

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

**Re: Federal Housing Finance Board; Proposed Rule: Excess Stock Restrictions and Retained Earnings; RIN Number 3069-AB30; Docket Number 2006-03**

On behalf of the Federal Home Loan Bank of Seattle (Seattle Bank) we thank you for the opportunity to comment on proposed changes to the regulations governing the excess stock and retained earnings of the Federal Home Loan Banks (FHLBanks). The Seattle Bank appreciates and commends the efforts of the Federal Housing Finance Board (Finance Board) directors and staff in taking action to ensure a safe and sound Federal Home Loan Bank System (Bank System). The Seattle Bank is supportive of the Finance Board's desired goals; however, several aspects of the proposed rule are problematic and we are concerned that there will be irrevocable harm to the Bank System from the many unintended consequences that will result from moving ahead with the regulation as proposed. Therefore, we respectfully urge the Finance Board to withdraw the proposed regulation and reissue it as an Advance Notice of Proposed Rulemaking so that much greater discussion and dialogue can take place.

**Summary**

The Seattle Bank cannot support adoption of the proposed retained earnings requirements for the following reasons:

1. Before the Finance Board can establish appropriate retained earnings requirements, they must first consider the role of capital in the Federal Home Loan Bank System.
2. A higher level of retained earnings would not have prevented our current financial challenges nor is there any evidence that our current situation has resulted in capital flight.
3. Unless an individual FHLBank's capital mix gives rise to safety and soundness issues, we believe member preference should be given significant weight when determining the appropriate capital mix.

**The role of capital in the Bank System must be considered in evaluating the adequacy of retained earnings levels.**

The proposed rule does not establish an adequate foundation for the need to adjust the capital structures of the FHLBanks. The proposal merely asserts:

“The Finance Board believes that the potential operational and financial consequences of capital stock impairment for both the Bank and the members justifies addressing the Banks’ levels of retained earnings as a safety and soundness matter”<sup>1</sup>

The proposal does not address the threshold question, which is: “What is the role of capital in the Bank System?” Without answering this question, there can be no logical determination of the level and mix of capital that best fulfills that role. Instead, the proposal appears to be based upon the presumption that there must be a sufficient level of retained earnings to ensure the par value of FHLBank capital stock.

“The proposed amendments aim to require the Banks to hold retained earnings sufficient to protect against the impairment of their capital stock.”<sup>2</sup>

It is unclear from the proposal why this is a valid presumption, given that the very nature of equity capital necessarily puts that par value at risk. Page 18 of the proposal states that the impairment of capital stock could lead to a downgrade in the credit rating of an FHLBank. This assumption confuses cause with effect and reporting with economics. A credit rating reflects an entity’s ability to service debt and absorb losses. If total capital, both capital stock and retained earnings, is adequate to absorb expected levels of loss, there is no reason to assume that the mix of this total capital will drive the credit rating determination. FHLBank total capital levels are adequate in this regard. The proposal rebuts its own presumption when it states on page 21:

“The Finance Board recognizes that capital stock impairment is not necessarily indicative of capital inadequacy... The Finance Board believes that its capital rules and the Banks’ overall capital levels remain adequate and the risk of capital insolvency at any Bank in the foreseeable future is de minimis.”

There appears to be an assumption that retained earnings must be sufficient to prevent suspension of dividends and stock redemptions in times of financial stress.<sup>3</sup> The Seattle Bank believes that this is contrary to standard financial practices of the FHLBanks. These practices are the same practices employed by our own member institutions should they encounter financial difficulty. The Finance Board’s proposal appears to advocate that retained earnings are a superior form of capital to paid-in capital. There is no such distinction in practice.

We are concerned that the Finance Board’s intense focus on retained earnings sends a signal to the capital markets that paid-in capital is not true loss-absorbing capital. The Gramm-Leach-Bliley Act of 1999 defined permanent capital as Class B stock and retained earnings, without giving preference to either form of capital. It is our belief that Congress intended both capital stock and retained earnings to act as a buffer against future losses, where the buffer provides an adequate opportunity for the FHLBanks to recover or allow for the orderly unwinding of operations in instances of severe financial distress.

