WORLD SAVINGS

July 11, 2006

Via Email: comments@fhfb.gov

Ronald A. Rosenfeld, Chairman
Federal Housing Finance Board
1625 Eye Street, NW
Washington, DC 20006

Attention: Public Comments

Re: Proposed Rulemaking Concerning Capital, Stock Dividends and Excess Stock

Dear Chairman Rosenfeld:

We appreciate this opportunity to comment on the Federal Housing Finance Board's proposed rulemaking regarding Federal Home Loan Bank capital rules, stock dividends and excess stock.[1] For the reasons discussed below, we believe the proposal requires significant revision if it is to achieve the goals which the Board has enumerated. We believe the proposed regulation does not create an appropriate capital structure, in some instances may have the opposite result of what is intended and, if approved in its current form, would likely have major adverse consequences for the FHLBanks, their members, other FHLBanks, the System and their respective communities. For these reasons, we are strongly opposed to the proposed regulation, particularly since it undercuts safety and soundness rather than strengthening it.

In the past several months, we have talked extensively with other FHLBank members and groups representing those members, both in analyzing the potential impact of the proposed regulation and in reviewing a number of draft comment letters. We have been impressed with the degree to which members and the FHLBanks have found consensus on this set of issues, and we support the thrust of their comment letters.

We encourage the Finance Board to withdraw the proposed regulation and issue an Advanced Notice of Proposed Rulemaking. In doing so, the Finance Board should create a process for a thorough analysis of what the risks at individual Banks and in the System are and how those risks, if they exist, are best addressed. And the implementation of any new capital regulations, assuming any are appropriate, must be done within the Gramm-Leach-Bliley construct, which intended that the capital of a given FHLBank, including retained earnings, should be part of a comprehensive capital plan for each FHLBank.

If we were to say nothing else, we would simply urge every Finance Board director and every policy-making staff member to read again the article by Alex Pollock that appeared in the April 28, 2006 issue of the American Banker, a copy of which is attached. Mr. Pollock has gone to the core of the issues in

[1] Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks, 71 FR 13306 - 13316 (Mar. 15, 2006).

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his article and states with the utmost clarity the fundamental errors in the Finance Board's proposal. And if the Finance Board can somehow argue against what Mr. Pollock says, we would request that the Finance Board share those contrary views with the public, because those of us who have decades of experience in running regulated banking institutions find Mr. Pollock's positions on this matter to be absolutely correct.

Rather than duplicate the other extensive comments that have already been submitted, we will merely enumerate our primary concerns:

- The proposed retained earnings formula is overly simplistic, is not based on an accurate economic analysis, and does not take into consideration the specific risks and risk management policies and practices of each FHLBank.

- The proposed retained earnings formula creates a retained earnings target that seems excessive in relation to the risks to the par value of capital stock for at least some FHLBanks.

- The proposed retained earnings formula creates incentives to take on more risk and reduce liquidity.

- A prescriptive 50% dividend payment limitation is unnecessarily harsh and limits the ability of an FHLBank to maintain safety and soundness while fulfilling its members' needs.

- Prohibiting dividends in a case where the level of retained earnings falls below the target level after it has been reached constrains the expansion and contraction features of an individual FHLBank as well as the FHLBank System, unnecessarily harms members and is out of proportion to the likely triggering events.

- The proposed regulation reduces the value of FHLBank membership by increasing the all-in cost of advances.

- The proposed regulation will cause members to seek funding elsewhere, with the result that the costs for the remaining members will increase still further, and with fewer members to cover the costs of an FHLBank's and the System's infrastructure.

- Defining net income available for dividends based on current quarter GAAP net income creates a disincentive to retain earnings that are the temporary result of accounting volatility and, in fact, promotes dividend volatility.

- The prohibition of stock dividends is not necessary to reduce the amount of excess stock in the FHLBank System, there are other more effective ways to address excess stock, and the prohibition of stock dividends would be damaging to members and is unnecessary.

We do not agree that there is justification for the Finance Board's proposed regulation. We believe a thorough analysis will show that even if it can be demonstrated that there are problems that need to be addressed, which itself is not a clear proposition, there are more effective ways to address those problems. Moreover, the specific provisions of the proposed regulation may have serious adverse consequences, including safety and soundness, for the FHLBanks, their members, the System, and their respective communities.

