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## Testimony

Before the Subcommittee on Capital Markets, Securities, and  
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# FHLBANK SYSTEM

## Reforms Needed to Promote Its Safety, Soundness, and Effectiveness

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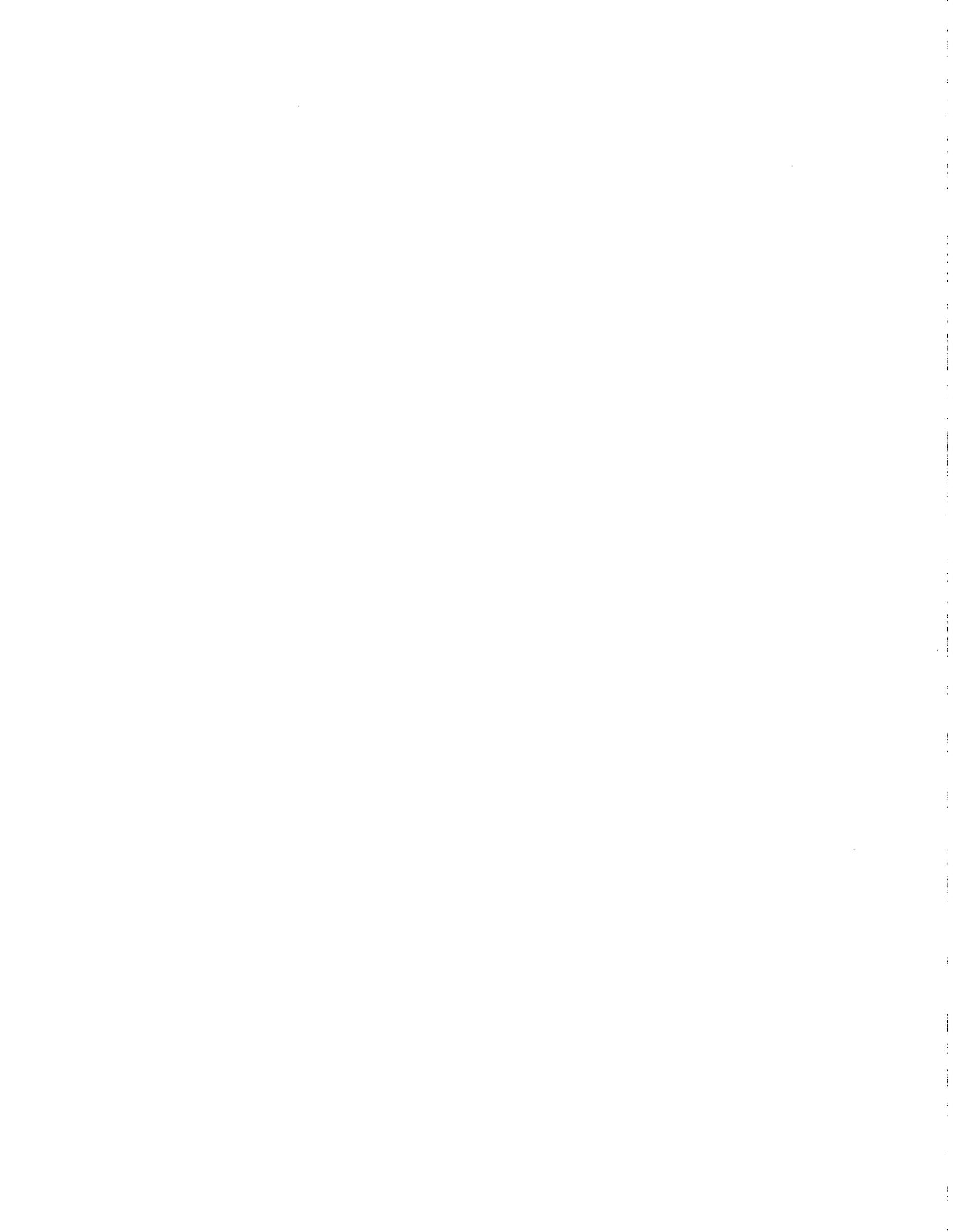
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Federal Home Loan Bank System  
Reforms Needed to Promote Its Safety, Soundness, and Effectiveness  
Summary of Statement by  
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U.S. General Accounting Office

