FEDERAL HOUSING FINANCE BOARD

OPEN BOARD MEETING

10:10 a.m.

Wednesday, November 13, 2002

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

MEMBERS PRESENT:

John T. Korsmo, Chairman
J. Timothy O'Neill, Director
Franz S. Leichter
John C. Weicher, Director (Telephonically)
Allan I. Mendelowitz, Director

PARTICIPATING STAFF:

Elaine L. Baker, Secretary to the Board
Arnold Intrater, General Counsel
Joseph McKenzie
Thomas Joseph
Stephen M. Cross

AGENDA

P R O C E E D I N G S

CHAIRMAN KORSMO: We're all here. John, can you hear me okay?

DIRECTOR WEICHER: Yes, I can, Mr. Chairman.

CHAIRMAN KORSMO: All right.

DIRECTOR WEICHER: I'm very sorry about this situation. It's just unavoidable all the way around.

CHAIRMAN KORSMO: No problem. No problem.

I call this meeting of the Federal Housing Finance Board to order. Dr. Weicher is joining us by telephone today because apparently some nut case on Independence Avenue announced that he had a bomb in his truck. And so the traffic has come to a halt between here and the Department of Housing and Urban Development. But, John, we're glad to have you here in spirit.

DIRECTOR WEICHER: Yes.

CHAIRMAN KORSMO: And thank you for joining us.

We have a brief agenda for today's Board meeting in anticipation of a full schedule for this afternoon and tomorrow at our Corporate Governance Conference for Bank Directors. So without any further adieu, we will turn to the first item on the agenda, the 2003 budget for the Financing Corporation, also known as FICO. Dr. Cross and Joe McKenzie are here from the Office of Supervision to present the budget.

DR. CROSS: Dr. McKenzie.

CHAIRMAN KORSMO: Dr. McKenzie, thank you.

DR. McKENZIE: Good morning, Mr. Chairman, and members of the board.

CHAIRMAN KORSMO: Can you hear us, John.

DIRECTOR WEICHER: Yes. I'm fine.

CHAIRMAN KORSMO: Okay. Thank you.

DR. McKENZIE: The Financing Corporation of FICO is a mixed ownership government corporation chartered by the federal--

DIRECTOR WEICHER: Excuse me. John, I can't quite hear whoever is speaking.

CHAIRMAN KORSMO: All right. Try it again, Joe.

DR. McKENZIE: The Financing Corporation, or FICO, is a mixed ownership government corporation chartered by the former Federal Home Loan Bank Board pursuant to the Federal Savings and Loan Corporation Recapitalization Act of 1987.

DIRECTOR WEICHER: John, excuse me. It's still not working.

CHAIRMAN KORSMO: You're flying, you're in flight, John. [Referring to the movement of the speakerphone]

DIRECTOR WEICHER: Thank you.

DR. McKENZIE: Okay. Let's try it again.

The Financing Corporation, or FICO, is a mixed ownership government corporation chartered by the former Federal Home Loan Bank Board pursuant to the Federal Savings and Loan Insurance Corporation Recapitalization Act of 1987. The purpose of FICO is to function as a financing vehicle for the FSLIC resolution fund.

Pursuant to the act, FICO issued approximately $8.2 billion of long term obligations and so these obligations in public markets. It also issued stock to the Federal Home Loan Banks. With the proceeds of the issuance of the stock FICO purchased zero coupon Treasury securities whose face value is expected to repay the FICO obligations at maturity.

FICO is subject to the general oversight of the Finance Board. Its day-to-day operations are under the management of a three person board of directors. Two of the directors are Federal Home Loan Bank presidents who serve one year terms and are appointed by the Finance Board. And the third member of the FICO directors is the Managing Director of the Office of Finance.

FICO has no paid staff, but relies on the Office of Finance for its staffing. FICO pays interest on its bonds by assessing FDIC insured banks and thrifts using a statutory formula. The FDIC collects this assessment for FICO. FICO pays its administrative expenses by assessing the Federal Home Loan Banks.

