FEDERAL HOME LOAN BANK OF DALLAS

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Federal Housing Finance Board
1625 Eye Street, NW
Washington, DC 20006
ATTENTION: Public Comments

Via e-mail (comments@fhfb.gov)

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 Number 2006-03

Ladies and Gentlemen:

The Federal Home Loan Bank of Dallas ("the Dallas Bank") appreciates the opportunity to comment on the Proposed Rule issued by the Federal Housing Finance Board ("the Finance Board") regarding amendments ("the amendments") to the regulations at 12 CFR part 931 and the incorporation of a new 12 CFR part 934 ("the regulations").

The Dallas Bank supports the Finance Board's stated goals of clarifying its expectations and bringing consistency to the retained earnings structures of all twelve Federal Home Loan Banks ("FHLBanks"). Further, we agree that undue reliance on a large and concentrated amount of excess stock potentially could lead to adverse consequences for a Federal Home Loan Bank under certain circumstances.

However, the Dallas Bank believes certain modifications to the proposed regulation would enhance its effectiveness. The Dallas Bank's comments are discussed below under the relevant section of the amendments.

Section 934.1 Limitation on excess stock and stock dividends.

The Finance Board invites comments on whether both the aggregate one percent of total assets limitation on excess stock and the prohibition of stock dividends are both necessary. The Dallas Bank believes that the aggregate limitation on excess stock alone would be sufficient to achieve the Finance Board's objective, and that the proposed prohibition on dividends paid in the form of stock in section 934.1(b) is unnecessary to limit the accumulation of large amounts of excess stock.

Stock dividends along with sales of excess stock can contribute to an accumulation of excess stock as noted in the proposed amendments, but the proposed aggregate one percent of total assets limitation on excess stock is sufficient in itself for the purpose of limiting a Bank's reliance on excess stock. The FHLBanks should be allowed to manage their excess stock in a manner that complies with the regulatory limit but also affords the FHLBanks the opportunity to establish capital management policies best suited to their members. The addition of a prohibition on dividends paid in the form of stock is overly prescriptive.

The Dallas Bank's track record is a case in point. We have issued dividends only in the form of stock since before the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989. Since 2003, we have had a formal policy of regular mandatory repurchases of a portion of members' excess stock, generally executed on a quarterly basis. Since it implemented its stock repurchase policy, the Dallas Bank has consistently maintained aggregate excess stock at levels well below the proposed one percent of total assets limit. The Dallas Bank's experience clearly demonstrates that stock dividends do not necessarily contribute to an undue accumulation of or reliance on excess stock. Our success in managing the level of members' excess stock demonstrates that it is not difficult for a Federal Home Loan Bank to issue stock dividends on a consistent basis and still comply with the proposed aggregate limitation on excess stock.

Further, the Dallas Bank believes there are valid reasons that the FHLBanks should be allowed to issue stock dividends. First, many members use the excess stock that they accumulate through stock dividends to support future increases in their minimum investment requirement. As member institutions grow and their utilization of FHLBank advances increases, both their membership and activity-based investment requirements (as specified in the Dallas Bank's Capital Plan) increase. Paying stock dividends that members can use to support future growth in their utilization of the Bank is a way of allowing members to reinvest their earnings in the company.

Second, payment of stock dividends coupled with a program of regular excess stock repurchases ensures that whatever amount of excess stock exists is widely dispersed across that FHLBank's entire membership. This combination of stock dividends and excess stock repurchases avoids a concentration of excess stock ownership in the hands of a small number of members and diminishes any threat of large scale demands for redemption of excess stock.

Finally, stock dividends may have tax advantages for our members which provide a marginal additional benefit to the members for their ownership interest in the FHLBanks. If the elimination of stock dividends is not necessary to accomplish the objectives of the proposed regulation, as the Dallas Bank's experience indicates, the opportunity to take advantage of the incremental tax advantages they provide over cash dividends should be retained.

Section 934.2 Minimum level of retained earnings.

Retained Earnings Minimum

The derivation of the calculation of the proposed Retained Earnings Minimum ("REM") is unclear to the Dallas Bank. In principle, the Dallas Bank believes the REM should be risk-based, and should reflect differences among the FHLBanks in terms of both the magnitude of the various risks they take and the complexity inherent in their respective business models. In accordance with Finance Board Advisory Bulletin 03-08, for instance, the Dallas Bank has created a risk-based framework for determining a minimum level of retained earnings required to protect against potential short term accounting losses, as well as a desirable level of retained earnings to protect against potential economic losses that might be realized over an extended period of time.

Further, in the context of the methodology of the proposed regulation, we do not understand the reason for the fixed $50 million requirement in addition to the requirement related to non-advances assets. Accepting that the one percent of non-advances assets is a reasonable methodology, it would seem that the proposed $50 million requirement either should be eliminated or should be similarly scaled rather than fixed.

