

The Federal Home Loan Bank System: Current Issues in Perspective

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Disclaimers

Outline

- The FHLB System
- Some history
- Some current issues
- Conclusion

The FHLB System: Overview (1)

- 12 wholesale banks (GSEs)
 - Each FHLB has a specific geographic service area
 - FHLBs are jointly and severally liable for System's debt obligations; financing through central Office of Finance
 - Cooperatively owned by 8,125 member/owners: savings institutions (1,245), banks (5,871), credit unions (875), insurance companies (134)
 - Member institutions must have at least 10% of assets in mortgage-related assets or be “community financial institutions”
 - Members provide equity capital as a consequence of membership and of using the FHLBs' financial services and products

The FHLB System: Overview (2)

- Largest of the three housing GSEs by assets: \$1,016 billion in assets (2006)
 - Larger than Fannie Mae or Freddie Mac
 - Fannie assets: \$724 billion + ?
 - Freddie assets: \$813 billion
 - But Fannie & Freddie also issue MBS
 - Fannie outstanding MBS: \$1,780 billion
 - Freddie outstanding MBS: \$1,123 billion
- Purpose of FHFB System
 - Assist their members' financing of housing and some community development

The FHLB System: Balance Sheet

● Total Assets	<u>\$1,016.5B</u>	<u>100.0%</u>
– Advances	640.7	63.0
– Mortgage loans (net)	98.0	9.6
– Mortgage-backed securities	130.2	12.8
– Other investments	140.5	13.8
– Other assets	7.1	0.7
● Total Liabilities and Capital	<u>\$1,016.5B</u>	<u>100.0%</u>
– Consolidated obligations	934.2	91.9
– Other liabilities	37.3	3.7
– Membership capital stock	42.0	4.1
– Retained earnings	3.1	0.3
– Other comprehensive income	(0.1)	0.0

The FHLB System: Advances

- Primary product of the FHLB System
 - Over 60% of the System's assets are advances to its members
- Members must post collateral (mostly residential mortgage-related assets) and contribute capital
 - FHLBs also have a “super lien” on members' assets
- But money is fungible
 - Why expect that the funds will be used for residential finance?

The FHLB System: GSEs

- Some attributes
 - Created by Act of Congress
 - U.S. Treasury can purchase up to \$4 billion in FHLB securities
 - FHLB securities are “government securities” under the Securities and Exchange Act of 1934
 - As “federal instrumentalities” the FHLBs are exempt from the bankruptcy code
- Some consequences
 - FHLB System can borrow at about 40bps below what its financial condition would otherwise warrant

The FHLB System: Regulation

- Regulated by the Federal Housing Finance Board for safety and soundness and for mission
- Since the FHLB System is a GSE, creditors expect that the federal government will bail them out
 - Safety-and-soundness regulation is necessary to protect the government
 - But does that regulation enhance creditors' expectations of being bailed out?

History: The Early Years

- FHLB System created in 1932
 - FHLBB as regulator
 - All federally chartered thrifts and state-chartered federally insured thrifts were required to be members; other thrifts and insurance companies could voluntarily join
 - Other federal housing actions in the 1950s: federally chartered and insured thrifts, FHA (and the 30-year fixed-rate mortgage), Fannie Mae
- Slow growth through the 1950s
 - As of 1960, advances were less than 3% of members' assets

History: The 1980s

- Advances grew substantially in the 1960s, 1970s, 1980s
 - By 1980, advances were about 8% of members' assets
 - Advances were seen as a source of low-cost liquidity and (in the 1980s) as a tool for asset-liability management
- FHLB System's role in regulating the thrift industry expanded in 1985
- In 1987 CEBA required that \$700 million of FHLB System capital be used to defease the principal on the FICO bonds

History: FIRREA (1989)

- FHLBB abolished, and FHFB created to regulate the FHLB System
- \$2.8 billion in FHLB System net worth was used to defease the \$30 billion in 40-year REFCORP bonds, and \$300 million/year from profits required to pay part of the interest, and funding required to support low- and moderate income housing
- Voluntary membership expanded to banks and credit unions that meet criteria

History: Post-FIRREA

- All membership was eventually made voluntary
- Voluntary membership (plus multi-district membership) has added competitive pressures on to the individual FHLBs
- Voluntary membership plus the FIRREA “tax” has created pressures for growth and greater leverage
- The FHLB System has expanded its mortgage activities
- The System’s leverage doubled
 - 1989: capital/assets = 8.9%
 - 2006: capital/assets = 4.4%

The Over-Riding Issue: Why?

- What legitimate purpose is served by the housing GSEs?
- When a GSE expands its activities, is this due to an inherent efficiency or synergy? Or is it just extending its GSE advantage?
- What about risks to taxpayers?
 - FHLB System's coop ownership doesn't restrain risk taking at the expense of creditors
 - FHLB System's joint-and-several liability has free-rider problems

SLOCs: What Are They?

- SLOCs are a guaranty (insurance, credit enhancement) by a third party that, if a borrower fails in its repayment obligation to the lender, the SLOC issuer will fulfill that obligation
- The borrower pays a fee to the SLOC issuer but gains better borrowing terms (e.g., a lower interest rate)
 - There's a big advantage if the SLOC issuer has a better debt rating than the borrower
- In the event of default, the SLOC issuer makes the necessary payments and acquires the claim on the borrower

SLOCs and the FHLB System

- FHLB System first gained authority to issue SLOCs in 1983
- FHFB expanded the System's authority in 1998
 - Over the objections of the Treasury and of the private-sector bond guarantors
- FHLB System current has \$20 billion in SLOCs outstanding
- FHLB System SLOCs for muni bonds would apparently cause the bonds to lose their tax-exempt status
- Current proposed legislation would allow the bonds to retain their tax-exempt status

FHLB SLOCs: Safety?

- FHLB SLOCs for muni bonds would be back-ups to member-issued SLOCs
 - Members must post collateral with FHLB
 - FHLB would be at risk only if original borrower defaulted and member defaulted
 - FHLB has collateral and a “super lien” on member’s assets
 - In this respect, safety doesn’t appear to be an issue
- But only a few FHLBs require capital contributions from members in return for the back-up SLOC
 - So maybe some added risk?

FHLB SLOCs: Efficiency?

- Where's the market failure?
- Are there barriers to entry?
- Is this just another instance of extending the GSE advantage?
- What principles should be brought to bear to limit GSE extensions?

Conclusion

- The FHLB System is relatively unknown but is clearly important
- The SLOC issue is just one of a larger number of issues for this and other GSEs that should be addressed
- What are the benefits? What are the costs? What are the risks? And what are the policy principles that should help guide decisions?