INDEPENDENT COMMUNITY BANKERS of AMERICA

July 13, 2006

Federal Housing Finance Board
1625 Eye Street NW
Washington DC 20006
ATTENTION: Public Comments

Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks. RIN Number 3069-AB30; Docket Number 2006-03

The Independent Community Bankers of America[1] welcomes the opportunity to comment on the Federal Housing Finance Board's proposed rule that would limit the amount of excess stock that a Federal Home Loan Bank can have outstanding and that would prescribe a minimum amount of retained earnings for each FHLB. The FHFB also proposes to amend its regulations to prohibit a FHLB from selling excess stock to its members or paying stock dividends and restrict a FHLB's ability to pay dividends when its retained earnings are below the prescribed minimum.

The FHFB has issued the proposal due to concerns that the FHLBs' current retained earnings are not adequate to protect against potential impairment of the par value of member stock. The FHFB is also concerned that some FHLBs increasingly use excess stock to capitalize assets that are long term in nature and not readily saleable, such as mortgages sold to the Mortgage Partnership Finance and Mortgage Purchase Programs, or that are not mission related. The FHFB has said member stock should be protected to ensure that it never falls below par value.

ICBA Opposes the Proposed Rule

ICBA reiterates our opposition to the rule as proposed. In a joint letter with other banking trade associations dated June 16, 2006, ICBA urged the Finance Board to withdraw the proposed rule and reissue it as an Advance Notice of Proposed Rulemaking to facilitate a discussion of among the Finance Board, the FHLBs, FHLB members and other interested parties, including ICBA.

[1] *The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

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A safe and sound FHLB system is vitally important to community banks that depend on FHLBs for liquidity, long term funding, a secondary market option, and other important products and services. Community banks also want a financial strong system because they hold a great deal of FHLB debt as investments.

While we support the concept that each FHLB should have adequate levels of retained earnings that is appropriate to the risk in its particular business, we believe that the methodology and approach that the FHFB has taken to develop this proposal is seriously flawed. In particular, we are concerned the proposal treats all non-advance assets the same, requiring all to be backed by the same amount of retained earnings, regardless of risk. This will cause FHLBs to favor risker, higher yielding assets over lower risk, lower yielding investments often used for liquidity. Indeed, FHLBs that need to quickly adjust their balance sheets in seeking compliance with the rule, if it goes forward, will likely liquidate all the lower yielding liquidity investments they can without violating existing regulations. We question why a safety and soundness regulator would create such a situation.

While over the longer term, a level of retained earnings in all FHLBs can strengthen the system, we are greatly concerned that the proposal will destabilize the FHLB system over the short-to medium-term. We believe this is unnecessary, given that FHFB has stated that all FHLBs are adequately capitalized. Therefore, each FHLB should have a reasonable period of time (e.g. a set number of years based on their current retained earnings levels) to increase retained earnings **if needed**, so as not to cause unnecessary disruptions to their business or that of their members.

ICBA also strongly opposes the prohibition on stock dividends that most FHLBs have periodically used and that provide members receiving them the advantage of deferring a tax liability until the stock is redeemed. There is simply no need to prohibit this long standing practice. Limits on excess stock should be set by each FHLB based on its particular situation, not as an across-the-board arbitrary limit.

The FHLBs spent several years and significant dollars to develop new capital plans as called for by the Gramm-Leach-Bliley Act of 1999, plans that address issues raised by the proposed rule, and plans that the FHFB has approved. Now, the FHLBs would face a new retained earnings requirement not anticipated by the capital plans and one that appears inconsistent with the intent of the 1999 Act and existing capital plan regulations.

We believe that the proposal itself is causing FHLB members, particularly larger members that can directly access the capital markets, to rethink their use of FHLB membership. If the proposal goes forward as proposed, financial institutions that have multidistrict memberships will likely move their business to follow dividends. Thus, those members—primarily the smaller members--that cannot shop for dividends or do not have other viable funding alternatives will be unfairly disadvantaged. Thus, we are greatly concerned that smaller FHLBs will bear the greatest burden of implementing the proposal if it goes forward.

In summary, we strongly urge the FHFB to withdraw the proposal and work with the FHLBs and interested parties to develop an approach that truly works. Our reasons for opposing the rule are discussed further below.

