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Ms. Elaine L. Baker
Secretary to the Board
Federal Housing Finance Board
1776 F Street, N.W.
Washington, DC 20006

RE: Comments Regarding Federal Housing Finance Board Resolution 2002-63

Dear Ms. Baker:

The Federal Home Loan Bank of Seattle appreciates the opportunity to once again formally offer comments relating to changes in the financial services industry and the need for the Federal Housing Finance Board to adopt rules to assure the continued safety and soundness and mission performance of the Federal Home Loan Bank System (Bank System).

One year ago, the Seattle Bank's Board of Directors adopted a formal resolution urging the Finance Board to adopt rules to enable the Bank System to adapt to changes in the financial services industry. That resolution, which was adopted on February 1, 2002, is attached. Our Board continues to support the five principles outlined in the resolution, and the points communicated in our earlier comment letter of March 1, 2001.

In this comment letter we will solely focus on key policy questions, additional information that has come to our attention since the last comment period, and a set of more specific suggestions for future rules.

Need for New Rules

There is ambiguity in existing statute concerning what Congress may or may not have intended concerning membership rules. However, there are three points that hold no ambiguity:

1. The statute places broad authority and responsibility with the Finance Board to assure the safety and soundness of the FHLBanks, and to assure they carry out their housing finance mission.
2. The statute specifically creates a set of regionally based, cooperatively owned, and independent FHLBanks.
3. The statute has already been interpreted in a manner that allows for at least one form of multi-district membership – currently, over 100 financial services holding companies hold membership in more than one FHLBank.

It remains the Seattle Bank's position that current membership rules do not adequately address safety and soundness, as well as mission performance, concerns posed by

interstate banking and the consolidation of the financial services industry. These fundamental trends in the financial services industry have only intensified in recent years, with large financial institutions --spanning regional and national markets -- representing over 80 percent of the business. The three largest housing lenders now account for almost 50 percent of all U.S. mortgage lending. Because of this reality, the Seattle Bank believes there is substantial urgency in implementing solutions. If the Finance Board is to fulfill its statutory responsibilities, the status quo cannot hold.

We believe modification of membership rules provides an opportunity for the Finance Board to proactively enhance the safety and soundness and mission performance of the Bank System. The current regulatory structure falls short in several important regards:

- Existing rules allow only holding companies the benefit of multidistrict membership. Therefore, only a fraction of FHLBank members (far less than 1 percent) currently have the authority to hold membership in more than one FHLBank. Because it requires a unique corporate structure -- a holding company -- it is impractical for the average FHLBank member to engage in this practice. Thus, only a relatively small number of FHLBank members benefit from current multidistrict membership rules. This inequity represents one reason why membership rules should be modified. Either multidistrict membership makes sense, should be a viable option for all members and should be pursued in a fair and safe and sound manner, or it should not be available to any member.

However, of more immediate concern, the 100 holding companies that hold multiple memberships represent some of the largest financial services companies in the United States and account for a substantial amount of FHLBank lending activity. The current membership rules increasingly pose important operational issues that affect safety and soundness for individual FHLBanks and the Bank System.

- Since the last comment period, the Seattle Bank commissioned a study by Oliver, Wyman and Company to explore some aspects of risks posed by larger borrowers. More recently, together with the San Francisco FHLBank, we commissioned phase II of the study to explore additional public policy implications of multidistrict membership. The report from Phase I and a draft of Phase II are attached.

In Phase I, this research reached two important conclusions. First, because advances are overcollateralized, the concentration of lending to any single member does not pose a concentration of credit risk to the Bank System or to individual FHLBanks. Very specifically, this research dispelled any simplistic comparison to concentration of credit risk in other sectors of the financial services industry, such as commercial banking. Second, however, this only holds true if the FHLBank's collateral valuation and management systems are adequate. Given the ad hoc nature of existing membership rules, the Seattle Bank believes that new multidistrict membership rules present an opportunity to put in place requirements and systems

that will better assure safety and soundness. Specific suggestions are offered later in this letter.

- Congress reaffirmed its support for the regional structure of the FHLBanks as recently as the 1999 Gramm-Leach-Bliley Act, but the current set of membership rules weakens the regional cooperatives. It is this regional system of cooperatives that differentiates the Bank System from the other government-sponsored enterprises, resulting in more financial value being passed through to members and consumers. This is also what is most valued by our membership.

The four petitions submitted to the Finance Board on this topic demonstrate that the current rules lead to unnecessary dislocation as industry consolidation occurs across the system. While each of the FHLBanks can adjust to changes in their membership, it would be more sensible, less risky and more consistent with the mission of the Bank System to adopt rules to accommodate these market-driven realities rather than ignore them.

We seek a set of membership rules that most fully connects lenders – big or small – to the markets in which they do business. Participation in the FHLBank cooperatives is one meaningful way to accomplish that. The capacity of every FHLBank to offer a full array of products and services, and to continually innovate, is essential to the individual competitiveness of each FHLBank. Yet, the dislocation caused by industry consolidation could eventually result in a few big, resource-rich FHLBanks able to innovate, provide a wider variety of products and services, and potentially greater financial returns. Unless rules are modified, the effect will be defacto disadvantages for smaller members located in smaller FHLBank districts, which is contrary to the intent of the protections provided by section 7(j) that prevents discrimination against members.