In its 1993 report on the Federal Home Loan Bank System (System), GAO made a series of recommendations to improve its overall functioning. GAO believes that these recommendations are still relevant and would provide the basis for a safer and sounder System. The biggest obstacles to effective reform are the Resolution Funding Corporation (REFCorp) and Affordable Housing Program (AHP) annual System obligations. Because these are currently both fixed in amount and of substantial size, they affect the way the system functions and impose constraints on reform efforts. Activities undertaken to increase System income to pay the obligations may have increased the extent of risk in the System. Because one of the bases for paying the REFCorp obligation is the amount of advances made, Federal Home Loan Banks (FHLBanks) are penalized for providing liquidity for mortgage lending, which is the primary purpose of the System. The fixed nature of the obligations also may inhibit potential improvements in the capital structure, and complicate possible moves toward consolidation. In its report, GAO suggested two options to resolve this problem and improve System incentives. Each approach would base the payment solely on some ability-to-pay measure such as net income or assets. One approach includes a shortfall allocation and the other does not.

In 1993, GAO reported on several weaknesses in the System's capital structure. The most important weakness was that required capital was not tied to the risks each FHLBank incurred. In addition, the capital was impermanent--it could be readily withdrawn from the System, and could not be relied upon to provide a sufficient cushion during a crisis. GAO recommended a risk-based capital requirement to deal with the first concern and a retained earnings requirement to deal with the second. To reduce the potential for System instability that exists when there are both voluntary and mandatory members, GAO also recommended making membership fully voluntary with similar terms of membership for all. GAO also suggested that all voluntary membership would provide a better basis for any consolidation of the System to take advantage of potential efficiencies and cost saving opportunities.

In its report, GAO recommended combining the regulation of all housing GSEs under the same regulator. This would combine the Federal Housing Finance Board (FHFB) and the Office of Federal Housing Enterprise Oversight. GAO also found that AHP has generally met Congress' intent that it be a flexible source of funding for affordable housing. GAO believes that administrative control of the program along with other management functions should be devolved to the FHLBanks rather than having them set by FHFB.



Mr. Chairman:

I am pleased to be here today to discuss our views on reforming the Federal Home Loan Bank System (System). As you know, we published a report on this subject in December 1993,<sup>1</sup> responding to a mandate of the Housing and Community Development Act of 1992.

Since that time, several bills have been introduced--including proposals made by this Subcommittee and the Administration--that have incorporated recommendations we made in that report. None of these bills were passed and you decided, Mr. Chairman, to hold hearings to take a fresh look at the System. Thus, we are taking this opportunity to step back and discuss the most important features that we believe should be included in any reform of the System.

My testimony today will discuss and update our conclusions and recommendations on Federal Home Loan Bank (FHLBank) and System reform, and comment on some suggestions others have made since our report was published. In your letter inviting us to testify, you included a set of questions. We are providing our answers in an appendix.

Our overall discussion of issues related to reforming the System is based on work we did for our 1993 report and a review of other studies done on the System. More recently, we have analyzed various legislative reform proposals and discussed reform issues with both the members and staff of the Federal Housing Finance Board (FHFB).

OUR RECOMMENDATIONS STILL PROVIDE  
THE BASIS FOR A SAFER AND SOUNDER SYSTEM

Mr. Chairman, as we examine the debate that has ensued since we reported on System reform in 1993, we believe that the reforms we recommended at that time still have merit. To be sure, the debate in some areas has evolved and more analysis has been done since our report. However, the main features needed for System reform have not changed. These are as follows:

Reform Fixed Annual Obligations: Currently the System is obligated to pay two sizable annual fixed amounts, one for thrift resolutions (the Resolution Funding Corporation, REFCorp, obligation) and one for the Affordable Housing Program (the AHP obligation). Under current law, each year the System must pay \$300 million to contribute towards interest payments on bonds

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<sup>1</sup>Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, (GAO/GGD-94-38, Dec. 8, 1993).

issued by REFCorp.<sup>2</sup> AHP requires each FHLBank to set aside 10 percent of the previous year's income or an aggregate amount for all FHLBanks of not less than \$100 million to subsidize the financing of eligible low-and moderate-income housing.

