FEDERAL HOUSING FINANCE BOARD

OPEN BOARD MEETING

1:02 p.m.

Wednesday, March 13, 2002

Board Room
1777 F Street, N.W.
Washington, D.C.

MILLER REPORTING CO., INC.
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MEMBERS PRESENT:

John T. Korsmo, Chairman

John C. Weicher, Board Director

Allan I. Mendelowitz, Board Director

Franz S. Leichter, Board Director

J. Timothy O'Neill, Board Director

PARTICIPATING STAFF:

James L. Bothwell, Managing Director

Elaine L. Baker, Secretary to the Board

Arnold Intrater, Acting General Counsel

Scott L. Smith, Acting Director, Office of Policy, Research and Analysis

P R O C E E D I N G S

CHAIRMAN KORSMO: Good afternoon. Thank you all for being here. Today is certainly a significant day for the Federal Housing Finance Board as the Board considers and I hope approves the first capital plan for a Federal Home Loan Bank as required by Title VI of the Gramm-Leach-Bliley Act of 1999.

For the representatives from Seattle who I assume are here, are with us and are watching the Board's meeting via the internet, thank you for all your very hard work. And a special thank you to the President of the Seattle Bank, Norman Rice. I appreciate how hard he and his staff have worked on making this thing possible.

This is a new ground we’re all treading and the people of the Seattle Bank have been very responsive during the process, working closely with the Finance Board staff who also I should mention did an excellent job. I want everyone to know how much I appreciate their hard work.

The experience gained during the Seattle review will serve everyone in good stead as the Board considers and approves the other 11 banks' capital plans. The Seattle Plan has been analyzed in the context of all 12 plans submitted by the banks. But it is being considered today as a capital plan designed for the Seattle Bank to seek its own members' needs and, of course, the needs of its business plan.

One thing we want to make clear. This plan is not a mandatory template for the System. As I said yesterday in a speech to America's Community Bankers, I am open to persuasion buy other Banks wishing to capitalize their activities in other ways. And while I would not presume to speak for my colleagues, I do believe we are in one accord on that point.

The Board's approval of the plan before us today will establish a permanent capital structure for the Seattle Federal Home Loan Bank. This Plan addresses the fundamental issues of safety and soundness while providing greater flexibility for the Bank to provide liquidity for mortgage lending by its members.

Today the Board is approving the capital structure component of the Seattle Plan. The internal market risk model and the risk assessment procedures and controls must also be approved before Seattle implements the Plan. We'll rely on the Finance Board's standard approval process to address these risk components, specifically the Finance Board staff will handle the approval subject to a three-day review period by the Board of directors. This approach recognizes that market risk modeling and risk assessment decisions and controls are subject to change and continuous monitoring.

By reserving the ability to modify the risk models and controls rapidly when other circumstances warrant, we enhance safety and soundness. Like routine exams by our supervision staff, the monitoring of risk models and risk occurrence is a standard operating procedure and will be watched closely by each and every Director of this Board.

All of this having been said, let me note that the renowned British mathematician and philosopher Alfred North Whitehead once observed, "The art of progress is to preserve order amid change and to preserve change amid order."

Today's action by the Board embraces change while maintaining order, that being safety and soundness within the entire Federal Home Loan Bank system. It represents the culmination of months of dedicated work and also the beginning of much more work to come.

Before I call on each of the Directors who may have comments before we consider the motion, let me recognize our Managing Director, Jim Bothwell, to orchestrate the resolutions before us. Jim?

MR. BOTHWELL: Thank you, Mr. Chairman, and good afternoon, Director O'Neill, Director Leichter, Secretary, Weicher, and Director Mendelowitz.

Mr. Chairman, there are three related resolutions on the agenda. The first of these resolutions would approve the Capital Structure Plan submitted by the Federal Home Loan Bank of Seattle. If the Board votes affirmatively today, this would be the first approved plan that allows a Federal Home Loan Bank to implement the permanent risk base capital structure required by Title VI of the landmark Gramm-Leach-Bliley Act.

In accordance with our regulations, the resolution requires Finance Board approvals for the Seattle Bank's internal market risk model and risk assessment procedures and controls before implementation can occur. And as you noted in your opening remarks, Mr. Chairman, such approval must be reviewed by the Board of Directors of the Finance Board before being issued.