Further, direct contribution to and participation in the community investment programs in the FHLBank districts in which the member does business with consumers, including the Affordable Housing Program, is another meaningful way to strengthen mission performance in a manner that is most consistent with the regional structure of the Bank System.

Suggestions for New Rules

From both a safety and soundness perspective and a mission performance perspective, we offer the following suggestions:

- Members should have the option to join any FHLBank district in which they have a substantial market presence. As an example, a financial institution could join any FHLBank in which it had at least one branch office; or, as another example, at least 10 percent of their deposit base was located in that bank district. This approach

captures our objective to connect FHLBanks with the financial institutions doing meaningful business in their respective districts.

- Members who join multiple districts would have the same rights and obligations as all other members, including voting rights, access to all products and services, and the same activity based stock requirements. Existing rules that limit a member's voting rights to the average number of shares required to be held by all members from its state would be retained, thus preventing any one member from dominating either a an individual FHLBank or the FHLBank system.
- There are a number of different ways that membership-based stock requirements could be handled. Among them:
 - Multidistrict members could be required to meet membership-based stock requirements only in the FHLBank district in which their principal base of business is located. Membership-based stock requirements would be waived in the other FHLBank districts in which they hold membership, but multidistrict members would be required to meet activity-based requirements in all FHLBank districts in which they were members.
 - Multidistrict members would be subject to smaller, more nominal membership-based stock requirements.
 - All FHLBank districts could move to capital structures that rely solely on activity-based stock requirements.
- Multidistrict members would be subject to existing rules concerning Class B capital redemption periods and rejoining restrictions. Thus there would strong incentives against multidistrict members entering or withdrawing from FHLBanks on a whim.
- Unlike current membership rules, new rules would be put in place with specific requirements and systems to manage collateral of multidistrict members. Under current rules, in which holding companies spread their business across FHLBank districts through their affiliates, there are no formal requirements or systems in place to coordinate collateral issues across FHLBanks. This could result in double-pledging of collateral. Further, there is lack of clarity should a number of FHLBanks attempt to exercise their blanket lien against affiliates tied together through a holding company. There is lack of consistency in valuation methodology across FHLBanks. There is uncertainty as to how FHLBanks, individually or jointly, would take possession of and dispose of large amounts of collateral should a large member fail. There are a number of approaches that should be considered when addressing these issues:
 - Requirements to establish inter-creditor agreements among FHLBanks, addressing the blanket lien and establishing an orderly process to deal with troubled or failed multidistrict members.

- More uniform requirements concerning collateral valuation methodology and collateral management.
 - For multidistrict members, require specific listing of collateral with each FHLBank.
 - Voluntary establishment of a collateral management system across FHLBanks to coordinate relationships with multidistrict members to share information, track collateral, and guard against double pledging. Such a system could be operated jointly by the 12 FHLBanks, or a system could be established in which the “lead” FHLBank in which the member’s principal base of business is located could coordinate collateral management among affected FHLBanks.
- Once membership rules are modified, there should be a presumption that members will actively seek membership in every FHLBank district in which they have a substantial market presence, and that the member will distribute their use of products and services across these FHLBanks. In fact, to the extent a member with more than one FHLBank membership unreasonably concentrates borrowings or other business dealings in one FHLBank, this will serve as a signal to the Finance Board to look more closely at this business relationship to assure the FHLBank is not engaging in unsafe or unsound practices or discriminating against other members.

The Long View

There have been several themes that run throughout this letter and our previous comment letter. Together, they paint a picture of our desired future for the Bank System.

We believe that it is essential that American consumers and businesses have stable, low cost, fair and convenient access to bank credit for homeownership and for economic growth. The Bank System is one pillar of the nation’s financial services industry that provides stable and low-cost access to the private capital markets, and assures the flow of private capital through good times and bad.

The Oliver, Wyman and Company draft Phase II study demonstrates that federal law and market forces have driven industry consolidation, not FHLBank advances. The FHLBanks level that playing field, enabling small institutions to compete in markets largely dominated by mega banks and mega secondary market GSEs. Consumers and local communities thrive when private capital flows into their communities and when there is a wide range of financial institutions connected to them, competing for their business, and responding to each local market.

We want to preserve what is unique and best about the FHLBanks’ contribution to the national and local economies – our cooperative structure and the regional system of independently owned FHLBanks. The cooperative structure assures that we must balance the imperative to maximize profits to FHLBank owners with the imperative to deliver products and services that are valuable and fairly priced. In this dynamic, because our owners are also our customers, it means that every dollar of value created by the FHLBanks flows to members and communities, not an anonymous class of

outside investors as is the case with publicly traded companies and other government-sponsored enterprises. Studies by the Congressional Budget Office confirm that this is the case.

Of equal importance, cooperative ownership means that the FHLBanks' success depends on the success of our members. Unlike other GSEs, there is a natural link between the Bank System and its membership – we are strategic partners, not competitors. We share the mutual goal of delivering bank credit to homebuyers and local businesses, and we are both stronger when we achieve these goals together.

