

# The Chicago Balance Sheet

A Federal Home Loan Bank of Chicago Publication

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## WASHINGTON WATCH

### Illinois Native Joins Federal Housing Finance Board

Geoff Bacino is the newest Director on the five-member Federal Housing Finance Board, which regulates the Federal Home Loan Banks. Appointed by President Bush and confirmed by the Senate this summer, Bacino replaces Franz Leichter as one of two Democrats on the FHFB for a term that expires February 27, 2013.



Originally from Illinois, Bacino has spent most of his career in Washington, D.C. Most recently he was Senior Vice President for Legislative and Regulatory Affairs at Centrix Financial, a company specializing in the sub-prime auto loan market for 180 credit unions nationally. During 2002-2004, he headed the Bacino Group, a lobbying and consulting firm for financial institutions.

In 2000, President Clinton appointed him to the Board of the National Credit Union Administration, which oversees 9,800 federally insured credit unions.

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**Chicago**  
Federal Home Loan Bank

## A Message from Mike Thomas

The first ten months of 2006 at the Federal Home Loan Bank of Chicago have been marked by significant progress. We continue to meet challenges and deliver valuable products and services to you. Before I outline some of our important achievements, I want to thank you again for your support of the Bank by maintaining your membership and by continuing to make use of advances, the MPF® Program, and our Community Investment products.



The Bank's top priority this year was to restore liquidity to your voluntary stock, and we have begun to do that. As you know, the Bank issued \$1 billion of subordinated debt this summer, and redeemed \$1 billion of member stock. We have previously communicated to you our intention to redeem more voluntary stock by the end of the year. To that end, the Federal Housing Finance Board has authorized the redemption of \$375 million in additional voluntary stock in the fourth quarter. I can assure you that our attention has been - and continues to be - squarely focused on our commitment to members.

In addition, we:

- Continue to evolve the MPF Program to ensure maximum value for you;
- Awarded \$13.6 million in AHP grants through the competitive process where our members partner with non-profit organizations to develop housing for low- to moderate-income families;
- Completed our SEC registration, which means you receive more financial information from the Bank;
- Completed our Finance Board exam. Also, the Finance Board approved our revised Business Plan and Retained Earnings and Dividend Policy.

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# Financial Impact of Stock Redemption

During the first redemption of voluntary stock in June, several members asked about the tax impact of redeeming. The FHLBC does not and cannot provide tax advice, but we did confirm their records of stock purchases and sales so that they could calculate the tax impact of redeeming stock. With another redemption planned for the fourth quarter, it is appropriate for members to consider this issue now. Depending on when you bought stock, among other factors, you (in consultation with your tax advisor) may conclude that keeping shares is more attractive than redeeming if redemption triggers capital gains taxes.

To illustrate the tax impact, consider this fictional community bank:

| EXAMPLE<br>(\$ IN MILLIONS) |                             |
|-----------------------------|-----------------------------|
| Total Assets                | \$600                       |
| Mortgage Related Assets     | \$400                       |
| Advances Outstanding        | \$50                        |
| Membership Requirement      | \$4.0 (1% of \$400 million) |
| Activity Requirement        | \$2.5 (5% of \$50 million)  |
| Stock Held (as of 12/31/99) | \$4.0                       |
| Reinvested Dividends        | \$1.7                       |
| Stock Held (as of 12/31/05) | \$5.7                       |
| Voluntary Stock             | \$1.7 (\$5.7 minus \$4.0)   |

## Reinvested Stock Dividends

Voluntary stock held by most members is a result of reinvesting stock dividends (see example). Because FHLBC paid stock dividends from 2000-2005, total

stock held has grown. To the extent that income tax on the stock dividends (on shares held since 1999) was deferred, upon sale, members may realize about \$30 per share in capital gains and pay taxes of about \$12 per share.

## Purchased Stock as an Investment

When interest rates fell in 2001-2003, many members bought additional stock in the FHLBC as an investment. As noted, tax may have been deferred on stock dividends. For example, stock purchased near year-end 2002 has accumulated 19% more shares from stock dividends. Upon sale, members may realize a taxable gain of \$16 per share and pay taxes of about \$6 per share.

