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July 12, 2006

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

Attention: Public Comments

Subject: Federal Housing Finance Board (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

The Board of Directors of the Federal Home Loan Bank of Des Moines (Bank) appreciates the opportunity to comment on the proposed rule concerning excess stock restrictions and retained earnings requirements (Proposed Rule). We share the Finance Board's commitment to preserving the safety and soundness of the FHLBank System but are concerned that the Proposed Rule, if adopted in its current form, could have a negative impact with respect to safety and soundness. Based upon such concern and other considerations, the Bank respectfully requests that the Finance Board withdraw the proposed regulation. Notwithstanding such request, the Bank supports the issuance of an Advanced Notice of Proposed Rulemaking recommended by the chairs and vice chairs of the 12 FHLBanks with regard to the Proposed Rule.

The Bank believes that the broad approximation of a Retained Earnings Minimum (REM) in the Proposed Rule will have long-term, negative implications for the FHLBanks and their members. Moreover, we believe that the Proposed Rule is not necessary given the current capital structure of the FHLBank System developed in response to the Graham-Leach-Bliley Act of 1999, which we believe adequately addresses issues pertaining to the FHLBanks' capital requirements.

Each of our concerns related to the Proposed Rule is discussed in detail below.

**The Proposed Rule could Encourage FHLBanks to Assume more Risk under the Broad Approximation Method to Determine the Retained Earnings Minimum (REM)**

The Proposed Rule provides a formula for calculating the REM. The formula provides that the REM shall be $50 million plus 1% of the average non-advance assets of a FHLBank. The Bank believes the proposed formula is an overly simplistic and arbitrary method of determining appropriate capital stock levels relative to the true risk position of a FHLBank. Such an approach seems particularly inappropriate in an era when international regulatory standards for banks continue to develop towards more sophisticated and dynamic risk-based capital models.

While we strongly agree that retained earnings play an integral part in protecting the market value of members' capital stock investment in light of potential market events and shortfalls in periodic Bank earnings, in our estimate the appropriate minimum level of retained earnings should be influenced by each FHLBank's balance sheet composition and implemented business model rather than through a broad approximation methodology.

The REM formula contained in the Proposed Rule fails to distinguish the various levels of risk associated with the different types of non-advance assets, such as cash, Fed Funds, and mortgages that are held by the FHLBs. In failing to weigh the different level of risk attributable to these very distinct forms of non-advance assets, the Proposed Rule could have the perverse impact of providing an incentive for the FHLBs to invest in riskier, higher-yielding instruments, since there is no difference in the charge to capital for doing so. Given the level of retained earnings at some FHLBs, and the attendant need to minimize the time during which dividend payments would be limited in order to meet the proposed REM, it is possible that some FHLBs may make riskier investments to meet the REM sooner.

**<u>The Methodology for determining REM under the Proposed Rule Does Not Capture the True Risk Position of the FHLBanks and Ignores Better Measurements for Determining such Position.</u>**

In the Bank's view, the Proposed Rule penalizes FHLBanks that maintain a more conservative non-advance investment portfolio. Currently, our Bank determines the appropriate level of retained earnings by measuring three different risk components: market, credit and operational risk. The Proposed Rule's formula for determining minimum retained earnings would require a retained earnings level that would currently be approximately 20% higher than the level determined by the Bank's analytic, risk-based model. Among other shortcomings, the absence of applicable risk factors in the proposed retained earnings minimum calculation does not take into account the due diligence required in determining a risk-based capital structure.

**<u>The Proposed Rule Would Negatively Impact the Members of Adequately Capitalized Smaller FHLBanks</u>**

The Proposed Rule would disproportionately penalize members of adequately capitalized smaller FHLBanks for the following reasons. The REM required under the Proposed Rule would account for more than 5.50% of total regulatory capital required for the advances of one of the smaller banks in the system while only accounting for approximately 0.75% of total regulatory capital required for one of the larger banks in the system. Given that both Banks meet the requirements of the Graham-Leach-Bliley Act of 1999, members of the smaller adequately capitalized FHLBanks would be disproportionately penalized by requiring their FHLB to hold a significantly larger portion of revenue as retained earnings rather than paying it out to members as a return on the capital they provide to the system.

**The Proposed REM Broad Approximation Fails to Provide Transparency and Clarity for Risks Associated with Individual Banks**

Although the Proposed Rule purportedly only sets a minimum requirement for the amount of retained earnings needed to be held by an individual FHLBank, we note that, as proposed, the Finance Board could subjectively require a FHLBank "to hold levels of retained earnings that would be higher than calculated under the formula….This flexibility would allow the Finance Board to refine a Bank's REM if a Bank is more exposed to credit or prevailing market risks than would be captured by the formula"[1]. By including this language in the proposed regulation, the Finance Board appears to acknowledge that the proposed methodology does not necessarily capture the true risks of a FHLBank as compared to methods that employ analytics, such as market value sensitivities and Basel II credit exposure methodologies referred to in the Proposed Rule. The proposed methodology therefore could lead to an inaccurate or even misleading reflection of the risk associated with members' investment in their respective FHLBank. Additionally, the flexibility provided by allowing the Finance Board to require a FHLBank to hold levels of retained earnings above the calculated formula suggests that the Finance Board may analyze each FHLBank's risk based on a more analytic method such as those described as above, which in turn calls into question the benefit of dual formulas and calculations when the analytic method is arguably more robust and directly related to risks facing the FHLBanks in the first instance.

**The Proposed Rule Discourages On-Going Business in AMA Programs (MPF® and MPP®)**

The Finance Board has authorized AMA programs that allow qualified members to sell to their FHLB mortgage loans rather than retain them on their own balance sheets with the related interest rate risk management and balance sheet funding requirements. The Bank believes these programs are important to our members. By its arbitrary REM requirements for non-advance assets, the Proposed Rule would adversely impact the MPF® program offered by FHLB-Chicago and participated in by many of the system FHLBanks and the MPP® program offered by other individual FHLBanks fulfilling this member need. The Proposed Rule provides no relief to those FHLBanks that conservatively manage their MPF®/MPP® assets. To the contrary, the Proposed Rule actually provides an incentive to increase the risk of these positions in order to increase the amount of earnings that are generated from these assets.

[1] Proposed Rules – Federal Register, Vol. 71, No. 50, pages 13312 – 13313.

**Conclusion**

The Bank views the Proposed Rule as unnecessary and believes that by substituting simplistic, arbitrary REM requirements rather than more rigorous analytical measures that result in dynamic capital requirements related to true risk, the Proposed Rule, if adopted in its current form, will negatively impact the Bank and the FHLBank system as a whole and thwart the Bank's efforts to operate safely and soundly and protect capital stock against impairment.

The Proposed Rule's REM formula actually could have the unintended effect of encouraging additional risk-taking by FHLBanks, threaten the profitability of the community banking system and discourage the continuance of AMA programs offered to members.

Respectfully, we strongly urge the Finance Board to withdraw the Proposed Rule, and issue an Advanced Notice of Proposed Rulemaking in accordance with the recommendation of the chairs and vice chairs of the 12 FHLBanks.

Respectively,

Randy L. Newman

Randy L. Newman
Chairman of the Board

Richard S. Swanson

Richard S. Swanson
President and CEO