In our report, we concluded that the fixed nature of these obligations had important effects on the way the System functioned and also imposed constraints on efforts to reform the system. First, efforts to increase System income to pay the fixed obligation may have increased the extent of risk in the System. Second, because one of the bases for paying the obligation is the amount of advances made, FHLBanks are penalized for providing liquidity for mortgage lending, which is the primary purpose of the System.<sup>3</sup> Third, the need to preserve sufficient capital to provide income to pay the fixed obligations makes capital structure reform more difficult. Last, because the payment formula affects some FHLBanks more than others, questions of consolidation are complicated by concerns about how the burden will be shifted. In our report we concluded that resolving this problem of paying the fixed obligation is of particular importance because it is so intertwined with these other issues. In an attempt to improve some of the incentives caused by the obligations, we have suggested two approaches. In one approach REFCORP payments could be based on ability-to-pay measures such as a percentage of net income, assets or FHLBank stock. In those years when the amount raised by this percentage is less than \$300 million, the difference could be made up by increasing the percentage applied to the same base. An alternative approach could limit the payments to a fixed percentage of net income with no shortfall allocation, but with the total payments covering the REFCORP obligation over time.<sup>4</sup>

Capital Reform: In 1993 we reported that the capital structure of the System had several weaknesses and that structure has not changed. The greatest weakness is that the capital required of each FHLBank is not related to the risks it undertakes. Another weakness is that the capital is impermanent--it could be withdrawn from the System relatively easily. Thus, it cannot be relied upon to provide the requisite cushion during a crisis. These weaknesses could be ameliorated by adopting a risk-based

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<sup>2</sup>The bond proceeds have been used to pay for part of the resolution cost of failed savings and loans.

<sup>3</sup>Advances are loans made by FHLBanks to their members. They provide liquidity to the home mortgage market and are secured by home mortgage loans.

<sup>4</sup>These payments would continue until the present value of the payments equals the present value of the obligation at the time this mechanism is adopted.

capital approach supplemented by a retained-earnings requirement as we recommended in our report. A risk-based capital requirement analogous to that used by banks and thrifts would allocate capital on the basis of credit risk associated with particular classes of assets. The retained earnings requirement should provide a buffer for interest rate risk, as well as management and operations risk undertaken by a FHLBank.

Membership Reform: Mixing voluntary and mandatory membership can pose unnecessary risk to the System. Basically, mixing these types of membership might lead to instability by permitting voluntary members to withdraw, leaving the mandatory members to absorb losses. To lower this risk, and as a matter of simple equity, we recommended that membership be fully voluntary. Furthermore, to provide for equal access to the System, we recommended that the membership terms be the same for all eligible members. We also stated that the stability and effectiveness of the System would be enhanced if stock purchase requirements and advance limits were the same for all members.

Regulatory Reform: The System is only one of the Government Sponsored Enterprises (GSEs) that support housing, the others being the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). In our 1993 report we recommended that all housing GSEs be regulated by the same regulator and that the responsibilities of the FHFB, which regulates the System, and the Office of Federal Housing Enterprise Oversight (OFHEO), which regulates Fannie Mae and Freddie Mac, should be combined. Such a combined entity could carry out both safety and soundness and program regulation. We stated that such a combination would increase objectivity and independence by providing a healthy tension in oversight, thus reducing the likelihood that the regulator would be "captured" by the regulated entities. We thought a combined entity would have more prominence within government and that this would make it easier to raise safety and soundness concerns in a timely manner. Last, we thought it would be a more efficient use of government resources to spread the overhead costs over a larger span of activities.

Governance Reform: We pointed out, and FHFB agrees, that the System's regulator should not also be a manager of the System. We were concerned that combining the roles of oversight and management may undermine the independence necessary to be an effective safety and soundness regulator. Being too closely tied to management and budget issues could make the regulator an advocate rather than an impartial judge. Thus, we recommended that all governance responsibilities currently exercised by the FHFB should be devolved to the System.

