	1,283,532	5,955,075	**21.6%**
First Federal of Northern Michigan Bancorp, Inc.	FFNM	MI	282,852	52,925	246,126	**21.5%**
Cascade Financial Corporation	CASB	WA	1,211,784	236,000	1,106,591	**21.3%**
NewMil Bancorp, Inc.	NMIL	CT	873,043	174,266	819,975	**21.3%**
Greenville First Bancshares, Inc.	GVBK	SC	405,092	79,500	374,840	**21.2%**
LSB Financial Corp.	LSBI	IN	371,962	72,033	339,843	**21.2%**
GS Financial Corp.	GSLA	LA	176,144	32,106	152,207	**21.1%**
MutualFirst Financial, Inc.	MFSF	IN	969,940	186,008	883,036	**21.1%**
Republic Bancorp Inc.	RBNC	MI	6,081,766	1,194,748	5,677,307	**21.0%**
United Community Financial Corp.	UCFC	OH	2,489,539	475,549	2,264,115	**21.0%**
Bancorp Rhode Island, Inc.	BARI	RI	1,442,157	279,973	1,337,447	**20.9%**
PVF Capital Corp.	PVFC	OH	882,964	167,004	809,125	**20.6%**
Broadway Financial Corporation	BYFC	CA	292,292	56,513	275,517	**20.5%**
Northern Empire Bancshares	NREB	CA	1,231,759	230,379	1,124,427	**20.5%**
Sterling Financial Corporation	STSA	WA	7,562,234	1,443,462	7,052,243	**20.5%**
Fidelity Bancorp, Inc.	FSBI	PA	698,997	134,471	657,240	**20.5%**
Severn Bancorp, Inc.	SVBI	MD	841,287	158,000	772,983	**20.4%**
First Federal Bancshares of Arkansas, Inc.	FFBH	AR	852,443	158,240	774,569	**20.4%**
Pocahontas Bancorp, Inc.	PFSL	AR	748,754	142,580	698,966	**20.4%**
Community Central Bank Corporation	CCBD	MI	462,012	86,545	426,480	**20.3%**
First Place Financial Corp.	FPFC	OH	2,608,141	482,944	2,381,340	**20.3%**
TF Financial Corporation	THRD	PA	662,066	121,260	598,191	**20.3%**
Peoples Community Bancorp, Inc.	PCBI	OH	1,040,911	193,132	954,865	**20.2%**
Community Financial Corporation	CFFC	VA	420,102	77,000	383,228	**20.1%**
Atlantic Coast Federal Corporation (MHC)	ACFC	GA	733,808	129,000	650,932	**19.8%**

Company Name	Ticker	State	Size of Bank (total assets) 12/05 Q ($000)	FHLB Borrowings 12/05 Q ($000)	Total Liabilities 12/05 ($000)	Ratio of FHLB Borrowings to Total Liabilities
BFC Financial Corporation	BFCF	FL	NA	1,283,532	6,504,424	**19.7%**
First Financial Holdings, Inc.	FFCH	SC	2,523,772	472,000	2,395,522	**19.7%**
Peoples Bancorp Inc.	PEBO	OH	1,855,277	328,816	1,672,200	**19.7%**
Salisbury Bancorp, Inc.	SAL	CT	402,922	71,016	361,480	**19.6%**
American Bank Incorporated	AMBK	PA	529,171	95,048	484,755	**19.6%**
International Bancshares Corporation	IBOC	TX	10,391,852	1,870,075	9,598,986	**19.5%**
First Federal Bankshares, Inc.	FFSX	IA	585,946	101,103	519,159	**19.5%**
First Mariner Bancorp	FMAR	MD	1,363,196	248,500	1,290,103	**19.3%**
OceanFirst Financial Corp.	OCFC	NJ	1,984,849	354,900	1,846,573	**19.2%**
Meta Financial Group, Inc.	CASH	IA	755,283	134,755	713,109	**18.9%**
Camden National Corporation	CAC	ME	1,653,257	287,501	1,523,719	**18.9%**
Hudson City Bancorp, Inc.	HCBK	NJ	28,076,183	4,300,000	22,873,877	**18.8%**
Slade's Ferry Bancorp	SFBC	MA	586,049	100,865	537,059	**18.8%**
Dime Community Bancshares, Inc.	DCOM	NY	3,094,020	531,500	2,834,512	**18.8%**
Naugatuck Valley Financial Corp. (MHC)	NVSL	CT	348,937	57,059	304,382	**18.7%**
Citizens & Northern Corporation	CZNC	PA	1,162,954	192,485	1,030,986	**18.7%**
PSB Holdings, Inc. (MHC)	PSBH	CT	392,976	64,300	349,255	**18.4%**
TCF Financial Corporation	TCB	MN	13,484,335	2,275,500	12,366,888	**18.4%**
First National Lincoln Corporation	FNLC	ME	1,042,506	172,647	938,757	**18.4%**
Century Bancorp, Inc.	CNBKA	MA	1,728,769	298,656	1,625,568	**18.4%**
Washington Federal, Inc.	WFSL	WA	8,307,967	1,300,000	7,106,662	**18.3%**
Pamrapo Bancorp, Inc.	PBCI	NJ	646,592	106,400	587,470	**18.1%**
First Financial Corporation	THFF	IN	2,139,024	337,266	1,867,595	**18.1%**
First Franklin Corporation	FFHS	OH	293,712	48,860	271,656	**18.0%**
Southcoast Financial Corporation	SOCB	SC	476,791	77,053	429,493	**17.9%**
HMN Financial, Inc.	HMNF	MN	987,503	160,900	900,509	**17.9%**
Provident New York Bancorp	PBNY	NY	2,628,805	393,567	2,237,256	**17.6%**
BCSB Bankcorp, Inc. (MHC)	BCSB	MD	803,753	135,403	771,905	**17.5%**
First BancTrust Corporation	FBTC	IL	274,522	43,200	247,819	**17.4%**
Auburn National Bancorporation, Inc.	AUBN	AL	608,258	98,205	564,199	**17.4%**
Millennium Bankshares Corporation'	MBVA	VA	421,515	65,000	373,822	**17.4%**
Oneida Financial Corp. (MHC)	ONFC	NY	434,782	66,400	383,113	**17.3%**
Team Financial, Inc.	TFIN	KS	696,529	111,131	643,180	**17.3%**
MBT Financial Corporation	MBTF	MI	1,638,866	256,500	1,486,737	**17.3%**
Lincoln Bancorp	LNCB	IN	844,277	127,072	744,514	**17.1%**
NB&T Financial Group, Inc.	NBTF	OH	651,422	100,791	591,750	**17.0%**
Benjamin Franklin Bancorp, Inc.	BFBC	MA	867,515	128,936	758,945	**17.0%**

Company Name	Ticker	State	Size of Bank (total assets) 12/05 Q ($000)	FHLB Borrowings 12/05 Q ($000)	Total Liabilities 12/05 ($000)	Ratio of FHLB Borrowings to Total Liabilities
Heritage Financial Group (MHC)	HBOS	GA	349,690	50,000	294,813	**17.0%**
Center Bancorp, Inc.	CNBC	NJ	1,114,829	171,870	1,015,340	**16.9%**
United Security Bancshares, Inc.	USBI	AL	621,483	89,588	533,948	**16.8%**
First Republic Bank	FRC	CA	9,329,142	1,429,500	8,587,200	**16.6%**
First Capital, Inc.	FCAP	IN	438,389	65,947	396,397	**16.6%**
New Hampshire Thrift Bancshares, Inc.	NHTB	NH	649,235	100,000	603,452	**16.6%**
Evans Bancorp, Inc.	EVBN	NY	468,546	70,468	431,670	**16.3%**
First Charter Corporation	FCTR	NC	4,232,534	636,002	3,908,712	**16.3%**
Carver Bancorp, Inc.	CNY	NY	648,971	96,482	597,866	**16.1%**
Southern Missouri Bancorp, Inc.	SMBC	MO	348,133	52,000	322,470	**16.1%**
Ameriana Bancorp	ASBI	IN	449,532	66,589	413,712	**16.1%**
Lake Shore Bancorp, Inc. (MHC)	LSBK	NY	NA	48,685	305,729	**15.9%**
Community Banks, Inc.	CMTY	PA	3,332,430	453,246	2,855,757	**15.9%**
HopFed Bancorp, Inc.	HFBC	KY	636,585	93,172	589,747	**15.8%**
Community West Bancshares	CWBC	CA	444,353	63,500	402,119	**15.8%**
Community Bank Shares of Indiana, Inc.	CBIN	IN	665,008	98,000	622,233	**15.7%**
Wauwatosa Holdings, Inc. (MHC)	WAUW	WI	1,507,923	201,212	1,279,513	**15.7%**
Boardwalk Bank	BORD	NJ	401,595	57,195	366,323	**15.6%**
CityBank	CTBK	WA	832,039	101,191	655,739	**15.4%**
Cheviot Financial Corp. (MHC)	CHEV	OH	291,747	33,209	216,981	**15.3%**
WesBanco, Inc.	WSBC	WV	4,422,137	612,693	4,006,885	**15.3%**
Provident Bankshares Corporation	PBKS	MD	6,356,987	872,057	5,725,431	**15.2%**
Shore Financial Corporation	SHBK	VA	248,828	34,050	223,790	**15.2%**
Greater Atlantic Financial Corp.	GAFC	VA	338,928	49,000	324,136	**15.1%**
Cooperative Bankshares, Inc.	COOP	NC	746,266	105,077	695,170	**15.1%**
Landmark Bancorp, Inc.	LARK	KS	468,162	63,212	421,037	**15.0%**

Source: SNL DataSource

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Stanford Washington Research Group Policy Bulletin Disclaimer

Appendix 11.

Comment Letter to Finance Board from the
National Housing Conference, dated June 19, 2006;
and Letter from House Financial Services Committee Chairman
Michael G. Oxley and Ranking Member Barney Frank, dated June 30, 2006.

National Housing Conference

Celebrate the Legacy, Shape the Future

June 19, 2006

Federal Housing Finance Board
1625 Eye Street, NW
Washington, DC 20006

Re: Federal Housing Finance Board Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks
RIN Number 3069-AB30
Docket Number 2006-03

On behalf of the National Housing Conference (NHC), I am writing regarding the proposed capital rule referenced above and the effect this proposal could have on affordable housing.

The National Housing Conference is a nonprofit 501(c) (3) membership association dedicated to advancing affordable housing and community development causes. A membership drawn from every industry segment forms the foundation for NHC's broad, nonpartisan advocacy for national policies and legislation that promote suitable housing in a safe, decent environment across the nation.

Our recent study, "The Housing Landscape for America's Working Families 2005," shed light on a troubling trend across America—the fact that working a full-time job does not guarantee families a decent, affordable place to live. In fact, the housing problems of working families are more persistent and pervasive than many experts may have thought, and are not confined to cities, renters, or the East and West coasts.

NHC's concerns regarding the proposed capital rule stem from the very real potential that the rule will reduce the profitability of the FHLBank System as a whole and thereby reduce the overall contributions to the Affordable Housing Program (AHP). The proposed rule would require each FHLBank to meet a fixed formula minimum retained earnings standard of $50 million plus one percent of non-advance assets. Over three years, FHLBanks would have to add over $2 billion to their retained earnings as a result of this proposal. Estimates of the impact of this requirement include required increases of $500 million for the FHLB of San Francisco, $280 million for the FHLB of Seattle, $180 million for the FHLB of Cincinnati and $150 million for the FHLB of Pittsburgh. NHC is concerned that the required increases to the retained earnings of the FHLBanks will lead to significant reductions in AHP contributions.

The proposed limitation on dividend payments could have the consequence of driving large members from the FHLBank System. Many large members can access the capital markets themselves and as the "all-in" cost of FHLBank advances increases due to dividend limitation, these members could decrease their usage of FHLBank advances or even leave the System. This could result in the shrinking of FHLBank assets and earnings.

As you know, 10 percent of FHLBank profits are dedicated to the AHP. In 2005, a total of $280 million in AHP funds were awarded, funding hundreds of affordable housing units. If there is a decline in the number of large members, and thus profits, the Affordable Housing Program will be significantly curtailed.

Additionally, a decrease in volume of the System will result in a higher cost of advances. Smaller members have no other access to the long-term debt markets. Raising the cost of FHLBank credit to small financial institutions will directly affect the amount of affordable housing lending these members can do. It could also raise borrowing costs for working families who are struggling to find mortgage funding. In light of the recent consumer price index information release, there does not appear to be an end in sight to interest rate increases. Higher borrowing costs, combined with an interest rate increase, could serve to end the dream of homeownership for many Americans.

In light of these possible impacts, NHC requests that the Finance Board withdraw the proposed rule and issue an Advanced Notice of Proposed Rulemaking in order to better study the potential effects of such changes on the supply of affordable housing in our nation.

Sincerely,

Conrad E. Egan
President and CEO

U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

June 30, 2006

The Honorable Ronald A. Rosenfeld
Chairman
Federal Housing Finance Board
1625 Eye Street N.W.
Washington, D.C. 20006-4001

Dear Chairman Rosenfeld:

The Federal Housing Finance Board (FHFB) has issued a proposed rule that would prescribe a minimum amount of retained earnings for each Federal Home Loan Bank (Bank) and would limit the amount of excess stock that a Bank can have outstanding. The proposal also would prohibit a Bank from selling excess stock to its members or paying stock dividends and restrict a Bank's ability to pay dividends when its retained earnings are below the prescribed minimum.

In our view, the potential impact of this proposal is critically important to the Banks, their members, and the housing finance system. The fact that the proposal has been criticized by the leadership of all twelve Banks and key industry trade groups indicates to us a need for pause. We are concerned that the proposed changes may go too far and actually harm the Bank system more than protect it.

Specifically, some of the questions we have are:

- Do the proposal's new capital requirements conform with the capital provisions of the Gramm Leach Bliley Act (GLBA), some of which are still being implemented? How does the proposal relate to the FHFB's development of risk-based capital standards?

- What would be the impact on the financial management and business operations of the Banks?

- Will the cost of Bank advances rise, possibly causing larger members to choose other funding sources and lessen their Bank borrowings and the flow of liquidity?

