



VIA Electronic Mail

July 13, 2006

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

Re: Federal Housing Finance Board Proposed Rule
Excess Stock Restrictions and Retained Earnings Requirements
RIN Number 3069-AB 30; Docket Number 2006-03

The Mortgage Bankers Association¹ (MBA) appreciates the opportunity to comment on the proposed rule issued by the Federal Housing Finance Board (the Finance Board) on retained earnings requirements and excess stock restrictions for the Federal Home Loan Banks (the FHLBanks).

MBA supports the Finance Board's goals of safety and soundness in the operation of the FHLBanks. We also support the mission of the FHLBanks to enhance the housing finance system through access to funding, assistance for those in need of affordable housing, and investment in community development. Further, we are in favor of flexibility in management for each of the FHLBanks in order for them to serve the specific business needs of their member institutions as determined by the leadership of each FHLBank, under regulatory supervision.

Our comments reflect what we see as the appropriate balance among safety and soundness, the mission of the FHLBanks, and their business value to their members. In our view, the proposed measures are not necessary to secure safe operations. The FHLBanks, in general, have been profitable institutions in recent years while they have expanded their services to their members and funded over \$2 billion through their Affordable Housing Program (AHP). Where there have been losses or inappropriate investments or controls, the FHLBanks involved and the Finance Board have taken

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

measures to correct those matters. If implemented, MBA believes the proposed rule would be detrimental to the overall success of the FHLBanks, the achievement of their mission and the delivery of business value to members.

MBA requests that the Finance Board consider the concerns presented here, and we reiterate our request² that the Finance Board issue an Advance Notice of Proposed Rulemaking in lieu of a final rule. Our objections consist, in summary, of the following points:

- The Finance Board does not establish a valid rationale, nor does MBA believe there is a case, that the proposed rule is needed for safety and soundness purposes.
- The Finance Board and its staff publicly have indicated they have current plans to change the approach to capital regulation in numerous specified ways; comment on the proposed rule is handicapped without knowledge of the overall capital regulation envisioned.
- Limitation of excess stock to 1% above the amount required to be held by each FHLBank's members is unnecessary, would create a burden on the FHLBanks and their members, and would make participation in FHLBank programs more difficult for some members, to the detriment of mission and service to members.
- The prohibition against distribution of dividends in the form of stock even for FHLBanks with excess stock below the Finance Board's proposed 1% limit is even more unnecessary than the 1% limitation itself.
- The permanent capital structure established under the Gramm-Leach-Bliley Act (GLBA) is sufficient; consequently, we do not agree with the proposal's mandate that additional retained earnings must be held against non-advance assets of the FHLBanks. The FHLBanks should have the flexibility to determine the mix of permanent capital suitable to their institutions.
- The retained earnings requirements have no relationship to the risk among non-advance asset types or the risk profile of the individual FHLBanks and do not represent discrete, state of the art risk-based regulation.
- Dividend restrictions related to the retained earnings requirement would penalize FHLBank members and significantly and immediately decrease the value of their membership. The Finance Board should take into consideration the impact of the retained earnings requirement, and other aspects of the proposal, on members of the FHLBanks.
- MBA believes that the proposed rule will discourage the FHLBanks from engaging in activities that are consistent with their mission, in particular the mortgage programs and investment in mortgage-related securities. Deterioration in those business activities will make the FHLBanks less profitable, will result in lower contributions to the affordable housing programs (AHP) and will result in poorer levels of service and return on investment to members.

² On May 8, 2006, MBA President and CEO Jonathan Kempner requested in a letter to Finance Board Chairman Ronald A. Rosenfeld that the proposed rule be withdrawn in favor of an Advance Notice of Proposed Rulemaking; because the Finance Board did not withdraw the proposed rule, we are presenting our full comments here.

I. The Finance Board has not established the need for the proposed rule.

The Finance Board is proposing to make major changes to the structure of the FHLBanks. The proposed rule would require at least temporary, if not permanent, sacrifices on the part of the FHLBanks and their members in terms of the profitability of the FHLBanks and the overall value proposition to membership.

MBA believes that the Finance Board should take any and all measures required to safeguard the FHLBanks from dangerous existing conditions or foreseeable problems. However, the FHLBanks, as part of the FHLB System (the System), constitute a housing government sponsored entity of importance and the luxury of overprotection is not affordable.

Therefore, we address the question: Is there a need for the proposed rule?

