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July 13, 2006

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

Re: FHFB; 12 CFR, Parts 900, 917, 925, 930, 931 and 934; 71 Federal Register, Number 50, Page 13307, Proposed Rule

Dear Sir or Madam:

The American Bankers Association ("ABA") appreciates this opportunity to comment on the rule proposed by the Federal Housing Finance Board ("Finance Board" or "Board") regarding changes to regulations governing the excess stock and retained earnings of the Federal Home Loan Banks ("the Banks").

The American Bankers Association, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership-which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks-makes ABA the largest banking trade association in the country.

The Finance Board has proposed a rule that would (1) set a minimum amount of retained earnings for each Bank consisting of $50 million plus one percent of the Bank's prior quarter's average non-advance assets; (2) prohibit any Bank that has not met the retained earnings minimum ("REM") from paying out more than 50% of its current net earnings in dividends, and thereafter, prohibit any dividend payments, 1without prior approval from the Board when a Bank falls below its REM; (3) limit the excess stock that a Bank can have outstanding to no more than one percent of a Bank's total assets (thereby requiring the redemption of outstanding excess stock); and (4) prohibit a Bank from selling excess stock to its members or paying stock dividends.

ABA recognizes the important role of the Board in ensuring that the Federal Home Loan Bank System ("System") remains safe, sound and mission-focused. We further agree that some increased level of retained earnings held by each of the Banks may be desirable in furtherance of these goals. However, we feel strongly that the rule as proposed takes an approach that is misguided and which may weaken rather than strengthen, the Bank System. The rule should be withdrawn, reconsidered in light of our and others' comments, and re-proposed as an Advance Notice of Proposed Rulemaking in order to provide for the maximum consultation with the affected

member/owners of the System. As the Board's proposal makes clear, the System is currently operating in a safe and sound fashion, and there is no crisis that must be immediately addressed. Given that, we believe that an orderly, collaborative process can best achieve our shared goal of ensuring the long-term safe, sound and mission-focused operation of the System.
Our detailed comments follow.

<u>Retained Earnings Requirement:</u>

The proposed rule's approach of requiring each Bank to establish retained earnings in an amount equal to $50 million plus one percent of the previous quarter's average non-advance assets is overly simplistic and does not take into consideration the very different risks, balance sheets, and operations of each of the twelve Banks. While we appreciate the Board's attempt to minimize burden by using a simple, "one size fits all" calculation of minimum retained earnings, the proposed calculation fails to reflect the significant differences among the twelve Banks. The Banks are vastly different entities, with different risks and different asset mixes, and each are operated differently. Congress recognized this when it vested the Banks with the authority to create individual capital plans under the Gramm-Leach-Bliley Act of 1999 ("GLB"). As the regulator of the Banks and the agency that must approve those capital plans, it is incumbent upon the Board to recognize the many differences among the twelve Banks. These differences should be taken into account when establishing a retained earnings policy to protect the par value of the stock issued by the Banks, just as they must be taken into account when establishing minimum capital to protect against insolvency under extreme stresses. The Board has not set forth a readily identifiable methodology used to determine the REM level. Instead, the rule indicates that the Board applied Basel II credit risk methodologies, using a target rating of AA/Aa, but does not reflect any kind of Basel analysis. A Basel approach requires an analysis of specific assets and risks posed by each Bank in the System. This is clearly at odds with the "one size fits all" approach taken in the rule applied to each of the Banks regardless of their risk or asset mixes.

We would also note that the REM formula creates incentives for the Banks to take on additional risk and reduce liquidity. By requiring a "one size fits all" one percent of non-advance assets in the REM formula, the Board is giving the Banks an incentive to take on higher-yielding, riskier investments in order to increase their return and boost their retained earnings faster. Additionally, because the REM applies to liquid assets, it creates an incentive for a Bank to reduce liquid assets to the lowest possible level. Reducing liquidity is counter to safety and soundness and to members' interests that the Banks maintain sufficient liquidity to meet members' credit needs.