The second resolution would waive the six-month notice requirement for redemption of a Bank's existing stock, thus allowing the Seattle Bank to convert more quickly to its new permanent capital stock.

And the third resolution, Mr. Chairman, specifies the provisions of the Finance Board's Financial Management Policy that the Seattle Bank would still be subject to upon implementation of its new capital structure.

And at this time, Mr. Chairman, I would like to ask Scott Smith, the Acting Director of the Policy Office, to please present Seattle Bank's Plan for consideration.

MR. SMITH: Thank you, Jim, and good afternoon, Mr. Chairman, and Members of the Board.

Staff is requesting that the Board of Directors consider and approve these three resolutions, all of which are concerned with and constitute approval of the structure component of the Seattle Federal Home Loan Bank's Capital Plan. In response to staff comments, the Seattle Plan has been revised several times since its submission last June. The Finance Board staff now finds that the most recent version of the Plan approved by the Bank's board of directors March 8th of 2002, complies with Finance Board regulations.

The Seattle Plan is a relatively straight forward all Class B stock plan with two subclasses of stock, Class B1 and Class B2. Such Class B stock thus retained earnings constitute permanent stock, as defined by Gramm-Leach-Bliley; all of the Bank's stock will be eligible to meet risk based capital requirements. In meeting the 4 percent leverage capital requirement for unrated stock, the Bank will also meet the 5 percent rated stock leverage requirement without question.

Let me add that based on staff and Bank estimates, the leverage requirement, rather than the risk base capital requirement will be the binding constrict on that final capital. With the risk base capital requirement estimated to be not more than 50 percent of the leverage requirement under foreseeable circumstances. Furthermore, staff finds that all futures that are planned appear to be consistent with the concept of fairness to all members and with the cooperative nature of the Bank System.

Implementation of the Plan is expected to allow the Bank to better manage its capital.

Specifically the Plan is designed in part to reduce the amount of excess stock that is fueling the growth of the Bank's investment portfolio. The Plan does so by limiting the amount of excess stock that any one member may hold, and by paying a below market rate dividend that roughly approximates the Bank's marginal cost of funds on a specified portion of the excess stock, which has been designated Class B2 stock.

The combination of the Plan's minimum investment requirements, excess stock limit, and lower dividend on any excess stock above the limit, will reduce the need for the Bank to leverage the full amount of its excess stock while minimizing to the extent possible the financial consequences for members that arise from the repurchase of their excess stock. The Bank expects that the resulting smaller capital base will enhance leverage and returns to stockholders over the longer term.

In addition to reducing excess stock, the bank's balance sheet management strategy following conversion to the capital structure involves increasing use of Bank products. Through competitive advance pricing and stock purchase requirements, they encourage members to sell mortgage loans to the Bank through its mortgage purchase program or MPP.

The Plan requires that each member hold at a minimum Class B1 stock such that the par value of the stock equals the total stock purchase requirement. The total stock purchase requirement equals the sum of the member advance stock purchase requirement, the membership stock purchase requirement, and the member MPP stock purchase requirement. However, the MPP stock purchase requirement is structured so that stock held to fulfill the membership stock purchase requirement can also be used to capitalize a portion of the MPP sold by the member to the Bank. Providing an incentive to members to sell those loans to the Bank. A member will be able to sell an amount of MPP loans to the Bank, such that MPP stock requirement on those loans will equal the membership stock purchase requirement, without having to buy any additional stock. Beyond that amount, however, all MPP loans will be capitalized under the MPP stock purchase requirement.

Initially the advance stock purchase requirement will be equal to 3.5 percent on advances outstanding to a member. The Plan provides a range of 3.5 to 4.5 percent, within which the percentages to calculate the advance stock purchase requirement may be changed by the Bank's board of directors without seeking an amendment to the Plan.

The membership stock purchase requirement specifies the amount of stock a member must own as a condition of membership which applies upon becoming a member and as long as the institution remains a member. Initially the membership stock purchase requirement is the greater of $500 or .75 percent of a member's home mortgage loans as of the most recent calendar year end.

