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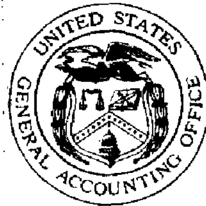
Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and the Chairman, Committee on Banking, Finance and Urban Affairs, House of Representatives

December 1993

FEDERAL HOME LOAN BANK SYSTEM

Reforms Needed to Promote Its Safety, Soundness, and Effectiveness



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**Comptroller General
of the United States**

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December 8, 1993

The Honorable Donald W. Riegle, Jr.
Chairman
The Honorable Alfonse M. D'Amato
Ranking Minority Member
Committee on Banking, Housing, and
Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman
The Honorable James A. Leach
Ranking Minority Member
Committee on Banking, Finance and
Urban Affairs
House of Representatives

This report responds to the questions concerning the Federal Home Loan Bank System contained in Sec. 1393 of the Housing and Community Development Act of 1992 (P.L. 102-550).

We are sending copies of this report to the Secretary of the Treasury, the Director of the Office of Federal Housing Enterprise Oversight, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association so that they can submit their comments on this report to your committees as required by the Housing and Community Development Act of 1992. Copies will also be made available to others upon request.

Major contributors to this report are listed in appendix II. If you have any questions about this report, please call Mr. James L. Bothwell, Director for Financial Institutions and Markets Issues on (202) 512-8678.

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Purpose

As a result of the savings and loan debacle, Congress overhauled federal regulation of the savings and loan industry. Many of these changes directly or indirectly affected the Federal Home Loan Bank (FHLBank) System. As a result, in the Housing and Community Development Act (HCDA) of 1992, Congress required GAO and several other groups to address 14 questions concerning various aspects of the FHLBank System (System).

GAO grouped the questions, which are listed in chapter 1, into five general issues:

1. Can the FHLBank System pay its assessments for affordable housing and for helping finance the savings and loan cleanup while carrying out its mission?

2. What are appropriate capital standards for the FHLBank System?

3. Should the terms of membership in the FHLBank System be changed?

4. What is, and what should be, the role of the FHLBank system in affordable housing, and how would System consolidation affect this?

5. Should the FHLBank System be permitted to offer new products and services?

GAO also addressed whether changes in the corporate governance and regulation of the FHLBank System are needed.

Background

The FHLBank System was set up in 1932. Its purpose was, and is, to facilitate the extension of mortgage credit. It does this by lending (in the System's terminology "making advances") to its stockholders/members, who in turn lend to homebuyers for mortgages. The FHLBank System is a government-sponsored enterprise (GSE), a federally chartered, privately owned system of 12 banks that raises funds by issuing consolidated debt securities in the capital market.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) made changes to the System's objectives and made other changes to how the System does business. It added objectives of helping to pay for savings and loan resolutions and affordable housing to the primary objective of supporting housing finance. The new objectives carry specific requirements in terms of the amount of financial support to be paid each

year. It abolished the System's old regulator (the Federal Home Loan Bank Board) and created a new regulator (the Federal Housing Finance Board—FHFB). It opened membership, which had been limited mainly to savings associations, to commercial banks and credit unions. These institutions can join by buying stock in the FHLBank that operates in the state where they are headquartered. They can also withdraw from the System if they wish. Currently, however, savings associations must be members of the System. Thus, the System now has two classes of members: voluntary and mandatory.

At the end of 1992, the System had 3,627 members. It had total assets of $162 billion, which included $80 billion of advances to members and $79 billion of investment securities. The System earned $850 million in 1992, a return on assets of 0.5 percent.

In FIRREA, Congress imposed two sizable fixed obligations on the System. One obligation requires the System to pay $300 million per year, for 38 more years, to help finance the expense of resolving bankrupt savings and loans. This obligation, known as the Resolution Funding Corporation (REFCorp) obligation, consists of a 20-percent levy on the net income of each FHLBank. If this levy raises less than $300 million, the shortfall is collected from the FHLBanks in proportion to each FHLBank's advances to members insured by the Savings Association Insurance Fund (SAIF). The other obligation is to fund an Affordable Housing Program (AHP). Initially, the System has been assessed $50 million or 5 percent of earnings, whichever was larger, to finance this program. This assessment rises to the larger of $100 million or 10 percent of earnings in 1995.

Results in Brief

While the System is currently able to pay its fixed obligations, the obligations are indirectly increasing risk and creating stresses in the System. This is resulting from the System having to search for new sources of revenue to meet its large fixed payments. Conflicts can arise between the need to make these payments and achieving the System's primary objective of supporting housing finance in a safe and sound manner. GAO concludes that changing the fixed nature of these obligations to one based on a percentage of System income would best ensure continued payment in the future, as well as ensuring that the System continues to achieve its primary objective. GAO presents several options for dealing with situations when the percentage approach yields less than the currently required $300 million.

FHLBanks have considerable capital stock outstanding, but GAO found that this capital stock is a poor buffer against loss because it is redeemable. Also, the amount of capital stock issued by FHLBanks is not directly related to the risks undertaken by FHLBanks. An improved set of capital rules would require permanent capital in the form of minimum required retained earnings, which would be based on the risks borne by the System. As retained earnings increased, and assuming that the risks undertaken by FHLBanks do not increase, then FHLBank stock purchase requirements imposed on System members could be lowered.

GAO found that having both mandatory and voluntary members may introduce added risk into the System. Both the fixed obligations and the ability of voluntary members to redeem their capital stock create potential conflicts between the interests of voluntary members and those of mandatory members. The problems that might result from having two membership classes would be removed if membership were voluntary for all eligible institutions. GAO believes that making System membership voluntary, and equalizing the terms of membership, would promote greater efficiency and better service from the FHLBanks to their members, because it would better allow market forces to work. For that same reason, such changes might encourage System consolidation on the basis of economic efficiency considerations.

The FHLBank System supports affordable housing through traditional advances to its members and through two targeted affordable housing programs. The targeted programs have funded over 130,000 units serving low- and moderate-income households. GAO's analysis of one of these programs suggests that FHLBank consolidation would be unlikely to compromise the System's support for affordable housing.

With regard to the issue of whether to expand FHLBank products and services, GAO suggests a set of criteria for policymakers to use in considering any expansion of FHLBank products and services. These criteria focus on preserving the System's mission and its low-risk characteristics.

Finally, GAO found that FHFB is not operating as an independent, arm's-length regulator of the System and has, in fact, defined itself as an advocate for the System. GAO believes that safety and soundness regulation of all housing-related GSES could be done more effectively by a single, independent regulator. GAO also believes that the corporate governance

responsibilities executed by FHFB should be given to the FHLBanks and their shareholders.

GAO's Analysis

The Fixed Financial Obligations of the FHLBank System Need to Be Modified

GAO has four concerns with the fixed nature of the REFCorp and AHP obligations. These concerns relate to potential conflicts between meeting the fixed obligations and achieving the primary objective Congress established for the System, which is to support housing finance by providing funds to institutions engaged in home mortgage lending.

First, the annual payments have large fixed minimums, but System earnings tend to fluctuate. In periods of low income, such as the System has recently experienced, the System must look to new sources of revenue to meet these large payments. From the end of 1988 to the end of 1992, outstanding advances to members have declined from $153 billion to $80 billion while investments have risen from $17 billion to $79 billion. In the investment category, mortgage-backed securities have risen from $5 billion at the end of 1990 to $22 billion at the end of 1992. By expanding their investment portfolios, particularly with mortgage-backed securities, the FHLBanks have increased the interest rate and management and operations risks they undertake. This interest rate risk can be mitigated but cannot be eliminated. Perhaps more importantly, the management and operations risks involved with these derivative securities can be considerable.

Second, the part of the formula used to assess any needed shortfall allocation for the REFCorp obligation penalizes FHLBanks for making advances to savings associations—the original mission of the System. Further, this part of the formula places a disproportionate amount of the financial burden on certain FHLBanks. For example, the San Francisco FHLBank paid 37 percent of the REFCorp shortfall in 1992, although that FHLBank earned 15 percent of System income and held 23 percent of System assets. These effects could ultimately be disruptive to the System by impeding cooperative action among the FHLBanks.

Third, state-chartered savings associations will be free to leave the System beginning in April 1995. As of September 10, 1993, there were 464 state-chartered and 1,324 federally chartered SAIF-insured savings

associations. Further, it is possible for a federally chartered savings association to convert to a state charter. A large exodus of such members could leave a smaller base from which to make the fixed payments. In the worst case, this could threaten the stability of the entire System.

Fourth, the size and structure of the fixed obligations complicate changing other aspects of the System. For example, since the REFCorp obligation is not distributed proportionately across all the FHLBanks, consolidating FHLBanks could be difficult.

Although the FHLBanks should be able to continue meeting their fixed obligations in the near term, the problems GAO identified with the obligations' fixed nature could weaken the financial stability of the System and ultimately threaten its ability to make future REFCorp payments. GAO believes that these problems are sufficiently serious to recommend changing the fixed nature of the obligations and presents several options for doing so. Under two of the options, the System would still be required to pay the full REFCorp obligation, although the timing of those payments could change. A third option is exemplified by the Federal Home Loan Bank Modernization Act of 1993, H.R. 1085, 103d Cong., 1st Sess. (1993). Under H.R. 1085, the shortfall would be assessed directly on SAIF-insured members through an added deposit insurance assessment. However, simply dropping the shortfall allocation without specifying another payment source would put the responsibility for it on the taxpayers. Each of these options has its advantages and disadvantages. (See ch. 2.)

The System's Capital Structure Needs to Be Reformed

FHLBanks face several types of risks—interest rate, credit, management, and operations risks. However, FHLBank stock purchase requirements for System members are not directly related to the risks undertaken by FHLBanks. Instead, they are set by statute and are based on members' mortgage assets and FHLBank advances.

Nearly all System capital comes from stock purchased by member institutions; the remainder comes from retained earnings. At the end of 1992, FHLBanks had $10 billion in capital stock outstanding. However, the stock held by voluntary members can be redeemed by voluntary members that give up System membership. Even though FHFB may refuse to redeem stock at par should the withdrawing member's FHLBank be in financial difficulty, this nonpermanent nature of FHLBank capital stock makes it a less suitable buffer for absorbing losses than other forms of capital. That is, in order for the FHLBank capital stock to be available to absorb losses,

FHFB must refuse to fully redeem the capital stock of withdrawing members at the first sign of potential financial difficulty in a FHLBank.

There are two aspects to setting regulatory capital requirements for FHLBanks. First, the requirements must provide a meaningful basis for members' FHLBank stock purchase requirement so that members continue to have an equity-based ownership stake in their FHLBanks. Second, the requirements must ensure an adequate amount of permanent, at-risk capital based on measurable risk, such as interest rate risk as well as management and operations risk.

After considering alternative FHLBank stock purchase requirements, GAO concluded that the risk-based capital and leverage requirement rules set for depository institutions would provide an acceptable framework. GAO further concluded that a minimum retained earnings requirement based on measurable risks—such as interest rate risk—as well as nonmeasurable management and operations risks should provide a permanent source of capital to protect against those risks. This could also allow a reduction in stock purchase requirements as retained earnings increase. (See chapter 3.)

Mixed Membership Adds Risks

Currently, the System has both voluntary and mandatory members. There are two risks to maintaining two FHLBank membership classes: (1) the potential instability created by piecemeal movement towards voluntary membership, and (2) the risks involved in allowing voluntary members to leave the System if their capital investments appear to be at risk while mandatory members are left to absorb losses. Since voluntary members may redeem their FHLBank capital stock and mandatory members may not, the incentives and attitudes toward FHLBank risk-taking may differ between the two membership classes.

One solution would be to make membership mandatory for all eligible institutions. GAO found no support for this approach within the System or from knowledgeable outsiders. GAO also concluded that all-mandatory membership would not create adequate incentives for efficient System management.

Alternatively, all-voluntary membership should reduce the risks just cited and therefore should improve the System's safety and soundness. Making membership voluntary should also give FHLBank managers a stronger incentive to provide their members with value for their membership. If a

FHLBank is not providing sufficient value, its members could redeem their capital and invest those funds elsewhere. However, if enough members no longer find sufficient reason to remain in the System, the System would begin to self-liquidate.

Large-scale withdrawals from the System appear unlikely in the foreseeable future, given that more than 1,900 new voluntary members have joined the System since the passage of FIRREA. However, if at some point in the future the System's stockholders/members no longer find sufficient value in its existence, GAO believes that the System should be allowed to naturally self-liquidate. GAO recognizes that without the System, another source for REFCorp payments would have to be found. GAO believes that it is preferable to have to find an alternative source for the $300 million annual REFCorp payment than to perpetuate a System in which the owners see no economic viability.

Similarly, GAO concluded that the improved incentives created by voluntary membership should give stockholders/members both a stronger financial incentive and an improved ability to seek the form of System consolidation that would best increase System efficiency. Finally, GAO concluded that other statutory and regulatory differences between members should also be removed. Such changes would recognize the similarities between commercial banks and savings associations in serving the home mortgage market. GAO also suggested that permitting eligible members to choose which FHLBank they wish to join may have similar benefits. (See ch. 4.)

The System Plays a Role in Affordable Housing

The System supports affordable housing through traditional advances to members and through its targeted affordable housing and community investment programs. The amount of affordable housing financed with traditional advances is unknown because advances are not tied to specific mortgages. Between 1990 and 1992, AHP has provided about $192 million in FHLBank funding to help fund about 53,000 units. Unlike AHP, members do not compete for funds in the Community Investment Program (CIP). Also, CIP does not have a statutorily determined level of participation, and it has a somewhat broader scope in that CIP funds may finance certain commercial and economic development activities. CIP provides a lower level of subsidy but has supported about 78,000 units through $2.7 billion in CIP advances.

The potential effects of consolidation on the affordable housing activities of FHLBanks cannot be projected with certainty. However, GAO's analysis of AHP revealed no evidence that larger districts were less able to deliver affordable housing services than were smaller districts. Furthermore, permitting branch offices to provide local delivery of housing services could maintain more widespread local presence of FHLBank personnel while at the same time consolidating FHLBank districts (See ch. 5.)

New Services Should Be Rigorously Evaluated Before Being Offered

FIRREA increased the role of the FHLBanks in affordable housing and community development by establishing AHP and CIP. There have been proposals to expand these programs or institute others to augment the role of the System. The law requiring GAO's report included three specific questions in this area—whether the System should buy housing-related assets, make construction loans, and provide credit enhancements for affordable multifamily housing projects. GAO proposes a set of six criteria for policymakers to use in evaluating these and other proposals. GAO developed these evaluation criteria on the basis of discussions with System members and FHFB and FHLBank officials and by considering criteria put forward by other interested parties. The criteria are (1) avoiding competition between FHLBanks and their members, (2) expertise in the new business, (3) consistency with the System's mission, (4) value added by new services, (5) proper pricing of new services, and (6) appropriate risk-taking for the System.

These criteria are rigorous, as they need to be to preserve the System's safety and soundness. For example, the proposals that the System buy housing-related assets and make construction loans do not meet several of them. The case of credit enhancements for multifamily affordable housing is less clear, and it may be possible to design a credit enhancement program that would meet the criteria.

GAO believes that any proposals to significantly expand the products and services the System offers need to meet its—or similarly rigorous—criteria before they are offered. (See ch. 6.)

FHFB Not Arm's-Length From the System

GAO has commented in the past that FHFB inappropriately combines safety and soundness regulation with corporate governance responsibilities over the System. Indeed, FHFB stated in its recent mandated report that this was a weakness and that the functions should be separated.

GAO found that FHFB has become an advocate for the System. In late 1992, for example, FHFB developed a congressional outreach plan to coordinate congressional lobbying between FHFB and the FHLBanks. In a document prepared by FHFB staff, FHFB defines its role to include presenting the System's views to Congress. GAO believes that a federal regulator responsible for protecting taxpayers by ensuring a GSE's safety and soundness should not be engaged in such activity.

That FHFB should become an advocate for the System underscores how difficult it is for a regulator that oversees just one entity to remain at arm's-length from that entity. GAO believes that the best way to solve this problem is by merging FHFB's safety and soundness responsibilities with those of the new Office of Federal Housing Enterprise Oversight (OFHEO).[1] GAO believes this approach would be the most consistent with the standards for regulating GSEs that GAO espoused in a recent report on GSEs.[2] The combined entity—which would regulate all three housing GSEs—would have greater independence, objectivity, and prominence than either FHFB or OFHEO alone. It may also be able to operate at lower cost by eliminating staff duplication at the two agencies. In addition, consolidating these two entities would help ensure consistency of regulation, where that is appropriate, across all housing-related GSEs.

The new entity should not, however, retain any of the corporate governance functions over the System. GAO currently does not see a need for a central coordinating institution for the FHLBank System besides what can be established voluntarily by the FHLBanks. FHFB has recently suggested a useful approach to beginning the process of separating System governance from safety and soundness oversight. (See ch. 7.)

Recommendations to Congress

GAO recommends that Congress take the following actions:

- Modify the shortfall allocation portion of the FHLBanks' REFCorp obligation and make each FHLBank's contribution to AHP a fixed percentage of its net income. GAO proposes several options for Congress to consider to ensure that the full REFCorp obligation is eventually paid.

[1]In the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Congress created OFHEO to be the safety and soundness regulator of the other two housing GSEs—the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

[2]Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks, (GAO/GGD-91-90, May 22, 1991).

- Direct the System's regulator to develop risk-based capital standards for FHLBanks analogous to those for commercial banks, with the added provision of having minimum requirements for retained earnings.
- Make FHLBank membership voluntary for all eligible institutions and make membership terms the same for all eligible members.
- Merge FHFB and OFHEO, thereby creating a single safety and soundness regulator for all three housing-related GSEs. The merged entity could be an independent office within HUD, as OFHEO is now, or a stand-alone independent agency, as FHFB is now.

Agency Comments

In HCDA, Congress required the Congressional Budget Office, the Department of Housing and Urban Development, and FHFB to complete the same study requirements as GAO. The CBO and FHFB reports were released earlier this year.[3] It further required the Director of OFHEO, the Secretary of the Treasury, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation to submit reports to the banking committees commenting on the four mandated studies to the extent that these officers and entities have differing views and recommendations. Also, the act required the System to establish a Study Committee comprising 24 System members to report to the banking committees on the 14 questions in the mandate and on the costs and benefits of consolidating the System. The Study Committee report was issued in July 1993.[4] Finally, the act required each individual FHLBank to submit a report evaluating the costs and benefits of consolidation.

Because of these requirements, GAO did not seek official agency comments on this report. At the end of the review, GAO briefed the chairman of FHFB, the chairman of the FHLBanks Stockholder Study Committee, and the Steering Committee of the FHLBank Presidents Conference on the findings and recommendations of this report. GAO also briefed senior representatives involved with the mandated studies from the Department of the Treasury, the Department of Housing and Urban Development, OFHEO, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. No major objections were raised concerning GAO's findings and recommendations.

[3]See Congressional Budget Office, The Federal Home Loan Banks in the Housing Finance System, July 1993; and FHFB, Report on the Structure and Role of the Federal Home Loan Bank System, April 28, 1993.

[4]See Federal Home Loan Banks Stockholder Study Committee, The Future Direction of the Federal Home Loan Bank System, July 1993.

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Abbreviations

AHP	Affordable Housing Program
BIF	Bank Insurance Fund
CBO	Congressional Budget Office
CIP	Community Investment Program
CIPA	Contractual Interbank Performance Agreement
FCA	Farm Credit Administration
FCS	Farm Credit System
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FHA	Federal Housing Administration
FHFB	Federal Housing Finance Board
FICO	Financing Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GSE	Government-sponsored Enterprise
HCDA	Housing and Community Development Act of 1992
HMDA	Home Mortgage Disclosure Act
HUD	U.S. Department of Housing and Urban Development
MSA	Metropolitan Statistical Area
OFHEO	Office of Federal Housing Enterprise Oversight
OTS	Office of Thrift Supervision
QTL	Qualified Thrift Lender
REFCorp	Resolution Funding Corporation
RTC	Resolution Trust Corporation
SAIF	Savings Association Insurance Fund

Introduction

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992—passed as part of the Housing and Community Development Act (HCDA) of 1992—requires that we report on 14 questions regarding the Federal Home Loan Bank System (System). This report fulfills that mandate. Congress asked for analysis and recommendations on several issues, including the System's ability to meet its fixed obligations established in the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA); setting minimum capital requirements for Federal Home Loan Banks (FHLBanks); System consolidation; expanding FHLBanks' products and services; and affordable housing.

Background

Congress created the Federal Home Loan Bank System in 1932 to lend money to thrift institutions and established the Federal Home Loan Bank Board (Bank Board) to oversee the 12 FHLBanks. The Bank Board also became the federal regulator of savings and loans and the overseer of the Federal Savings and Loan Insurance Corporation (FSLIC). All federally chartered or federally insured savings and loans were required to become members in their district's FHLBank. Membership requirements included purchasing stock in their FHLBank.

During the Great Depression, over 1,700 thrift institutions failed, and the need for liquidity in the home mortgage market was acute. As created, the System was a central credit facility, which loaned money to savings and loans secured by home mortgage loans. Making these loans—called advances—remains the primary function of FHLBanks. All advances are secured by home mortgage loans or other eligible collateral. Access to System advances enhances the liquidity of holding home mortgages and mortgage-related assets such as mortgage-backed securities. Since depository institutions face fluctuations in their deposits, the availability of advances may reduce the liquid assets they need to carry. Further, the System enhances the allocation of credit to housing nationwide by helping to overcome regional credit shortages.

The System is one of several government-sponsored enterprises (GSE). GSEs are federally chartered but privately owned entities whose activities are limited by their charters. Recently, congressional interest in the safety and soundness of GSEs has increased. Several congressionally mandated

studies of GSEs were completed in 1990 and 1991.[1] These studies led to passage of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of HCDA), which established the Office of Federal Housing Enterprise Oversight (OFHEO) as a new federal regulator for two other housing-related GSEs, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The act also directed GAO to study issues regarding the System.

System Promotes Housing Finance

While the System's charter contains no explicit statement of the System's purpose, the history of the enabling legislation and language in FIRREA identify that purpose to be to support housing finance.[2] As noted, the primary mechanism used to support housing finance is advances, which provide a direct funding source for mortgages. They also allow member institutions to obtain liquidity by using illiquid mortgage assets as collateral.

FHLBanks' sources of funds for making advances are consolidated obligations, which are issued jointly by the 12 FHLBanks, the stock purchased by member institutions, and member deposits at their FHLBanks. Consolidated obligations are debt securities issued in the capital markets. Their cost is less than the cost of similar securities issued by a typical depository institution because of the perceived well-capitalized position of the FHLBanks and the tax-exempt status of consolidated obligations at the federal, state, and local levels. Additionally, because the System is a GSE, implicit government backing for these securities may be perceived although no explicit federal guarantee exists.

Each FHLBank sets its own prices on advances, subject to regulatory requirements established by the Federal Housing Finance Board (FHFB), the System's current federal regulator. FHLBanks are required to take into account the marginal cost of raising matching maturity funds and the administrative and operating costs associated with making such advances. Beyond setting the rates charged on advances, each FHLBank also sets

[1]See Congressional Budget Office, Controlling the Risks of Government-Sponsored Enterprises, April, 1991; Department of the Treasury, Report of the Secretary of the Treasury on Government-Sponsored Enterprises, May, 1990; Department of the Treasury, Report of the Secretary of the Treasury on Government-Sponsored Enterprises, April, 1991; Government-Sponsored Enterprises: The Government's Exposure to Risks, (GAO/GGD-90-97, Aug. 15, 1990); and Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks, (GAO/GGD-91-90, May 22, 1991).

[2]12 U.S.C. §1422a(a)(3)(B) (Supp. IV 1992) charges the Federal Housing Finance Board (FHFB) with "[ensuring] that the Federal Home Loan Banks carry out their housing finance mission."

other terms when granting an advance. Again, law and regulations establish general requirements on these terms. Nonprice terms include the type and amount of collateral a FHLBank will accept in making an advance. Also, each FHLBank is required to charge prepayment penalties for early repayment of an advance. FHLBanks are required to offer advances with maturities of up to 10 years and may offer advances with longer maturities.

The FHLBanks have suffered no credit losses since their creation. This loss history reflects their conservative credit standards and the use of collateral as a credit enhancement. FHLBanks generally obtain collateral with a current market value of at least 110 percent of an advance. The collateral required may be more, depending on the financial strength of the borrower and the credit policies of the FHLBank. Eligible collateral, as defined by law, consists only of high-quality assets, such as first mortgages, U.S. Treasury or agency securities, deposits at a FHLBank, and a limited amount of other real estate collateral if it is acceptable to the FHLBank. FHFB officials said the FHLBanks determine the market value of this collateral regularly. If the market value falls below the required level, additional collateral must be provided. Beyond the collateral requirements, a security interest granted to a FHLBank by a member depository institution has priority over most other creditors in the event of the depository institution's failure.

Prepayment fees assessed on prepaid, fixed-rate advances limit the interest rate risk in making such loans. According to FHFB regulations, the prepayment fees must act to make a FHLBank financially indifferent to a borrower's decision to repay an advance. Also, the FHLBanks closely match the repricing of their assets and liabilities and use other hedging techniques to manage their interest rate risk.

Beyond advances, FHLBanks offer other products and services to their members. These include letters of credit, swap transactions, check clearing, and other correspondent services. FHLBanks also offer advice to members in such areas as interest rate risk management and lending for affordable housing.

System Is a Member-Owned Cooperative

Before FIRREA, all FSLIC-insured thrift institutions were required to be System members. Savings banks insured by the Federal Deposit Insurance Corporation (FDIC) had the option of joining the System, which most did. Membership was also open to eligible insurance companies, although

there were few such members. FIRREA opened System membership to commercial banks and credit unions, although the membership terms offered such depositories differed from those for savings associations.

By law, members must purchase stock in their FHLBanks according to a given formula. These stock purchases are the chief source of capital for FHLBanks. Members that borrow advances totaling more than a certain multiple of their outstanding stock may be required to purchase additional stock.

Each FHLBank is governed by a board that has at least 14 directors. Members elect eight member-directors to serve 2-year terms. FHFB appoints six directors to serve 4-year terms. Of these six, at least two must qualify as community interest directors.[3] A member's voting rights in selecting the elected board members for its FHLBank are based on its minimum required stock purchase. FHFB designates two Board members to be the chair and vice-chair for 1-year terms. The chair is an appointed director, and the vice-chair is an elected director.

