PROVIDENT Bank™

July 10, 2006

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

Attention: Public Comments

RE: Federal Housing Finance Board
Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks.
RIN Number 3069-AB30
Docket No. 2006-03
71FR 13306 (March 15, 2006)

Dear Sir or Madam:

This letter is Provident Savings Bank, F.S.B.'s (Provident) comment on the Federal Housing Finance Board's (Finance Board) proposed rule on excess stock restrictions and retained earnings requirements for the Federal Home Loan Banks (FHLBanks). Provident is a $1.6 billion thrift located in Southern California. Provident is an active borrower with FHLB San Francisco and these borrowings represent over 32% of our total liabilities. As a director of the FHLB San Francisco, I'm very aware of the impact of this proposed rule on FHLB system members as well as my institution. I request that the Finance Board withdraw the proposal and issue an Advance Notice of Proposed Rulemaking to address the numerous issues raised by the current proposal. I believe that an Advance Notice of Proposed Rulemaking provides a better opportunity for discussion and dialogue between the Board and the owners of the System.

Provident strongly opposes the current proposed rulemaking. I have serious concerns about the proposal and believe that the rule, if adopted as currently proposed, could have significant negative consequences for the FHLBanks, their member institutions and the communities they serve. I believe that this rule has a great potential to fundamentally alter the direction and makeup of the System, and limit the System's ability to adapt to future financial challenges and demands.

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Excess Stock Limitation

Provident opposes the limits on excess stock for the following reasons:

- The excess stock provision treats Class B member stock as quick-take out capital rather than the stable source of permanent capital provided by Congress in the Gramm-Leach-Blilely Act ("GLBA").
- The proposal assumes that FHLBank investments to ensure adequate liquidity in the FHLBanks are not mission related investments, when, in fact, the liquidity that these investments provide assures members access to ever-ready advances. The proposed regulation implies that the acquired member assets (AMA) program is not a core mission of the FHLBanks, which is contrary to the Finance Board's regulations. The excess stock restriction is a destabilizing shift in policy by the Finance Board. Having approved some FHLBank capital plans that utilize excess stock to capitalize AMA programs and other activities, the Finance Board is changing course without any factual and legal basis.
- I believe that the FHLBank System would be better served by a system that places greater reliance on membership and activity-based stock requirements to capitalize the System, rather than rely on excess stock purchases. Despite our protests, the Finance Board approved a range for activity based stock that began at zero thus permitting excess stock in lieu of activity based stock for the AMA programs. The Finance Board cannot now change the policy without first undertaking a rulemaking to change the capital regulations governing activity-based stock (12 CFR part 930), and permitting the FHLBanks to resubmit capital plans for approvals.
- The rapidity with which FHLBanks must comply with the Proposed Rule is a grave concern. In order to meet regulatory requirements, FHLBanks may be required to liquidate assets at an imprudently quick pace or be required to substitute inferior forms of capital, for excess member stock.
- The restrictions on excess stock will cause serious tax consequences for many member institutions.

Prohibition on Stock Dividend

Provident opposes the prohibition on stock dividends for the following reasons:

- Stock dividends have for several decades enhanced the stability of the FHLBanks system capital, while providing member institutions a valuable tax savings. Stock dividends clearly benefit both the FHLBanks and their members and should be retained as an option for FHLBanks.
- The Finance Board asked for comments on whether it would be appropriate to permit an FHLBank to pay stock dividends, as long as the FHLBank were in compliance with the excess stock restrictions. In order not to run afoul of the excess stock limit, it is unlikely that any Bank would issue stock dividends.

