

A.M. BEST

SPECIAL REPORT

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Recently Proposed FHLB Regulation Creates Uncertainty For Many U.S. Banks That Rely on the System for Funding

For more than 70 years, the Federal Home Loan Bank System (FHLBanks) has been an important source of cost-effective funding and correspondent banking services for community-based financial institutions in the United States. A recent proposal by FHLBanks' regulator, the Federal Housing Finance Board (FHFB), has created uncertainty for the FHLBanks' members as to whether the current level of funding and services will remain available.

Among the primary components of the proposal, the FHLBanks would be required to maintain a minimum level of retained earnings. In addition, if an individual district bank's retained earnings fall below the required level, the amount of dividends it could pay to its members would be limited to 50% of the bank's net income, until its minimum-retained earnings requirement is met. The proposed rule also would place new restrictions on the timing of dividend payments, would limit the amount of "excess" stock in any district bank to 1% of that

bank's total assets, and would prohibit the issuance of stock dividends.

If the proposed rule were in effect as of March 31, 2006, only two of the banks would be in compliance with the minimum-retained earnings requirement (see chart). Notably, the San Francisco District Bank had both the largest retained earnings shortfall and the largest growth in advances (in dollars) in the year ending March 31, 2006. One common concern that has emerged among industry participants is whether the proposal will impact member banks' ability to access funds on a cost-effective basis or force members to hold added liquidity on their own balance sheets. As the estimated retained-earnings shortfall represented only 0.29% of total advances to U.S. banks, at March 31, 2006, it is unclear whether any restriction on available funds will materialize. Given that the minimum requirement is based in part on the level of a district bank's "non-advance" assets, the target level is a moving figure. As a result, district banks may make balance sheet adjustments that ultimately could minimize the required level of retained earnings.

The limitation on the amount of excess stock

This report was written by Steven Wollum, CFA, financial analyst with A.M. Best Co.

Retained Earnings Deficit/Surplus Estimates

FHLB District Bank	Advances		Annual Growth Rate	Retained Earnings	Estimated Required Retained Earnings	Estimated (Deficit)/ Surplus
	Outstanding (\$ million) ¹	To U.S. Banks 3/31/2005	(Advances) Q1 05:Q1 06	(\$ Million)	(\$ million) ²	(\$ million)
Atlanta	\$95,763	\$91,664	4.47%	\$328.4	\$465.6	-\$137.2
Boston	39,175	24,461	60.15%	146.5	257.9	-111.4
Chicago	24,946	22,606	10.35%	553	674.3	-121.3
Cincinnati	42,531	43,871	-3.06%	217.7	412.8	-195.1
Dallas	35,355	36,387	-2.84%	181.3	194.8	-13.5
Des Moines	14,750	20,157	-26.82%	329.2	284.4	44.8
Indianapolis	21,938	24,298	-9.71%	155.5	307.7	-152.2
New York	46,581	42,179	10.44%	308.0	279.4	28.6
Pittsburgh	52,013	42,542	22.26%	214.2	323.1	-108.9
San Francisco	183,375	161,113	13.82%	130.0	682.1	-552.1
Seattle	21,937	15,930	37.71%	76.8	364.5	-287.7
Topeka	19,689	20,876	-5.69%	137.3	248.7	-111.4
Total	\$598,051	\$546,084	9.52%	\$2,777.9	\$4,495.3	-\$1,717.4

¹ FDIC

² Estimates of minimum required retained earnings are based on filings with the Securities and Exchange Commission (SEC). With the exception of the Des Moines and Topeka Banks, all estimates are based on financial information prepared as of March 31, 2006. Estimates for the Des Moines and Topeka Banks were made using financial information from Dec. 31, 2005, the most recent time period for which information was available.



that a bank may have outstanding will be an issue to watch, especially in the Chicago District Bank, which has one of the highest levels of excess stock, at an estimated \$2.4 billion. As part of an agreement with the FHFB to reduce its excess stock, the Chicago District Bank recently received approval to issue \$1 billion in securities for which it is the sole obligor. Historically, all securities issued by the FHLBanks were joint obligations of all 12 district banks.

Several aspects of the proposal that are likely to have the most direct impact on the member institutions are the limitation on excess stock, the prohibition on the issuance of stock dividends, and the potential restriction on the amount of dividends payable. The limitations on the amount of excess stock and the issuance of stock dividends both create tax implications that members institutions would likely view as unfavorable. For those members that hold excess stock, a repurchase of the stock would essentially create a taxable distribution. However, by receiving dividends in the form of stock, instead of cash, the taxes on the stock dividend can be deferred. By receiving a cash dividend, taxes are payable for the period in which the dividends were received.

The limitation on dividends for banks that do not meet the required level could be notable in districts such as Boston, which paid out 71% of its net income in dividends in 2005. Potential strategies for the Boston District Bank to meet the required retained-earnings level indicate that bank dividends currently yield LIBOR plus 50 to 70 basis points in 2006, but that if the proposal is enacted, the dividend yield could fall to the LIBOR minus 13 to 174 basis point range.³ A reduction in the dividend yield on these required stock holdings also could potentially place additional strain on an institution's margins, an issue of particular concern in this flat yield curve environment.

As with any regulation, the final form and ultimate effect cannot readily be determined when it is initially proposed. In addition, the impact of

the proposal on individual institutions may be uneven. Nonetheless, the uncertainty surrounding this proposal is especially keen as all 12 of the district banks and many member institutions already have voiced their opposition to it. Once the final form is known, member institutions can then begin to assess its ultimate impact on their operations and can make any necessary adjustments to their funding and balance sheet management strategies.

3 FHLB Boston filing with SEC.

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For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.



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A.M. Best Company

Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
<http://www.ambest.com>

A.M. Best Europe Ltd.

12 Arthur Street, 6th Floor
London, UK EC4R 9AB
Phone: (44-20) 7626-6264
Fax: (44-20) 7626-6265
www.ambest.co.uk

A.M. Best Asia-Pacific Ltd.

Unit 5707 Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Phone: (852) 2827-3400
Fax: (852) 2824-1833
www.ambest.com.hk