IN THE FEDERAL HOUSING FINANCE BOARD

IN THE MATTER OF:)
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OPEN MEETING)
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Board Room
Federal Housing Finance Board
1777 F Street, N.W.
Washington, D.C. 20006

Monday
May 22, 2000

The parties met, pursuant to the notice, at 10:08 a.m.

BEFORE: BRUCE A. MORRISON, Chairman

APPEARANCES:

Board Members:

WILLIAM C. APGAR
J. TIMOTHY O'NEILL

Staff:

WILLIAM A. GINSBERG
JAMES L. BOTHWELL
SCOTT L. SMITH
NEIL CROWLEY
DEBORAH F. SILBERMAN

P R O C E E D I N G S

(10:08 a.m.)

MR. MORRISON: Okay. The Board will come to order. We have one item on our agenda, Proposed Rule on Capital Requirements for the Federal Home Loan Banks. The rulemaking that is mandated by the Gramm-Leach-Bliley Act. And, Mr. Managing Director.

MR. GINSBERG: Thank you, Mr. Chairman. Good morning, members of the Board. This morning, the staff puts before the Board for consideration a Proposed Rule on Capital Requirements for the Federal Home Loan Banks. This proposed rule would set the framework for recapitalizing the Banks over the next several years with more permanent capital and capital that is related more to the risks on the balance sheet of the Banks than the capital structure that exists today.

This capital reform is the central change provided by the Congress in the Federal Home Loan Bank Modernization Act of 1999, Title 6 of the Gramm-Leach-Bliley Act, and is, I would say, the basis for Congress' vision of an even stronger Federal Home Loan Bank System in the new century.

This proposed rule also reflects the thinking of the Finance Board, even before Gramm-Leach-Bliley. Board members will I'm sure recall last year the Finance Board Proposed a Rule on Financial Management and Mission

Achievement, which included a risk based, more permanent capital structure within the constraints of the law that was then existing.

Before turning this over to Jim Bothwell to briefly summarize the rule that is before you, I want to make a couple of process points. First, the Board members should be aware there has been extensive interaction between the Finance Board staff and others interested in these issues already to date. We as a staff have been working with the Federal Home Loan Banks capital regulation task force over the last several months, and we have worked with the consultants to that task force as well.

The task force, on behalf of the Banks, had retained consultants both on risk based capital and had retained investment bankers, and we have worked with both of those groups. And of course the task force investment bankers, J.P. Morgan, met with the Board last week.

There has also been consultation with representatives of the Senate and House Banking Committees on these matters.

Finally, as another process point, Gramm-Leach-Bliley requires as a matter of law that this Board adopt a final rule on capital requirements for the Banks not later than the first anniversary of the passage of the statute. That is November 12th of this year. So we have moved quickly on this to get this proposed rule in front of the Board today. It has taken an extraordinary effort to get this proposed rule out in time so that there can be a 90-day comment period, which is what the proposed rule calls for and still have the opportunity to finalize the rule by November 12th. So I do want to thank my colleagues on the staff, those at the table and others on the staff, for the efforts to get this rule before you this morning.

With that, I would ask Jim Bothwell to summarize the rule briefly. Jim.

MR. BOTHWELL: Thank you, Will. Good morning, Mr. Chairman, Director O'Neill, Director Apgar. We are requesting that the Board of Directors consider and approve for publication this morning the Proposed Rule on Capital Requirements for the Federal Home Loan Banks. The proposed regulation would implement an entirely new capital structure for the Banks as required by the Gramm-Leach-Bliley Act. Specifically, the proposed rule addresses the different classes of stock that a Bank may issue and the rights and preferences associated with each class of stock that a Bank may impose.

It also establishes new requirements for total capital and risk based capital and addresses the capital structure plans that each Bank must submit for Finance Board approval.

We are recommending a 90-day public comment period for this proposed rule, which should allow adequate time for public comment and still permit the Finance Board to complete a final rule by the deadline of November 12th of this year, as Will just mentioned.