A FHLBank's Board selects a president according to the FHLBank's bylaws. FHFB must approve each year the president's compensation package, which is proposed by the FHLBank's board.

In 1985, the Bank Board moved the field examination staff from the Bank Board to the FHLBanks, under delegated authority to the FHLBank presidents in their capacity as primary supervisory agents. Thus, from 1985 to 1989, FHLBanks were both wholesale lenders to thrifts as well as the home base for thrift supervision and examination staff. FIRREA terminated the supervisory role played by the FHLBanks, limiting them to their role as credit facilities.

FIRREA Initiated a New Era for the System

FIRREA made many changes to the System, although the core business, making advances for housing finance, remains the same. Further, FIRREA expanded membership eligibility rules. It also added two affordable housing requirements and imposed financial requirements relating to the thrift crisis.

[3]This provision, which was added by section 707 of FIRREA, Pub. L. No. 101-73, 103 Stat. 183 (1989), requires that the two directors be chosen from organizations with more than a 2-year history of representing consumer or community interests on banking services, credit needs, housing, or financial consumer protections.

System Now Focused on Role as a GSE

As a result of the savings and loan debacle, FIRREA abolished the Bank Board and replaced it with the Office of Thrift Supervision (OTS) and with FHFB. As part of that change, it removed the regulatory responsibilities housed at the FHLBanks. OTS field offices were established separate from the FHLBanks, and staff at the FHLBanks were split between OTS and the FHLBanks accordingly. Furthermore, FIRREA dissolved FSLIC and created a new deposit insurance fund—the Savings Association Insurance Fund (SAIF)—for savings associations, under the management of FDIC.

Since the Bank Board had overseen the FHLBanks, Congress vested that authority in a new regulator, FHFB. Congress charged FHFB with ensuring that the FHLBanks carry out their housing finance mission in a safe and sound manner.

These changes introduced significant cultural changes for the FHLBanks and their members. Members used to look to their FHLBanks as a credit facility and as a regulator. Now, only the former role remains. Similarly, FHLBanks, while technically overseen by the Bank Board, were an arm of the Bank Board in their regulatory role. Now, a new federal entity exists to supervise the FHLBanks.

Voluntary Membership

At the time FIRREA was passed, there were fewer than 500 voluntary members. These were mainly FDIC-insured savings banks concentrated in a few FHLBank districts, notably Boston, New York, Pittsburgh, and Seattle. Additionally, a few insurance companies were voluntary members. All other members were mandatory members. That is, membership was required because of their federal thrift charter or their FSLIC deposit insurance. FIRREA opened membership in the System to include federally insured commercial banks and credit unions that engage in mortgage lending. The basic membership requirement for these voluntary members is that they have at least 10 percent of their assets in residential mortgage loans. Table 1.1 shows the System's membership mix at the end of 1992.

Table 1.1: Types of Members in the FHLBank System as of December 31, 1992

Dollars in billions

Type of institution	Number	Percent of all members	Assets	Percent of assets of all members
Thrifts	2,294	63	$988	76
Commercial banks	1,295	36	307	24
Credit unions	26	1	4	0
Insurance companies	12	0	7	1
Total	**3,627**	**100**	**$1,306**	**100**

Source: FHFB, Report on the Structure and Role of the Federal Home Loan Bank System, April 28, 1993, p. 112.

With mandatory membership, FHLBanks were not subject to a strict market test on the return they provided shareholders. The great expansion in the pool of potential voluntary members changes the dynamics for FHLBanks. Now, FHLBanks may try to offset declining thrift membership by trying to attract new members from the expanded universe of potential voluntary members. To attract and retain such members, FHLBanks must provide sufficient value—through the products and services offered and the dividends paid—to warrant the required stock investment for membership.

FIRREA Added Two FHLBank Programs to Promote Affordable Housing

FIRREA directed each FHLBank to establish or maintain two low- and moderate-income housing programs—the Community Investment Program (CIP) and the Affordable Housing Program (AHP)—both of which are implemented by a community lending officer designated by each FHLBank.

CIP targets advances to benefit households whose income does not exceed 115 percent of an area's median income.[4] CIP advances are funded the same way as regular advances. As part of CIP, each FHLBank has established a program to make advances to finance the purchase or rehabilitation of housing for eligible households and to finance other

[4]12 U.S.C. § 1430(i)(2) (Supp. V 1993). The FHLBanks' Community Investment Program was established in 1978 at the urging of President Carter. The centralized program was terminated in 1983, but 10 of the 12 FHLBanks continued or created separate Community Investment Fund programs since then. FIRREA established the Community Investment Program as a legislative requirement.

projects benefitting residents of low- and moderate-income neighborhoods.

AHP, which began in 1990, requires each FHLBank to contribute 5 percent of its previous year's net income, or an aggregate amount for all FHLBanks of not less than $50 million, to subsidize the financing of eligible low- and moderate-income housing. The required contribution increases to the greater of 6 percent of net income or $75 million in 1994. By 1995, the FHLBanks will be required to set aside 10 percent of the previous year's income or an aggregate amount for all FHLBanks of not less than $100 million.

Under this program, low- and moderate-income is defined as families with income less than 80 percent of the area's median income. The statute sets priorities for use of these advances among eligible projects. It also provides the grounds for suspending a FHLBank's AHP obligations if such payments are contributing to financial instability.

FHLBanks Obligated to Help Pay for Thrift Crisis

Under FIRREA, the System was required to pay out most of its retained earnings to capitalize the Resolution Funding Corporation (REFCorp). Furthermore, the System must pay up to $300 million per year of annual earnings for 40 years to contribute towards interest payments on bonds issued by REFCorp. The bond proceeds have been used to pay for part of the resolution cost of failed savings and loans. Hence, this fixed obligation is known as the "REFCorp obligation."

In chapter 2, we describe these payments and their effects on the System. Combined with the AHP obligation, by 1995 at least $400 million of System earnings will be required each year to help pay for resolving the thrift crisis and to subsidize affordable housing.

Objectives, Scope, and Methodology

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 listed 14 issues for us to address in this report. These issues are:

1. The appropriate capital standards for the Federal Home Loan Bank System. (See ch. 3.)

2. The relationship between the capital standards for the Federal Home Loan Bank System and the capital standards for Fannie Mae and Freddie Mac. (See ch. 3.)

3. The relationship between the capital standards for federally insured depository institutions and the capital standards for Fannie Mae and Freddie Mac. (See ch. 3.)

4. The advantages and disadvantages of expanding credit products and services for member institutions of the Federal Home Loan Bank System, including a determination of the FHLBanks

a. purchasing housing-related assets from member institutions,
b. providing credit enhancements and other products to members in addition to making advances, and
c. making direct loans for housing construction. (See ch. 6).

5. The advantages and disadvantages of expanding eligible collateral for advances to member institutions of the Federal Home Loan Bank System by removing the limits on the amount of housing-related assets that member institutions can use to collateralize advances. (See ch. 6.)

6. The advantages and disadvantages of further measures to expand the role of the Federal Home Loan Bank System as a support mechanism for community-based lenders and to reinforce the overall role of the System in housing finance. (See ch. 6.)

7. The advantages and disadvantages of measures to increase membership in, and increase the profitability of, the System by modifying

a. restrictions on membership and stock purchases of nonqualified thrift lenders,
b. the overall advance limit imposed on the Federal Home Loan Bank System to nonqualified thrift lenders, and
c. the membership requirement for qualified thrift lenders. (See ch. 4.)

8. The competitive effect of the mortgage activities of Fannie Mae and Freddie Mac on the home mortgage activities of federally insured depository institutions and the cost of such activities to such institutions, SAIF, and the Resolution Trust Corporation (RTC). (See below.)

9. The likelihood that the Federal Home Loan Banks will be able to continue to pay the amounts required under FIRREA of 1989. (See ch. 2.)

10. The extent to which a reduction in the number of Federal Home Loan Banks would reduce noninterest costs of the System. (See ch. 4.)

11. The impact that a reduction in the number of Federal Home Loan Banks would have on the effectiveness of affordable housing programs and community support programs under the Federal Home Loan Bank System. (See ch. 5.)

12. The impact that a reduction in the number of Federal Home Loan Banks would have on the availability of affordable housing in rural areas and the ability of small rural financial institutions to provide housing financing. (See ch. 5.)

13. The current and prospective impact of the Federal Home Loan Bank System on

a. the availability and affordability of housing for low- and moderate-income households; and
b. the relative availability of housing credit across geographic areas, with particular regard to differences depending on whether properties are inside or outside central cities. (See ch. 5.)

14. The appropriateness of extending to the Federal Home Loan Bank System the public purposes and housing goals established for Fannie Mae and Freddie Mac under applicable law. (See ch. 5.)

We found that question 8 was well beyond the scope of the other questions. That question concerns the relative competitive positions of Fannie Mae, Freddie Mac, and insured depository institutions. Since the act also requires GAO to study the feasibility of privatizing Fannie Mae and Freddie Mac, we deferred question 8 to that study. We expect that the question asked here bears directly on the feasibility of privatizing these GSES.

Putting aside question 8, the objectives and scope of our work were defined by the remaining 13 questions. We believe that one additional issue needed to be considered, given this scope: the appropriateness of current federal oversight of the FHLBanks and the current structure of corporate governance. We made recommendations to Congress in 1991 regarding GSE regulation.[5] At that time, we raised several concerns about the authorities, independence and objectivity, prominence, and economy and efficiency of FHFB as the System's regulator. Therefore, we expanded the scope of the study to reconsider this issue.

[5]GAO/GGD-91-90.

To address the above questions, we reviewed relevant literature, congressional testimony, and previous GSE studies. We reviewed System financial statements and annual reports, other System financial data, System research reports and related documents, and research reports and other documents prepared by FHFB. We attended a public hearing held by FHFB on the study questions, and we attended a conference on the System sponsored by the FHLBank of San Francisco. We met with representatives of all 12 FHLBanks to describe the scope of our effort and had further discussions with representatives from most of the FHLBanks. We also met or spoke with representatives from (1) the other institutions required under HCDA to address and report on the same 14 questions and (2) those groups commenting on these reports. In addition, we visited three FHLBanks and met with FHLBank presidents and other senior staff, including those responsible for housing and community development programs, members of the advisory councils, and representatives from member institutions at each of the FHLBanks. Finally, we contracted with a consultant with experience in community development finance and secondary markets for assistance on various aspects of job design, execution, and reporting.

We did the work underlying this report between December 1992 and September 1993 in accordance with generally accepted government auditing standards. However, much of the information in our report on the operations and financial activities of the FHLBanks was derived from published financial reports or from information provided to us by the FHLBanks and FHFB and was not independently verified.

HCDA required the Congressional Budget Office (CBO), the Department of Housing and Urban Development (HUD), and FHFB to complete the same study requirements as GAO. The CBO and FHFB reports were released earlier this year.[6] HCDA further required OFHEO, the Department of the Treasury, Fannie Mae, and Freddie Mac to submit reports to the banking committees commenting on the four mandated studies to the extent that these entities have differing views and recommendations. Also, the act required the System to establish a Study Committee comprising 24 System members to report to the banking committees on the above-listed 14 questions and on the costs and benefits of consolidating the System. The Study Committee report was issued in July 1993.[7] Finally, the act required each individual

[6]See CBO, The Federal Home Loan Banks in the Housing Finance System, July 1993; and FHFB, Report on the Structure and Role of the Federal Home Loan Bank System, April 28, 1993.

[7]See Federal Home Loan Banks Stockholder Study Committee, The Future Direction of the Federal Home Loan Bank System, July 1993.

FHLBank to submit a report evaluating the costs and benefits of consolidation.

Because of these requirements, we did not seek official agency comments on this report. During the course of our work we discussed the issues with responsible officials at FHFB, the FHLBank System, OFHEO, CBO, the Department of the Treasury, HUD, Fannie Mae, and Freddie Mac, and we took their views into account in preparing our report. Between September 30, 1993, and November 8, 1993, we briefed the chairman of FHFB, the chairman of the FHLBanks Stockholder Study Committee, and the Steering Committee of the FHLBank Presidents Conference on the findings and recommendations of this report. We also briefed senior representatives involved with the mandated studies from the Department of the Treasury, the Department of Housing and Urban Development, OFHEO, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. No major objections were raised concerning our findings and recommendations.

Fixed Financial Obligations Create Uncertainties and Risks for the FHLBank System

FIRREA imposed two sizable, annual fixed obligations on FHLBanks, one for thrift resolutions (the REFCorp obligation) and one for affordable housing (AHP). We have four areas of concern with the fixed nature of these obligations. First, the annual payments have large fixed minimums, but System earnings tend to fluctuate over time. In periods of low income, such as the System has recently experienced, the System must look to new sources of revenue. By expanding their investment portfolios, particularly with mortgage-backed securities, the FHLBanks have increased the interest rate and management and operations risks they undertake. Second, part of the formula used to assess each FHLBank for the REFCorp obligation penalizes FHLBanks for making advances to savings associations—the original mission of the System. Further, the second-round (shortfall) allocation of the REFCorp obligation places a disproportionate amount of the financial burden on certain FHLBanks. This could ultimately be disruptive to the System since it could impede cooperative action among the FHLBanks. Third, since state-chartered, SAIF-insured institutions will be free to leave the System beginning in 1995, a large exodus of such members could leave a much smaller base from which to make the fixed payments. In the worst case, this could threaten the stability of the entire System. Fourth, the size and structure of the fixed obligations complicate changing other aspects of the System.

Although the System has recently increased its interest rate and management and operations risks, the FHLBanks should be able to continue meeting both the REFCorp and AHP obligations in the near term. However, the problems we identified with the fixed nature of these obligations could weaken the financial stability of the System and ultimately could threaten its ability to make future REFCorp payments. We believe that these problems are serious enough to recommend modifying the fixed nature of the REFCorp and AHP obligations, especially the shortfall allocation formula used to distribute the second-round allocation of the REFCorp obligation. We do not advocate a particular change, but we present several options that we believe are superior to the current formula. Under two options that we discuss, the System would still be required to help pay the full REFCorp obligation although the timing of those payments could change. The third option is exemplified by a recent congressional proposal to shift the shortfall to a direct assessment on SAIF-insured savings associations.

Background

Before FIRREA, the Federal Home Loan Bank Act required each FHLBank to allocate the first 20 percent of its net earnings to a legal reserve account.

Each FHLBank had to continue contributing until its account reached an amount equal to its outstanding capital stock. Thereafter, each FHLBank had to add 5 percent of its net income to the legal reserve. After making this payment, each FHLBank distributed its remaining earnings into two other reserve accounts and paid dividends to its shareholders. The other two reserve accounts were the dividend stabilization reserve and an undivided profits account. The dividend stabilization reserve supplemented dividend payments in years of low earnings.[1] This was important because of the cyclical nature of FHLBanks' earnings. At the end of 1988, the System had $2.8 billion in retained earnings (see table 2.1). Adjusted for payments made in 1987 and 1988 to the Financing Corporation (FICO)[2] to help pay for thrift resolutions, the retained earnings at the end of 1988 were $2.3 billion.

[1]An important use of the dividend stabilization reserve was as a repository for income from prepayment fees earned on advances. Such prepayment fees were allocated on a pro rata basis over the maturity of the advances prepaid, thereby allocating the income to future dividend periods.

[2]In the Competitive Equality Banking Act of 1987, Congress authorized the Bank Board to establish a special entity, FICO, to borrow up to $10.8 billion to recapitalize FSLIC. Congress required the FHLBanks to capitalize FICO with up to $3 billion from the FHLBanks' reserves.

Table 2.1: December 31, 1988 Retained Earnings and Capital

Dollars in millions

FHLBank	Legal reserve	Dividend stabilization reserve	Undivided profits	Total retained earnings[a]	FICO payments[b]	Adjusted retained earnings[c]	FHLBank stock outstanding	Adjusted retained earnings as percent of FHLBank stock
Boston	$90	$28	$3	$120	$-9	$111	$842	13.2
New York	267	24	12	303	–45	258	1478	17.4
Pittsburgh	96	32	7	135	-21	113	562	20.2
Atlanta	304	47	17	367	–72	296	1,645	18.0
Cincinnati	147	27	20	194	–41	153	588	26.0
Indianapolis	126	36	4	167	-26	140	560	25.1
Chicago	176	6	12	194	-48	146	627	23.3
Des Moines	137	37	10	183	–34	149	571	26.1
Dallas	202	64	10	276	–44	232	1501	15.5
Topeka	113	29	9	151	-26	125	790	15.8
San Francisco	466	45	35	546	–99	447	3,300	13.5
Seattle	141	31	9	181	–31	151	714	21.1
System	**$2,264**	**$406**	**$170**	**$2,840**	**$-497**	**$2,343**	**$13,177**	**17.8**

Note: Columns may not add to System totals due to rounding and to combining adjustments.

[a]Total retained earnings consist of the legal reserve, the dividend stabilization reserve, and undivided profits. Components may not add to the total because of rounding.

[b]FICO distributions for the System were $155.5 million in 1987 and $341.5 million in 1988. As of December 31, 1988, the System had contributed $497 million to FICO, paid out of retained earnings.

[c]Adjusted retained earnings were calculated as total retained earnings less FICO payments. Numbers may not add due to rounding.

Source: Federal Home Loan Bank Board 1988 Annual Report and GAO calculations.

Congress appropriated most of these retained earnings to help cover deposit insurance fund losses resulting from savings and loan failures. FIRREA required the FHLBanks to capitalize REFCorp with $2.5 billion paid from retained earnings.[3] Together, the capitalization of FICO and REFCorp absorbed about $3.2 billion of retained earnings from 1987 through 1991, leaving only $500 million in retained earnings in the System by the end of

[3]In FIRREA, Congress created REFCorp to provide $30 billion to finance thrift failure resolutions off-budget, thereby avoiding Gramm-Rudman-Hollings deficit ceilings.

1991. Retained earnings as a percent of FHLBank stock fell from 18 percent to 5 percent from 1988 through 1991.[4]

Table 2.2 compares the payments made by each FHLBank from 1988 through 1991 to capitalize REFCorp to the retained earnings in each FHLBank at the end of 1988. Four FHLBanks—Atlanta, Chicago, Dallas, and San Francisco—made payments to capitalize REFCorp that were in excess of their 1988 retained earnings. Also, five FHLBanks—Atlanta, Cincinnati, Chicago, Des Moines, and San Francisco—borrowed from the other FHLBanks to meet this obligation.[5] FIRREA required the borrowing FHLBank to set aside up to 20 percent of its net earnings before dividends each year to repay these loans. Any amounts not repaid after 2 years begin to accrue interest. This provision temporarily led to reduced earnings available for dividends at the borrowing FHLBanks while increasing the earnings available for dividends at the lending FHLBanks. By January 1993, all inter-FHLBank borrowing to recapitalize REFCorp was repaid.

[4]For a more technical discussion of these transactions, see the Federal Home Loan Banks 1990 Financial Report.

[5]In FIRREA, Congress established a maximum investment limitation for each FHLBank based, among other things, on each FHLBank's reserves as of December 31, 1988. Congress also provided that once a FHLBank reached its maximum investment limitation, its required REFCorp payment was reallocated to other FHLBanks that were not at their maximum investment limitations. Several other FHLBanks also borrowed from the remaining FHLBanks in particular quarters but maintained a net position of having lent more money for this purpose than they had borrowed. This situation arose because the REFCorp capitalization did not occur with a single payment. Rather, the payments were spread out between 1989 and 1991.

Table 2.2: Initial REFCorp Payments by Each FHLBank

Dollars in millions

FHLBank	1988 adjusted retained earnings	Gross payments to REFCorp, 1989 through 1991[a]	1988 retained earnings left after REFCorp payments	FHLBanks that were net borrowers in capitalizing REFCorp [b]
Boston	$111	$53	$58	
New York	258	228	30	
Pittsburgh	113	91	22	
Atlanta	296	387	–91	$72
Cincinnati	153	151	2	26
Indianapolis	140	102	38	
Chicago	146	171	–25	38
Des Moines	149	112	37	9
Dallas	232	251	–19	
Topeka	125	115	10	
San Francisco	447	755	–308	219
Seattle	151	97	54	

Note: The table compares each FHLBank's gross payments to capitalize REFCorp with its 1988 retained earnings. Each FHLBank had retained earnings between 1989 and 1991 that are not reflected here.

[a]Gross REFCorp payments are the actual amount of REFCorp capitalization that each FHLBank was required to pay. Some FHLBanks borrowed funds from other FHLBanks to make these payments. The last column indicates which FHLBanks were net borrowers for this purpose. All such borrowings were repaid by January 1993.

[b]Amount shown is highest quarter-end deficiency (that is, loans outstanding) for each FHLBank that was a net borrower in capitalizing REFCorp. For all five FHLBanks, the highest deficiency was reached on December 31, 1990.

Sources: GAO calculations using data from Federal Home Loan Bank Board 1988 Annual Report, Federal Home Loan Banks 1991 Financial Report, and data received from the Federal Home Loan Bank of Atlanta.

Losing most of their retained earnings has had three important effects on the FHLBanks. First, appropriation of their retained earnings left the FHLBanks with almost no permanent capital because retained earnings are the only source of permanent capital.[6] Second, retained earnings were invested and so contributed to profits. Thus, the loss of retained earnings is one of several factors that has lowered System earnings the past few years. Third, inter-FHLBank borrowing to meet the REFCorp capitalization resulted in several FHLBanks having to commit 20 percent of their net income to repay these loans.

[6]Paid-in capital may be redeemed when an institution withdraws from the System or when it fails.

Beyond capitalizing REFCorp, FIRREA also required the FHLBanks to make regular payments to support REFCorp expenses. FIRREA removed the requirement that FHLBanks put 20 percent of their annual income in a legal reserve account, effective in 1992. In its place, FIRREA required the FHLBanks to pay $300 million annually to cover some of the interest payments on REFCorp bonds. This annual payment will be required for 38 more years. Annual payments used to fund interest expense on REFCorp bonds began in 1991. In 1992, the System's $300 million payment to REFCorp constituted 11 percent of the interest paid that year to REFCorp bondholders. The taxpayers paid virtually all of the remaining 89 percent, or $2.3 billion.

FIRREA requires the $300 million to be allocated among the FHLBanks in two steps. First, each FHLBank must pay up to 20 percent of its net earnings. If this does not generate $300 million, the remainder is collected from the 12 FHLBanks on the basis of their average outstanding advances to SAIF-insured member institutions in the prior year. This second-round allocation is known as the shortfall allocation, or REFCorp shortfall. In 1992, the System paid $171 million in first-round assessments and $129 million using the shortfall allocation.

The AHP obligation differs in at least four important respects from this ongoing REFCorp obligation. First, the AHP obligation is stated as the greater of a fixed minimum amount or a percentage of income. Second, the requirement was phased in, starting at the greater of $50 million or 5 percent of the preceding year's net income, increasing in 1994 to the greater of $75 million or 6 percent of the preceding year's net income, and increasing to the greater of $100 million or 10 percent of the preceding year's net income in 1995 and thereafter. Third, the AHP obligation is smaller than the REFCorp obligation. Fourth, members may compete for AHP funds provided by their FHLBanks to use in affordable housing ventures. Further, these ventures usually help the members satisfy their Community Reinvestment Act (CRA) requirements.[7] On the other hand, the AHP obligation is essentially a fixed cost imposed on the System, and in this way it is like the REFCorp obligation.

[7]In the Community Reinvestment Act, Congress encouraged banks to be attentive to serving the credit needs of their local communities, particularly those with low- or moderate-income households. A bank's performance under the act is assessed as part of the bank's regulatory examinations. It is also considered by regulators in evaluating applications for things such as bank mergers.

The Fixed Obligations Are Among Several Competing Objectives Given to the FHLBank System

The System's primary objective is to support housing finance by providing funds to institutions engaged in home mortgage lending.[8] We believe that the Federal Home Loan Bank Act makes clear that Congress intended this objective to be carried out with a high degree of safety and soundness. FIRREA added two more objectives for the System: to provide financial support for resolution of the savings and loan crisis and to support affordable housing. These new objectives carry specific requirements, as noted earlier in this chapter. These requirements include that the System make minimum fixed payments towards the resolution of the thrift crisis (the REFCorp obligation) and towards subsidizing affordable housing (the AHP obligation).[9] FIRREA also required that each FHLBank establish a program targeted at community-oriented mortgage lending (CIP).[10]

In the next section we show that the fixed obligations conflict, to some extent, with the System's primary objective. While the System currently appears to be satisfying its primary objective, at some point this conflict could result in the System failing to adequately meet its primary objective in a safe and sound manner, or having difficulty in making payment on its fixed obligations.

Since there is no clear congressional direction for how to balance paying the fixed obligations with serving the System's primary objective, we assume the System must continually satisfy both the payment of the fixed obligations and adequately serve housing finance lenders in a safe and sound manner.[11] In that case, as we will show next, we conclude that the fixed nature of the REFCorp and AHP obligations is the primary reason why the System may, at some point, be unable to pay the fixed obligations while also meeting its primary objective in a safe and sound manner.

Concerns With the Annual REFCorp Payment

Virtually everyone we spoke with stated some concern about the annual REFCorp payment. From these discussions, from our review of the statutory requirement, and from our analysis of the FHLBanks, we identified four concerns. First, the fixed-dollar value of the obligation does not recognize

[8]Section 2A(a) of the Federal Home Loan Bank Act provides that "the primary duty of [FHFB] shall be to ensure that the Federal Home Loan Banks operate in a financially safe and sound manner." This section further provides that to the extent consistent with its primary duty, one of FHFB's secondary duties is "to ensure that the Federal Home Loan Banks carry out their housing finance mission."

[9]12 U.S.C. §1441b(f)(c) and §1430(j) (Supp. IV 1992).

[10]12 U.S.C. §1430(i) (Supp. IV 1992).

[11]FHFB is authorized to suspend a FHLBank's AHP obligation if the payment would contribute to the "financial instability" of the FHLBank. 12 U.S.C. §1430(j)(6) (Supp. IV 1992).

the cyclical nature of FHLBank earnings. Thus, when advance demand is weak, in order to satisfy their annual REFCorp obligation FHLBanks must focus their energies on activities that are not directly related to their missions and that may add to the risks they normally undertake. As a result, paying the REFCorp obligation could interfere with maintaining the System's safety and soundness.

