Federal Home Loan Bank of New York

Response to the Federal Housing Finance Board's Request for Comments Regarding Concerns Over and Consequences of Ongoing Changes in the Financial Services Industry

INTRODUCTION

The financial services industry has changed significantly since the Federal Home Loan Bank Act ("Bank Act") was passed in 1932. The loosening of geographic restrictions on bank expansion, the broadening of bank products and services, and the application of new technologies have all contributed to the transformation of the U.S. financial services industry. Consolidation among U.S. banks has been a strong trend over the past two decades as a consequence of these transforming factors. In the 1990s, for example, 7,500 mergers and acquisitions valued at roughly $1.6 trillion were consummated among financial firms. Many of these mergers and acquisitions occurred between banking organizations in different geographic markets and across the district lines of the 12 Federal Home Loan Banks ("FHLBanks"). This consolidation will continue as banks strive to increase shareholder returns, grow revenues, reduce expenses and reach into new markets.

As a result of mergers of FHLBank members across district lines, the Federal Housing Finance Board ("Finance Board"), the Federal regulator of the FHLBank System, is studying whether current regulations need to be modified to enable the FHLBank System to continue to fulfill its mission while maintaining regional connections and operating safely and soundly. In the Federal Home Loan Bank of New York's ("FHLBNY") District, there has been a significant shift towards banks having operations in more than one district; the same trend has been observed in other FHLBank Districts.

These trends have important implications for the FHLBank System and require a response that will maintain the regional character of the System and allow the System to meet its housing mission. This response outlines the issues that industry consolidation creates for the FHLBank System, defines a practical and workable solution in the form of Limited Multi-District Membership ("Limited MDM") that can be applied in cases where a member bank acquires a member from another district and wishes to continue membership in the multiple Home Loan Banks, defines the rulings the Finance Board needs to make to achieve this solution safely and soundly, and describes why this solution is optimal for the System.

OBJECTIVES FOR THE FHLBANK SYSTEM IN RESPONDING TO INDUSTRY CHANGES

In considering how the FHLBank System should adapt to these industry changes, the overriding goals of the Finance Board should be to:

- Ensure the continued safety and soundness of the FHLBank System;
- Ensure the continued ability of the FHLBanks to achieve their mission;
- Maintain the balance in the FHLBank System's current structure by maintaining the level of funding for the Affordable Housing Program ("AHP") in each district;
- Maintain the aggregate level of REFCORP contributions across the FHLBanks; and
- Ensure that the regulatory response is practical and workable for members.

The solution proposed by the FHLBNY in this response is designed to satisfy all of these objectives.

SOLUTION: LIMITED MULTI-DISTRICT MEMBERSHIP

To address these industry changes, the FHLBNY requests that the Finance Board amend its regulations to permit Limited MDM. By this, we mean that a member maintains proportional market representation in more than one FHLBank when a member in one district acquires a member of another district FHLBank, the combined entity consolidates charters, and the inter-district organization wishes to maintain pre-existing FHLBank memberships and "partnerships." As implied by the word "limited," advance usage in the district FHLBanks in which the concerned member continues membership would be limited. The determinants of proportional FHLBank advance limits, e.g., community deposits in each district, would have to be determined appropriately by the Finance Board in the rulemaking process.

This response also describes in some depth appropriate responses by the Finance Board and each FHLBank to ensure continued safe and sound practices regarding collateral management and equitable treatment of member capital. Limited MDM would help maintain the regional character of each FHLBank district and the overall FHLBank System. This would allow for the current level of knowledge and expertise in certain aspects of AHP and community development to continue to flourish, thereby maintaining jobs and housing opportunities within the community.

ISSUES CREATED BY FINANCIAL SERVICES INDUSTRY CHANGES

Mission

The regional character of the FHLBanks is a critical element of the FHLBank System and needs to be preserved. The FHLBank System fulfills its mission through district FHLBanks. The ability of the FHLBanks to meet the needs of local housing markets and to provide liquidity to local members is of paramount importance to fulfilling the mission of the FHLBank System. The flexibility of the FHLBanks to meet the needs of unique local housing markets is a direct result of the involvement of local FHLBanks in their districts with their members, and in the FHLBanks' ability to understand the unique assets that are generated in their districts. Local housing markets differ substantially across the country in the composition of multi-family, mixed-use, cooperative and condominium, and affordable housing stock. As inter-district consolidation continues, Limited MDM will help ensure continued liquidity in support of members' community lending activities and preservation of key regional knowledge and expertise.