- Will Bank mortgage purchase programs and investments in non-advance assets be reduced?

- Will the Bank System's payments to the Affordable Housing Program and REFCorp bond defeasance be lower?
- What will be the ramifications for smaller, community financial institutions compared to larger members?
- Will competition and consolidation within the Bank System result?

We understand that for the FHFB there is no question of capital solvency of any Bank. Given there is no apparent urgency, we encourage the FHFB to take an open-minded, cautious approach on such a far reaching proposal. The FHFB should thoroughly address the concerns raised in working toward an appropriate outcome.

The comment period on this proposal ends July 13, 2006. Subsequently, the FHFB should be prepared to testify on the proposal and the comments received at a Financial Services Committee hearing to be held soon after the August recess.

We appreciate your consideration and look forward to your response.

Yours truly,

Michael G. Oxley
Chairman

Barney Frank
Ranking Member

Appendix 12.

Letter from Finance Board General Counsel
to Patricia A. Milon, dated July 6, 2006,
transmitting supplemental materials
in response to ACB's FOIA appeal.

OFFICE OF GENERAL COUNSEL
1625 Eye Street NW, Washington DC 20006
www.fhfb.gov
Phone: 202-408-2983
Fax: 202-408-2580
E-Mail: kennedyj@fhfb.gov

July 6, 2006

Patricia A. Milon
Chief Legal Officer and Senior Vice President, Regulatory Affairs
America's Community Bankers
900 19th Street NW, Suite 400
Washington, DC 20006

Dear Ms. Milon:

This is in response to your appeal of our May 5, 2006 response denying in part your Freedom of Information Act (FOIA) request dated April 3, 2006, for all records relating to the drafting, formulation, and approval of Resolution Number 2006-03, Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks.

I have considered your assertions on appeal, reviewed the relevant case law, including the case you cited, and carefully examined the responsive records. On the basis of my review, I have concluded that we may disclose a portion of one responsive record that previously was withheld under FOIA Exemption 8. This document is enclosed.

With regard to the remainder of the responsive documents, I have concluded that denial of your appeal is appropriate pursuant to FOIA Exemption 5, which exempts from disclosure inter- or intra-agency records that could injure the quality of agency decisions and compromise the integrity of the Finance Board's deliberative process; and FOIA Exemption 8, which exempts records that are contained in or related to examination, operating or condition reports prepared by, on behalf of, or for the use of the Finance Board, Federal Home Loan Banks or a financial regulatory agency. *See* 5 U.S.C. § 552(b)(5) and (8); 12 C.F.R. § 910.5(a)(5) and (8).

I also have confirmed that staff completed a diligent search and provided to you all non-exempt responsive records. More specifically, I am not aware of any "additional investigative tools that generate raw data or empirical evidence" such as models, data, or analysis of data.

You may seek judicial review of my decision under 5 U.S.C. § 552(a)(4).

Sincerely,

John P. Kennedy
General Counsel and FOIA Appeal Official

Enclosure

Federal Housing Finance Board

TO: Chairman Ronald A. Rosenfeld
HUD Secretary Alphonso Jackson
Director Alicia R. Castaneda
Director Franz S. Leichter
Director Allan I. Mendelowitz

FROM: Stephen M. Cross, Director, Office of Supervision
John P. Kennedy, General Counsel

SUBJECT: Proposed Regulations Concerning Excess Stock and Retained Earnings

DATE: March 1, 2006

I. Overview

We are proposing to amend Parts 917, 925, 930, and 931 of the Rules and Regulations of the Federal Housing Finance Board (Finance Board) and to add a new Part 934. These proposals would establish a regulatory limit for excess stock in a Federal Home Loan Bank (FHLBank or Bank) and establish a regulatory minimum retained earnings requirement for each FHLBank. If the proposed amendments are adopted, a Bank would no longer (i) be permitted to pay stock dividends or (ii) sell capital stock to members if the stock would be excess stock at the time of purchase. A Bank's dividends would be constrained if the Bank had less than its regulatory minimum retained earnings. These proposed regulatory amendments are intended to prevent recurrence of supervisory concerns regarding capital composition, capital management, and retained earnings that have given rise to formal and informal enforcement actions taken by the Finance Board in recent years. There is no question of capital solvency of any FHLBank; it is the composition of the capital that gives rise to these proposals.

II. Excess Stock Limitation

FHLBank capital stock that members hold in excess of the amount they are required to purchase as a condition of membership or to support their activities with the Bank is referred to as "excess stock." Excess stock presents two principal supervisory issues for the Finance Board. First, member institutions can redeem their excess stock at its par value without curtailing activities with the Bank or withdrawing from membership. Many of the Banks have commonly repurchased member stock on request,

notwithstanding the provisions in the Federal Home Loan Bank Act that establish six-month to five-year statutory redemption periods.[1] Repurchasing excess stock "on demand" can create capital management difficulties for the Bank if the Bank relies on excess stock to fulfill any part of its regulatory capital requirements, particularly if multiple, large redemption requests were to be submitted in a short period of time. Second, advances are normally supported by required "activity" stock. Any excess stock will typically be used to capitalize non-advance assets, such as mortgages (Acquired Member Assets or AMA), mortgage-backed securities (MBS), and other investments. Although a Bank may impose an "activity" charge to support AMA, only six of the 12 FHLBanks do so. Using excess stock to capitalize mortgages or other long-term assets is undesirable from a supervisory perspective to the extent that members expect the stock to be repurchased at par and virtually upon notice. Using excess stock to capitalize investment securities beyond an amount needed for liquidity is also undesirable from a public policy perspective to the extent that the Government Sponsored Enterprise (GSE) borrowing privilege is being used to fund activities that are not related to the GSE's core mission.

The proposed regulatory amendments should serve to reduce the risks of capital instability associated with relying on excess stock to meet regulatory capital requirements. It would also limit the use of excess stock as a way of funding mortgages or investments. Specifically, we are recommending that the board of directors of the Finance Board amend or introduce the aforementioned regulations to:

1. Limit excess capital stock in any FHLBank to no more than one percent of the Bank's assets;

2. Prohibit members from purchasing capital stock in excess of their required stock investment; and

3. Prohibit the payment of stock dividends.

With these regulatory changes, excess stock would arise only when stock is not redeemed or repurchased following a reduction in a member's required stock investment.

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[1] An FHLBank may buy back excess stock from a member either through repurchase or redemption. A repurchase transaction occurs at the discretion of the FHLBank, and the FHLBank may repurchase excess stock at any time, after providing members with notice of its intent to do so. FHLBanks generally repurchase excess stock either upon the request of a member or in accordance with an established schedule. Redemptions are initiated by the member. Under the regulations that pertain to the Chicago Bank, which has not yet implemented the capital provisions of the Gramm-Leach-Bliley Act (GLB Act), a member may withdraw from membership in an FHLBank six months after filing a written notice of intent to withdraw and, "upon surrender and cancellation of its capital stock, the member shall receive a sum equal to its cash paid subscriptions for the capital stock surrendered." Under the capital provisions of the GLB Act, a redemption transaction is initiated by a member's filing of a written request to have stock redeemed and occurs at the end of a notice period established by the FHLBank Act. The FHLBank, subject to certain exceptions, is required to redeem a member's excess stock at the end of this statutory redemption period. The statutory redemption periods are six months for Class A stock and five years for Class B stock.

Discussion

As of December 31, 2005, the FHLBanks held $7.4 billion in excess stock, or approximately 17 percent of the FHLBank System's total capital stock of $43.5 billion. The Banks had retained earnings of $2.5 billion and, therefore, total capital of $46.0 billion. Required capital totaled $36.1 billion

Under current Finance Board regulations, a member's investment in excess stock may arise from any of three sources: (i) a purchase of FHLBank stock in excess of the amount required as a condition for membership or to support certain activities, such as advances from the Bank; (ii) a payment of dividends by the FHLBank to its members in the form of stock rather than cash; or (iii) a reduction in a member's required stock holdings – such as through the repayment of an outstanding advance – without a commensurate reduction in the FHLBank stock held by that member.

The FHLBank of Chicago has the largest concentration of excess stock. In recent years, only the Chicago Bank has made direct sales of excess stock to members. Much of the stock was sold to members for "investment" purposes at a time during which the dividend yield on the Bank's stock significantly exceeded yields on alternative short-term investments. At one point, more than 60 percent of the FHLBank of Chicago's capital was in the form of excess stock, and excess stock was more than three times greater than the limit proposed by these regulatory amendments. However, other FHLBanks have capital plans that will allow such direct sales. If the proposed amendment to the regulations is adopted, the regulatory restrictions on excess stock would supersede any capital plan provisions that allow direct sale. The proposed amendments are intended to prevent the sale of FHLBank stock for investment purposes and to prevent undue reliance on excess stock by any FHLBank in the future.

redacted in prior package

The FHLBank of Cincinnati has the second largest concentration of excess stock. Its excess stock is largely the result of the Bank paying stock, rather than cash, dividends to its members. Stock dividends allow a member to defer payment of taxes until any stock is redeemed – and for tax management purposes many FHLBank members have chosen to hold the excess stock created by stock dividends.

Seven of the FHLBanks have paid stock dividends since 1995. As shown in the table below, those seven Banks also paid out stock dividends in 2005.[2] Four of those seven Banks have excess stock exceeding the proposed limitation.

[2] The data reflect dividends actually paid to members in a particular quarter. Dividend policies vary among the FHLBanks. In some cases, dividends are paid in a quarter based on actual and projected earnings for the quarter. In other cases dividends are paid based on actual earnings from the preceding quarter. In still other cases, dividends are paid based on actual earnings from one or more months in the preceding quarter as well as one or more months from the current quarter.

Stock Dividend Payments by FHLBanks
Payments Made in Each Quarter of 2005
(Dollars in Millions)

Bank	1Q05	2Q05	3Q05	4Q05
Boston	0	0	0	0
New York	0	0	0	0
Pittsburgh	0	0	0	0
Atlanta	0	0	0	0
Cincinnati	42	45	42	50
Indianapolis	21	21	0	0
Chicago	60	58	52	38
Des Moines	0	0	0	0
Dallas	18	22	25	25
Topeka	19	21	21	23
San Francisco	82	87	101	107
Seattle	9	0*	0*	0*

*Did not pay any dividends.

The proposed amendments would prohibit any FHLBank from paying stock dividends to its members, thereby preventing the buildup of excess stock resulting from them.

Rationale for Proposed Changes

An FHLBank's reliance on excess stock raises safety and soundness and public policy concerns. Since FHLBanks often repurchase excess stock from a member promptly upon request, a Bank's reliance on excess stock can leave the Bank vulnerable to capital management problems if it were to experience substantial requests for repurchase over a relatively short timeframe. Furthermore, if excess stock is needed to meet an FHLBank's regulatory capital requirements, the Bank must refuse to honor a member's request for repurchase as such a repurchase would result in noncompliance with Finance Board regulations. Such refusals could undermine members' confidence in the FHLBank to the extent that the members had believed or expected that the Bank would repurchase their investments in excess stock upon demand.

Public policy concerns arise as the FHLBanks use excess stock to arbitrage the capital markets to generate earnings. The Banks' GSE status permits them to borrow funds at favorable rates and invest proceeds in non-mission related assets, most notably mortgage-backed securities and money market investments. While these activities increase FHLBank income, they do not directly further the FHLBank System's public purpose. Critics of this practice maintain that the GSE borrowing privilege should be restricted to housing finance mission-related activities and should not be used to arbitrage the capital markets. In the 1990s, the Finance Board set regulatory limits for mortgage-backed securities investments to address public policy concerns; however, no limits have been set for investments in money market instruments.

A limit on excess stock serves to reduce the potential for capital instability at the FHLBanks and limit the use of excess stock as a funding vehicle for non-mission related assets. Our recommendations would limit excess stock holdings by an FHLBank to one percent of assets and prohibit stock dividends altogether. The regulatory limits would allow for sufficient liquidity at the FHLBanks while promoting a stronger and more stable capital structure.

As of December 31, 2005 excess stock held by the FHLBanks of Chicago, Cincinnati, Seattle and Indianapolis was in excess of one percent of total assets as shown in the table below. As shown in the preceding table, each of those four Banks paid stock dividends in 2005.

Excess Stock as Percentage of Total Assets
As of December 31, 2005

Bank	Excess Stock ($ in millions)	Excess Stock/ Total Assets (as percentage)	Stock in Excess of Limitation ($ in million)
Boston	353	0.61	0
New York	0	0.00	0
Pittsburgh	85	0.12	0
Atlanta	12	0.01	0
Cincinnati	1,492	1.93	720
Indianapolis	686	1.43	205
Chicago	2,331	2.73	1,478
Des Moines	91	0.20	0
Dallas	370	0.57	0
Topeka	386	0.82	0
San Francisco	1069	0.48	0
Seattle	563	1.07	38

With the proposed amendments, we are also recommending that any FHLBank that exceeds the one percent of total assets limit as of the last business day of a quarter be required to notify the Finance Board. Within 60 days following that quarter-end, the FHLBank would have to certify, in writing, that it has corrected the deficiency or develop a compliance plan acceptable to the Finance Board.

III. Minimum Retained Earnings Requirement

An FHLBank's net income that is not distributed to shareholders as dividends is known as "retained earnings." Retained earnings can serve several functions, including to:

1. Provide a cushion to absorb losses and protect the par value of capital stock;
2. Enable payment of dividends in the event of a shortfall in earnings;
3. Allow relative stability in dividends when accounting income is not stable; and
4. Provide a source of capital for growth.

The level of an FHLBank's retained earnings critically affects a Bank's ability to absorb fluctuations in earnings and pay dividends to its members. Retained earnings are a particularly important component of capital for the FHLBanks because of the statutory, regulatory, and supervisory priority the Finance Board places on maintaining the par value of member stock. In response to supervisory guidance and increased earnings volatility, the FHLBanks have made progress in increasing their retained earnings over the past three years. Although the FHLBanks have increased retained earnings since the Finance Board issued Advisory Bulletin 03-08 in August 2003, progress has been modest and uneven among the Banks. The proposed regulatory amendments should ensure greater consistency among the FHLBanks in establishing and maintaining an adequate level of retained earnings.