Capital Structure is Governed by Capital Plans
The Gramm-Leach-Bliley Act of 1999 called for significant changes to the capital structure of the FHLBs with new, more permanent member stock by creating B Stock that has a five year notice of redemption. A FHLB may not repurchase or redeem the stock if it has incurred or is likely to incur losses that result in or are expected to result in a charge against capital without permission of the FHFB. Redemptions or repurchases are prohibited if it would cause the FHLB to fall below its minimum capital requirement. Thus, this stock is truly available to absorb losses.

The FHLBs have spent several years and significant dollars developing capital plans to implement the new capital structure, plans that have required FHFB approval for implementation. Each FHLB developed its plan based on its specific situation and the needs of its members. In our view, any changes to the capital structure must be consistent with the 1999 Act and retained earnings policies should be part of the capital plan and based on the risk profiles and business plans of each individual FHLB, not on a formula applied across the system without regard to the varied risks of an individual FHLB or of asset classes. We are also concerned about the potential impact of a proposed risk-based capital rule that we understand the FHFB board is considering on the proposed retained earnings requirement. The FHLBs have undergone five years of needed changes to their capital structure as a result of the 1999 Act and are now facing a new retained earnings calculation not anticipated when they developed their capital plans. Several months from now, will a new proposal cause changes again? In our view, this proposal should be considered along with the existing capital plan rules and any planned risk based capital rule, to minimize costs and disruptions to the FHLBs and their members.

Minimum Retained Earnings Requirement Is Seriously Flawed
The proposed rule would require each Federal Home Loan Bank to build and maintain retained earnings equal to $50 million plus 1 percent of assets, other than advances, such as mortgages acquired from members and investments. We believe that this approach is seriously flawed. We regard the proposed level of 1 percent of assets as a very arbitrary amount which does not truly reflect risks in individual FHLBs. Further, an arbitrary flat minimum of $50 million is more onerous on smaller FHLBs. Rather than impose an across-the-board retained earnings requirement, retain earnings levels should be what is appropriate for a FHLB's particular business risk profile and business plan. Some FHLBs have already developed a retained earnings plan as part of their capital plans. In our view, this is the appropriate approach.

ICBA is greatly troubled by the fact that the calculation treats all non-advance assets equally for the purpose of calculating a retained earnings requirement, regardless of their risk levels. Riskless cash and securities backed by the full faith and credit of the U.S. government must be backed by the same amount of retained earnings needed for long-term fixed-rate mortgages held in portfolio or mortgage backed securities.

We are concerned that this calculation will encourage FHLBs to hold greater amounts of riskier assets because of their higher yield and hold lower levels of safer but lower yielding liquidity investments. This is most likely to occur in FHLBs that will have significant retained earnings shortfalls as they aggressively seek more earnings to meet the proposed minimum retained earnings requirements. Because the minimum requirement would go into effect immediately upon publication of a final rule, FHLBs not immediately in compliance will likely rush to liquidate investments in an effort to become compliant. The best business decision would likely dictate that low yielding, very liquid, and by their nature very safe investments be the first to go. It appears to us that this proposal would encourage a situation counter to institutional safety and soundness. We question why a regulator would create an environment that encourages FHLBs to hold the lowest level of liquidity permissible by regulations.

Some FHLBs project that they would meet the minimum retained earnings requirement by the time a final rule is expected, but it would take months or years for others to meet it. Some FHLB members could see significant, prolonged cuts in their dividends. We are concerned that if the proposal goes forward as proposed, it will cause financial institutions with multi-district memberships to shop their advance business among FHLBs to obtain the highest dividend payouts. Or the largest FHLB members with other funding options may flee the system for less costly funding as steep dividend cuts raise their all-in cost of funds. In either case, community banks that do not have such choices will be significantly disadvantaged. They will likely see higher rates on advances and even lower dividend rates as the FHLBs continue to build retained earnings. And they will face a greater competitive disadvantage against those members that were able to flee the system in search of a cheaper funding alternative.

A significant loss of business would also result in a decline in funds for the very successful Affordable Housing Program and other community development programs supported by FHLB earnings.

Retained Earnings Requirement and Stock Impairment

The FHFB believes retained earnings must be built to protect member stock from ever being impaired should FHLBs face financial difficulties. The FHFB has pointed to recent problems that raised questions about the adequacy of retained earnings. For example, the FHLB of New York's $189 million loss on the sale of securities backed by manufactured housing loans nearly exhausted its retained earnings. The FHLB suspended dividends to rebuild them. The FHFB also cites increased income volatility due to changes in the balance sheets of FHLBs and recent accounting changes as compelling reasons to increase retained earnings.

