FHLBank
Topeka
Building Communities Together

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July 12, 2006

By e-mail to comments@fhfb.gov

Federal Housing Finance Board
1625 Eye Street NW
Washington DC 20006

Attn: Public Comments

Re: Federal Housing Finance Board Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for Federal Home Loan Banks.
RIN Number 3069–AB30. Docket Number 2006–03.

Ladies and Gentlemen:

The Federal Home Loan Bank of Topeka (FHLBank Topeka) is pleased to submit comments on the proposed rule on Excess Stock Restrictions and Retained Earnings Requirements published in the *Federal Register* March 15, 2006.

We agree that the Federal Housing Finance Board (Finance Board) must continue to carry out its statutory mission to ensure that the Federal Home Loan Banks (FHLBanks) "operate in a financially safe and sound manner" and, to the extent consistent with that primary mission, ensure that they "carry out their housing finance mission" and "remain adequately capitalized and able to raise funds in the capital markets." However, we firmly believe that the proposed rule is unnecessary and could have serious adverse consequences for the FHLBanks, their members - especially community banks - and housing and community development. More specifically, we concur with the thought recently expressed by the Honorable Michael G. Oxley and the Honorable Barney Frank that the proposed changes may go to too far and actually harm the Federal Home Loan Bank system more than protect it. Consequently, we strongly urge the Finance Board to withdraw the proposed rule, for the above-mentioned and additional reasons summarized below.

The proposed rule is unnecessary. In the preamble, the Finance Board stated:

> "The Finance Board believes that its capital rules and the Banks' overall capital levels remain adequate and the risk of capital insolvency at any Bank in the foreseeable future is *de minimis.*" (71 *Fed. Register* 13306, 13311 [March 15, 2006])

FHLBank Topeka has a rigorous process to evaluate the risks of its current balance sheet and assess the adequacy of its retained earnings under a large number of possible scenarios, in compliance with Advisory Bulletin 2003-AB-08. We are confident that we have sufficient retained earnings to address even the worst case scenario. In addition to Advisory Bulletin 2003-AB-08, the FHLBanks are subject to numerous other capital and risk management requirements. If the Finance Board believes that the retained earnings level or policy of FHLBank Topeka, or any other FHLBank, is inadequate, it can more effectively address its concerns through the examination process, based on such FHLBank's particular needs and situation, than by subjecting all FHLBanks and their members to the crude mechanism of a simplistic, one-size-fits-all standard.

The proposed rule could have serious adverse consequences. Knowledgeable independent observers have predicted that the proposed rule could have serious adverse consequences on the FHLBanks and their members. A Fitch Ratings report predicted that the proposed rule:

> "...could have a negative effect on membership trends and put pressure on the financial condition of some of the FHLBanks. ... If significant enough, the end result could destabilize some FHLBanks, which would impair not only the value of any remaining stock, but also their cash flow, and consequently their ability to provide advances and other products." (Fitch Ratings Special Report, "Insurance Company Usage of the Federal Home Loan Bank System on Rise," at 1, 5 [May 15, 2006])

Another independent report commented on the adverse impact on community banks from the significant reduction in dividends that will result until FHLBanks can meet the Retained Earnings Minimum ("REM"):

> "Smaller banks suffer twice under the proposal. Not only do they lose the dividend income on their FHLB stock, but most also are unable to limit their downside by switching to other funding sources. Big banks, by contrast, can tap Wall Street directly for financing." (Stanford Washington Research Group, Financial Services Policy Bulletin: "FHLB Capital Proposal Bigger Threat to Smaller Banks," at 1 [April 17, 2006])

The combination of the excess stock limit, the REM and the severe limitation on dividends when the REM is not attained may compel an FHLBank to shrink its non-advance assets, resulting in lower income and earnings. Since much of these non-advance assets are highly liquid money market securities, an unintended consequence of the proposed rule will be that it will force a well run FHLBank to decrease its liquidity position. The negative unintended consequence only gets worse when the decrease in liquidity will make it more difficult for an FHLBank to provide liquidity to its members as they need it, which will then reduce their ability to effectively provide credit for their communities.

The proposed rule may also reduce an FHLBank's advance balances. We believe this is the case because dividends are a significant factor in the cost of advances to members. Lower dividends will increase the cost of advances and make them less attractive to our members. To make matters worse, the proposed rule would restrict an FHLBank's ability to pay dividends when its retained earnings are below a prescribed minimum. We believe the likely result of this double assault is that many members will reduce their advance balances with such an FHLBank, lowering their mission-related assets and further reducing income and earnings.

Lower earnings will mean less money available for the Affordable Housing Program and other mission-related community investment activities.

Because there is no public market for FHLBank stock, which cannot appreciate beyond its $100 par value, dividends are the only means by which members can earn a return on their investment in FHLBank stock. Consequently, the maintenance of appropriate dividend levels is of much greater importance to an FHLBank member than to shareholders of most other corporations. Therefore, the lower dividends that could result from adoption of the proposed rule would not only decrease the level of FHLBank advances, but probably will induce some members to decide that FHLBank stock and membership are no longer a worthwhile investment. Such members might withdraw from FHLBank membership. This unfortunate consequence would further reduce advances, income and earnings, further decrease the funds available for our Affordable Housing Program and other mission-related community investment activities, and generally reduce an FHLBank's effectiveness in carrying out its housing finance mission.