Because the proposed regulation would significantly change the capital structures of the FHLBanks, it is imperative that the objectives, benefits, and potential adverse consequences of the proposed changes be carefully weighed and fully understood prior to implementation. The appropriate way to address any valid capital concerns is to request modification of a particular FHLBank's capital plan, including an appropriate assessment of specific risks at that particular FHLBank. Given the critical role played by the FHLBanks in the nation's housing finance system, these proposed regulatory changes deserve to be fully debated by all affected parties.

We believe a return to the core concepts of production cooperatives, including an emphasis on activity-based stock, would far more effectively accomplish what the Finance Board seems to intend in the proposed regulation.

We urge the Finance Board to withdraw the proposed regulation and issue an Advanced Notice of Proposed Rulemaking.

Sincerely,

Herbert M. Sandler
Chairman of the Board
and Chief Executive Officer

Attachment

AMERICAN BANKER ONLINE
THE FINANCIAL SERVICES RESOURCE

Viewpoint: No Reason to Tighten Dividend Rules for FHLBs

From: American Banker
Friday, April 28, 2006
By Alex J. Pollock

The Federal Housing Finance Board, which regulates the Federal Home Loan banks, has proposed a regulation that would mandate increasing retained earnings by cutting dividends to member banks, even though the FHLBs have plenty of capital.

A number of the FHLBs have warned their members that the proposal would force them to make large cuts in their dividend rates. In the San Francisco bank's case, it estimates that the dividend would be reduced by almost half, to 2.5%, and with the three-month Libor about 5%, the regulation would cause negative carry of 2.5% on their members' stock investment. Since FHLB stock has zero appreciation potential, this would be expensive, indeed.

FHLB members are not pleased, and rightly so, because the Finance Board's position is misguided and conceptually confused.

Interestingly, this same confusion was evidenced more than a decade ago by the Finance Board staff, a few years after the agency emerged from the demise of the old Federal Home Loan Bank Board. Since in the interim there were FHLB capital reforms in the Gramm-Leach-Bliley Act, the position is more off the mark now than it was then.

The role of equity capital, in the FHLBs as elsewhere, is to protect bondholders, depositors, and other creditors. It is not to protect the equity, as in the Finance Board's proposed regulation, where retained earnings are thought to protect paid-in capital. In other words, the Finance Board's idea is to punish the equity investors in order to protect them against themselves.

What apparently has the Finance Board confused is the "par value" notion of FHLB stock. In normal times, members can withdraw their stock at the par value of $100 a share. You might imagine a regulator worrying that if things don't go well, members will withdraw capital.

However, since Gramm-Leach-Bliley was enacted in 1999, the withdrawal right is completely trumped by the statutory prohibition of any withdrawal if the required capital ratio would be breached. Under GLB, there can then be no withdrawals whatsoever. Hence, capital equal to 4% of assets cannot be withdrawn -- and 4% is a very conservative capital ratio, given the low risk of FHLBs.

So fear of capital withdrawal is six years out of date.

But the Finance Board's confusion runs to a deeper level.

They are worried that the par value for members might not be protected. Suppose an FHLB lost money (this has happened, though very infrequently), and the value of its shares dropped below par. Wouldn't it be terrible if the value of the members' stock was $99, instead of $100? Maybe the accountants would make them write down the carrying value by $1.

Two observations:

* No, it wouldn't be so terrible -- the economic effect on members is exactly the same as cutting dividends by $1.

* The Finance Board seems to think FHLB stock is a money market fund.

Note that this issue is not about the safety and soundness of the FHLBs or about protecting bondholders and depositors. It is all an issue inside the equity account.

In its proposal to force the FHLBs to cut dividends and increase retained earnings as a buffer for the par value, the Finance Board is telling the member shareholders: "Here's how we will protect you from yourselves. We will take away a dollar from you today. You can never have this dollar back. In exchange, you will be protected from the minor chance that you might lose a dollar someday in the future."

This is roughly equivalent to offering to buy a dollar from you for a nickel. No one would find such a deal sensible, and naturally, the FHLB members don't. Of course, the idea is not to offer it as a deal, but to impose it as a regulatory mandate.

The situation is made even worse by another part of the Finance Board's proposal, which would force increased taxes on the FHLB members. It would do this by mandating that all dividends be paid in cash, which subjects the members to corporate income taxes. FHLBs have always had the option of paying stock dividends, which result in deferred income taxes for the members.

Because of this effect, the Finance Board proposal is even more expensive for the members.

It is possible that a good many of them are wishing the GSE reform bills pending in Congress, which would create a new regulatory structure, would get moving.

Mr. Pollock is a resident fellow at the American Enterprise Institute. He was previously the president and chief executive officer of the Federal Home Loan Bank of Chicago.