Second, the shortfall allocation formula penalizes lending to savings associations and places a disproportionate burden on some FHLBanks. Thus, the REFCorp obligation may conflict with the objective of supporting housing finance by making lending to savings associations smaller than it might otherwise be. In addition, it may conflict with safety and soundness because certain FHLBanks bear the brunt of the REFCorp burden.

Third, state-chartered savings associations will become voluntary System members in 1995. If such institutions choose to leave the System, this shrinkage will force the fixed obligations to be absorbed by fewer institutions, while at the same time withdrawals would lower System earnings. Such an outcome could be destabilizing, putting the System's safety and soundness at risk.

Fourth, without modifying at least the REFCorp shortfall allocation, it will be difficult to make other changes to the System, such as changing the capital structure or allowing System consolidation. Thus, the REFCorp obligation may also inhibit making other System changes. Such changes could improve the System's safety and soundness by achieving cost-saving efficiencies and by making FHLBanks currently bearing relatively larger REFCorp burdens more attractive merger partners.

The Fixed Obligations Are More Burdensome in Periods of Low Advance Demand

The $300 million annual REFCorp payment and AHP are fixed obligations that are allocated primarily on the basis of each FHLBank's annual income. However, a FHLBank's income stream can vary greatly, on the basis of such things as advance demand and interest rates. Thus, the portion of annual income needed to make these annual payments can vary widely over time. System income has fallen considerably since FIRREA was enacted because of declining advance demand and interest rates and because of the loss of income from retained earnings taken to capitalize REFCorp. In order to meet their operating expenses,[12] plus the fixed $350 million REFCorp and AHP obligations, the FHLBanks have greatly enlarged their portfolios of investment securities. By issuing consolidated

[12]System operating expenses in 1992 were $207 million.

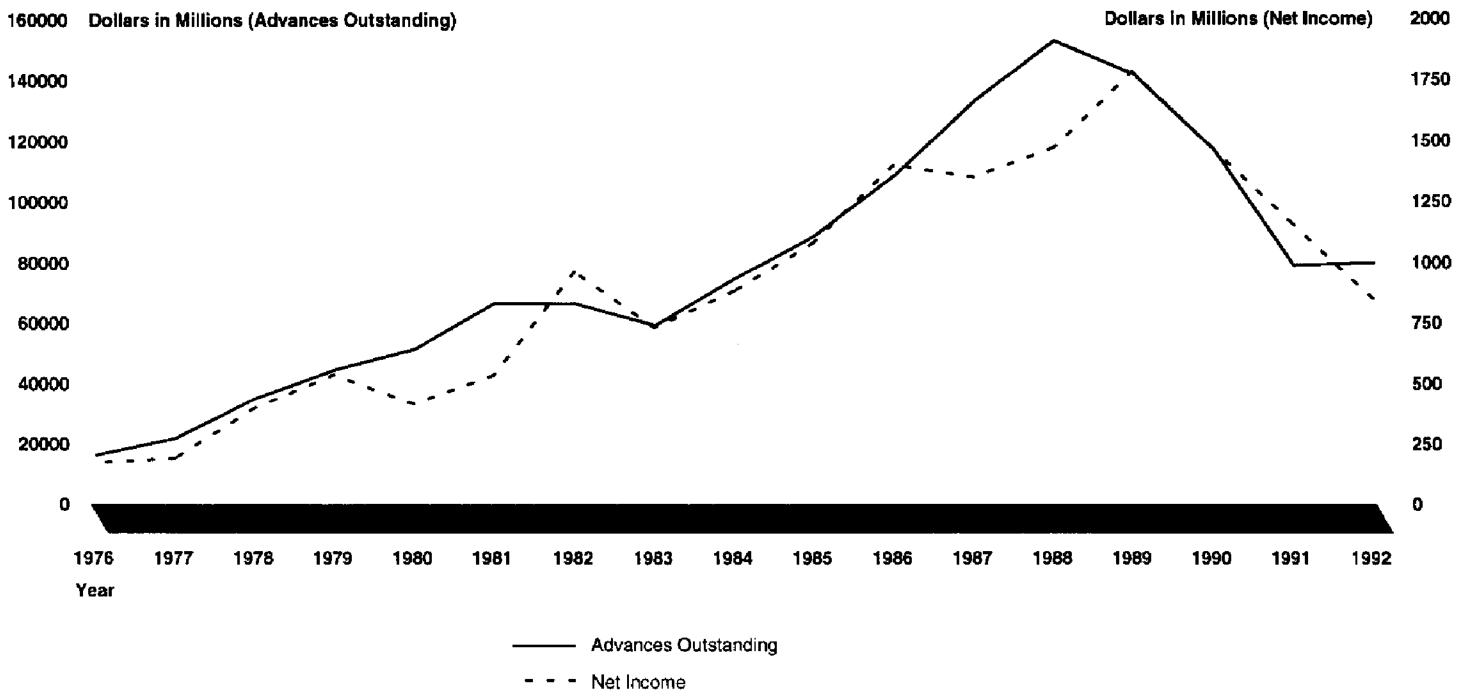
obligations and investing the proceeds in mortgage-backed derivative securities, the FHLBanks are using the interest rate spread to generate income to help meet the REFCorp obligation and pay dividends to members. This action has increased both the interest rate risk and management risk in the System, thereby raising the possibility that meeting the fixed obligations could conflict with the System's safety and soundness.

Advance Demand Is Cyclical

When FIRREA passed in August 1989, the System was experiencing its highest earnings ever. At the end of 1988, the System had $153 billion in outstanding advances, $17 billion in investments, and $1.5 billion in net earnings. In 1989, it earned $1.8 billion. By the end of 1992, however, outstanding advances had dropped to $80 billion, investments had risen to $79 billion, and earnings had declined to $0.85 billion. Thus, while $300 million was 20 percent of the System's 1988 income, it was 35 percent of its 1992 income. Although the most recent decline in advances resulted partly from important structural changes in the System, the decline also reflects the cyclical nature of advance demand.

Figure 2.1 shows the growth and decline in advances and earnings over the period 1976 through 1992. This figure shows the dramatic drop in advances since 1988 and the corresponding fall in system income.

Figure 2.1: FHLBank System Net Income and Advances Outstanding –1976 to 1992



Note: Read advances outstanding on the left axis, net income on the right axis.

Sources: Various issues of FHLBB Journal, FHLBB Annual Report, and financial statements of the FHLBank System.

Whether the System can continue to meet its REFCorp obligation partly depends on whether advance demand increases, remains stagnant, or continues to decline. Is the shrinkage in advances experienced since 1989 about to be reversed, or will it continue? The answer depends on a number of factors, including overall economic activity, the state of the housing market, interest rates, the substitutes for advances, the number of new members, and the value of the System to its members. Most System officials we spoke with expect the demand for advances to grow modestly if the economy continues to pick up strength. Still, there have been five periods since 1960 in which outstanding advances for the System have declined: 1967, 1971, 1975-1976, 1983, and 1989-1991. Except for the first and last periods, each of these periods of declining advances occurred

during an economic recovery. Thus, even though advance demand has increased in recent months, this may not continue.

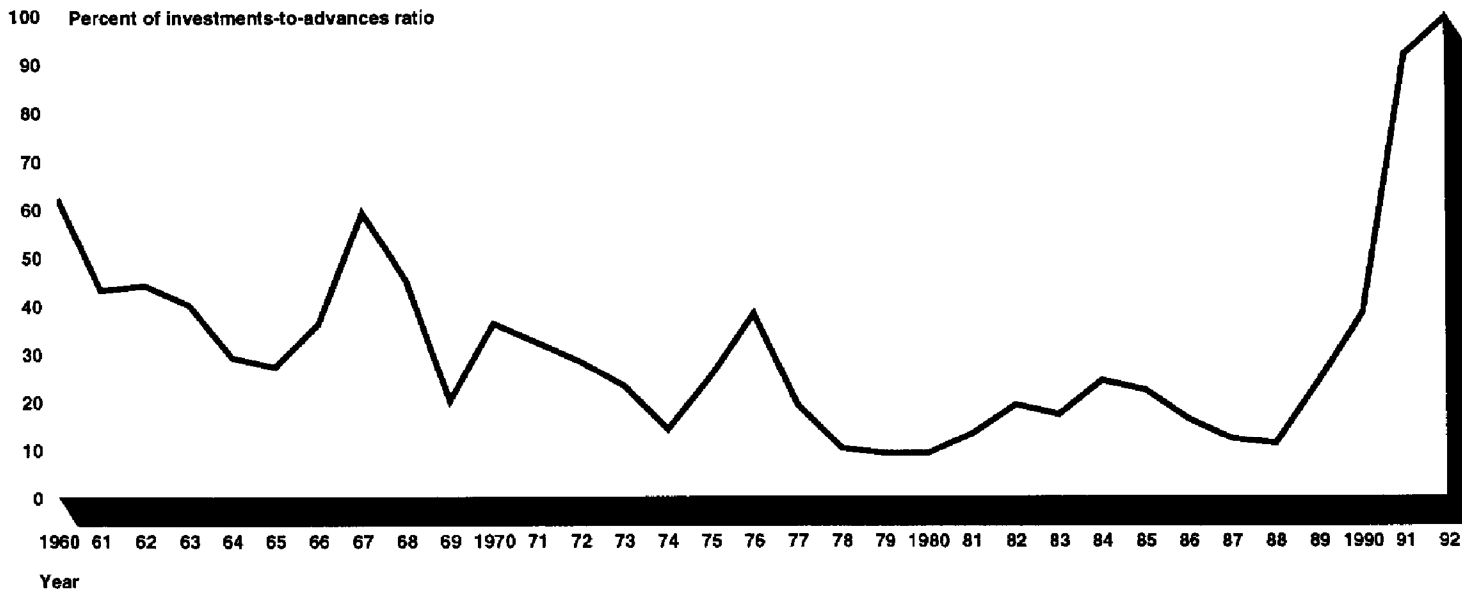
Investment Portfolio Needed to Maintain Liquidity and Earnings

Traditionally, FHLBanks have maintained a portfolio of investment securities for three reasons: to earn interest income on proceeds from prepaid advances, to invest members' overnight deposits, and to have ready liquidity for the normal business needs of the FHLBank. When advance demand is low, FHLBanks have also held investments to maintain a revenue stream so that they may continue to cover their noninterest expenses. That is, the FHLBanks need revenue to meet their operating expenses and fixed costs and to pay dividends. They used the dividend stabilization reserve, described earlier, to retain earnings in high-income periods in order to maintain dividend payments in periods of low income. The REFCorp and AHP obligations imposed by FIRREA added to the need for revenue.

At the present time, facing a fixed payment of $350 million (REFCorp and AHP) while experiencing a downward turn in advance demand and having lost most of their retained earnings to capitalize REFCorp, the FHLBanks have increased their investment portfolios to generate the needed income. Figure 2.2 shows the relationship between FHLBanks' investments and advances since 1960. For the years 1960 through 1988, the average year-end ratio of investments-to-advances was 27 percent. From 1977 through 1988, the average ratio was 15 percent. After 1988, however, investments as a percentage of advances increased dramatically. At the end of 1992, they were roughly equal to advances outstanding, an unprecedented level, at least since 1960,[13] and investments exceeded advances in 8 of the 12 FHLBanks (see table 2.3). Only two FHLBanks, Indianapolis and San Francisco, had investments-to-advances ratios below 60 percent (48 and 55 percent, respectively). At the same time, the Chicago FHLBank had an investment portfolio equal to 231 percent of its advance portfolio.

[13]We chose 1960 because it was the earliest year available in the series of annual figures on advances and investments given to us by FHFB.

Figure 2.2: Investments-To-Advances Ratio for Fhlbank System, 1960 - 1992



Source: GAO calculations based on data provided by FHFB and data taken from various issues of FHLBB Journal, FHLBB Annual Report, and financial statements of the FHLBank System.

Table 2.3: Mix of Advances and Investments Held by FHLBanks as of December 31, 1992

Dollars in millions

FHLBank	Advances	Investments[a]	Investments-to-advances (percent)
Boston	$5,038	$6,550	130
New York	8,780	10,246	117
Pittsburgh	3,547	6,283	177
Atlanta	9,301	9,035	97
Cincinnati	2,415	5,138	213
Indianapolis	5,657	2,720	48
Chicago	2,873	6,636	231
Des Moines	3,314	3,735	113
Dallas	7,322	6,057	83
Topeka	3,502	3,951	113
San Francisco	23,110	12,642	55
Seattle	5,025	6,172	123
System	**$79,884**	**$79,133**	**99**

Note: Total System assets were $162 billion at the end of 1992.

[a]Includes a System-wide total of $2.8 billion of securities held for sale.

Source: Federal Home Loan Banks: Combined Financial Statements and Combining Information, December 31, 1992, 1991 and 1990.

The FHLBanks' investment portfolios include mortgage-backed securities, overnight federal funds, term federal funds, reverse repurchase agreements, commercial paper, and other securities. These securities pay interest rates greater than the FHLBanks' cost of funds, thereby allowing the FHLBanks to earn a positive interest spread on their securities holdings. The recent growth in investments as a share of advances differs from that in previous periods of declining advance demand. First, investments as a percentage of advances are considerably higher than at any point at least since 1960. Second, the investment portfolios for the first time have a considerable amount of mortgage-backed securities.

FHFB tacitly endorses this strategy of expanding investments for meeting the System's REFCorp obligation. In its HCDA-mandated report, FHFB said that investments "[have] been and will continue to be essential for the System to generate sufficient income to meet the $300 million obligation."[14]

[14]Report on the Structure and Role of the Federal Home Loan Bank System, p. 172.

We recognize that the fixed nature of the REFCorp and AHP obligations requires the FHLBanks to come up with sufficient revenues each year from some source in order not to deplete capital. FHLBanks principally hold two types of assets: advances and investment securities. Since demand for advances has been relatively low, some FHLBanks have expanded their investment portfolios in order to generate income for meeting their fixed obligations, pay other fixed costs, and pay a dividend to shareholders.

Still, allowing FHLBanks to increase their investment portfolios raises two concerns. First, running a large securities portfolio may conflict with the System's objective of providing liquidity to mortgage lenders if it distracts the System and FHFB from focussing on that objective. For example, FHLBanks may be reluctant to reduce their investment portfolios—thereby for going the added income generated by having a large securities portfolio—and return to their traditional mission when advance demand returns.

Second, large investment portfolios may conflict with safety and soundness by adding interest rate and management and operations risk to a System that traditionally has operated relatively risk-free. Managing a large securities portfolio, particularly the investments in mortgage-backed securities, alters the risk management challenges facing FHLBank managers. Managing a large portfolio of mortgage-backed securities is a complex task because the value of different types of mortgage-backed securities may change in different ways as interest rates, housing markets, and consumer behavior change.[15] Hedging strategies can mitigate, but not eliminate, interest rate risk. Perhaps more importantly, the management and operations risk involved can be considerable.

It is beyond the scope of our assignment to independently quantify the interest rate and management and operations risks undertaken by each of the FHLBanks. Yet, we believe that the risks just described are a potential impediment to the System paying its fixed obligations while also operating in a safe and sound manner.

[15]For purposes of generating income, mortgage-backed securities may be more attractive to FHLBanks than most other kinds of high-investment grade securities because the spread over FHLBanks' cost-of-funds is typically much larger for mortgage-backed securities than for other securities. This larger spread is due largely to the added interest rate risk associated with mortgages.

In its HCDA-mandated report, FHFB projected that at December 31, 1992, a 200 basis point[16] increase in interest rates could cause losses in the market value of equity in 9 FHLBanks about equal to all the retained earnings in the System. Likewise, a 200 basis point decline in interest rates could produce losses in the market value of equity in three FHLBanks equal to about 85 percent of all the retained earnings in the System. In each case there would be increases in the market value of equity of those FHLBanks that benefit from the particular rate change.

The important point is that in some FHLBanks, a 200 basis point change in interest rates could produce market value losses that would eliminate the FHLBank's retained earnings and potentially reduce the value of the FHLBank's capital outstanding. Losses in a FHLBank that exceed its retained earnings could result in a decrease in value of that FHLBanks' members' capital stock.[17] As described in the next chapter, this could result in members wanting to withdraw from the System since members do not generally look at their FHLBank capital stock as a true equity investment. Furthermore, a 200 basis point shock is small relative to the 600 basis point shock test required by HCDA when OFHEO sets regulatory capital requirements for Fannie Mae and Freddie Mac. Generally, the greater the interest rate shock, the greater the need for retained earnings.[18]

An additional concern is that large-scale investments in mortgage-backed securities are a new phenomenon for FHLBanks. Such investments grew from $5 billion at the end of 1990 to $22 billion at the end of 1992.[19] This is a rapid growth into an area that requires careful interest rate risk management as well as considerable management and operational expertise. This means that FHLBanks need to have appropriate strategic

[16]A basis point is one-hundredth of a percent.

[17]According to a FHFB official, a simulated rate shock that projected a decline in the market value of a FHLBank's equity in excess of the FHLBank's retained earnings would not necessarily require a write-down of the FHLBank's capital stock. Several reasons for this were cited. First, interest rates would probably not change by 200 basis points instantaneously, thereby giving the FHLBank time to adjust its balance sheet. Second, because accounting is done using generally accepted accounting principles (GAAP), rather than using market value accounting, such losses would not be immediately reflected on the balance sheet. Third, even if losses did exceed retained earnings, a FHLBank may not be required to write down the value of its capital stock if it could demonstrate expected near-term earnings that would restore the capital stock's value to par.

[18]Also, simple interest rate shocks may be inadequate to measure interest rate risk exposure. See Hugh Cohen, "Beyond Duration: Measuring Interest Rate Exposure," Federal Reserve Bank of Atlanta Economic Review (Mar./Apr. 1993).

[19]At the end of 1992, the $22 billion in mortgage-backed securities accounted for about 29 percent of the System's $76 billion in investment securities not held for sale.

and operational plans, as well as adequate accounting and management information systems. In other financial institutions, we have seen rapid growth into new areas result in large, unexpected losses, in part because they were ill-equipped to handle the new risks being undertaken.

Also, as noted earlier, should advance demand continue to be insufficient to generate the earnings needed to pay REFCorp, FHLBanks may have little choice but to continue adding to their investment portfolios. Consequently, FHFB may raise or remove the current limits placed on mortgage-backed securities investments through FHFB's Financial Management Policy.[20] FHFB expanded FHLBank investment limits in mortgage-backed securities from 50 percent of an FHLBank's capital to 200 percent of capital in July 1991.

In conclusion, we found that the System responded to the combination of the fixed obligations and declining advance demand by dramatically increasing its investment portfolio. Without some change to the fixed obligations, the System may continue to rely on nontraditional revenue sources to pay these obligations. This response has increased the interest rate and management and operations risk in the System. If the pressure to generate revenue to pay the fixed obligations continues to grow, the objective of serving housing finance in a safe and sound manner could conflict with paying the fixed obligations.

The Shortfall Allocation Penalizes Lending and Could Disrupt the System

As noted earlier, the $300 million REFCorp obligation is allocated among the 12 FHLBanks in 2 rounds. In the first round, each FHLBank pays up to 20 percent of its income. The second-round (shortfall) allocation of the REFCorp obligation, if required, is based on each FHLBank's outstanding advances to SAIF-insured members.

We believe there are two problems with the shortfall allocation formula. First, if System earnings do not reach $1.5 billion for the year, then each dollar of advances to a SAIF-insured member increases the shortfall amount that a FHLBank must pay.[21] This means that a FHLBank can reduce its share of the $300 million REFCorp payment by not making advances to SAIF-insured members. Thus, the shortfall allocation formula penalizes FHLBanks for doing just what they were originally chartered to do: lend

[20] Report on the Structure and Role of the Federal Home Loan Bank System, pp. 139-143.

[21] In economic terms, it increases the cost of making an advance to a SAIF-insured member, thereby lowering the net return on such advances.

money to savings associations.[22] As a practical matter, it is unclear how this penalty affects FHLBanks' lending policies, including the price charged for advances.

It should be noted that since over 1,500 voluntary members have joined the System since 1989, they have implicitly accepted at least part of the REFCorp obligation as a cost of membership. That is, voluntary members already share in both the first-round allocation and the added costs generated by the current shortfall allocation formula through reduced earnings available for dividends.

Second, the shortfall allocation formula puts a greater financial burden on certain FHLBanks. This is because some FHLBank districts have more SAIF-insured members than others and because some SAIF-insured members borrow more than average.

Table 2.4: Comparison of FHLBanks' Size and Income With the 1992 Shortfall Allocation of the REFCorp Obligation

FHLBank	Percent of System assets	Percent of System capital	Percent of System income	Percent of SAIF assets	Percent of REFCorp shortfall
Boston	7.2	8.0	6.2	1.9	1.7
New York	12.3	11.2	16.6	9.6	9.6
Pittsburgh	6.2	5.4	6.8	3.5	2.9
Atlanta	11.5	12.7	14.6	13.4	12.4
Cincinnati	4.8	5.3	4.8	6.6	3.0
Indianapolis	5.2	5.2	7.0	5.3	7.0
Chicago	6.0	5.4	6.0	7.4	2.5
Des Moines	4.4	4.9	5.5	3.8	3.0
Dallas	8.5	6.3	3.0	7.0	9.1
Topeka	4.7	4.5	3.9	3.7	5.4
San Francisco	22.5	23.3	15.4	33.8	36.9
Seattle	7.0	7.4	10.9	4.0	6.6

Note: All figures are as of December 31, 1992, except for distribution of SAIF-insured assets, which are as of September 30, 1992.

Source: GAO calculations based on Federal Home Loan Banks: Combined Financial Statements and Combining Information, December 31, 1992, 1991 and 1990, and data provided by FHFB.

[22]There is no corresponding disincentive to lending to non-SAIF-insured members. There is, however, an overall System limit that restricts advances to members that do not meet the qualified thrift lender (QTL) test. Advances to such members may not exceed 30 percent of outstanding advances in the System.

Table 2.4 shows that the distribution of the shortfall allocation is widely different across the 12 FHLBanks. Further, it shows that this distribution differs significantly from what the distribution would look like if the shortfall had been based on FHLBanks' asset size, capital, or income. Using a measure of size or income would provide a more equal distribution of the REFCorp burden across the FHLBanks and would more closely approximate a tax based on ability to pay. For example, the San Francisco FHLBank paid 37 percent of the REFCorp shortfall in 1992. Although it is by far the largest FHLBank, this percentage still is quite large relative to the percentage of System assets, capital, and income in the San Francisco FHLBank. While the shortfall allocation percentages come closer to aligning with the percentage of assets in SAIF-insured institutions held by the members in each district, there are also clear differences here as well. For instance, SAIF-insured savings associations in the San Francisco district pay a relatively greater portion of the shortfall than do such associations in the Chicago and Cincinnati districts. Moreover, the fact that the current formula allocates the shortfall unevenly across the 12 FHLBanks means that voluntary membership is also likely to be unevenly distributed, because the cost of voluntary membership varies across the 12 FHLBanks.

These data suggest the potential for a conflict between the fixed obligations and supporting housing finance by providing liquidity to mortgage lenders in a safe and sound manner. Both FHLBank officials and System members acknowledge that the disproportionate REFCorp burden has made it difficult for them to reach agreement on other issues of mutual concern. We believe that a lack of comity across the FHLBanks and their shareholders impedes the cooperative action and understanding needed in a System where debt obligations are a jointly shared liability. This disproportionate burdening of individual FHLBank districts could create internal frictions within the System and, in our view, does not contribute to a stable situation over the long run.

Thus, we conclude that the shortfall allocation ensures that the REFCorp obligation is paid, but in doing so, it may impede the System's ability to support housing finance in a safe and sound manner.

Pending Voluntary Membership for Some SAIF-Insured Members May Conflict With REFCorp Obligation

Before FIRREA, all FSLIC-insured savings associations were required to become System members as a condition of obtaining FSLIC deposit insurance. In addition, federally chartered savings associations were required by their federal charter to be System members.

Currently, an OTS regulation requires that each savings association obtain membership in a FHLBank and subsequently maintain such membership.[23] However, this regulation further provides that state-chartered savings associations may freely exit the System beginning in April 1995. At that time, only federally chartered savings associations will still be required to maintain System membership.

The impact of this OTS regulation is potentially far-reaching. Granting voluntary membership to state-chartered savings associations effectively gives federally chartered savings associations a way out of the System too. By converting from federal to state charters, these institutions could also become voluntary members. For example, according to OTS, 33 such federal-charter to state-charter conversions took place from June 1, 1992, to June 1, 1993. Additionally, three federally chartered savings associations converted to national bank charters. Table 2.5 shows the mix of state-chartered and federally chartered, SAIF-insured institutions as of September 10, 1993.

[23] 12 C.F.R. §563.49 (1992).

Table 2.5: Number of OTS-Regulated Federal and State-Chartered SAIF-Insured Institutions by Fhlbank District

As of September 10, 1993

FHLBank	Number of federally chartered	Number of state-chartered	Total	Percent state-chartered
Boston	52	19	**71**	27
New York	87	69	**156**	44
Pittsburgh	77	37	**114**	32
Atlanta	337	34	**371**	9
Cincinnati	163	96	**259**	37
Indianapolis	107	13	**120**	11
Chicago	119	52	**171**	30
Des Moines	89	39	**128**	30
Dallas	93	58	**151**	38
Topeka	62	17	**79**	22
San Francisco	95	19	**114**	17
Seattle	43	11	**54**	20
System	**1,324**	**464**	**1,788**	**26**

Source: OTS.

OTS, like FHFB, and nearly everyone else with whom we spoke, advocates fully voluntary membership in the System. In chapter 4, we describe that issue on its own merits, and we explain why we also support the idea. However, piecemeal implementation of voluntary membership without Congress addressing the fixed obligations may be destabilizing to the System.

If many state-chartered institutions withdraw from the System, this could hurt the System's ability to pay the fixed obligations in three ways. First, reduced advance demand would give the FHLBanks fewer earning assets from which to generate the revenue stream needed to pay the fixed obligations. Second, the reduced FHLBank stock outstanding would also reduce earning assets. Third, membership withdrawals, absent offsetting additions from other potential members, would leave fewer institutions to absorb the cost of the fixed obligations. As these costs are spread among fewer institutions, System membership could become less attractive to other voluntary members who may also opt to depart. In the extreme, this could create a spiralling effect in which only mandatory members are left to absorb the fixed obligations.