Besides these local benefits, Limited MDM could have positive FHLBank System-wide benefits as well. Mergers and acquisitions among members across FHLBank district lines, without the provision for Limited MDM, have the potential to significantly alter the relative sizes of the local FHLBanks by creating some very large FHLBanks while drastically reducing the size of other FHLBanks. In addition, the potential domination of one FHLBank over the other FHLBanks might be problematic for the FHLBank System. Acquiring members would presumably continue the pre-existing level of local housing activity of the acquired banks in their markets. However, shifts in members' geographic activity need to be offset by a commensurate shift in the balance of resources among the FHLBanks (e.g., people, expertise, operational capacity, risk management capabilities) to manage a higher level or different mix of activity safely and soundly. Without this rebalancing, each FHLBank's ability to fulfill its local mission - providing local lenders with the opportunity and the tools to serve their local markets - could be impaired and thus harm the System' s ability to meet its overall mission.

Impact on our Communities

Funding for Affordable Housing Program activity is an important element of the support that the FHLBanks provide to their local communities. AHP funding is directly tied to the level of income at each FHLBank, which in turn is directly linked to the level of advances and capital at each FHLBank. AHP funding should be distributed in a way that reflects the regional character of the System and the participation of FHLBank System members in affordable housing activity in each region. Continued mergers and acquisitions across district lines without the provision for Limited MDM could distort the funding levels for AHP across the System, reducing the level in some FHLBank districts relative to the market presence of System members in those districts. The most straightforward way to avoid this negative consequence is to approve Limited MDM.

The 2001 acquisition of Summit Bank ("Summit") by Fleet Bank and the 2002 acquisition of The Dime Savings Bank of New York ("The Dime") by Washington Mutual Bank, FA brought the ramifications of this issue into particularly sharp focus for the FHLBNY. Both Fleet Bank and Washington Mutual are strongly committed to affordable housing and community reinvestment and hoped to retain the respective memberships of Summit and The Dime in the FHLBNY. In 2000, the last full year both institutions were members of the FHLBNY, The Dime and Summit together contributed 14.6% of the total AHP subsidy pool for that year. And, if 1995 (the first year in which the FHLBNY contributed a full 10% of its net income to the AHP) is used as the starting point in determining the contributions of these two banks, statistics show that Summit Bank and The Dime contributed 17.1% of the total funds available for the period 1996 through 2001 under the AHP of the FHLBNY. Because Limited MDM is not currently allowed, the community banking networks, originally created by The Dime and Summit Bank, continue to take deposits from localities within the New York region, and are forced to migrate their advances business and associated AHP funding to the FHLBanks located in Boston and in San Francisco, respectively. This transfer of resources from the New York district to other districts will cause a reduction in the availability of scarce funding for community reinvestment and affordable housing in the New York region - resulting in job and housing loss.

The Dime and Summit Bank were particularly active members in the FHLBNY's Affordable Housing Program. They had both built a good corporate record of community support and valuable, difficult-to-replicate neighborhood partnerships. Since 1990, Summit Bank has supported 56 AHP projects with total affordable housing grants of $13.3 million. These dollars helped provide 2,107 new affordable housing units in New Jersey. The Dime has supported 18 AHP projects with total affordable housing grants of $7.6 million. These dollars helped provide 1,479 new affordable housing units in New York. The loss of the surviving Banks' access to FHLBNY AHP dollars and technical expertise has been felt by local housing groups throughout the states of New Jersey and New York.

In the New York/New Jersey area, multi-family housing is a significant segment of the affordable housing market. Developing affordable multi-family housing projects often involves many units with very complex financing. Both The Dime and Summit Bank were experts in this area and were relied upon by non-profit organizations to get the projects developed. These funding conduits for multi-family housing projects are no longer available to the Second FHLBank District. Further, many of these local housing groups do not have community partnerships developed with other community banks to the extent they did with The Dime and Summit Bank. It will take years for them to develop new partnerships with other FHLBNY members to fill this gap. Just as troubling, few of the other FHLBank members have the capacity for community support that The Dime and Summit Bank offered; therefore, in some respects this hole in the housing network may never be completely filled without regulatory relief.

In sum, the loss of Summit Bank's and The Dime's operations through acquisitions injures the FHLBNY in two ways: by significantly decreasing the future amount of AHP dollars available in the FHLBNY's district each year and by denying the surviving organizations access to the previous partnerships built over many years among the FHLBNY, local housing groups and former member banks.