Retained Earnings Requirement and Dividend Restriction

While Provident agrees that retained earnings are one component of capital for the FHLBanks, I oppose the REM requirement and the restrictions on dividends that are part of that requirement for the following reasons:

- The proposal on retained earnings fails to recognize that Class B stock is permanent capital, as provided by Congress in GLBA.
- The proposal incorrectly assumes that capital in forms other than retained earnings is not available to protect against impairment and to maintain par value of member stock.
- The dividend restriction will cause large member institutions with funding choices to reduce their use of the FHLBank system, which, in turn, will reduce the earnings and increase costs of the FHLBanks. The proposal diminishes the individual cooperative owners' equity in the FHLBank System by transferring a substantial amount of earnings of the FHLBanks to the retained earnings accounts of the FHLBanks, permanently depriving the individual cooperative owners of their interest in those earnings.
- The proposal hinders the FHLBanks' ability to manage liquidity.
- The dividend restriction will result in a destabilizing increase in the cost of advances and other FHLBank services, over the interim term, and will possibly long-term adverse consequences.
- The reduction in dividend income and increase in costs of FHLBank services will have disproportionately greater impact on institutions like Provident.
- The proposal fails to recognize that dividends are an essential component of a cooperative.

Serious Tax Consequences for Member Institutions

The restrictions on excess stock will cause serious tax consequences for many member institutions. The proposed rule would force the early redemption of excess stock above one percent of assets, creating a taxable distribution for many members who otherwise likely would have chosen to hold the stock in anticipation of future borrowing or other FHLBank mission-related activity. The Finance Board estimated that as of December 31, 2005, there was approximately $2.44 billion in member stock at four FHLBanks in excess of the proposed limitation. Although that estimate may not currently be accurate, the precipitous redemption of this stock will create a significant tax liability for the members of these four FHLBanks in the year the stock is redeemed. The proposal fails to recognize that dividends are an essential component of a cooperative.

Stock Dividends Enhance Capital Stability

Stock dividends enhance capital stability in the FHLBank System. Unlike cash dividends, stock dividends actually maintain the level of capital in an FHLBank. Stock dividends are not taxed until the stock is actually redeemed. The tax treatment associated with stock dividends provides an incentive for members to leave the stock in the System. Moreover, the tax savings reduces members' net cost of using FHLBank advances and other services. Stock dividends clearly benefit both the FHLBanks and their members and should be retained as an option for FHLBanks.

Proposal is an Arbitrary Change in Policy

For many years, several FHLBanks have customarily paid stock dividends to their members – with no adverse effects – in large part because of more flexible tax treatment accorded members receiving dividends in this manner. The use of stock dividends has occurred with the approval of the Finance Board and its predecessor, the Federal Home Loan Bank Board. For example, the Finance Board expressly approved the use of stock dividends in connection with the approval of capital plans after the passage of GLBA. In fact, in 2005, seven of the 12 FHLBanks distributed stock dividends. It is arbitrary for the Board to now prohibit stock dividends on a system-wide basis without a clearer justification for the change.

Retained Earnings Requirement

Provident agrees that retained earnings are one component of capital for the FHLBanks. However, Provident opposes the REM requirement and the restrictions on dividends that are part of that requirement for the reasons detailed below.

The Finance Board's proposal implies that retained earnings is the only form of capital available to prevent capital stock impairment by protecting the par value of FHLBank stock, at least with respect to risks associated with non-advance assets. The Finance Board also implies that risks of loss from the advances business can be readily absorbed if necessary by resort to collateral protection and confiscation of membership and activity-based stock purchases in the event of default on advances obligations. This idea of bifurcating different forms of capital to match against different forms of risk is faulty. Different forms of capital, while not identical, are highly fungible at the margin. It is incorrect to regard retained earnings as the only form of capital available to protect against risks arising from non-advances asset holdings, or the businesses that necessitate trading in such assets.

Unexpected losses from non-advance businesses could be absorbed against retained earnings, or could be absorbed by a reduction or suspension of dividend payments. In fact, over the history of the FHLBank System, losses have been addressed by one or both methods.