The Plan provides that the Bank's board of directors may change the percentage used to calculate the membership stock purchase requirement within a range of from .5 percent to 1 percent without seeking Finance Board approval of an amendment to the Plan.

The MPP stock purchase requirement is equal to 5 percent of the outstanding principle balance of mortgage loan sold by a member to the Bank minus the amount of membership stock purchase requirement. In no case, however, will the MPP stock purchase requirement be less than zero. The Plan provides a range of 4 to 6 percent, within which the percentages, to calculate the stock purchase requirement may be changed by the Bank's board of directors without seeking an amendment to the plan.

Finance Board rules provide that the minimum investment requirements established by a capital plan must be set at a level, which provides sufficient capital for the Bank to comply with its minimum capital requirements. The Finance Board indicated in the original capital rule and amendments to that rule that the Bank has flexibility in capitalizing some portion of its balance sheet with stock that had not been raised through members purchase of required stock, in other words excess stock, as long as the minimum investment requirements in the Bank's Capital Plan do not create undue reliance on such excess stock.

Toward that end, the Finance Board staff required that the Seattle Plan include a provision limiting the amount of excess stock that the Seattle Bank uses to meet its minimum capital requirements. This sufficiency provision essentially assures that Seattle's excess stock is used primarily to support short-term investment. The Seattle Bank agreed to this change and it is reflected in the March 8th Plan.

Staff analyzed the Seattle Plan to determine whether the minimum stock purchase requirements complied with Finance Board Rules and a similar statutory provision and will result in sufficient capital for the Bank to operate in a safe and sound manner within the guidelines articulated by the Finance Board. As part of the analysis staff reviewed material submitted by the Bank to support approval of the Plan, including pro forma financial statements, the assumptions behind these statements, and management's estimate of the amount and type of stock that is associated with the pro forma statements.

Staff's review also includes a stress testing of the capital structure as discussed in the Plan. The stress test results did not reveal any obvious safety or soundness concerns, though some scenarios show a possibility that the Bank's dividend could decline and thus make the stock a less attractive investment. These scenarios did not result in capital declining enough to compel the liquidation of long-term assets.

Staff also found that the Plan as structured displays a degree of stability with regard to capital because most assets are implicitly capitalized with stock that members are required to purchase under the total stock purchase requirement. Thus, capital will generally increase as risk increases.

Overall, given the activities and risk profile implicit in the pro forma financial statement submitted by the Bank and based on the review of the stress scenarios, staff believes that the Plan should allow the Bank to meet the leverage an risk base capital requirements under normal conditions and under the stressful conditions specifically tested.

Staff also found no indication that the pricing of activities or of the structure of the minimum investment requirements would result in the Bank undertaking transactions in an unsafe and unsound manner or in a manner that would materially benefit some members over others. Staff further did not find any apparent impediment to the Bank's achieving dividend levels that would be attractive to members. Thus, staff has not identified any apparent structural flaws or other problems in the Plan and the initial propose minimum investment requirements that would prevent the Bank from maintaining sufficient capital that mind the statutory and regulatory requirements and to continue to operate in a safe and sound manner.

Thank you. I'll be pleased to answer any questions.

CHAIRMAN KORSMO: Before we do that, Mr. Intrater, do you have anything to add to Mr. Smith's, Dr. Smith's comments?

MR. INTRATER: Absolutely not. I thought he did very well.

CHAIRMAN KORSMO: Well said.

MR. LEICHTER: Pretty Good?

CHAIRMAN KORSMO: Before we consider the motion I will open the floor for any questions or comments any of the Directors may have.

Mr. Leichter?

MR. LEICHTER: If I can, I'd like to ask a question on the test for sufficiency of required capital. I know that is one of the changes that occurred as the Plan evolved. And I would thought it would be helpful to have your comments and maybe the Managing Director's comments on the reasons for this and also the implications that this may have for other Banks as to a similar requirement?

MR. BOTHWELL: Yes, Director Leichter. The Gramm-Leach-Bliley Act requires that the Capital Plan contents have a provision there that the minimum investment required members be sufficient to meet the minimum capital requirements required in the Federal Home Loan Bank. That sufficiency doesn't mean 100 percent, because when you change banks, for example, is a component in permanent capital, it can also be used to meet the minimum capital requirements.

