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February 7, 2003

Ms. Elaine L. Baker
Secretary to the Board
Federal Housing Finance Board
1777 F Street, N.W.
Washington, D.C. 20006

Re: Request for Comment: Concerns Over and Consequences of Ongoing Changes in the Financial Services Industry

Dear Ms. Baker:

The Federal Home Loan Bank of Dallas ("Dallas Bank") appreciates the opportunity to respond to the Federal Housing Finance Board's ("Finance Board") December 20, 2002 Resolution requesting comments from the Federal Home Loan Banks regarding specific concerns over and consequences of ongoing changes in the financial services industry that comprises FHLBank membership, and how those issues should be addressed.

The Dallas Bank remains convinced that modernizing FHLBank membership rules is critical to the preservation of a strong regional Federal Home Loan Bank System. As discussed below, we are concerned that the current charter-based membership system will eventually undermine the existing regional structure of the FHLBank System. As a result, the Dallas Bank enthusiastically endorses the Finance Board's efforts to come to grips with this matter.

The Dallas Bank particularly welcomes the finding summarized in the introduction of Morrison & Foerster's legal opinion that the Finance Board should be viewed as having the legal authority to address multi-district membership pursuant to its Congressional mandate and broad authority to "'ensure that' the FHLBanks 'operate in a financially safe and sound manner,' 'carry out their housing finance mission,' and 'remain adequately capitalized and able to raise funds in the capital markets.'" Acceptance of this conclusion will allow the Finance Board to properly focus not on the fine points of statutory construction, but rather on the fundamental policy issue of what membership structure is best suited for the FHLBanks as the market environment evolves.

The Dallas Bank remains convinced that the best approach is to permit limited multi-district membership along the lines set forth in our December 17, 2000 Petition to the Finance Board (subsequently withdrawn at the request of the Finance Board Chairman, but retained at the

Dallas Bank pending further regulatory consideration of the larger issue), as supplemented by our January 31, 2001 Letter Response to the Finance Board's request for supplemental information, our April 24, 2001 Response to Requests to Intervene and our March 4, 2002 comment letter. We incorporate those earlier filings by reference and ask that they be taken into consideration by the Finance Board as well. In particular, our 2002 comment letter focused on many of the economic and policy issues underlying our position on this issue.

Industry Changes

When Congress created the Federal Home Loan Bank System and the Federal Home Loan Bank Board established the 12 FHLBank Districts in 1932, thrift institutions operating in local markets were the predominant providers of mortgage loans in this country. Among many changes in the mortgage finance industry over the last 70 years, the business line distinctions between community commercial banks and thrift institutions have blurred almost to the point of extinction, and many banking organizations have begun to operate across state lines. The FHLBanks' membership framework has adapted to the convergence of charter types within the banking industry, but must still adapt to the more recent changes in the geographic structure of the industry.

The evolution of thrift institutions and commercial banks into community banking organizations with overlapping business lines was recognized in 1989 in FIRREA, which expanded eligibility for membership in the FHLBanks to include all FDIC-insured institutions. As a result, commercial banks now represent 75 percent of all FHLBank members, and the FHLBanks have been able to evolve with the industry they serve to continue their long standing role of providing funds for mortgage and other community lending.

The geographic market structure of the financial institutions industry that comprises the FHLBanks' membership has also evolved, particularly in the eight years since the federal authorization of interstate branching. An industry that was comprised predominantly of individually chartered banking organizations operating in single states (and often in smaller market areas within states) has moved rapidly toward an industry with many market participants operating across state lines and even nationally. We believe FHLBank membership rules must be updated to adapt to this ongoing trend.

The most comprehensive and readily available information on the interstate structure of the banking industry can be found in the data compiled by the FDIC in its annual branch office survey of deposits. All FDIC-insured institutions report the amount of deposits held as of June 30 of each year by the location of the branch through which the deposits were acquired. This data is compiled and published annually, and is available along with other banking industry data on the FDIC web site.

