Federal Home Loan Bank of New York

June 27, 2006

VIA FEDERAL EXPRESS

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

ATTENTION: Public Comments

Re: Proposed Regulation Regarding Excess Stock Restriction and Retained Earnings Requirements for the Federal Home Loan Banks

To the Federal Housing Finance Board:

The following represent the views of the Board of Directors of the Federal Home Loan Bank of New York (the "FHLBNY" or "Bank") regarding the Federal Housing Finance Board's (the "FHFB" or "Finance Board") proposed regulation on excess stock restriction and retained earnings requirements for the Federal Home Loan Banks published in the Federal Register on March 15, 2006.

A letter dated May 2, 2006 from the Chairs and Vice Chairs of the Boards of each of the Federal Home Loan Banks (the "May 2nd Letter") urged that the Finance Board withdraw the proposed regulation and then issue an Advance Notice of Proposed Rulemaking. The letter suggested that this process would permit interested parties to engage in a meaningful dialogue for purposes of discussing the important issues raised in the proposal, as well as other issues pertaining to capital and excess stock. We hope that the Finance Board will give consideration to the proposal from the Chairs and Vice Chairs contained in the May 2nd letter.

That being said, what follows are specific comments and observations with respect to the text of the Finance Board's March 15, 2006 proposed rule on retained earnings. (This letter contains no comments on the Finance Board's proposals pertaining to excess capital stock as the Bank, due to its policy of repurchasing excess stock, has no such stock outstanding.)

1. The FHFB should develop a risk-based approach with respect to the Retained Earnings Minimum. We note that the proposed regulation would establish a minimum level of retained earnings known as the "Retained Earnings Minimum", or "REM", that is not risk-based. As proposed, each FHLBank's REM would equal $50 million plus 1 percent

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of the FHLBank's non-advance assets. However, this approach ignores the balance sheet differences that exist among the FHLBanks. Applying the proposed REM will inevitably establish unnecessarily high REM for FHLBanks with low risk profiles and inadequate REM for FHLBanks with high risk profiles. We strongly encourage the FHFB to reconsider the proposal and take the time to develop a risk-based methodology for the REM to help ensure that the objective of protecting the par value of a FHLBank's capital stock can be achieved.

Specifically, the FHFB should develop a risk-based approach to more accurately adjust the REM with the risk posed by the FHLBank's assets and activities. It is understood that the stated purpose of the REM is to protect the par value of the FHLBank's stock. Any impairment in par value will be the result of losses incurred due to inherent risks embedded in the balance sheet and operations. As such, the level of REM should correspond to the risks inherent in each respective FHLBank's balance sheet and operations.

Another important reason for a risk-based requirement is that it will encourage prudent risk management practices. A requirement that is not risk-based may encourage behavior that is contrary to prudent banking practices and inconsistent with the stated purpose in the preamble of the proposed regulation. The preamble to the proposed regulation states: *"The proposed rule, however, does aim to change the composition of capital and to ensure that the Banks hold retained earnings in amount that would significantly reduce the risk that losses at a Bank would result in capital stock impairment."* However, the regulation as currently proposed does not differentiate between credit ratings, maturities and other risks inherent in the non-advance assets, which consist mainly of investments. A REM that is not risk-based will encourage a riskier investment choice when a financial manager is faced with an investment decision between two assets because the decision to select the "riskier" asset will likely generate a higher return but not a higher REM. As such, the regulation will unintentionally provide management with the incentive to invest in riskier assets.

In addition to the possibility of increasing the risk profile of the FHLBank's non-advance assets, the requirement will also increase liquidity risk by discouraging the FHLBanks from holding short-term liquid assets. The proposed REM requirement includes 1% of the HLBank's non-advance assets, including liquid assets required by the FHFB Regulations §932.8 and §965.3. The regulatory liquidity requirement of the FHLBNY for the first 5 months of 2006 ranged from $2.5 billion to as high as $4 billion. At the $4 billion level, the FHLBNY would have to put aside retained earnings of $40 million against mostly overnight Federal funds if the regulation were enacted.