In addition, the Dallas Bank believes certain types of non-advances assets inherently pose significantly less risk than others and that the REM calculation should be modified to recognize this fact. Specifically, overnight Fed Funds sold to highly rated counterparties, which are an important source of the liquidity that is vital to our mission, are extremely low risk investments. The Dallas Bank believes, therefore, that those assets should be excluded from the calculation of the non-advances portion of the REM, at least up to some balance scaled to the size of an FHLBank's advances portfolio or its total assets. At a minimum, overnight fed funds should be assigned a lower, more appropriate percentage factor than other types of non-advances assets.

Applicable period for calculation of REM

The Dallas Bank believes the description of the calculation period for the REM should be clarified, and that the period used in the calculation should be more closely aligned with the period to which it applies.

The calculation period for the one percent of non-advances assets component of the REM is somewhat unclear in the proposed regulatory language. The final regulation should clarify, perhaps with an example, how the REM will be calculated for any given quarter. As written, the Dallas Bank believes the REM for a quarter is meant to be $50 million plus the one percent factor based on the average daily balance of non-advances assets for the prior quarter, which creates a one quarter lag between its calculation and its application. For example, if the average daily balance of non-advances assets for the quarter beginning January 1 and ending March 31 was $10 billion, the REM for the quarter ended June 30 would be $150 million ($50 million plus one percent of $10 billion). This understanding is derived, in part, from a footnote in the discussion of the proposed regulation rather than strictly from the proposed regulatory language.

Further, if our understanding is correct, the Dallas Bank does not believe such a lag is either necessary or appropriate. First, the calculation of one percent of non-advances assets is readily prepared. Also, the lag potentially could result in either an excessive or a deficient REM if a Bank experiences material growth or reduction (respectively) in non-advances assets from one quarter to the next.

Application of the REM

The Dallas Bank believes the application of the REM could be improved. The proposed regulation provides that a FHLBank must meet its REM after declaring and paying the dividend that pertains to that quarter. This construct fails to take into account any accumulation of retained earnings since the close of the quarter to which the dividend pertains.

For instance, the Dallas Bank has historically declared dividends during the quarter to which they pertain, typically based on two months of actual earnings and one quarter of projected earnings, and has paid dividends on the last business day of the same quarter. In light of modest earnings volatility related to fair value adjustments required by SFAS 133, the Bank will modify its current practice during the third quarter 2006 to declare and pay dividends only after earnings for the relevant quarter have been calculated. In order to do this, the Dallas Bank will declare a dividend during the third quarter 2006 based on actual earnings and holdings of capital stock for the second quarter 2006, and pay that dividend on September 29, 2006.

Under the proposed regulation, the dividend paid on September 29 would be deducted from the Bank's actual retained earnings recorded as of the close of business June 30 to determine compliance with the Bank's REM. This calculation ignores the actual accumulation of retained earnings for the three months from June 30 to September 30. The Dallas Bank recommends the Finance Board consider an alternative methodology that would incorporate the actual level of retained earnings at the time the dividend is paid.

Other Matters

When the final rule on REM is issued, the Finance Board should formally rescind Advisory Bulletin 2003-AB-08, *Capital Management and Retained Earnings* in order to avoid any confusion over the applicability of the Advisory Bulletin in light of the new regulations.

Section 934.3 Dividend limitations if retained earnings are below the Retained Earnings Minimum.

The Dallas Bank believes the proposed 50% of current earnings limitation on dividends until a FHLBank exceeds the REM is unnecessarily restrictive. Since AB 03-08 has been in effect for almost three years, and all FHLBanks have presumably adopted retained earnings policies and targets consistent with the Advisory Bulletin, it would be advisable to adopt a more gradual phase-in period that would be less disruptive to the business of the FHLBanks and their members.

In that context, a higher level of permissible dividends, perhaps combined with a maximum period of time in which to achieve compliance with the REM, would seem to be appropriate. The Dallas Bank urges the Finance Board to consider a dividend limitation no more restrictive than 75% of current earnings instead of the proposed 50% limitation.

Alternatively, or in combination, the Finance Board should consider establishing a timetable for initial achievement of any new REM that might be adopted. Such a timetable might be scaled to the magnitude of the increase required for the FHLBank in question, with a longer time period provided for those FHLBanks for which the new REMs represent the largest relative increases over their current balances of retained earnings.

We appreciate the Finance Board's consideration of the Dallas Bank's comments and concerns. If you have any questions regarding these comments, please contact Charles Lockyer, General Counsel at 214.441.8716 or Paul Joiner, Chief Risk Officer at 214.441.8582.

Sincerely,

Terry Smith
President