According to the June 14, 2006 announcement of the FHLBanks Office of Finance, the combined total assets of the FHLBanks stood at \$998 billion at the end of the first quarter of this year. Advances represent 62% of total assets, investments total \$273 billion and member mortgage assets are at \$104 billion. The primary investments of the FHLBanks fall into the categories of mortgage-backed securities (MBS), overnight and term Federal funds sold, commercial paper and GSE securities. FHLBank combined capital was at \$45 billion. Income was down from the first quarter of 2005 due to the impact of FAS 133, but equaled \$620 million, and the AHP contribution was \$71 million, a very sizeable and important sum for housing the disadvantaged and underserved.

All twelve SEC registrations of the FHLBanks are effective or pending.

The debt securities of the FHLBanks are rated at the triple-A level by both Standard & Poor's and Moody's Investors Service. In their analyses of the FHLBanks, the rating agencies applaud such features as the fact that "securities investments made by the FHLBs are...predominantly of low asset risk...MBS investing...has been well managed" (Standard & Poor's) and "System liquidity is solid and...the risk-based capital rules strengthen the System's already strong capital policies." (Moody's Investors Service)³

Despite this positive information, the Finance Board could believe that there is a present or foreseeable problem such that the imposition of new rules for retained earnings and excess stock would be justified. However, a reading of the preamble to the proposed rule would not lead to that conclusion. The Finance Board states that, "the Banks' overall capital levels remain adequate and the risk of capital insolvency at any Bank in the foreseeable future is *de minimus*."⁴ Instead, the Finance Board submits that it does not like the mix of capital permitted under the GLBA and it prefers retained earnings to paid-in

³ The evaluations of both rating agencies can be found on the Web site of the Federal Home Loan Banks Office of Finance at <http://www.fhfb-of.com/specialinterest/credit.html>

⁴ 71 Federal Register No. 50 13306, et seq. at 13311.

capital. The objections to excess stock noted by the Finance Board are of a speculative nature or reflect the Finance Board's aversion to non-advance activity.

II. The Finance Board already intends to make changes to the proposed rule and other relevant, but currently uncertain, changes to the capital rules; we believe that submission of the proposed rule is premature.

As we have stated, MBA does not agree with the advisability of the measures the Finance Board presented in the proposed rule. However, putting those objections aside, it is difficult to evaluate the retained earnings and excess stock measures without knowing how the Finance Board intends to alter the rest of its regulatory capital framework.

On March 8, 2006, the Finance Board held a public meeting during which the proposed rule was discussed among the Finance Board Directors. A record of that meeting (the Finance Board Meeting Record) is available⁵ and will be referenced in our letter. Even as to the currently proposed minimum retained earnings requirement, Finance Board staff stated that it "should be viewed as a first step...we intend to explore the development of a more refined approach."⁶

In addition, Finance Board staff indicated that over the next twelve to eighteen months, they will be considering amendments to the risk-based capital rule to streamline the market risk component. Further, the Finance Board Meeting Record reflects intent to update the credit risk component, possibly to conform to Basel II. There is also a plan to update the operational risk component, and a plan to consider changing or amending requirements for Finance Board pre-approval of changes to the market risk models of the FHLBanks. As a catch-all, the Finance Board Meeting Record indicates that "in considering ideas for improving our retained earnings and risk-based capital requirements, we plan to review best practices and explore alternatives with the banks, other regulators and other market participants."⁷

In the midst of plans to change the risk-based capital parameters in numerous ways and to consult and compare notes with other parties, not to mention plans to change one important aspect of the proposed rule, it seems to us that release of the proposed rule was untimely. The proposed rule seems particularly unnecessary at this time in view of the position of Finance Board staff that "the risk of capital insolvency for any Federal Home Loan Bank is extremely remote. [emphasis added]"⁸

We understand that oversight of the complex institutions that the FHLBanks have become will require the Finance Board to review its policies constantly for their adequacy. However, we believe that prior to publication of a rule, even in proposed form, there should not be then-current plans by the regulator to change it unless there is an urgent need for

⁵ The Finance Board Meeting Record is available at <http://www.fhfb.gov>.

⁶ See Finance Board Meeting Record at p. 13.

⁷ See Finance Board Meeting Record at p. 14.

⁸ See Finance Board Meeting Record at p. 10.

the rule. There is no such need by the Finance Board's own admission, and publication of the proposed rule was premature.

III. The proposed 1% excess stock limitation and other restrictions on excess stock would reduce the flexibility of the FHLBanks and could thereby burden their members, and would make participation in FHLBank programs more difficult for some members.

The FHLBank of Cincinnati stated in its comment letter that the "economic value to a member of an individual FHLBank is a function of two components---the long-term, after tax, *risk adjusted* return on capital and the value of access to the services available from that FHLBank."⁹ We agree entirely with that summary.