Based on our conversations with members last June, many members have elected to sell the specific shares (and stock dividends thereon) bought after 1999. Some members may elect to keep their earliest investment to continue deferring the tax obligation. Deferral is most advantageous for members that are growing and may have a higher membership requirement in the future.

## Consult your tax advisor

We can supply you with FHLBC stock transaction records for your tax advisor to analyze. Please contact your Relationship Manager for more information.

The information presented in this article should not be used as a substitute for consultation with professional accounting, tax, legal or other competent advisors. Since tax matters are extremely involved, the FHLBC cannot provide you with tax law advice. We suggest that you contact your tax advisor before making any decision or taking any action with respect to redeeming your stock in the FHLBC.

## New Collateral Options

Your institution can now increase its borrowing capacity to meet changing liquidity needs by pledging open-end home equity lines of credit (HELOCs) or closed-end home equity loans (Seconds)—or both. These options are open to all members of the Federal Home Loan Bank of Chicago. You can review the FHLBC Credit Guide and Collateral Guidelines on the eBanking website.

To take advantage of these new options, contact your Relationship Manager, who will ask you to follow these steps:

- Submit a copy of your home equity underwriting policy to the FHLBC's Credit Department for review.
- Work with our Credit Department to ensure that a security interest can be perfected.
- Add home equity loans that qualify to your available collateral report (ACR).
- Arrange for a field review of home equity collateral.

## A Message from Mike Thomas

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Every employee of the Federal Home Loan Bank of Chicago is committed to serving you better. Recently, that has meant working hard to expand your collateral options and to offer new products. You can now pledge both open-end home equity lines of credit (HELOCs) and closed-end home equity loans (Seconds) as eligible collateral.

And, you can take advantage of our new Strike Rate and short-term advance products, including an advance based on the overnight fed funds rate.



*photo: courtesy of Edward Fox Photography.*

*Mike Thomas introduced Mayor Richard M. Daley at the National Housing Conference Policy Summit in Chicago on October 12. Mayor Daley was the keynote speaker.*

If you have any questions, please feel free to contact me, your Relationship Manager, or Charlie Huston, Executive Vice President, Member Relationship Management, at (312) 565-5715.

Sincerely,  
Mike Thomas  
President and CEO  
Federal Home Loan Bank of Chicago

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## Proposed Capital Rule Update

Three years ago, the Federal Housing Finance Board (FHFB) prompted discussions concerning the Federal Home Loan Banks' approaches to retained earnings, which in February of this year were followed by a proposal involving that issue. This proposal, sometimes referred to as the capital rule, would require that dividends be limited until retained earnings were equal to \$50 million plus 1% of non-advance assets such as mortgages and mortgage-backed securities.

You may have heard of letters being sent to the FHFB from the Home Loan Banks; this is partly because the proposal would limit total amounts of excess ("voluntary") stock and impede a Home Loan Bank's ability to declare a

stock dividend. Although these outcomes may occur, the FHFB has signaled recently they intend to grant more time for the Home Loan Banks to build retained earnings. Or, the FHFB could revise or replace the proposal altogether.

"We are a well-capitalized institution, and thus far, have the highest level of retained earnings of any of the Home Loan Banks, even those with greater asset size," says Mike Thomas, the President and CEO of the Federal Home Loan Bank of Chicago.

At press time, no announcement has been made about the Finance Board's decision on the proposed capital rule.

### New Member News

The Federal Home Loan Bank of Chicago welcomes the following members:

Community State Bank of Plymouth, Plymouth, IL  
Integrity First Bank, Wausau, WI  
Bank of Kenney, Kenney, IL  
Federal Life Insurance Company (Mutual), Riverwoods, IL  
Bank of Modesto, Modesto, IL  
Brewery Credit Union, Milwaukee, WI  
MEMBERS Life Insurance Company, Madison, WI  
CUMIS Insurance Society, Inc., Madison, WI  
Marine Credit Union, Fond du Lac, WI

### FDIC Ruling on Advances

The FDIC received 569 comment letters addressing whether Home Loan Bank advances should be included as "volatile liabilities" in deposit insurance assessments. All but one letter argued that these advances should not be included. Thanks to those letter writers, the final rule does not include the volatile liability ratio.