On the other hand, voluntary System membership may provide numerous benefits, as described in chapter 4. Among other things, it would focus the FHLBanks on ensuring that they provide sufficient value to their members for those members to remain with the System. This market-based focus should improve the System's efficiency and its responsiveness to changing market conditions.

Currently, it is impossible to predict how many, if any, SAIF-insured institutions will want to leave the System when the opportunity becomes available. Certainly, if the fixed obligations were to make continued membership unattractive, or if voluntary members were to find they do not receive sufficient value for their membership, they would leave. If that happened, the fixed nature of the REFCorp and AHP obligations could become destabilizing. On the other hand, if these obligations could grow and shrink with some measure of the FHLBanks' ability to pay, membership departures would have less impact on the System's stability or safety and soundness.

The Fixed REFCorp Obligation Distorts Consideration of Other Changes to the FHLBank System

In the remaining chapters in this report, we examine several questions concerning updating or otherwise changing the current structure and/or scope of the FHLBank System. However, the REFCorp obligation limits the possible options because the System must continue to fund the fixed REFCorp obligation. While we will explain these issues in detail later, it is important to list here several of the major interactions between the REFCorp obligation and these other issues.

- Establishing appropriate capital requirements for FHLBanks requires accounting not only for the size and risks of each FHLBank, but also preserving sufficient capital to ensure the ongoing REFCorp payments.
- Having two membership classes—voluntary and mandatory—gives some members the ability to withdraw their capital if the REFCorp obligation or losses from risk-taking begin to erode capital. However, mandatory members must stay and see their capital erode even faster.
- Since the shortfall allocation burdens some FHLBanks more than others, questions of consolidating the System are complicated by how the REFCorp burden would be shifted.
- Introducing new products and services (consistent with the System's mission) might provide alternative revenue sources from which to pay the fixed obligations. Yet, if they added risk to the FHLBanks' operations there may not be sufficient capital to support the risk, and the added risk-taking could compound the risk-management challenges recently introduced.

In summary, the REFCorp obligation is a major factor inhibiting other possible changes to the FHLBank System.

Options for Funding the REFCorp Obligation

The problems that we have described arise from the fixed nature of the REFCorp and AHP obligations. We are mindful of Congress' desire to see the FHLBank System contribute to the cost of the thrift crisis. We believe that this overall requirement can still be met in a variety of ways while eliminating the aspects of the current obligations that conflict most directly with other congressional objectives for the System. If the REFCorp and AHP payments were allowed to shrink and grow with the System's ability to pay, the conflicts we identified between the fixed obligations and the System meeting its primary objective in a safe and sound manner could be substantially reduced. This could enable the System to generally satisfy all of the objectives set for it by Congress whether the demand for advances is rising or falling.

Therefore, we offer several approaches for funding the REFCorp obligation that step away from the problems posed by the existing shortfall allocation. With respect to AHP, like the fixed nature of the REFCorp obligation, requiring fixed contributions to AHP without regard to System earnings potentially puts AHP in conflict with the System's primary objective of serving housing finance lenders in a safe and sound manner.

Three Options for Modifying the Shortfall Formula

We identified three general options for modifying the current REFCorp obligation. Two of these retain the entire responsibility for the REFCorp obligation within the System but in a manner that conflicts less with the other objectives established for the System. The third option would shift some amount of the obligation outside of the System whenever System income was less than $1.5 billion—that is, whenever the shortfall allocation would be used.

First, the entire $300 million annual obligation could be kept within the System but distributed among the 12 FHLBanks on a more proportionate basis. That is, after each FHLBank paid 20 percent of its income in a given year, any shortfall would be collected on the basis of some measure of ability to pay. This could be earnings or it could be asset size or FHLBank stock. The incentives resulting from this approach would vary somewhat depending on the basis used to collect the shortfall.

This approach would remove the connection between advances to SAIF-insured institutions and the REFCorp obligation and would put all the FHLBanks on relatively equal financial footing. Thus, the REFCorp obligation would become essentially a cost of membership in the System. The major advantage to this approach is it would result in a more equitable distribution of REFCorp's financial burden across the 12 FHLBanks. This would somewhat improve safety and soundness and would make it easier for other changes to be introduced, such as System consolidation.

The biggest drawback to this approach is that it still imposes a large fixed obligation on a System that typically experiences a variable income stream from its traditional business. Thus, some or all FHLBanks could still have to retain large portfolios of investments to earn enough income to satisfy their REFCorp obligation. Also, FHLBanks that currently bear a less-than-proportionate share of the REFCorp burden would naturally be expected to oppose this approach because it would increase their costs while benefitting those FHLBanks that currently pay a more-than-proportionate share of the REFCorp shortfall.

The second general option could be to keep the long-term obligation to pay REFCorp within the System but allow the annual payments to fluctuate on the basis of the System's ability to pay. For example, the FHLBanks could pay 20 percent of their income each year—as currently required—until the present value of the payments equals the current present value of the obligation (which is roughly $4.2 billion, using a 6.5 percent 30-year Treasury bond rate as the discount rate). Thus, in some years the System could pay more than $300 million, in other years less. In each year, however, the payment would better reflect the FHLBanks' current financial condition than does the current formula. As a concession for the immediate relief this would grant it, the System could be required to pay 20 percent of income each year until the present value amount was repaid or the remaining 38 years of obligation had passed, whichever occurred last.[24] Finally, Congress could monitor the payments made, and could adjust the percentage rate charged, or the assessment base used, as circumstances warranted.

This approach would also remove the connection between advances to SAIF-insured members and the REFCorp obligation. This approach, like the

[24]This is one of several steps that could ensure that the System did not work to reduce reported income in order to reduce its REFCorp payments. In any event, such concerns, which have been raised by some, are unlikely to be important. This is because members that borrow infrequently will demand that they receive some benefit through dividends paid on reported income. If adequate dividends are not paid, such members will withdraw from the System.

first, makes the distribution of the burden proportionate across the 12 FHLBanks. Moreover, the biggest advantage of this approach is that the REFCorp obligation should no longer produce significant conflicts with the System operating in a safe and sound manner. It would allow the System to reduce or eliminate the buildup of its investment portfolio and to eliminate investments that add materially to the interest rate and management and operations risk in the System.

One drawback to this approach is its short-term budget impact. Specifically, while the long-term economic impact on the federal budget would be unchanged, this approach could violate the current pay-as-you-go rules in that it would alter the timing of receipts from the current formula.[25] The Budget Enforcement Act of 1990 established two mechanisms to enforce the act's deficit reduction plan. One of these, the pay-as-you-go requirement, requires that legislative increases in mandatory spending authorized in substantive law or cuts in taxes be offset by reductions in other mandatory programs or by revenue increases. A Department of the Treasury official testified last year that the Office of Management and Budget had tentatively advised that certain alterations to the fixed REFCorp payment could have pay-as-you-go consequences.

A third option is exemplified by the Federal Home Loan Bank Modernization Act of 1993 (H.R. 1085, 103d Cong. 1st Sess. (1993)), also known as the Baker-Neal bill, after its chief sponsors). Under this proposal, the shortfall would be assessed directly on SAIF-insured members through an added deposit insurance assessment. This has three distinct advantages over the current formula if the intent is to have SAIF-insured institutions pay. First, it distributes the burden among all SAIF-insured institutions more evenly. Second, since state-chartered, SAIF-insured members will soon be allowed to leave the System, a direct assessment on them weakens the linkage between System membership and this obligation. Third, it would remove the disproportionate burden among the FHLBanks.

This approach could also introduce new problems. Since capitalizing SAIF is also an issue that involves assessments on SAIF-insured institutions, there would be a need to coordinate these various taxes imposed on such institutions, both in terms of their ability to pay and in terms of the

[25]This second approach could potentially result in FHLBanks paying more than would be the case if the REFCorp obligation was left unchanged. If the System was required to make payments on the basis of a fixed percentage of income until the present value of the REFCorp obligation was paid or 38 years had passed, whichever occurred last, then the net effect could be to increase the REFCorp payment made by FHLBanks (in present-value terms) above what would be paid if no changes were made.

economic impact of such taxes. SAIF-insured institutions already have about $800 million of their SAIF premiums redirected each year to pay interest on FICO bonds. Placing an additional burden on SAIF-insured thrifts that survived the thrift crisis would reduce the profitability of the very institutions that maintained their financial integrity—while the rest of the industry failed—during the 1980s. At some point, it becomes counter-productive to keep adding costs resulting directly or indirectly from the thrift crisis on the surviving institutions. Also, in 1994 the FIRREA-imposed moratorium on institutions switching from SAIF insurance to Bank Insurance Fund (BIF) insurance is scheduled to expire. If there is a significant movement from SAIF to BIF (motivated perhaps by SAIF premium assessments greatly exceeding BIF assessments), there would be a shrinking base of institutions to assess for FICO and REFCorp and to capitalize SAIF.

Another approach under this option would be to maintain the current first-round REFCorp payment of 20 percent of each FHLBank's income but collect any shortfall from some other source outside of the System. However, simply dropping the shortfall allocation would put the responsibility for the shortfall directly on taxpayers.

Conclusions

We were asked about the System's current and prospective ability to pay the fixed obligations introduced in FIRREA. Large fixed obligations assessed on a System with variable income and an uncertain membership base make the System itself unstable. We found that the System is currently managing to pay these obligations, although it is adding risk and the obligations are creating various stresses within the System.

The future is less clear. While an improvement in general economic conditions and continual addition of new members may make the fixed obligations less burdensome than they are today, other outcomes could put continued payment of these obligations in jeopardy. We identified several potential problems, including the added risk-taking from nontraditional activities, the penalty imposed on making advances to SAIF-insured members and the disproportionate burden placed on certain FHLBanks that results, the pending switch to voluntary membership for state-chartered savings associations, and the barriers to other System changes imposed by the fixed obligations. We also noted the potential conflict between the fixed obligations and the System's primary objective of supporting housing finance by providing liquidity in a safe and sound manner.

We found three options for modifying the current REFCorp obligation that would overcome its most serious deficiencies and would permit the System to contribute to REFCorp while meeting its other objectives. Two of these options keep the entire REFCorp obligation within the System but reorder the distribution and/or timing of the payments. The third option would be to put the responsibility for paying the shortfall allocation outside of the System. H.R. 1085, an example of this option, would have SAIF-insured institutions pay the shortfall. Simply dropping the FHLBanks' responsibility to pay the shortfall without reassigning that responsibility to a specific group would put the shortfall payment directly on taxpayers. Choosing among these options requires policy judgments for Congress because each option allocates financial burdens differently among different parties.

Finally, we found that the minimum contribution requirement in the AHP generally has the same problems created by the fixed nature of the REFCorp obligation. We believe that removing the minimum annual payment requirement and making the AHP obligation a fixed percentage of income would overcome these problems.

To consider the remaining questions in the mandate, we must make an assumption about the fixed obligations. Otherwise, the analysis of each question must be qualified by reference to the obstacles posed by the fixed obligations. Therefore, in the remainder of this report, we assume that the REFCorp shortfall allocation is modified using any one of the options listed earlier and that the AHP obligation is changed to simply a fixed percentage of income.

Recommendations to Congress

We recommend that the shortfall allocation portion of the FHLBanks' REFCorp obligation be modified to improve the relationship between the System's REFCorp and AHP obligations and the System's earnings; to reduce the risks being undertaken because of the fixed obligations; to eliminate the penalty that may be imposed on advances made to SAIF-insured members; to reduce the possible instability from state-chartered, SAIF-insured savings associations becoming voluntary members; and to enhance the ability to make other System changes.

A number of ways exist for doing this. Congress could change the shortfall formula to a different basis, such as earnings, asset size, or FHLBank stock. It could require the current present value of the obligation be paid over time but allow the annual payment to fluctuate on the basis of System

earnings. Or, it could have SAIF-insured institutions, or some other source(s) outside the System, pay the shortfall. In this chapter, we described the benefits and shortcomings of each option. The choice among these or other possible options represents policy judgments for Congress.

We also recommend that the floor dollar amount required for AHP be dropped, making each FHLBank's contribution to AHP a fixed percentage of its income. We believe that these recommendations will allow the System to continue to meet the obligations established for it in FIRREA while not jeopardizing the other objectives Congress previously defined for the System.

Regulatory Capital Rules Needed That Are Appropriate for FHLBank System

Current requirements for FHLBank capitalization, which are based on stock purchase requirements by member institutions, are not directly related to the risks undertaken by FHLBanks. FHLBanks have substantial amounts of capital stock outstanding. Yet, this capital can be redeemed by voluntary members that choose to give up System membership. Even though FHFB may refuse to redeem this stock at par should the FHLBank be in financial difficulty, the nonpermanent nature of FHLBank capital stock makes it a questionable buffer for absorbing losses. By contrast, a minimum retained earnings requirement would provide a permanent source of capital that is capable of absorbing losses.

We found that the risk-based capital requirements imposed on depository institutions provide an acceptable framework for setting FHLBank stock purchase requirements for System members. Additionally, a minimum retained earnings requirement based both on measurable risks, such as interest rate risk, and unmeasurable risks, such as management and operations risks, should also be established. While implementation of these proposals may permit outstanding FHLBank stock to decline, FHLBanks would have to build retained earnings at the same time. This could reduce dividends during the transition period.

Current System Capital Structure Not Based on Risks

Nearly all System capital comes from stock purchased by member institutions; the remainder comes from retained earnings. The current stock purchase requirements imposed on members are not based on measured risk but on ratios defined in statute and regulation. While the System has a considerable amount of capital stock outstanding, the ability of that capital to absorb losses is questionable.

System Capital Consists Mainly of Members' Capital Stock

FHLBank stock accounted for 96 percent of System capital at the end of 1992. Table 3.1 shows the capital composition at each FHLBank and for the System as of December 31, 1992.

Table 3.1: Fhlbank Capital Composition as of December 31, 1992

Dollars in millions

FHLBank	Capital stock outstanding	Retained earnings	Total capital-to-assets ratio (percent)
Boston	$771	$72	7.2
New York	1,130	51	5.9
Pittsburgh	530	36	5.6
Atlanta	1,312	22	7.2
Cincinnati	549	14	7.3
Indianapolis	526	22	6.5
Chicago	557	7	5.8
Des Moines	482	33	7.2
Dallas	628	33	4.8
Topeka	439	36	6.3
San Francisco	2,451	3	6.7
Seattle	730	52	6.9
System	**$10,102**	**$429**	**6.5**

Note: Numbers may not add due to rounding and combining adjustments.

Source: Federal Home Loan Banks: Combined Financial Statements and Combining Information, December 31, 1992, 1991 and 1990.

FHLBank capital stock is an asset on the books of its members, and the members carry this asset at par value. Should the value of the stock decline below its par value because of FHLBank losses, each member's own capital could be reduced. Therefore, stockholders have a direct financial incentive to ensure that the operations of their FHLBank do not impair the value of their FHLBank stock.

Since members' FHLBank stock is an asset on the members' balance sheets, the members must hold equity capital against their FHLBank stock. As CBO shows in its recent report on the System, the current bank and thrift risk-based capital rules allow depository institutions to hold as little as $1.60 in capital for each share of FHLBank stock ($100 par value) owned.[1]

[1]The Federal Home Loan Banks in the Housing Finance System, p. 39 and 40.

Members' FHLBank Stock Purchase Requirements Determined by Statute

The Federal Home Loan Bank Act dictates minimum stock purchase requirements for both mandatory and voluntary members. The statute requires that members purchase stock in their FHLBank equal to 1 percent of home mortgage loan principal outstanding.[2] Furthermore, if a member's home mortgage loans are less than 30 percent of its total assets, the statute requires the stock purchase formula be calculated as if the member had at least 30 percent of its assets in home mortgage loans.[3]

Members that borrow advances may have to purchase additional stock beyond these minimums. An institution that meets the QTL test[4] may borrow advances up to 20 times its stock investment. To borrow beyond that amount, the member must purchase additional stock equal to 5 percent of the additional advances. In this way, the member maintains outstanding advances no greater than 20 times its stock investment. For non-QTL members that borrow advances, the requirement is more restrictive. Such members must maintain a minimum stock purchase of 5 percent of their advances divided by their QTL ratios.[5]

Regulations Relate Maximum FHLBank Debt to FHLBank Capital

The stock purchase requirements just described make the FHLBanks passive recipients of most of their outstanding capital stock. Regulations then limit the extent to which each FHLBank may borrow against capital. Currently, a FHLBank's consolidated obligations plus members' deposits may not exceed 20 times its capital. Prior to January 29, 1993, FHLBanks were limited to issuing consolidated obligations up to 12 times capital stock and reserves.

[2]See 12 U.S.C. §1426(b)(4) for a complete definition of home mortgage loans for purposes of this formula.

[3]12 U.S.C. §1430(e)(3) (Supp. IV 1992). For an institution whose mortgage loans are less than 30 percent of its total assets, 0.3 percent (1 percent of 30 percent) of total assets results in the same stock purchase requirement as would be the case if the institution had 30 percent of its portfolio in home mortgage loans.

[4]The QTL test states the minimum proportion of mortgage-related assets that a thrift must have in its portfolio on an average basis over a specified period of time to be designated a qualified thrift lender. Mandatory members that fail to meet the QTL test may not borrow any advances except if requested in writing by OTS. In the FDIC Improvement Act of 1991, Congress set the minimum proportion to 65 percent on a monthly average basis in 9 out of 12 months and broadened the categories of investments considered to be qualified thrift assets to include FHLBank capital stock. For more information on the QTL test, see Thrifts and Housing Finance: Implications of a Stricter Qualified Thrift Lender Test (GAO/GGD-91-24, Apr. 30, 1991).

[5]12 U.S.C. §1430(c)(1) (Supp. IV 1992). For more information, see Report on the Structure and Role of the Federal Home Loan Bank System, p. 113 to 115.

Thus, the current capital requirements for FHLBanks are not directly related to the risks undertaken, as is the case with the other housing GSEs and with insured depository institutions. The capital requirements are simple stock purchase requirements imposed on members, combined with a simple FHLBank borrowing limit that is related to the FHLBank's capital.

FHLBank Capital Structure Not Well-Suited for Absorbing Risk

Common equity capital is generally a permanent source of funds for a firm. Once the equity shares are issued by a firm, the firm permanently retains the proceeds. The stock may trade among investors, but an individual stockholder may not demand that the firm redeem the stock. FHLBank capital stock is unlike common equity capital. Voluntary System members may withdraw from the System and redeem their stock, and members with capital stock above their required purchase amount may redeem their excess stock. Also, receiverships for failed mandatory members may redeem the failed entities' FHLBank stock. FHFB has the authority to limit stock redemptions, but only if it concludes that the redemptions would impair the soundness of the FHLBank.

If pending losses threaten the value of a FHLBank's stock, the FHLBank's voluntary members may try to withdraw their stock before the losses impair its value. Mandatory members would be unable to withdraw their stock and could be forced to absorb the bulk of any actual losses that occur.

FHFB can mitigate this sort of capital flight, thereby lending some degree of permanence to FHLBank stock as equity. A voluntary member that wishes to withdraw from the System must give 6 months' notice. According to the Federal Home Loan Bank Act, if FHFB

> "finds that the paid-in capital of a Federal Home Loan Bank is or is likely to be impaired as a result of losses in or depreciation of the assets held, the Federal Home Loan Bank shall on the order of the [FHFB] withhold from the amount to be paid in retirement of the stock a pro rata share of the amount of such impairment as determined by the [FHFB]."[6]

Thus, if impairment of the FHLBank's capital is likely, FHFB can withhold a portion of a withdrawing member's capital stock.

As a practical matter, the degree to which this makes FHLBank stock a buffer for absorbing losses depends on the extent to which FHFB exercises its authority to withhold redemptions. For FHFB to use this authority in a

[6]12 U.S.C. §1426(e) (Supp. IV 1992).

way that makes capital stock a meaningful buffer, FHFB would have to recognize potential future losses in a timely manner and be willing to withhold proceeds from stock redemption requests. Such an action could affect all members of that FHLBank because their regulators could require members to write down a portion of their investments in FHLBank stock. By withholding a portion of a withdrawing member's stock, FHFB would be signaling the expected impairment of that FHLBank's capital. For that reason, FHFB might be reluctant to refuse to make full redemptions until the evidence of loss was unambiguous. By then, some members may have redeemed their stock, and the remaining members would share the entire loss.

Therefore, despite the large amount of capital stock issued by FHLBanks, that capital is less capable of absorbing losses than is traditional equity capital stock. While the risks undertaken by FHLBanks are low compared with the other housing GSEs and insured depositories, the ability of FHLBank stock to absorb unforeseen losses is also less than that of common stock issued by these other entities. Also, how much FHLBank capital would be available to absorb actual losses partly depends on whether FHFB recognized upcoming problems and acted to limit stock redemptions.

The System recognizes that FHLBank stock is a poor buffer against loss. In its December 1992 task force report[7] on capital structure, members' required capital investment was described in a way that highlights both the System's capital structure and its tolerance for risk:

"Common equity invested by owners is normally a bank's fundamental, permanent cushion against losses. However, in the Banks' case one must ask whether the equity invested by members truly functions as a cushion against losses. From a legal standpoint, members' investment in Bank stock is an "at-risk" investment like any common stock. Nevertheless, it is arguable that in a government-sponsored enterprise, subject to regulation and governance by a Federal agency, members who have limited ownership or control do not expect and would not tolerate a write-down of their investment. This perception is clearly magnified for [mandatory] members. . . . Accordingly, it is understandable these members resent even minimal risk in the Banks' balance sheets. On the other hand, voluntary members . . . understand their ability to redeem Bank stock, and withdraw from membership, should the Banks ever show the potential for incurring losses which might impair the value of their Bank stock investment. As a result, the Banks are managed in a manner that eliminates essentially all practical business risk to the members' investment.

[7] Report on Recommended Capital Standards and Capital Structure for the Federal Home Loan Banks (Dec. 10, 1992) prepared by the Capital Standards and Capital Structure Task Force of the FHLBank Presidents' Conference and FHFB, pp. 21 and 22.

From a practical standpoint, therefore, many members view their investment in Bank stock as equivalent to a bond in a government-endorsed cooperative, necessary for access to Bank credit, and not as true "at risk" position in a wholesale bank which serves them. From this perspective, a loss of any kind in such investment would represent a breach of trust.

"It follows that such capital should not normally be treated as available to absorb any permanent losses. Not only, then, is the Banks' current capital structure dominated by the most expensive form of capital, but it may well be a high-cost, low-quality structure which functions poorly as a cushion." [Underscoring supplied.]

Capital Is Only One Component of the Federal Government's Protection From Losses in Financial Institutions

Questions 2 and 3 of the HCDA mandate directed us to consider the appropriate relationship between the capital standards established for FHLBanks, Fannie Mae, Freddie Mac, and insured depository institutions. Each of these financial institutions serves the housing finance sector and each has ties to the federal government.[8] Currently, the government does not impose uniform capital requirements on these institutions but it does rely on more than capital requirements to limit its exposure to losses or other financial disruptions that could result from losses that occur in these institutions. For example, the government uses laws, regulations, examinations, and other means to assess and control potential losses. Thus, rather than considering the appropriate relationship between the capital standards for each of these institutions in isolation, the government should consider its overall risk exposure from the operations of each type of institution and the full array of tools the government uses to control or mitigate that risk.

Regulatory Capital Requirements Intended to Protect Taxpayers and the Financial System

The federal government has two general goals in setting capital requirements for insured depository institutions and GSEs. First, capital requirements put owners' equity at risk, thereby providing an incentive for owners and managers to consider the cost of risk-taking. Second, minimum capital requirements protect taxpayers and the financial system by ensuring these financial institutions have a buffer to withstand losses.

[8]The obligations of these GSEs are not backed by the full faith and credit of the United States. Yet, GSEs operate with special ties to the government, the government has an interest in GSEs' successfully carrying out their public mission, and a GSE's failure could be disruptive to the financial system in general and to the housing finance market and federally insured depository institutions in particular.

Regulatory Capital Requirements on FHLBanks, Insured Depositories, Fannie Mae, and Freddie Mac Are Unrelated

Regulatory capital requirements imposed on banks and thrifts, FHLBanks, Fannie Mae, and Freddie Mac are unrelated. Further, the capital requirements imposed on each of these groups are changing and it is unclear how closely related the future requirements will be.

In the previous section of this chapter, we described the statutory and regulatory rules governing FHLBank System capital. Members' FHLBank stock comprises most of the System's capital. The minimum amount of stock a member must hold is set in statute and is based on the member's mortgage-related assets, not on the activities of its FHLBank.

Capital requirements for banks[9] are based, in part, on a risk-based capital framework developed by U.S. banking regulators and other members of the international Basle Committee of bank regulators (the Basle Accord). The framework establishes capital requirements that reflect the relative riskiness of a bank's assets. This framework provides only a rough measure of credit risk and fails to account for interest rate or other risks, such as operations risk. Thus, regulators supplement the risk-based requirement with a leverage requirement, which requires a minimum capital-to-assets ratio.

Two statutory requirements supplement this framework. The FDIC Improvement Act (FDICIA) of 1991 requires federal banking agencies to develop a system of prompt corrective actions to protect the deposit insurance funds.[10] This requirement directs the agencies to define five capital categories and requires certain regulatory action when a bank's capital falls within the lower capital categories. Additionally, the act requires the regulators to ensure that the risk-based capital standards take adequate account of interest rate risk, concentration of credit risk, and risks from nontraditional activities.[11]

Capital requirements for Fannie Mae and Freddie Mac were recently established in HCDA. These requirements call for OFHEO to develop stress tests. These stress tests will establish the amount of capital these GSEs must hold for the measurable credit and interest rate risk in their operations. The statute sets general parameters for the degree of stress these GSEs must withstand without eroding all of their capital. Each of

[9]Throughout this discussion, references to banks generally mean both commercial banks and savings associations. Federal banking agencies include both federal bank regulators and OTS.

[10]FDIC Improvement Act of 1991, Pub. L. No. 102-242, §131, 105 Stat. 2236 (1991).

[11]FDIC Improvement Act of 1991, Pub. L. No. 102-242, §305(b), 105 Stat. 2236 (1991).

these GSEs must then add 30 percent to this amount for covering management and operations risk. Since OFHEO is not yet fully established, the new requirements have not yet been implemented.

