

June 23, 2006

The Honorable Ronald A. Rosenfeld
Chairman
Federal Housing Finance Board
1777 F Street, N.W.
Washington, D.C. 20006-5210

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

Dear Chairman Rosenfeld:

The Board of Directors and Management of the Federal Home Loan Bank of Pittsburgh welcomes this opportunity to offer its comments on the proposed rule concerning excess stock and the level of minimum retained earnings in the Federal Home Loan Banks.

In many ways the proposed rule would enact strictures with which the Pittsburgh Bank and its members already have some experience. We limited our dividend pay-out to 50% of earnings during 2004-2005, for example, and we adopted a policy of holding little or no excess stock. Our practical experience in such measures leads us to focus our comments in three areas:

- Capital Structure in a Federal Home Loan Bank,
- Market Impact of Curtailed Dividends, and
- Timing and Process.

We emphasize that in offering these comments, our intent is to work cooperatively with the Finance Board. The proposed rule is generating much controversy, but our hope is to pursue a process with you that results in a stronger and better capitalized set of Banks.

I. Capital Structure in a Federal Home Loan Bank

The proposed rule rests on one critical assumption: member capital stock is not truly available to absorb losses. As a practical matter, capital stock that is redeemable at par can never be impaired as to value. This logic suggests that it is therefore necessary to build up retained earnings in order to create a layer within the capital structure that is available to meet all risk-based capital requirements.

We believe most members understand that their capital investment in the Home Loan Bank is subject to risk. Of course, members expect the risk of FHLB stock to be low. Our Board, for example, has long insisted that management maintain a stand-alone, Triple-A credit rating as an indication of that low-risk profile. Nonetheless, members nationwide have seen FHLBanks incur losses recently. They have clearly witnessed the fact that when a Bank experiences problems, the ability to redeem FHLB stock is not assured. FHLB stock can be held without redeemability for a long and indefinite period. This represents true liquidity and credit risk.

To those who argue that members' capital stock is not true capital-at-risk, we offer a word of caution. That assumption should not be pushed to an extreme. Members are not so naïve as to believe that their capital is entirely risk-free. Still, no one can argue that in the end, members must somehow provide the true, permanent capital-at-risk in each Home Loan Bank. The question is the vehicle. It may come from paid-in capital, or from surplus or retained earnings, or from some other form of security instrument. **The proposal to increase retained earnings is one means to the end, but not the only one.**

- The Chairman himself has offered the notion of a Letter of Credit structure which might provide contingent protection in the event of losses at a Bank. This proposal might alleviate fears of another future confiscation of retained earnings that motivates opposition in some quarters to the proposed rule. Of course, issues such as cost and renewability would be necessary to resolve. We would welcome a longer opportunity to explore this concept.
- The capital markets are currently inventing new species of hybrid equity securities that have some intriguing qualities; for example, forms of subordinated debt that automatically convert to perpetual preferred stock if certain events are triggered. Perpetual and other forms of preferred stock are familiar vehicles that might be engineered to provide a more explicit layer of loss protection within the overall capital structure. There is not sufficient time within the comment period to engage investment banks to design specific structures, but as alternatives to a simple build-up in retained earnings, they merit investigation, and may prove to be more attractive. They may also possess fewer troublesome features that cause some members to resist the proposed rule with its sole focus on retained earnings.
- Assuming the Banks continue to build retained earnings as one of several means to our desired goal, there are ways to alleviate other member concerns. For example, there is precedent at another GSE for creation of "Attributable Retained Earnings" which are earmarked by member. The benefit of a member's pro rata share of retained earnings can be paid to a member in the form of an interest rebate on loans. If a member departs, its share of retained earnings is "retired" and paid to the member over time. Notions like "Attributable Retained Earnings" illustrate the type of creativity that is possible.

We emphasize that the proposed rule really begs the question of the appropriate capital structure for the Federal Home Loan Banks. The Finance Board's proposal challenges the adequacy of the capital plans adopted by the Banks after the Gramm-Leach-Bliley Act. **We concur with the Finance Board's fundamental, though implied insight that the capital plans of the Federal Home Loan Banks need to be revised** to support the risk profile of the Banks, particularly as those risks have evolved in recent years. We believe it is important for the Finance Board and the Banks to allow sufficient time for thoughtful consideration of other approaches.

We recommend that the proposed rule be amended in order to require or allow the Banks to re-open their capital plans and create a more explicit form of permanent, at-risk capital. We encourage the Finance Board to welcome ingenuity in this process. Until revised plans are approved by the Finance Board and implemented, the Banks would be expected to build retained earnings toward the proposed levels *in lieu of other means* (e.g., L/C, hybrid instruments, etc.) as might be approved in a revised capital plan.

II. Market Impact of Curtailed Dividends

Reflecting on the proposed rule and our experience with a 50% pay-out ratio in recent years, we believe that the proposal needs to give far greater consideration to the impact on members, the competitive positioning of the FHLBanks and the likely consequences that this proposal will have on the Banks' core business of advances.