And what we are saying is that you don't want to have an under reliance on excess stock to meet that requirement. And so we have, the Seattle Bank has put in a provision, as the Chairman said, this is not a mandatory template for any other Bank necessarily. But there is a provision in the Seattle Plan that should be some type of similar provision in all the Plans on this particular format, but Seattle Bank has a provision which would just limit the amount of excess stock that will use to meet the minimum capital requirements, only for very short term liquid assets, that is excess stock will not be relied on to support longer term assets.

MR. LEICHTER: And this also provides for this two-year test two years after conversion?

MR. BOTHWELL: Yes. In the Seattle Plan there is a provision that there be a two-year window of time to prove this provision.

MR. LEICHTER: Thank you.

CHAIRMAN KORSMO: End of questions of the staff? Any other questions?

MR. MENDELOWITZ: Will we have an opened discussion.

CHAIRMAN KORSMO: Yes. One the motion is on the floor.

CHAIRMAN KORSMO: Do you have any questions?

If not, thank you to the staff. At this point the Chair would entertain a motion to approve the resolution. If there's no objection, we'll consider the three resolutions as one.

Hearing no objection, I'd ask for a motion.

CHAIRMAN KORSMO: Director O'Neill?

MR. O'NEILL: Before making the motion I just wanted to compliment the Chairman for getting us to this point, because I think that many people wouldn't have thought that we would have gotten to one of the 12 capital plans so quickly. And I have always thought that this is the main business before this Board because once we have all a voluntary membership, but no permanent capital. This, to me, is the period that we are the most vulnerable. So my hat is off to you, Mr. Chairman, to make this the shortest possible time for that situation that is occurring.

And I guess one other thing is we all long ago members when everybody gives lip service to the cooperative nature of the System. To me, this exercise is what makes this System cooperative. Because this is something that with the Chairman's leadership this Board of Directors, our staff, the staff of the Seattle Bank and the Seattle Bank board of directors all work together very cooperatively to get us to this point. So I think it's not just lip service to say that this is a very cooperative System. And I think that this is, the proof is in the pudding.

But with that I would make a motion to approve all three parts of the staff presentation.

CHAIRMAN KORSMO: The three resolutions have been moved. Is there any discussion?

Director Mendelowitz?

MR. MENDELOWITZ: Thank you, Mr. Chairman.

I would like to make a couple of brief comments. First is that I am very happy to see a capital plan that sets in motion a strategy to align the magnitude of the assets in a Bank's balance sheet with the mission of the Bank rather than being driven by the need to put investments on the balance sheet via profits with which to pay dividends on excess stock.

And when we talk about and deal with and regulate a government sponsored enterprise, with it preferred access to capital markets, it's important to bear in mind that big as a stand-alone consideration is not necessarily a desirable attribute. Aligning balance sheet assets with the mission of the Bank is an important safety and soundness matter in my view. Any asset that's placed on the balance sheet entails placing risk on that balance sheet. And it's good to see a plan that puts in motion a process that will, in fact, remove non-mission risk of the balance sheet. So I think I was very encouraged by that aspect of the plan.

Secondly, I also want to reiterate that Gramm-Leach-Bliley provides permanent capital in the form of five year B stock. While the Seattle Bank may choose to repurchase excess stock and members may indicate their desire to have excess stock repurchased, I would like to ensure that there is no misinterpretation as to the nature of B stock. This permanent capital in the System should not be viewed by members as a liquid asset. The possibility of repurchase should not be interpreted by anyone as the equivalent of redemption. Redemption may only be exercised with five years notice. And at that, only if at the end of the five years the Bank in question is well capitalized. Thank you.

CHAIRMAN KORSMO: Thank you, Dr. Mendelowitz. I appreciate your comments. They're well taken.

Are there any other comments on the motion? Mr. Leichter?

MR. LEICHTER: I'm sorry to say that the Tim O'Neill plagiarized my speech.

CHAIRMAN KORSMO: You have to be quicker on the draw.