An important factor contributing to earnings volatility at the FHLBanks has been the implementation of Statement of Financial Accounting Standards Number 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities,* which contributes to higher earnings volatility due to its asymmetric accounting of derivative instruments and held-to-maturity hedged items. Increased holdings of mortgage assets, with long contractual lives coupled with borrower prepayment options have also contributed to higher market risk exposure and greater earnings fluctuations among the FHLBanks.[3]

By establishing a minimum retained earnings requirement, each FHLBank should have in place a sufficient cushion for potential losses in order to avoid impairment to the par value of members' capital stock. Specifically, we are recommending that Parts 917, 930, and 931 be amended and a new Part 934 be added to state that:

1. Each FHLBank shall achieve and maintain minimum retained earnings totaling $50 million plus one percent of non-advance assets. The calculation would be performed quarterly using the FHLBank's average daily balances of non-advance assets during the preceding quarter.

2. For reasons of safety and soundness, the Finance Board may require an FHLBank to achieve and maintain retained earnings in excess of the minimum requirement of this regulation.

3. Until an FHLBank achieves compliance with its minimum retained earnings requirement, it may not declare or pay dividends in excess of 50 percent of its current net earnings without prior written approval from the Finance Board.[4]

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[3] On January 25, 2006, the Financial Accounting Standards Board (FASB) released an exposure draft, "The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115." The changes proposed in the exposure draft would allow an FHLBank to designate certain hedged assets to be carried at fair value and thereby eliminate much of the asymmetric accounting of derivative instruments and held-to-maturity hedged items. The proposed changes would allow entities to re-designate the carrying status of existing assets.

[4] "Current net earnings" are defined under the proposed amendments as the net income of a FHLBank for a calendar quarter in accordance with generally accepted accounting principles (GAAP) after deducting the FHLBank's required contributions for that quarter to the Resolution Funding Corporation under Sections 21A and 21B of the Bank Act (12 U.S.C. 1441a, 1441b) and to the Banks' Affordable Housing Program

4. An FHLBank that subsequently falls below its minimum retained earnings requirement would be prohibited from declaring or paying a dividend without prior written approval from the Finance Board.

5. Dividends for a quarter shall be declared only after the FHLBank's net earnings for the quarter have been recorded. Dividends shall not be based on projected or anticipated earnings.

Discussion

When retained earnings are negative, the par value of an FHLBank's capital stock is considered "impaired." When "other than temporarily impaired," the FHLBank capital stock held by member institutions would be reported on the members' balance sheets at a value that is less than its par value under generally accepted accounting principles (GAAP).

Capital stock impairment, particularly in the FHLBank context, is not synonymous with either capital insolvency or capital inadequacy. A Bank can exceed its minimum capital requirements by a substantial amount, but still have the par value of its capital stock impaired if retained earnings have been exhausted and the members' capital stock has absorbed losses.[5]

An "other than temporary" impairment of the par value of an FHLBank's capital stock carries significant negative consequences. First, an FHLBank is prohibited from redeeming or repurchasing members' capital stock without the prior approval of the Finance Board, when the Finance Board or the Bank's board of directors has determined that the Bank has incurred or is likely to incur other than temporary losses that result or are expected to result, in negative retained earnings. *See* 12 U.S.C. § 1426(f) and 12 C.F.R. § 931.8. Second, an FHLBank may not pay dividends if the par value of its capital stock is impaired. *See* 12 U.S.C § 1436 and 12 C.F.R. § 917.9. Third, market participants (members, bondholders, rating agencies, other banking regulators, and others) may respond negatively to impairment of FHLBank stock. Such reactions could include unwillingness on the part of members to acquire additional Bank stock, a slowdown in new advance business, an increase in the risk-based capital requirement by members' regulators, or a downgrade in an FHLBank's counterparty credit ratings. Any one of these reactions could increase the FHLBank's costs.

By regulation (12 C.F.R. §931.1(a)(2) and (b)(2)), new Class A or Class B FHLBank stock must be purchased at par value ($100 per share) even when the capital stock on a

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under Section 10(j) of the Bank Act (12 U.S.C. 1430(j)) and Section 951.2 [of the Finance Board's rules], but before declaring any dividend under Section 16 of the Bank Act (12 U.S.C. 1436).

[5] A member would classify or write down its capital stock in an FHLBank, however, only if the impairment was "other than temporary." That determination would be made based on a number of factors influencing the ultimate recoverability of the par value of the stock. "Other than temporary" impairment would not reflect a temporary decline in value, but would be influenced by the size of the impairment relative to par value and the permanence of factors that have contributed to the impairment.

book value basis is less than par value, *e.g.*, $90 per share.[6] Consequently, any stock purchased at par value when the book value of capital stock is below par is an immediate economic loss to the acquirer. In such situations, existing members would be reluctant to purchase new stock to expand their activity-based relationship with the FHLBank and potential new members would likely defer joining the Bank. As a result, a Bank's ability to provide mission-related services to its members could be severely curtailed.

Rationale for Proposed Changes

At present, all twelve of the FHLBanks exceed their minimum capital requirements and the risk of capital insolvency for any FHLBank is extremely remote. However, one or more of the Banks reasonably could incur sufficient losses that could deplete retained earnings and result in the impairment, at least temporarily, of the par value of capital stock.

The capital stock of an FHLBank has characteristics that require its par value to be fully protected. By statute or regulation, FHLBank stock is purchased and redeemed at par. In many respects, and with the exception of capital stock supporting advances, an FHLBank's retained earnings function as the Bank's operating capital.

In an effort to encourage the FHLBanks to bolster their retained earnings, the Office of Supervision issued Advisory Bulletin 03-08, *Capital Management and Retained Earnings*, in August 2003. That advisory bulletin required that each FHLBank adopt a capital management and retained earnings policy that includes a retained earnings target commensurate with the Bank's risk profile under a variety of economic and financial scenarios. However, in our examinations and in a supplemental review of the Banks' retained earnings polices, we found broad differences among the Banks' policies and in their approaches to establishing their retained earnings targets.[7] [redacted]

(b)(8)

Under the proposed amendments, each FHLBank would be required to achieve and maintain a minimum amount of retained earnings equal to $50 million plus one percent of the FHLBank's non-advance assets. We considered several alternative measurements tied explicitly to risk-based capital requirements or measures of income volatility, but concluded that the proposed measure, which uses non-advance assets as a proxy for risk,

[6] The cited regulation does not apply to the FHLBank of Chicago, which has not yet converted to it new capital structure as set forth in the Gramm-Leach-Bliley Act of 1999. *See* 12 C.F.R. §925.19, which applies to the FHLBank of Chicago until the time of its capital plan conversion.

[7] *Review of Federal Home Loan Bank Retained Earnings Policies*, Regulations and Research Division, Office of Supervision, Federal Housing Finance Board, February 10, 2005.

captures an FHLBank's exposure to risk in a transparent, straightforward, and easily calculable manner. Our estimates also indicated that the formula is a reasonable approximation of alternative measurements we considered. In addition, the most significant risks faced by the FHLBanks generally are associated with non-advance assets, such as mortgages and mortgage-related securities and the hedging and funding instruments associated with those assets. Further, advances differ from other FHLBank assets in that members normally must purchase capital stock, known as "activity stock," in support of advances. Stock in the FHLBank held by the member is available to absorb credit losses incurred from advances and other indebtedness of a member to the FHLBank.

Implications of the Proposed Rule

If the proposed rule had been in place at year-end 2005, the FHLBanks' minimum retained earnings requirement at year end 2005 would have ranged from a low of $218 million at the FHLBank of Topeka to a high of $672 million at the FHLBank of Chicago. As shown in the following table, eleven FHLBanks, the exception being the FHLBank of New York, would have fallen short of the proposed requirement. The estimated retained earnings shortfalls would have ranged from zero for the FHLBank of New York to $393 million at the FHLBank of San Francisco.

Minimum Retained Earnings (MRE)
As of December 31, 2005
($ in millions)

	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
MRE	226	255	265	383	399	245	672	275	224	218	525	378
Actual RE	139	291	182	343	208	149	523	161	174	138	132	69
MRE Shortfall	87	0	83	40	191	96	149	114	50	80	393	309

We are also recommending that dividends be restricted to 50 percent of net current earnings until the FHLBank reaches its minimum retained earnings requirement. As the following table indicates, nine of the FHLBanks would likely be able to meet their minimum retained earnings requirement in two years or less and, except for Seattle, each of the FHLBanks would likely meet its minimum retained earnings requirement in less than three years if the proposal were to be adopted. The table also shows the length of time for each FHLBank to reach its minimum retained earnings requirement at various dividend payout rates above 50 percent.[8]

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[8] These timeframe estimates are based on the assumption that 2005 net current earnings are representative of income; however, if 2005 earnings are not representative, these estimated timeframes will expand or contract.

Years to Meet Minimum Retained Earnings Requirement
Under Alternative Dividend Payout Limitations*

Payout Rate	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
50%	1.3	n/a	1.0	.2	1.7	1.3	1.2	2.5	.8	1.2	2.1	**
60%	1.6	n/a	1.3	.3	2.2	1.6	1.5	3.2	1.0	1.4	2.7	**
70%	2.1	n/a	1.7	.4	2.9	2.1	2.1	4.2	1.4	1.9	3.5	**
80%	3.1	n/a	2.5	.6	4.3	3.2	3.1	6.3	2.1	2.9	5.3	**

* Estimated using net current earnings in 2005.
**Not meaningful because of negligible net earnings in 2005.

Generally, we would expect the FHLBanks to hold retained earnings at least modestly above their minimum requirement as protection against an unforeseen quarterly loss or accounting volatility. Under the proposed amendments, if a Bank were to fall below its minimum retained earnings requirement after initially satisfying the standard, the FHLBank would be prohibited from declaring or paying a dividend without the prior written approval of the Finance Board. This restriction would likely arise in only extreme circumstances, principally as a result of substantial losses in one or more quarters, which would reduce retained earnings to a level below the required minimum. Indeed, the proposed dividend restriction would provide an incentive for an FHLBank to maintain retained earnings above the minimum requirements, much like FHLBanks and other financial institutions regularly maintain capital in excess of regulatory requirements.

IV. Conclusion

The proposed amendments would address conditions among the FHLBanks that have given rise to formal and informal supervisory actions in the past two years. The proposed amendments would limit an FHLBank's reliance on "excess stock" as a source of capitalization and increase retained earnings at eleven of the twelve FHLBanks. Reliance on excess stock can make an FHLBank's capitalization vulnerable to redemptions, particularly at times when that capital is needed to absorb losses or support longer-term investments. Higher retained earnings would permit FHLBanks to absorb losses with a lower likelihood that the losses would impair, even temporarily, the value of the members' capital stock. As such, the proposed changes would enhance the overall safety and soundness of the FHLBanks and the FHLBank System.

V. Further Information

Principal staff work was done by Scott Smith and Tony Cornyn in the Office of Supervision and Tom Joseph in the Office of the General Counsel. Questions or comments on the proposal may be sent directly to their attention.

Appendix 13.

Letter from Thomas J. McCool, Director,
Financial Institutions and Market Issues, GAO, to the Chairman and
Ranking Member of the Subcommittee on Capital Markets of the House
Banking and Financial Services Committee (Aug. 31, 1999), on the Capital
Structure of the Federal Home Loan Bank System.

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United States General Accounting Office
Washington, D.C. 20548

General Government Division

B-283453

August 31, 1999

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises
Committee on Banking and Financial Services
House of Representatives

The Honorable Paul E. Kanjorski
Ranking Minority Member, Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises
Committee on Banking and Financial Services
House of Representatives

Subject: Capital Structure of the Federal Home Loan Bank System

This letter responds to your July 27, 1999, request that we summarize our past positions and recommendations regarding the capital structure of the Federal Home Loan Bank System (System). As stated in your request letter, selected House and Senate members will soon confer on H.R. 10 and S. 900, the financial modernization bills (Bills) passed this year. The Bills provide for changes in the System and its regulator, the Federal Housing Finance Board (FHFB). In our previous work, we recommended that Congress reform the existing capital structure. In your letter, you acknowledged the extensive body of work we have produced on the System and its capital structure. You further stated that a summary of our past positions and recommendations regarding the capital structure of the System would be useful in reviewing and discussing H.R. 10 and S. 900 during conference.

Results in Brief

We have consistently supported the establishment of risk-based capital standards applied in combination with a leverage ratio that requires a minimum capital-to-asset ratio for the System.[1] A risk-based capital standard offers a number of benefits that include giving the

[1]See Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991); Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/GGD-94-38, Dec. 8, 1993); Bill Comment on proposed legislation entitled "The Federal Home Loan Bank System Modernization Act of 1995" (Oct. 11, 1995); and Bill Comment on proposed legislation entitled "The Enterprise Resource Bank Act of 1996" (GAO/GGD-96-140R, June 27, 1996).

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government a mechanism to influence the System's risk-taking without involving itself in the System's daily business. In supporting the establishment of risk-based capital standards, we have recommended that System capital should be made more permanent. There are a number of ways this could be achieved, including increasing the time period for repayment after terminating membership or establishing capital requirements that provide for minimum retained earnings in each Federal Home Loan Bank (FHLBank).

Background

The System is a government-sponsored enterprise (GSE) consisting of 12 federally chartered, privately owned FHLBanks located in Boston, MA; New York, NY; Pittsburgh, PA; Atlanta, GA; Cincinnati, OH; Indianapolis, IN; Chicago, IL; Des Moines, IA; Dallas, TX; Topeka, KS; San Francisco, CA; and Seattle, WA; with each FHLBank serving a defined geographic region of the country. The FHLBanks raise funds by issuing consolidated debt securities in the capital market. Each FHLBank is subject to a capital rule based on a leverage ratio that requires capital to be at least a fixed proportion of assets. Currently, the combination of statutory capital requirements and FHFB regulations results in a 4.76 percent leverage requirement. The System was set up in 1932 to extend mortgage credit by making loans, called advances, to its member institutions, which in turn lend to homebuyers for mortgages. Advances are secured by home mortgage loans and other collateral. To date, collateral has included U.S. Treasury securities, deposits at a FHLBank, and a limited amount of other real estate-related collateral. These advances help member institutions, originally limited to thrifts, by enhancing liquidity and providing access to national capital markets. In 1989, as part of the Financial Institutions Reform, Recovery, and Enforcement Act, Congress opened membership to non-thrift federally insured depository institutions that offer residential mortgage loans. As of June 30, 1999, the FHLBanks held about $330 billion in advances to members; $148 billion in investments; and $25 billion in capital, of which $550 million was in the form of retained earnings. In addition, the System had 7,101 members, which included 5,112 commercial banks, 1,618 thrifts, and 371 credit unions and insurance companies.