According to the FDIC data, the number of FDIC-insured institution charters has declined 44 percent in the last 14 years, from 16,993 in 1988 to 9,455 in 2002. Despite the decline in the number of separately chartered institutions, however, the number of banking

offices is virtually unchanged, having actually grown slightly from 85,639 in 1988 to 86,549 in 2002. While much of the reduction in the number of banking charters may be attributed to consolidations of individually chartered banks within holding companies operating in formerly unit banking states (such as Texas), or through mergers and acquisitions of institutions within state boundaries, there has also been a great increase in the number of institutions operating branch offices across state lines.

FDIC statistics indicate there were 91 institutions operating 1,881 interstate branch offices in January 1994. By June 30, 2002, those numbers had escalated to 448 institutions operating 23,684 interstate branches. While only 4.7 percent of FDIC-insured institutions operated across state lines, interstate branches accounted for 27 percent of all banking offices in the country, and held 27 percent of the banking industry's total deposits.

Complicating the picture is the fact that interstate branching is not evenly distributed across the states, and does not follow population or economic activity. Because the Texas banking industry (thrifts as well as commercial banks) was decimated by the banking crises that swept through the region in the mid- to late-1980s, for instance, the state does not have a share of larger banking organization headquarters commensurate with its market size. Consequently, 41.7 percent of the deposits in the state of Texas, which accounts for 6.3 percent of the banking industry's total deposits, are held by interstate branches of banks chartered in other states.

Other states are in the opposite position of being the headquarters location for banks that are far larger than would be expected based on the state's market size. Still other states have experienced unique circumstances over time that have created similar disconnects between market size and the location of banking organization charters.

This profile of the geographic structure of the United States banking industry reveals an industry with two components. First, a large number of banking organizations (95 percent of FDIC-insured institutions) each operate in only a single state. Second, a small (but growing) number of larger institutions that account for a large proportion of the country's banking activity operate across state lines – and in some cases across multiple state lines.

Despite developments in technology and communication that have supported interstate banking and made deposit and lending markets more homogeneous across the nation, those markets still have significant regional components. A visit to the web sites of multi-state banks in search of product information makes the point. Before gaining access to specific information about products and pricing, the web visitor must identify a state or geographic region. These larger companies tailor their product offerings to regional and local markets.

In this context, the traditional connection between a bank's primary market area and its headquarters location breaks down. For many community banks, the primary market area is, as it has always been, the area around the home office – a neighborhood, a town or city, or a region within a state. On the other hand, larger interstate banks operate in a series of local markets, each of which may constitute one of many primary market areas.

Impact on the Federal Home Loan Banks

In the years since FIRREA, the FHLBanks' membership base has expanded to include 77 percent of all FDIC-insured institutions, with a composition representative of the entire banking industry. For instance, 94 percent of all FDIC-insured institutions have total assets less than $1.0 billion, and 94 percent of all FHLBank depository institution members are in that size category. Like the banking industry as a whole, FHLBank members are predominantly smaller institutions operating within single states. Also like the industry, however, a small number of FHLBank members operate across state lines (about 2.6 percent as of June 2000, according to the Finance Board's 2001 solicitation of comments on this issue).

Multi-state members come predominantly from among a relatively small group of larger institutions that accounts for a large proportion of the FHLBanks' business. As of September 30, 2002, for instance, the two percent of the FHLBanks' members with total assets greater than $5.0 billion accounted for 65 percent of total advances, while the 94 percent of FHLBank members with total assets less than $1.0 billion accounted for 18 percent of the FHLBanks' advances. This group of larger institutions represents those most likely to be involved in substantial interstate – or inter-District – activity, either now or in the future as the industry continues its consolidation trend.

Although the statistics cited above might be interpreted to reflect disproportionate use of the FHLBanks by large members, a complete understanding of the dynamics of the FHLBanks reveals that usage of FHLBank advances across asset size groups is in proportion to the groups' relative sizes. In addition, we believe that the mix of large and small institutions within the FHLBanks is good for both groups and furthers the FHLBanks' housing finance mission.

First, it should be noted that the proportion of advances to large institutions is not out of line with the distribution of member assets. For instance, members with assets greater than $5 billion hold 65 percent of the FHLBanks' aggregate advances, and account for 58 percent of combined member assets.