However, the FHLBNY does not maintain its liquid assets at the regulatory minimum. Instead, the FHLBNY believes that, in order to have the flexibility of meeting member needs, it is important to have liquidity in excess of regulatory requirements. For the first five months of 2006, the FHLBNY maintained an average of $2.3 billion in overnight Federal funds and $6.5 billion of money market investments with less than 2 months in weighted average maturity and highly rated at a minimum long-term rating of "A" and the highest short-term rating of "A1/P1". Under the proposed regulation, the Bank would be required to put aside $88 million of retained earnings against this low-risk short-term liquidity portfolio. Due to the low return on this portfolio (average at 5 bps of net spread), however, this would not be an efficient use of capital. As such, the proposed requirement could create a strong incentive for the FHLBanks to minimize their liquidity portfolios – which may not be a preferred result, especially for those customers who depend on the FHLBanks as a source of liquidity.

We recognize the desire of the FHFB to provide a straightforward, consistent and predictable means to calculate REM across the FHLBanks. However, one of the most important principles of modern supervisory policy is to help foster an environment that positively rewards prudent behavior. We believe that the proposed "one size fits all" measure will have the opposite effect.

2. <u>The limit on paying dividends should be predicated on the severity of the deficiency</u>. The proposed 50 percent limit on paying dividends may not be appropriate if a FHLBank is close to meeting the REM. But if a FHLBank is far short of the REM, say only 50% of the required REM, a 50% payout may be appropriate. If the level can be set to reflect the level of REM deficiency, it may make the transition more orderly, especially based on the FHFB's analysis that all of the FHLBanks with one exception can meet the REM by 2008.

   The table below illustrates a possible dividend limit based on the level of REM. The table is not meant to provide the definitive "answer", but rather a suggested approach for consideration by the Finance Board.

Percent REM Deficient	Percent Payout of Earnings
10	90
20	80
30	70
40	60
50	50

   Alternatively, since there are only twelve FHLBanks, the FHFB can request any FHLBank that does not comply with the REM to submit a compliance plan within a certain timeframe, for example, 90 days. This would allow the FHFB to tailor a plan that addresses an individual FHLBank's performance and risks rather than utilizing a rigid, regulatory defined percentage.

3. <u>The stated objective of the FHLBNY's Retained Earnings and Dividend Policy is consistent with the FHFB's proposed regulation, that is, preservation of the value of the members' investment</u>. To achieve this objective, the FHLBNY believes that the level of retained earnings should be sufficient to: prevent the impairment of par value of capital due to losses that arise in the ordinary course of business; pay a predictable level of dividends; maintain the confidence of members, counterparties and other entities with

respect to the Bank's ability to operate as a going concern; and meet all regulatory requirements. As such, the Bank's stated objective is consistent with the objective articulated by the FHFB in the proposed regulation.

Historically, the FHLBNY has maintained a level of retained earnings commensurate with the risks inherent in the balance sheet. From 2000 to 2003, the FHLBNY's year-end retained earnings ranged from $70 million to $244 million with an average of $148 million, or 0.2 percent of average assets. These retained earnings provided the Bank with the flexibility of selling our impaired investments in late 2003 without par value impairment of members' equity.

After the aforementioned sale, FHLBNY management, with guidance from the FHLBNY Board, rebuilt retained earnings to a historically high level. The Bank retained all of its 2003 fourth quarter GAAP earnings and then paid out 40% of its GAAP earnings in 2004 and 70% in 2005. During that period, the Bank's average dividend rate ranged from 3.99% in 2003, 1.83% in 2004, and 4.50% in 2005. During the fourth quarter of 2003, when the Bank suspended the dividend payment, some members were concerned about the potential impairment of the carrying value of Bank capital stock on their balance sheets. Fortunately, the Bank did not lose any members due to the dividend actions taken and the feedback regarding the Bank's actions was generally positive primarily due to two factors: (1) demonstration of the ability and willingness on the part of the Bank to repurchase stock at par by continuing the Bank's routine excess stock repurchase program; and (2) the Bank's quick resumption of dividend payments.

During our marketing efforts, potential members often ask about the safety of their investment. We point to the Bank's low risk profile and the fact that, although past performance cannot be a guarantee of future performance, in over 70 years of the System's existence, the stock of each FHLBank has always been redeemed at par without exception. We also highlight our Bank's policy of redeeming excess capital stock at par every day.

Thank you for consideration of these comments and observations.

Very truly yours,

George Engelke
Chair of the Board of Directors of the
Federal Home Loan Bank of New York