---

<sup>1</sup> Excess Stock Restrictions and Retained Earnings Requirements for the Federal Home Loan Banks, Federal Housing Finance Board, Proposed Rule, p. 21.

<sup>2</sup> Ibid. p. 29.

<sup>3</sup> See proposal at page 19.

The Finance Board proposal implicitly assumes that current capitalization levels are greater than necessary to protect the safety and soundness of the individual FHLBanks, given the proposal's treatment of excess stock. Consequently, there can be no safety and soundness issue with respect to capital adequacy of the FHLBanks, either collectively or individually, based upon the proposal's own logic. Given that the level of total capital is at the very least adequate, the issue the proposal actually introduces is whether the mix of capital the individual FHLBanks have elected to maintain is appropriate. Since the management and governance of each FHLBank is firmly vested in its Board of Directors, and that the choice of capital structure is a governance and management matter, and that there is no question of capital adequacy, the only issue that can and should be addressed by the Finance Board as part of its proper oversight role is: Does the Finance Board's proposal to reduce the level of paid-in-capital and increase the level of retained earnings provide a clearly superior opportunity to recover during times of financial distress or a better opportunity to unwind the operations of an FHLBank than the capital structures chosen by the boards of the respective banks?

The Seattle Bank believes that the answer to this question is "no" for the reasons noted below:

Chairman Rosenfeld was quoted as stating, "Our intent in issuing the proposal is very simple—to prevent the recurrence of conditions that gave rise to [the] need for formal enforcement action against the Seattle and Chicago Federal Home Loan banks and examination findings in other banks."<sup>4</sup> The Seattle Bank cannot comment on the activities of any other FHLBank, but can state that none of the actions taken by the Seattle Bank that ultimately led to the written agreement were affected by the Seattle Bank's level of retained earnings. Furthermore, a higher level of retained earnings would not have prevented their occurrence. Hence, the retained earnings proposal would not necessarily accomplish its stated objective. In contrast, the Seattle Bank agrees that the limitation on excess stock addresses some of the root causes behind the Seattle Bank's financial difficulties and has no objection to placing a reasonable limit on excess stock. However, the level of excess stock permitted should be neither formulaic nor generic as proposed in the rule but rather should be established by each FHLBank's Board of Directors and reviewed by the Finance Board after careful consideration of the entire capital plan of each individual FHLBank.

The proposal notes that the Finance Board issued an Advisory Bulletin in August 2003 that required each FHLBank to develop a retained earnings policy. The proposal further notes that there is a general lack of consistency among the FHLBanks' retained earnings policies and target retained earnings levels. However, no support is offered that the retained earnings policies of the individual FHLBanks result in an unsafe and unsound condition, and there is no indication that the Finance Board has found such policies inadequate in a formal determination.

#### **How would shareholders react to a financial loss?**

The role of capital in a financial institution is to provide an economic buffer in times of economic loss that will allow the institution to recover or, if need be, to unwind operations in an orderly manner. From a safety and soundness perspective, the mix between paid-in capital and retained earnings is only important if one expects shareholders to react to a loss differently depending on the type of capital at risk. The recent experience at the Seattle Bank has provided insight to shareholder reaction during times of economic stress, as indicated by the following statistics:

---

<sup>4</sup> "Making the Long-Term Case; Finance Board chief: Plan Protects FHLBs," American Banker, March 15, 2006.

- There has been no significant capital flight since the Seattle Bank entered into its written agreement with the Finance Board in December 2004:
  - Ten members have requested excess stock redemptions of approximately \$115 million of Class B(1) stock (approximately 5% of total stock). It should be noted that, under the proposal, these withdrawals would be mandated since they involve excess stock.
  - Ten members with total stock of approximately \$67 million (approximately 3% of total stock) have withdrawn from membership.
    - Five of these withdrawing members, with stock totaling approximately \$10 million, have withdrawn due to mergers/closed charters.
    - One of the withdrawing members, with stock totaling approximately \$55 million, has multiple FHLBank memberships and has elected to withdraw its membership from all FHLBanks.
    - Four members, with total stock of approximately \$2 million, appear to have elected to withdraw as a direct result of the Seattle Bank's financial situation.
- Members have continued to purchase stock to support activities. Since December 2004, 139 members have purchased \$111 million of stock. Of this amount, \$103 million was to support new advances and \$8 million was the result of an increase in the membership requirement.
- To our knowledge, no member has impaired the value of their capital stock invested in the Seattle Bank.