We seek a change in membership rules because we believe it is the best way to protect what we value most – cooperatively and independently owned FHLBanks in a regional system. This is proving to be very challenging as the underlying financial services industry evolves. But we are convinced that there is greater risk in doing nothing than adapting to this reality.

As we adapt, first and foremost, we must assure the safety and soundness of the FHLBanks. Failure of the Bank System, given the quasi-public nature of our enterprise and the amount of private capital at risk, is not an option. That is why we focus so strongly on issues relating to collateral – the bedrock of our credit risk management practices.

Moreover, it is neither realistic nor good public policy to shift FHLBank risk to others, such as the FDIC. In fact, as the draft Phase II research by Oliver, Wyman and Company points out: “We conclude that the use of Home Loan Bank advances does not materially increase the risk to the insurance fund (and may even reduce it).” Among other things, the study analyzed all bank failures since 1990 and found that there is no statistically significant correlation between the amount of advances an institution used and the costs of resolving its failure.

The Bank System and the FHLBanks must and do stand on their own. There are two lines of defense that we rely on. First, sound regulation, supervision and examination, and in the last year the Finance Board has done much to strengthen those functions. But there is clearly a continuing need to demonstrate to others that the regulatory agency is up to the task; it is imperative that the FHLBanks advocate for continued strengthening of the agency.

The second line of defense is the \$35 billion in private capital that is invested in the Bank System. Due to the Gramm-Leach-Bliley Act, the FHLBanks are held to higher minimum capital levels than other government-sponsored enterprises and are subject to risk-based capital standards. The Seattle Bank, as an example, currently holds almost four times as much capital as it required to hold to meet the Finance Board's risk-based capital standards.

This focus on safety and soundness can only prudently manage risk, not eliminate it. The nature of banking is to deliberately take on risk, manage it appropriately and get adequately compensated for doing so. FHLBanks are no different in that regard than other banking enterprises. Nor should safety and soundness be used as an excuse to dampen legitimate and prudent competition, even in a cooperative system such as ours. This FHLBank, like all 12, is not entitled to our members' business; we must earn it.

While some argue, since all FHLBanks share the same low-cost funding advantage, competition will only come in the form of the "race to the bottom" in credit and collateral practices. This is a risk, but it is not inevitable. A race to the bottom implies that FHLBank management and boards would be willing to engage in otherwise uneconomic behavior by taking on too much risk without developing the capacity to manage it. It also presumes a failure of the regulatory and supervisory regime. Finally, such a view completely misses the value of other important ways FHLBanks can compete that hold value for members and the public. For example, the move by some FHLBanks into mortgage purchase holds great value for members and homebuyers and is increasingly perceived to offer a competitive advantage to a FHLBank and its members. Generally offering a richer array of products and services is as likely a response to competitive pressures, including greater focus on community investment, as a way to differentiate a FHLBank from the competition.

We envision some greater level of competition among the FHLBanks because we believe that competition drives greater innovation and value creation. Unless the Finance Board rolls back the current limited form of inter-district competition, we can already see the trend towards greater competition and, as discussed earlier, the associate higher risks relating to credit and collateral. We would oppose efforts to stifle competition, but we are equally insistent that the new rules be set in a way that neither jeopardizes safety and soundness nor tilts the playing field toward any particular competitor.

Conclusion

Multidistrict membership exists for 100 holding companies and their 400 affiliated charters. Given interstate banking and industry consolidation, this trend will accelerate in future years. It is incumbent upon the Finance Board to establish a more rigorous set of rules governing multidistrict membership to better assure safety and soundness and mission performance, and establish equitable rules that do not disadvantage smaller members not operating within a holding company structure.

A failure to act presents greater risk to the Bank System due to lack of coordination among FHLBanks, primarily related to collateral management. This is an obvious problem with the existing set of multidistrict membership rules that must be addressed.

The suggestions we have outlined are not the only possible solutions to these issues. For example, we have expressed support in the past for use of advance participations as

an interim solution. While that approach could be made to work in theory, we concluded that it required regulatory action that was more problematic than the suggestions we have offered above. Among other things, advance participations would require creation of a new form of capital, the improbable decision to put zero-risk weighting on advances, and a number of accounting and regulatory decisions by a variety of regulatory agencies. Moreover, advance participations hold few of the advantages discussed above concerning strengthening the regional cooperatives and mission performance.

Finally, from a policy and business perspective, the Seattle Bank believes its fundamental responsibility is to increase consumer access to bank credit for housing and economic development. We will do that most effectively if we can develop direct business relationships with those lenders that serve our markets, not just those members who, by coincidence, happen to have their principal base of business located within our geographical boundaries. It is time this system adapted to larger market forces to both assure our continued safety and soundness and our mission performance.

Respectfully,

Norman B. Rice
President and Chief Executive Officer

Attachments

Seattle FHLBank Board of Directors Resolution
Phase I research – Oliver, Wyman and Company
Phase II draft research – Oliver, Wyman and Company