Affordable Housing Program: In our recent report, we found that AHP has generally met Congress' intent that it be a flexible source of funding for affordable housing.<sup>5</sup> In our report, we also pointed out that FHFB had proposed regulations to delegate more administrative control over the program to the FHLBanks. For many of the reasons discussed above, if governance reform is adopted, AHP implementation should be devolved to the FHLBanks.

SYSTEM CONSOLIDATION  
COULD PROVIDE BENEFITS

In our 1993 report, we stated that the regional structure of the System, established 60 years ago, with 12 FHLBanks each with an exclusive geographic territory, appeared to be outmoded. Since then, the nation's population and economic activity have grown relatively faster in the South and West. In the U.S. financial system, commercial banks, thrifts, and other financial institutions have been consolidating. However, despite these changes, the System has not consolidated.

In our report, we did not conclude that the System should consolidate, only that the ability to consolidate could allow the system to take advantage of certain efficiencies and cost saving opportunities. If the System were allowed to consolidate, membership were to be voluntary, and member banks and thrifts could choose which FHLBank they wished to join, our report suggested that incentives would exist to move the System toward improved cost control and efficiency, as well as improved service provision. Those whose costs were higher and service offerings were poorer would lose members and eventually be absorbed by their more efficient brethren. Market forces would likely push the System toward a more efficient structure, including the determination of how many FHLBanks the system could support.<sup>6</sup>

RECENT REFORM PROPOSALS HAVE  
ADVANTAGES AND DISADVANTAGES

This Subcommittee and the administration made several suggestions for changes in proposed legislation that were not explicitly addressed in our report. Many of these proposed changes are related to positions we took in our 1993 report or in other reports on financial institutions or GSEs. We would like to take

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<sup>5</sup>Housing Finance: Improving the Federal Home Loan Bank System's Affordable Housing Program, (GAO/RCED-95-82, June 9, 1995).

<sup>6</sup>We should note here that we did an analysis of whether consolidation would adversely affect the System's affordable housing program. Our analysis, although necessarily limited, showed that the affordable housing program would probably not be damaged by consolidation.

this opportunity to comment on some of the changes that are contained in one or more of the proposals.

New asset requirement for membership: Some legislative proposals include a requirement that members hold 10 percent of their assets in whole mortgage loans rather than "mortgage-related" assets such as mortgage-backed securities. This would be a way to ensure that members had a substantial commitment to mortgage finance and, as one observer put it, "It puts the 'home' in Federal Home Loan Bank." Because the holder of a mortgage loan is at least one step closer to the borrower than is a holder of a mortgage-backed security, such a membership requirement would mean that member institutions were more likely to be actively engaged in the residential mortgage market rather than passive holders of securities. As such, the provision should better support the mission of the System, which is to provide liquidity for residential mortgage lending.

Devolution of System Financing from FHFB: The legislative proposals contemplate abolishing the FHFB's Office of Finance and delegating the responsibility of raising funds to the System. In keeping with our concern that a safety and soundness regulator maintain independence from the System, we do not believe that raising funds is properly a function for the System's regulator. Having the System responsible for raising funds is more in keeping with the way the Farm Credit System, a similar GSE, raises its funds.

Changes in FHFB Structure: The legislative proposals contemplated restructuring the FHFB by adding the Secretary of the Treasury as a board member. Some also provide that the Chairperson serve full-time and the other two appointed directors serve part-time. As noted above, we believe that the housing-related GSEs would be better regulated by amalgamating FHFB with OFHEO. If our suggestion is not adopted, then adding the Secretary of the Treasury to FHFB would be a positive step because it would extend Treasury's concern over financial safety and soundness of the financial system to the FHLBanks.

Certain proposals would continue the practice of having the FHFB appoint some directors of each FHLBank. Because of the System's public purpose, there is probably a legitimate need for board members who represent broader interests than those of the member banks and thrifts. However, we have questions about whether FHFB should appoint those public directors because the FHFB may nominate directors who support the regulator's views and may not reflect the views of the public. One possible alternative would be to have public members selected in the same manner as they are for other housing-related GSEs, by Presidential appointment.