The strength of the FHLBanks is their strategic advantage in local markets; the FHLBanks know the dynamics, people, and potential of their markets. This advantage is particularly beneficial to the success of the Affordable Housing Program. The continued trend towards consolidation without a change in the regulatory structure permitting Limited MDM will likely eliminate this advantage and weaken the character of the Home Loan Bank System.

System Safety and Soundness

As previously stated, the potential domination of one FHLBank over the other FHLBanks due to consolidation might be problematic for the FHLBank System. The continued consolidation in the financial services industry creates safety and soundness issues for the FHLBank System through increased concentration of borrowings in one FHLBank System member. This concentration of borrowings and other activities could create resource issues for a single FHLBank, impacting their ability to manage risks in a safe and sound manner.

Limited MDM would mitigate these risks through distribution of borrowings across several FHLBanks. While borrowing concentrations in a single FHLBank System member will still exist, diversification across several FHLBanks will reduce this risk. The differences among FHLBanks' capital rules and investment policies will create an additional mitigant to concentration risk. In addition, resource and operational risks are reduced by the diversification of activities across several FHLBanks.

The regional character of the FHLBanks also serves to ensure that appropriate business practices and operating controls are established and maintained to preserve the safety and soundness of each Bank. While being responsive to the funding needs of members, FHLBanks must also adhere to prudent risk management practices. Unique local housing needs supported by members create unique collateral types and challenges for FHLBanks. As a result, time-tested expertise in understanding, managing and valuing assets unique to a particular region (in type or concentration) has been developed at individual FHLBanks. Limited MDM will help ensure that key regional knowledge and expertise remain intact.

Member Equity

Another argument in favor of Limited MDM is the issue of basic charter equity. This point has two aspects. The first involves what current Finance Board regulations permit. The second deals with what is permitted by Federal and state banking statutes regarding charter types.

Members operating across district lines are treated differently under Finance Board rules today, depending upon their legal entity status. Bank or thrift holding companies whose bank or thrift subsidiaries operate under separate bank charters are, in effect, eligible to maintain memberships in multiple FHLBanks. Today, approximately 101 member lenders responsible for some 240 FHLBank memberships do in fact enjoy multi-district membership in this manner. In contrast, banks or thrifts that operate in multiple states under one charter are ineligible for membership in multiple FHLBanks. The charter decision is a business decision, and members electing single charters should not be penalized. There is no legal, financial, economic or public policy basis for treating members that expand across FHLBank district lines through acquisition and subsequent operation of multiple institutions differently from members that expand across district lines through acquisition and subsequent consolidation into one institution. Yet, under the current structure, the "regional" character of single-charter organizations and the "super-regional" character of the multi-bank organizations are ignored. A regulatory change enabling Limited MDM would provide a level playing field for all members.

Also, commercial banks and thrifts are today treated differently in the event of a business combination. This difference is unfair in its implication for FHLBank membership opportunities. With the passage of Riegle-Neal, commercial banks gained the choice of maintaining multiple inter-state charters or combining multiple charters into one (or utilizing a combination of the two). However, the ability of thrift holding companies to hold multiple thrift charters is more restricted, largely subject to varying state laws governing interstate banking by thrifts. Once again, a regulatory change enabling Limited MDM would provide a level playing field for all members and not disadvantage members that either decide to, or are forced to, operate under one charter.

<u>LIMITED MDM IS PRACTICAL AND WORKABLE</u>

The FHLBNY realizes that, with the approval of Limited MDM, various operational issues will have to be addressed. Three key implementation issues for Limited MDM are: (a) management of collateral, (b) promoting equitable use of advances, and (c) capital requirements for Limited MDM members.

In this response, the FHLBNY offers solutions for each of these key implementation issues. The implementation details for each potential solution have not been fully examined. However, the FHLBNY has considered these issues carefully and strongly believes that these implementation solutions are practical and workable for the FHLBanks and our members, and will ensure the continued safety and soundness of the System. These implementation issues should not impede the Finance Board's approval of Limited Multi-District Membership.