Section 995.6(b) of the Finance Board's regulations requires FICO to submit its annual budget to the Finance Board for approval following approval by the FICO director. FICO submits two categories of expenses for approval. The first are administrative expenses, such as service contracts, legal fees, professional fees, and other operating expenses. These are paid by assessments on the Federal Home Loan Banks. FICO also submits a budget of non administrative expenses, most of which are interest on the FICO bonds. As I noted earlier, the FDIC collects these assessments quarterly from depository institutions.

The FICO directors approved this 2003 administrative and non administrative budgets on October 24th of this year. For 2003 FICO has requested the Finance Board approve an administrative budget of $14,000 and a non administrative budget exclusive of interest expenses of $5,000. The total budget requested, $19,000, is $200 less than FICO's combined 2002 budget request.

The FICO budget request presents no unusual issues and we recommend its approval.

CHAIRMAN KORSMO: Thank you, Dr. McKenzie.

Are there any questions of the staff?

Any questions of the staff?

If not the, the Chair would entertain a motion to approve the FICO budget as proposed.

DIRECTOR O'NEILL: I--

DIRECTOR LEICHTER: Go ahead.

CHAIRMAN KORSMO: We'll go with Franz.

Director Leichter moves adoption of the proposed resolution.

Is there any discussion of the motion? Any discussion of the motion?

John, your hand isn't up, is it?

DIRECTOR WEICHER: No.

CHAIRMAN KORSMO: Okay. Hearing none, the question is on approval of the 2003 administrative and non administrative budgets of the Financing Corporation, the secretary will please call the roll.

MS. BAKER: On the motion before the Board, Director Leichter, how do you vote?

DIRECTOR LEICHTER: Yes.

MS. BAKER: Director O'Neill?

DIRECTOR O'NEILL: Aye.

MS. BAKER: Director Mendelowitz?

DIRECTOR MENDELOWITZ: Aye.

MS. BAKER: Director Weicher?

CHAIRMAN KORSMO: That's you, John?

DIRECTOR WEICHER: I can't really hear Elaine. I vote aye.

MS. BAKER: Chairman Korsmo?

CHAIRMAN KORSMO: Aye.

The motion is carried. The budget is adopted.

The other item on our agenda today are proposed amendments to the capital plan of the Federal Home Loan Bank of Cincinnati. I note that the Bank's board of directors met yesterday to review the amended plan and approved the amendments recommended by the Bank's management. I also would note that the President of the Federal Home Loan Bank of Cincinnati, Chuck Thiemann, the Chairman of the Board, Paul Tipps, and at least one other board member, Bob Bennett, are present with us here today.

Cincinnati is the third Bank to present amendments to the recently approved capital plan. A fourth Bank has a request pending. The Director of Supervision and the General Counsel will shortly send guidance to all Banks on the processing of capital plan amendments. The guidance will share the lessons we've learned in reviewing the first three requests and will provide our staff and each Director, we're hoping, more time to consider these requests.

I believe Dr. Cross and Arnie Intrater are here to present the staff's recommendation which, again, I believe is for approval. So who is going to do the talking?

MR. CROSS: I'll kick it off.

This analysis began in the latter part of October following receipt of a letter from the Cincinnati Bank. The Office of Supervision analysis was led by Joe McKenzie on the safety and soundness aspects of the plan and Christina Muradian with respect to the details of the amendments. Representing the OGC was Tom Joseph. Tom Joseph prepared much of the paperwork for the Board. And so we've asked Tom Joseph to present to the Board the requested changes and the recommendation for your consideration. Tom?

MR. JOSEPH: Mr. Chairman, Members of the Board, the proposed amendments would set the minimum allocation percentage for loans purchased under the Cincinnati Bank's mortgage purchase program at 0 percent. Under the plan as originally adopted this percentage was 2 percent.

The Cincinnati Bank also proposes to change the range within which the minimum and maximum allocation percentages for MPP loans may be changed without amending the plan from 0 percent to 6 percent. The range as originally adopted was from 1 percent to 6 percent.

The Bank is not proposing to alter the initial maximum percentage requirement for MPP loans of 4 percent, nor is it proposing to alter the minimum or maximum allocation percentages or the related range as applicable to other mission asset activity.

