

**GAO**

Testimony  
Before the Committee on Banking,  
Housing, and Urban Affairs, U.S. Senate

---

For Release on Delivery  
Expected at 10:00 a.m. EDT  
Wednesday, April 13, 2005

# FEDERAL HOME LOAN BANK SYSTEM

## An Overview of Changes and Current Issues Affecting the System

Statement of Thomas J. McCool, Managing Director  
Financial Markets and Community Investment





Highlights of [GAO-05-489T](#), a testimony to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

## Why GAO Did This Study

The FHLBank System (FHLBank System or System) is a government-sponsored enterprise (GSE) that consists of 12 Federal Home Loan Banks (FHLBanks) and is cooperatively owned by member financial institutions, typically commercial banks and thrifts. The primary mission of the FHLBank System is to promote housing and community development generally by making loans, also known as advances, to member financial institutions. To minimize the potential for significant financial problems, the Federal Housing Finance Board (FHFB) regulates the FHLBank System's safety and soundness. Over time, a number of developments have affected the System's safety and soundness and have created pressures on its traditional cooperative structure.

To assist the committee in understanding the important issues surrounding the FHLBank System and its regulation, this testimony provides information on the development of the System; two legislative changes and FHFB rulemaking that led to changes in membership, asset composition, and capital structure; and important challenges and questions the FHLBank System currently faces.

[www.gao.gov/cgi-bin/getrpt?GAO-05-489T](http://www.gao.gov/cgi-bin/getrpt?GAO-05-489T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Thomas J. McCool at (202) 512-8678 or [mccoolt@gao.gov](mailto:mccoolt@gao.gov).

# FEDERAL HOME LOAN BANK SYSTEM

## An Overview of Changes and Current Issues Affecting the System

### What GAO Found

Established in 1932 to facilitate the extension of mortgage credit, the FHLBank System has undergone significant statutory changes in the last 15 years. Between the 1930s and the 1980s, the System consisted primarily of thrift members that accepted advances from the FHLBanks. However, during the 1980s, hundreds of FHLBank member thrifts failed forcing Congress to fundamentally reform the System through the Financial Institutions Recovery, Reform, and Enforcement Act of 1989 (FIRREA). For example, FIRREA permitted commercial banks to join the System. Although FIRREA is credited with strengthening the thrift industry and the System, concerns were raised during the 1990s about the System's capital structure. In particular, commercial bank members could remove stock from their FHLBank on 6-months notice, which raised concerns about the System's financial stability. Among other provisions, the Gramm-Leach-Bliley Act (GLBA) of 1999 created a more permanent and risk-based capital structure for the System.

Due to these statutes and FHFB rulemaking, the FHLBank System has evolved substantially since 1990. For example, commercial banks now account for more than 70 percent of all System members. The composition of FHLBank System assets has also fluctuated considerably over the years. For example, FHFB authorized the FHLBanks to purchase mortgages directly from their members in the 1990s. The System's mortgage assets grew to about \$113 billion at yearend 2003 representing about 14 percent of total assets. However, the rapid growth in System mortgage assets leveled off in 2004 as two FHLBanks experienced problems managing the interest-rate risks associated with holding mortgages on their books. As provided by GLBA, System capital is now more permanent as members generally must invest capital for a period of 5 years and the FHLBanks are subject to new leverage and risk-based capital requirements.

The FHLBank System faces important challenges and questions going forward. For example, FHFB has called the FHLBanks' risk-management practices into question, particularly those related to mortgage purchase programs. Further, proposals to permit the FHLBanks to issue mortgage-backed securities (securitization) could help ensure the growth of the mortgage purchase business and improve risk management, however these proposals raise questions regarding the FHLBanks' capacity to manage the related risks. Additionally, there is limited empirical information available regarding the extent to which the System is fulfilling its housing and community mission. Finally, questions have been raised regarding the potential negative affects that large financial institutions may have on the traditional cooperative structure of the FHLBank System and its programs designed to benefit targeted groups.

---

Dear Mr. Chairman and Members of the Committee:

I appreciate the opportunity to participate in today's hearing to provide an overview on the Federal Home Loan Bank System's (FHLBank System or System) operations, its federal oversight, and challenges that it faces. As you know, the FHLBank System is a government-sponsored enterprise (GSE) that consists of 12 Federal Home Loan Banks (FHLBanks) and is cooperatively owned by member financial institutions, typically commercial banks and thrifts (or savings and loans). The primary mission of the FHLBank System is to promote housing and community development generally by making loans, also known as advances, to member financial institutions. These institutions are required to secure FHLBank advances with high-quality collateral (such as single-family mortgages) and may use the advances to fund mortgages. To raise the funds necessary to carry out its activities, the FHLBank System issues debt in the capital markets at favorable rates compared to commercial borrowers due to its GSE status. According to the Federal Housing Finance Board (FHFB), as of December 31, 2004, the System had \$855 billion in outstanding debt obligations.<sup>1</sup>

Because the FHLBank System is a GSE, the potential exists that the federal government would be called on to provide financial assistance to the System if it was unable to meet its financial obligations. To minimize the potential that the FHLBank System would experience significant financial problems, Congress established the FHFB as the System's safety and soundness regulator in 1989. FHFB is also responsible for helping to ensure that the FHLBanks fulfill their housing and community development mission.