For some of our members, their investments in their FHLBanks are the largest investments they own. Most of them rely on the FHLBank advances they receive for their favorable funding rates. However, they also evaluate the value of their membership based on the dividends they receive, the availability of the FHLBank as an execution outlet for their mortgages and the complete array of other services offered by the FHLBank. The value of the dividends often is about evenly comparable to the availability of the advances in evaluation of the return on capital for FHLBank membership.

The Finance Board proposes to limit excess stock to 1% of an FHLBank's total assets, to prohibit the sale of excess stock and to prohibit entirely the payment of a dividend in the form of stock. The rationale stated for these measures is that excess stock leads to balance sheet inflation and to investment in non-advance related business, for which the Finance Board clearly has an aversion. In addition, the Finance Board fears that if the custom (but clearly not the requirement) of the FHLBanks' prompt repurchase of Class B stock (redeemable by its terms upon five years' notice) is ever discontinued, it would create some lack of confidence in the FHLBanks.

There are advantages to members in the payment of dividends in the form of stock, including the deferral of tax otherwise payable on the dividends, and the ability to use some of the FHLBank programs without purchasing additional stock. These benefits are not trivial and neither is the burden to members that would result from having to recognize tax liabilities at an unexpected time due to Finance Board imposition of the excess stock restriction.

MBA questions if the Finance Board has undertaken an analysis of the impact of this measure, or any other measures in the proposed rule, on the members of the FHLBanks or on the operations of the FHLBanks themselves. From the member standpoint, the measure is undesirable due to the tax implications and also because receipt of dividends in the form of excess stock helps members, particularly small members, because they do not need to purchase additional stock with cash assets in order to expand their participation in FHLBank programs. For the FHLBanks, it limits their flexibility substantially

⁹ See April 28, 2006 Public Comment Letter of the Federal Home Loan Bank of Cincinnati, signed by Charles J. Koch, Chairman of the Bank, and available at <http://www.fhfb.gov>.

and forces them to use cash to redeem outstanding excess stock in lieu of using those resources to generate profits to be shared with their members.

The Finance Board does not make a convincing case that there is a current or a foreseeable problem associated with the excess stock. As noted, the Finance Board's rationale for its proposal rests in part on its view that the excess stock could be used to facilitate programs other than advancing, such as the mortgage programs and certain portfolio investments. In addition, the Finance Board fears member loss of confidence if their Class B stock functions according to its terms. We think the Finance Board's fear is speculative and that there is more reason to fear member loss of confidence due to unpredictable regulatory requirements, for example, those that could cause unanticipated tax consequences or decreased dividend distributions.

The Finance Board should not confuse its safety and soundness and mission oversight functions with a philosophical preference for restricting the FHLBanks to the safest and most traditional of their functions. The investments of the FHLBanks in mortgages, mortgage-backed securities and liquid instruments are consistent with their mission. Those programs and investments produce profits for the FHLBanks, additional member services and funds for AHP contributions.

The Finance Board has stated no realistic basis in mission or safety and soundness for curtailment of dividend distributions in the form of stock and no basis for requiring rapid adherence to a 1% excess stock restriction.

IV. Where an FHLBank's excess stock level is below the 1% ceiling, distribution of dividends in the form of excess stock should be permitted.

The Finance Board asked explicitly in the proposed rule for comments whether a dividend distribution in the form of excess stock should be permitted in the event that an FHLBank has not reached its permitted 1% ceiling for excess stock. MBA believes it is consistent with our opposition to a ceiling that an FHLBank should be able to distribute an excess stock dividend if it has less than 1% excess stock outstanding.

V. The Finance Board should not impose the retained earnings requirements in the proposed rule because those requirements are inconsistent with GLBA and would deprive the FHLBanks' management of flexibility in structuring their permanent capital and would represent a tax on the mission of FHLBanks.

Both the Finance Board Meeting Record and the proposed rule demonstrate that the Finance Board views retained earnings as a superior form of permanent capital to Class B stock, which is redeemable upon five years notice. In this regard, the Finance Board holds a viewpoint inconsistent with GLBA and its construction of permanent capital and a viewpoint inconsistent with the practice of many of the Federal Home Loan Banks.