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He also was responsible for the National Credit Union Share Insurance Fund. Previously, he was a lobbyist for the Credit Union National Association and founded the National Association of State Chartered Credit Unions.

The 44-year-old calls himself a “free-market Democrat” and says he considers his role on the Finance Board to be similar to that of a referee: making calls but not deciding the plays. “It’s our job to determine the safety and soundness of an act, not whether or not we feel that act fits best in the overall structure of a financial institution,” he told the *American Banker*.

Despite his years in Washington, Bacio remains an avid Chicago sports fan. His office contains a framed basketball jersey signed by Michael Jordan, and Chicago Bears memorabilia is scattered throughout the room.

#### Prospects Fading for GSE Bill

The prospects for passage of legislation to create a new Federal agency to regulate the Federal Home Loan Banks, Fannie Mae, and Freddie Mac are fading. Without action, the bill will expire at the end of the year.

Despite an intense push by the Bush Administration, efforts to strike a deal prior to adjournment failed to produce a compromise. The key sticking point remains whether and how to limit the size of Fannie’s and Freddie’s \$1.4 trillion portfolio of mortgage-backed securities, which generates significant profits for the GSEs but critics say pose systemic risk to U.S. taxpayers.

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*The Mission of the Federal Home Loan Bank of Chicago is to promote and support the growth and success of our members’ housing, community investment, and other financing needs.*

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## Community Investment Cash Advances Work for Community Banks

Over the past 5 years, Oostburg State Bank in Oostburg, Wisconsin, has taken down 25 advances as part of the Federal Home Loan Bank of Chicago’s Community Investment Cash Advance Program (CICA). These Community Investment Cash Advances are priced below standard FHLBC advance rates; to qualify, a member’s lending must meet certain criteria such as financing a small business, an affordable rental project, or a portfolio of loans to low- and moderate-income families. These requirements are often easily met by community financial institutions.

Though Oostburg State Bank traditionally funds owner-occupied homes through this program, it recently financed three economic development deals, including a mixed-use rental/retail project. President Gary DeMaster says CICA allows Oostburg State Bank to:

- Invest in its community. Dutch immigrants settled Oostburg in the 1840s. The village’s population is 2,700, though Oostburg State Bank also serves the people of nearby Cedar Grove, Gibberville, and Hingham. With loan growth outpacing deposit growth, the bank was looking for other funding sources when it turned to the FHLBC. “If we don’t have funding, we can’t make loans,” DeMaster says. “We can use these funds to take care of our local community.”
- Manage its balance sheet. Like many banks, Oostburg State Bank’s cash position is asset-driven. These advances “fit into our liability portfolio,” says DeMaster. The FHLBC’s ability to provide longer-term funding is also attractive, he says. Terms range from 1 month to 10 years but can extend to longer terms for affordable housing projects.
- Obtain competitive pricing. DeMaster looks beyond retail brokers for the most beneficial pricing and calls the application process to receive these preferential CICA rates a “good investment” of his time.

FHLBC Relationship Manager Katie Naftzger met with DeMaster and his management team to explain in greater detail which activities qualified for the CICA rate. Since that meeting, the bank’s lenders know what kinds of loans are eligible, and they bring them to DeMaster to obtain FHLBC funding. He plans to do both CICA and regular FHLBC advances as needed in the future, he says.

To learn more about CICA advances or the other community investment programs of the FHLBC—Competitive Affordable Housing Program, Downpayment Plus® Program, or the HUD Section 184 Mortgage Program—contact your Relationship Manager or visit [www.fhlbc.com](http://www.fhlbc.com) and follow the Community Investment links. Applications for Community Investment Cash Advances can be downloaded from the website. If you have questions about the process, our team of Relationship Managers and specialists in the Community Investment Group will walk you through the application process.