In practical terms a 0 percent minimum allocation percentage for MPP loans means a member can borrow all of the stock needed to capitalize the outstanding balance of MPP loans that it has sold to the Bank at the 4 percent maximum allocation percentage level.

Under the plan as originally approved, the member needed to own stock at least equal to 2 percent of its outstanding balance and could borrow the remaining stock needed to raise its stockholding level to the 4 percent level. The proposed change in range will allow the Banks to move the minimum and maximum allocation percentages for MPP loans within the new ranges without further amending the plan.

I would like to note that in addition to ratifying the text of the amendments before you today, the Bank's Board also yesterday discussed and unanimously agreed that it is their intent that the maximum allocation percentage applicable to MPP loans would remain greater than 0. This would mean that they wouldn't be able to set a true 0 requirement for the loan in practical terms.

The amendments proposed by the Bank are consistent with the stock purchase requirements and ranges approved in other capital plans by the Finance Board. There is also no indication that the Bank will fail to meet its minimum capital requirement should the amendments be approved nor is there an indication that the Bank would apply the ranges contemplated in the revisions in a manner that is unsafe or unsound or would cause the Bank to fail to comply with these requirements.

We are thereby recommending that the Finance Board approve the amendments to the capital plan as requested by the Bank. We would be happy to answer any questions that anyone may have.

CHAIRMAN KORSMO: Before we open the floor for questions, Tom is the spokesman on this. Joe, did you have any input on this?

DR. MCKENZIE: I'm available to answer questions on the economic impact of the proposal if the Board members have any questions.

CHAIRMAN KORSMO: Okay. Thank you.

Any members of the Board have any questions of the staff? Dr. Mendelowitz?

MR. MENDELOWITZ: I just would like to clarify the implications of some of these things.

The Cincinnati plan is a unique plan designed to address the balance sheet aspects of capitalization of the Cincinnati Bank. And so I just wanted to make sure that I understood clearly what the different provisions mean. Because this plan does use terminology that has different meanings and, you know, a broader context than they have in the context of the Cincinnati plan.

Usually when people talk about minimum and maximum they're talking about a given range. And here minimum and maximum mean two very different things. I just want to clarify. When they talk about a minimum activity base charge, that refers to what exactly?

MR. JOSEPH: The minimum allocation

percentage is the amount of stock or the percentage of stock to a certain level of activity that the member must own, is required to own under the plan. The maximum amount is the upper level, and they may reach this upper level through stock they both own and stock that they borrow from the pool of bank excess stock.

DIRECTOR MENDELOWITZ: Now, moving a member owned activity based charge for AMA to 0 is not novel within the context of the Home Loan Bank System and the new capital plans. There are a number of Banks which have sought and gotten approval for a 0 activity based AMA charge.

How does the Cincinnati plan with a maximum AMA charge differ from these plans?

MR. JOSEPH: Cincinnati will allocate a member's stock, first of all, based on the minimum allocation percentage. They will first allocate--well, stock to membership stock. The rest of the stock will be allocated to activity based on the product of the minimum allocation percentage times the outstanding activity.

To the extent that that amount of stock is less than the maximum allocation percentage times the level of outstanding activity, the member will be required to borrow stock from the Bank, from the pool of Bank excess stock to reach that maximum allocation percentage.

If, however, the member owns enough stock to capitalize it at the maximum allocation percentage, the member will be required to hold that stock.

DIRECTOR MENDELOWITZ: Okay. So that if I understand what you're telling me is that if a member sells mortgages to the Cincinnati Bank and it has sufficient capital already on the books equal to 4 percent that's required now, their own capital would be the capital that capitalizes those AMA sales?

MR. JOSEPH: Mm-hum.

DIRECTOR MENDELOWITZ: But if on the other hand, for argument's sake, this member has no excess stock at all, it's all partly accounted for based on activity based charges for other, for advances, or whatever, and it sells mortgages, it then will now be able to borrow all of the capital needed to capitalize that; is that correct?

MR. JOSEPH: The 4 percent, right.

DIRECTOR MENDELOWITZ: The 4 percent. Okay.