Additionally, we would note that the use of the AA/Aa as a target rating may be prudent and desirable for determining the capital necessary to protect against insolvency, but may not be the best or wisest target for protecting against the breach of the par value of the stock. The ramifications of an impairment of par value, while potentially severe, are not the same as those of insolvency. To hold the System (or even the individual Banks) to this standard to avoid impairment is unnecessarily conservative and seems likely to harm the Banks by overly diverting income that should be used to attract and retain members. The end effect is likely to weaken individual Banks and the System overall rather than to increase safety and soundness. This broad, uniform and little-explained standard should be replaced with a more detailed, Bank-specific approach. At a minimum, the rationale for the Board's proposal should be better explained so that affected entities may assess the appropriateness of the approach. As it is, the Banks and their members are presented essentially only with the option of trying to improve an approach with which they disagree. Rather than tweak a flawed approach, the Board should step back and consider the overall objectives of the System and the impact that alternatives could have on it.

Prohibitions on Dividend Payments

The proposed rule would prohibit any of the Banks from paying (without regulatory approval) more than 50 percent of current net earnings as dividends to members until the REM for that Bank is attained. Thereafter each Bank would be prohibited any dividend payment without prior regulatory approval if that Bank fell below its REM. It has been estimated by the Council of Federal Home Loan Banks that the REM requirement will reach $3 billion in additional retained earnings for the System. Because the System is a member-owned cooperative, this requirement amounts to an immediate tax of $3 billion on member institutions. Dividends are an important and necessary component of any cooperative organization. They are a feature that attracts and retains members. The return on investment in Bank stock via dividends is calculated into a member's cost of doing business – reducing or eliminating the dividend reduces the affordability of borrowing from the System and makes membership less useful and attractive.

We have already argued above why the imposition of an across-the-board REM policy is not advisable. Combining such an ill-advised requirement with a restriction on dividend payments only magnifies the error of the proposed rule. If there is a pending problem with an individual Bank that requires dividend limitations, the Board has the authority (at 12 CFR Sec. 917.9) to prohibit a Bank's board from declaring or paying any dividend if such payment would result in a projected impairment of the par value of the capital stock of the Bank. Imposing an across-the-board limitation on payment of dividends reduces the value of membership in the System, may lead to members leaving the System, and may create an unforeseen "free rider" issue down the road, as financial institutions who have left the System or who are not yet members, join or re-join once the REM is met, thereby leaving those remaining in the System to forego any dividends longer until the REM is met. Just as a "one size fits all" REM requirement is ill-advised, so too is an across the board dividend restriction. We would further note that imposing a universal dividend restriction reduces the value of membership in the System and increases the financial instability of the System overall – which is directly in opposition to what the Board should be striving to achieve.

Additionally, by prohibiting the payment (absent regulatory approval) of any dividend if a Bank fails to achieve its ongoing REM, once the initial REM has been achieved, is unduly harsh and likely to unnecessarily alarm members. It is unclear why a potential total prohibition of dividends is necessary if the REM is not consistently met. It appears that the Board is confusing meeting the REM with protecting the par value of the stock. As noted above, the Board clearly has the authority to prohibit a Bank's board from paying a dividend if such a payment would impair the par value of the stock. However, not meeting the REM (especially a REM as conservative as the Board proposes) is a far different event than impairment of the stock. To make no distinction between the two is likely to create an impression among members that a Bank that does not meet its REM is in dire financial straits and may lead to an exodus from the System. Regulatory restrictions must be imposed in a limited, reasonable degree. The universal limitation on dividends and the total restriction on dividends for not meeting the on-going REM should be withdrawn and reconsidered.

Limitation on Excess Stock

The pending proposal would limit the amount of excess stock that a Bank may have outstanding to one percent of the Bank's total assets. In the proposal, the Board expressed a concern that "some of the Banks use excess stock to capitalize assets that are long term in nature and not readily saleable, such as acquired member assets (AMA) or that are not mission related..." Thus it appears that the Board is seeking to address concerns it has related to the amount or type of assets the Banks are acquiring. The Board should address those concerns directly, through supervisory powers, not through excess stock restrictions. Again, it appears that the Board is seeking to impose a "one size fits all" solution on the entire System to address concerns or potential concerns the Board may have with the actions of individual Banks.

A particular concern over the limitation on excess stock is that it would force a taxable event on many System members who otherwise would hold the stock in anticipation of future borrowing or other mission-related activity. To force a taxable event onto System members to indirectly address a concern (or potential concern) that the Board may have with individual Banks is particularly harmful in that it undercuts business assumptions that have been made by members, undercuts the value of System membership, and further exacerbates the harm caused to member/owners of the System by the proposed imposition of the REM. Additionally, the forced redemption of excess stock will make the mandate to achieve the REM that much more difficult. Every dollar spent to redeem excess stock will be a dollar that cannot be used to build retained earnings.