In general, the proposed rule grants the Federal Home Loan Banks significant flexibility in transitioning from the existing single stock capital structure to the two new classes of stock authorized by Gramm-Leach-Bliley. By statute, the Banks will be permitted to issue in any proportion class A stock, which is redeemable on six months notice, and a permanent class B stock, which is redeemable on five years notice, to replace the existing capital stock.

As you know well, all of the existing stock is currently redeemable upon six months notice.

Under the proposed rule, the Banks can accomplish this transition through any manner of conversion, exchange, auction, or other fair and equitable method. And following the initial issuance of the new stock, the Banks may obtain additional capital as needed through activity based stock purchase requirements, supplemental stock issuances, or other means.

There is also new flexibility from a member's perspective in that beyond any membership requirement to purchase and hold some specified amount of stock, members will now be able to sell their stock to other members or to the Federal Home Loan Bank at negotiated prices. Furthermore, each Bank will have appreciable latitude to specify the voting rights and dividend preferences of each class or subclass of stock.

There are a few limitations contained in the proposed rule designed to ensure that class B stockholders have a voting right and that class B stock receives a residual dividend in keeping with the intended risk bearing role of class B stock. Or in other words, a class B stock has features just like traditional common equity for purposes of safety and soundness.

Also, to prevent the potential domination of the Federal Home Loan Bank by any member or affiliated group of members, the proposed rule limits such groups to no more than 20 percent of the votes assigned to any class of stock and to ownership of no more than 40 percent of any class of stock.

As required by Gramm-Leach-Bliley, and as required by the proposed rule, each Bank will set forth the specifics of its transition to the new capital structure and a capital plan. The plans must be submitted to the Finance Board within 270 days of the date of publication of the final rule, and ultimately must be approved by the Finance Board prior to implementation. As described in the proposed rule, each capital plan will need to address whether the Bank intends to issue class A and/or class B stocks, and the terms, rights, and preferences for each class or subclass of stock issued.

Each plan must also include a provision to require that as a condition of membership, each member maintain a capital investment in the Bank for pay and annual membership as determined by the Bank.

The list of other issues to be addressed by each plan includes the criteria governing the transfer of Bank stock between the Bank and its members, disposition of capital stock associated with a termination of membership, and the independent reviews of the plan by a certified public accountant and a national recognized rating agency as they are required by the legislation.

Once the transition to the new capital structure is completed, the Banks will be subject to the total capital and risk based capital requirements specified by Gramm-Leach-Bliley. To meet the total capital requirement, the Banks must maintain a ratio of 4 percent total capital to total assets. The total capital includes all paid-in class A and class B stock, retained earnings, any general allowance for losses, and the amount of any other sources that the Finance Board determines are available to absorb losses incurred by the Bank.

The act also requires the Banks to meet a leverage requirement of 5 percent, but where permanent capital, defined as paid in class B capital, against retained earnings receives a 150 percent weight. The act is somewhat less prescriptive on the specifics of the risk based capital requirements. This has allowed the Finance Board the opportunity to develop, in consultation with other regulators and experts, a state of the art approach to determining risk based capital requirements.

In particular, the proposed rule brings the Finance Board in line with where other financial regulators intend to go, that is, it achieves safety and soundness by better aligning both the credit and market risk capital requirements with actual economic risk as assessed during periods of financial stress. Specifically, the credit risk requirement is based on the rated credit risk or credit rating of each asset or item, both on and off balance sheet, adjusted for maturity and type of asset. And the market risk capital requirement is determined by the market value at risk as assessed for the entire Bank portfolio, again including both on and off balance sheet items during stress periods.

In addition, the proposed rule includes an operations risk capital requirement similar in design to that imposed by statute from the other housing GSEs. Even though this added measure for safety and soundness is not required by Gramm-Leach-Bliley, we believe that without an operation first requirement, the Banks could be vulnerable to losses arising from potential operational failures.

The proposed rule also includes new, somewhat stricter limits on unsecured extensions of credits to single counterparties, and a new requirement for Banks to report monthly on any total extension of credit to a single counterparty that exceeds 5 percent capital.

In conclusion, we believe that the provisions of the proposed rule will ensure a safe, sound, and viable Federal Home Loan Bank System for the future while providing the banks with a flexible framework for designing their individual capital plans. Such flexibility may be necessary if the Banks are to accommodate the particular needs of their members with the requirements of the completely new capital structure as mandated by Gramm-Leach-Bliley.