Restrictions on Withdrawing Capital: The legislative proposals include provisions to restrict capital withdrawals by members. Once a member decides to withdraw and so notifies the FHLBank, the repayment of that member's stock will take place in two installments; 50 percent upon surrender and cancellation of the stock and 50 percent 6 months later. There will be proportional reductions in the amount to be withdrawn if the FHLBank is already undercapitalized (called haircuts). In addition, the repayment period may be extended under specified conditions. These proposed restrictions were meant to help stabilize the System in the event that many members wish to withdraw at the same time. We believe this provision is a useful safety feature.

Basing REFCORP Payments on Required Capital: The administration has proposed legislation to base REFCORP payments on the amount of capital each FHLBank holds in relation to the total of all FHLBanks' required capital. While this basis is different from our suggestion that payments be met out of net income, assets, or stock, it would achieve the goal of keeping the REFCORP obligation within the System and would base it on a FHLBank's size and risk level. We believe that this suggestion addresses the perverse incentives which are caused by the present arrangement and so would be a reasonable approach to the REFCORP problem that we discussed in our 1993 report.

Prompt Corrective Action: The legislative proposals would establish a System-wide prompt corrective action procedure to deal with capital shortfalls. Such a procedure specifies an action or set of actions the regulator must take once some tripwire is reached. These tripwires can be based on capital levels or some other indicator. Their purpose is to reduce the ability of regulators to delay taking action regarding a troubled institution in the hope that the institution will turn itself around. We have endorsed prompt corrective action for banks and thrifts in the past and believe it should be extended to the Federal Home Loan Bank System.<sup>7</sup>

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Mr. Chairman, this concludes my comments on Federal Home Loan Bank reform. I would be happy to answer any questions you and other members of the Committee may have.

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<sup>7</sup>Banks and Thrifts: Safety and Soundness Reforms Need to be Maintained, (GAO/T-GGD-93-3, Jan. 27, 1993)

RESPONSES TO THE CHAIRMAN'S QUESTIONS

Question #1. If you were asked to design a FHLB System from scratch today, how would the recommended structure differ from the current structure?

Response: Based on the recommendations in our 1993 report, along with our overall body of work in the financial institutions area, we believe that several changes would need to be made to the current structure in order to improve the ability of the System to carry out a housing finance mission. Specifically:

1. Change the REFCORP shortfall allocation system. The two most logical ways to do this would be to (1) distribute the responsibility according to some ability-to-pay measure such as income, capital, or assets; or (2) let payments fluctuate from year to year by charging a percentage of net income but assuring that the total payments equal the (present value) of the REFCORP obligation.
2. Make AHP a percentage of net income.
3. Institute risk-based capital, leverage requirements, and prompt corrective action procedures.
4. Consolidate the FHLBank System's regulator with OFHEO.
5. Institute fully voluntary membership, including a member's right to affiliate with any FHLBank.
6. Make terms of membership equal for all.

Question #2. If not for the need to pay the REFCORP obligation, could (a) the FHLB System be downsized or (b) the FHLB System be eliminated altogether with FHLB System services being adequately provided by others in the marketplace?

Response to (a). If the REFCORP obligation were eliminated, the FHLB System would not need to have a large investment portfolio one of whose purposes was to generate income to pay the obligation. The current portfolio is now about \$114 billion, nearly as much as outstanding advances (\$120 billion). Except for investments made for operating purposes, much of the investment portfolio could be eliminated without harming the system's ability to accomplish its mission. The size of the System, as measured by assets, would depend primarily on the demand for advances which would normally grow and shrink with the business cycle.

Response to (b). The FHLB System was established in the 1930s when there were a number of perceived problems in the mortgage finance market. Since that time some of the gaps and market failures have been eliminated or mitigated. For example, the market for conforming and jumbo mortgages has become a competitive nationwide market due to the existence of Fannie Mae and Freddie Mac and private sector efforts. However, in other market segments, such as nonconforming loans and the area of community and economic development, the ability of the private sector to fill a gap, in the absence of the FHLB System, is less certain.

Question #3. Is there a need for 12 FHLBanks or should they be consolidated?