Beyond the unnecessarily harsh consequences to members of the System, the limitation on excess stock may also have the unintended consequence of destabilizing the System. By forcing the Banks to repurchase any of their Class B (i.e., five year) excess stock within sixty days, the proposal will have the effect of making the Class B stock even less permanent than the Class A (i.e., one year) stock. This prevents the Banks from using the full five year redemption period established under GLB for Class B stock and potentially creates the very instability that Congress sought to avoid in creating the Class B stock. The Board should withdraw the proposal to limit excess stock held by the Banks and address any concerns over assets and mission related activities on an individual Bank basis.

Prohibition on Stock Dividends

The proposed rule would prohibit the Banks from paying dividends in the form of stock rather than cash. A number of the Banks have paid stock dividends to their members for many years – with no adverse effects. Stock dividends have been preferred by some members due to the more flexible tax treatments accorded members receiving such dividends. This favorable tax treatment (which does not apply to cash dividends) offsets the relatively low yield on members' capital stock investment. By eliminating the ability of a Bank to pay stock dividends, the Board would decrease the tax-adjusted returns to the Bank's members, decrease the value of their stock and adversely affect the value of becoming or remaining a member – harming the overall System. The only justification the Board seems to offer for this prohibition is that "(s)tock dividends, along with the sale of excess stock to members, are the main causes of growth in excess stock on the Banks' balance sheets" and the suggestion in the rule that it would be difficult for the Banks to issue stock dividends on other than a sporadic basis to remain in compliance with the excess stock limitation. We submit that these justifications fail to support the proposed action. Therefore, consistent with our view stated above that the limitation on excess stock should be withdrawn, this prohibition, which will prove harmful to members and the System overall, should also be withdrawn as serving no legitimate purpose.

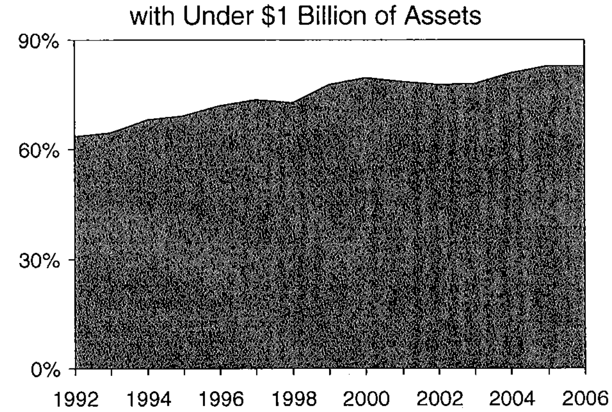
Additional Concerns

Smaller financial institutions that are members of the System may be disproportionately harmed by the proposal as they are more dependent upon the System than larger members for liquidity.

Liquidity and funding are increasingly becoming critical issues for community banks. These banks serve a central role in meeting a healthy demand for consumer and small business credit in local communities across the country. Yet these banks struggle to fund that credit in the highly competitive market for deposit funds. Figure 1 demonstrates that loan-to-deposit ratios for these banks continue to rise steadily.

Figure 1

Loans/Deposits for Banking Firms with Under $1 Billion of Assets

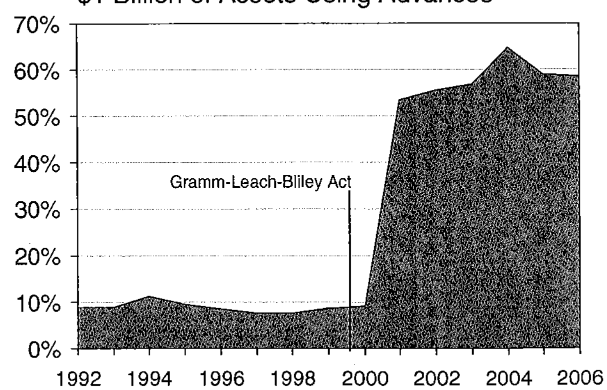


ABA analysis of data from www.fdic.gov

Advances from the Federal Home Loan Banks have been extremely important in helping to make up the funding shortfall. Figure 2 shows that, after 1999 legislation expanded access to Federal Home Loan Bank membership, a growing portion of community banks – now about sixty