Second, these larger borrowers are a conduit for the delivery of a significant portion of the FHLBanks' contribution to the housing finance market. They are active users of FHLBank advances, deliver loans under the FHLBanks' acquired member asset (AMA) programs, and actively participate in the FHLBanks' Affordable Housing and Community Investment Cash Advance Programs.

Third, smaller members benefit from the presence of larger members through access to regional FHLBanks that make advances and provide other services at lower prices than would otherwise be possible. The advances and AMA loan volume of large members provides the critical mass that enables FHLBanks to generate economies of scale so that they can make advances at lower rates, purchase member assets at better prices, and / or pay higher dividends. In other words, the critical mass of business from the large members helps pay the bills for the

infrastructure each FHLBank needs to provide services to smaller members, which in turn contributes to the FHLBanks' housing finance mission.

As discussed at some length in the Bank's 2002 comment letter, both the Dallas Bank's experience and its analysis indicate that these larger borrowers add value to the cooperative by generating the scale that enables the Bank to provide greater value to its smaller institution members. If the Bank lost the advances business of its large borrowers, the Bank's business model would be much different and the losers would be the remaining smaller members.

For this reason, the Dallas Bank believes that maintaining the balance of large and small members across the FHLBanks is central to the economics of preserving a strong regional System. Larger members are also most likely to be involved in interstate banking activity – either as acquirers of institutions across state lines or as targets of acquisitions by institutions from other states. Concentration of larger institutions at a few FHLBanks as a result of interstate acquisitions erodes the desirable balance of large and small members. Over time, providing multi-state members a mechanism to do business with the FHLBanks in the Districts where they operate will be critical to maintaining that balance.

Our March 4, 2002 comment letter outlined the original analysis we conducted to determine the impact that losing a large borrower's advances would have on the Dallas Bank under the specific circumstances we faced when Washington Mutual Bank acquired Bank United and terminated its charter. We will not repeat the discussion of that analysis in this comment, but refer the Finance Board to that discussion for more detail. Based on that analysis, we determined that the loss of existing advances to our largest borrower would be detrimental to the Bank's remaining stockholders because losing that business would reduce the economic value of Bank membership for them.

The Bank has more recently updated its original analysis to determine whether changing market conditions and the intervening growth in the Bank's advances business with other members would have changed the Bank's conclusion. We performed a pro forma analysis of the impact of losing advances equal to the amount currently held by Washington Mutual, losing the advances outstanding to the Bank's two largest borrowers, and losing the advances to the five largest borrowers.

Since the Dallas Bank's District includes a fairly large economy but does not contain a commensurate share of large banking organizations headquarters, the relatively larger borrowers within this District appear more likely to be interstate acquisition targets than interstate acquirers of other institutions. While losing all five of the Bank's largest borrowers is not anticipated, the Bank's analysis provides a picture of not only the impact of losing a single large borrower, but also (and more important) the cumulative impact of losing multiple large borrowers through acquisition over time.

The pro forma analysis was based on estimated spreads the Bank is able to earn on various asset categories. For each reduction in advances, the analysis assumed that the capital

stock supporting the advances would be reduced in proportion and that the Bank's mortgage securities investments would decline in proportion to the reductions in capital stock. The Bank assumed no other changes to its balance sheet or operations, and used the same interest rate environment for the comparative analysis.

The analysis indicates that the loss of the Bank's two largest borrowers would reduce the Bank's return on members' capital stock investment (return on capital stock, or ROCS) by about 47 basis points (0.47 percent), while losing the Bank's five largest borrowers would reduce ROCS by about 65 basis points (0.65 percent). This impact is somewhat smaller than that reported in our previous comment letter, primarily because advances to other members have grown in the interim period, but it is still significant.

In either case, our analysis demonstrates that the impact of losing the larger borrowers' advances would be negative for our remaining members. That loss of economic value could be passed through to the Bank's remaining members in a variety of ways, such as reducing dividends, increasing advances rate, or eliminating operations that add value to members' relationship with the Bank.