The Finance Board Meeting Record recognizes that, "At present, all twelve Federal Home Loan Banks exceed their minimum capital requirements. And the risk of capital insolvency for any Federal Home Loan Bank is extremely remote...In making this proposal [referring

to the retained earnings requirement], there's no question about the capital solvency of any Federal Home Loan Bank. The proposal is designed to address the composition of the capital."¹⁰

The Finance Board proposes that each FHLBank, regardless of size, should retain earnings equal to \$50 Million and 1% of non-advance assets. If an FHLBank does not have sufficient retained earnings to meet the requirement, then dividend payouts in excess of 50 percent of net earnings would be subject to Finance Board approval. Furthermore, the language of the proposed rule reinforces that the proposed \$50 Million and 1% would be a **minimum** and that the Finance Board could "refine" (which we assume to mean "increase") the minimum retained earnings level if an FHLBank is exposed to market or credit risk.¹¹

The Gramm-Leach-Bliley Act of 1999 defined permanent capital of the FHLBanks to include both Class B stock and retained earnings. No specific formula for the two sources of permanent capital was specified by Congress. To the contrary, there is every indication that Congress intended for the individual FHLBanks to have the ability, based on the needs of their members and the business goals of the individual institutions, to decide on the appropriate mix of retained earnings and Class B stock.

The current retained earnings proposal represents the decision of the Finance Board that retained earnings are superior to stock, regardless of how long a notice period attaches to the stock. While we appreciate the need for the FHLBanks to provide for losses and to protect the par value of their stock, we believe that there is a point where excessive loss provisions interfere with the dynamic mission of the FHLBanks. Effectively, the Finance Board is asking the FHLBanks to set aside billions of dollars which would otherwise be distributable to member institutions that engage in residential mortgage lending. That money belongs to the members and, through the leadership of their FHLBanks, they should be able to determine if there is a need for earnings to be retained against risk, subject to the permanent capital requirements of GLBA.

As the Finance Board acknowledges, there is no current risk or loss-related reason for an increase in permanent capital. The Finance Board has not made the case that retained earnings are 'better' than paid-in capital in the form of Class B stock, that the GLBA parameters are insufficient, and that there is a compelling reason to subject the FHLBanks and their members to the dividend restrictions which would be necessary for some of the FHLBanks.

VI. The retained earnings requirement in the proposed rule is arbitrary and bears no relationship to the risk-based nature of the FHLBanks' non-advance assets and no relationship to the individual risk profiles of the FHLBanks.

The proposed rule discusses the mechanism through which the Finance Board arrived at the 1% level and the \$50 million level as retained earnings minimums for each of the

¹⁰ See Finance Board Meeting Record at p. 10 and p. 12.

¹¹ 71 Federal Register at 13312.

FHLBanks in terms of “estimates,” “approximations,” “and ease of application.” In an era of risk-based capital evaluation by regulators, we see the broad brush approach as being inconsistent with the high standards the Finance Board holds for itself.

It is obvious that different FHLBank strategies for investment and program availability will lead to different risk profiles. While the proposed dollar and percentage levels are described as “minimums,” it seems to us that those minimums are in fact quite significant given the volume of non-advance assets against which they are measured. The Finance Board should undertake the refinement it already recognizes is necessary to the “one size fits all” approach before they publish even a proposed retained earnings rule.

VII. MBA believes that the retained earnings requirement will discourage the FHLBanks from engaging in activities that are consistent with the mission of the FHLBanks.

The Chairman and Ranking Member of the Committee on Financial Services of the House of Representatives recently wrote to the Chairman of the Finance Board with regard to the proposed rule, asking a series of questions about its impact.¹² The interest of these Congressional leaders in the proposed rule is reassuring to our members and we look forward to any Congressional hearing on the rule. Representatives Oxley and Frank look at the proposed rule from the standpoint of what it will do to the mission and effectiveness of the FHLBanks. At MBA, we think that perspective is very important.

MBA believes that the Finance Board’s rule will adversely impact the mortgage programs of the FHLBanks and their investment in mortgage-related securities to the detriment of profitability, member return on investment and the value of the FHLBanks to the community they serve.

MBA supports the mortgage programs which we believe function to lower housing costs through increased market competition while providing a valuable mortgage execution service to members of participating FHLBanks. Over 900 FHLBank members have joined the Mortgage Partnership Finance (MPF) program and others are participants in the Mortgage Purchase Program (MPP). Information for the MPF program shows that 83% of its participants are community financial institutions.¹³ Questions about whether MPF was an appropriate FHLBank program were resolved when a U.S. District Court (affirmed by the Fifth Circuit) found that the mortgage program was consistent with the mission of the FHLBanks.¹⁴ Furthermore, MPF and MPP provide the FHLBanks with a line of business

¹² See letter of June 30, 2006, from Chairman Michael G. Oxley and Ranking Member Barney Frank to The Honorable Ronald A. Rosenfeld, Chairman of the Federal Housing Finance Board.

