

# HOUSING POLICY COUNCIL

## THE FINANCIAL SERVICES ROUNDTABLE

July 13, 2006



1001 PENNSYLVANIA AVENUE, N.W.  
SUITE 500 SOUTH  
WASHINGTON, D.C. 20004  
Tel. 202.289.4322  
Fax 202.289.1903

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

Re: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks. RIN 3069-AB30, Docket No. 2006-03

Dear Sir or Madam:

The Housing Policy Council (HPC) of The Financial Services Roundtable appreciates the opportunity to comment upon the Finance Board's proposal regarding excess stock and retained earnings requirements for the Federal Home Loan Banks ("FHLBs").<sup>1</sup> The Housing Policy Council and its member companies share the goal of the Board to strengthen and assure the safety and soundness of the Federal Home Loan Bank System. HPC member companies are active participants in the Federal Home Loan Bank System and have substantial investments in the FHLBs. FHLB filings with the Securities and Exchange Commission indicate that ten HPC members hold more than \$10 billion of the \$45 billion in total FHLB capital.

Given the substantial investment of HPC members in the FHLBs (more than 20% of the outstanding stock of the System), we have a strong incentive to ensure that the FHLBs are safe and sound, and not destabilized. We are concerned, however, that the proposed rule would have a destabilizing impact on the FHLBs, thereby making them less safe and sound. We also believe that the goals of the proposed rule could be achieved through alternative regulatory actions. For these reasons, which are more fully discussed below, we respectfully request that the proposed rule be withdrawn and suggest that the Board issue an Advance Notice of Proposed Rulemaking to seek a more balanced solution to these important issues.

### **I. Summary of Proposed Rule**

The proposed rule would impose three new limitations on the capital structure of the FHLBs. First, it would limit the amount of excess stock a FHLB may have outstanding to one percent of its total assets (the "Excess Stock Regulation"). Second, it would prohibit a FHLB from paying a dividend in the form of additional shares of capital stock (the "Dividend Regulation"). Finally it would require a FHLB to maintain a level of retained earnings equal to \$50 million plus

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<sup>1</sup> The Housing Policy Council of The Financial Services Roundtable was formed in 2003 to focus on national mortgage finance issues of significance to consumers, the economy, and mortgage lenders. Currently, the HPC consists of twenty-two financial services firms that provide mortgage credit to consumers. We estimate that the members of the HPC originate over 62 percent of residential mortgages in the United States.

one percent of the FHLB's total non-advance assets, and would limit dividend payments by the FHLB until it met this requirement (the "Retained Earnings Regulation").

## **II. The Proposed Rule Will Destabilize the FHLB System**

### **A. The Proposed Rule Will Cause HPC Members to Reduce Their Involvement with the System**

The proposed rule will destabilize the System because it will cause larger lenders, such as HPC members, to either reduce their involvement with the System or even exit the System entirely. The loss of large members will deprive the System of financial, managerial, and other resources at a time when the marketplace and the Finance Board are urging the FHLBs to adopt more sophisticated risk management systems. The participation of larger institutions provides the System with financial resources that support its efficient operations. The loss of such institutions will place cost burdens on smaller members that will be difficult for them to meet.

The proposed rule will have this impact on large lenders because it will significantly increase the cost of membership in the System, and, unlike small members, large members have the ability to turn to lower-cost sources for funding and other products and services provided by the FHLBs.

One of the most obvious cost impacts is the loss of dividend income imposed by the Retained Earnings Regulation. The loss of dividend income until a Bank achieves the retained earnings minimum (REM) will cost HPC members millions, and in some cases, tens of millions of dollars.

The Dividend Regulation also has a significant cost impact for HPC members. Currently, most of the FHLBs pay dividends in the form of stock, and the tax effect of such distributions can be deferred until the stock is redeemed. The Dividend Regulation would trigger an immediate tax liability since cash dividends are not subject to the same deferral treatment that applies to stock dividends.

### **B. The Retained Earnings Regulation Will Force the FHLBs to Look to Riskier, Higher Yielding Investments**

The Retained Earnings Regulation will have a destabilizing effect on the System by forcing the FHLBs to look to riskier, higher yielding investments in order to provide sufficient return on the excess capital mandated by the Regulation. Ironically, the Finance Board cites this danger in its discussion of the Excess Stock Regulation, but fails to recognize the incentive for risk taking that is inherent in the overcapitalization that will result from the Retained Earnings Regulation.