MR. LEICHTER: So if this sounds a little self-congratulatory on the part of the Board -- excuse me -- I think we're entitled to be self-congratulatory because I think it's really quite an achievement to, I mean, I don't want people to think I’m choked up over this capital plan.

[Laughter.]

MR. LEICHTER: But seriously, I think this is a remarkable achievement when you take a look at the fact that we have met the Congressional mandate in every way, that we met the time tables, that we met the regulations, that the Banks all got their plans in on time, that we've been responding quickly analyzing the plans, working, as Tim O’Neill so properly pointed out, cooperatively with the Banks. And that we have here before us ready for passage the first of the Capital Plans. And I really want to commend first you, Mr. Chairman, because you set a tough schedule. And I think that was appropriate. And you've seen that everybody has kept to it. And hopefully with the continued cooperation of the Banks we'll be able to get the Capital Plans done within the timetable that we have set.

And I also want to commend and really speak to the professionalism of the staff of the Finance Board and the way that they have done this work. I'm not going to mention any names because there’s too many of them, but you certainly have my gratitude and I know the thanks of all the other Members of the Board.

And I also want to thank very much the Seattle Board for its cooperation, its excellent President, Norman Rice, and their staff for the work that they have done. And again as Tim O'Neill so appropriately stated, it really shows the cooperative nature of the System at work.

I just want to say that I think we have a Plan here that meets what is our primary purpose which is the safety and soundness of the System and I think will continue to guide us, but also a Plan, as Director Mendelowitz pointed out, recognizes mission and tries to align the assets with the mission of a Bank. I must say I think we're off to a good start. One down, 11 to go.

[Laughter.]

MR. LEICHTER: I'm sure we're going to proceed in the same very expeditious, but also at the same time very thorough and careful manner as we have with the Seattle Plan.

CHAIRMAN KORSMO: Thank you Director Leichter for that. And I take recognition of the daunting task that remains before us.

Any other comments?

MR. WEICHER: Nobody's left me anything to say, but except one thing. Which noticing the second of the resolutions, the waiver withdrawal notice requirement, a sort of reminder that when this body was created and when FIRREA was established and when Congress and the Administration were wrestling with the problems of the S&Ls, one of the biggest problems, one of the biggest complications was the required membership in this System. And it tied things up in knots. And so it is interesting to see that this resolution in this context, especially the clause about waiving a six-month notice requirement, would not endanger the safety and soundness of the Seattle Bank or the Bank System. I can't help wishing we could have been there 13 or 14 years ago. Life would have been simpler. Mr. Intrater was here as we were wrestling with the debris that was left after the passage of FIRREA. And it is sort of interesting to see what happens over time on an issue that not very long ago was a total mess. I do think that the staff has done a very solid job on an extremely, exceedingly complex document. And I appreciate it.

CHAIRMAN KORSMO: Any other comments?

Any other comments?

Hearing none, I will call the question on the resolutions.

Will the Secretary please call the role?

SECRETARY BAKER: On the resolutions before the Board, Chairman Korsmo, how do you vote?

CHAIRMAN KORSMO: Aye.

SECRETARY BAKER: Director Leichter?

MR. LEICHTER: Aye.

SECRETARY BAKER: Director Mendelowitz?

MR. MENDELOWITZ: Yes.

SECRETARY BAKER: Director O'Neill?

MR. O'NEILL: Aye.

SECRETARY BAKER: Director Weicher?

MR. WEICHER: Aye.

CHAIRMAN KORSMO: The vote is unanimous. The Capital Plan for the Federal Home Loan Bank of Seattle is approved. And, gosh, I sure like the votes that are this way.

Thank you all. At the risk of being repetitive, thank you again to the excellent work that has been done by the staff and also to the excellent work done by President

Norm Rice and the staff at the Seattle Bank and also to the excellent work and the support that I know the staff has felt of the Board. I appreciate it very much. I know that this has been an arduous task and we've, as mentioned earlier, we've only just begun. And so again, we appreciate the hard work that is going into this point recognizing that we have a major task yet ahead of us in approving Plans for the other 11 Banks.

There being no other business on our agenda, this meeting is adjourned. Thank you.

[Whereupon, at 1:20 p.m., the meeting was adjourned.]