Capital in Context: How Government Protects the Financial System

Minimum regulatory capital requirements are one of several means used by the federal government to protect taxpayers, depositors, and the stability of the financial system. Insured depositories pay deposit insurance premiums for the deposit insurance guarantee. Moreover, laws and regulations restrict the risks undertaken by insured depositories and GSEs. Regulators oversee and examine these entities to ensure that capital requirements and laws and regulations are met.

The federal government is not alone in wanting to see risks properly controlled. As already noted in this chapter, shareholders have their investments at risk and want the value of those investments to grow. Additionally, managers have an incentive to avoid financial trouble. Finally, other parties—such as subordinated debt holders, uninsured depositors, and other creditors—also have an incentive to ensure that risks are properly controlled and managed.

Therefore, the federal government sets minimum capital requirements for insured depositories and GSEs as a crucial, but not the only, form of protection against losses from risk-taking. Capital requirements alone are incomplete indicators of the degree of protection taxpayers, depositors, and the financial system have against such losses. The cumulative cost of regulatory capital requirements, deposit insurance premiums, regulations, examinations, and so forth is part of the price the entities pay for the right to operate with a bank, thrift, or GSE charter.

Assessing Taxpayer Exposure to Losses From Banks and GSEs Requires Measuring More Than Capital

Since capital is not the only protection against taxpayer losses and system disruptions, simply equating capital requirements for FHLBanks, Fannie Mae, Freddie Mac, and insured depositories would not necessarily give the same degree of protection. Achieving the same protection against risk exposure from the operations of housing GSEs and insured depository institutions requires looking at more than capital. The government must consider the actual risks undertaken by each entity and the cumulative protection provided by capital requirements, laws and regulations, regulatory supervision, and other means.

Thus, we conclude that it is not necessary to equate capital requirements across depository institutions, Fannie Mae, Freddie Mac, or FHLBanks. In principle, the government should be concerned with the total price it charges each of these entities for the risks they pose. Measuring this may be difficult. However, equitable regulation among the institutions serving a market requires considering all the tools used by the government to limit and/or price risk-taking.

If the federal government failed to roughly equate the price charged for undertaking a given level of risk, the market response could be that risk would accumulate in those institutions undercharged for risk. This means that without a level playing field for these institutions, the risks inherent in serving some market—here, housing finance—could wind up concentrated where the price charged for risk was lowest. At the same time, the government should be concerned that it not impose an excessive price on risk-taking in the form of, for example, excessive capital requirements. To do so would weaken the economic efficiency of the market. This description of a level playing field considers only regulated entities serving the housing finance market. However, this market is also served by unregulated entities. While regulated entities benefit from their ties to the government, they also incur the costs associated with these ties that have been discussed in this section.

Capital Requirements Need to Ensure Sufficient Permanent Capital

There are two aspects to considering appropriate regulatory capital requirements for FHLBanks. First, the requirements must provide a meaningful basis for members' FHLBank stock purchases so that members continue to have an equity-based ownership stake in their FHLBanks. Second, the requirements must ensure an adequate amount of permanent, at-risk capital based on measurable risk such as interest rate risk as well as management and operations risk.

We identified three models for establishing a regulatory capital requirement for FHLBanks. Of these, a hybrid approach may best suit the FHLBanks. Because of the peculiar nature of FHLBank capital stock described earlier in this chapter, we believe an important aspect of the capital requirements should be setting minimum requirements for retained earnings. Minimum required retained earnings would represent the only permanent at-risk capital held by FHLBanks.

Risk in the FHLBank System

Before considering how to best establish regulatory capital requirements for FHLBanks, it would be useful to review the sources and degrees of

risks undertaken by FHLBanks. First, FHLBanks have little or no credit risk in making advances. As described in chapter 1, there are several statutory and regulatory provisions that help ensure that this is the case. Additionally, FHLBanks have a long history of making secured advances consistent with these rules and no credit losses have ever been suffered on an advance. Credit risk in an investment securities portfolio is not zero, but, given FHFB's restrictions on the securities FHLBanks may hold, credit risk appears minimal.

Interest rate risk exists in funding both advances and investment securities. As described in chapter 2, this risk is growing as FHLBanks increase their securities holdings, particularly with mortgage-backed securities. While this type of risk can be measured and hedged, there are limitations as to how well either may be done.

Management and operations risks are not measurable, but they may often be the most serious source of risk in a financial institution. Ultimately, decisions regarding credit and interest rate risk are made by management. Their understanding of these risks, their attitudes towards them, and the quality of information generated internally on them all contribute to the degree of management and operations risks.

As described earlier in this chapter, capital provides a buffer from losses arising from risk-taking. Requiring too little capital could leave the federal government more exposed to possible losses and/or financial disruptions than it intends to be. Requiring too much capital also has costs. The principal problem with a capital rule that requires excessive capital is the opportunity cost of that excess capital. For the FHLBank System, members that purchase FHLBank stock could invest those proceeds elsewhere or could make loans with those funds. Requiring excessive amounts of FHLBank capital prevents members from productively employing the excess amount in these ways.

Options for Setting Regulatory Capital Requirements

On the basis of our discussions with FHFB, System representatives, others involved with the FHLBank studies, and on previous GAO work in this area, we identified three approaches for setting regulatory capital requirements for FHLBanks. The first is the current approach, the second is the stress test approach recently established for the other housing GSEs, and the third is the risk-based capital model used for commercial banks.

First, staying with the current approach seems unsatisfactory because the amount of required capital stock bears no relationship to the risks undertaken and is limited in its ability to absorb losses. Also, restricting a FHLBank's liabilities to some multiple of its capital is unrelated to the risk inherent in the assets being funded and to the interest rate risk in funding those assets.

Second, the new capital rules for Fannie Mae and Freddie Mac could be applied to FHLBanks. HCDA instructs OFHEO to set minimum capital requirements for these GSEs. The capital requirements include both stress tests to measure the capital needed to protect against measurable credit and interest rate risk and a leverage requirement to set an overall minimum capital requirement.

Since Fannie Mae and Freddie Mac undertake measurable credit and interest rate risks as an essential aspect of their operations, this approach bases their capital requirement heavily on the measured credit and interest rate risk undertaken. However, credit risk for FHLBanks is small. Further, assessing credit risk for FHLBanks in the manner that it is done for Fannie Mae and Freddie Mac could produce questionable results. Many of the assumptions needed for modeling the FHLBank system would have to be arbitrary. For example, one would have to assume how many mandatory members would fail in the stressed environment and how many voluntary members would leave the System. Any modeling results could depend more on the assumptions used than on the true financial strength of the System. We conclude that directly applying the stress test approach used to set capital requirements for credit risk undertaken by Fannie Mae and Freddie Mac would not generate meaningful results for the FHLBanks.[12] Still, the stress test used to set a minimum capital requirement for interest rate risk could be applied to the FHLBanks.

Third, the risk-based capital requirements currently used for banks could be applied to FHLBanks. This approach would assign risk weights to FHLBank assets and set capital requirements on the basis of the sum of risk-weighted assets. Additionally, there would be a core capital (leverage) requirement setting a minimum capital requirement based on asset size. Since bank regulators are finalizing an interest rate risk component for the risk-based capital rules, some variant of that would also be applied to FHLBanks.

[12]For a more technical explanation of some of the difficulties associated with applying a credit-risk stress test to the System, see The Federal Home Loan Banks in the Housing Finance System, p. 42 and 43.

Since the bank risk-based capital requirements were designed to set capital requirements for credit risk, this approach also may seem inappropriate for the FHLBank System. Yet, analyses prepared within the System and by FHFB convince us that this approach may still be an appropriate basis for setting FHLBank stock purchase requirements. The FHLBank Presidents Conference and FHFB established a task force to recommend capital standards for FHLBanks. Its December 10, 1992, report recommended applying the commercial banks' risk-based capital standards to FHLBanks.[13] FHFB, in its recent report, endorsed a modified version of the task force position.[14]

The task force recommended that FHLBanks hold 10 to 12 percent risk-based capital and 2 to 3 percent core capital.[15] As of December 31, 1992, 12 percent risk-based capital would be about $4.7 billion and core capital—which is based on asset size, not risk—would be about the same. Members' outstanding capital stock as of December 31, 1992, was $10.1 billion.

The task force defined three types of capital.[16] Tier 1 capital is members' capital stock and is the principal source of System capital under its model. Tier 2 capital is "elastic capital" that is set on the basis of the amount of advances a member uses. This "elastic capital" would take the form of additional FHLBank stock purchases by a member so that the member's outstanding advances should not exceed some multiple of the FHLBank

[13]Report on Recommended Capital Standards and Capital Structure for the Federal Home Loan Banks.

[14]Report on the Structure and Role of the Federal Home Loan Bank System, p. 131 to 150. The FHFB recommendations are somewhat of an amalgamation of the task force report and of the capital requirements established for Fannie Mae and Freddie Mac. FHFB recommended a statutory requirement that FHFB establish a risk-based capital requirement of at least 8 percent. This requirement "should be modeled after the international risk-based capital standards established by the Basle Accord and generally adopted by U.S. thrift and banking regulators." (p. 150) FHFB also recommended that the regulator, FHFB, use stress tests to ensure the adequacy of this capital standard. Finally, it recommended a core capital requirement similar to that established for Fannie Mae and Freddie Mac.

[15]By comparison, among other requirements, commercial banks must hold 10 percent risk-based capital to be classified as well capitalized, and 8 percent risk-based capital to be adequately capitalized. The 8-percent standard is the international (Basle Accord) requirement; the 10-percent standard is part of the prompt corrective action requirement established by FDICIA. The core capital requirement for banks varies, depending in part on a bank's regulator and its bank examination ratings.

[16]Commercial banks may satisfy their risk-based capital requirements with different types of capital instruments. These different types are sorted into two "tiers," and the regulations specify how much of each tier may be used to satisfy the risk-based capital requirements. For the Capital Standards Task Force, the three tiers represent three different types of capital. The task force describes the different purposes of each tier but does not propose a specific relationship between the various tiers. Importantly, the task force states that the purpose of the first two tiers would not be to absorb permanent impairments.

stock it holds. Such a requirement exists today. For a mandatory member that wishes to borrow more than 20 times its stock purchase requirement, the member must purchase additional FHLBank stock to keep the ratio of borrowings to stock at 20:1. Since elastic capital acts as a compensating balance,[17] the report contends that elastic capital should not earn the same dividend rate as required capital. Tier 3 capital is retained earnings. The task force noted that building retained earnings would shield members' capital stock from loss. However, it proposed leaving the responsibility for establishing a retained earnings target, if any, to each FHLBank.

We believe this risk-based capital approach is reasonable for setting FHLBank stock purchase requirements for the System. However, we believe it needs one crucial modification. As noted in chapter 2, because FHLBank capital stock is redeemable if a member withdraws from the System or fails, retained earnings offer the only permanent at-risk capital in the System. Therefore, we believe that it is appropriate to include minimum requirements for retained earnings in the risk-based capital structure. Since the REFCorp capitalization requirement in FIRREA absorbed nearly all of the System's retained earnings, building up retained earnings will take time. However, we believe that the long-term stability of the System requires a more stable capital base than just members' capital stock.[18]

One concern expressed in the task force report regarding retained earnings is that they could again be taken to fund thrift resolutions. We think that making retained earnings a specific requirement in the FHLBanks' capital requirements could insulate these funds from being used for thrift resolutions in the future.

We do not have a specific model for establishing minimum retained earnings in the risk-based capital requirements, but such a model could be developed. For example, the interest rate stress tests used for Fannie Mae and Freddie Mac could be adapted for the FHLBank System. At a minimum, having sufficient retained earnings to cover interest rate risk

[17]A compensating balance is a deposit balance maintained by a bank customer to, among other possible reasons, ensure the availability of a credit line, have checking privileges, or offset a bank's expenses in providing various services to the customer.

[18]Unlike FHFB, we believe that the elastic capital requirement described in the task force report should be retained. It seems appropriate to us that heavy advance borrowers be required to contribute added capital to the System. Since this capital does have the characteristics of a compensating balance as described in the task force report, it allows System capital to grow and shrink with a FHLBank's advance activity. We also concur with the task force report in its recommendation that such elastic capital not earn the same general dividend rate as required paid-in capital.

and its associated management and operations risks should be required.[19] Also, the retained earnings requirement should cover any credit risk added by new products and services offered in the future. Finally, while retained earnings that exceed required levels might be used to reduce members' stock purchase requirements, the reverse would not be true. That is, because of the nonpermanent nature of FHLBank stock as capital, such stock should not be used to meet retained earnings requirements.

Applying the capital rules just described would probably lower members' stock purchase requirements.[20] Both FHFB and the FHLBanks Stockholders Study Committee in their respective reports noted the need to maintain sufficient capital to continue meeting the REFCorp obligation since FHLBanks may leverage capital to generate a revenue stream that is important to paying the REFCorp obligation.[21] Thus, carrying out any capital requirement that lowered members' stock purchase requirements could require some change in the REFCorp obligation and/or offsetting increases in retained earnings. Further, given the current portion of income going to REFCorp and AHP, it could be difficult for some FHLBanks to make meaningful additions to their retained earnings account while still paying dividends.

An additional concern with setting the appropriate capital level using the structure outlined here is the joint and several nature of consolidated obligations. Since repayment of consolidated obligations is a legal obligation shared by the FHLBanks, risks undertaken by any one FHLBank are underwritten by the capital of all. For the FHLBanks to remain autonomous entities with joint and several liability for their debt obligations, capital requirements must be sufficiently rigorous to protect each FHLBank from the risks undertaken by others.

[19]Given the current low level of retained earnings in many FHLBanks, a transition rule would be needed for such a requirement.

[20]As noted earlier in this chapter, applying the Capital Standards Task Force's suggested requirement of 12 percent of risk-weighted assets to December 31, 1992, System assets implies required stock purchases of $4.7 billion. At that time, outstanding FHLBank capital stock was $10.1 billion.

[21]Report on the Structure and Role of the Federal Home Loan Bank System, p. 149; and The Future Direction of the Federal Home Loan Bank System, pp. 32 and 33.

Modifying Capital Rules Is One Part of a Larger Package of System Reforms

Our conclusions on the fixed obligations and capital, and those described later on membership, consolidation, and governance, form a package for modernizing the System. The elements of this package integrally depend on each other, and they may not necessarily be appropriate if taken individually. Modifying the fixed obligations is a necessary condition for moving forward with other System changes, although in any event we believe that a risk-based retained earnings requirement should be established by FHFB. Putting the REFCorp and AHP obligations on a percentage-of-income basis should eliminate most of the problems created by the current fixed size of these obligations. By removing the need to generate a required income stream and by equalizing the relative burden across FHLBanks, the incentive for FHLBanks to take on added risks is removed. (FHLBank investment portfolios should decline, although there is no guarantee that this will happen without regulatory changes.)

Once the constraints imposed by the fixed obligations are removed, the rest of the elements of the package may be introduced. The System's capital stock is high, but there is an insufficient amount of capital capable of absorbing losses. Here there is a trade-off for members. Introducing the risk-based capital framework will allow members to reduce their required FHLBank stock purchases. This will free up members' funds for investment elsewhere. As this is done, however, the FHLBanks must build their retained earnings to a level commensurate with their measurable risks. Building retained earnings, even after changing the fixed obligations to a percentage-of-income basis, might result in lower dividends for some period of time. Thus, while transition rules would need to be determined, members could have lower stock requirements, but also somewhat lower dividends, while retained earnings were being rebuilt.

Conclusions

We find that the commercial banks' risk-based capital structure would be an appropriate basis for setting capital stock purchase requirements for FHLBanks. Since only retained earnings offer a sure buffer against losses, regulatory capital regulations should also provide for a meaningful retained earnings requirement. The retained earnings requirement should, at a minimum, sufficiently cover the interest rate risk and the associated management and operations risks undertaken by a FHLBank. The overall capital requirement could result in less total capital for the System than is required today. However, the composition of that capital would change.

In reaching these conclusions, we assumed three things. First, the current overall risk level of the FHLBanks should not increase. If this is not the

case, the capital requirements may need to be modified accordingly. Moreover, FHFB should be given sufficient authority to modify any capital rule over time to keep it consistent with changes in the System and with changes in how risk is measured and managed. Second, the REFCorp obligation must be changed. Otherwise, as noted above, the FHLBanks may need all of the capital they currently have to acquire earning assets that will add to the earnings needed to pay REFCorp. Third, System membership should be voluntary for all depository institutions. As we describe in chapter 4, setting FHLBank capital stock purchase requirements using the risk-based capital framework complements treating all System members equally. While this may appear to increase risk by allowing all members to leave, we describe in chapter 4 why we think such a change would probably reduce risk, not increase it. The transition to this new approach for setting capital requirements should coincide with changes in the REFCorp and membership requirements.

Recommendations to Congress

To make System capital requirements commensurate with the risks undertaken by FHLBanks, we recommend that the current capital stock requirements and the FHLBanks' debt-to-equity limit be replaced by a risk-based capital requirement analogous to that used for banks and thrifts.

Recognizing that FHLBank stock is redeemable and, therefore, is not permanent capital, we also recommend that the new capital requirements provide for minimum retained earnings in each FHLBank. These retained earnings should, at a minimum, protect against the measurable risk undertaken by each FHLBank and the associated management and operations risks.

Voluntary Membership Should Improve System Stability and Allow for Consolidation

In chapter 2, we identified problems with the current mix of mandatory and voluntary System members. Consistent with the recommendations we made in chapters 2 and 3, we believe that making System membership voluntary for all eligible institutions would improve the System's long-run safety and soundness. This benefit should outweigh what we see as a small risk of voluntary members exiting en masse.

Voluntary membership may also work to promote greater System efficiency through voluntary consolidation. Letting market forces work should make the System more efficient and reduce operating expenses. Finally, a logical extension of all-voluntary membership is to equalize the terms of System membership.

Equalizing System Membership Requirements Should Reduce Risks in System

Maintaining the current system of having two FHLBank membership classes has two risks: the potential instability created by piecemeal movement toward voluntary membership and the risks associated with voluntary members being able to leave the System if their capital investment appears to be at risk. All-voluntary membership for all System members should reduce these risks and, therefore, improve safety and soundness. The potential downside is that if the members no longer found sufficient reason to remain in the System, the System would begin to self-liquidate as members left.

Mix of Voluntary and Mandatory Membership May Add Risks to the FHLBank System

In chapter 2, we noted that OTS recently ruled that state-chartered, SAIF-insured members will become voluntary members in 1995. We do not know how many, if any, of these members may depart then or at some future date. However, this situation will leave just federally chartered, SAIF-insured savings associations as mandatory System members. If the currently voluntary members, or those mandatory members whose membership becomes voluntary in the future, believe the fixed obligations are too expensive, they may withdraw, leaving fewer members to share the expense of the fixed obligations. As we described in chapter 2, in the extreme, this situation could conceivably create a spiraling effect of voluntary members withdrawing from the System, leaving the mandatory members to pay the fixed obligations.

In chapter 3, we noted that if voluntary members perceived a threat to their capital investments in their FHLBank, they would have an incentive

to leave the System.[1] If the perceived losses were serious and all voluntary members withdrew, only the capital of the mandatory members would be available to absorb the losses. Voluntary members may also have less interest in ensuring their FHLBank is conservatively operated if they believe they could leave the System and still redeem their capital at par if FHLBank risk-taking generated losses.[2]

Considering these risks of mixed membership, we conclude that the current mix of mandatory and voluntary System members may not be stable over the long term. While this is not an immediate problem for the System, our concern is that two membership classes could be problematic if a FHLBank or the System experiences sudden or ongoing financial strain.

All-Voluntary System Membership May Improve Safety and Soundness

On the basis of our discussions with interested parties, there appears to be widespread approval for an all-voluntary System. Making membership voluntary is appealing because it should give FHLBank managers a stronger incentive to provide their members with value for their membership. If a FHLBank is not providing sufficient value, its members may redeem their FHLBank stock and invest those funds elsewhere. Similarly, making membership voluntary should provide an incentive for FHLBanks to respond to their members' changing needs and make FHLBanks more concerned with how efficiently they provide member services.

Before endorsing voluntary membership, however, one must consider whether and how all-voluntary membership could make the System more unstable. There are at least two possible concerns here.

First, there is the concern that once all mandatory members are made voluntary, many of them may withdraw their System memberships. Such an outcome appears unlikely. For example, more than 1,900 new voluntary members have joined the System since FIRREA, suggesting that the System still provides value. This occurred even though FIRREA imposed less favorable membership terms on voluntary members than those existing for

[1]Actual or perceived losses are not the only reasons a member might depart the System. If the System failed to produce acceptable value for a member's capital stock investment, a voluntary member could decide to withdraw from the System and invest its funds elsewhere. Once a member withdraws, it cannot rejoin the System for 10 years. This prevents voluntary members from quitting and rejoining on the basis of short-term financial results.

[2]As we noted earlier, FHFB may refuse to redeem a member's capital at par if FHFB believes there are losses pending at a particular FHLBank. However, if FHFB made such a determination, this determination would immediately threaten the value of every member's paid-in capital at that FHLBank.

mandatory members. Also, these voluntary members share in the cost of the fixed obligations as part of being members. Furthermore, very few savings banks, who have long been voluntary members, have left the System in the past few years.

Another reason it is unlikely that many mandatory members would leave the System if so permitted is that voluntary membership removes the incentive problem we described in which members may have different degrees of concern for FHLBank risk-taking based on the nature of their membership. Because all members could withdraw their capital, and because a 6-month waiting period is required to do so, there is a smaller chance of some members "escaping" the System, leaving losses to be absorbed by others.[3] Therefore, unless the fixed obligations become more onerous, it appears unlikely that many mandatory members would leave the System if given the option. In any event, correcting the problems associated with the fixed obligations should remove many of the concerns about such an outcome.

The second potential concern in making membership all-voluntary is that either because of losses or a lack of need for the System, many members may withdraw at some point in the future. Yet, this concern also should not be viewed as a problem. If many members withdraw from the System, this action could be a message that the System had outlived its usefulness. In that case, it would be better to have the System naturally self-liquidate than to linger past its natural life. Making all members voluntary could prevent the FHLBanks from lingering beyond the time that they serve a useful purpose to their members. Of course, should the System lose members and ultimately self-liquidate before the REFCorp obligation is paid off, the obligation would have to be transferred elsewhere, and could perhaps end up with the taxpayers.

By contrast, an all-mandatory membership could help ensure continued payment of the fixed obligations by preventing the System from naturally self-liquidating. However, such a barrier to closing down the System could increase risk in the System if FHLBanks begin searching for some new rationale for their continued existence. We believe that a System based on voluntary membership that could one day self-liquidate is preferable to

[3]In some sense, this 6-month waiting period makes FHLBank stock a more sure buffer for absorbing losses. Yet, losses on FHLBank stock would reduce members' own capital, which could pose a risk to the deposit insurance funds. Thus, if FHLBank stock in an all-voluntary System was supporting a significant amount of risk-taking activity, the bank and thrift regulators should alter the risk-weight applied to FHLBank stock in computing the members' risk-based capital requirement. As we described in chapter 3, however, FHLBank stock is poorly suited to absorb losses. Therefore, measurable risk-taking should be backed by the required amount of retained earnings.

using mandatory membership to keep alive a multi-billion dollar GSE for the primary purpose of paying $300 million per year to REFCorp. To keep it alive primarily for this purpose could result in both GSE losses and losses in insured depositories that exceed the value of the REFCorp payments.

Voluntary Membership Could Include the Ability of Members to Choose Their FHLBank

Just as other businesses choose the banks they patronize, FHLBank members could be allowed to affiliate with the FHLBank of their choice. The stockholders/customers are the best judges of whether the FHLBanks provide value through their products and services. Currently, with limited exception, members must join the FHLBank in the district where they are headquartered. Thus, members have little choice over the package of services available to them. Consistent with other recommendations made in this report that promote FHLBanks providing the best value to their members, members could be allowed to invest their funds in the FHLBank they believed best provided that value.

While letting members choose their FHLBank would be a significant change from the current practice, it is the way markets usually function. Smaller commercial banks can choose among larger banks for various services, mortgage lenders can choose between Fannie Mae and Freddie Mac to securitize home loans, and companies can choose among investment banks to raise funds in capital markets. Just as competition in these areas promotes efficiency and service, competition for members among the FHLBanks could produce a more efficient system that would better meet members' needs.

Part of promoting economic efficiency would be for members to vote with their feet on the efficiency with which their FHLBank provides services. If FHLBank Boards of Directors are not responsive to members' concerns in promoting efficiency, or if individual members have needs different from other members in their region, choosing one's FHLBank should enable a member to operate more profitably by selecting the package of services best suited to its own needs.

There are other reasons to consider permitting members to choose their FHLBank. The market area of individual depository institutions has changed since Congress created the System in 1932. Mortgage lending was then a localized activity, and lenders were constrained by law to lending in their local area. Advances were a means to move surplus funds from regions of the country with excess funds to other areas of the country where demand for mortgage financing exceeded the local thrifts' supply of

funds. Today, mortgage lending is an activity that is national in scope. Many mortgage lenders now operate in large areas of the country or nationwide. For example, a thrift in California could easily borrow advances from the San Francisco FHLBank to fund mortgages made on the East Coast.[4]

Finally, freely choosing an FHLBank is a logical extension of the arguments for the System to have all-voluntary membership. If allowing all eligible members to voluntarily join or leave the System under equal terms encourages System efficiency and responsiveness to members' needs, then allowing eligible members to choose which FHLBank best satisfies their particular needs should help accomplish that objective.

We recognize that permitting eligible members to choose their own FHLBank may have drawbacks, particularly in the transition from the current to the proposed structure. Generally speaking, it is not clear what potential disruptions to the System could arise if members were permitted to freely move among FHLBanks.[5] In particular, risks could arise depending on how individual FHLBanks responded to either losing members or to the possibility of being able to add members from elsewhere in the System. Because the System relies on a joint and several obligation to repay System debt, FHFB would have to be vigilant to ensure that safety and soundness in any one FHLBank was not threatened by such movement. Finally, it is unclear whether potential competition for members among FHLBanks would damage needed System cooperation brought on by joint and several liability.

Although we are inclined to support allowing members to choose their FHLBank, given the limited scope of this study, we were not able to fully explore all the possible implications of such a proposal. On the basis of our analysis to date, however, we believe that this added flexibility could be an important stimulus to a market-based consolidation of the System that promotes both diversity among FHLBanks and the individual needs of System members, although there may be transitional issues to be worked out.