Thank you very much.

MR. MORRISON: Thank you. And I have an amendment that I shared with my colleagues relating to the issues of concentration and voting rights and small members, which I know is an issue of concern, both at the Board table and elsewhere, which I will withhold for the moment. We can discuss this as separate matters. So may I suggest to my colleagues first that if there are questions or comments or discussion, that we ought to go on with respect to other issues with respect to the rule that we handle those first, and then I'll offer the amendment, and we can talk about the concentration and the voting rights issues.

The floor is open.

MR. APGAR: Okay. Well, I am concerned and I am pleased that the chairman has developed this amendment to the rule relative to concentration of ownership.

Before starting with that, of course, this has been a massive undertaking, bringing the capital structure into the kind of 21st century, and I applaud the work of the staff for this. Obviously, it is tricky to both provide the needed safety and soundness support, while at the same time the flexibility of the individual member, the individual Banks, needed to operate effectively. And I think this balance has been largely achieved.

On the other hand, I do remain concerned about the effect the rule has on small institutions. Obviously, an important part of the legislation was to recognize the importance of the small member institutions and their roles particularly, provided this new class of community financial institutions, smaller $500 million or less in asset, that had a special carved out role.

The historical strength of the Federal Home Loan Bank has been its cooperative nature, its capacity to bring to members large and small alike a range of benefits that help promote services in a wide range of communities. So I am concerned that the voting requirements and limitations contained in the rule may not apply the proper balance. But that is why you have rulemaking, to set up the right framework, to ask for appropriate comments, and commentary.

So in addition to supporting the proposed amendment, I'm confident that I will be able to work with you and Mr. O'Neill and others as we finalize the preamble language to pose a number of questions that will make sure there is particular pointed debate and discussion on these items, in particularly asking if there are other approaches other than those included in the rules and consistent with the Bank Act that will ensure the voting system established by the Banks preserves the cooperative nature of the System while allowing flexibility. So we want to certainly ask on that question.

I also think you ought to ask the detailed questions on the various limitations. The proposed limits to 40 percent the total share of stock any member or group of affiliated members can own and requires that no more than 20 percent of the votes eligible be cast in any election. Is this in effect a limitation to achieve the desired goal? I think we ought to continue to ask that question ourselves and make sure that everyone explores it.

We know what the goal is. But does this particular combination of limitations achieve that goal? Are there other more appropriate voting limitations that the Finance Board should impose that would enhance this cooperative system? We can think of various options here, but we ought to particularly ask questions in that arena.

So consistent with the idea that the rulemaking has established an appropriate framework, I think it is largely asking the right questions. I would like to see us sharpen a little bit the questions we ask in this arena of the effect of the rule on small member participation and particularly on whether we achieve the right structure and balance in that aspect.

MR. MORRISON: Why don't I offer my amendment at this time?

MR. APGAR: Sure.

MR. MORRISON: And the amendment has been distributed, I believe. This amendment is on page 16. These amendments are on page 16 and 17 of the Board book rule section, proposed rule section. Implicit in these is also adjustments that will be made. These are adjustments in voting that do two things: number one, allow a Bank to establish a lower than 20 percent voting maximum in its capital plan; and secondly, to say that the capital plan shall, to the extent feasible, provide for the representation on the board of directors of smaller members than own class B stock, especially members that are community financial institutions, which is intended to in part address the concern the Mr. Apgar has expressed.

Implicit in this amendment also would be flexibility to the Banks to set a lower number than the 40 percent in their capital plan. Both of these questions, the limitation on voting and the representation of the board of directors, are extremely challenging issues, both in a legal and a policy sense.

In the legal sense, Congress passed section 6 of the Bank Act in a completely new form from the existing section 6, and granted to the Banks a good deal of flexibility in deciding how to array the economic and political interests represented by shareholding under the new system.