The Bills include a number of provisions related to the System that would, among other things, change the basis for membership in the System from a mix of voluntary and mandatory to all voluntary and expand the purposes of System advances with corresponding expansion in eligible collateral.

Scope and Methodology

We reviewed provisions concerning reforms in the capital structure of the System in H.R. 10 and S. 900. To summarize our past positions and recommendations regarding the capital structure of the System, we reviewed reports and bill comments on the System and FHFB that we issued between 1993 and 1998. We also reviewed our 1990 and 1991 reports on the government's exposure to risk from GSE activities.

We obtained oral comments from FHFB on a draft of this letter. These comments are discussed near the end of this letter. We conducted our work in Washington, D.C., during the month of August 1999 in accordance with generally accepted government auditing standards.

System Capital Should Be Risk-Based and More Permanent

We have consistently supported the establishment of risk-based capital standards applied in combination with a leverage ratio that requires a minimum capital-to-asset ratio for the System. For financial purposes, capital is generally defined as the long-term funding for a firm that cushions the firm against unexpected losses. Losses are caused by exposure to various risks the financial firm faces in its business activities. The federal government has no legal obligation to protect GSE creditors, but there is a widespread perception in the financial markets that during a financial emergency the U.S. government would rescue a GSE. This perception weakens private market discipline. A risk-based capital standard has a number of benefits that include giving the government a mechanism to influence the GSE's risk-taking without involving itself in the GSE's daily business. Such a mechanism could become more important for the System as it engages in new FHLBank activities initiated over the past 3 years and because of potential expansions in the purposes of System advances authorized by the Bills. In addition to supporting the establishment of risk-based capital standards, we have recommended making System capital more permanent.

FHLBank System Faces a Number of Risks

The primary risks inherent in System activities are interest-rate risk, credit risk, and operations risk. FHLBanks are exposed to interest-rate risk because they face possible losses and changes in the value of their portfolios due to changes in interest rates. Credit risk is the potential for financial loss from a borrower or counterparty failing to perform on an obligation. Operations risk is the potential for unexpected financial loss arising from inadequate information systems, operational problems, breaches in internal controls, or fraud.

Risk-Based Capital Standards Provide Incentives to Avoid Undue Risk

Requiring capital sufficient to balance a GSE's risks provides several public benefits. It gives the government a mechanism to influence a GSE's risk-taking without involving itself in the GSE's daily business. A risk-based capital standard also helps ensure that the GSE's shareholders have incentives to demand that management not take undue risks, since increased risk taking would impose costs resulting from raising additional capital to meet a risk-based capital standard. In addition, a risk-based capital standard gives some assurance of a buffer adequate to absorb unforeseen GSE losses and thus to prevent or reduce potential taxpayer losses.

The potential for moral hazard[2] exists in the System in three dimensions, with each FHLBank having an incentive to take on greater risk because some losses could be borne by others.

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[2]The term "moral hazard" has been defined as "a description of the incentive created by insurance that induces those insured to undertake greater risk than if they were uninsured because the negative consequences are passed through to the insurer." In this context, the possibility that a FHLBank could become troubled would create a moral hazard, because U.S. taxpayers, the other FHLBanks, and the deposit insurance funds could in effect become the insurers of the troubled FHLBank's activities. In such a situation, the troubled FHLBank would have incentives to undertake risky activities because profits would accrue to the FHLBank's owners, whereas losses could fall on others.

First, U.S. taxpayers are at risk due to the possibility that the U.S. government would come to the rescue of the System during a financial emergency. Second, the FHLBanks are jointly and severally liable for the System's outstanding debt securities. Therefore, all FHLBanks are at risk due to the possibility that a FHLBank could become troubled and not be able to meet its debt obligations. Third, the System has lien status in which advances generally have priority over other security interests, including insured deposits, in the assets of failed insured financial institutions. Therefore, the deposit insurance funds may be at risk to the extent that a FHLBank provided advances to a troubled federally insured member that subsequently failed. Authorizing FHFB's promulgation of risk-based capital standards would provide FHFB with a mechanism to limit moral hazard.

In our 1993 report on the System, we recommended that the current capital stock requirements and the FHLBanks' debt-to-equity limit be replaced by a risk-based capital requirement analogous to that used for banks and thrifts.[3] We stated that the risk-based capital framework developed by U.S. banking regulators provides only a rough measure of credit risk and fails to account for interest rate or other risks, such as operations risk. Thus, we stated that regulators should supplement the risk-based requirement with a leverage requirement, which requires a minimum capital-to-asset ratio.

Of the methods available for setting capital standards, we have concluded that a combination of stress tests and a leverage ratio would best cover all the risks undertaken by a GSE such as the System. Stress tests are empirically based tests that can project capital levels required for measurable risks—that is, credit and interest-rate risk. These tests are especially applicable to GSEs in a single line of business, because economic conditions that are adverse to the business are more easily identified in this case.

Risks in New Activities Should Be Balanced With Adequate Capital

Currently, the principal purpose of System advances is to provide funds to any member for residential housing finance. The Bills would expand the purposes of System advances. Purposes listed in S. 900 include providing funds to any community financial institution[4] for small businesses, small farms, and small agribusinesses. Purposes listed in H.R. 10 include providing funds to any community financial institution for small business, agricultural, rural development, or low-income community development lending. The Bills specify corresponding expansions in eligible collateral for System advances.

The broader mission and additional eligible collateral could lead to an increase in the taxpayers' potential exposure to risk because it is likely to lead to expanded System activity, possibly in higher risk assets.[5]

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[3]GAO/GGD-94-38, Dec. 8, 1993, p. 69.

[4]A community financial institution is defined in the Bills as a FDIC-insured institution that has less than $500 million in assets.

[5]GAO/GGD-96-140R, June 27, 1996, p. 5.

The System's lien status would mitigate, to some extent, each FHLBank's credit-risk exposure resulting from expansion into new advance activities and associated collateral. FHFB regulations require that advances be fully secured and subject to a written security interest in the collateral. Current law provides that the FHLBank's security interest generally has priority over the claims and rights of any party, including receivers, conservators, and trustees. However, the System's lien status increases potential credit risk to the deposit insurance funds to the extent that a FHLBank provided advances to a troubled federally insured member that subsequently failed.

As well as being providers of advances, the FHLBanks have large investment portfolios. In addition, over the past 3 years, FHFB has approved pilot programs that have authorized the FHLBanks to make new types of investments and share risks with System member institutions. FHLBank investments do not have the same priority over other security interests as advances, and therefore investments can increase credit risk as well as interest-rate risk. According to testimony by the FHFB Chairman, FHFB began to follow a strategy "...to encourage the development of additional mission-related assets..." as an outgrowth of concerns about nonmission-related investments.[6] Thus far, FHFB has authorized four pilot programs ranging in size from $25 million to $9 billion. In general, the programs involve FHLBank funding or financing for housing in new ways. For example, in one program, the FHLBank purchases participation interests in affordable multifamily housing loans originated by a consortium of small banks that are mostly FHLBank members. Another program offers FHLBank members a different alternative to holding loans in their own portfolios. In this program, the FHLBank is to fund and retain in its portfolio the loans originated, serviced, and credit-enhanced by members. The risks are to be shared between the members and the FHLBank.

Taken as a whole, expansion in new FHLBank activities and the expansion in eligible collateral authorized by the Bills could lead to an increase in the taxpayers' potential exposure to risk. In previous work, it appeared to us that new expertise would be required of FHLBank management in an environment with expanded mission and collateral, because without a thorough understanding of the risks associated with the new collateral and lending activities, it may be difficult to properly monitor and manage the risks.[7] Here we also note that each of the 12 FHLBanks serves a defined geographic region of the country. Such geographic containment may contribute to concentration of credit risk.[8] Based on these observations and on our past positions and recommendations, establishment of risk-based capital standards, in addition to a leverage ratio, could become more important for the System, considering the potential for increased risk-taking by each of the 12 FHLBanks.

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[6]Statement of Bruce Morrison, Chairman of the Federal Housing Finance Board, Before the Subcommittee on Financial Institutions and Regulatory Relief of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 24, 1997.

[7]GAO/GGD-96-140R, June 27, 1996, p. 11.

[8]Concentration of credit risk could increase risk for (1) all FHLBanks due to the possibility that a FHLBank could become troubled and not be able to meet its debt obligations and (2) the deposit insurance funds to the extent that a FHLBank provided advances to a troubled federally insured member that subsequently failed. However, concentration of credit risk would not likely increase risk for U.S. taxpayers because the FHLBanks are jointly and severally liable for the System's outstanding debt securities.

Designing a stress test for the System, given the mix of different types of business activity the Bills would authorize, would be a difficult task. For example, evaluating the value of collateral for commercial loans, such as those to finance multifamily housing, small business, and agricultural activities, can be difficult due to the heterogeneity of the business activities. For FHLBank investments in such activities, it may not always be possible to design a stress test to quantify the credit risk. In this and other situations where risks cannot be quantified, we have concluded that a leverage ratio is still necessary to cover such risks.[9] Given the challenge FHFB would likely have in quantifying credit risk from new activities, the appropriate role and level for a leverage ratio would logically be inversely related to the extent to which such credit risk could be quantified.

To Provide a Suitable Cushion Against Unexpected Losses, Capital Should Be More Permanent

Common equity capital provides a cushion against unexpected losses, because individual stockholders cannot demand that the firm redeem the stock. In contrast, System capital from voluntary members does not provide a cushion against unexpected losses, because voluntary System members may withdraw from the System and redeem their stock. Current requirements for FHLBank capitalization are based on stock purchase requirements by member institutions. A voluntary member that wishes to withdraw from the System must give 6 months' notice. If impairment of the FHLBank's capital is likely, FHFB can withhold a portion of a withdrawing member's capital stock. In our 1993 report, we raised the possibility that if pending losses threaten the value of a FHLBank's stock, the FHLBank's voluntary members may try to withdraw their stock before the losses impair its value. We also concluded that, as a practical matter, the degree to which FHFB's authority makes FHLBank stock a buffer for absorbing losses depends on the extent to which FHFB exercises its authority to withhold stock redemption. We stated that for FHFB to use this authority in a way that makes capital stock a meaningful buffer, FHFB would have to recognize potential future losses in a timely manner and be willing to withhold proceeds from stock redemption requests.

To address this concern, we have recommended that System capital from voluntary member institutions should be more permanent in order to provide a suitable cushion against unexpected losses in the System. There are a number of ways greater permanence could be achieved, two of which were addressed in our previous work. In our 1995 bill comment, we noted that the pending legislation would have increased the time period for repayment after a member terminated membership from 6 months to a minimum of 12 months. This is one way of increasing the permanence of System capital.

Another way of increasing the permanence of System capital was addressed in our 1993 report. We recommended that the new capital requirements provide for minimum retained earnings in each FHLBank, and that these retained earnings should, at a minimum, protect against the measurable risk undertaken by each FHLBank as well as the associated

[9] GAO/GGD-96-140R, June 27, 1996, p. 16.

management and operations risks. Since retained earnings represent funds that are not distributed to members, they would provide a source of permanent at-risk capital held by FHLBanks.

Conclusions

We have consistently supported the establishment of risk-based capital standards applied in combination with a leverage ratio for the System. Such a mechanism could become more important for the System considering new FHLBank activities initiated over the past 3 years and expansions in the purposes of System advances authorized by the Bills. At the same time, some of these additional credit risks may be difficult to quantify, and therefore the role of the leverage ratio, in combination with a new risk-based capital standard, could also become more important. Finally, we have also concluded that System capital would have to become more permanent if it is to provide a cushion against unexpected losses.

Agency Comments and Our Evaluation

We provided a draft of this letter to FHFB for comment. FHFB's Director, Office of Policy, Research, and Analysis, provided comments in two areas discussed below and also provided a number of technical comments, which we incorporated where appropriate. First, he stated that real risks need to be backed by real, permanent capital. He cited a principle from our May 1991 report stating that the elements of regulatory capital should include only those items that protect the government's interests. He added that our December 1993 report noted that capital requirements must ensure an adequate amount of permanent at-risk capital based on measurable risk and that retained earnings were the only source of permanent capital in the System. He suggested our letter emphasize that retained earnings are not necessarily the only source of permanent capital and that Congress could act to create a nonredeemable class of stock that, in their view, could also serve as a permanent buffer against loss and provide a positive incentive for building retained earnings.

We added statements to clarify that there are a number of ways to make capital more permanent in addition to those discussed in our previous work. In our 1993 report, we stated that, from 1987 through 1991, Congress appropriated most of the System's retained earnings to help cover deposit insurance fund losses resulting from savings and loan failures. Therefore, we emphasized retained earnings as a source of permanent capital. In our 1995 bill comment, we noted that the pending legislation would have increased the time period for repayment after a member terminated membership from 6 months to a minimum of 12 months. At that time, we emphasized the impact of the legislative proposal on the permanence of System capital. While a nonredeemable class of stock could also serve as a permanent buffer against loss, there are tradeoffs between establishing permanent capital and creating incentives for the System to provide their members with value. In our 1996 bill comment, we stated that all-voluntary membership should give System managers a stronger incentive to provide their members with value for their membership, lest the members redeem their stock and invest their funds elsewhere.

Second, he stated that statutory capital requirements for GSEs should not create "uneven playing fields." He cited a principle from our May 1991 report stating that a minimum capital requirement should avoid giving any GSE an undue advantage or disadvantage in competing with other market participants. He added that the capital provisions in H.R. 10 would establish equal statutory minimum capital leverage requirements for the FHLBanks, Fannie Mae, and Freddie Mac.

The minimum capital requirement principle discussed in our report addressed the combination of leverage and risk-based requirements. We have also supported the principle that capital requirements should take into account differences in the lines of business and associated risks among financial institutions. Thus, our principles do not necessarily support the establishment of equal statutory minimum capital leverage requirements for the FHLBanks, Fannie Mae, and Freddie Mac.