Management of Collateral

As asset-based lenders, the credit risk of the FHLBanks is tied directly to the FHLBanks' capabilities and practices in valuing and managing collateral. The risk-based capital framework adopted in 2001 by the Finance Board confirms the importance of collateral management practices. The credit risk of an advance to any member is mitigated by the collateral securing that advance. By assigning the same risk-based capital requirements to all advances of a certain tenor, the regulations implicitly state that the risk of those advances is the same across all FHLBanks. Therefore, the creditworthiness of advances is independent of the creditworthiness of the member taking the advance, implying that FHLBank collateral practices are homogenous. This in turn requires that the collateral management and reporting practices of each FHLBank be more than adequate to manage the risks of the advances. Ensuring the highest quality of standard collateral management practices across the System is critical to support the joint and several liabilities of the FHLBanks.

It is also critical to ensure that the investing community continues to believe in the creditworthiness of the System and continues to buy the debt that the System needs to issue in order to help fund its housing and community development activities. The emergence of Limited MDM, combined with the advent of risk-based capital, highlight the need to ensure minimum standards for collateral management practices across the FHLBanks (e.g., eligibility, valuation, analysis, tracking and reporting) as critical to the safety and soundness of the System.

To implement Limited MDM, each FHLBank should require listed mortgage collateral for Limited MDM advances and have a process in place to screen for duplicate pledged mortgage collateral across the FHLBanks and other creditors (e.g., Federal Reserve Banks, Corporate Central Credit Unions, warehouse lenders, affiliates, etc.) lending to that Limited MDM member.

Equitable Use of Advances

The intent of Limited MDM is to preserve balance among the FHLBank districts and to support the regional character of the System. To achieve this, the FHLBanks should limit or index the amount of advances in the new geography of the acquirer by some formula that ties the future level of funding to the conditions at the time of the merger, or to the member's deposits in each district over time or to some other balance sheet element relevant to geography over time. The FHLBNY believes that *pro rata* deposit share is the most appropriate index to provide a sound basis for ensuring equitable distribution of advances within the FHLBank districts in question. The amount of advances for a Limited MDM could be restricted to a percentage equal to the ratio of the Acquirer's total deposits applied to its deposits in each FHLBank district (plus some specified transitional and tolerance levels). The rationale for using deposits as the basis for allocation is that deposits represent a measure of a bank's commitment to its local communities and degree of presence in those communities. Deposits by branch are reported annually to the FDIC by all insured depository institutions; therefore, members would not need to expend additional effort to produce this information and the annual reporting can be used to reflect changes in a member's geographic mix over time.

In addition, a minimum allocation in each FHLBank district could be required in order to minimize the risk of advance competition and to ensure continued support of the community investment programs across Limited MDM districts. This would enable the member to best decide how the FHLBank System can support the member's needs in each of the markets in which it operates. While these ideas have not been fully researched or analyzed, the spirit of the proposed solution is to ensure that Limited MDM members support local housing activity in all their markets and do not abuse their privilege of being members in multiple FHLBanks.

Capital Requirements

The membership capital requirement is a complex issue. Two possible ways to handle membership capital are as follows. In the first alternative, the Finance Board would rule that owning full membership capital in one FHLBank enables that Limited MDM member to continue membership in other FHLBanks without the need to purchase additional membership capital in other FHLBanks. In the second alternative, the membership capital requirement would be scaled on a *pro rata* basis across the FHLBanks in which the Limited MDM continues membership based upon the amount of its total deposits held within the respective FHLBank districts. The amount of capital required could be determined by using the highest membership requirement of the capital plans of the FHLBanks in question, or by applying the scaling factor derived from deposit distribution to the membership capital requirement of each FHLBank.

Under the Limited MDM option as structured in the above alternatives, members in multiple FHLBanks would be full members in those FHLBanks, with all the rights, privileges and obligations ascribed to full members. In either case, the Limited MDM member would be required to purchase activity capital at all the FHLBanks in which it has activity, according to the capital rules of those FHLBanks. Implementing the capital requirements in this way for Limited

MDM members is practical for the members, preserves the safety and soundness of the System, and provides the FHLBanks with flexibility to manage their balance sheets.