It is argued that the Banks' dividend is important, but not part of the Banks' core mission. Yet, members see the dividend as part of the whole economic rationale for Home Loan Bank membership. The value of membership derives principally from access to liquidity at an attractive, all-in cost. The all-in cost of advances is clearly the advance rate, net of the dividend on the associated stock. Dividends are an inextricable component in the overall equation of advances pricing, and therefore, in the basic economic value proposition of the Home Loan Bank. We can debate whether the dividend is part of our core mission, but we cannot underestimate the dividend as a key element in the business model of the institution.

The proposed rule, by sharply curtailing dividends in most FHLBanks, will abruptly shock members' all-in cost of funding, reduce the Banks' competitiveness and jeopardize our core business. There is no FHLBank today that can pay out a 50% dividend and yield a Fed Funds-equivalent dividend. As a result, members will now experience a negative carry on their capital stock which increases the cost of FHLB funding. A brief example may illustrate this problem.

Assume a typical, \$100 million fixed-rate bullet advance for one year. Recently the Pittsburgh Bank would offer this loan at 5.41%, and require \$4 million in supporting capital. Assuming a 50% pay-out of earnings, the dividend on that capital would approximate 3.30%, or 195 basis points less than a Fed Funds rate of 5.25%. From the member's perspective,

the interest on the loan would be \$5.41 million *plus an additional cost of \$78,000 in negative carry on the stock*. The all-in cost of the loan rises from 5.41% to 5.49%. Those familiar with capital markets and our core business understand that an additional eight basis points represents a serious competitive disadvantage. Eight basis points is an enormous difference in markets where deals hinge on a basis point. This affects not only larger members, but also members with less than \$5 billion in assets who are being courted by our Wall Street competition. We estimate that over 80% of the Banks' core advances business would be out-of-the-money on pricing with an increase of five to ten basis points.

This example is more than hypothetical. We want the Finance Board to know that the Pittsburgh FHLBank is already experiencing loss of advance volume as a result of the *proposed* rule. One member has advised us that it will not renew a multi-billion dollar outstanding because of the dividend consequences of the proposal. Our community banks are now being actively targeted by alternative funding suppliers. Even in the proposal stage, this rule is driving out large members and dissuading smaller members from doing business with the FHLBank. Driving away our customers, both large and small, will have spiraling consequences. Spreading the costs of recent infrastructure upgrades over a smaller base of business will only reduce our value proposition for community banks. It will undermine our competitiveness and erode earnings, cascading into negative results for REFCORP debt and affordable housing.

Certainly the Finance Board does not wish to inflict damage on the core business of the Banks. Therefore **we recommend that the proposed rule be amended to permit at least a five-to-ten year phase-in of the retained earnings minimum in place of a pay-out limitation at 50%. If the Finance Board still determines to retain a pay-out limitation, we would suggest that the rule permit no less than an 80% pay-out of earnings or the Fed Funds rate, whichever is greater, until the standard is met or, as suggested above, a new capital plan is implemented.**

III. Timing and Process

A number of important institutions have called for the full withdrawal of this proposed rule. We certainly understand why so many members, trade associations and others are urging you to follow a more deliberative and consultative process. We too recommend that you take as much time as necessary to assure an inclusive and logical process. There are too many critical issues at stake for the Finance Board to move with undue haste along its current path. Some of the key questions that remain unanswered include:

- What are the consequences on members of forcing an abrupt change in policy regarding excess stock and stock dividends?
- Does the Finance Board truly seek to impose a large tax payment burden on so many members, and what are the effects on the members' value proposition in the FHLBanks?

- Does the \$50 million retained earnings minimum make sense for all the Banks, and why?
- What is the safety-and-soundness reason to require dividend declarations on a trailing, calendar-quarter basis only? Does the rule require this approach, as some suggest, or will the Finance Board require this interpretation at some later date? Why should boards not be free to declare dividends out of earnings from closed periods as they deem prudent?
- What is the Finance Board's policy after the Retained Earnings Minimum has been achieved in terms of using retained earnings, replenishing them over time, and the dividend consequences in later years? What is the business impact of leaving these questions unanswered?
- In a Basel II environment, why not work to create a credible, risk-based approach to FHLB capitalization? What is the need to rush into a simplified, but less than state-of-the-art scheme?

We believe that the Finance Board needs to conduct an open and inclusive process to develop solid, clear and credible answers to these and other key questions. To proceed otherwise risks too many unknown and unintended consequences.

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The Board and management of the Pittsburgh Bank pledges to work cooperatively with the Finance Board to re-examine the issues at stake in this proposed rule. Together we can devise a capital structure that meets the Finance Board's true goal of assuring safeguards against impairment of member capital stock while also preserving the economics of our core business.

We appreciate this opportunity to offer our comments.

Yours truly,



Marvin N. Schoenhals
Chairman of the Board



John R. Price
President & CEO