



FEDERAL HOME LOAN BANK OF INDIANAPOLIS
Building Partnerships. Serving Communities.

July 10, 2006

Via Electronic Mail

Federal Housing Finance Board
1625 Eye St., N.W.
Washington, D.C. 20006
Attention: Public Comment

Re: Federal Housing Finance Board Proposed Rule: Excess Stock Restrictions and Retained Earnings Requirements for Federal Home Loan Banks

Dear Federal Housing Finance Board Members:

The Federal Home Loan Bank of Indianapolis (FHLBI) would like to thank the Federal Housing Finance Board for providing the opportunity to comment on the proposed rule on excess stock restrictions and retained earnings. The 120 day comment period sends a clear message that the Finance Board is interested and open to input on how to ensure a safe and sound Federal Home Loan Bank System.

As we share what we currently find problematic with the proposed regulation, we believe we have a responsibility to open up further dialogue and to offer solutions. Everyone has the same goal as the proposed regulation—a safe and sound System.

Listed here are our major concerns.

- **The proposal appears to be in disagreement with the existing FHLBank capital structure established by the 1999 Gramm-Leach-Bliley (GLB) Act.**
One example is that the GLB Act required each FHLBank to develop a capital plan meeting minimum requirements for a risk-based standard and a non-risk adjusted leverage ratio and permitted each FHLBank to issue to its members a new class of stock—class B stock—redeemable at par after a five-year notice period, which the legislation specifically defined as constituting, along with retained earnings, the “permanent” capital of the FHLBanks. The Finance Board’s proposal would essentially override the statutory determination that class B stock should serve as the permanent capital to support FHLBank activities. Further, the provisions in the proposed rule are totally inconsistent with the FHLBanks’ capital plans that have already been implemented with the prior approval of the Finance Board.
- **The premise that a System-wide retained earnings minimum formula is necessary to protect the par value of the FHLBank stock.**
If the Finance Board’s supervisory examinations indicated a problem with an FHLBank’s retained earnings target or risk analysis, the Finance Board has ample authority to address the problem at any FHLBank through the supervisory process. The solution to such a problem is not through the imposition of a uniform System-wide regulation with a retained earnings formula that does not take into account the particular risk profiles of the individual FHLBanks.
- **The proposed REM formula is a one-size-fits-all approach and is not based on an individual FHLBank’s risk.** The Finance Board’s capital proposal would require each FHLBank to achieve and maintain a retained earnings minimum or “REM” of \$50 million plus one percent of all non-advance assets. This proposed across-the-board formula does not take into account differences in business

plans, asset mixes, and capital plans among the FHLBanks. The proposed formula requires that each FHLBank hold an REM of one percent of every asset that is a non-advance asset, having the effect of treating cash, short-term Treasury notes, fed overnight funds, and mortgage-backed securities the same. The proposed formula would result in a significantly higher retained earnings requirement than a risk-based approach would obtain. Perhaps a more prudent approach would be to evaluate the soon to be developed risk-based standard rather than force the FHLBanks to comply now with an admittedly less than precise across the board REM formula. (The Finance Board's Office of Supervision has stated that it expects to have a risk-based approach to FHLBank capital, similar to the Basel II capital rule for large financial institutions, within the next nine months.)

- **The Finance Board's approach toward retained earnings may place an FHLBank in a position to take on increased risk.** The proposed policy could encourage FHLBanks to invest in a riskier, higher yielding asset in place of cash and Treasuries. Further, the Finance Board's decision to impose an immediate dividend restriction of 50 percent of earnings for FHLBanks that have not met the REM could put pressure on the FHLBanks to take on additional risk to augment earnings to meet the REM as soon as possible.
- **The dividend restrictions amount to an unwarranted tax on FHLBank members.** The proposed rule would immediately place into effect System-wide restrictions on paying dividends to FHLBank members until the REM for each FHLBank is attained (dividends could not exceed 50 percent of current net earnings without regulatory exception), and thereafter would prohibit any dividend payments without prior approval, if an FHLBank fell below its REM. The proposed rule would require the FHLBanks to raise an estimated \$3 billion in additional retained earnings, imposing the equivalent of a \$3 billion tax on their members. The System-wide dividend restrictions are unwarranted. The Finance Board's Regulations at 12 C.F.R. Section 917.9 specifically prohibits an FHLBank's board from declaring or paying any dividend if such payment would result in a projected impairment of the par value of the capital stock of the FHLBank.
- **The prohibition on stock dividends is unwarranted.** The proposal prohibits paying dividends in the form of stock rather than cash. Several FHLBanks have customarily paid stock dividends to their members for years with no adverse effect, in large part because of more flexible tax treatment accorded members receiving dividends in this manner. The proposal also ignores the fact that cash dividends reduce the capitalization of the FHLBanks, while stock dividends have the effect of increasing capital levels. For FHLBanks that issue stock dividends, Standard and Poor's has noted this effect as ratings support, stating, "Capitalization is further improved by the (Bank's) policy of issuing stock dividends in lieu of cash dividends."
- **The proposal could diminish the value of FHLBank membership.** The proposal could potentially cause members to redeem excess stock at levels above the mandated level. This would result in creating the instability in the System that the proposal is seeking to avoid.
- **If the FHLBanks are less profitable, the contributions to the Affordable Housing Program (AHP) would likely be reduced.** Under the Federal Home Loan Bank Act, each year the FHLBanks must contribute the greater of ten percent of their net earnings for the prior year, or \$100 million, to the FHLBanks' AHP. Last year the FHLBanks contributed a total of \$280 million to this program.