As agreed with your offices, we plan no further distribution until 30 days from the date of this letter unless you publicly release its contents earlier. We will then send copies to Representative Jim Leach, Chairman, and Representative John LaFalce, Ranking Minority Member, House Committee on Banking and Financial Services; Representative Tom Bliley, Chairman, and Representative John Dingell, Ranking Minority Member, House Committee on Commerce; Senator Phil Gramm, Chairman, and Senator Paul Sarbanes, Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs; and the Honorable Bruce Morrison, Chairman of FHFB. Copies will be made available to other interested parties upon request.

Please call me or Bill Shear, Assistant Director, at (202) 512-8678 if you or your staffs have any questions concerning this letter. M. Kay Harris and Orice Williams also contributed to this letter.

Thomas J. McCool

Thomas J. McCool
Director, Financial Institutions and Markets Issues

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Appendix 14.

ACB's original FOIA requested, dated April 3, 2006;
Finance Board's Second Response, claiming exemptions
for information, dated May 5, 2006;
and ACB's Appeal of Determination, dated June 5, 2006.

America's Community Bankers Shaping Our Future

April 3, 2006

FOIA Officer
Federal Housing Finance Board
1625 Eye Street, NW
Washington, DC 20006

Dear Sir or Madam:

America's Community Bankers submits this Freedom of Information Act request pursuant to 5 U.S.C. Section 552, and the Federal Housing Finance Board's ("Finance Board") Freedom of Information Act regulations, 12 CFR part 910. America's Community Bankers is a trade association representing over 1,000 depository institutions that hold over half the stock of the Federal Home Loan Bank System.

We request copies of all records and documents relating to the drafting, formulation and approval of the proposed rule entitled "Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks," published in the Federal Register on March 15, 2006 (71 Fed. Reg. 13306 – 13316).

Included within our request are the following: all records containing and describing the data, methods and analysis used to determine the proposed retained earnings minimum ("REM") and the proposed limitation on excess stock.

In addition, we request the Finance Board provide us with any records or information pertaining to:

1. the model equation employed in the linear regression analysis undertaken to determine the proposed REM;
2. definitions of the dependent and independent variables employed in that analysis;
3. the data used for these variables; and
4. the parameter estimates obtained from the analysis, including coefficients for the independent variables, the intercept value, standard deviations and t-statistics for the coefficients and the intercept, the r-square for the estimation, and other summary statistics that may be available.

We also request that the Finance Board provide all records relating to the consideration of alternatives to the approach taken in the proposed rule and all cost-benefit analyses related to the proposed rule and alternatives.

We believe that the records and information requested by this letter are critical to enabling the public to provide the most meaningful comments on the proposed rule, as contemplated by the Administrative Procedure Act. We agree to pay all fees incurred as determined in accordance with 12 CFR Part 910.9.

Sincerely,

Patricia A. Milon
Chief Legal Officer and Senior Vice President,
Regulatory Affairs

FEDERAL HOUSING FINANCE BOARD
1625 Eye Street NW, Washington DC 20006
www.fhfb.gov
Phone: 202-408-2511
Fax: 202-408-2580
E-Mail: FOIA@fhfb.gov

May 5, 2005

Patricia A. Milon
Chief Legal Officer and Senior Vice President,
Regulatory Affairs
America's Community Bankers
900 19th Street NW, Suite 400
Washington, DC 20006

Dear Ms. Milon:

This completes the response to your Freedom of Information Act (FOIA) request dated April 3, 2006, for all records relating to the drafting, formulation, and approval of Resolution Number 2006-03, Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks.

I have redacted portions of the enclosed documents under FOIA exemptions 5 and 8. FOIA Exemption 5 exempts from disclosure inter- or intra-agency records that could injure the quality of agency decisions and compromise the integrity of the Finance Board's deliberative process. *See* 5 U.S.C. § 552(b)(5) and 12 C.F.R. § 910.5(a)(5). Under Exemption 5, I have withheld certain pre-decisional information, which may include directions to and advice from staff and legal and policy opinions. FOIA Exemption 8 exempts from disclosure records that are contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of the Finance Board, Federal Home Loan Banks, or a financial regulatory agency. See 5 U.S.C. § 552(b)(8) and 12 C.F.R. § 910.5(a)(8). I have marked the appropriate exemption on the enclosed documents.

I am the Finance Board official responsible for the partial denial of your request. This partial denial is not a final agency action. Under the Finance Board's FOIA regulation (12 C.F.R. part 910), you may appeal the partial denial by submitting a written application stating the grounds for the appeal within 30 working days of the date of this letter.

Sincerely,

Janice A. Kaye
FOIA Officer

2006-017_ACB2

Federal Housing Finance Board

TO: Chairman Ronald A. Rosenfeld
HUD Secretary Alphonso Jackson
Director Alicia R. Castaneda
Director Franz S. Leichter
Director Allan I. Mendelowitz

FROM: Stephen M. Cross, Director, Office of Supervision
John P. Kennedy, General Counsel

SUBJECT: Proposed Regulations Concerning Excess Stock and Retained Earnings

DATE: March 1, 2006

I. Overview

We are proposing to amend Parts 917, 925, 930, and 931 of the Rules and Regulations of the Federal Housing Finance Board (Finance Board) and to add a new Part 934. These proposals would establish a regulatory limit for excess stock in a Federal Home Loan Bank (FHLBank or Bank) and establish a regulatory minimum retained earnings requirement for each FHLBank. If the proposed amendments are adopted, a Bank would no longer (i) be permitted to pay stock dividends or (ii) sell capital stock to members if the stock would be excess stock at the time of purchase. A Bank's dividends would be constrained if the Bank had less than its regulatory minimum retained earnings. These proposed regulatory amendments are intended to prevent recurrence of supervisory concerns regarding capital composition, capital management, and retained earnings that have given rise to formal and informal enforcement actions taken by the Finance Board in recent years. There is no question of capital solvency of any FHLBank; it is the composition of the capital that gives rise to these proposals.

II. Excess Stock Limitation

FHLBank capital stock that members hold in excess of the amount they are required to purchase as a condition of membership or to support their activities with the Bank is referred to as "excess stock." Excess stock presents two principal supervisory issues for the Finance Board. First, member institutions can redeem their excess stock at its par value without curtailing activities with the Bank or withdrawing from membership. Many of the Banks have commonly repurchased member stock on request,

notwithstanding the provisions in the Federal Home Loan Bank Act that establish six-month to five-year statutory redemption periods.[1] Repurchasing excess stock "on demand" can create capital management difficulties for the Bank if the Bank relies on excess stock to fulfill any part of its regulatory capital requirements, particularly if multiple, large redemption requests were to be submitted in a short period of time. Second, advances are normally supported by required "activity" stock. Any excess stock will typically be used to capitalize non-advance assets, such as mortgages (Acquired Member Assets or AMA), mortgage-backed securities (MBS), and other investments. Although a Bank may impose an "activity" charge to support AMA, only six of the 12 FHLBanks do so. Using excess stock to capitalize mortgages or other long-term assets is undesirable from a supervisory perspective to the extent that members expect the stock to be repurchased at par and virtually upon notice. Using excess stock to capitalize investment securities beyond an amount needed for liquidity is also undesirable from a public policy perspective to the extent that the Government Sponsored Enterprise (GSE) borrowing privilege is being used to fund activities that are not related to the GSE's core mission.

The proposed regulatory amendments should serve to reduce the risks of capital instability associated with relying on excess stock to meet regulatory capital requirements. It would also limit the use of excess stock as a way of funding mortgages or investments. Specifically, we are recommending that the board of directors of the Finance Board amend or introduce the aforementioned regulations to:

1. Limit excess capital stock in any FHLBank to no more than one percent of the Bank's assets;

2. Prohibit members from purchasing capital stock in excess of their required stock investment; and

3. Prohibit the payment of stock dividends.

With these regulatory changes, excess stock would arise only when stock is not redeemed or repurchased following a reduction in a member's required stock investment.

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[1] An FHLBank may buy back excess stock from a member either through repurchase or redemption. A repurchase transaction occurs at the discretion of the FHLBank, and the FHLBank may repurchase excess stock at any time, after providing members with notice of its intent to do so. FHLBanks generally repurchase excess stock either upon the request of a member or in accordance with an established schedule. Redemptions are initiated by the member. Under the regulations that pertain to the Chicago Bank, which has not yet implemented the capital provisions of the Gramm-Leach-Bliley Act (GLB Act), a member may withdraw from membership in an FHLBank six months after filing a written notice of intent to withdraw and, "upon surrender and cancellation of its capital stock, the member shall receive a sum equal to its cash paid subscriptions for the capital stock surrendered." Under the capital provisions of the GLB Act, a redemption transaction is initiated by a member's filing of a written request to have stock redeemed and occurs at the end of a notice period established by the FHLBank Act. The FHLBank, subject to certain exceptions, is required to redeem a member's excess stock at the end of this statutory redemption period. The statutory redemption periods are six months for Class A stock and five years for Class B stock.

Discussion

As of December 31, 2005, the FHLBanks held $7.4 billion in excess stock, or approximately 17 percent of the FHLBank System's total capital stock of $43.5 billion. The Banks had retained earnings of $2.5 billion and, therefore, total capital of $46.0 billion. Required capital totaled $36.1 billion

Under current Finance Board regulations, a member's investment in excess stock may arise from any of three sources: (i) a purchase of FHLBank stock in excess of the amount required as a condition for membership or to support certain activities, such as advances from the Bank; (ii) a payment of dividends by the FHLBank to its members in the form of stock rather than cash; or (iii) a reduction in a member's required stock holdings – such as through the repayment of an outstanding advance – without a commensurate reduction in the FHLBank stock held by that member.

The FHLBank of Chicago has the largest concentration of excess stock. [redacted] The proposed amendments are intended to prevent the sale of FHLBank stock for investment purposes and to prevent undue reliance on excess stock by any FHLBank in the future.

Ex. 8

The FHLBank of Cincinnati has the second largest concentration of excess stock. Its excess stock is largely the result of the Bank paying stock, rather than cash, dividends to its members. Stock dividends allow a member to defer payment of taxes until any stock is redeemed – and for tax management purposes many FHLBank members have chosen to hold the excess stock created by stock dividends.

Seven of the FHLBanks have paid stock dividends since 1995. As shown in the table below, those seven Banks also paid out stock dividends in 2005.[2] Four of those seven Banks have excess stock exceeding the proposed limitation.

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[2] The data reflect dividends actually paid to members in a particular quarter. Dividend policies vary among the FHLBanks. In some cases, dividends are paid in a quarter based on actual and projected earnings for the quarter. In other cases dividends are paid based on actual earnings from the preceding quarter. In still other cases, dividends are paid based on actual earnings from one or more months in the preceding quarter as well as one or more months from the current quarter.

Stock Dividend Payments by FHLBanks
Payments Made in Each Quarter of 2005
(Dollars in Millions)

Bank	1Q05	2Q05	3Q05	4Q05
Boston	0	0	0	0
New York	0	0	0	0
Pittsburgh	0	0	0	0
Atlanta	0	0	0	0
Cincinnati	42	45	42	50
Indianapolis	21	21	0	0
Chicago	60	58	52	38
Des Moines	0	0	0	0
Dallas	18	22	25	25
Topeka	19	21	21	23
San Francisco	82	87	101	107
Seattle	9	0*	0*	0*

*Did not pay any dividends.

The proposed amendments would prohibit any FHLBank from paying stock dividends to its members, thereby preventing the buildup of excess stock resulting from them.

Rationale for Proposed Changes

An FHLBank's reliance on excess stock raises safety and soundness and public policy concerns. Since FHLBanks often repurchase excess stock from a member promptly upon request, a Bank's reliance on excess stock can leave the Bank vulnerable to capital management problems if it were to experience substantial requests for repurchase over a relatively short timeframe. Furthermore, if excess stock is needed to meet an FHLBank's regulatory capital requirements, the Bank must refuse to honor a member's request for repurchase as such a repurchase would result in noncompliance with Finance Board regulations. Such refusals could undermine members' confidence in the FHLBank to the extent that the members had believed or expected that the Bank would repurchase their investments in excess stock upon demand.

Public policy concerns arise as the FHLBanks use excess stock to arbitrage the capital markets to generate earnings. The Banks' GSE status permits them to borrow funds at favorable rates and invest proceeds in non-mission related assets, most notably mortgage-backed securities and money market investments. While these activities increase FHLBank income, they do not directly further the FHLBank System's public purpose. Critics of this practice maintain that the GSE borrowing privilege should be restricted to housing finance mission-related activities and should not be used to arbitrage the capital markets. In the 1990s, the Finance Board set regulatory limits for mortgage-backed securities investments to address public policy concerns; however, no limits have been set for investments in money market instruments.

A limit on excess stock serves to reduce the potential for capital instability at the FHLBanks and limit the use of excess stock as a funding vehicle for non-mission related assets. Our recommendations would limit excess stock holdings by an FHLBank to one percent of assets and prohibit stock dividends altogether. The regulatory limits would allow for sufficient liquidity at the FHLBanks while promoting a stronger and more stable capital structure.

As of December 31, 2005 excess stock held by the FHLBanks of Chicago, Cincinnati, Seattle and Indianapolis was in excess of one percent of total assets as shown in the table below. As shown in the preceding table, each of those four Banks paid stock dividends in 2005.

**Excess Stock as Percentage of Total Assets
As of December 31, 2005**

Bank	Excess Stock ($ in millions)	Excess Stock/ Total Assets (as percentage)	Stock in Excess of Limitation ($ in million)
Boston	353	0.61	0
New York	0	0.00	0
Pittsburgh	85	0.12	0
Atlanta	12	0.01	0
Cincinnati	1,492	1.93	720
Indianapolis	686	1.43	205
Chicago	2,331	2.73	1,478
Des Moines	91	0.20	0
Dallas	370	0.57	0
Topeka	386	0.82	0
San Francisco	1069	0.48	0
Seattle	563	1.07	38

With the proposed amendments, we are also recommending that any FHLBank that exceeds the one percent of total assets limit as of the last business day of a quarter be required to notify the Finance Board. Within 60 days following that quarter-end, the FHLBank would have to certify, in writing, that it has corrected the deficiency or develop a compliance plan acceptable to the Finance Board.