Congress did not take care to amend section 7, which has existed essentially in the current form with small modifications since 1932, and which is at its core premised on the existing section 6 rather than the new section 6, giving us a good deal of heartburn in trying to reconcile this. The Office of General Counsel has carefully reviewed the language and found the minimum number of irreconcilable provisions in section 7 which in fact cannot be carried forward as a matter of law and still recognize what Congress has done in terms of changes in section 6. And this proposed rule embodies that legal analysis and frees the Banks from certain quota requirements in section 7 that are premised on the old stock structure.

Everything else in section 7 is preserved, such as the size of boards and the like. But state by state representation and statutory maximum voting cannot prevail in light of what has gone in section 6. On the other hand, the values reflected in old section 7 provisions having to do with spreading the political power broadly among members and with respect to representing geography as well as stock ownership are perfectly valid objectives to be sought, as long as they don't do violence to the basic risk based capital requirements that are in section 6.

So everyone is going to be challenged. And we have been asked by the Banks and their consultants to treat lightly in terms of making any significant restraints on their ability to try to array these political and economic interests in putting their capital plans together.

So I think we have struck that balance. And I think the questions that you, Mr. Apgar, have suggested are absolutely appropriate. And the questions really are addressed in two directions. Is there any more restriction that the Finance Board should put on this question, or are there things that the Finance Board in its approval process should encourage in the capital plans, even without making it an explicit requirement, in other words, to work with the Banks to encourage certain objectives. And I think both of those are embodied in what you have suggested, and I think we can achieve.

There is in this capital planning process a level of economic reality thrust upon the Banks that has not existed before. For the first time, the Banks will have to sell stock to their members absent a statutory compulsion of particular levels of ownership. And there many conflicts that exist out in the Bank System that this brings to the surface, and one of them is the conflict between a large concentration of large members and large numbers of small members, both of whom have legitimate public policy reasons to be participants in the System, but which are very much different in the way they operate and in their size and in their economic capacity. And I think that the Banks and the Finance Board will continue to struggle with this question of finding the right balance, not only in this rule, but beyond, and no one should be surprised to find this because it has been observed in questions about loan to one borrower limits and other concentration issues as we have been working on this over the last few years.

So it is exactly the issue that is going to come to the surface in this process, and it is one we should be focused on.

So I offer my amendment. Is there discussion either on the amendment or the related issues? Mr. O'Neill?

MR. O'NEILL: I wanted, I guess, to praise the staff, not only for all the work that has gotten us to this point, but for the flexibility that you have shown. Obviously, I was the one that wanted to hear from J.P. Morgan and PriceWaterhouseCoopers. And not only did we hear from them, but the things that they thought were good ideas for this have been incorporated. So I thank you for all of that. And I think that the Board members as well have encouraged that flexibility. And I do think that this is a great jumping off place.

I think that we have done a lot of good work. And I guess the only other thing is that the staff and the Chairman have said that this is the way it is going to be. But during the 90 days, rather than simply wait until the 90 days end to kind of see what comments come in, that the staff continue to work with the Banks, consultants, and everybody else during those 90 days so that by the time this whole process ends, we can come up with a rule that the Board will be proud of.

But I think this is tremendously positive first step, and I thank you for all of the good work that has gone into it.

MR. MORRISON: Okay. If there is no objection, the vote occurs on the amendment. All in favor, please say aye.

MR. APGAR: Aye.

MR. O'NEILL: Aye.

MR. MORRISON: Opposed, no. The amendment is adopted. Other comments or questions for the staff or otherwise with respect to any other issue with respect to the rule?

If not, let me just say a couple of things on that. The staff has done an extraordinary job here, which could get overlooked. And I don't think it should be overlooked. The process of designing and appropriate risk based capital regime for the Banks did not start with the passage of Gramm-Leach-Bliley. And the much maligned FMMA was not, as some would have had it, an attempt to derail congressional action on these matters, but in fact to lay the groundwork for exactly what the Congress did in Gramm-Leach-Bliley with respect to risk based capital. And everything that is in this proposed rule with respect to risk based capital has its origins in important work that the staff did in analyzing the question of how to structure a state of the art, risk based capital regime uniquely suited to the business of the Federal Home Loan Banks.