FHFB Chairman Rosenfeld has said that the intent of the FHFB in issuing the proposal is to avoid the recurrence of conditions that gave rise to the need for a formal enforcement action in the FHLBs of Seattle and Chicago. In a comment letter on the proposal, the FHLB of Seattle states "…none of the actions taken by the Seattle Bank that ultimately led to the written agreement were affected by the Seattle Bank's level of retained earnings. Furthermore, a higher level of retained earnings would not have prevented their occurrence. Hence, the retained earnings proposal would not necessarily accomplish its stated objective."

It is our understanding that while the par value of the stock of the FHLB of Seattle has been breached, from an accounting perspective it is not impaired because of the intent and ability of members to hold their stock as the breach is repaired. If the stock of one FHLB becomes impaired, its members would likely need to write down their stock and reflect it in earnings. Members of other FHLBs may be forced by their accountants to revisit their member stock valuations too. And banking regulators may become critical of the amount of stock members are holding once it has lost its historic nearly riskless profile. Impairment of FHLB stock would have a devastating effect on the FHLB system, its members and the banking system as a whole. Thus, it should be avoided.

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However, the FHLB of Seattle situation clearly demonstrates that the proposed retained earnings requirement is not an impairment insurance policy. Rather, a level of retained earnings must be coupled with strong regulatory examination and supervision to avoid the risk of impairment.

Dividend Restrictions Are Overly Harsh

The FHFB proposes to limit dividend payouts to 50 percent of current net earnings, unless it approves otherwise, if a FHLB's retained earnings levels are below the minimum requirement. After the initial implementation, a dividend may not be declared or paid, without FHFB approval, if retained earnings would fall below the minimum after the payment. Some FHLBs have been building retained earnings so are likely to meet the minimum requirement by the time a new rule would become effective. It could take several quarters for others to reach the goal, but at least one FHLB will need a couple of years.

While the primary reason most community banks join FHLBs is for access to advances, the dividends they receive are an important benefit that lowers their overall cost of funds and ultimately benefits consumers. For active FHLB members, dividends can be an important part of their earnings.

We are concerned that absent financial difficulties, the initial restriction of dividend payments is overly harsh. We are even more concerned that should a FHLB breach its minimum requirement once that has been established and achieved, dividends might need to cease entirely. We are concerned that, should a FHLB face such a severe constraint, those members that can will flee the system for alternative funding sources. Surely, members with significant income at risk, due to potential dividend cuts certain FHLBs would be forced to make must be carefully considering their FHLB membership and usage even while this is only a proposal.

We believe that the minimum retained earnings requirement and payout restrictions are too constraining given that the FHFB states that the FHLBs are currently adequately capitalized. FHLB earnings can fluctuate from quarter to quarter and thus, dividend payments could become quite volatile. To help members who depend on the payments better plan their income streams—and avoid encouraging the FHLBs to "smooth" earnings to provide more stable dividend payments--more flexibility should be permitted for dividend payout ratios over time. If a FHLB must increase retained earnings, unless it is facing significant financial difficulties, it should have an appropriate period of time to build retained earnings without such significant dividend cuts to minimize the disruption to the FHLB system and its members.

Stock Dividends Should Be Permitted

The proposal would prohibit the FHLBs from issuing dividends in the form of stock. Some FHLBs pay stock dividends, enabling members to enjoy the attendant tax advantages, but the FHFB plans to ban that practice for fear that excess stock encourages FHLBs to employ the stock in riskier, higher return assets or activities that are not mission-related.

ICBA believes that there are better ways to address the FHFB's concern about excess stock (as discussed below) rather than a ban on the payment of stock dividends. Some FHLBs, such as the Dallas FHLB, have long paid stock dividends yet manage excess stock levels through regular stock repurchases. Thus, we see no reason to prohibit the payment of stock dividends and we strongly urge the FHFB not to prohibit the payment of dividends in stock.

Even the one percent limit proposed on excess stockholdings by the FHLB would limit excess stock, negating the need to prohibit the payment of dividends in stock. The FHLBs, working with their members, decided whether or not to pay dividends in stock (or to permit their members to chose their payment method). This was incorporated in the capital plans developed by the FHLBs in response to the 1999 Act, plans that required Finance Board approval. In our view, the FHLBs should continue to have the option to pay stock dividends, enabling members to continue to enjoy the tax advantages this dividend form provides, if they choose. If stock dividends are prohibited, the result will be an effective higher cost of funds that will be passed to consumers by FHLB members by way of higher loan rates.