In practice, the Bank would probably attempt to offset the lower rate of return caused by the loss of advances through some combination of lower dividend rates, higher offering rates on advances, and reduced operating expenses. However, all of those approaches are simply ways to allocate the negative economic impact among remaining members. Since the Bank's smaller members have fewer alternatives for wholesale funding, that allocation would necessarily fall disproportionately on those members.

While these figures indicate that the loss of a single large borrower would not threaten the financial viability of a FHLBank, they also demonstrate that the economic impact on remaining stockholders is significant. And, as significant as the economic impact of losing one or two large borrowers may be, a larger concern is that the impact becomes greater with the loss of each successive large borrower. If a FHLBank loses several of their large borrowers over time through consolidations, the cumulative impact will become harder and harder to overcome without serious negative consequences for remaining members.

Federal Home Loan Banks are perhaps unique in their ability to absorb significant reductions in business without threatening their financial viability. The FHLBanks' cooperative, self-capitalizing structure generally allows them to adjust to changes in their business mix without suffering losses that would be passed through to their member stockholders. However, some combination of higher advance rates, lower dividend rates or a lower level of FHLBank services will result initially. Over time, FHLBanks that experience large reductions in member business volume may be tempted to expand into unfamiliar activities or accept greater interest rate or credit risk to overcome the negative impact. We believe that the best way to avoid this outcome, facilitate the continued safe and sound operation of all the FHLBanks, and preserve a System of strong regional FHLBanks is to allow some form of limited multi-district membership.

Recommended Actions

As noted above, FHLBank membership rules were originally formulated to create regional FHLBanks serving banking (thrift) institutions that were both located and lending within their respective regions. Despite the market changes outlined above, FHLBank membership rules are still based primarily on the location of a member's charter, rather than the location(s) where the member does business. These rules essentially assume there is only one geographic area that represents the primary market for each member bank. For a small but growing segment of the FHLBanks' membership, that assumption is no longer valid.

The Dallas Bank recommends that the Finance Board promulgate regulations to modify the existing membership framework and realign FHLBank business activity with the FHLBanks' designated geographic markets. We believe that a regulation modifying the FHLBanks' membership framework must satisfy three key objectives:

1. Enhance the safety and soundness of individual FHLBanks and the FHLBank System.

2. Promote fulfillment of the FHLBanks' housing finance mission.

3. Meet a market test by being mutually advantageous for eligible members and FHLBanks that choose to participate.

We believe that a framework for limited multi-district membership that includes the following elements would be consistent with the evolution of the geographic market structure of the depository institutions industry and would achieve these three objectives.

1. An institution eligible for FHLBank membership would be required to become a member of and maintain membership in the FHLBank whose District includes the institution's home office. The location of the home office membership would continue to be based on criteria such as the location of its charter or its corporate offices, and / or a preponderance of its branch offices or assets.

2. A FHLBank member would also be eligible to become a member of and acquire advances or other services from one or more other FHLBanks in whose Districts the member maintains a market presence. No member would be required to become a member of, or do business with, multiple Banks.

3. A member's access to advances or other services from the additional FHLBank(s) would be limited in proportion to the member's market presence in each respective District.

4. A multi-district member would have capital stock requirements, voting rights and director representation in each FHLBank in which it maintains membership, consistent with other members' rights and requirements and based on its market presence in that District.

5. Individually chartered affiliated institutions would continue to be eligible to become members of the FHLBanks in whose Districts the chartered entities are located.

The Dallas Bank believes that this membership framework will contribute to a more equal balance among the FHLBanks as the industry continues to consolidate. This will reinforce the strong regional structure of the FHLBank System and, in turn, promote the safe and sound operation of all the FHLBanks. FHLBanks that might otherwise face the prospect of a declining membership base will not be tempted to take more risks or engage in activities unrelated to their primary business in order to maintain the economic returns that make membership valuable for remaining members.

This membership framework will promote fulfillment of the FHLBanks' housing finance mission by strengthening the connection between their lending activity and communities in their Districts, and by preserving the economics that allow the FHLBanks to provide value to all members even as the charter structure of the membership base changes. It will also maintain a strong nexus between the regional FHLBanks' Affordable Housing Programs (AHP) and their respective regions, first by helping create the pool of AHP funds, second by enabling members to apply for AHP grants in the Districts where the projects are located, and third by requiring those projects to compete with others within the District to obtain funding.