III. Minimum Retained Earnings Requirement

An FHLBank's net income that is not distributed to shareholders as dividends is known as "retained earnings." Retained earnings can serve several functions, including to:

1. Provide a cushion to absorb losses and protect the par value of capital stock;
2. Enable payment of dividends in the event of a shortfall in earnings;
3. Allow relative stability in dividends when accounting income is not stable; and
4. Provide a source of capital for growth.

The level of an FHLBank's retained earnings critically affects a Bank's ability to absorb fluctuations in earnings and pay dividends to its members. Retained earnings are a particularly important component of capital for the FHLBanks because of the statutory, regulatory, and supervisory priority the Finance Board places on maintaining the par value of member stock. In response to supervisory guidance and increased earnings volatility, the FHLBanks have made progress in increasing their retained earnings over the past three years. Although the FHLBanks have increased retained earnings since the Finance Board issued Advisory Bulletin 03-08 in August 2003, progress has been modest and uneven among the Banks. The proposed regulatory amendments should ensure greater consistency among the FHLBanks in establishing and maintaining an adequate level of retained earnings.

An important factor contributing to earnings volatility at the FHLBanks has been the implementation of Statement of Financial Accounting Standards Number 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities,* which contributes to higher earnings volatility due to its asymmetric accounting of derivative instruments and held-to-maturity hedged items. Increased holdings of mortgage assets, with long contractual lives coupled with borrower prepayment options have also contributed to higher market risk exposure and greater earnings fluctuations among the FHLBanks.[3]

By establishing a minimum retained earnings requirement, each FHLBank should have in place a sufficient cushion for potential losses in order to avoid impairment to the par value of members' capital stock. Specifically, we are recommending that Parts 917, 930, and 931 be amended and a new Part 934 be added to state that:

1. Each FHLBank shall achieve and maintain minimum retained earnings totaling $50 million plus one percent of non-advance assets. The calculation would be performed quarterly using the FHLBank's average daily balances of non-advance assets during the preceding quarter.

2. For reasons of safety and soundness, the Finance Board may require an FHLBank to achieve and maintain retained earnings in excess of the minimum requirement of this regulation.

3. Until an FHLBank achieves compliance with its minimum retained earnings requirement, it may not declare or pay dividends in excess of 50 percent of its current net earnings without prior written approval from the Finance Board.[4]

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[3] On January 25, 2006, the Financial Accounting Standards Board (FASB) released an exposure draft, "The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115." The changes proposed in the exposure draft would allow an FHLBank to designate certain hedged assets to be carried at fair value and thereby eliminate much of the asymmetric accounting of derivative instruments and held-to-maturity hedged items. The proposed changes would allow entities to re-designate the carrying status of existing assets.

[4] "Current net earnings" are defined under the proposed amendments as the net income of a FHLBank for a calendar quarter in accordance with generally accepted accounting principles (GAAP) after deducting the FHLBank's required contributions for that quarter to the Resolution Funding Corporation under Sections 21A and 21B of the Bank Act (12 U.S.C. 1441a, 1441b) and to the Banks' Affordable Housing Program

4. An FHLBank that subsequently falls below its minimum retained earnings requirement would be prohibited from declaring or paying a dividend without prior written approval from the Finance Board.

5. Dividends for a quarter shall be declared only after the FHLBank's net earnings for the quarter have been recorded. Dividends shall not be based on projected or anticipated earnings.

Discussion

When retained earnings are negative, the par value of an FHLBank's capital stock is considered "impaired." When "other than temporarily impaired," the FHLBank capital stock held by member institutions would be reported on the members' balance sheets at a value that is less than its par value under generally accepted accounting principles (GAAP).

Capital stock impairment, particularly in the FHLBank context, is not synonymous with either capital insolvency or capital inadequacy. A Bank can exceed its minimum capital requirements by a substantial amount, but still have the par value of its capital stock impaired if retained earnings have been exhausted and the members' capital stock has absorbed losses.[5]

An "other than temporary" impairment of the par value of an FHLBank's capital stock carries significant negative consequences. First, an FHLBank is prohibited from redeeming or repurchasing members' capital stock without the prior approval of the Finance Board, when the Finance Board or the Bank's board of directors has determined that the Bank has incurred or is likely to incur other than temporary losses that result or are expected to result, in negative retained earnings. *See* 12 U.S.C. § 1426(f) and 12 C.F.R. § 931.8. Second, an FHLBank may not pay dividends if the par value of its capital stock is impaired. *See* 12 U.S.C § 1436 and 12 C.F.R. § 917.9. Third, market participants (members, bondholders, rating agencies, other banking regulators, and others) may respond negatively to impairment of FHLBank stock. Such reactions could include unwillingness on the part of members to acquire additional Bank stock, a slowdown in new advance business, an increase in the risk-based capital requirement by members' regulators, or a downgrade in an FHLBank's counterparty credit ratings. Any one of these reactions could increase the FHLBank's costs.

By regulation (12 C.F.R. §931.1(a)(2) and (b)(2)), new Class A or Class B FHLBank stock must be purchased at par value ($100 per share) even when the capital stock on a

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under Section 10(j) of the Bank Act (12 U.S.C. 1430(j)) and Section 951.2 [of the Finance Board's rules], but before declaring any dividend under Section 16 of the Bank Act (12 U.S.C. 1436).

[5] A member would classify or write down its capital stock in an FHLBank, however, only if the impairment was "other than temporary." That determination would be made based on a number of factors influencing the ultimate recoverability of the par value of the stock. "Other than temporary" impairment would not reflect a temporary decline in value, but would be influenced by the size of the impairment relative to par value and the permanence of factors that have contributed to the impairment.

book value basis is less than par value, *e.g.*, $90 per share.[6] Consequently, any stock purchased at par value when the book value of capital stock is below par is an immediate economic loss to the acquirer. In such situations, existing members would be reluctant to purchase new stock to expand their activity-based relationship with the FHLBank and potential new members would likely defer joining the Bank. As a result, a Bank's ability to provide mission-related services to its members could be severely curtailed.

Rationale for Proposed Changes

At present, all twelve of the FHLBanks exceed their minimum capital requirements and the risk of capital insolvency for any FHLBank is extremely remote. However, one or more of the Banks reasonably could incur sufficient losses that could deplete retained earnings and result in the impairment, at least temporarily, of the par value of capital stock.

The capital stock of an FHLBank has characteristics that require its par value to be fully protected. By statute or regulation, FHLBank stock is purchased and redeemed at par. In many respects, and with the exception of capital stock supporting advances, an FHLBank's retained earnings function as the Bank's operating capital.

In an effort to encourage the FHLBanks to bolster their retained earnings, the Office of Supervision issued Advisory Bulletin 03-08, *Capital Management and Retained Earnings*, in August 2003. That advisory bulletin required that each FHLBank adopt a capital management and retained earnings policy that includes a retained earnings target commensurate with the Bank's risk profile under a variety of economic and financial scenarios. However, in our examinations and in a supplemental review of the Banks' retained earnings polices, we found broad differences among the Banks' policies and in their approaches to establishing their retained earnings targets.[7] [redacted]

Ex 8

Under the proposed amendments, each FHLBank would be required to achieve and maintain a minimum amount of retained earnings equal to $50 million plus one percent of the FHLBank's non-advance assets. We considered several alternative measurements tied explicitly to risk-based capital requirements or measures of income volatility, but concluded that the proposed measure, which uses non-advance assets as a proxy for risk,

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[6] The cited regulation does not apply to the FHLBank of Chicago, which has not yet converted to it new capital structure as set forth in the Gramm-Leach-Bliley Act of 1999. *See* 12 C.F.R. §925.19, which applies to the FHLBank of Chicago until the time of its capital plan conversion.

[7] *Review of Federal Home Loan Bank Retained Earnings Policies*, Regulations and Research Division, Office of Supervision, Federal Housing Finance Board, February 10, 2005.

captures an FHLBank's exposure to risk in a transparent, straightforward, and easily calculable manner. Our estimates also indicated that the formula is a reasonable approximation of alternative measurements we considered. In addition, the most significant risks faced by the FHLBanks generally are associated with non-advance assets, such as mortgages and mortgage-related securities and the hedging and funding instruments associated with those assets. Further, advances differ from other FHLBank assets in that members normally must purchase capital stock, known as "activity stock," in support of advances. Stock in the FHLBank held by the member is available to absorb credit losses incurred from advances and other indebtedness of a member to the FHLBank.

Implications of the Proposed Rule

If the proposed rule had been in place at year-end 2005, the FHLBanks' minimum retained earnings requirement at year end 2005 would have ranged from a low of $218 million at the FHLBank of Topeka to a high of $672 million at the FHLBank of Chicago. As shown in the following table, eleven FHLBanks, the exception being the FHLBank of New York, would have fallen short of the proposed requirement. The estimated retained earnings shortfalls would have ranged from zero for the FHLBank of New York to $393 million at the FHLBank of San Francisco.

Minimum Retained Earnings (MRE)
As of December 31, 2005
($ in millions)

	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
MRE	226	255	265	383	399	245	672	275	224	218	525	378
Actual RE	139	291	182	343	208	149	523	161	174	138	132	69
MRE Shortfall	87	0	83	40	191	96	149	114	50	80	393	309

We are also recommending that dividends be restricted to 50 percent of net current earnings until the FHLBank reaches its minimum retained earnings requirement. As the following table indicates, nine of the FHLBanks would likely be able to meet their minimum retained earnings requirement in two years or less and, except for Seattle, each of the FHLBanks would likely meet its minimum retained earnings requirement in less than three years if the proposal were to be adopted. The table also shows the length of time for each FHLBank to reach its minimum retained earnings requirement at various dividend payout rates above 50 percent.[8]

[8] These timeframe estimates are based on the assumption that 2005 net current earnings are representative of income; however, if 2005 earnings are not representative, these estimated timeframes will expand or contract.

Years to Meet Minimum Retained Earnings Requirement Under Alternative Dividend Payout Limitations*

Payout Rate	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
50%	1.3	n/a	1.0	.2	1.7	1.3	1.2	2.5	.8	1.2	2.1	**
60%	1.6	n/a	1.3	.3	2.2	1.6	1.5	3.2	1.0	1.4	2.7	**
70%	2.1	n/a	1.7	.4	2.9	2.1	2.1	4.2	1.4	1.9	3.5	**
80%	3.1	n/a	2.5	.6	4.3	3.2	3.1	6.3	2.1	2.9	5.3	**

* Estimated using net current earnings in 2005.
**Not meaningful because of negligible net earnings in 2005.

Generally, we would expect the FHLBanks to hold retained earnings at least modestly above their minimum requirement as protection against an unforeseen quarterly loss or accounting volatility. Under the proposed amendments, if a Bank were to fall below its minimum retained earnings requirement after initially satisfying the standard, the FHLBank would be prohibited from declaring or paying a dividend without the prior written approval of the Finance Board. This restriction would likely arise in only extreme circumstances, principally as a result of substantial losses in one or more quarters, which would reduce retained earnings to a level below the required minimum. Indeed, the proposed dividend restriction would provide an incentive for an FHLBank to maintain retained earnings above the minimum requirements, much like FHLBanks and other financial institutions regularly maintain capital in excess of regulatory requirements.

IV. Conclusion

The proposed amendments would address conditions among the FHLBanks that have given rise to formal and informal supervisory actions in the past two years. The proposed amendments would limit an FHLBank's reliance on "excess stock" as a source of capitalization and increase retained earnings at eleven of the twelve FHLBanks. Reliance on excess stock can make an FHLBank's capitalization vulnerable to redemptions, particularly at times when that capital is needed to absorb losses or support longer-term investments. Higher retained earnings would permit FHLBanks to absorb losses with a lower likelihood that the losses would impair, even temporarily, the value of the members' capital stock. As such, the proposed changes would enhance the overall safety and soundness of the FHLBanks and the FHLBank System.

V. Further Information

Principal staff work was done by Scott Smith and Tony Cornyn in the Office of Supervision and Tom Joseph in the Office of the General Counsel. Questions or comments on the proposal may be sent directly to their attention.

Proposed Regulatory Changes to Establish a Retained Earnings Target

Presentation to Finance Board

January 5, 2006

Agenda

Discuss:

- Retained Earnings Requirement
- Retained Earnings Target
- Dividend Limitation
- Recent Data Indications

redacted 11 pages - Ex. 5

Proposed Regulations: FHBank Risk Management and Capital Standards

Presentation to Finance Board

December 15, 2005

Agenda

Discuss:

- Excess stock restriction
- Retained Earnings Requirement
- Risk-based Capital Credit Risk Requirement

redacted 5 pages - Ex. 5

Proposed Regulations: Excess Stock Restrictions and Minimum Retained Earnings Requirement

Presentation to Finance Board

November 16, 2005

Agenda

Discuss:

- Excess stock restrictions
- Revised Minimum Retained Earnings Requirement

redacted 9 pages - Ex. 5

Proposed Regulations: Excess Stock Restrictions and Minimum Retained Earnings Requirement

Presentation to Finance Board

September 7, 2005

Agenda

Discuss:

- Excess stock restrictions
- Minimum Retained Earnings Requirement

redacted 19 pages - Ex. 5

2

From: Cross, Stephen
Sent: Thursday, January 26, 2006 5:05 PM
To: Meeks, Daris D.
Cc: Cross, Stephen
Subject: RE: 2 Simple Questions

Excess Stock Limited to 1 Percent of Assets:

[redacted]

Retained Earnings at least $50 mm plus 1 percent of non-advance assets:

[redacted]

[redacted]

I hope this helps.

Ex. 5

Joseph, Thomas E.

From: Smith, Scott L.

Sent: Friday, January 20, 2006 11:39 AM

To: Cross, Stephen; FHFB Board & Assistants

Cc: Kennedy, John P.; Sciacca, Christie A.; Cornyn, Anthony; Joseph, Thomas E.