In recent years, the FHLBank System has undergone important changes and questions have been raised regarding the adequacy of FHLBanks' risk-management practices and the functioning of the System's cooperative structure. For example, since 1997, the FHLBank System has moved beyond the traditional advance business by establishing programs to purchase mortgages directly from member financial institutions, an activity similar to the mortgage purchase business of the two other housing GSEs: Fannie Mae and Freddie Mac. Although such mortgage

---

<sup>1</sup>As of the date of this testimony, the FHLBanks 2004 annual combined financial report was not yet available. For this testimony, we used FHLBank System's Office of Finance data from 1990 through 2003 and obtained the best available data for 2004 from FHFB.

---

purchase programs have the potential to increase profitability and better serve member institutions, they also expose FHLBanks to interest-rate and credit risk.<sup>2</sup> FHFB recently identified interest-rate risk management deficiencies at two FHLBanks and required them to take corrective measures. The traditional cooperative structure of the FHLBank System has also been challenged by sometimes sharp differences in business strategies among the 12 FHLBanks. In particular, FHLBanks have disagreed over proposals to permit securitization of mortgage assets.<sup>3</sup> While securitization may permit FHLBanks to expand their purchase of mortgage assets, some FHLBanks also regard it as changing the business of the System and increasing potential risks.

To assist the committee in understanding the important issues surrounding the FHLBank System and its regulation, my testimony today is divided into three parts. First, I will provide an overview on the development of the FHLBank System and its supervision with a focus on how two statutes: the Financial Institutions Recovery, Reform, and Enforcement Act of 1989 (FIRREA) and the Gramm-Leach-Bliley Act of 1999 (GLBA) made substantial changes to the System's original structure and capital requirements. Second, I will provide more detailed information as to how FIRREA and GLBA, as well as FHFB rulemaking have changed the System's membership, asset composition, and capital structure over the past 15 years. Third, I will discuss important challenges and questions affecting the FHLBank System.

In summary:

- Congress established the FHLBank System in 1932 to help rescue the housing finance market, which had been decimated by the Great Depression. Between the 1930s and the 1980s, each FHLBank made

---

<sup>2</sup>Interest-rate risk is the risk that relative and absolute changes in interest rates may adversely affect an institution's financial condition. Credit risk is the risk of nonperformance by counterparties to derivative agreements and other obligations or the risk that an FHLBank member would default on an advance. No FHLBank has reportedly ever suffered a credit loss on an advance due, in part, to the System's collateral requirements. Also, FHLBanks have a priority lien status on the assets of members who experience financial problems and are placed into receivership.

<sup>3</sup>Securitization is the process of aggregating similar instruments, such as loans or mortgages, into pools and selling investors securities that are backed by cash flows from these loan pools. Proposals have been made to permit FHLBanks to securitize mortgages that they purchase and issue mortgage-backed securities to investors. Fannie Mae and Freddie Mac are large issuers of mortgage-backed securities.

---

advances to thrifts in its district that were required to be members of the System, and these activities were credited with helping to develop a unified housing finance market. However, in response to the thrift crisis of the 1980s, Congress enacted FIRREA which, among other provisions, opened FHLBank System membership to commercial banks and other insured depository institutions on a voluntary basis and permitted such members to withdraw capital from the System with 6-months notice (whereas thrifts were still required to become members and as mandatory members could not withdraw their minimum required amount of capital). In 1999, due to concerns that voluntary members' ability to withdraw capital increased risks to the System, GLBA made System membership voluntary for all institutions but required a more permanent capital structure with leverage and risk-based capital requirements.

- Due to FIRREA, GLBA, and FHFBS rulemaking, the FHLBank System has evolved substantially since 1990. For example, commercial banks now account for more than 70 percent of all the System members, whereas thrifts accounted for nearly 100 percent of all members in 1990. The composition of FHLBank System assets have also fluctuated considerably over the years, although advances remain the largest asset. In the early to mid 1990s, advances declined from about 70 percent of the System's assets to about 50 percent as the FHLBanks increased investments in mortgage-backed and other types of securities (investments increased from about 27 percent of the System assets in 1990 to 43 percent in 1996). System investment assets increased as FHLBanks sought higher returns than those available from the traditional advance business. Between 1997 and 2003, FHLBank System mortgage holdings increased as a percentage of assets, relative to advances and other investments. However, mortgage holdings leveled off in 2004 as a result of the financial difficulties some FHLBanks experienced with their mortgage purchase programs. Consistent with GLBA, the FHLBank System has also largely implemented its new capital structure.
- The FHLBank System is currently facing several important challenges and questions regarding its risk-management practices, future business strategies, mission accomplishment, and organizational structure. As I described previously, FHFBS has entered into written supervisory agreements with two FHLBanks due to risk management deficiencies in their mortgage purchase programs—including the Chicago bank which has been the engine of growth for the System's mortgage purchases—and placed limits on future purchases until identified deficiencies are corrected. Although securitization has been proposed as a means to permit the FHLBank System to continue expanding its mortgage purchase programs over the long-term, the idea is highly controversial. Another

---

challenge facing the System is that there is limited empirical information on the extent to which FHLBank advances and other services benefit housing and community finance. Finally, concerns have been raised that large financial institutions that may have subsidiaries with memberships in two or more FHLBank districts could generate dangerous competition within the System and negatively affect its community development efforts.