Finally, this membership framework will ensure that the market test is met. Multiple memberships would be voluntary for both the member and the FHLBank, so the terms of membership would have to be equitable and mutually advantageous. Likewise, FHLBanks would have to offer a competitive value proposition in order for a member to accept the inevitable overhead of simultaneous memberships at more than one FHLBank.

Alternative Market Presence Measures

The Dallas Bank's proposed multi-district membership framework would limit access to advances from all but the home FHLBank based on some measure of market presence. The two best measures of geographic market presence would be mortgage lending activity or deposits in the respective FHLBank Districts. Mortgage lending activity could be measured either by loan originations or by loans held in portfolio. Either a mortgage lending or deposit measure could be used, but neither is ideal. On balance, the Dallas Bank believes that deposits will be a more feasible alternative.

Access to a FHLBank based on mortgage activity in that District would be conceptually the best measure of market presence if it were feasible to implement. The purpose of the FHLBanks' primary products – advances, acquired member assets, CICA, AHP – is to enable members to fund more loans in their communities than they would otherwise be able to do. The connection to the FHLBanks' housing finance mission is clear and direct.

Mortgage activity could be based either on a member's loan origination activity over a given period of time, or its portfolio holdings of mortgage loans at a given point in time. Which of these is a better measure of a member's market presence will depend on the individual institution's business focus. For members that primarily originate and sell mortgages, origination activity would be the best measure; for members that are primarily portfolio lenders, mortgage holdings would be a better measure. Selecting one or the other measure for all members will distort the actual market presence of some members, while allowing either to be used will make the process susceptible to manipulation.

In addition, there are data collection and verification issues with either measure. While loan origination activity could be tracked through HMDA reports, data on outstanding loans based on the location of the property will be difficult to obtain and is not publicly available. A measure of market presence based on outstanding loans would create a new reporting and certification requirement for members, and a new verification requirement and burden for the FHLBanks. While reports could be created and procedures established to gather the data, doing so could be an impediment to prospective members and cause the method to fail the market test.

The distribution of a member's deposits among FHLBank Districts may represent a reasonable proxy for the institution's lending presence in a market area. Although deposit gathering is not the primary focus of the FHLBanks, FDIC deposit data provide the most consistent and comprehensive picture of the interstate activities of the nation's banks. Depository institutions already report deposits by branch office location to the FDIC as of each June 30, and the data is readily available to the public.

As noted above, data on the distribution of outstanding mortgage debt by the state in which the property is located is not readily available. However, proprietary data obtained by the Dallas Bank on outstanding securitized conforming and non-conforming mortgage loans indicates that the distribution of these loans is highly correlated with the distribution of deposits. While a particular institution's deposit gathering activity in a given state may not be a precise indicator of its lending activity in that market, deposits represent one clear indicator of an institution's market presence.

A decision to base market presence on a member's deposits would be similar to the decision the Finance Board made to use specific call report line items to define loans eligible as CFI collateral, rather than requiring individual members to provide new *ad hoc* reports to the FHLBanks to determine the amount of collateral available. Neither mortgage lending nor deposit activity is an ideal market presence measure, but the Dallas Bank favors deposits as a more practical alternative.

Transition Provisions

Modifying the FHLBanks' membership framework represents substantial change. Any change of that magnitude could conceivably have unintended consequences that could potentially destabilize the operations of one or more FHLBanks when it is implemented. While

we do not expect that outcome, it might be wise for the Finance Board to consider a transition period to ensure that the ramifications of multi-district membership are well tested and well understood before multi-district membership becomes widespread.

One transition alternative would be to limit multiple memberships for some period of time following the effective date of the new regulation to cases in which a member of one FHLBank acquires a member of another FHLBank. (If adopted, this should include at least the prior multi-district acquisitions that have been the subject of petitions previously submitted to the Finance Board.) The regulation could include a trigger date at which time the new membership rules would take full effect unless the Finance Board had taken affirmative action otherwise in the interim. This would both help preserve the current membership base of each FHLBank, and provide a test period to determine whether multi-district membership raises unforeseen issues or has a destabilizing impact. Three years should be a reasonable transition period.