[4]Securitization of mortgages by the Government National Mortgage Association, Fannie Mae, and Freddie Mac has also contributed to the nationwide character of mortgage lending, as financial institutions can purchase securities backed by mortgages from other parts of the country.

[5]As we noted earlier, voluntary members that leave the System must wait 10 years for readmittance. It may also make sense to have some limits on the frequency with which members could change FHLBanks. CBO, in its report, suggested an annual open season for such changes (see The Federal Home Loan Banks in the Housing Finance System, p. 53).

All-Voluntary Membership Should Let the System Consolidate or Expand as Needed

Because nearly all sectors of the financial industry have undergone significant consolidation recently, some have questioned the need for having 12 regional FHLBanks. Many of the FHLBank districts are small in area, and several of them also have relatively few members and low levels of outstanding advances. Thus, there may be potential efficiencies and savings that could benefit both members and homebuyers.

We see this issue as closely connected to membership. An all-voluntary membership structure should have the advantage of automatically adjusting the size and number of FHLBanks necessary to meet the needs of members and ultimately the home-buying public.

The Regional Structure of the System Is Outmoded

Much has changed since the FHLBank districts were first drawn up in 1932. The nation's population and economic activity grew relatively faster in the south and west. The number and role of thrifts have shrunk, and the commercial banking industry is also consolidating.[6] The housing finance industry has also changed with the development of secondary mortgage markets and the rise of mortgage banking companies.

Telecommunications and computer technology have made geographic proximity far less important than it was 60 years ago. In a recent survey of FHLBank System members, FHFB found that members ranked having a FHLBank near them only seventh in importance out of nine functions or characteristics. Table 4.1 shows the states and territories that make up the FHLBank districts, which as we noted earlier, have changed little since 1932. The districts obviously vary greatly in geographic area as shown in tables 4.1 and 4.2. They also vary considerably in population, number of members, and asset size of members.

[6]From the end of 1982 to the end of 1992, the number of FDIC-insured commercial banks and trust companies declined from 14,451 to 11,465. Over the same period, the number of thrifts declined from 3,287 FSLIC-insured institutions to 1,788 OTS-regulated, SAIF-insured institutions.

Table 4.1: Composition of FHLBank Districts

FHLBank	States and territories
Boston	Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont
New York	New Jersey, New York, Puerto Rico, Virgin Islands
Pittsburgh	Delaware, Pennsylvania, West Virginia
Atlanta	Alabama, District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia
Cincinnati	Kentucky, Ohio, Tennessee
Indianapolis	Indiana, Michigan
Chicago	Illinois, Wisconsin
Des Moines	Iowa, Minnesota, Missouri, North Dakota, South Dakota
Dallas	Arkansas, Louisiana, Mississippi, New Mexico, Texas
Topeka	Colorado, Kansas, Nebraska, Oklahoma
San Francisco	Arizona, California, Nevada
Seattle	Alaska, Guam, Hawaii, Idaho, Montana, Oregon, Pacific Islands, Utah, Washington, Wyoming

Table 4.2: Characteristics of FHLBank Districts - 1992

Sorted in order of area in square miles

FHLBank district	Area (in square miles)	Population (in thousands)	Number of FHLBank members	Total assets of members (in millions)
Seattle	1,147,171	13,483	160	$65,839
Dallas	525,834	27,645	322	80,831
San Francisco	379,421	34,627	169	301,547
Des Moines	349,282	13,604	289	72,600
Topeka	331,110	10,496	216	46,928
Atlanta	290,929	45,148	582	178,529
Cincinnati	121,905	19,410	460	78,848
Chicago	109,907	16,322	321	82,692
Indianapolis	92,679	14,839	217	61,117
Pittsburgh	70,862	14,341	314	84,686
Boston	62,811	13,207	339	111,265
New York	58,234	29,344	238	141,411

Sources: Area of districts from GAO calculations based on information in the Statistical Abstract of the United States–1992, U.S. Department of Commerce, Bureau of the Census; Population of the districts from GAO calculations based on information in General Population Characteristics (for each state as well as the District of Columbia, Puerto Rico, the Virgin Islands, and Guam) from the 1990 Census, U.S. Department of Commerce, Bureau of the Census; number of members from GAO calculations based on data provided by FHFB as of December 31, 1992; assets of members from GAO calculations based on data provided by FHFB, as of September 30, 1992.

FHLBank districts also vary in ways other than those shown in table 4.2. For example:

- The rural and central city composition of the districts varies significantly, ranging from 42 percent central city and 8 percent rural in the San Francisco district to 22 percent central city and 35 percent rural in the Pittsburgh district.
- The population density of the districts is diverse, with the Seattle district having a population density of only 12 persons per square mile compared to the New York district, which has a population density of 504 persons per square mile.

Potential Cost Savings From Consolidation

The evidence on potential cost savings from consolidation is mixed. While FHFB, the FHLBanks, and the FHLBank Stockholders Study Committee generally agree that consolidation would reduce System operating expenses, they disagree as to how consolidation might affect the System in other ways, such as in delivering various System services. Estimating the magnitude of potential cost savings is difficult because the answers depend on the assumptions that are made. For example, consolidating two FHLBanks may save on operating expenses, but the effect of consolidation on revenue may be harder to forecast.

FHFB, in its recent report, concluded that consolidation would produce cost savings.[7] Yet, FHFB also argued that such savings may be offset by lost revenue from the reduced local presence of FHLBanks. In its report, FHFB concluded that "the current structure and location of FHLBanks may not be optimal" but it equivocates on the benefits of consolidation.

Similarly, of the 12 FHLBank reports on consolidation recently submitted to Congress, only the San Francisco FHLBank strongly supported consolidation. While many of the other FHLBanks agreed that consolidation would reduce System expenses, they pointed to other factors that could outweigh this benefit. For example, the fixed REFCorp obligation, the need for flexibility, and the need for local delivery of AHP and CIP are all cited as barriers to consolidation.

By contrast, the FHLBank stockholders' committee reported that on the basis of its preliminary analysis, "there may be potential to reduce System

[7]Report on the Structure and Role of the Federal Home Loan Bank System, p. 159.

costs significantly through both operational and functional consolidation and process improvement activities."[8]

In our view, the potential for savings from consolidating system banks is limited but not insignificant. The following are the main reasons for the limited potential:

- The FHLBank's territories do not overlap. Thus, there is no potential for savings by closing unneeded branches as is often the case when commercial banks merge.
- The operating expenses of the FHLBanks are low. According to FHFB, FHLBanks had operating expenses as a percentage of average assets and of total revenues of .14 percent and 18.1 percent, respectively, in 1992.[9] Wholesale commercial banks' operating expense ratios averaged 3.46 percent and 67.0 percent, respectively, that same year.

Still, potential cost savings do exist. In particular, consolidation could reduce overhead costs. Also, consolidation could result in cost savings in the production of member services.

In 1992, System operating expenses were $207 million. To illustrate the potential magnitude of possible savings in operating expenses, consolidation that reduced the System's 1992 operating expenses by 25 percent would have added about $52 million to net income, assuming that the consolidation had no impact on revenue. This would have made approximately $10 million more available for REFCorp and $2.6 million more available for AHP in 1992. Still, this 25-percent figure is merely an illustration. Estimating potential savings from consolidation is extremely difficult without better knowledge of where the highest cost savings could be achieved and what form the consolidation should take. We believe the best source of knowledge for this information is the member/stockholders. With the proper incentives and authorities, they should find it in their best interest to seek out such savings where they exist.

While overall savings may be modest, we believe that for the System to maintain an inefficient structure is unfair to taxpayers. It is clearly in the public interest to ensure that the System is operated efficiently. As we describe in the next section, the government's interest in this matter should coincide with that of System members, especially if all members were voluntary.

[8] The Future Direction of the Federal Home Loan Bank System, p. 70.

[9] Report on the Structure and Role of the Federal Home Loan Bank System, p. 156.

Finally, we note that the System currently has several districts that are quite large in terms of their asset size and/or their geographic region. These FHLBanks do not appear to be disadvantaged in how efficiently they provide member services. In fact, in chapter 5, we show that FHLBanks with economically or geographically large territories have experience with AHP that is similar to, or possibly more favorable than, that of the smaller FHLBanks.

Voluntary Membership Provides a Mechanism for Consolidation

Mandatory membership makes it more difficult for FHLBank members to ensure that their FHLBank's management is efficiently meeting their needs as stockholders. With voluntary membership, members that are dissatisfied with the value generated by their FHLBank, and that find themselves unable to improve the situation through the FHLBank's board of directors, may leave the System.

With regard to consolidation, voluntary members would have an incentive to see that their FHLBanks control costs and operate efficiently. That is, an all-voluntary system should pressure FHLBanks to cut costs. If costs were high, resulting in lower dividends, a FHLBank would risk losing members. Thus, if having 12 FHLBanks was optimal, then stockholders may have no reason to push System consolidation, although the stockholders may still want to redefine the existing district boundaries.[10] However, if the stockholders in an all-voluntary System saw the potential for cost savings from consolidation that could increase their returns as stockholders—without an offsetting reduction in the responsiveness or value provided by their FHLBank—they should work to that end. We conclude that with all-voluntary membership, members would have both a financial interest in ensuring their FHLBanks are cost efficient and the means to consolidate the System if such consolidation improves the System's cost-effectiveness in meeting its mission.

Therefore, we believe the answer to how many FHLBanks there should be could be addressed by making membership in the System all-voluntary. Furthermore, if members were free to affiliate with any FHLBank, they could choose the one that provided the services they needed. Thus, if some FHLBanks were not providing value to stockholders/customers, their customer base would shrink as members switched to FHLBanks that gave better service. The FHLBank that lost members would have to improve its service or eventually lose so many members that it would have

[10]The Federal Home Loan Bank Act currently requires the System to have no fewer than 8, and no more than 12, FHLBanks.

to merge with a stronger institution. At the same time, if different FHLBanks developed somewhat different product and service lines, members could join the FHLBank that offered the product and service mix most appropriate to their needs. With this flexibility, the FHLBank System should be able to evolve to better meets its members' needs and to adapt as those needs changed.

Overall, we believe that all-voluntary membership could move the System to a more efficient structure. As we described in chapter 2, however, it will be very difficult for this to happen as long as FHLBanks are differentially burdened by their fixed obligations. Thus, changing the fixed obligations along the lines we recommended in chapter 2 would be a prerequisite to consolidation actually taking place.

If all-voluntary membership were established, and if changes were made to the fixed obligations and to capital requirements as recommended in chapters 2 and 3, it is reasonable to ask what assurances there are that the System will, in fact, consolidate on the basis of market forces. It is also reasonable to ask how to ensure that this change promotes taxpayers' interest in the System. While we do not have specific criteria to apply to ensure that the System actually operated as we have argued here, we make the following observations. First, it may be reasonable to provide for a transition period after the fixed obligations are modified and membership is made completely voluntary for FHLBank boards of directors to work to merge individual FHLBanks. After some point, however, it may make sense to ensure that cost efficiencies have been achieved by then giving individual members the opportunity to freely choose their FHLBank. At all times, FHFB should retain its existing authority to force consolidation. In fact, after some point, Congress may wish to require that FHFB demonstrate that the System has successfully consolidated or otherwise achieved all reasonable cost savings.

Membership Rules Should Be the Same for All Members

We have proposed modifications to the System's existing structure that should promote two general outcomes. First, the modifications should make the potential costs and benefits of membership more equal for all eligible institutions. Second, the modifications should give stockholders/customers greater control over the System, thereby making the System more responsive to ongoing market changes and market forces.

We were asked to consider the advantages and disadvantages of changes to existing membership restrictions, stock purchase rules, and advance limits placed on non-QTL members. Consistent with the conclusions and recommendations already reached, we believe that non-QTL members should face the same stock purchase rules and advance limits as QTL members. The advantages of such a change would be to put all stockholders/customers on the same economic basis in terms of their membership. This change should more closely align the interests of stockholders/customers. As we described earlier, the fixed obligations and the differential capital and borrowing rules give mandatory (i.e., usually QTL) members different incentives from those faced by voluntary (i.e., usually non-QTL) members.

Making the terms of membership more equal would also recognize the economic reality that mortgage lending is no longer the principal domain of savings associations. In fact, all types of insured depository institutions are actively involved in home mortgage lending, so there appears to be no public policy basis for discriminating among these institutions in their access to the System. Presumably this characteristic of home mortgage lending was an important reason why Congress, in passing FIRREA, permitted commercial banks and credit unions to become members.

Equalizing the terms of System membership would not, however, completely remove the advantages now held by QTL members. Assuming that the stock purchase requirement would remain a function of a member's mortgage holdings (technically, its qualified thrift investments), QTL members would hold more stock than non-QTL members of the same asset size. Since they hold more mortgages, those members would be able to borrow more advances because they had more eligible collateral.

Overall, we believe the System would be more stable and effective if membership were voluntary and rules governing access to advances were the same for all members. Making the System more responsive to the needs of its members should ultimately improve its profitability and efficiency.

The disadvantage of making membership terms equal for all eligible members is that it would increase the likelihood that advances were used to fund assets other than mortgages. For QTL members, since the bulk of their portfolios is in mortgages, the likelihood that advances are taken out to fund mortgages is greater than it is for members with a much smaller percentage of mortgages-to-assets. Still, money is fungible, and there is no

guarantee that an advance is being used directly to fund particular mortgage investments. We believe this disadvantage is minor because no member would be allowed to take advances beyond the level at which they could be collateralized with eligible collateral.

This leaves the question of changing membership eligibility rules both for QTL and non-QTL members. If the general intent of having the System is to provide a credit facility for financial institutions that make and hold home mortgage loans, then retaining some minimum requirement for holding mortgage loans makes sense. We draw two conclusions from this. First, whatever the other merits or problems with the QTL test, we see no reason why SAIF-insured institutions that fail the QTL test should be prohibited from taking advances. For example, access to advances may permit such institutions to more easily return to QTL status. In any case, such institutions may have considerable mortgage holdings, even if those holdings are insufficient to pass the QTL test.

At this time, we see no need to expand the membership eligibility criteria to other financial institutions. For example, we believe it may be inappropriate to open the System to mortgage banks. Such institutions already benefit from the existence of Fannie Mae and Freddie Mac. Moreover, their need for credit can be readily met by depository institutions and other financial firms. Mortgage banks are generally not portfolio lenders and therefore do not have the same need for long-term credit as do depository institutions that hold home mortgages and mortgage-backed securities as intermediate and long-term assets. Relying on the criterion that the System exists to provide credit to regulated institutions that make and hold mortgage loans, we found no persuasive argument for expanding the eligibility criteria in order to better satisfy the System's mission.[11]

Conclusions

Having a mix of voluntary and mandatory System members may add risk to the System because the incentives of these two groups may not always be the same. Making membership voluntary for all eligible institutions overcomes these problems and also has additional potential benefits. In particular, all-voluntary membership, along with our recommended changes to the fixed obligations, should enable the System to consolidate

[11]In chapter 6, we propose six criteria that could be applied in considering expansion of System products or services. These same criteria may also be applied to expanding the universe of eligible members, with the same result as stated in the text. In particular, expanding membership eligibility to mortgage banks fails the criterion that the System expand only where the market fails to meet a demonstrated need.

on the basis of economic factors. That is, with all-voluntary membership, it would be in the economic interest of stockholders/customers to seek the structure that most efficiently provides the products and services permitted by the FHLBanks' charter.

Consistent with these findings, other statutory and regulatory differences between members should also be removed. Such a change recognizes the existing similarities between commercial banks and savings associations in serving the home mortgage market. At the same time, it provides QTL members with relatively greater access to advances and a relatively greater ownership share in their FHLBank by virtue of QTL members' greater concentration in home mortgage lending.

Recommendations to Congress

To improve the long-term efficiency and value of the FHLBank System, we recommend that Congress make FHLBank membership voluntary for all eligible institutions and make membership terms the same for all eligible members.

The FHLBank System and Affordable Housing

The FHLBank System supports affordable housing through traditional advances to its members and through programs specifically designed for this purpose. Because data are not collected on the types of activities supported through traditional advances, we are unable to measure the System's support of affordable housing through traditional advances. According to available FHFB data, the targeted programs together have provided funding for over 130,000 units serving low- and moderate-income households.

Likewise, our analysis of the impact of Bank consolidation on the System's support for affordable housing is also limited by available data. Our analysis of the one affordable housing program that generates appropriate data shows a moderately positive relationship between a FHLBank's asset size, the size of its district, and its support of this program. Moreover, any adverse impact that consolidation might have on the delivery of housing services, including services in rural areas, likely could be mitigated or eliminated if the System established branch offices to support affordable housing programs.

Because the methods used by the System to support affordable housing are quite different from those of Fannie Mae and Freddie Mac, we do not believe it would be appropriate to extend their housing goals to the System. Unlike Fannie Mae and Freddie Mac, the System does not purchase or securitize mortgages; rather, it provides liquidity to its members in support of portfolio lending. At the same time, the System provides direct subsidies in support of affordable housing, which is not done by either Fannie Mae or Freddie Mac. Thus, the housing goals of the System would necessarily have to take a form different from those of Fannie Mae and Freddie Mac.

Extent of FHLBank System Support for Low- and Moderate-Income Housing Is Not Known

The System has both direct and indirect impacts on affordable housing. Members can use subsidized and unsubsidized advances to fund such housing directly. In addition, by supporting the liquidity needs of portfolio lenders, the FHLBanks may indirectly support affordable housing. Unfortunately, data on the extent of FHLBanks' support do not exist. However, some data do exist for those direct subsidy programs that support affordable housing.

FHLBanks lend to member institutions that in turn make loans to borrowers. Since the System does not make loans to the ultimate borrower, it does not have information on borrowers' income or the

location of the property financed (rural versus central city). The System indirectly provides support for low- and moderate-income households by supporting portfolio lenders, which do make such loans. However, the magnitude of that support has yet to be accurately measured.

In its HCDA-mandated report, FHFB provided an analysis of 1991 Home Mortgage Disclosure Act (HMDA) data for single-family loans.[1] This analysis showed that about 135,000 loans to households with incomes below the median for their area were originated and held in the portfolios of banks and thrifts during the first 9 months of 1991. While this analysis provides some insight into the support by depository institutions of low- and moderate-income housing, it has serious limitations. First, the data are not broken out specifically by FHLBank members but rather are used for depository institutions regardless of whether they are System members. Second, even if member institutions could be identified, there is no information in the HMDA data that would identify whether advances from the System were being used to originate mortgages for low-income housing. Third, the HMDA data do not indicate whether the institutions that use advances most extensively also make a larger share of their loans to low- and moderate-income households.

FHFB recognized these limitations in the HMDA data and hired an independent contractor to identify System members in the HMDA data and determine the extent to which these members were using advances to support low-income housing. Technical problems precluded the contractor from successfully completing this project. However, it is our understanding that FHFB plans to conduct additional analyses to try and resolve these technical problems.

Better data exist on the System's programs that directly support financing affordable housing and community development activities. These programs—AHP and CIP—were established by Section 720 of FIRREA to help expand the capital devoted to affordable housing. AHP provides subsidized housing finance to projects for very low-, low-, and moderate-income households. CIP funds both housing and commercial development activities for low- and moderate-income households and/or communities. CIP subsidies are much smaller than those of AHP.

Affordable Housing Program

AHP provides direct subsidies to System members engaged in long-term lending for owner-occupied and rental housing for households with very

[1] Report on the Structure and Role of the Federal Home Loan Bank System, p. 74 and 75.

low-, low-, or moderate-incomes. Subsidies—which are allocated semiannually through a competitive bidding process—encourage member institutions to increase their support for affordable housing.

AHP subsidies must be used to finance the purchase, construction, and/or rehabilitation of

- owner-occupied housing for households whose income does not exceed 80 percent of the area's median income; or
- rental housing, in which at least 20 percent of the units are occupied by and affordable to very-low-income households—earning 50 percent or less of the area's median income—for the building's remaining useful life or the mortgage term.

There are four threshold tests projects must meet to qualify for consideration.[2] After satisfying the threshold tests, projects meeting at least three of the following seven priorities have priority for funding. These priorities are (1) provide financing for owner-occupied housing for very low-, low-, and moderate-income households in that priority order; (2) provide financing for rental housing with at least 20 percent of the units occupied by and affordable to very-low-income households; (3) finance projects that are currently held by a U.S. government agency or instrumentality; (4) finance projects sponsored by nonprofit organizations, states, or local and state housing authorities; (5) finance projects that meet critical urban or rural housing needs; (6) finance projects that provide permanent housing for the homeless; and (7) finance projects that meet a FHLBank's housing objectives.

FIRREA set AHP subsidies at a percentage of the net income of the FHLBanks in the previous year. For 1993 and beyond, those subsidy amounts are

- 5 percent of the preceding year's annual net income for the System or $50 million, whichever is greater, through 1993;
- 6 percent of the preceding year's annual net income for the System or $75 million, whichever is greater, in 1994; and
- 10 percent of the preceding year's annual net income for the System or $100 million, whichever is greater, thereafter.

[2]The four threshold tests are (1) compliance with fair housing laws and regulations, (2) project feasibility, (3) ability of the member to qualify for an advance to fund the project, and (4) ability to begin the projected within 12 months.

According to FHFB data, the System provided about $192 million in AHP subsidies from 1990 through 1992. AHP subsidies have been used to help fund about 53,000 units, of which about 70 percent were rental units and about 30 percent were owner-occupied. Some 30,000 of these units, or about 60 percent, were for households with very-low-incomes.

Regarding location, according to conservative estimates made by FHFB about half of AHP units are located in projects within central cities, and at least 11 percent are located outside of a Metropolitan Statistical Area (MSA). The remaining units are in projects located partially or entirely in suburbs and small cities.

Community Investment Program

CIP provides funds for community-oriented mortgage lending, that is, loans to

- finance home purchases by families whose incomes do not exceed 115 percent of the area's median income,
- finance the purchase or rehabilitation of housing to be occupied by families whose incomes do not exceed 115 percent of the area's median income, and
- finance commercial and economic development to benefit low- and moderate-income families (with incomes at 80 percent or less of the area's median) or activities located in low- and moderate-income neighborhoods.

Unlike AHP, CIP is not a competitive program. FHLBanks' CIP advances to member institutions are subsidized in the sense that they are made at cost. Individual FHLBanks do not include markups for profits and are encouraged to charge only "reasonable" administrative costs on CIP loans.

CIP advances have totaled over $2.7 billion in the first 3 years that the program has operated. These loans have financed about 78,000 units, 72 percent owner-occupied and 28 percent rental units. Excluding multijurisdictional and statewide projects, about 76 percent of the units were located in central cities and about 6 percent were located in non-MSAS.

Future Role of FHLBanks in Affordable Housing

The System's future impact on affordable housing will depend on several factors, including (1) System earnings, (2) other subsidies, and (3) whether the System expands into new products and services. More specifically, future AHP funding depends on how much the System earns above the

required minimum funding level. Should these earnings exceed $1 billion per year, the System's contribution to AHP will increase beyond the statutory minimum of $100 million by 1995.

The FHLBanks provide small subsidies per unit[3] in their affordable housing programs. Their housing programs require additional subsidies from other sources to reach very-low-income people. Without these additional subsidies, the System will not reach many very-low-income households. Finally, the future impact the System has on affordable housing will be affected by changes in FHLBank products and services. This issue is examined further in the following chapters.

Consolidating FHLBanks Should Not Adversely Affect Affordable Housing Activities

Question 11 asked about the effects that consolidation would have on the effectiveness of affordable housing and community development programs. Question 12 emphasizes the effects on rural areas. To some degree the answer to these questions must be "it all depends." In other words, the effects depend on the policies the consolidated FHLBanks adopt. Thus, if management of a consolidated FHLBank believed that consolidation in and of itself would lead to a deterioration in affordable housing services, it could adopt policies to prevent that. If Congress believed that rural areas were being slighted, it could also instruct the FHLBanks to be sure that adequate attention was paid to those areas.

A district FHLBank may be more effective in its affordable housing activities if it is relatively "close" to its members. This view was shared by both FHLBank staff and advisory council members at the three FHLBanks we visited. However, our analysis of data relating to the 12 FHLBanks disclosed a moderate positive relationship between a FHLBank's asset size, the size of its district, and its support of AHP. We recognize that these comparisons only provide an indication of the impact FHLBank consolidation may have on affordable housing activities. In fact, the most meaningful assessment of this impact would have to be made after an actual consolidation took place. In lieu of a post-consolidation assessment, we believe our analyses at least provide some insight into how FHLBanks of widely different sizes are administering the AHP today. Moreover, we believe that the FHLBanks could mitigate any adverse effect resulting from consolidation by establishing branch offices dedicated to providing services for affordable housing and community support programs.

[3]The term in the affordable housing field for this is "shallow subsidy." For example, the total AHP subsidy per unit since the program started averaged about $3,700.

We chose two indicators of size for our analysis: the assets of the FHLBank and the number of square miles in the FHLBank district. Tables 5.1 and 5.2 illustrate these dimensions of district size for 1992.

Table 5.1: FHLBanks Ranked by Total Assets, as of December 31, 1992

Dollars in millions

FHLBank	Assets
San Francisco	$36,408
New York	19,874
Atlanta	18,631
Dallas	13,825
Boston	11,706
Seattle	11,370
Pittsburgh	10,123
Chicago	9,661
Indianapolis	8,478
Cincinnati	7,757
Topeka	7,562
Des Moines	7,154

Source: Federal Home Loan Banks: Combined Financial Statements and Combining Information, December 31, 1992, 1991 and 1990.

Table 5.2: FHLBanks Ranked by District Size in Square Miles

Size in thousands of square miles

FHLBank	Square Miles
Seattle	1,147
Dallas	526
San Francisco	379
Des Moines	349
Topeka	331
Atlanta	291
Cincinnati	122
Chicago	110
Indianapolis	93
Pittsburgh	71
Boston	63
New York	58

Source: Statistical Abstract of the United States - 1992, U.S. Department of Commerce, Bureau of the Census.