To prepare for this testimony, we reviewed several reports and testimonies that we have completed on the FHLBank System and FHF<sup>4</sup>. We also obtained FHLBank System financial data for 2004 from FHF. Additionally, we interviewed several FHLBank presidents as well as the FHF Chairman, two FHF board members, and agency officials. We conducted our work in Washington, D.C., between March and April 2005 in accordance with generally accepted government auditing standards.

---

## Overview of the Federal Home Loan Bank System and Its Regulation

I would like to begin my testimony by briefly describing the development of the FHLBank System, significant statutory changes to the System, and its operations. Then, I will describe FHF's structure and activities.

---

<sup>4</sup>See GAO, *Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness*, [GAO/GGD-94-38](#) (Washington, D.C.: Dec. 8, 1993); *Capital Structure of the Federal Home Loan Bank System*, [GAO/GGD-99-177R](#) (Washington, D.C.: Aug. 31, 1999); *Comparison of Financial Institution Regulators' Enforcement and Prompt Corrective Action Authorities*, [GAO-01-322R](#) (Washington, D.C.: Jan. 31, 2001); *Federal Home Loan Bank System: Establishment of a New Capital Structure*, [GAO-01-873](#) (Washington, D.C.: Jul. 20, 2001); *Financial Regulation: Review of Selected Operations of the Federal Housing Finance Board*, [GAO-03-364](#) (Washington, D.C.: Feb. 28, 2003); and *Federal Home Loan Bank System: Key Loan Pricing Terms Can Differ Significantly*, [GAO-03-973](#) (Washington, D.C.: Sep. 8, 2003).

---

---

## The FHLBank System Was Established to Facilitate Housing Finance and Has Undergone Significant Changes in Recent Decades

Congress passed the Federal Home Loan Bank Act (FHLBank Act) in 1932 and established the FHLBank System to facilitate the extension of mortgage credit and the housing finance market, which had been severely affected by the Great Depression. The FHLBank Act required all federally chartered thrifts to become members of the FHLBank located in their districts (see fig. 1) and invest capital in the FHLBanks. The System acted as a central credit facility that made advances to thrifts which, in turn, were expected to make additional mortgage credit available to homebuyers and thereby revive the housing finance market. The act also established safeguards to help ensure the financial soundness of the FHLBanks. In particular, thrifts had to pledge high-quality assets in excess of the value of their advances as collateral. In addition, the act created the Federal Home Loan Bank Board (Bank Board) to oversee the safety and soundness regulation of the FHLBanks as well as the thrift industry. However, between 1985 and 1989, the Bank Board delegated its oversight responsibility of the thrift industry to each of the FHLBanks.

Figure 1: Location of the 12 Federal Home Loan Banks



Source: FHFB.

The business of the FHLBank System and its members essentially remained unchanged from the 1930s until the 1980s. The System is generally credited with serving as a relatively low-cost funding source for thrifts during that period and helping to overcome regional shortages in housing credit. However, due to regional downturns, sharply rising interest rates, and poor management, hundreds of FHLBank member thrifts failed during the 1980s, causing a contraction in FHLBank System business. As a result, Congress appropriated billions of dollars to cover the costs associated with ensuring the payment of insured thrift deposits. In addition, the regulatory structure for the thrift industry—where FHLBanks supervised thrifts on behalf of the Bank Board—involved significant conflicts of interest. These conflicts (such as FHLBanks regulating



---

institutions to which they made advances) compromised the safety and soundness oversight of the thrift industry. In response to these issues, Congress enacted the FIRREA, which made substantial changes to the FHLBank System's membership, regulation, and mission requirements as summarized below:

- FIRREA opened FHLBank system membership to commercial banks and credit unions that engaged in mortgage activities. These voluntary members were required to invest capital in their FHLBank but could normally withdraw such capital on 6-months notice. However, FIRREA still required thrifts to be members of their FHLBank and did not allow them to withdraw their capital contributions.
- FIRREA required the System to capitalize the Resolution Funding Corporation (REFCORP) to help pay for the deposit insurance fund losses resulting from thrift failures. Furthermore, the System had to pay up to \$300 million per year of annual earnings to contribute towards interest payments on bonds issued by REFCORP to pay for thrift losses.
- FIRREA abolished the Bank Board and established FHFBS to regulate the 12 FHLBanks. FIRREA also transferred the Bank Board's previous supervisory and regulatory responsibilities for thrift institutions and their holding companies to the newly created Office of Thrift Supervision.
- FIRREA also 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). As part of CIP, each FHLBank makes advances to finance the purchase or rehabilitation of housing for eligible households and finance other projects benefiting residents of low- and moderate-income neighborhoods. AHP requires each FHLBank to subsidize the financing of eligible low- and moderate-income housing and FIRREA sets priorities for use of these advances among eligible projects.

Although FIRREA is credited with helping to restore the financial condition and supervision of the thrift industry during the 1990s, the capital structure of the FHLBank System and the financial obligations that the act imposed on the System and its members subsequently raised concerns. In particular, the fact that voluntary members, such as commercial banks, had the option of removing their capital from the System with 6-months notice appeared to increase financial risks to the System. Additionally, since the FHLBanks' earnings had been weakened by the declining profitability of the thrift industry, the \$300 million REFCORP obligation posed a challenge. Consequently, FHLBanks looked for new

---

sources of revenue and increased investments in mortgage-backed securities that offered potentially higher returns, but exposed them to increased risks.