There is no empirical evidence that an FHLBank's members will look to exit immediately at the first indication of a loss. In fact, based upon the communications the Seattle Bank has received from its members, the greatest stimulus to capital flight by our members may be the enactment of the retained earnings proposal.

**Member preference should be given significant weight in determining the appropriate capital mix.**

The FHLBanks' shareholder capital belongs to its owners. Absent a compelling showing to the contrary, it is the preferences of the owners that should receive the greatest weight in determining the mix of capital they are asked to contribute. Ultimately, if shareholders cannot be induced to contribute capital, an FHLBank's creditors will have no economic buffer. Conceding the importance of the shareholders' perspective, it is vital to understand the structural and economic considerations that bias our shareholders towards contributing capital in the form of stock.

- The absence of a secondary market biases FHLBank shareholders against retained earnings.

The Seattle Bank's shareholders do not view their statutory right to redeem stock as a put exercisable on short notice that effectively transforms their equity investment into an overnight money-market instrument. Redemption is required because there is no available secondary market for an FHLBank's equity. Absent the redemption provision, there would be no available vehicle for either the FHLBanks or our shareholders to adjust their respective positions in an FHLBank's common equity. The redemption provision is an imperfect substitute for a public secondary market in common equity, and this imperfection acts to bias shareholders away from recognizing a portion of their return in the form of retained earnings.

Modern corporate finance argues that absent other costs (e.g., transaction costs, bid-ask spread, taxes, etc.) and given fixed-investment, financing, and operating policies, shareholders should be indifferent to receiving their returns in the form of dividends or in the form of retained earnings. Dividend irrelevance is rational in such a world because shareholders of publicly traded companies can transform, without cost, cash dividends into capital contributions and capital contributions into cash. The transformation mechanism is simple. If shareholders prefer to increase the size of their investment in the firm, they can purchase more shares with the dividends they receive. Similarly, if shareholders prefer cash dividends to retained earnings they can simply sell the fraction of their shares that corresponds to the increase in value their shares experience as a result of retained earnings.

Dividend irrelevance does not apply to FHLBank shareholders because there is no public equity market in which they can transform the forgone dividends used to build retained earnings into cash.

- Transactions at par bias FHLBank shareholders against retained earnings.

Transactions in an FHLBank's stock occur at par. Consequently, FHLBank shareholders do not have the ability to realize any capital appreciation on their investment that would otherwise result from the retention of previous earnings. The inability to profit from capital appreciation causes an intergenerational inequity between shareholders that biases our shareholders to receive their returns in the form of dividends rather than by increasing retained earnings. The intergenerational inequity occurs because our stock, by statute, is redeemed at par while new shareholders also purchase our shares at par. The new shareholder is effectively given a legal ratable claim to any future distribution of retained earnings that were generated by the foregone returns of previous shareholders. Distributing earnings on a current basis in the form of dividends removes the intergenerational inequity. Under the proposal there is a very real possibility that larger members with alternative access to the capital markets will withdraw from the system until adequate levels of retained earnings are established. This would place the burden of building the retained earnings of the System on the smaller members that have little or no access to alternative funding sources.

- FHLBank shareholders perceive political risk in retained earnings.

FHLBank shareholders attach a higher risk premium to retained earnings than they do to paid-in capital because of past governmental actions.

“FHLBanks are required to contribute heavily to the SA (Savings Association) resolution. FIRREA (Financial Institutions Reform Recovery and Enforcement Act of 1989) *expropriates* (emphasis supplied) each FHLBank's retained earnings for the purpose of funding REFCORP.”<sup>5</sup>

Notwithstanding the provisions of the Gramm-Leach-Bliley Act conferring ownership of retained earnings to Class B stockholders, FHLBank shareholders retain their risk aversion given the possibility of other forms of governmental takings.