The Participation Alternative

Advances participations have been suggested as a remedy to the problem created by members with inter-District operations being able to borrow from only one FHLBank. To make the participation concept more concrete, the FHLBanks of San Francisco and New York recently submitted to the Finance Board an outline of the issues that they determined must be resolved in order to successfully implement a participation approach to the issue. The outline submitted by those FHLBanks included a list of regulatory exceptions and exemptions that would be necessary in order for the concept to work. Most of these regulatory accommodations are within the jurisdiction of the Finance Board to consider, but one would require confirmation of the proposed accounting treatment by the FHLBanks' external auditor, and another would require agreement on members' risk-based capital treatment by bank regulatory agencies.

While approval of all of the component parts of the participation outline would make multi-district participations operationally feasible, the Dallas Bank is concerned that multi-district participations would fail the market test requirement by complicating the transaction in several ways. First, the participation structure requires the member to invest in two different FHLBanks to support the same advance. The member receives advances structured and priced by one FHLBank, but is subject to the dividend policies of two FHLBanks that may have different approaches to balancing advances pricing and dividends. Second, the member would not have voting rights at the participant FHLBank despite making an investment in a capital instrument issued by that FHLBank that is available to absorb losses incurred by that FHLBank.

From the FHLBanks' perspective, the participant FHLBank may become captive to the pricing policies, advances terms and structures, and appetite for additional advances at the lead FHLBank. The lead FHLBank's pricing policies may or may not be consistent with the value proposition the participant FHLBank has created for its members. Every advance could become a three-way negotiation among the member, the lead FHLBank and the participant FHLBank over terms of pricing, structure and percentage distribution between participating FHLBanks.

The Dallas Bank believes that participations may represent a viable alternative in some cases and should be authorized if the necessary technical, regulatory and logistical issues can be resolved satisfactorily. However, the Dallas Bank does not believe that participations provide a comprehensive solution to the central problem created by the misalignment of geographic markets and FHLBank membership.

Operational Issues

Credit Concentration Risk. A recent study conducted on behalf of the FHLBank of Seattle concluded that a FHLBank's risk of credit loss in the advances business is so small that concentrations of credit to individual institutions are not a significant issue. This is true because of the stringent collateral policies and statutory preferences to pledged collateral. That study concluded that collateral management, not credit concentration, would be a more likely source of risk and, therefore, should be addressed by the FHLBanks.

Consistent with the findings of that study, the Dallas Bank believes that several factors related to the structure of the FHLBanks generally prevent concentration from being as important a concern as it would be for typical financial institutions. First, by law, the FHLBanks must fully secure all advances with high quality collateral. Second, the FHLBanks have a statutory preference to collateral pledged by the member over any unsecured creditors. Third, members must capitalize their advances with capital stock purchases that, under the risk-based capital guidelines adopted by the Finance Board pursuant to the Gramm-Leach-Bliley Act, will be sufficient to capitalize the credit, market and operational risks represented by the advances. These factors make FHLBank advances unique.

In addition, the limited proportional multi-district membership framework outlined here would actually serve to reduce the concentration of advances that would otherwise be created when one large borrower acquires another large borrower from a different district and consolidates its combined borrowing activity at a single FHLBank. Spreading advances across more than one FHLBank will also reduce the business risk associated with one FHLBank having a large share of its business concentrated in a single member institution.

Collateral Considerations. As noted above, the recent study conducted on behalf of the Federal Home Loan Bank of Seattle indicated that collateral management poses a greater potential risk to the FHLBanks than credit concentration. In the context of one member institution being a member of, securing advances from, and pledging collateral to more than one FHLBank, careful collateral management is absolutely essential. The most likely reason for a credit loss in such a scenario is a situation in which a member has (unwittingly or not) pledged the same collateral to more than one FHLBank. However, we believe the FHLBanks can mitigate this potential collateral risk in satisfactory ways.