Subject: Update of Table on Retained Earnings

Attachments: REM table Jan 18 2006.xls

Ex. 5

Attached is a revised table on the proposed retained earnings minimums. The new table, [redacted] includes different dividend limits and corresponding estimates of the number of years for each Bank to meet its 2006 REM at the different dividend limits. For example, for Boston, subject to a 60% dividend limit, the contribution to RE would be 40% or $56 million per year as shown in the table, and at that rate, Boston would achieve its REM in 2.1 years.

The results show that, excluding Seattle because they had no income last year, at the 60% dividend limit, all (other) Banks would reach their REM in less than 3 years except S.F. which would need 3.4 years. At the 70% dividend limit, only Des Moines and S.F. require more than 3 years (although a recent positive adjustment to RE for Des Moines is not reflected in these numbers as yet, so again its likely that only S.F. would require more than 3 years). At the 80% dividend limit, 7 Banks would require more than 3 years but less than 5 (including Des Moines once corrected). An 8th Bank, S.F. would require 6.8 years.

Table 1

Proposed Retained Earnings Minimums (REMs) of the FHLBanks

Based on End of period non-advance assets as of September 30 of the previous year

FHLBank	BOS	NYK	PIT	ATL	CIN	IND	CHG	DSM	DAL	TOP	SFR	SEA	total
Bank RE Targets (12/04)	104	247	200	331	160	180	312	123	153	108	130	35	174
RE as of 12/31/04	96	223	94	255	167	116	442	133	139	81	139	76	163
Bank Estimated shortfall	8	24	106	76	0	64	0	0	14	27	0	0	10
FB REM for 06	256	288	292	442	374	239	638	260	245	250	638	403	4,325
Actual RE end of 05	139	273	182	343	208	149	523	161	174	138	132	69	2,491
FB Estimated shortfall	117	15	110	99	166	90	115	99	71	112	506	334	1,834
Annual Income 05	139	212	163	323	220	149	242	90	120	138	370	2	2,168
Ann. Dividend at 50%	69.5	106	81.5	161.5	110	74.5	121	45	60	69	185	1	1,084
Contribution to RE	70	106	82	162	110	75	121	45	60	69	185	1	1,084
Yrs to meet 06 FB REM	1.7	0.1	1.3	0.6	1.5	1.2	1.0	2.2	1.2	1.6	2.7	334.0	349
Ann. Dividend at 60%	83.4	127.2	97.8	193.8	132.0	89.4	145.2	54.0	72.0	82.8	222.0	1.2	1,301
Contribution to RE	56	85	65	129	88	60	97	36	48	55	148	1	867
Yrs to meet 06 FB REM	2.1	0.2	1.7	0.8	1.9	1.5	1.2	2.8	1.5	2.0	3.4	417.5	436
Ann. Dividend at 70%	97.3	148.4	114.1	226.1	154.0	104.3	169.4	63.0	84.0	96.6	259.0	1.4	1,518
Contribution to RE	42	64	49	97	66	45	73	27	36	41	111	1	650
Yrs to meet 06 FB REM	2.8	0.2	2.2	1.0	2.5	2.0	1.6	3.7	2.0	2.7	4.6	556.7	582
Ann. Dividend at 80%	111.2	169.6	130.4	258.4	176.0	119.2	193.6	72.0	96.0	110.4	296.0	1.6	1,734
Contribution to RE	28	42	33	65	44	30	48	18	24	28	74	0	434
Yrs to meet 06 FB REM	4.2	0.4	3.4	1.5	3.8	3.0	2.4	5.5	3.0	4.1	6.8	835.0	873
FB REM for 05	212	256	262	375	421	269	694	286	232	199	539	424	4,169
FB REM for 04	248	213	247	338	381	207	634	248	250	178	387	324	3,655
FB REM for 03	216	287	238	312	362	206	410	206	226	164	389	304	3,320

Joseph, Thomas E.

From: Smith, Scott L.
Sent: Wednesday, January 18, 2006 1:57 PM
To: Cross, Stephen; FHFB Board & Assistants
Cc: Kennedy, John P.; Sciacca, Christie A.; Cornyn, Anthony; Joseph, Thomas E.
Subject: RE: PROPOSED REGULATORY CHANGES January 06
Attachments: REM table Jan 18 2006.xls

[redacted] As shown in the table, the proposed Banks' retained earnings minimums for 2006 would range from a low of $239 million for Indianapolis, to a high of $638 million for both Chicago and San Francisco. After deducting actual retained earnings as of the end of 2005, the shortfall ranges from as little as $15 million for New York to as much as $506 million for San Francisco. Applying the proposed dividend limitation of 50 percent, nine Banks would achieve compliance with the 2006 retained earnings minimum in less than two years. Both Des Moines and San Francisco would achieve compliance in less than 3 years. Seattle will take more than three years to achieve compliance because the Bank's income is currently very low.

The table also shows the retained earnings minimums developed by the Banks as of Dec. 2004, and their shortfalls at that time. Based on 2006 retained earnings, all Banks are nearly at or above their 2004 minimums as determined by the Banks. The Finanace Board proposed retained earnings minimums for 2006 are a little more than double the Banks' proposed minimums for 2004. Also, the Banks increased retained earnings system-wide about 25% between the end of years 2004 and 2006.

Table 1

Proposed Retained Earnings Minimums (REMs) of the FHLBanks

Based on End of period non-advance assets as of September 30 of the previous year

FHLBank	BOS	NYK	PIT	ATL	CIN	IND	CHG	DSM	DAL	TOP	SFR	SEA	total
Bank RE Targets (12/04)	104	247	200	331	160	180	312	123	153	108	130	35	2,083
RE as of 12/31/04	96	223	94	255	167	116	442	133	139	81	139	76	1,961
Bank Estimated shortfall	8	24	106	76	0	64	0	0	14	27	0	0	319
FB REM for 06	256	288	292	442	374	239	638	260	245	250	638	403	4,325
Actual RE end of 05	139	273	182	343	208	149	523	161	174	138	132	69	2,491
FB Estimated shortfall	117	15	110	99	166	90	115	99	71	112	506	334	1,834
Annual Income 05	139	212	163	323	220	149	242	90	120	138	370	2	2,168
Ann. Dividend at 50%	69.5	106	81.5	161.5	110	74.5	121	45	60	69	185	1	1,084
Yrs to meet 06 FB REM	1.7	0.1	1.3	0.6	1.5	1.2	1.0	2.2	1.2	1.6	2.7	334.0	349
FB REM for 05	212	256	262	375	421	269	694	286	232	199	539	424	4,169
FB REM for 04	248	213	247	338	381	207	634	248	250	178	387	324	3,655
FB REM for 03	216	287	238	312	362	206	410	206	226	164	389	304	3,320

Table 1.2: Basel II and FHFB Credit Risk Capital Charges for Residential Mortgages

Basel II External Ratings-Based Approach (RBA)*

RBA must be applied to securitization exposures that are rated by a NRSRO. The target rating standard underlying the RBA capital requirements is A-.

Basel II Internal Ratings-Based (IRB) Approach - Includes both expected and unexpected losses

Internal Ratings-Based (IRB) approach is applicable to residential mortgage pools that are not securitized and are internally rated. IRB approach capital charges reported below are based on implied insolvency standards of BB (99th percentile of the credit loss distribution), BBB (99.5th percentile), A (99.925th percentile), A- (99.9th percentile), and AA (99.97th percentile). A loss severity rate of 65.8 percent is assumed which is the mean loss severity rate as a percent of defaulted balance from Moody's.** OFHEO Benchmark Loss Severity rate is 63 percent.***

Capital Charges Based on External or Inferred Rating (in percent)

	RBA - NRSRO Rated****				IRB - Internally Rated					
	Senior, Granular Tranches		Subordinate, Granular		Residential Mortgage Pools					
Long-Term Rating	Current FHFB	Basle II RBA	Current FHFB	Basle II RBA	Current FHFB	Basle II BB Standard	Basle II BBB Standard	Basle II A- Standard	Basle II A Standard	Basle II AA Standard
AAA	0.37	0.56	0.37	0.96	0.37	0.09	0.13	0.25	0.27	0.37
AA+	0.60	0.64	0.60	1.20	0.60	0.14	0.19	0.36	0.40	0.54
AA	0.60	0.64	0.60	1.20	0.60	0.20	0.27	0.51	0.56	0.74
AA-	0.60	0.64	0.60	1.20	0.60	0.31	0.42	0.76	0.84	1.10
A+	0.86	0.80	1.60	1.44	0.86	0.37	0.50	0.88	0.96	1.26
A	0.86	0.96	1.60	1.60	0.86	0.45	0.60	1.05	1.15	1.49
A-	0.86	1.60	1.60	2.80	0.86	0.58	0.76	1.32	1.43	1.85
BBB+	1.20	2.80	4.45	4.00	1.20	0.77	1.01	1.71	1.85	2.36
BBB	1.20	4.80	4.45	6.00	1.20	1.03	1.33	2.20	2.38	3.00
BBB-	1.20	8.00	4.45	8.00	1.20	1.61	2.05	3.27	3.51	4.36
BB+	2.40	20.00	13.00	20.00	2.40	2.35	2.95	4.56	4.88	5.96
BB	2.40	34.00	13.00	34.00	2.40	3.27	4.04	6.07	6.46	7.78
BB-	2.40	52.00	13.00	52.00	2.40	4.42	5.38	7.87	8.35	9.92
B+	4.80	100	34.00	100	4.80	5.95	7.16	10.17	10.74	12.58
B	34.00	100	100.00	100	34.00	9.26	10.88	14.79	15.49	17.76
B-	34.00	100	100.00	100	34.00	15.34	17.53	22.49	23.35	26.04
CCC	34.00	100	100.00	100	34.00	24.31	26.96	32.58	33.51	36.33
CC and Below	34.00	100	100.00	100	34.00	31.94	34.69	40.26	41.15	43.80

* Under the RBA approach, The Basle Committee considered, but, rejected, suggestions from some industry representatives to differentiate RBA risk weights by the asset type. The Committee has concluded that, for a given rating category, available evidence does not provide an adequate basis for assigning different capital charges to securitization exposures based solely on the composition of the underlying asset pool. Please see empirical evidence on securitization losses for varoius asset types from Moody's.

** "Measuring Loss Severity Rates of Defaulted Residential Mortgage-Backed Securities: A Methodology", Moody's Investor Service, April 2004, Figure 2.

*** Benchmark Loss Experience, Average 10-Year Severity Rate in Risk-Based Capital Rule; Proposed Rule, OFHEO, June 11, 1996, Table 2.

**** Higher capital requirements apply to NRSRO rated tranches of non-granular pools.

Table 2: Basle and FHFB Credit Conversion Factors for Off-Balance Sheet Credit Exposures

Basle II (January 2004)

Basle I (1988) credit conversion factors (CCFs) for exposures other than derivatives have been slightly revised as shown below.

FHFB Table 2 (2000)

FHFB adopted the Basle I framework as it existed in year 2000. Credit conversion factors (CCFs) in FHFB Table 2 are from Basle except for standby letters of credit (SLOCs). FHLB SLOCs were assessed a 50% factor CCF.

Credit Conversion Factors for Off-Balance Sheet Items Other Than Derivatives

	Credit Conversion Factor or CCF (in percent)			
Instrument	**Basle I**	**FHFB**	**Basle II Standardized & Foundation IRB Approaches***	**Basle II Advanced IRB Approach**
Assets sales with recourse	100	100	100	
Commitments with certain drawdown	100	100	100	
Standby Letters of Credit	100	50	100	
Other Commitments with maturity over one year	50	50	50	
Other Commitments with maturity less than one year	0	20	20	
Unconditionally cancelable Commitments & uncommitted lines of credit	0	0	0	
Assets sold under an agreement to repurchase (Repos)	100	?	100	
Lending or borrowing of securities	?	?	100	**Estimated using approved internal models**
Posting of Securities as Collateral	?	?	100	
Commitment on another off-balance sheet instrument	?	?	Lower of the two applicable CCFs	

* IRB stands for Internal Ratings-Based Approach.

Table 3: Basle, ISDA, and FHFB Credit Conversion Factors for Credit Exposure from Derivatives

Basle II (January 2004)

Basle I standardized credit conversion factors for potential future exposure (PFE) from derivatives are expected to be revised in the near future. Basle will most likely allow Advanced IRB (Internal ratings-Based Approach) banks to use approved internal models to calculate PFE.

ISDA (May 2001)

In the exercise undertaken by ISDA, nine leading internationally active banks submitted their estimates of Expected Positive Exposure for derivative contracts for a one year credit risk horizon. Table below provides a comparison of FHFB Table 3 and ISDA industry averages.

FHFB Table 3 (2000)

The Finance Board adopted the Basle I framework as it existed in the U.S. in year 2000.

Credit Conversion Factors for Potential Future Credit Exposure from Derivatives (FHFB Table 3)

	Credit Conversion Factor or CCF (in percent)						
	Maturity						
	< 1 Year		1 to 5 Years		> 5 Year		All Maturities
Type of Derivarive/Underlying Risk	FHFB, Basle I, Basle II Standardized and Foundation IRB[1]	ISDA	FHFB, Basle I, Basle II Standardized and Foundation IRB	ISDA	FHFB, Basle I, Basle II Standardized and Foundation IRB	ISDA	Basle II Advanced IRB
Interest Rate	0.0	0.2	0.5	0.6	1.5	1.5	Basle Committee Expected to Allow use of internal estimates
Foreign Exchange	1.0	3.0	5.0	3.0	7.5	3.0	
Equity Indices	6.0	6.5	8.0	6.5	10.0	6.5	
Gold	1.0	3.5	5.0	3.5	7.5	3.5	
Precious Metals other than Gold	7.0	5.5	7.0	5.5	8.0	5.5	
Commodities	10.0	10.0	12.0	10.0	15.0	10.0	
Other Derivatives[2]	10.0	?	12.0	?	15.0	?	

1 IRB stands for Internal Ratings-Based Approach.

2 As per U.S. Banking Agencies, applies to any derivative contract that does not fall within one of the specified categories.

Credit Conversion Factors for Potential Future Credit Exposure from Credit Derivatives (FHFB Table 3)

	Credit Conversion Factor or CCF (in percent)			
Type of Derivarive/Underlying Risk	**Basle I**	**FHFB & U.S. Banking Agencies**	**Basle II**	**ISDA**
Credit Derivatives	?[3]	Other Derivatives[4]	5.00 or 10.00[5]	3.00 or 10.00

3 Credit derivatives market was not mature enough for Basle I to recognize and specify a counterparty risk capital requirement.