OTHER PROPOSED ALTERNATIVES HAVE SIGNIFICANT HURDLES AND ARE PROBLEMATIC

Multi-District Advance Participations

Advance Participations have been offered in the public debate as a possible alternative to Limited MDM. In the case of member acquisition with charter consolidation, the Member-Acquirer would retain membership in only one FHLBank and the other FHLBank(s) affected would share in the future advances made to that member based on some predetermined allocation formula. The Lead Bank (i.e., the FHLBank where the member charter resides) would bear the credit risk to the member, manage the collateral of the member and price the advances. The Lead Bank would offer to the Participant Bank (i.e., the FHLBank of the "merged out" member) a share of the advances traded with the member, and the Participant would have the right to "opt out" (i.e., refuse to participate) of any particular advance. The member would purchase membership and activity-based capital stock (against the portion of the advance retained on the Lead's balance sheet) in the Lead Bank, per the Lead Bank's capital plan. The member would also purchase a "sub-debt" instrument in the Participant Bank to satisfy the activity-based capital stock requirement for the portion of the advance that resides on the Participant Bank's balance sheet, per the Participant Bank's capital plan. This sub-debt would act like class B stock in all financial respects; however, it would not carry voting rights nor would it qualify as permanent capital for the purpose of meeting regulatory risk-based capital requirements. The Lead and Participant Banks would each earn income to fund their AHP programs. In addition, if the Finance Board makes the rulings outlined below, the sum of the AHP contributions and REFCORP contributions made by the Lead and Participant Banks are identical to what would have been made in the absence of the merger.

The FHLBNY and Federal Home Loan Bank of San Francisco ("FHLBSF") have jointly researched the requirements for making Participations successful. Our analysis shows that the Finance Board would need to make several interacting and interdependent rulings in order for Participations to begin to become a viable option for the FHLBank System, specifically:

- Include in total FHLBank capital for regulatory purposes the sub-debt purchased by the Acquirer-member in the Participant Bank.
- Exclude from the determination of net earnings in AHP and REFCORP assessment calculations the payments on the sub-debt.
- Include the sub-debt in total capital for the purpose of calculating the MBS limit for the Participant Bank.
- Permit the issuance of sub-debt by the FHLBanks.
- Assign a zero credit risk-based capital requirement to participated advances.
- Interpret that the exemption provision of Section 932.9(c)(4) applies if the Lead Bank guarantees the credit of the participated advance, and deem the Participant Bank's exposure to the Lead Bank as a result of the guarantee to be an unsecured extension of credit to the Lead Bank.

In addition, Generally Accepted Accounting Practice as promulgated by the Financial Accounting Standards Board and rulings by member regulators would also affect the viability of Participations as an alternative to Limited MDM. The FHLBNY and FHLBSF elaborated on the need for these rulings in a joint letter to the Finance Board dated December 16, 2002. A copy of the letter is included as an attachment to this response.

In the absence of any of these rulings, the benefits of Advance Participations cannot accrue to the parties involved and there would be no compelling reason to enter into Participations. Given the current scrutiny on corporate accounting practices and the perception that these rulings could foster a less transparent regulatory and accounting regime for the System, these rulings will be difficult to justify. <u>As such, Advance Participations are not a viable alternative to Limited MDM</u>.

Direct Adjustments of AHP Funding Pools

In this alternative, the Lead Bank would calculate the portion of its AHP pool that was derived from the share of the income of "prior out-of-district members" that were acquired by its "in district" Member-Acquirers, using a pre-defined allocation formula. The Lead Bank would then allocate that portion of its AHP pool to the Participant Bank so that the Participant Bank would administer these AHP funds. The Participant Bank would award these funds to its members to support projects in its district. Therefore, the Lead Bank would be allowing its AHP pool to fund out-of-district projects sponsored by out-of-district members.

For this solution to work, the Finance Board would have to rule that out-of-district members are eligible to receive AHP funding. It is not clear that the Finance Board has the statutory or regulatory authority to make this ruling. In addition, other considerations might make this approach impractical. For example, local community groups and FHLBank members in the districts that would "lose" AHP funds (i.e., have a portion of their AHP pool allocated away to another district FHLBank) might feel disadvantaged and challenge the Finance Board's ruling. <u>Given the uncertainties and practical risks of this solution, Direct Adjustment of AHP Funding Pools is not a viable alternative to Limited MDM</u>.

<u>CONCLUSION</u>

The FHLBNY believes that good public policy strongly favors approving Limited Multi-District Membership. As the most practical solution, the FHLBNY strongly recommends that the Finance Board swiftly amend 12 C.F.R. § 925.24 to allow a consolidating member to continue the existing membership of the disappearing institution. The FHLBNY also recommends that the Finance Board make the effective date of the change retroactive to allow the surviving organizations of acquired institutions that have previously petitioned the Finance Board on the issue of multi-district membership to again enjoy the benefits of membership in their FHLBanks.