### **C. The Retained Earnings Regulation Will Force the FHLBs to Reduce Liquid Assets**

The Retained Earnings Regulation has the unintended effect of causing FHLBs to reduce their short-term liquid investments. Director Mendelowitz noted at the Finance Board meeting that the 1% retained earnings requirement would apply to all non-advance assets, regardless of how risky the assets may be. For instance, short-term federal funds sold would be treated the same as 30-year fixed rate mortgages, even though the latter are more risky because of interest rate and prepayment risk. The Finance Board has previously recognized the importance of managing liquidity 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 debt markets. The penalty the proposed rule imposes on such investments is at odds with this existing requirement, and does not advance safety and soundness.

### **III. The Goals of the Proposed Regulation Could Be Achieved Through Alternative Actions**

#### **A. The Finance Board Could Substitute Specific Asset Limitations for the Excess Stock Regulation**

The Finance Board has stated that the Excess Stock Regulation is intended to address concerns that excess stock has been used to support the purchase of long-term assets, which are not readily saleable or not mission related. An obvious alternative to the Excess Stock Regulation is to directly regulate such activities, rather than adopt a general capital restriction that, ironically, makes it more difficult for the FHLBs to increase retained earnings because they must use excess capital to repurchase stock. The Finance Board already limits the amount of mortgage-backed securities in which an FHLB may invest. Similar limitations could be placed upon other assets that raise safety and soundness concerns.

#### **B. The Finance Board Should Consider the Stock Impairment Within the Context of a New Capital Regulation or Substitute A New Hybrid Instrument for the Retained Earnings Regulation**

The Retained Earnings Regulation is, in effect, a capital regulation designed to protect the value of FHLB stock. The Finance Board has indicated that a new capital rule is forthcoming, possibly within the next 12 months. It would seem more appropriate for the issue of retained earnings to be addressed within the context of that broader rule. Alternatively, the Finance Board could consider other approaches to capital that would not destabilize the FHLB System. For example, the Finance Board could authorize the issuance of some form of hybrid capital instrument that would absorb losses before a FHLB's stock could be impaired. The federal banking regulators have recognized certain types of hybrid instruments for capital purposes.

The FHFB's argument that changes to retained earnings are required to protect the par value of stock is not supported by the applicable accounting guidance. The accounting guidance requires a write-down of stock only when there is a "permanent" impairment of the value of the stock. Given the fact that (1) the FHLB's have an inherent funding advantage relative to the market that almost ensures that the FHLB's will be profitable in the long term, and (2) the FHFB's ability to

limit capital withdrawals if the withdrawals would put a bank's viability at risk, there currently is no foreseeable scenario that would result in the permanent impairment in the value of the stock.

Also, an extensive amount of work has been performed by numerous international regulatory agencies and participants in financial markets to establish a capital adequacy framework that appropriately adjusts for the risks managed by an organization ("Basel"). Basel recognizes that there are inherent differences with respect to what assets are managed and how they are managed. The proposed rule fails to recognize these inherent differences in asset management strategies, and therefore, will penalize FHLBs that have historically implemented effective risk management strategies (and accepting historically lower returns) compared to FHLBs utilizing aggressive asset management strategies.

#### **IV. Summary**

The HPC respectfully recommends that the Finance Board withdraw the proposed rule. In its current form, it would have a destabilizing impact on the FHLB System. It will cause larger members to reduce their involvement with the System or even leave the System. It will force the FHLBs to invest in riskier assets, and to reduce liquid assets. As a result, the System will shrink in size, be less safe and sound, and less responsive to housing finance needs. Alternative actions by the Finance Board would avoid this destabilizing impact. Those actions could include substituting specific asset limitations for the Excess Stock Regulation or permitting some form of hybrid capital as a substitute for the Retained Earnings Regulation.

The Housing Policy Council suggests that the Finance Board withdraw the proposed rule and issue an Advance Notice of Proposed Rulemaking to seek solutions that will strengthen the Federal Home Loan Bank System. The Housing Policy Council wants to play a productive role in this process. Please contact Paul Leonard at 202 589-1921 if you have any questions. Thank you for your consideration of our views.

Sincerely,



John H. Dalton  
President  
Housing Policy Council  
The Financial Services Roundtable