Now, as a practical matter in the Cincinnati plan there is a formal borrowing of stock from the pool of excess stock on the balance sheet of the bank. But in other banks where the AMA activity based charge is 0 and those assets are sold to another Home Loan Bank, they have to be capitalized somehow. And they, in effect, are going to be capitalized out of the available capital on the balance sheet of the bank.

Are there any practical differences from a safety and soundness perspective or an equity perspective? Are there any appreciable differences from those criteria or any other possible criteria by which having the member borrow the cooperative capital at Cincinnati as a practical effect that's different than just capitalizing the AMA assets out of whatever capital is available on the balance sheet of the bank?

MR. JOSEPH: Well, the way the plan would work, a member that is borrowing stock receive additional stock through, let's say, a stock dividend or because they freed up some capital because their level of advances has gone down, the capital so received would first be used to replace the borrowed stock.

DIRECTOR MENDELOWITZ: Mm-hum.

MR. JOSEPH: That wouldn't happen if you had a 0 charge because there is no charge.

Secondly, for a member that withdrew from the System, they would be required to hold stock at up to the maximum allocation percentage for their activity. And so the bank would first take the membership stock, which would be no longer needed after the withdrawal date, put that to try to max it up to the maximum allocation percentage. And if that doesn't work, then the bank will not redeem or repurchase any stock from the member until the level of activity is such that the activity times the maximum allocation percentages is less than the amount of stock that the member is holding.

DIRECTOR MENDELOWITZ: So a member who chooses to exit won't be required to buy stock to fully capitalize the assets it leaves behind, but it will not be able to redeem any of its stock that is required to capitalize any of the assets left on the bank's books?

MR. JOSEPH: Right.

DIRECTOR MENDELOWITZ: And so--

MR. JOSEPH: Right. Yes.

DIRECTOR MENDELOWITZ: So that if, for argument's sake, I realize that a 30 year mortgage isn't a 30 year mortgage in reality, but for argument's sake, if a party member had sold a portfolio of mortgages to the Cincinnati Bank, they were 30 year mortgages and for some reason the homeowners never moved and never refinanced, in effect the party member's capital would have to stay on the books to capitalize those mortgages until they were fully extinguished?

MR. JOSEPH: Right. At the maximum allocation percentage.

DIRECTOR MENDELOWITZ: Right.

MR. JOSEPH: At that point.

DIRECTOR MENDELOWITZ: So in effect what this cooperative capital provision ensures, then, is that there's a fairness or equity issue here that when a member departs, if they sold lots of mortgages to the Cincinnati Bank and, in fact, left risk on the balance sheet in the form of mortgages, they couldn't sort of depart and leave any potential losses to the surviving members of the bank. Their capital would be there and they would have to bear a share of the risk associated with the operations of the bank because even though they're no longer a member, they still have assets on the book?

MR. JOSEPH: So long as--right.

DIRECTOR MENDELOWITZ: Okay. Thank you.

CHAIRMAN KORSMO: Any other questions?

Dr. Weicher, any questions? I can't see your hand.

DIRECTOR WEICHER: Oh, no, Mr. Chairman.

CHAIRMAN KORSMO: Okay. Thank you.

Hearing none, is there a motion to approve the resolution? Director Mendelowitz?

DIRECTOR MENDELOWITZ: I move to approve.

CHAIRMAN KORSMO: It has been moved that we approve the amendment to the capital structure plan of the Federal Home Loan Bank of Cincinnati. Is there any discussion of the motion? Director Leichter?

DIRECTOR LEICHTER: Yeah. I've, in the past, expressed my concern about capital plans which have a 0 charge for AMA activity. I am concerned that as more and more banks take advantage of this--

DIRECTOR WEICHER: Mr. Chairman?

CHAIRMAN KORSMO: Yes, sir.

DIRECTOR WEICHER: I'm sorry. I can't hear Director Leichter.