And, obviously, there are things that have been markedly refined, and we are in the debt of those people who have provided us consultation, both on behalf of the Banks and behalf of the Finance Board in coming to this conclusion. But as the OFHEO rule was debated with respect to Fannie and Freddie, what we hear repeatedly from the enterprises is that economic capital and regulatory capital should be brought in as close alignment as possible if one is to actually allow capital to be a management tool of the institutions as well as a regulatory protection against failure.

And while that talk is going on, the reality here is being realized in that that has been the goal of the staff in designing this risk based capital regime from the beginning. And while I'm sure that it isn't perfect, and it will never be perfect, and that we will see it modified and amended over the years to come, it is a very good first effort or second effort, if we count last year's publication, in this regard.

We have managed to identify a credit risk management regime which reflects the essentially rated asset balance sheets of the Banks, but also especially focuses on two specialized assets, one advances, and has achieved an appropriate database setting of credit risk scoring for advances which is different from either risk free assets or triple A assets because there is a special characteristic.

And the staff has really worked very effectively in finding an appropriate way to define what that ought to be; and mortgages set forth as a separate category with separate behaviors, which applies both to pools of mortgages created by the Banks as well as mortgage backed securities brought by the Banks.

So there really is real achievement on the credit front. And on the market risk front, there are two things of note. First of all, the use of Bank models, which are and should be the management tool of the Banks to determine how much capital they need depending on the risk they undertake, to be reviewed by the regulator and approved by the regulator, but essentially be the same tool for regulation and for risk management, which is a goal perhaps easier for us to reach given only 12 regulated entities than for the Banking System as a whole, but clearly a goal that many seek to achieve.

And in addition to that, in both the area of operations risk and the area of market risk, the proposed rule leaves open the opportunity for the Banks to demonstrate an alternative methodology in the case of market risk cash flow over value at risk, and in the case of operations risk to actually quantify those risks with an acceptable methodology. And so there is flexibility for and even more finely tuned risk based capital scoring, if that is available.

With this rule, the Banks will really for the first time have to think about risk as a management tool. In the past, the way the capital was accumulated and the enormous excess of capital over the actual risk on the balance sheet, has made capital risk management really a nonexistent activity in the Banks. And in fact, regulatory conformity was the governing principle.

This is a fundamental change in that, and it is a change for the better. But it is obviously going to be a challenge for the Banks to take that on board and really use it and benefit from it.

The capital structure that goes with that is a whole other matter and full of potential difficulties, but also full of potential opportunities. The recasting of capital to not exceed the risk presented by particular assets is also the opportunity to have the return on those assets appropriate to the risk. And much of what we hear about earnings and will the Banks have enough and statements about losing money on the stock I think will really go away when people recognize that they can shape their capital to the actual risks. And if your capital reflects the risks, then the return should be adequate, or something is wrong with the way you are doing the business or pricing the product.

So I think there is real opportunity down this road. If everybody takes on board the opportunity side of this change, I think we'll do just fine.

So once again, to my colleagues, thank you for your consultation and to the staff, an enormously good job done, which couldn't have been achieved in just the six months since Gramm-Leach-Bliley if you hadn't done all that work last year. So sometimes doing it twice is worth the reward. So thank you.

Are there any further comments or questions or amendments before we vote? If not, all in favor of the proposed rule as amended, please say aye.

MR. APGAR: Aye.

MR. O'NEILL: Aye.

MR. MORRISON: Opposed, no. The proposed rule is adopted. I ask unanimous consent that the staff be permitted to make technical and conforming changes in the proposed rule, and further, that they make appropriate drafting changes as discussed here and otherwise with respect to the preamble, subject to the review of the three board members prior to publication. Without objection, so ordered. The board is adjourned.

(Whereupon, at 10:42 a.m., the meeting was adjourned.)

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REPORTER'S CERTIFICATE

DOCKET NO.: N/A
CASE TITLE: Open Meeting
HEARING DATE: May 22, 2000
LOCATION: Washington, DC

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the Federal Housing Finance Board.

Date: May 22, 2000

Jan M. Jablonsky
Official Reporter
Heritage Reporting Corporation
Suite 600
1220 L Street, N. W.
Washington, D. C. 20005-4018