4 By implication, credit derivatives fit in the category of "Other Derivatives" as in table above.

5 Irrespective of maturity, 5 percent for investment grade and 10 percent for below investment grade counterparties. This charge applies to trading book. It is not clear if the same treatment applies to banking book as it is for all other types of derivatives.

FHLBank Credit Risk Capital and Retained Earnings Requirements

(Millions of Dollars)

Basel II AA Target Rating Capital Requirement

(Includes all on- and off-balance sheet items)

Date	SYS	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
30-Sep-05	3,682	196	306	263	506	266	160	437	189	200	215	596	348
30-Jun-05	3,668	185	288	258	513	259	179	445	201	265	195	563	317
31-Mar-05	3,612	187	273	236	509	287	167	452	194	255	193	540	321
31-Dec-05	3,594	200	270	238	487	284	175	450	202	242	203	502	341

FHLB Retained Earnings Requirement For Credit Risk

(Excludes Advances, Advances Commitments, Letters of Credit, Premises, Equipment, and Other Assets)

Date	SYS	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
30-Sep-05	2,932	158	211	205	366	208	125	402	156	141	172	460	327
30-Jun-05	2,920	153	198	202	370	201	143	409	162	208	152	428	296
31-Mar-05	2,893	153	185	189	373	226	134	415	158	198	150	412	301
31-Dec-05	2,870	165	175	188	353	227	141	411	165	183	158	381	322

Credit Risk Capital Charges Under Basel II AA Rating Standard (Millions of Dollars)												
30-Sep-05												
	SYS	**BOS**	**NYK**	**PIT**	**ATL**	**CIN**	**IND**	**CHI**	**DSM**	**DAL**	**TOP**	**SFR**
Non-MBS Investments (CRC @ AA Rating Standard)												
U.S.Treasury Obligations	0	0	0	0	0	0	0	0	0	0	0	0
Bankers Acceptances	0	0	0	0	0	0	0	0	0	0	0	0
Commercial Paper	31	0	0	1	0	10	0	4	2	0	0	12
U.S. Agency Obligation	332	13	0	6	127	0	0	48	19	5	20	0
COs	84	0	0	0	3	0	0	0	2	1	0	0
State Agencies (FMP II.B.11)	175	15	44	35	8	1	1	4	0	0	14	52
Other	6	3	0	0	0	0	0	3	0	0	0	0
Cash and Due from Banks	3	0	0	1	0	0	0	0	0	1	0	0
Interest Bearing Deposits in Banks	226	15	51	24	5	33	3	0	3	4	33	41
Securities purchased under resale agreem.	3	1	0	0	0	0	0	0	0	0	0	2
Federal Funds Sold - Overnight	285	19	19	9	34	22	10	24	5	33	21	61
Federal Funds Sold - Term	376	26	25	11	44	29	13	32	6	44	28	80
Accrued Interest Receivable	29	1	3	5	5	2	1	3	1	1	1	5
Total: Non-MBS	1,551	94	143	91	226	98	27	118	39	89	117	253
FHLB Reported Current Total: Non-MBS	835	64	64	34	186	47	19	58	13	67	57	115
MBS Investments (CRC @ A- Rating Standard)												
GSE MBS (FMP II.B.8)	223	8	23	9	15	64	7	16	21	32	9	5
Other MBS, CMOs, REMICs (FMP II.9)	411	24	16	37	90	3	30	5	2	16	24	141
Manufactured Housing/HEL (FMP.B.10)	22	2	13	3	0	0	0	4	0	0	0	0
Total: MBS	656	34	52	49	106	67	37	25	23	47	33	147
FHLB Reported Current Total: MBS	445	22	34	32	70	44	25	17	16	43	22	97
Advances												
Up to One Month	56	4	4	9	3	5	1	1	2	8	7	11
Over One Month Up to One Year	105	8	8	8	15	5	6	5	3	8	2	33
Over One Year to Three Years	144	5	14	7	25	9	6	6	4	9	4	53
Over Three Year to Five Years	172	8	18	13	35	20	8	9	7	16	8	25
Over Five Years	185	8	35	15	52	14	9	5	14	11	12	5
Total: Advances	662	34	77	52	130	52	31	26	30	52	33	126
FHLB Reported Current Total: Advances	665	33	77	54	136	50	31	26	32	52	34	121
AMA (CRC @ AA Rating Standard)												
Total: Mortgage Loans	648	27	10	58	20	41	56	253	90	1	18	40
FHLB Reported Current Total: Mortgage Loa	686	38	10	48	20	48	56	253	87	19	26	29
Other Balance Sheet Items (CRC @ AA Rating Standard)												
Deposits for AMA with Other FHLBanks	0	0	0	0	0	0	0	0	0	0	0	0
Loans to Other FHLBanks	0	0	0	0	0	0	0	0	0	0	0	0
Bank Premises and Equipment, net	16	0	1	1	3	1	1	5	0	2	1	1
Other Assets	47	2	2	3	8	4	3	4	2	2	9	7
Total: Other Balance Sheet Items	63	2	3	4	10	4	4	9	2	4	10	8
Off-Balance Sheet (CRC @ AA Rating Standard)												
Letters of credit	7	0	0	1	0	1	0	0	1	2	1	1
Advance commitments	19	1	15	2	0	0	0	0	0	0	0	1
Other commitments excluding advances	2	1	0	0	0	0	0	0	0	0	1	0
Derivatives: Current Exposure	7	0	0	2	1	0	1	2	0	0	0	0
Derivatives: Potential FutureExposure	68	2	6	5	14	3	3	4	3	4	3	20
Total: Off-Balance Sheet	102	4	21	9	15	4	4	6	5	6	5	22

Basel II AA Capital Requirement	3,682	196	306	263	506	266	160	437	189	200	215	596
FHFB Calculated Current Requirement	2,601	136	205	180	339	208	129	372	148	142	139	398
Percentage Increase in Capital Requiremen	42	44	49	46	49	28	24	17	27	40	55	50

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Credit Risk Capital and Retained Earnings Requirements (Millions of Dollars)													
30-Sep-05													
Credit Risk Capital Requirement	SYS	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
(Includes all on- and off-balance sheet items)													
FHLB Reported Requirement (Current Tables)	2,707	159	205	176	419	191	134	372	151	187	144	367	204
FHFB Estimated Requirement (Current Tables)	2,601	136	205	180	339	208	129	372	148	142	139	398	203
Basel II AA Target Rating Capital Requirement	3,682	196	306	263	506	266	160	437	189	200	215	596	348
Retained Earnings Requirement	SYS	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
(Excludes Advances, Advances Commitments, Letters of Credit, Premises, Equipment, and Other Assets)													
FHLB Retained Earnings For Credit Risk	2,932	158	211	205	366	208	125	402	156	141	172	460	327

Credit Risk Capital Charges Under Current FHFB Requirements (Millions of Dollars)													
30-Sep-05													
	SYS	**BOS**	**NYK**	**PIT**	**ATL**	**CIN**	**IND**	**CHI**	**DSM**	**DAL**	**TOP**	**SFR**	**SEA**
Non-MBS Investments													
U.S.Treasury Obligations	0	0	0	0	0	0	0	0	0	0	0	0	0
Bankers Acceptances	0	0	0	0	0	0	0	0	0	0	0	0	0
Commercial Paper	17	0	0	1	0	6	0	2	1	0	0	7	0
U.S. Agency Obligation	143	5	0	2	55	0	0	21	8	2	9	0	41
COs	28	0	0	0	1	0	0	0	1	0	0	0	26
State Agencies (FMP II.B.11)	41	4	10	8	2	0	0	1	0	0	3	12	0
Other	3	2	0	0	0	0	0	1	0	0	0	0	0
Cash and Due from Banks	2	0	0	0	0	0	0	0	0	1	0	0	0
Interest Bearing Deposits in Banks	124	8	28	13	3	18	1	0	2	2	18	22	8
Securities purchased under resale agreem.	4	1	0	0	0	0	0	1	0	0	0	2	0
Federal Funds Sold	363	25	25	11	43	28	13	31	6	42	27	77	36
Accrued Interest Receivable	16	1	1	3	3	1	0	1	0	1	1	3	0
Total: Non-MBS	742	46	64	38	106	53	15	58	19	48	58	124	112
FHLB Reported Current Total: Non-MBS	835	64	64	34	186	47	19	58	13	67	57	115	109
MBS Investments													
GSE MBS (FMP II.B.8)	147	5	15	6	10	42	4	11	14	21	6	4	8
Other MBS, CMOs, REMICs (FMP II.9)	272	16	10	24	60	2	20	3	1	10	16	93	16
Manufactured Housing/HEL (FMP.B.10)	15	1	8	2	0	0	0	3	0	0	0	0	0
Total: MBS	434	23	34	32	70	44	25	17	15	31	22	97	24
FHLB Reported Current Total: MBS	445	22	34	32	70	44	25	17	16	43	22	97	24
Advances													
Up to One Month	56	4	4	9	3	5	1	1	2	8	7	11	1
Over One Month Up to One Year	105	8	8	8	15	5	6	5	3	8	2	33	5
Over One Year to Three Years	144	5	14	7	25	9	6	6	4	9	4	53	4
Over Three Year to Five Years	172	8	18	13	35	20	8	9	7	16	8	25	4
Over Five Years	185	8	35	15	52	14	9	5	14	11	12	5	5
Total: Advances	662	34	77	52	130	52	31	26	30	52	33	126	18
FHLB Reported Current Total: Advances	665	33	77	54	136	50	31	26	32	52	34	121	18
AMA													
Total: Mortgage Loans	642	29	9	48	17	52	53	259	80	3	15	32	45
FHLB Reported Current Total: Mortgage Loa	691	38	9	48	20	48	56	259	87	19	26	29	51
Other Balance Sheet Items													
Deposits for AMA with Other FHLBanks	0	0	0	0	0	0	0	0	0	0	0	0	0
Loans to Other FHLBanks	0	0	0	0	0	0	0	0	0	0	0	0	0
Bank Premises and Equipment, net	16	0	1	1	3	1	1	5	0	2	1	1	1
Other Assets	47	2	2	3	8	4	3	4	2	2	9	7	2
Total: Other Balance Sheet Items	63	2	3	4	10	4	4	9	2	4	10	8	3
Off-Balance Sheet													
Letters of credit	3	0	0	0	0	0	0	0	0	1	1	0	0
Advance commitments	19	1	15	2	0	0	0	0	0	0	0	1	0
Other commitments excluding advances	2	1	0	0	0	0	0	0	0	0	1	0	0
Derivatives: Current Exposure	4	0	0	1	1	0	0	1	0	0	0	0	0
Derivatives: Potential FutureExposure	32	1	3	2	6	1	2	2	2	2	1	9	1
Total: Off-Balance Sheet	59	3	18	5	7	2	2	3	2	3	3	11	1
FHFB Calculated Current Requirement	2,601	136	205	180	339	208	129	372	148	142	139	398	203
FHLB Reported Curent Requirement	2,707	159	205	176	419	191	134	372	151	187	144	367	204

America's Community Bankers
Shaping Our Future

June 5, 2006

FOIA Officer
Federal Housing Finance Board
1625 Eye Street, NW
Washington, DC 20006

Dear Sir or Madam:

America's Community Bankers hereby appeals the Federal Finance Board's (FHFB) determination to partially deny our Freedom of Information Act (FOIA) request to the agency dated April 3, 2006. By letter dated May 5, 2006, Ms. Janice Kaye, FHFB's FOIA officer, withheld certain information under FOIA Exemption 5 and redacted other information pursuant to Exemption 5 and Exemption 8 and the FHFB's implementing regulations thereunder.

Our original FOIA request dated April 3, 2006 requested copies of all records and documents relating to the drafting, formulation and approval of the proposed rule entitled "Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks," published in the Federal Register on March 15, 2006 (71 Fed. Reg. 13306 – 13316).

Included within our request were the following: all records containing and describing the data, methods and analysis used to determine the proposed retained earnings minimum ("REM") and the proposed limitation on excess stock.

In addition, we requested the Finance Board provide us with any records or information pertaining to:

1. the model equation employed in the linear regression analysis undertaken to determine the proposed REM;
2. definitions of the dependent and independent variables employed in that analysis;
3. the data used for these variables; and
4. the parameter estimates obtained from the analysis, including coefficients for the independent variables, the intercept value, standard deviations and t-statistics for the coefficients and the intercept, the r-square for the estimation, and other summary statistics that may be available.

We also requested that the Finance Board provide all records relating to the consideration of alternatives to the approach taken in the proposed rule and all cost-benefit analyses related to the proposed rule and alternatives.

We do not dispute the FHFB's application of Exemption 8 to the materials provided in response to our April 3, 2006 request.

However, we believe that the information we requested (as detailed above) is factual information that would not disclose the agency's decision-making process, and therefore is not within the scope of Exemption 5 and may not be withheld by the FHFB pursuant to Exemption 5.

The Supreme Court has noted that the statutory exemptions contained in FOIA "do not obscure the basic policy that disclosure, not secrecy, is the dominant objective of [FOIA]...[a]ccordingly, these exemptions must be narrowly construed." *John Doe Agency v. John Doe Corp.* 493 U.S. 146, 152 (1989)(quoting *Dept. of Air Force v. Rose*, 425 U.S. 352, 361 (1976)).

In particular with respect to Exemption 5, a federal court recently held that "investigative tools that generate raw data or empirical evidence" used by an agency in the rulemaking process are not protected and are subject to disclosure. See *Reilly v. EPA*, Civ. No 05-10450-RBC (D. Mass), April 13, 2006.

Similarly, the factual bases, including the models, data and analysis of the data, underlying the FHFB's retained earnings requirements and excess stock restrictions are not protected by Exemption 5 and should be disclosed. This will allow the public to provide the most meaningful comments on the proposed rule, as contemplated by the Administrative Procedure Act.

We agree to pay all fees incurred in connection with this appeal as determined in accordance with 12 CFR Part 910.9.

Sincerely,

Patricia A. Milon
Chief Legal Officer and Senior Vice President,
Regulatory Affairs