After years of attempting to resolve these issues, Congress passed the Gramm-Leach-Bliley Act of 1999 (GLBA), which contained provisions that

- Eliminated the requirement that thrift institutions be members of the FHLBank System and made membership voluntary for all members. Additionally, GLBA established new capital requirements for FHLBank members that were intended to make the System's capital more permanent. I will describe the capital provisions of GLBA in more detail later in my testimony;
- Revised the System's REFCORP obligations, moving from a fixed annual payment of about \$300 million to a specified percentage (20 percent) of the System's annual earnings after AHP expenses. This change minimized the financial obligation on the System during periods of relatively low profitability but increased the total payment when profits increased; and
- Expanded the amounts and types of collateral that FHLBanks could accept for advances from small members known as community financial institutions (CFI).<sup>5</sup> GLBA permitted CFIs to pledge small business and agricultural loans as collateral for FHLBank advances.

---

## The Structure and Operations of the FHLBank System

Each of the 12 FHLBanks has a board of directors of at least 14 persons, with 8 elected by members and at least 6 appointed by FHFBS. The FHFBS appointed directors are commonly referred to as public interest directors.<sup>6</sup> Additionally, each FHLBank board appoints a president who is responsible for overseeing the institution's staff (see table 1). The president and staff are responsible for such activities as the FHLBank's asset and liability management, AHP and other community development activities, and compliance with laws and regulations.

---

<sup>5</sup>CFIs are defined as Federal Deposit Insurance Corporation insured institutions that have less than \$500 million in total assets, adjusted for inflation. In 2004, the CFI designation was \$548 million. GLBA also allowed FHLBank members to make greater use of other real estate related collateral—such as commercial real estate loans and home equity loans—as collateral for FHLBank advances.

<sup>6</sup>At least two of the public interest directors are designated as community development directors because of their ties to the local community.

---

**Table 1: Staff at Each FHLBank as of December 31, 2003**

<b>FHLBank</b>	<b>Full-time</b>	<b>Part-time</b>	<b>Total</b>
Boston	154	2	<b>156</b>
New York	204	4	<b>208</b>
Pittsburgh	192	5	<b>197</b>
Atlanta	278	0	<b>278</b>
Cincinnati	144	2	<b>146</b>
Indianapolis	127	7	<b>134</b>
Chicago	295	6	<b>301</b>
Des Moines	154	17	<b>171</b>
Dallas	135	0	<b>135</b>
Topeka	135	2	<b>137</b>
San Francisco	220	4	<b>224</b>
Seattle	148	3	<b>151</b>

Source: FHLBank System Office of Finance.

The FHLBank System raises funds in the capital markets through its Office of Finance (OF), which has a board of directors consisting of three individuals who serve 3-year terms. FHLBank appoints the OF chair and selects two FHLBank presidents to serve as the other OF board members. As I discussed earlier, the FHLBank System can issue debt, generally referred to as consolidated obligations, at a relatively low cost due to its GSE status, which may allow members to fund mortgages at lower rates. Consolidated obligations are the “joint and several” obligations of the FHLBanks. That is, if an FHLBank defaults on its repayment obligations, all the other FHLBanks may have to cover its obligations. Although the federal government does not explicitly guarantee that it would provide financial assistance to the FHLBank System in a financial emergency, investors perceive an implied guarantee because of the ties between the government and the System. For example, each FHLBank has a federal charter and consolidated obligations are exempt from federal, state, and local taxes. Moreover, the federal government did provide financial assistance to other GSEs, such as Fannie Mae and the Farm Credit System, when they experienced financial difficulties during the 1980s.

In addition to providing advances to its members, the FHLBank System provides member institutions other benefits and services. For example, FHLBanks generally pay dividends to their member financial institutions. Other services FHLBanks may offer members include providing discounts on advances for large transactions, funding the AHP and CIP programs to

---

help members finance affordable housing and community development activities, and offering mortgage purchase programs as discussed next.

Although reportedly no FHLBank has ever suffered a credit loss on an advance, the business activities of the FHLBanks have become increasingly complex and potentially risky in recent years largely due to the implementation of the mortgage purchase programs. All of the FHLBanks are authorized to purchase mortgages from members through programs such as the Mortgage Partnership Finance (MPF) program and the Mortgage Purchase Program (MPP).<sup>7</sup> Through these mortgage purchase programs, FHLBanks purchase conventional or government-guaranteed mortgages directly from their members. The FHLBanks hold the mortgages on their books and bear the interest-rate risks associated with them.<sup>8</sup> To manage the interest-rate risks, FHLBanks must employ sophisticated risk-management techniques including the use of financial derivatives. Although such strategies are appropriate for risk management, they require specialized expertise, sophisticated information systems, and an understanding and application of sometimes complex accounting rules. As I discuss later, some FHLBanks recently have encountered financial problems in managing the interest rate risks associated with their mortgage portfolios.

---

## FHFB Regulates FHLBank System Safety and Soundness and Mission Achievement

FHFB is responsible for regulating the FHLBank System's safety and soundness as well as its mission achievement. The agency has a five-member board, with the President of the United States appointing four board members, subject to Senate approval. Each appointee serves a 7-year term. The fifth board member is the Secretary of the Department of Housing and Urban Development, or the secretary's designee. The President also designates one of the four appointed board members as the chair, subject to Senate approval. FHFB is located in Washington, D.C. and

---

<sup>7</sup>In 1997, the FHLBank of Chicago received approval from FHFB to begin operating a pilot program for MPF. In 1998, FHFB granted all 12 FHLBanks the authority to establish similar mortgage purchase programs. Today, 9 FHLBanks offer MPF in conjunction with the Chicago FHLBank, and the remaining 3 (Cincinnati, Indianapolis, and Seattle) offer their own individual MPPs. However, the Seattle FHLBank recently announced its intention to exit from its MPP.