Figure 2

Portion of Banking Firms with Under $1 Billion of Assets Using Advances



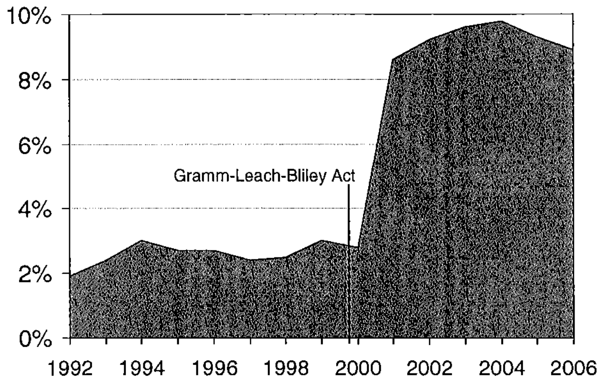
ABA analysis of data from www.fdic.gov

percent of the total – uses advances. This funding is more stable and reliable than other alternatives to core deposits, can be matched to the maturity of the credits it supports, and therefore promotes the soundness of community banks.

Figure 3 demonstrates how important this funding has become. Nine percent of community bank credit is now backed by advances. Advances are even more critical for home mortgage credit; Figure 4 demonstrates that advances for community banks now amount to 28 percent of single-family home mortgage loans held in portfolio.

Figure 3

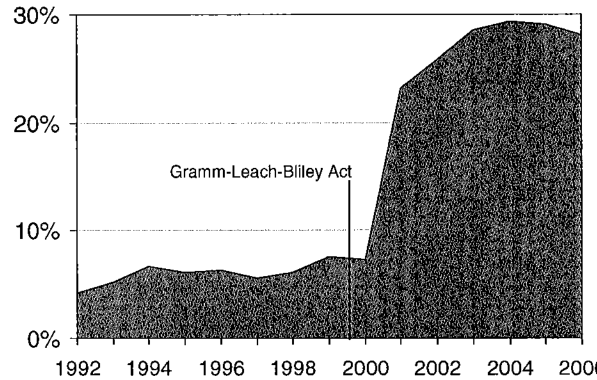
Advances/Loans for Banking Firms Under $1 Billion of Assets with Advances



ABA analysis of data from www.fdic.gov

Figure 4

Advances/Home Mortgage Loans for Banking Firms Under $1 Billion of Assets with Advances



ABA analysis of data from www.fdic.gov

Yet the Board proposal, if it becomes a rule, would reduce the ability of System members to access liquidity in a number of ways. It would require each of the Banks to hold more retained earnings than needed from a risk perspective, and therefore drive them to de-leverage. It would also create an unnecessarily higher retained earnings charge for liquid assets, such as Treasury bills, agency securities, and cash. To build up their capital ratios, as required, the Banks would have to restrict dividends until the retained earnings goal is met.

Additionally, the proposal would reduce capital in the System by requiring the Banks to redeem excess stock. Doing so reduces funds available to make advances. The combination of a reduction in dividends, the forced redemption of excess stock (which will trigger a taxable event for most System members) and the reduction of liquidity available may have the effect of driving members from the System, further reducing the efficacy of the System to meet the liquidity needs of community banks.

Just as important, the proposal would reduce Federal Home Loan Bank asset size, mortgage holdings and liquidity investments, thereby reducing income and ultimately funds available to help low-income families obtain housing under the successful Affordable Housing Program.

In sum, it is important to consider the potential unintended consequences of the proposal. Forcing the Federal Home Loan Banks to redeem stock limits funds available for advances and/or dividends and may cause members to withdraw from the System – thus creating more risk for the Banks and their remaining members.

Penalizing the Banks for holding liquidity would be contrary to safety and soundness principles and the industry's need for immediate access to liquidity.

The long-term viability of the Federal Home Loan Banks is vital to banks of all sizes and the communities they serve. Increasing the retained earnings of the Banks may serve to increase their safety and soundness, and additional regulatory efforts may be necessary to ensure that the Banks continue to meet their mission goals. However, we very strongly believe that this proposal takes the wrong approach in addressing all of these issues, and that the proposal should be withdrawn. We urge that the Board reconsider the rule in light our comments and those received from the member/owners of the System and then issue an Advance Notice of Proposed Rulemaking. A strong, safe and useful Federal Home Loan Bank System is a goal of the banking industry, the Federal Home Loan Banks themselves and the Federal Housing Finance Board. We are confident that through a collaborative process we can ensure that goal continues to be met.

Sincerely,

Joseph Pigg
Senior Counsel