Since the program began in 1990, the FHLBanks have contributed over \$2 billion to this program. To the extent that the proposed rule reduces the overall profitability of the FHLBanks, the proposal will have a direct and negative effect on the amount of contributions to the AHP.

- **The proposal has the potential to result in deterioration in the FHLBanks' strong financial status.** The Finance Board has acknowledged that the FHLBanks are in a strong financial position. Overall capital levels remain adequate and the risk of capital insolvency at any FHLBank in the foreseeable future is de minimis as stated in the preamble to the proposed rule. The Finance Board's proposal is not intended to address any existing problems but instead is directed at future potential safety and soundness problems that remain unknown. However, publication of such a prescriptive proposal may send the wrong message to members by encouraging member requests for excess stock redemption, resulting in a drop in FHLBank liquidity. The overall impact of the proposal for some FHLBanks could be lower liquidity, lower capital levels, a ratings downgrade, higher funding costs, and lower profitability.
- **We believe that the current proposal raises certain statutory concerns.**

Excess Stock...The GLB Act does not place any limit on the amount of excess stock that may be issued or held by FHLBank members. Instead, it gives the individual FHLBanks the authority to determine an appropriate amount of excess stock as long as redemption of that stock does not impair capital. The Finance Board's discretion concerning excess stock appears to be only a negative discretion to prohibit redemption, not an affirmative discretion to require redemption.

Stock Dividend Prohibition...The proposed prohibition on an FHLBank's declaring or paying dividends in the form of stock is inconsistent with the FHLBank Act (Act). While the Act prohibits the FHLBanks from paying dividends from sources other than retained earnings or current net earnings (12 U.S.C. Sec.1436(a)), there is nothing in the Act that restricts the ability of the FHLBanks to pay dividends in the form of stock. Further, by eliminating the ability of the FHLBanks to pay stock dividends, the Finance Board lowers the tax-adjusted dividend returns to the FHLBanks' members, decreases the value of their stock, and adversely affects the advantage of becoming or remaining a member of the FHLBank System. Given the voluntary nature of FHLBank membership, many members may decide to withdraw from FHLBank membership and reinvest the proceeds of their FHLBank stock in higher-yielding alternatives.

Retained Earnings Minimum and Dividend Limitations...The Finance Board cites Sections 1422a(a) and 1422b(a)(1) of the Act as legal authority for these requirements. Section 1422a(a)(3) provides that the duties of the Board are to ensure that the FHLBanks operate in a financially safe and sound manner, carry out their housing finance mission, and remain adequately capitalized. Section 1422b(a)(1) provides the Finance Board with the power to "supervise the Federal Home Loan Banks and to promulgate and enforce such regulations and orders as are necessary from time to time to carry out the provisions of this Act." As additional authority for these provisions, the Finance Board cites Section 1436(a) of the Act, which provides that "Each Federal Home Loan Bank may carry to a reserve account from time-to-time such portion of its net earnings as may be determined by its board of directors."

The Finance Board asserts that Section 1436 grants it the legal authority to require the FHLBanks to establish additional reserve for reasons other than "depreciation or impairment of its assets" in spite of the fact that the statute states, "Each Federal Home Loan Bank shall establish such additional reserves and/or make such charge-offs on account of depreciation or impairment of its assets as the (Finance

Board) shall require from time-to-time.” A reasonable reading of the statutory language is that the phrase “on account of depreciation or impairment of its assets” modifies both the establishment of additional reserves and the making of charge-offs, indicating that Congress intended the Finance Board to apply its reserve authority only when an FHLBank’s capital is threatened for one of the specified reasons.

Under Section 1426(h) of the Act, the class B holders of the stock own and have private property rights in the retained earnings of the FHLBank. Under this provision, retained earning distributions are generally permitted under the Act, if the FHLBank continues to meet the applicable capital requirements after the distribution as expressly provided in Section 1426(h)(3), absent safety-soundness or other legitimate supervisory concerns. This one-size-fits-all proposed REM formula is contrary to this statutory framework. The legislative history of the GLB Act indicates that Congress had an opportunity to require minimum retained earnings but chose not to. Had Congress wished to require minimum retained earnings, it clearly could have done so directly by giving the Finance Board the authority to take this action.

FHLBI respectfully submits the following recommendations.

- We believe that each FHLBank should have the opportunity to develop its own plan based on its own capital and business plans. This plan would ultimately be reviewed by the Finance Board.
- There should not be an arbitrary ban on paying stock dividends in any form.
- Work to address the problems (outlined above) in the formula to truly address real risk.
- Once a regulation is determined, the Finance Board should allow FHLBanks an appropriate time period for the transition. We would suggest a minimum of a five- year transition period. In the GLB Act, Congress provided appropriate transition periods and a five-year redemption period for the FHLBanks’ class B stock. A similar time frame would work.

FHLBI submits that the most important consideration at this time is the fact that the Finance Board staff has acknowledged that it is working on a new risk-based capital model, consistent with the Basel II capital proposal for large financial institutions. We understand through the Finance Board’s staff remarks that they intend to have it ready in about nine months. It would seem logical, given this plan, that the Finance Board withdraw the present proposed regulation, issue an advance notice of proposed rulemaking (ANPR), and then solicit a broader range of comments on various approaches to the FHLBank capital issues.

In closing, FHLBI again thanks the Finance Board for providing the comment period so that all involved and interested parties’ voices can be heard because in the end we will all want and benefit from a safe and sound FHLBank System.



Paul C. Clabuesch
Chairman