<sup>8</sup>Interest-rate risk management has always been necessary to deal with advances and holdings of investments in mortgage backed securities, but the increasing purchases of mortgages from members through MPF and MPP has increased the FHLBanks' need to manage the interest-rate risk associated with holding mortgage assets.

---

has a staff of about 124 individuals, including 17 examiners in eight cities where FHLBanks are located.

FHFB supervises the FHLBanks by conducting annual on-site examinations and off-site monitoring to ensure that the Banks satisfy capitalization requirements and maintain their ability to raise funds in the capital markets. On-site examinations are focused on particular risk areas (interest-rate risk, credit risk, and operational risk) and compliance with mission requirements such as the AHP program.<sup>9</sup> Examiners set the scope for the examinations based on potential issues identified at previous examinations, as well as through quarterly monitoring. Off-site monitoring involves FHFB headquarters staff reviewing financial data on the FHLBanks on a continual basis. FHFB also conducts systemwide reviews of significant FHLBank operational, governance, and other practices and uses advisory bulletins and regulatory interpretations to convey guidance that addresses supervisory issues with systemwide implications.

Under the FHLBank Act, FHFB is authorized to promulgate and enforce such regulations and orders that it deems necessary to carry out its responsibilities. The following summarizes several of FHFB's key authorities:

- FHFB has the authority to issue cease-and-desist orders and other enforcement actions to address unsafe FHLBank practices. FHFB also has the authority to remove FHLBank officials and prohibit actions by FHLBank officers and directors.
- FHFB does not have specific statutory authority to establish a prompt corrective action (PCA) mechanism as do other federal banking regulators such as the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. Under such PCA authorities, bank regulators are required to take specific supervisory actions when bank capital levels fall below specified levels and may take other actions when specified unsafe and unsound actions occur. Although FHFB does not have PCA authority, FHFB officials believe they have all the necessary authorities to carry out their responsibilities; and
- FHFB has the statutory authority to liquidate or reorganize a critically undercapitalized FHLBank “whenever [FHFB] finds that the efficient and

---

<sup>9</sup>Operational risk is the risk of potential loss due to human error, systems malfunctions, man-made or natural disasters, fraud, or circumvention or failure of internal controls.

---

economical accomplishment of the purposes of the [FHLB Act] will be aided by such action.”<sup>10</sup>

---

---

## FHLBank System Membership, Asset Composition, and Capital Structure Have Undergone Significant Changes in the Past 15 Years

Until 1989, the FHLBank System consisted of the 12 FHLBanks, OF, and thrifts, which were required to join. However, FIRREA and GLBA made substantial changes to this traditional structure. In this section, I will describe in more detail how FHLBank System membership, asset composition, and capital structure have changed over the past 15 years after the implementation of these statutes and FHFBS regulations.

---

## Commercial Banks Currently Account for the Majority of System Members and Advances

Between 1990 and 2004, FHLBank System membership nearly tripled from 2,855 to 8,131 institutions (see fig. 2). As shown in the figure, the vast majority of membership increase can be attributed to commercial banks; whereas in the same period, thrift membership declined markedly. In 1990, thrifts accounted for 98 percent of all the System members but only 16 percent in 2004. In contrast, commercial banks accounted for 2 percent of all members in 1990 and 73 percent in 2004.<sup>11</sup> A variety of factors may account for the surge in commercial bank membership. First, FHLBanks actively recruited commercial banks as members after FIRREA. Commercial banks may also have been attracted by the fact that FHLBank advances represent a stable and relatively low-cost source of funding. Additionally, in an attempt to offset declining membership resulting from the failure of many thrifts, FHLBanks modified their services and products to attract new members. For example FHLBanks made changes in advance pricing and terms in response to market pressures.

---

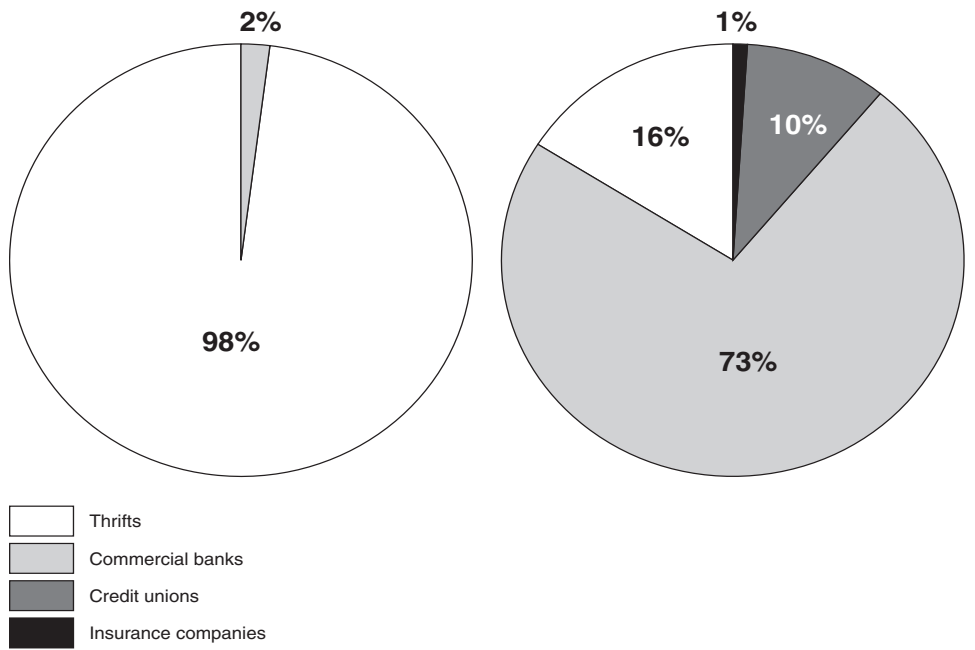
<sup>10</sup>12 U.S.C. §1446.