¹³ See Mortgage Partnership Finance Press Release, dated July 25, 2005, at http://www.fhlbmpf.com/docs/press/2005/050725_pr.pdf.

¹⁴ See Texas Savings and Community Bankers Association, et.al, v. Federal Housing Finance Board (W.D. Texas 1998) affirmed by the United States Court of Appeals for the Fifth Circuit (2000). The District Court rejected the arguments that the FHLBanks had no authority to hold mortgage loans in portfolio and concluded that 1) the FHLBanks have such authority, 2) mortgage program funding is the functional equivalent of traditional FHLBank advances, and 3) the challenged mortgage program was “incidental” to the housing finance mission of the FHLBanks.

to augment the advance programs. In operation, the mortgage programs have been profitable and have generated negligible losses while providing a member benefit. We do not understand the motivation of the Finance Board in moving to diminish the size of those programs.

The predisposition of the Finance Board to the nearly risk-free advancing programs is understandable, but we believe the FHLBanks can and should do more. Certainly there is reason for concern for the health of the FHLBanks if their efforts to expand beyond single line businesses are handicapped by unnecessary capital restrictions.

The proposed rule would result in limitation of the mission of the FHLBanks through capital regulation. While the mission of the FHLBanks is a topic of legitimate discussion and debate, we think that debate should take place in Congress, among the FHLBanks themselves and among all participants in the housing finance system. The proposed rule, if enacted, would preempt that important debate.

VIII. We believe the proposed rule, if implemented, would be damaging to the value of FHLBank membership, the profitability and financial health of the FHLBanks, and the ability of the FHLBanks to contribute to AHP.

For members of the FHLBanks, the proposed rule, if finalized, would be problematic in several ways. Higher retained earnings requirements mean that their money will be held against losses and not distributed as dividends. The need for some FHLBank members to recognize tax liability on excess stock previously received as dividends would impose a potentially severe and unnecessary financial burden. To the extent that the proposed rule would place another requirement on the mortgage programs, a membership advantage would be diminished.

For the FHLBanks themselves, the proposed rule would leave them with less management flexibility and no certainty as to where the Finance Board is going on their framework for regulation of capital. The mortgage programs and their investments in mortgage-related securities, both of which are profitable and consistent with their mission, would be less viable. With potential profits not available from those sources, there would be potentially less to contribute to AHP.

Although regulation of financial institutions is expensive, it is essential. However, individual regulatory proposals should be tested to determine if they restrict or take away more institutional value than the security the regulator is trying to obtain is worth. Furthermore, regulation should be directed to the goals of safety and soundness and not toward eliminating programs and powers through indirect means.

Conclusion

The Finance Board's 120-day comment period on the proposed rule allowed the FHLBanks, their members, housing finance trade associations, low-income housing advocates, policy makers and other interested parties to communicate with one another on the proposed rule. As the Finance Board is aware, an extraordinary amount of

coordination and discussion ensued. Earlier letters to the Finance Board asking for withdrawal of the proposal and comment letters like this one reflect the nearly universal and deep concern all of us have about the potentially adverse impact of the proposed rule. The proposed rule is not a good or sufficient foundation for proceeding to final regulatory action.

MBA recommends that the Finance Board refrain from proceeding to issue a final rule based on the proposed rule. We ask that the Finance Board build on the comments it receives on the proposed rule through issuance of an Advance Notice of Proposed Rulemaking (ANPR) as a framework for further discussion of the best approach to capital regulation for the FHLBanks. There is certainly room for constructive thought and debate on how to regulate a cooperative institution, and the FHLBanks, in particular, to balance the goals of safety and soundness, support for housing finance, member service and service to those who are in need or underserved.

MBA commends the Finance Board for giving interested parties time to consider the proposed rule. Prior to the comment period, the Finance Board and its staff were generous in making themselves available to hear the views of MBA and our members on this subject and others within the Finance Board's jurisdiction. We thank the Finance Board and its staff for their dedication to satisfying their regulatory obligations and their open door policy. We look forward to further discussion of the issues relevant to the FHLBanks and regulation of their mission and safety and soundness. Any questions regarding any of the comments or recommendations in this letter should be referred to Kathy Gibbons, MBA Senior Director for Government Affairs, at 202/557-2870 or kgibbons@mortgagebankers.org.

Sincerely,



Regina M. Lowrie, CMB
Chairman
Mortgage Bankers Association