We have the following further comments regarding certain provisions of the proposed rule:

1. Stock dividends should not be prohibited. The payment of dividends in stock rather than cash allows members to defer taxation of their dividends. This valuable benefit should not be taken away unless it can be shown that the payment of stock dividends results in substantial harm, which cannot be addressed by any less drastic measure. The preamble to the proposed rule states:

> "The Finance Board also believes that it would be difficult for Banks to issue stock dividends on other than a sporadic basis and still comply with the proposed limit on excess stock." (71 *Fed. Register* 13306, 13309 [March 15, 2006])

On the contrary, FHLBank Topeka has been paying stock dividends since December 2003, and is well within the proposed excess stock limit. Given the adoption of an appropriate limit on the amount of excess stock, there is simply no basis to prohibit stock dividends. So long as an FHLBank controls the amount of excess stock outstanding, no regulatory objective is achieved by banning stock dividends.

2. The limit on excess stock should be higher than 1 percent of total assets. Based on historical experience and the lack of any explanation in the preamble to the proposed rule on how the 1 percent limit was determined, we believe a 1 percent limit is too low. A higher limit would provide greater flexibility for an FHLBank to hold liquid assets and thereby maintain higher liquidity, increasing its ability to operate in a safe and sound manner and better serve its members' fluctuating advance needs. In addition, we question why the rule limits excess stock regardless of what that excess stock is capitalizing. Specifically, while we follow the rationale that excess stock should not be used to support long-term illiquid assets, we do not believe it is a safety and soundness concern if excess stock capitalizes short-term, highly liquid, highly rated money market investments. As noted earlier, those investments provide greater liquidity to an FHLBank and reduce rather than increase its risk profile. Finally, distinct from the sentiment expressed in the proposed rule, we view excess stock as permanent

capital and we believe members do as well. Members recognize that we will not waive the redemption periods if the capital stock is needed to meet our capital requirements.

3. There should be a reasonable phase-in period to meet the REM. The proposed rule would limit dividends to 50 percent of net income immediately if the REM is not met when the regulation is effective. The 50 percent immediate limitation is too severe and restrictive and could significantly hurt a member's income. It is also unreasonable and unfair to impose a dividend restriction the day the rule becomes effective. There should be at least a three-year implementation period where dividend restrictions are not imposed if an FHLBank is making reasonable progress in meeting its REM. Consistent with normal corporate governance practice, it should be up to each non-complying FHLBank to determine during the implementation period how it comes into compliance with its REM, including the decision to pay out lower dividends or to gradually reduce the amount of non-advance assets it holds.

4. The REM applicable to money market assets should be reduced. There is no justification for imposing the same retained earnings requirement on money market assets as is required for 30-year, fixed-rate mortgages. For example, it would not unduly complicate the rule to make the REM equal to $50 million plus ¼ or ½ percent of money market assets and 1 percent of non-advance, non-money market assets.

5. The REM applicable to FHLBank Topeka's mortgage purchase program should be reduced. The FHLBank Topeka already requires a 2 percent stock purchase to support all mortgage purchase program assets, therefore, an additional 1 percent holding in retained earnings is excessive.

6. Once fully implemented, there should be some flexibility before dividend restrictions are imposed. The proposed rule would impose the 50 percent limitation immediately when an FHLBank failed to meet its REM. This will effectively require an FHLBank to hold substantially more than its REM in order to prevent a violation through normal balance sheet volatility. For example, it would be preferable to impose dividend restrictions only in the event that an FHLBank falls below 90 percent of its REM in a quarter or fails to meet its REM for three consecutive quarters. In addition, we believe the percentage payout limitation should vary based on how far below its REM an FHLBank may be. For example, a payout ratio of 70 percent may be appropriate if an FHLBank is at 90 percent of its REM, but 80 percent may be more appropriate if the FHLBank holds 95 percent of its REM. Given that the current REM calculation is very conservative (relatively high level of retained earnings being required), the flexibility allowed before dividend restrictions are imposed would achieve the Finance Board's objective while not being as operationally difficult for the FHLBank.

7. The payout of dividends should not be tied to income earned in a specific period. The rule appears to suggest that dividends paid in a period must relate to earnings in that period and be paid to stockholders proportionate to the stock held in that period. While there is no question but that dividends over a period of time will reflect income earned, common corporate governance and dividend practice does not relate dividends paid in a specific time period to the income earned in that specific time period. We believe that the board of a well performing FHLBank must and should have the ability to manage dividend levels over time.

Importantly, members benefit from a stable dividend policy over time as it provides them greater confidence in dividend levels so that they can better evaluate the dividend impact on the overall cost of borrowing.

We appreciate the opportunity to comment on the proposed rule. If you have any questions or would like to discuss any of our comments, please call me at (785) 438-6001.

Sincerely,

Andrew J. Jetter
President and CEO