<sup>11</sup>As of 1999 before GLBA made membership voluntary for all members, commercial banks accounted for 72 percent of all System members.

**Figure 2: Composition of FHLBank System Membership, 1990 and 2004, by Member Institution Type**

1990 (2,855 member institutions)

2004 (8,131 member institutions)

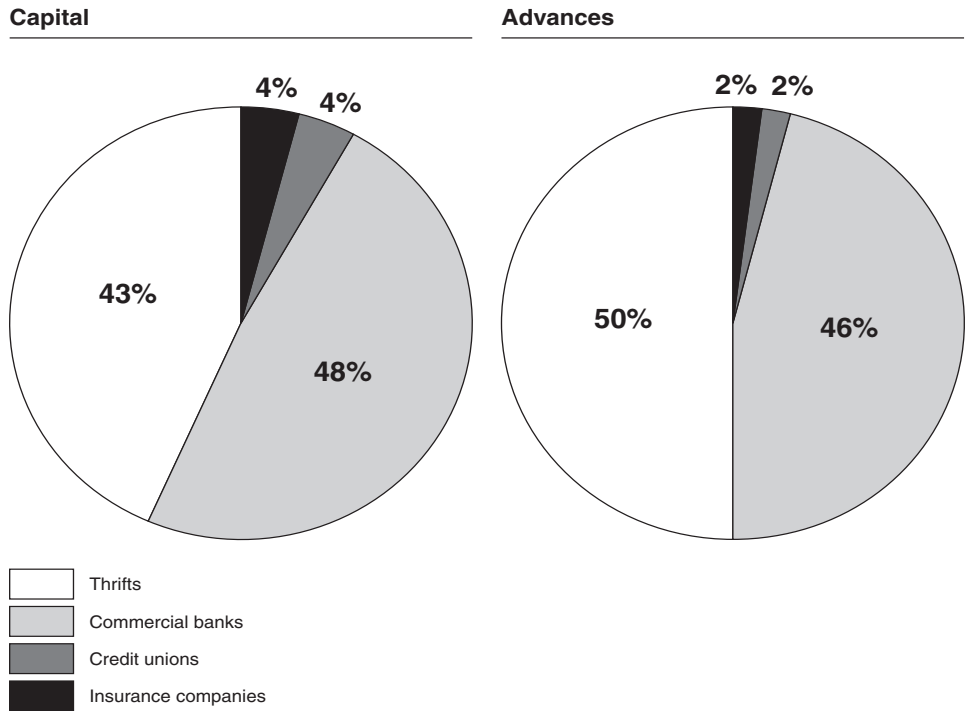


Source: GAO analysis of Federal Housing Finance Board data.

Not only do commercial banks represent a large percentage of FHLBank System members, they also hold a large percentage of System capital and advances.<sup>12</sup> As shown in figure 3, commercial banks now account for almost half of the System’s capital and advances. However, member thrifts still account for 43 percent of all system capital and 50 percent of all advances. Although thrifts account for a relatively small percentage of FHLBank members, they have remained significant customers of the FHLBank System due to their focus on mortgage financing.

<sup>12</sup>FHLBank members are required to invest capital in their FHLBank as a condition for membership. Members are generally also required to place additional capital in their FHLBank on the basis of the size of their advance business or mortgage purchases.

**Figure 3: System Capital and Advances, by Member Institution Type, as of December 31, 2004**



Source: GAO analysis of Federal Housing Finance Board data.