FHLBanks have often confronted this situation and been able to ensure that each FHLBank has clear rights to adequate collateral in situations where members with outstanding advances are acquired by other FHLBanks' members and choose to maintain the outstanding advances until

they mature. In such cases, the disappearing member's FHLBank typically provides for either delivery or a listing of adequate collateral to fully secure the outstanding advances. On occasion, the FHLBanks involved have also formally recognized each other's collateral positions by use of a simple inter-creditor agreement. In such a situation, each FHLBank remains responsible for its own credit judgment and each FHLBank recognizes the other's collateral position.

This historical experience makes it clear that the FHLBanks involved in such situations can act to protect their collateral positions and to fully secure outstanding advances. The same approaches would be effective in a multi-district membership context. We note, for example, that the Dallas and San Francisco Banks have utilized this approach in the context of Washington Mutual Bank's acquisition of the advances of Bank United. We see no reason why such an approach cannot be adapted to the multi-district membership context to collateralize new advances as well as existing advances.

Given the importance of this issue to the success of multi-district membership, the Finance Board may want to consider including guidelines for inter-FHLBank collateral arrangements in a multi-district membership regulation. Those guidelines should be structured to help the FHLBanks guard against pledges of the same collateral to multiple FHLBanks, and to address in advance the allocation of FHLBanks' respective rights to collateral under blanket and specific lien pledging arrangements.

Competition Among FHLBanks. Some concern has been expressed that multi-district memberships may lead to harmful competition between or among FHLBanks as they compete for the advances business of multi-district members by discounting the price of advances to those members, only to raise the price to smaller members unable to compete across Districts.

We believe that multi-district membership can be structured to preclude the possibility of harmful competition across FHLBanks. Evidence that this is the case is provided by the current environment, in which approximately 100 holding companies have multi-district memberships through separately chartered institutions in multiple districts. There is no evidence that these institutions have created harmful price competition among FHLBanks. In addition, the Finance Board's applicable advances pricing regulation (12 C.F.R. 950.5(b)) prohibits a FHLBank from pricing advances below its marginal cost of funds plus administrative and operating expenses. By regulation, therefore, no FHLBank could price advances in a manner that would threaten its economic viability.

We believe the multi-district membership structure we have suggested would not result in a large member being positioned to coerce a FHLBank into making an advance pricing decision that is not in that FHLBank's interests. Multi-district members would be limited in their ability to obtain advances from each FHLBank based upon some formula, such as a percentage or multiple of its deposits in the District. As a result, a multi-district member could not assert unlimited market power and dictate harmful pricing decisions.

In addition, each FHLBank's board of directors is ultimately responsible for establishing advances pricing policies for their FHLBank. The Dallas Bank's practice is to make the same pricing available to all members, regardless of size. If the Bank decided to lower advances rates to attract a large member's business, all members would benefit by being able to borrow at the lower rates.

Even if single large institutions are members of multiple FHLBanks, their ability to control pricing policies by controlling boards of directors will continue to be extremely limited due to statutory limitations on the number of votes that large members can cast in the election of directors. In June 2002, for instance, member institutions with total assets less than $1.0 billion held 23 percent of the FHLBanks' capital stock, but held 67 percent of the elected director positions. In this environment, vigilance by a board of directors will ensure that the FHLBank does not price advances or other products for multi-district members in a manner that disadvantages other members.

Conclusion

As stated in our March 4, 2002 comment letter, and reiterated here, the Dallas Bank believes the Finance Board faces a simple, basic issue: should a strong regional System of Federal Home Loan Banks be preserved? Or should the natural evolution of the geographic market structure of the FHLBanks' membership base be allowed to erode that strong regional structure until one or more FHLBanks is disabled and unable to fulfill its public purpose, to the detriment not only of remaining members but the nation's housing finance system.

The Dallas Bank believes that the regional structure of the FHLBank System deserves to be preserved. We believe the best way to accomplish that objective is to modify the FHLBank membership framework to realign the FHLBanks' geographic and customer markets. If the Finance Board does not act, the long term viability of the regional structure of the FHLBank System will be jeopardized and the value of the FHLBank System to its 8,000 members and the nation's housing finance system will be compromised.

Sincerely,

Terry Smith

cc: FHLBank of Dallas Board of Directors