Any Excess Stock Limits Should Be Set By FHLBs
The proposal would also limit the amount of excess stock a FHLB could hold to one percent of total assets. The FHFB would interpret this change narrowly to only prevent the sale of excess stock by the FHLBs that would be excess at the time of sale. In its comment letter, the FHLB of Seattle states that it agrees with the proposed limitation on excess stock as it addresses some of the root causes behind its financial difficulties. It has no objection to placing a reasonable limit on excess stock, but limits should be established by the board of directors and reviewed by the FHFB after careful consideration of the entire capital plan of the FHLB.

ICBA understands that some limit on excess stock may ensure that the FHLBs are not forced to engage in higher risk/higher reward activities because of a need to provide an attractive return to holders of the excess stock. However, while the proposed 1 percent limit on excess stock may be workable, each FHLB should set its own excess stock limits based on its business profile within its FHFB approved capital plan. Indeed, Congress gave the FHLBs the authority, at their sole discretion, to redeem or repurchase stock in excess of that required for membership. If the FHFB believes that the excess stock balance held by a FHLB is excessive and is causing mission creep or risking a FHLB's safety and soundness, it should address it directly rather than a blanket prohibition on paying stock dividends or imposing a specific limits across the board for all FHLBs.

We strongly agree with the FHFB's view that any restrictions on excess stock should be narrowly interpreted to permit excess stock under certain circumstances such as when a member has paid down advances or has acquired excess stock during a consolidation as suggested. We believe this flexibility is needed and reflects the ebb and flow of the advance needs of members.

MPP/MPF Capital Issues Need to Be Appropriately Resolved
Some have criticized the proposal as an attempt to curtail the FHLBs' mortgage asset purchase programs such as the Mortgage Partnership Finance program, a charge the FHFB has strongly denied. However, since the FHFB proposal uses these non-advance assets in the calculation for retained earnings requirements, there clearly is a direct link to the programs. Community banks that sell loans through the FHLB secondary market programs such as MPP and MPF find them to be an important way to provide their customers with lower cost mortgages. Community banks that have used these programs report to ICBA that they have enjoyed more competitive pricing from Fannie Mae and Freddie Mae due to the competition from the FHLBs for their mortgages. These are banks that historically did not receive the pricing advantages from Fannie Mae and Freddie Mac available to larger volume lenders. As result, the FHLB MPP and MPF programs have helped level the playing field among mortgage lenders, with benefits passed on to homebuyers.

ICBA has long held that the secondary market programs should not squeeze out the advance business that is so important to the vast majority of community bank members. And, they must be conducted in a prudent manner that does not risk that safety and soundness of individual FHLBs or the FHLB system itself. We urge the FHFB to work with the FHLBs offering these programs to appropriately resolve capitalization issues in a manner that permits their long term viability so that community banks have secondary market options they can use to remain competitive in the residential mortgage market.

Summary

The FHLBs need a capital structure that ensures their safety and soundness and is appropriate to their business structure, allowing for differences among FHLBs. All FHLBs should hold some level of retained earnings to enhance their safety and soundness, but the specific level should be determined FHLB by FHLB, not by an arbitrary across-the-system standard. ICBA is greatly concerned about the proposed minimum retained earnings requirement— the proposed across-the-system level, how it was calculated and the potentially severe dividend cuts that will result. ICBA strongly opposes the FHFB's proposal to prohibit the payment of stock dividends.

We again urge the FHFB to withdraw this proposal and reissue it as an Advance Notice of Proposed Rulemaking. The proposal has broad short-term and long-term ramifications on the FHLBs, their members and the communities they serve. If changes are needed in the capital structure of the FHLBs and dividend payment policies, sufficient time should be taken to ensure they are properly considered and truly accomplish the intended goals. There needs to be an opportunity for FHFB and FHLBs and their members, and other interested parties to discuss, develop and implement an approach that does not disrupt the business of the FHLBs or that of their members and the customers they serve.

ICBA would welcome the opportunity to work with the FHFB to develop a more workable approach.

Sincerely,

Camden R. Fine

Camden R. Fine
President & CEO