**Mix of System Asset Types Has Fluctuated Significantly from 1990 through 2004**

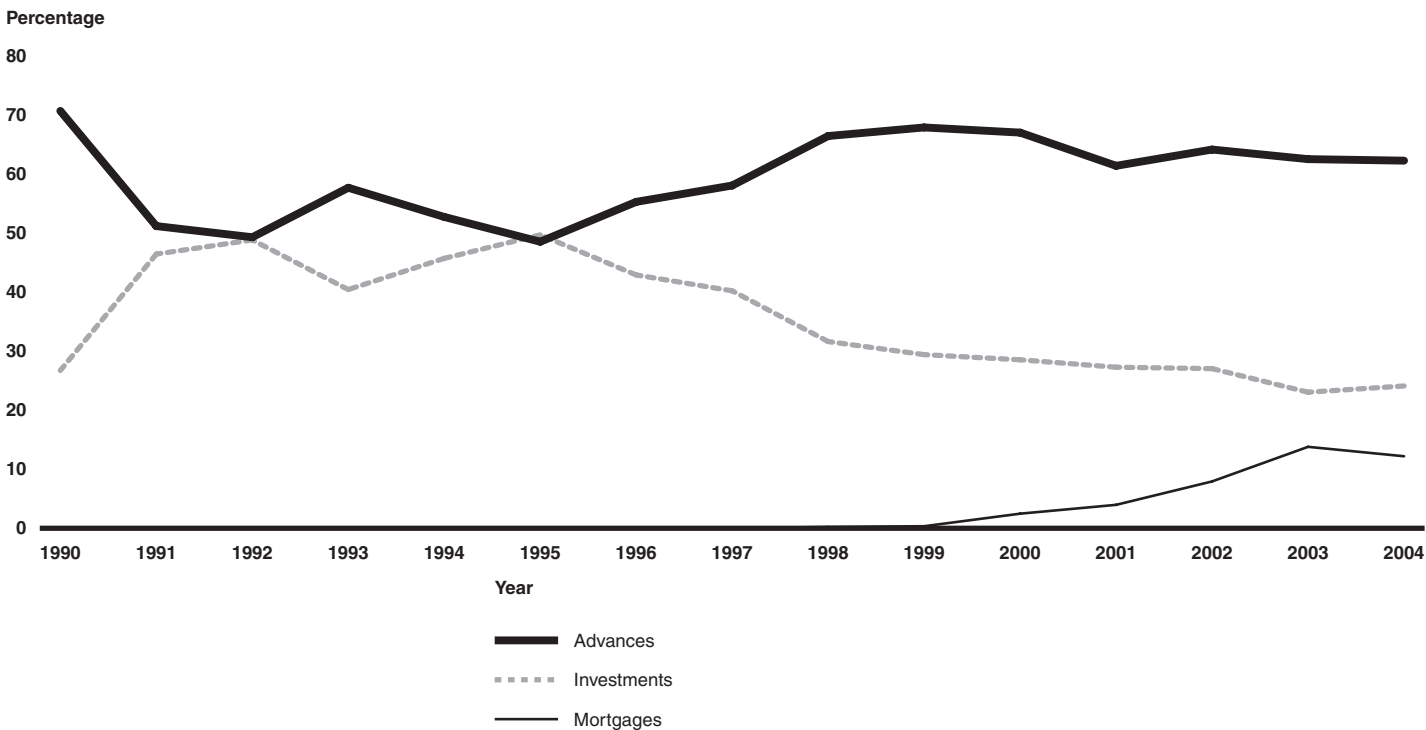
FHLBank System assets, which consist of advances, investments, and mortgages, increased from \$165 billion in 1990 to \$934 billion in 2004. As shown in figure 4, the mix of the three asset types has fluctuated in this time period although advances remained the largest category of assets. However, I note that the System did not hold mortgage assets until 1997.

In 1990, advances represented about 70 percent of all the System’s assets, but declined to about 50 percent between 1991 and 1996. In contrast, FHLBank System investments—such as holdings of mortgage-backed securities (MBS) issued by Fannie Mae and Freddie Mac—increased from 27 percent of all assets in 1990 to 43 percent in 1996. During that period, as I have discussed, the number of thrifts declined, resulting in a loss of System advance customers and concerns were raised that REFCORP obligations imposed significant financial burdens on the FHLBanks. Investments in MBS were viewed within the System as more profitable



than traditional advances and a potential means to comply with the REFCORP obligations. Through rulemaking, FHFB facilitated the FHLBanks' ability to invest in MBS. In 1991, FHFB increased the percentage of MBS that the FHLBanks could hold as a percentage of their capital from 50 percent to 200 percent and, in 1993, FHFB raised the MBS to capital ratio to 300 percent. I note that investments as a percentage of all the System's assets began to decline in 1995 while advances began to increase perhaps due, in part, to the increase in commercial bank members joining the System and taking advances.

**Figure 4: Mix of System Assets between 1990 and 2004, by Advances, Mortgages, and Investments**



Source: GAO analysis of Federal Housing Finance Board and Office of Finance data.

Note: Data from 1990 to 2003 is from Office of Finance annual reports. According to the Office of Finance, the FHLBank of Chicago restated its 2003 financial results, which resulted in changes to certain FHLBank System financial information. As of the date of this testimony, the restated report was not available, so we used the originally reported data for 2003. Since the Office of Finance 2004 annual report was not available at the time of this testimony, we used yearend 2004 data from FHFB. However, FHFB and the Office of Finance calculate investments differently. Therefore, we obtained 2004 data on investments from highlights of the upcoming Office of Finance 2004 annual report.

---

As I have discussed, FHFBS also authorized the FHLBanks to begin purchasing mortgage assets through mortgage purchase programs in 1997. By 2003, such mortgage assets grew to almost 14 percent of all the System's assets (about \$113 billion in total System mortgage assets at year-end 2003). The growth in mortgages generally occurred relative to investments which declined from 40 percent of all assets in 1997 to 23 percent in 2003. However, in 2004, the System's mortgage assets leveled off, partly because of difficulties identified at some FHLBanks in managing such assets. I discuss this issue in the next section.

---

## FHLBank System Has Implemented a New Capital Structure

As I discussed earlier, prior to 1999 voluntary FHLBank members, such as commercial banks, could withdraw their capital on 6-months notice, which raised questions about the stability of the FHLBanks' capital structure. To address this concern, GLBA established that FHLBank membership was voluntary but required that financial institutions that choose to become members invest more permanent stock in their FHLBank. Under the new capital structure, FHLBanks can issue class A stock, which can be redeemed with 6-months notice, and class B stock, which can be redeemed with 5-years notice, or both. To help ensure that capital does not dissipate due to redemption in times of stress, GLBA does not allow an FHLBank to redeem or repurchase capital if following the redemption the FHLBank would fail to satisfy any minimum capital requirement.