Members are skeptical of the Finance Board's stance on retained earnings. Ms. Diane Casey-Landry, the president of America's Community Banker was quoted in the American Banker Online voicing the concerns of FHLBank members:

---

<sup>5</sup> *An Executives Guide to FIRREA*, Price Waterhouse, September 8, 1989, p. 35.

“Gramm-Leach-Bliley established a capital framework and put a system in place. ... They are rewriting what the banks spent years doing. They are causing unnecessary hardships in the system. ... We do believe that [equity capital] is real capital. You don’t get to throw out a framework Congress established.”<sup>6</sup>

Members are concerned about what the ultimate end-game is.

“No one has told us how much is going to be enough. We went through one round with the increase in retained earnings and we thought it was settled. Now it’s happening all over again.”<sup>7</sup>

The proposal itself fosters this skepticism when it states on page 25:

“As proposed, the rule also would provide the Finance Board with the flexibility to address specific problems or events at individual Banks by requiring a Bank to hold retained earnings that would be higher than that calculated under the formula, if warranted for safety and soundness reasons:

- Forcing the FHLBanks to lower dividends is effectively a tax.

The only economic income generated by FHLBank stock is the present value of current and future dividend payments. Because the cash received sooner has greater value than the same amount of cash received later, the current dividends are more valuable than the later dividends. The proposal would with certainty reduce the most valuable current dividends so as to build a retained earnings balance that would be available only to protect against the potential of capital impairment in the future. It would be a tax because the retained earnings accumulated today would never be available for the payment of dividends. If the bank suffered a loss in the future the retained earnings would not be available as a reserve from which dividends could be paid. The retained earnings balance would be written down by the amount of the loss and the FHLBank would then have to forego dividends once again to rebuild the level of retained earnings to the level specified in the proposal. Members will never see the dividends foregone to build retained earnings absent a merger or liquidation.

In light of the above comments, the Seattle Bank strongly encourages the Finance Board to continue its policy of allowing each FHLBank Board of Directors to establish a retained earnings policy appropriate for its institution and the members they represent. The safety and soundness of each policy can and should continue to be a function of the examination process.

### **Other Comments/Observations**

#### **Carve-out for Liquidity Investments**

As noted above, the Seattle Bank strongly opposes the proposed retained earnings requirement. However, should the Finance Board elect to finalize the proposal, we believe there should be a “carve-out” of liquid assets for the purpose of determining non-advance assets at a reasonable level. In the proposal, the Finance Board notes that the liquidity portfolios of the FHLBanks have historically averaged 10 to 12 percent of total assets. The Seattle Bank believes that this level of “carve-out” would be appropriate. Liquid assets are a critical component of FHLBank balance sheets if the FHLBanks are to remain consistent

---

<sup>6</sup> American Banker Online, Rob Blackwell, March 10, 2006.

<sup>7</sup> William White, President of Dearborn Federal Savings Bank, quoted in March 15, 2006, issue of the American Banker.

liquidity providers to members. Capital rules should never be designed to discourage sound levels of liquidity in any financial institution. Accordingly, we believe a carve-out level is appropriate. Moreover the investments that would be employed to provide this liquidity are low risk and by definition highly liquid.

**Prohibition on stock dividend**

The proposal requested comments on the proposed limitation on stock dividends given the proposed limitation on excess stock. The Seattle Bank believes this prohibition is unnecessary. The one-percent limit on excess stock achieves the Finance Board objective of limiting large amounts of excess stock. Accordingly, each FHLBank should have the flexibility to manage its dividend payments as long as such payments would not cause such FHLBank to exceed the excess stock limit. Dividend distributions have certain tax consequences, and the FHLBanks should not be limited in providing dividends in a form that is most beneficial for its members and the cooperative.

Sincerely,

Mike C. Daly  
Chairman of the Board

James E. Gilleran  
President and Chief Executive Officer