If large districts were less able to administer AHP successfully, that would suggest that larger, consolidated districts might have problems in supplying affordable housing, both in general and to rural areas in particular. Experience with AHP is appropriate for three reasons:

- Comparing the experience members have in winning AHP funding available in their district may indicate that some FHLBanks are better at encouraging members to develop good affordable housing projects. If larger districts are less able to carry out affordable housing activities successfully, they might not be able to use the full amount of their assessments for AHP projects. In this case, districts have to turn over 90 percent of the unused portion to an Affordable Housing Reserve Fund administered by FHFB. Thus, if larger (or smaller) districts were less successful in affordable housing delivery, one indicator might be their turning over unused AHP funds to FHFB.
- The economic and geographic size of districts may influence their ability to attract applications for AHP funds. For example, FHLBanks in large districts may find it difficult to communicate the program to members and may be less efficient in administering it. Thus, there may be an inverse relationship between the size of districts and the relative number of applications the FHLBank receives.
- AHP funds are given only on the approval of FHFB. Thus, FHFB routinely compares the applications for funds from all districts and is in a position to know if any districts submitted generally superior or inferior applications.

Table 5.3 compares each FHLBank's AHP obligation to the amount each FHLBank actually committed to approved projects. The table shows that each FHLBank used essentially all its AHP dollars to fund projects. Thus, no particular size district apparently had difficulty in generating enough proposals of sufficient quality for FHFB approval.

Table 5.3: Obligated and Committed AHP Funds

Dollars in thousands

FHLBank	Total AHP obligation 1990-1992	Total commitments of AHP funds 1990-1992	Percent of AHP obligation actually committed
Atlanta	$22,541	$21,349	94.7
Boston	15,048	15,005	99.7
Chicago	7,049	6,994	99.2
Cincinnati	6,452	6,324	98.0
Dallas	21,220	21,145	99.6
Des Moines	6,282	6,229	99.2
Indianapolis	9,226	9,219	99.9
New York	20,582	20,251	98.4
Pittsburgh	8,461	8,281	97.9
San Francisco	49,573	49,578[a]	100.0
Seattle	10,384	10,372	99.9
Topeka	11,480	11,374	99.1

[a]Includes small amounts of unreconciled funds in commitment account.

Source: FHFB.

Another possible indicator of whether large or small districts are more effective in administering the AHP program is the relative number of applications from members. FHLBanks in smaller districts may have closer contact with their members because of the smaller district size and be able to attract more AHP applications. This could be important since, presumably, the more applications there are the more likely that good projects will be among the competitors for the limited funds.

Tables 5.4 and 5.5 show the results of this analysis. The tables show the number of applications per member for each district, for 1992, with the districts listed by asset size (table 5.4) and geographic area (table 5.5). The number of applications per member was chosen rather than simply the number of applications because districts vary widely in the number of members they have.

Table 5.4: Number of AHP Applications in 1992 Per FHLBank Member With FHLBank Districts Ranked by Assets of the FHLBank

FHLBank	Number of AHP applications per member
San Francisco	.62
New York	.32
Atlanta	.15
Dallas	.31
Boston	.30
Seattle	.58
Pittsburgh	.16
Chicago	.15
Indianapolis	.29
Cincinnati	.16
Topeka	.24
Des Moines	.27

Source: GAO calculations derived from FHFB data.

Table 5.5: Number of AHP Applications in 1992 Per FHLBank Member With FHLBank Districts Ranked by Geographic Size of the District

FHLBank	Number of AHP applications per member
Seattle	.58
Dallas	.31
San Francisco	.62
Des Moines	.27
Topeka	.24
Atlanta	.15
Cincinnati	.16
Chicago	.15
Indianapolis	.29
Pittsburgh	.16
Boston	.30
New York	.32

Source: GAO calculations derived from FHFB data.

We analyzed these data to see if there was any relationship between geographic or economic size and the number of AHP applications per member for 1992.[4] We found a moderately positive relationship between both variables and applications. In other words, larger FHLBanks (measured either by total assets or assets per member) tend to attract more AHP applications from each member. The same is true for geographic size, with the larger districts attracting more applications per member. Thus, any concern that larger FHLBanks or bank districts are less able to commit AHP funds or attract AHP applications is not supported by the indicators we examined.

We also discussed FHFB's experience with AHP with the FHFB official in charge of the program to get a perspective on whether some districts have better AHP programs than others. According to this official, each FHLBank has strengths and weaknesses in various parts of the AHP process. However, the official emphasized that all districts do an adequate job and none have experienced problems serious enough to jeopardize the program in their districts.

The data presented above and the experience of FHFB with AHP do not "prove" that affordable housing services would not deteriorate with consolidation. They do show, however, that the FHLBanks with economically or geographically large territories have experience with AHP that is similar to, or possibly more favorable than, that of the smaller FHLBanks. This gives some assurance to policymakers that consolidating some of the smaller districts would not necessarily result in a lower level of affordable housing services.

Branch Offices Could Maintain Appropriate Levels of Affordable Housing Services, Particularly in Rural Areas

The impact any future consolidation has on housing services could depend on the size of the new district and the resources devoted to affordable housing, including using branch offices to provide these services to the members. In fact, using branch offices to provide housing finance services, particularly in remote parts of a district, could enhance the provision of these services to members.

[4]We also looked at similar data concerning the relationship between the amount of resources each FHLBank devoted to affordable housing activities and the number of AHP applications received. There was a moderately positive relationship between these factors. In other words, increasing the amount of money spent on administering the program leads to more applications for AHP funding. Both variables were measured on a per-member basis. These and other data relevant to AHP can be found in appendix I.

Currently, there is no relationship between support for AHP and the percentage of population in rural areas. For example, the five districts with the highest percentage of rural population ("most rural") are Atlanta, Pittsburgh, Cincinnati, Indianapolis, and Des Moines. The average amount of AHP funds spent in rural areas by the 12 FHLBanks was 14 percent of total funding. The five most rural districts spent from 4 percent to 25 percent of their AHP funding on rural projects.[5] Thus, there is no obvious relationship between current efforts to support rural affordable housing and the percentage of a district's population residing in rural areas. Given this experience and the ability of any consolidated district to act affirmatively regarding rural affordable housing, we see no reason for concern that consolidation would necessarily lead to less affordable housing construction in rural areas.

Conclusion

The actual impact consolidation would have on affordable housing activities in general, and rural housing in particular, can be evaluated only after specific consolidations are proposed and implemented. However, our examination of current program experience led us to conclude that detrimental impacts are not likely.

Fannie Mae's and Freddie Mac's Affordable Housing Goals Should Not Be Extended to the FHLBank System

Congress mandated in HCDA three different and complex housing goals for Fannie Mae and Freddie Mac. The first is an interim target of 30 percent of the total number of dwelling units financed by mortgage purchases in the low- and moderate-income category for 1993-94. The low- and moderate-income categories were defined by Congress as income not in excess of 80 percent and 100 percent of area median income respectively. The second interim goal is a special affordable housing goal for families with incomes under 80 percent of the area median. This goal establishes a loan purchase target of $2 billion for Fannie Mae and $1.5 billion for Freddie Mac, with the dollar amount of these loan purchases equally divided among targeted low-income multifamily and single-family loans. The third interim goal targets 30 percent of the total number of dwelling units financed by mortgage purchases to be located in central cities, rural areas, or other underserved areas.

Following the transition period, HUD may by regulation adjust any of these housing goals. However, regarding the special affordable housing goal, Congress established a minimum goal of not less than 1 percent of the

[5]The figures for these districts are: Indianapolis (4 percent), Atlanta (10 percent), Pittsburgh (12 percent), Cincinnati (15 percent), and Des Moines (25 percent). Data for all districts can be found in appendix I.

dollar amount of the mortgage purchases by Fannie Mae and Freddie Mac, respectively, for the previous year.

In 1992, 29 percent of Fannie Mae's mortgage purchases were for low- and moderate-income mortgages, and 26 percent of its purchases were in central cities. In that same year, 24 percent of Freddie Mac's mortgage purchases were in the low- and moderate-income category, while 28 percent were in central cities.

The affordable housing goals for the FHLBanks are quite different and in one sense much simpler. AHP is the only FHLBank program with a binding goal. As noted previously, the System must contribute the greater of $50 million or 5 percent of the preceding year's net income through 1993. Since earnings in 1992 were considerably below $1 billion, the FHLBanks' AHP contribution in 1993 was $50 million. This minimum amount will rise to at least $75 million in 1994 and $100 million in 1995.[6] This goal is simpler in the sense that it requires expending a minimum amount of funds and is less dependent on a fluctuating volume of business.

CIP gives below-market advances to member banks. Although Congress did not establish any dollar volume goal for CIP advances, in 1991 FHFB began setting nonbinding CIP targets for the System and each of the 12 FHLBanks. For example, in 1991 and 1992 the System targets were $678 million and $795 million, respectively. These System-wide targets were substantially exceeded in both years: $948 million in 1991 and $1.28 billion in 1992. The System target in 1993 is $1.2 billion, which is equivalent to about 1.5 percent of the System's traditional advances. Prior to these FHFB-set targets, the total CIP advances amounted to $498 million in 1990. Although CIP advances can be used for both housing and community development loans, through September 1992 the overwhelming percent (98 percent) have gone to housing.

CIP has income limitations different from those established for Fannie Mae's and Freddie Mac's low- and moderate-income housing goals. The CIP income ceiling is 115 percent of area median income, while Fannie Mae's and Freddie Mac's low- and moderate-income goals were set not to exceed 80 and 100 percent of area median income, respectively. Although FHFB does not regularly collect income data under CIP, as it does under AHP, it did conduct an informal survey in 1992 of members that received CIP advances. This survey showed that most CIP loans went to borrowers

[6] The AHP subsidy would vary if the net income of the FHLBanks were above $1.25 billion in 1993 and $1.0 billion in 1994.

earning above (between 100 and 115 percent) the median income for their areas. This disparity in income requirements between Fannie Mae's and Freddie Mac's low- and moderate-income housing goals and those of CIP makes comparability difficult. This is because a loan to a household making between 100 to 115 percent of the area median income counts under the CIP standard but does not count under the Fannie Mae/Freddie Mac standard.

Conclusions

The current housing goals of the GSEs are very different. One is set as a percentage of mortgage purchases, while the other is set as a percentage of net income with a minimum dollar amount. The financial requirements of the programs used to achieve the goals are also quite different. Fannie Mae and Freddie Mac are expected to make a profit on the loans they purchase while pursuing their goals. In the FHLBanks' case, AHP is a direct subsidy from their net income, that is, every dollar they spend is a dollar less profit.

The mechanisms the GSEs use to achieve the goals are also dissimilar. Fannie Mae and Freddie Mac purchase mortgage loans. Consequently, they can exert some control over the mix of loans they buy. This control, of course, is by no means absolute. These companies would be less profitable if they had to turn away other business in order to raise the percentage of loans in those categories that count toward their housing goals. The FHLBanks do not control how the members use traditional advances. Advances can be used for any purpose the members choose, as long as the advances are adequately collateralized. Since the FHLBanks do not make direct mortgage loans or buy loans originated by others, the amount of advances that go to fund low- and moderate-income housing, housing in designated areas, or other types of housing is essentially beyond the FHLBanks' control. AHP avoids this problem by specifying exactly how much money each FHLBank must provide. It guarantees that the funds will be used in the intended way by setting up a mechanism that ensures the funds will be used on approved projects only.

Since the FHLBanks have no control over whether advances are used for low- and moderate-income housing, applying Fannie Mae's and Freddie Mac's goal to the FHLBanks would not be practical under current circumstances.

Should the FHLBank System Offer New Products and Services?

By creating the Affordable Housing and Community Investment Programs discussed in chapter 5, Congress has moved the FHLBank System into new activities involving System support of affordable housing and community development lending. A major public policy issue regarding the System is whether to continue to expand the System's credit products and services. Addressing this issue raises the fundamental question of whether the System should continue to operate in its traditional "no risk" mode or, because of changing needs for housing finance, continue to expand its product lines and the risks it assumes.

Generally, we believe that the housing finance industry is meeting the credit requirements of middle and upper income households. However, the same may not be true for lower income households. We believe if the System were to expand its product lines to serve this group, either through direct purchases of loans from its members or through credit enhancements, it should do so only after satisfying rigorous criteria that take into consideration the public benefits as well as the associated risks. We developed a set of criteria for judging proposals for new products and services. These, or similarly rigorous, criteria need to be used so that the safety and soundness of the System is maintained and new products and services are compatible with the System's mission. We also believe that these same criteria should be applied in determining whether the System should expand its role as a support mechanism for community-based lenders.

Regarding the question of expanding collateral that can be used to support FHLBank advances, we found the current eligible collateral to be adequate.

Criteria for Judging Whether FHLBanks Should Offer New Products and Services

Some of the proposals listed in questions 4 and 6 of the HCDA mandate may have merit; however, we believe that a consistent set of criteria should be used to judge whether they are good ideas. In addition, we believe that future proposals need to be rigorously evaluated against consistent criteria. In that spirit, we developed evaluation criteria on the basis of discussions with System members and FHFB and FHLBank officials and by considering criteria put forward by other interested parties.

Criterion 1: Avoiding Competition Between FHLBanks and Their Members

FHLBanks should not offer products and services that put them in competition with their members. The reasoning here is obvious—competition between the FHLBanks and their stockholder/members would create serious conflicts of interest for the FHLBanks and could damage the financial health of their federally insured members.

Criterion 2: Expertise for New Business

FHLBanks should have the expertise to carry out new activities profitably. A corollary to this criterion is that the new activity should not require skills that are unrelated to current operations. If the activity requires exotic skills, senior management may not fully understand the new activity. Without a thorough understanding of the risks involved, it may be difficult for management to monitor and control the new activity. With GSEs this is even more true because of the potential risk that ill-advised ventures place on the government and the taxpayer.

Criterion 3: Consistency With FHLBank System Mission

Since GSEs exist to carry out a public purpose, their activities should be consistent with that purpose. FIRREA expanded the public purpose of the System beyond just supporting housing finance to include supporting affordable housing and community development.

Criterion 4: Added Value

We believe there is no reason for the System to undertake an activity unless it clearly is a net benefit to participants in the housing finance market. This means that the new product or service is addressing a need that others are not adequately meeting. Thus, if the private sector is providing the product or service, the System should not expand into that line of business. As a GSE, the System has economic advantages; it would not be fair for the System to employ those advantages to penetrate markets adequately served by fully private firms.

Criterion 5: Proper Pricing

Any new products or services the System offers should be properly priced. This means that the price should provide an adequate rate of return to the FHLBanks after any risk adjustments. Underpricing fails to produce an adequate risk-adjusted rate of return, which would eventually threaten the capital of the System. Further, it may have anticompetitive effects by inhibiting private sector firms from offering the same product. If such a pricing policy is followed, there would be no subsidy to customers through pricing the product or service below its cost to the FHLBanks.

Criterion 6: Appropriate Risk

The System's AAA rating for its consolidated obligations should be maintained to help protect taxpayers against loss. Any new activity, while not necessarily meriting a AAA rating itself, should not cause a material deterioration in the System's level of safety and soundness. The System would also have to reserve adequate capital against the anticipated risk.

Opportunities Exist to Expand Products and Services, but Associated Risks Must Be Properly Managed

The capital markets today provide mixed results in meeting the credit needs for housing finance. Specifically, in the areas of conforming single-family mortgages, "jumbo loans,"[1] and construction loans, the capital markets are generally satisfying credit demand; accordingly, we see no need for the System to expand its support in these areas. Conversely, some low-income housing advocates believe that the capital markets are not providing sufficient mortgage credit to meet the need for multifamily housing for lower income households, possibly creating a market opportunity for the System.

Limited Opportunities for Purchasing Housing-Related Assets

Question 4 of the congressional mandate asks, in part, whether the FHLBank system should expand by beginning to purchase housing-related assets from its members. There are many kinds of housing-related assets. They vary according to type of housing (single or multifamily), whether the asset conforms to secondary market underwriting standards, size and type of loans, and type of financial instrument (whole mortgage or mortgage-backed security). Four of the most commonly discussed housing-related assets are (1) conforming single-family mortgages, (2) nonconforming single-family mortgages, (3) multifamily mortgages, and (4) construction loans.

Conforming Single-Family Mortgages

The idea of FHLBanks purchasing conforming single-family mortgages from their members violates some of our criteria. Most notably, it fails the "added value test." Fannie Mae and Freddie Mac clearly meet the need for a secondary market for conforming mortgages. This point was made by the President of the FHLBank of San Francisco both in testimony before FHFB and in correspondence to us, noting that Fannie Mae and Freddie Mac already offer FHLBank members liquidity for conforming mortgage loans that they want to sell. In addition, the president noted that the FHLBanks would not be able to achieve the level of efficiency that Fannie Mae and Freddie Mac have achieved in purchasing and securitizing conforming single-family mortgages. The Savings and Community Bankers of America

[1] For single-family units, mortgage loans above $203,150—the current conforming loan limit—are defined as jumbo loans.

and the Independent Bankers Association of America also testified that there is no viable role for the System in securitizing conforming single-family loans. They feel that the market is well served by the competition between Fannie Mae and Freddie Mac. Consequently, there is no obvious value the FHLBanks can provide in this area. Also, the FHLBanks presently do not have the expertise for purchasing and securitizing conforming single-family mortgages. Secondary mortgage market operations are highly sophisticated and specialized. It may be difficult for FHLBanks, which have no experience in the secondary market, to develop or acquire sufficient expertise to compete with Fannie Mae and Freddie Mac.

Nonconforming Single-Family Mortgages

The second housing-related asset we considered—nonconforming single-family mortgage loans—are of two basic types: jumbo loans (those above the $203,150 conforming limit) and loans below the limit that do not meet conditions for sale on the secondary market. Jumbo loans seem to be readily available; in fact, many members of the System make such loans and hold them in portfolio. There is also an emerging private secondary market in jumbo loans. Thus, having the FHLBanks purchase jumbo loans would not meet a real need and would likely put the FHLBanks in competition with their members.

The case of smaller nonconforming loans is less clear. The size of the unmet need for nonconforming small mortgages is not clear because the data are incomplete. Data limitations also impede an evaluation of the riskiness of these loans; thus, the impact of buying them on the System's AAA rating is uncertain.

Although the evidence is equivocal, advocates for low-income groups are strong supporters of expanding the FHLBanks' involvement in purchasing nonconforming single-family mortgages. Specifically, the National Council of State Housing Finance Agencies maintains that there is a large unmet need for nonconforming single-family loans for lower income persons. The Council believes the FHLBanks could meet credit needs of lower income persons who are underserved by the standardized products like those offered by Fannie Mae or Freddie Mac. In the opinion of the Council, meeting these credit needs would give the FHLBanks an opportunity to add a profitable line of business that is consistent with their mission. The Consumer Federation of America shares the Council's opinion that mortgage credit is scarce for such borrowers, particularly those in rural and inner-city communities who do not meet standard underwriting criteria.

However, a factor that may influence the availability of financing for smaller nonconforming single-family mortgages is the housing goals established for Fannie Mae and Freddie Mac in HCDA. This act established these housing goals for low- and very-low-income homebuyers. To the extent that low- and moderate- income homebuyers are greater users of nonconforming small loans, this market may be served more as the other housing GSEs change their standards in an attempt to penetrate it to achieve their goals. It would probably be prudent to wait until the data in this area become clearer and the outreach activities of Fannie Mae and Freddie Mac are evaluated before the FHLBanks enter this market.

Multifamily Mortgages

There has been considerable discussion concerning whether the System should buy mortgages for multifamily housing. Our report on a congressionally mandated study of credit enhancements for affordable multifamily mortgages[2] points out that financing available to multifamily housing has been declining since the mid-1980s, largely because of (1) changes in federal policies and regulations on housing subsidies, taxation, and banking; (2) the poor performance of multifamily mortgages purchased or insured by major financial institutions; and (3) overbuilding in certain housing markets. Since the early 1980s, the Community Reinvestment Act has encouraged more local banks and thrifts to be active lenders in low- and moderate-income neighborhoods. Many of them originate and service affordable multifamily housing loans. However, the complexity of originating and servicing affordable multifamily mortgage loans requires specialized staff that smaller financial institutions often cannot support. Several of these lenders have overcome this problem by forming metropolitan or statewide loan consortia to specialize in this type of lending.

Despite a generally positive track record by these affordable multifamily housing lenders, because of a lack of standardization in multifamily loans, only a handful have successfully sold their loans on the secondary market. This is particularly true for projects serving low-income families where complex financial structuring results in variations in mortgage terms, conditions, and underwriting criteria. The System would have to develop minimum standards for purchasing multifamily affordable housing loans. To be effective, such standards would have to strike an appropriate balance between the need for System members to exercise their judgment in underwriting individual mortgages while also providing for proper risk management. If this balance were struck and more lenders entered the

[2]Housing Finance: Expanding Capital for Affordable Multifamily Housing (GAO/RCED-94-3, Oct. 28, 1993).

market, the supply of credit for multifamily lending might increase. Thus, there is at least a putative case that the FHLBanks could add value to the real estate market by buying mortgages on affordable multifamily projects.

Accepting this for the moment, how does the idea of purchasing multifamily loans fare against the other criteria? The activity seems to be consistent with the System's mission. Since these loans would be bought from the members, it is unclear whether purchasing such loans would put FHLBanks in competition with their members. That leaves the questions of expertise, proper pricing, and risk.

The FHLBanks do not currently have the expertise to evaluate individual affordable multifamily housing loans, and acquiring the proper expertise could take some time. While some private lenders that specialize in such lending have had great success, other financial institutions in the broader multifamily housing market have had greater difficulties. For example, the Federal Housing Administration (FHA) and Freddie Mac each incurred significant losses in their multifamily mortgage portfolios in the 1980s and early 1990s. These losses were mainly due to poor program management, inexperienced underwriters, and ineffective loan monitoring. The System would have to take care that it acquired the necessary skills to avoid the problems experienced by others in this area.

Proper pricing and risk evaluation could also pose problems in buying multifamily mortgages. Pricing and risk assessment depend on an accurate evaluation of prospective loan performance. Such an evaluation would have to be based on experience with multifamily projects. However, multifamily mortgage underwriting is much more complex than underwriting single-family mortgages. There is no national database on multifamily loan performance. Congress established, in section 543 of HCDA, a federal task force that will be co-chaired by the Secretary of HUD and the Chairman of FHFB. The primary purpose of this task force is to develop recommendations for establishing a multifamily database that could be used by interested developers, lenders, credit enhancement providers, and investors. However, Congress has yet to appropriate funds for the task force to carry out its mandate.

In summary, there are some factors that would support the purchase of multifamily mortgages by FHLBanks. However, as noted above, there are constraints that the System would have to overcome before it became involved in this activity without compromising System safety and soundness.

Construction Loans

Some industry observers have suggested that the FHLBanks make direct loans for housing construction. However, this idea violates several of our criteria for judging new products and services. In the case of competition, System members make construction loans. In addition, the Independent Bankers Association of America testified during a public hearing sponsored by FHFB in March 1993 that the housing construction industry has sufficient sources of construction credit, so this demand is probably being adequately served by the private sector.

Also, the San Francisco FHLBank advised us that it does not believe that such activity would add value for the FHLBank or its members. In its view, construction lending is an extremely risky activity. First, the potential for increased earnings from such activity is slight. The San Francisco FHLBank's analysis showed that, as with purchasing housing-related assets, the increased risk to the FHLBanks and the significant investment in time, capital, and personnel required to make direct housing construction loans would offset any increase in revenue. The FHLBank of San Francisco also commented that direct construction lending lies outside the bank's core competencies. Officials of the Indianapolis and Topeka FHLBanks concurred with the San Francisco FHLBank in their opposition to making direct construction loans.

FHLBanks Could Use Credit Enhancements to Encourage Lending for Affordable Housing

Credit enhancements are mechanisms to transfer the credit risk of a loan or pool of loans from one party, such as a lender, to another party, such as an investor or insurer. Credit enhancements can make more capital available at lower rates and/or for longer terms by substituting the creditworthiness of the enhancer for that of the project. System members could benefit from credit enhancements because enhancements could lower risk-based capital requirements for portfolio loans and could also increase the amount of loans members could make to individual borrowers. The latter is particularly important to smaller community-based lenders operating with limited capital bases.

If the FHLBanks were to provide credit enhancements, the enhancements could take a number of forms. Some common credit enhancements are mortgage insurance, guarantees (often of securities based on mortgages), letters of credit, and overcollateralization of loans. However, whatever the exact form of the enhancement, it would entail the FHLBank picking up some credit risk of an individual project and reserving the appropriate capital to compensate for the risk. If the FHLBank assumed this risk, the

project would be less risky for the member-lender, who could then provide the financing on better terms than it could without the enhancement.

The private sector offers credit enhancements for single-family mortgages and securities backed by these types of mortgages. However, a number of regulatory and risk-related factors have limited or eliminated the use of these credit enhancements for multifamily housing in general and affordable multifamily housing in particular.

Private companies and GSEs charge fees for their credit enhancements. The fees charged for these enhancements compensate the enhancers for the risk they bear and include a return on their capital. If the FHLBanks were to enter the credit enhancement business, they would presumably charge member-lenders on the same basis. Any price for this service lower than one that fully compensates for risk and return on FHLBank capital would entail a subsidy to the member-lender (and possibly the borrower). However, evaluating the credit risk involves more than just assessing the quality of the individual loan insured; it also involves judgments regarding the experience and degree of success the individual lender has had in making these kinds of loans in the past. Because the System enjoys a competitive advantage over private sector companies through its oversight of members' financial condition, it may be able to charge a lower fee on the basis of its more thorough knowledge of lenders than is available to outside private insurers.

How does the idea of providing credit enhancements fare when evaluated under our criteria? First, credit enhancements would presumably be provided only at the request of the member-lender. If this were the case (that the FHLBank did not market credit enhancements loans directly), there would not be a problem of competition between the FHLBank and its members.

Second, as is true in the case of buying multifamily mortgages, providing credit enhancement for multifamily housing is fundamentally different from the FHLBanks' core wholesale banking business, and the FHLBanks do not currently have the necessary expertise. They would have to develop it before meeting our second criterion. In the case of wholesale banking, what is important is the creditworthiness of the borrowing institution. In contrast, when an institution buys individual loans or sells credit enhancements, the creditworthiness of the particular loans, as well as the capacity of the lending institutions to originate and service these loans, is crucial. While the FHLBanks would have to develop the expertise to

evaluate the quality of individual loans or pools of loans, the System already has some valuable expertise. This expertise is based on the FHLBanks' close and continuous review of their members' financial condition. The FHLBanks also have some knowledge of local and regional housing markets, particularly the low- to moderate-income markets, through AHP and CIP.

The third criterion concerns consistency with the System's mission. If a credit enhancement program were targeted to housing only, it would be compatible with the FHLBanks' housing mission.