Response: Our views on possible consolidation were described in our statement.

Question #4. Should the FHLB System charter be expanded to include new activities, and if so, what activities?

Response: In our report, we did not take a position on whether the System should expand its provision of products and services. However, we did outline a set of criteria that could serve as a basis for judging whether such an expansion was warranted. The criteria include:

- a. FHLBanks should not offer products and services in competition with member institutions;
- b. FHLBanks should have the expertise to carry out the activities profitably and manage the activities effectively;
- c. the activities should be consistent with the System's mission;
- d. the System's high credit rating should be protected.

While these criteria are meant to be suggestive, some similar set of rigorous criteria should be used to evaluate proposals for new products and services.

Question #5. Please comment on the investment activities of the System, including the FHLBank's practice of arbitraging using borrowed funds to invest in higher yielding instruments, primarily mortgage-backed securities. (1) Do the investment activities pose too much risk to the FHLB System?

Response to (1): The investment activities may pose substantial risk. Our report observed that "...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."<sup>8</sup> In addition, there is also the potential for risk to the taxpayer if the government decides that it must rescue a troubled GSE.

(2) Are the investment activities in which the FHLBanks are currently engaged essential to the generation of revenue needed to pay the REFCORP obligation as the Banks claim?

Response to (2): Advances do not generate enough income to pay the combined REFCORP and AHP obligations, so a certain level of investment activity is probably necessary to generate the necessary income. It is not clear, however, that all of the FHLBanks' investment activity is based solely on the need to pay the fixed obligations. Some of the FHLBanks appear to be undertaking investments to increase bank income and member dividends. Whatever the purpose of the investment portfolios, our report suggested two concerns with their size. First, a potential conflict with the System's purpose of providing liquidity to mortgage lenders if it distracts FHLBanks from focusing on that objective. Second, an increased safety and soundness concern if interest rate, management, and operation risk are increased as a result of the larger portfolios.

(3) Should the investment activities be either expanded or curtailed?

Response to (3): If the REFCORP/AHP obligations are altered so that they are no longer a fixed obligation, and the System's mission and government connection remain the same, some curtailment of investment powers may be in order. This is because the ultimate risk-bearers are the taxpayers and there is no mission-related reason to put taxpayers at risk when the benefits go to the System's members. One model of more narrow investment powers which could be followed is the policy on investments set out by the Farm Credit Administration for the Farm Credit System. Its regulations limit investments to the specific purposes of complying with liquidity reserve requirements<sup>9</sup> and managing interest rate risk. As of March 31, 1995 the investment-to-loan ratio for the FHLB System was 95 percent and the ratio for the Farm Credit System was 16 percent<sup>10</sup>.

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<sup>8</sup>GGD-94-38, p.40.

<sup>9</sup>This is equal to 50 percent of borrowings and interest due during the next 30 days. [FCA reg. 615.5134 and 615.5135]

<sup>10</sup>FCS Quarterly Financial Report, First Quarter 1995, p. F-2.

Question #6. As compared to large bank operations in the private market, please provide an analysis of FHLBanks' overhead/administrative costs and dividends. Please explain whether the aforementioned statistics for banks and FHLBanks are comparable. If not comparable, could you suggest a method that could be used by Congress to benchmark the expenses of the FHLB System?

Response: Data provided by the FHFBS show that, in 1992, FHLBanks' operating expenses were about 18 percent of total revenue, while large commercial banks' operating expenses were 67 percent of total revenue. These data are not comparable, however, because commercial banks have many expenses which the FHLBanks do not, e.g. retail branches, retail lending, ATMs, diverse product lines. Since such cost comparisons are problematic, it would be difficult to decide whether expenses are higher or lower than they should be. Rather than trying to make that judgment, we believe that the lowest possible costs should be the objective and that these are more likely to be achieved if the FHLBanks were exposed to the same competitive pressures that force other businesses to control costs. Thus, we would reiterate our 1993 recommendation that membership be fully voluntary and that terms of membership be equal for all. In addition, allowing members to choose the FHLBank which offers them the best package of services at lowest cost would probably increase the pressure for FHLBanks to lower costs.

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