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August 18, 2003

Federal Housing Finance Board
Office of Supervision

To:	Federal Home Loan Bank Chairs, Presidents, Chief Financial Officers, and Directors of Internal Audit
From:	Stephen M. Cross Director Office of Supervision
Subject:	Capital Management and Retained Earnings

Background:

Section 917.3(c) of the Federal Housing Finance Board (Finance Board) regulations (12 C.F.R. § 917.3) requires that the management of each Federal Home Loan Bank (FHLBank) perform, at least annually, a risk assessment. This risk assessment must be reasonably designed to identify and evaluate all material risks that could affect the achievement of the FHLBank's performance objectives and compliance requirements. The FHLBank's board of directors must promptly review this written assessment upon its completion.

Section 931.8(a) of the Finance Board regulations (12 C.F.R. § 931.8) prohibits an FHLBank from redeeming or repurchasing any stock without the prior written approval of the Finance Board if either the board of directors of the FHLBank or the Finance Board has determined that the FHLBank has or is likely to incur losses that result in, or are likely to result in, charges against the capital of the FHLBank. Furthermore, section 931.4(a) (12 C.F.R. § 931.4(a)) permits an FHLBank to pay dividends only from current or previously retained earnings.

The level of retained earnings critically affects an FHLBank's risk profile, capital compliance, and ability to pay dividends to its members. As of June 30, 2003, the FHLBanks had capital stock of $38.1 billion and retained earnings of $1.3 billion. While their risk profiles, operating strategies, and corporate organization differ, the FHLBanks have a capital-to-assets ratio of about one-half, a ratio of retained earnings to capital of about one-tenth, and a ratio of retained earnings to assets of about one-fifteenth that of large banks and thrifts. In terms of the return on average assets, large banks and thrifts are four times more profitable than the FHLBanks.

The FHLBanks face a number of risks that can contribute to potential earnings and capital volatility. Among these factors are: (1) Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), (2) mortgage purchase programs that expose the FHLBanks to market risk associated with assets that have long contractual lives, (3) low levels of interest rates that have led to unprecedented prepayment speeds on mortgage assets, and (4) changing basis spread between FHLBank funding costs and Treasury rates, mortgage rates, and LIBOR. These risks are greater now than they were five years ago.

<u>Guidance</u>:

Either as part of or in addition to its risk assessments, at least annually, each FHLBank should specifically assess the adequacy of its retained earnings in light of alternative possible future financial and economic scenarios. The scenarios should include optimistic, pessimistic, and most likely forecasts. At a minimum, the analysis should show the expected change in retained earnings that would result from immediate parallel shifts in the yield curve. As a matter of sound practice, the analysis should be supplemented with non-parallel rate shocks such as a flattening and a steepening of the yield curve. It would also be useful to analyze scenarios that highlight the effect on retained earnings of other key factors, including changes in prepayment speeds; changes in interest-rate volatility; changes in basis spread between FHLBank funding costs and Treasury rates, mortgage rates, and LIBOR; and changes in the credit quality of the FHLBank's investment portfolio. In formulating scenarios, it is important to include ones that are truly stressful. A thorough analysis of these issues will require the use of both market value- and earnings-based approaches.

Each FHLBank's board of directors should promptly review the FHLBank's analysis of the adequacy of its retained earnings. The Finance Board also expects that an up-to-date analysis of retained earnings will be available for the Finance Board's review as part of each FHLBank's annual examination, starting with examinations that commence after January 1, 2004. If the analysis of retained earnings indicates that retained earnings should increase, the Finance Board expects that each FHLBank's board of directors will adopt a plan that will enable the FHLBank to achieve target levels of retained earnings within 12 months.

If an FHLBank does not have a formal retained earnings policy, the Finance Board expects that each FHLBank's board of directors will adopt a retained earnings policy before March 31, 2004. The retained earnings policy should specify the priority the FHLBank places on retained earnings relative to dividends.

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