CHAIRMAN KORSMO: We'll move you, John. Hold on. You're in flight again, John. [Referring to the movement of the speakerphone]

DIRECTOR LEICHTER: John, I was just expressing concerns which you've heard me express before about having a 0 charge for AMA activity. And my concern is that as we see more and more banks taking advantage of what the majority on the Board has enacted or permitted as far as these AMA charges are concerned, that we're seeing--that we may be moving toward a change in the character of the System and will lead eventually to undermining, at least in some respects, the cooperative nature of the System.

Cincinnati, for me, presents a somewhat different problem because at the time that the Cincinnati capital plan was being considered and when we approved it I think the members of this Board expressed their concern to the Cincinnati Bank about the high level of excess stock. And I want to say the bank has been very responsive in addressing that issue and has assured the Board that they will come up with a plan that will reduce the somewhat high level of excess stock.

Now, their plan is to use the excess stock to capitalize their MPP activity. So having urged the Bank to take some steps, it presents difficulties for me in saying, well, I don't like the step that you're taking because I think it is a rational business plan that the bank has come up with. In fact, I voted for the Dallas plan and the Pittsburgh plan, both capital plans which provided for 0 charge in AMA activities because those banks in their business plan did not expect to hold a large portfolio of mortgages. They actually transmitted the mortgages to the Chicago Bank.

I think similarly here in Cincinnati, I think there's a rational business plan. And as I've stated, Cincinnati is addressing what has been the concern of this Board and the concern of the Cincinnati Bank to reduce their high level of excess stock.

So having once again stated my apprehension and my concern that we not take steps that undermine the cooperative nature of the System by creating an investor class or doing other things that change the nexus that we've created between people who use the services of the bank and the capital structure of the bank. But I think there's a rational reason for Cincinnati to do what they're doing and I'm going to support this plan.

CHAIRMAN KORSMO: Is there any other discussion of the motion? Any other discussion of the motion?

[No response.]

CHAIRMAN KORSMO: Hearing none, the question is on the amendment to the capital structure plan of the Federal Home Loan Bank of Cincinnati.

The Secretary will please call the roll.

MS. BAKER: On the matter before the Board, Director Leichter, how do you vote?

DIRECTOR LEICHTER: Aye.

MS. BAKER: Director O'Neill?

DIRECTOR O'NEILL: Aye.

MS. BAKER: Director Mendelowitz?

DIRECTOR MENDELOWITZ: Aye.

MS. BAKER: Director Weicher?

DIRECTOR WEICHER: Aye.

MS. BAKER: Chairman Korsmo?

CHAIRMAN KORSMO: Yes.

The motion is carried.

The amendment to the capital structure plan of the Federal Home Loan Bank of Cincinnati is approved.

Anybody have any other business to bring before the Board?

I just have a brief statement I wanted to submit. Today's agenda, obviously, was modest because our annual conference for bank directors begins at noon. But the balance of the year will be very busy for the Finance Board. In early December I'm planning to convene a public hearing to afford the banks an opportunity to discuss their work to become role models for disclosure and to hear their suggestions for the Finance Board, to hear their suggestions for regulatory actions in support of that goal.

The staff is working hard to draft a proposed regulation for consideration at our next meeting that would establish a state of the art disclosure program for debt issued by the system and for any mortgage backed security issued by the

Banks if--and I stress the word "if"--the Finance Board were at some point to approve such a request.

I also expect that the December meeting of the Finance Board will consider establishing a mechanism and a timeline aimed at bringing process to the debate on whether or not a multiple bank membership should be extended to all members of the System. This is a preliminary step only, but one I believe is necessary if we, as a Finance Board, are to resolve the issue ultimately. To paraphrase Mitch Daniels, the words "adjoining district and/or" have been tortured mercilessly in our process. And they will not confess. So instead I believe we'll find the answer by referring to the first principles of the Federal Home Loan Bank Act. Will multiple memberships enhance safety and soundness in the housing finance mission?

With the process in place focused on the right questions, this long debate, I'm assuming, can be concluded in the new year.

Are there any other comments or announcements anyone had to make?

[No response.]

CHAIRMAN KORSMO: Hearing none, this meeting is adjourned. And we'll see you all in an hour and-a-half at the Director's Conference.

Thank you very much.

[Whereupon, at 10:27 a.m., the meeting was adjourned.]