The fourth criterion is that the activity has to add value. The purpose of a credit enhancement is to reallocate risk, in this case from the affordable housing lender or developer to the FHLBank. The fees paid for the reallocation should compensate for the risk transferred. If they compensate exactly, then a credit enhancement may not add value. If however, the FHLBank can judge the risk more accurately than a private lender, and if private lenders are overly cautious in evaluating the risk of affordable multifamily housing, then the FHLBank can make a profit while adding to the stock of affordable multifamily housing.[3]

Evidence on this question is not conclusive. For example, FHA experienced large losses in its coinsurance program. These losses demonstrate that multifamily lending can be risky and that careful analysis of credit risk is crucial. At the same time, there are a number of innovative lending institutions, committed specifically to affordable multifamily housing, that have achieved consistent records of success in this area. Given this disparity in experience, there is a recognized need for further analysis to understand the factors that generate successful affordable multifamily housing finance. As noted previously, Congress responded to this need by authorizing the creation of an interagency task force that is to develop recommendations for establishing a national database on multifamily housing loans. Such a database would certainly be useful to the FHLBanks and other agencies that might consider offering credit enhancements on multifamily mortgages.

There are also other reasons credit enhancements may be economic. Regulatory constraints are often cited (e.g., risk-based capital rules that

[3]For example, suppose a lender believes a project is risky and would only offer a loan to a developer with an interest rate 1 percentage point above the true risk level, which is 10 percent. A credit enhancer could guarantee the loan for less than a 1 percentage point premium (e.g., .5 percent). In that case, the lender could make the loan at 10.5 percent (10 percent plus the .5 percent guarantee fee). In this case, all three parties would be better off.

make it more expensive to hold a whole loan than to hold a guaranteed loan or limits on loans to one borrower). If the private market is not filling this need, then there may be an opportunity for the FHLBanks to provide a valuable service.

For credit enhancements to be properly priced, the fifth criterion, a FHLBank would have to set the price to cover all its costs. Included in these costs are (1) establishing an adequate capital base to back activities that carry demonstrable credit risk and (2) providing a market rate of return on the capital devoted to this line of business. As pointed out in chapter 3, under the current system this risk-based capital should be built from retained earnings. We also pointed out that it will be difficult for FHLBanks to generate enough retained earnings to build capital while funding the REFCorp and AHP obligations and maintaining adequate dividends on members' stock. Thus, we do not know whether the System would have the financial means to add credit enhancements or other activities until an adequate capital base is established.

The sixth criterion is that the activity should not materially increase risk in the System. Since the purpose of a credit enhancement is to transfer risk, the FHLBanks would obviously be taking on this additional risk. Assuming the enhancement was properly priced and enough capital was set aside to cover the risk, selling credit enhancements should not materially compromise the System's AAA rating. In order to ensure that the System's credit rating was not compromised, a credit enhancement program should start out on a small scale until adequate experience and reliable data on true risks are acquired. One such risk reduction mechanism already exists. Congress recently enacted a new FHA demonstration program for affordable multifamily housing. The program requires FHA to make risk-sharing agreements with "qualified financial institutions" and specifically mentions FHFB as such an institution. One way of limiting a new credit enhancement program would be to restrict the amount of credit enhancement the System could provide either to a fixed amount or to a small percentage of the System's capital. An alternative of this approach would be to capitalize a separate subsidiary to provide the credit enhancement. Such a suggestion was made by the Affordable Housing Advisory Council of the FHLBank of Chicago.[4]

[4]The Affordable Housing Advisory Council of the FHLBank of Chicago stated that it believes that a subsidiary to the whole System could limit the System's liability to the amount of paid-in capital and could also develop the resources to hire and retain specialized staff needed to design and monitor new credit enhancement products. Finally, the subsidiary could develop long-terms relationships with other national credit enhancement programs, such as the FHA demonstration program discussed earlier, rather than having 12 FHLBanks each develop such relationships.

In summary, it may be possible to design a credit enhancement program for multifamily affordable housing that would meet our criteria. Any proposal for providing new products and services, including multifamily mortgage credit enhancements, should be submitted to FHFB for review and public comment. This review should ensure that the proposal satisfies our criteria or a similarly rigorous and comprehensive set of criteria.

Presently No Evidence to Support the Need to Expand Eligible Collateral

Question 5 asked for an assessment of the advantages and disadvantages of expanding eligible collateral for advances to member institutions. Many types of collateral can be used to secure FHLBank advances. Residential mortgages are the most important, but all securities issued by the U.S. government or the other housing GSEs are eligible in any amount. In addition, other housing-related assets are eligible to comprise up to 30 percent of the member's capital. In 1992, members held about $760 billion in these categories of assets that could be pledged as collateral for advances. Simultaneously, members held approximately $80 billion in advances. Thus, the collateral base seems to be more than adequate to meet the task of supporting advances.

Expanding FHLBank Support for Community-Based Lenders and Housing Finance Should Be Evaluated on a Case-By-Case Basis

Question 6 of the congressional mandate asks about advantages and disadvantages of "further measures to expand the role of the FHLBank System" to support community lenders and housing finance. The question does not specify what these measures might be, but they are presumably different from the possible expansions set forth in questions 4 and 5. Any such proposals, we believe, should be evaluated using the criteria enumerated previously. Only the proposals that meet these criteria should be seriously considered.

Reform of FHFB's Responsibilities Needed

In our 1991 GSE report, we raised several concerns about the corporate governance responsibilities that FHFB carries out for the System under its charter.[1] We also identified five criteria that we believe a federal GSE regulator needs to meet to carry out its oversight responsibilities effectively. We pointed out that FHFB, as well as most other GSE regulators at that time, failed to meet several of these criteria.

We revisited these issues in this study on the FHLBank System. We continue to believe that FHFB plays an inappropriate role in managing the System. We also found several instances where FHFB, far from being arm's length from the System, has adopted an advocacy role that we believe is inappropriate for a safety and soundness regulator.

We believe that the System should manage itself, as other GSEs do, and that Congress should shift FHFB's management functions to the FHLBanks and their members. We also believe that there should be a single safety and soundness regulator for the housing-related GSEs. We propose that Congress should create such an agency by merging the safety and soundness regulatory functions of FHFB and those of OFHEO.

The Federal Housing Finance Board Inappropriately Combines Safety and Soundness Oversight and System Management Functions

We have had serious concerns about FHFB's role in managing the FHLBank System since FHFB was established in 1989. In our 1991 report on GSEs, we commented that "a GSE regulator should usually not involve itself in the GSE's business affairs by approving budgets, salaries, hiring decisions, etc."[2] At that time we observed that "having broad management oversight powers may undermine FHFB's regulatory independence. By involving itself in the business operations of the FHLB system . . . FHFB is not arm's length from the outcome of those decisions. In effect, it becomes an advocate for the system. As a result, FHFB would not be an impartial judge of outcomes arising from such decisions."[3]

There has been no lessening of FHFB's management of the FHLBank System since we issued that report. FHFB still approves FHLBanks' budgets, salaries, and staffing levels and is involved in many management processes it must then audit or examine. For example, all AHP projects must be approved by FHFB. In effect, the program is run by the regulator.

[1]Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991).

[2]GAO/GGD-91-90, p. 32.

[3]GAO/GGD-91-90, p. 33 and 34.

FHFB is also responsible for examining the FHLBanks' execution of the AHP projects FHFB has previously approved; this is clearly a potential conflict of interest.

FHFB itself recognizes these conflicts. In its recent report, FHFB said that "the roles of regulation and governance residing in one entity are not compatible and, indeed, represent a long-standing, well-understood inherent conflict when joined."[4]

However, our concerns now run deeper. We reported in 1991 that independence and objectivity were crucial to having effective safety and soundness regulation. We said:

"Our experience in auditing bank and thrift regulators convinces us that the regulator's function should not be to promote a GSE over other market participants nor should it include promotion of the economic sector served by the GSE. Under this criterion, the regulator would have to ensure that a GSE complies with its responsibilities under its charter, but would not be allowed to coerce the GSE into activities that go beyond the charter requirements.

"We also believe a regulator that oversees a single regulated entity may have difficulty remaining at arm's length from that entity. This difficulty may stem from the fact that the future of the regulator may depend on the continued existence of the regulated entity."[5]

We recognize the difficult balancing act imposed on FHFB of having both governance and safety and soundness responsibilities. Still, FHFB clearly violates this independence criterion and has become a direct advocate for the System. Two examples make clear that FHFB is operating inappropriately as the System's advocate and manager.

First, FHFB's Congressional Affairs Division developed a congressional outreach plan in late 1992 that is designed to coordinate FHFB's and FHLBanks' congressional lobbying. FHFB presented this plan to the FHLBank presidents in the fall of 1992, soliciting their input. FHFB then distributed a revised plan in December 1992 that incorporated comments from the FHLBank presidents. The document outlines the shared responsibilities between FHFB and the FHLBanks in lobbying Congress on behalf of the System. FHFB defines its role to include presenting the System's views to Congress: "Through its Office of Legal and External Affairs' Congressional Affairs Division, the Finance Board would deliver

[4]Report on the Structure and Role of the Federal Home Loan Bank System, p. 153.

[5]GAO/GGD-91-90, p. 45.

the System's policy message to the Banking Committee staff and Banking Committee Members' staff." The document also says that FHFB "would meet with the District Bank Congressional liaisons to coordinate strategy." At another point, the document says "it is important to recognize the interdependence of the Finance Board and the District Banks in Congressional Affairs matters...." We believe that a federal regulator responsible for protecting taxpayers by ensuring a GSE's safety and soundness should not be engaged in such activity.

Second, FHFB is also intimately involved in planning the System's future through participating with the FHLBanks in developing a strategic plan. This "System 2000 Plan" will set parameters and policies for the System's future business. The plan is clearly a management plan, not a regulatory plan. Participation in such planning activities is not normally undertaken by regulators.

FHFB's Safety and Soundness Regulatory Function Could Be Improved by Merging It With That of OFHEO

In our 1991 GSE report, we identified five criteria that a GSE regulator should satisfy to be an effective safety and soundness regulator.[6] On the basis of these criteria, we recommended that Congress establish a single regulator for all GSEs. While Congress did not implement this recommendation, in 1992 it created OFHEO to assume safety and soundness oversight responsibility over Fannie Mae and Freddie Mac.

In our 1991 report, we applied our criteria to FHFB and found that FHFB had structural deficiencies that raised questions about its potential to be an effective safety and soundness regulator. Similar concerns arise if these criteria are applied to OFHEO. Combining FHFB's and OFHEO's responsibilities into a single, independent regulator responsible for overseeing all the housing-related GSEs would overcome some shortcomings of both agencies.

FHFB and OFHEO Each Fail to Satisfy Key Criteria for Effective Regulatory Structure

The first criterion for a safety and soundness regulator enunciated in our 1991 report was independence and objectivity. This criterion states that a regulatory structure should require an arm's-length evaluation of the regulated entity's safety and soundness. We believe that recent experience demonstrates that a regulator should promote neither the regulated entity/industry nor the market served by the regulated entity/industry. As we noted above, FHFB is not arm's length from the System and so does not meet this criterion.

[6] GAO/GGD-91-90. This section draws on chapter 3 of this report.

The structure set up for OFHEO should help it to be somewhat more arm's length from Fannie Mae and Freddie Mac than FHFB is from the System, since OFHEO does not involve itself in managing Fannie Mae and Freddie Mac. However, it may be difficult for OFHEO to remain fully arm's length from its regulatees over time because it is responsible for just two similar GSEs. This difficulty may stem from the fact that OFHEO's future may depend on the continued existence of Fannie Mae and Freddie Mac.

Structurally, OFHEO, while a part of HUD, is supposed to be largely independent of HUD's authority.[7] While OFHEO is charged with overseeing safety and soundness, HUD retains authority for overseeing Fannie Mae's and Freddie Mac's compliance with government housing goals. It remains to be seen how HUD's authorities as a promoter of housing will interact with OFHEO's responsibility to ensure that Fannie Mae and Freddie Mac operate safely and soundly.

By merging FHFB's and OFHEO's responsibilities, we believe that the combined entity can be more independent and objective than retaining two separate entities. Since the operations and interests of the System do not align precisely with those of Fannie Mae and Freddie Mac, there should be a healthy tension in the oversight of these GSEs that may help avoid the regulator being "captured" by its regulated entities.

The second criterion we enumerated was prominence within government. We pointed out that inadequate prominence "may make it difficult for a GSE regulator to raise safety and soundness concerns to Congress and the administration in a timely manner."[8] We believe that a combined regulator of all housing GSEs may have more prominence than either FHFB or OFHEO.

The third criterion for a GSE regulator is economy and efficiency. OFHEO is too new to have a track record in this regard, and we have not done an efficiency study of FHFB. Still, we pointed out in our 1991 report that any regulator incurs significant overhead costs. FHFB has about 105 full-time staff equivalent positions to oversee the 12 FHLBanks. OFHEO was originally budgeted to have a staff of 30 and has recently been authorized to increase its staffing level to 45. Combining FHFB and OFHEO would spread some of this overhead, such as administrative staff, examiners, financial analysts, attorneys, and an inspector general, over a larger span of activities. The net result should be lower costs than would be the case

[7]For example, OFHEO has sole authority to issue safety and soundness regulations, conduct examinations, and determine capital levels. It also sets its own personnel level and budget.

[8]GAO/GGD-91-90, p. 45.

with two separate regulators. In addition, bringing oversight of the three housing GSEs together would enable the staff to share expertise in such areas as examinations, monitoring credit and interest rate risk, and financial analysis.

The fourth criterion is separating primary and secondary market regulation. This means that a GSE regulator should not be responsible for overseeing other regulated entities that are counterparties (customers) of the GSEs. This is not a problem for either FHFB or OFHEO.

The fifth criterion is consistency—competing institutions should be subject to the same regulatory regime. While the System, Fannie Mae, and Freddie Mac do not directly compete in all of their activities, they are all players in the residential mortgage market. Consolidating their regulation would enable a regulator to take into account the competitive effects that regulatory decisions made concerning Fannie Mae and Freddie Mac would have on the System, and vice versa.

Considerations in Combining FHFB and OFHEO

If safety and soundness regulation of the housing-related GSEs were consolidated through a merger of FHFB and OFHEO, the regulator's authorities should be expanded in one respect. Most safety and soundness regulators (including FHFB) have the power to remove officers of the businesses they regulate under specified conditions. OFHEO was not given this authority. We believe that this authority should be included in the combined regulator's powers.

We also note that combining FHFB and OFHEO would give the combined entity a strong staff base to start with. The combined entity could retain those staff at FHFB involved with safety and soundness oversight and augment them with OFHEO staff that have been recently hired.

The appropriate location for FHFB staff that develop and monitor the System's housing mission is ambiguous. In our 1991 report on GSEs[9], we recommended including both the safety and soundness and the program regulation in a single regulator. However, in HCDA, Congress elected to divide these responsibilities for overseeing Fannie Mae and Freddie Mac between two separate entities within HUD. Congress assigned safety and soundness oversight of Fannie Mae and Freddie Mac to OFHEO but assigned oversight of these GSEs' housing mission to HUD's Office of the Secretary.

[9]GAO/GGD-91-90, p. 28 to 31.

One question concerning a possible merger of FHFB and OFHEO is whether the combined entity should be a stand-alone independent agency like FHFB or an independent office within HUD, like OFHEO. Either approach is plausible; our concern is that whatever structure is chosen satisfy the criteria described above for an effective regulatory structure.

Currently, HUD has a relationship with both FHFB and OFHEO. As noted, OFHEO is an independent office within HUD. FHFB, while an independent agency, is run by a five-member board that includes the Secretary of HUD as an ex officio member. The other four board members are not permitted to serve in any other federal government position, so they do not have direct ties to other executive branch agencies.

Finally, we are concerned that OFHEO's current structure makes it subject to budgetary pressures that could conflict with its needs as a safety and soundness regulator. While OFHEO may set its budget and its personnel level free from involvement by HUD, these must still be approved by Congress through HUD's annual congressional appropriation. Thus, even though OFHEO's budget will be funded by assessments on Fannie Mae and Freddie Mac, its budget has been altered by the appropriations process.

Corporate Governance Should Reside in the FHLBanks

The FHLBank System does not have a corporate governance mechanism. Since all FHLBanks are jointly and severally liable for the System's debt, there may be a need for a central coordinating mechanism. Currently, FHFB serves in that role. As pointed out above, we believe this is inappropriate and if the System needs a separate governance mechanism, it should reside within the System itself.[10]

In theory, there are several alternative forms of corporate governance depending on the extent of central control the System needs. If the need for central control is perceived to be great, a holding company model may be appropriate. Under a holding company scheme, the central body often asserts control through organizational structure and by setting operational policies. Bank holding companies often attempt to integrate their subsidiaries organizationally by having representatives on the subsidiaries' boards of directors. They also often have management committees made up of holding company and subsidiary company representatives to deal with certain policy areas. The parent company may also establish operational influence through financial reporting by the subsidiary, parent

[10]GAO/GGD-91-90, p. 33 and 34.

company approval of subsidiary bank budgets, and centralized auditing and accounting.[11]

The reason the holding company can exert control over subsidiaries is ownership, which conveys the authority to set policy. The FHLBanks are, however, owned by their members. It would take some basis other than ownership authority for a central governing body to exert control over the FHLBanks. This is not a problem for FHFB since it also exercises supervisory and regulatory authority. However, it could be difficult for a central governing body that did not have ownership or supervisory/regulatory authority to make and enforce policy over an uncooperative FHLBank or group of FHLBanks. On the other hand, considering the considerable control now exercised by FHFB, the members might find it appropriate to transfer FHFB's governance functions to another institution.

Another way of implementing the holding company approach would be to drop membership in a particular FHLBank and institute at-large membership in the FHLBank System. This would be similar to having a single FHLBank with regional branches. The advantages of such an approach might be enhanced cost control through consolidation and centralization of certain business functions. The drawbacks might include hard-to-measure losses in service and responsiveness from a FHLBank that has a national rather than regional focus.

An alternative approach to System governance would be a body chartered to carry out specific functions on behalf of the System. The Farm Credit System (FCS)—the GSE most similar in structure to the FHLBank System—uses this approach to governance.[12] FCS operates under a "loose" governance model that grants a good deal of independence to its banks. FCS banks have considerable autonomy to conduct the affairs of their districts within regulations issued by the Farm Credit Administration (FCA), the FCS regulator. There is little central control and no central policymaking body as such.[13]

[11]John T. Rose, "Bank Holding Companies as Operational Single Entities," in The Bank Holding Company Movement to 1978: A Compendium, A Staff Study of the Board of Governors of the Federal Reserve System, p. 77 to 79.

[12]FCS, the core of which was established between 1916 and 1933, provides credit directly to farmers and ranchers. It consists of 10 Farm Credit Banks and over 200 associations. It also includes three Banks for Cooperatives that lend money to agricultural-related cooperatives and rural utility systems.

[13]While there is no central policymaking body that exercises independent power, FCS institutions consult extensively among themselves concerning topics of common interest in such forums as the Presidents' Planning Council, which includes the presidents of the Farm Credit Banks. The FHLBanks already have an informal coordinating body, the FHLBank Presidents' Conference.

The FCS has adopted a Contractual Interbank Performance Agreement (CIPA), which establishes performance standards for the banks. CIPA encourages FCS Banks to achieve financial and performance standards developed by FCS itself. These standards are in addition to the normal safety and soundness regulation and examination functions carried out by FCA.

CIPA is an agreement among the FCS banks to measure each other's performance and to provide economic incentives for the banks to achieve and maintain agreed-upon financial performance targets.[14] When a Farm Credit Bank does not achieve the agreed-upon targets for these ratios, it must place a percentage of its assets into a fund administered by the Farm Credit Funding Corporation, the fiscal agent for FCS. In addition, CIPA creates peer pressure to encourage Farm Credit Banks to perform adequately.

FCS has addressed other corporate governance issues in various ways. For example, the Farm Credit Funding Corporation not only acts as the fiscal agent for the System but also serves as its financial spokesperson. In addition, it provides financial advisory services and supports the FCS banks in interest rate risk management. FCS also has a full-service trade association, the Farm Credit Council. It acts as the FCS' Washington representative and provides support services to its members on a fee basis. Services commonly provided include training, marketing, insurance, and purchasing.

What is especially noteworthy about the institutions that FCS has developed is that they were set up by FCS, not by Congress or FCA. Thus, FCS has been evolving institutions to take care of at least some System-wide concerns through voluntary association.

How Much Need Is There for Central Corporate Governance in the FHLBank System?

What, then, would be the reasons why the System might need a central governing body? In its recently released System 2000 Plan, FHFB cited several functions that it believes the System needs to manage centrally. These functions include

- strategic planning,
- establishment of general credit policies,
- legislative coordination and lobbying,
- cultural leadership and image building, and

[14] The Banks for Cooperatives and CoBank are also included under CIPA.

- data collection and financial modeling.

The FHLBank Stockholders Study Committee proposes in its report that the FHLBank System create a central policy entity to "set broad policies for the Bank System for joint and several liability issues, capital, and risk management."[15] This proposal is similar to the CIPA agreement among the Farm Credit Banks.

Joint and several liability is an important issue for FCS, in part because agricultural lending has inherent risks. In the mid-1980s, various financial assistance agreements were used to enable some FCS institutions to provide financial assistance to financially troubled FCS banks and associations. Federal financial aid to FCS was enacted in 1987, with provisions for repayment of the assistance to be made by FCS over time.

Concerns about joint and several liability currently are relatively less important in the FHLBank System. As we noted earlier, no FHLBank has ever suffered a loss an any advance. The chances of joint and several liability being invoked to stave off default on FHLBank debt is quite small under the traditional risk profiles of the FHLBanks. This last qualifier is crucial. If the FHLBanks take on significantly more risk, as some of the proposals discussed previously would have them do, or as the fixed obligations might compel them to do, the chances of financial difficulty could increase. Then, the need for central oversight of access to the debt market and coordination of the FHLBanks' activities would also increase.

Governance functions such as those cited by FHFB or those cited by the FHLBank Stockholders Study Committee probably can be assigned to one or more entities by the System. While the details require more examination, a government-created central governance body does not appear to be necessary. The functions cited in the System 2000 Plan seem to us to be ones that could be carried out by an institution created by and accountable to the FHLBank System, not a federal agency.

FHFB, in its System 2000 Plan suggests a useful approach to beginning the process of separating System governance from safety and soundness oversight. Specifically, FHFB proposes the following three steps be taken jointly by FHFB and the FHLBanks:

- research the current legal authorities possessed by FHFB and the FHLBank Boards,

[15]The Future Direction of the Federal Home Loan Bank System, p. 44.

- explore the appropriate vehicle for coordinating System-wide business issues, and
- develop a contractual risk control agreement among the 12 FHLBanks.

These are practical steps toward identifying those powers that should be removed from FHFB and lodged in either the FHLBank Boards or a new central governing entity as appropriate. In any case, movement in this direction will require the cooperation and approval of the FHLBanks as well as legislative changes regarding management authorities currently assigned to FHFB.

Conclusion

Our analysis leads us to the conclusion that with no significant change in risk and with a strong safety and soundness regulator, the System can develop its own central governing body voluntarily. This avoids the problem currently embodied in FHFB in which the federal government takes an inappropriate role in managing (as opposed to regulating) the FHLBank System. FHFB has proposed a process that may result in a more detailed plan for devolving FHFB's management functions to the FHLBanks and possibly to a new central governance entity. We believe this is a positive step that should help lead to the eventual redesign of an arm's length safety and soundness regulator for the System.

Recommendations to Congress

To ensure an efficient and effective arm's length regulator for the System, we recommend that the safety and soundness functions of FHFB be merged with those of OFHEO. The merged entity could be an independent office within HUD (as OFHEO is now) or could be a stand-alone independent agency (as FHFB is now). The combined federal regulator would have full safety and soundness responsibilities for all three housing-related GSEs. We further recommend that corporate governance responsibilities currently assigned to FHFB not be given to the combined regulator but be left to the FHLBanks and their shareholders.

Housing Services and AHP Data

Table I.1: Projected Operating Expense Budget and Staffing Levels, Total and for Housing Services, at Each FHLBank

For calendar year 1992

FHLBank	Total budget (in thousands)	Total staff (FTEs)[a]	Housing services budget (in thousands)	Number of housing services staff (FTEs)[a]
Boston	$13,503	107	$1,082	9
New York	24,593	195	1,068	8
Pittsburgh	18,346	223	872	9
Atlanta	25,520	306	1,566	17
Cincinnati	16,983	220	927	10
Indianapolis	11,675	145	768	10
Chicago	11,979	111	515	6
Des Moines	16,320	257	547	8
Dallas	17,159	122	1,235	10
Topeka	13,122	186	380	4
San Francisco	28,319	190	920	8
Seattle	9,206	95	813	8

[a]Full-time equivalents

Source: FHFB.

Table I.2: AHP Awards by FHLBank District

For calendar year 1992

FHLBank	Number of AHP applications	Number of AHP awards	Dollar amount of AHP applications (in thousands)	Dollar amount of AHP awards (in thousands)	Number of members
Boston	100	23	$18,214	$3,900	338
New York	77	40	19,101	8,200	238
Pittsburgh	50	19	5,781	2,730	314
Atlanta	88	31	27,000	9,300	590
Cincinnati	65	42	7,409	3,000	460
Indianapolis	63	31	5,804	2,900	217
Chicago	49	27	6,810	2,900	321
Des Moines	79	39	4,765	2,600	289
Dallas	99	49	14,581	4,300	322
Topeka	52	26	7,857	2,900	216
San Francisco	104	54	41,940	16,100	169
Seattle	93	22	12,715	3,500	160

Source: FHFB.

Table I.3: Central City and Rural Population, by FHLBank District

For calendar year 1992

FHLBank	Percent central city population	Percent rural population	Percent AHP to central cities	Percent AHP to rural areas
Boston	30	26	67	13
New York	37	16	49	8
Pittsburgh	22	35	60	12
Atlanta	25	30	58	10
Cincinnati	27	33	77	15
Indianapolis	28	32	66	4
Chicago	36	21	79	7
Des Moines	24	34	56	25
Dallas	39	27	58	17
Topeka	32	28	47	29
San Francisco	42	8	28	1
Seattle	27	26	55	23

Source: GAO calculations using data from FHFB.

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