Proposal Diminishes the Cooperative Owners' Equity

Shareholders gain the benefits of ownership through the distribution of dividends, lower prices for FHLBank services, or a combination of both. Provided that the proposed build up of retained earnings is not intended to increase capital above statutory levels, a build up of retained earnings beyond prudent levels diminishes the value of the FHLBank shareholders equity by transferring what would otherwise be member equity positions to the FHLBanks. The cooperative owners will never be able to recapture this equity.

Moreover, the Finance Board's proposal seeks to deprive the owners of their equity without a clearly articulated and supported rationale for doing so.

The FHLBank owners are particularly sensitive to a build up of retained earnings because of the federal government's history of expropriation of FHLBank earnings to fund the deposit insurance system. In 1987, Congress took $3 billion in retained earnings from the FHLBank System to fund the Financing Corporation. In 1989, Congress took $2.5 billion of retained earnings to fund REFCORP. Moreover, since 1989, part of the FHLBank earnings have been used to defease REFCORP bonds. Currently, 20 percent of the FHLBanks earnings are used to pay REFCORP obligations. Although GLBA provides that the retained earnings of the FHLBank System belong to the Class B stockholders, a level of retained earnings beyond the statutory mandate and economic necessity could again tempt placement of an additional direct tax on the earnings of the FHLBanks.

Dividend Restriction Will Result in a Destabilizing Cost Increase for Advances and Other Services

The REM requirement and the restriction on dividends will have a significant adverse impact on member institutions and have a great potential to create instability within the FHLBank System. At least one analyst estimates that the amount of forgone dividends over the 18 months to 36 months to be between $2 billion and $3.1 billion. The FHLBanks will have to target an amount of retained earnings above the actual REM requirement because the consequences of falling out of compliance once the target is obtained. The proposal harms member institutions by decreasing member income and by increasing the all-in cost of advances and other FHLBank services.

Impact on Large Member Institutions

The increase in cost of using the FHLBank System will lead to diminished use of the System by large members. Large members with other access to wholesale funding sources will seek those alternatives and reduce their use of FHLBank advances and other services. Reduced use by the larger members will deprive the FHLBanks of a valuable source of earnings. The net result is that the proposal's dividend restriction frustrates the Board's over all goal of increasing retained earnings. The FHLBanks with the largest retained earnings deficit under the proposal are the ones most likely to see a reduced presence of larger members. Moreover, those larger financial institutions that are eligible to borrow from more than one FHLBank will move their borrowing away from the FHLBanks with the largest retained earnings deficit to FHLBanks with no deficits or relatively smaller deficits. The shift will make it more difficult for those FHLBanks to comply with the REM requirement.

Significant Reduction in the Amount of Funds Available for the Affordable Housing Program

Because the proposed rule will make advances and FHLBank membership in general less attractive to members, I expect that the core business of the FHLBanks will shrink significantly as some members, particularly the larger ones, either leave the FHLBank System entirely or reduce their capital stock investment in the FHLBanks by decreasing their use of advances to minimize the impact of the reduction in dividend payments. This, in turn, will cause a decline in profitability for the FHLBanks and reduce the amount of funds available for the FHLBanks' Affordable Housing Program, which is funded from the FHLBanks' net earnings. The proposed regulation may also limit the ability of the FHLBanks to set aside additional, voluntary contributions for affordable housing and community economic development initiatives, as many of them, including the San Francisco Bank, currently do.

Conclusion

Provident does not agree that there is justification for the Finance Board's proposed regulation on excess stock, stock dividends, and retained earnings. I believe a thorough analysis of each issue will show that even if it can be demonstrated that there are problems that need to be addressed, there are more effective ways to address those problems. Moreover, the specific provisions of the proposed regulation may have serious adverse consequences for the FHLBanks, their members, the FHLBank 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. 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.

Provident again urges the Finance Board to withdraw the proposed regulation on excess stock, stock dividends, and retained earnings and issue an Advanced Notice of Proposed Rulemaking.

Sincerely,

C. J. Bl

CRAIG G. BLUNDEN
President
Chief Executive Officer