Under GLBA, the FHLBanks are also subject to both a leverage requirement (minimum capital-to-assets ratio) and a risk-based capital calculation. Under the leverage requirements, each FHLBank must comply with two minimum capital ratios. First, permanent capital (equal to amounts paid in for class B stock plus retained earnings) plus class A stock is to be at least 4 percent of assets. Second, class A stock plus 1.5 times permanent capital is to be at least 5 percent of assets. The risk-based capital standards account for credit risk, interest-rate risk, and operations risk. For credit risk, a FHFBS regulation specifies capital requirements according to the mix of activities (advances, mortgages, etc.) in which the individual FHLBank is engaging. For interest-rate risk, each of the FHLBanks must have a FHFBS-approved interest-rate risk model that provides an estimate of the market value of the FHLBank's portfolio during periods of market stress. The capital requirement for operations risk is generally 30 percent of the total capital charge for credit and interest-rate risk.

GLBA required each FHLBank to submit a capital plan to FHFBS for review and approval. FHFBS approved all 12 FHLBank capital plans by 2002 and 11

---

of the 12 FHLBanks have implemented their capital plans. According to FHFBS, 10 of the 12 capital plans rely entirely on class B stock and two of the capital plans include class A stock. As part of the capital plan implementation process, FHFBS has required the FHLBanks to submit plans for modeling interest-rate risk and related procedures for managing these risks.

---

## FHLBank System Faces Important Challenges and Questions

Finally, I would like to discuss some important challenges and questions affecting the FHLBank System. They include risk-management practices, the securitization of mortgage assets, the extent to which the FHLBank System is meeting its mission requirements, and the alleged impacts that large financial institutions are having on the System's traditional cooperative structure and AHP program.

---

## FHFBS Has Questioned FHLBanks' Risk-Management Practices

Over the past year, FHFBS identified risk-management deficiencies at two FHLBanks—Chicago and Seattle—primarily related to their management of the interest-rate risks associated with mortgage purchases. FHFBS identified weaknesses at these FHLBanks in such areas as corporate governance, financial recordkeeping, audit, and financial performance. Additionally, FHFBS entered into written enforcement agreements with both FHLBanks that require improvements in accounting practices and internal controls. The Chicago and Seattle FHLBanks were both required to submit 3-year business and capital plans to FHFBS and hire outside management consultants to review the banks' management and their board's oversight of the banks. The Chicago FHLBank has submitted its plan to FHFBS, which accepted it. The Seattle FHLBank received an extension and submitted its plan to FHFBS on April 5, 2005.

The financial problems identified at the Chicago and Seattle FHLBanks have had significant effects on their operations and business practices. For example, FHFBS required the Chicago FHLBank to restate its financial results for 2003 and placed limits on the growth of the institution's mortgage purchases until its risk-management practices improve. Previously, the Chicago FHLBank had been the primary engine of growth for the mortgage purchase programs within the FHLBank System. The Seattle FHLBank has decided to exit from the MPP program and thereby stop purchasing mortgages from its members.

FHFBS officials told us they continue to monitor risk management practices within the FHLBank System, particularly the management of interest-rate risks. FHFBS officials said that their examinations continue to identify

---

deficiencies in these areas and that they are working with the FHLBanks to correct them.

---

### Proposals to Use Securitization to Expand FHLBanks' Mortgage Purchase Programs Are Controversial

In recent years, proposals have been made to permit the FHLBanks to securitize mortgage assets to provide for the continued growth of the mortgage purchase programs. Without securitization, which would permit FHLBanks to remove mortgage assets from their balance sheets, the System's ability to increase its mortgage purchases may be constrained by capital requirements. That is, since the FHLBanks must comply with capital requirements for assets such as mortgages held on their balance sheets, they would not be able to expand these programs without obtaining additional capital from their members, which may prove difficult. According to FHF's chair, the agency should defer to Congress on the question of whether FHLBanks should be permitted to securitize their mortgage assets.

Securitization offers potential benefits to the FHLBank System but it raises questions as well. One potential benefit of securitization is that it would provide the FHLBanks with an additional tool to manage the interest-rate risks associated with mortgage purchases. Authorizing the FHLBanks to securitize mortgage assets has also been advocated as a means to increase competition in the secondary mortgage market, which could benefit lenders and homebuyers. However, questions exist on whether the FHLBanks would be able to develop the necessary infrastructure, including hiring staff with specialized expertise, to effectively manage securitization programs. Some FHLBank System members have also commented that securitization would further alter the System's traditional focus on providing advances to member institutions, and therefore, be undesirable.

---

### Limited Information Exists on the Extent to Which the FHLBank System Is Meeting Its Mission

Although anecdotal information exists on the benefits of the FHLBank System, limited quantitative analysis exists on the extent to which the FHLBanks' activities benefit homebuyers, mortgage finance, and community development. We recognize that conducting such research is challenging. First, isolating the FHLBanks' effects on mortgage markets is a complex and technical undertaking. Second, with the addition of mortgage purchase programs, the financial activities of the FHLBanks have become more sophisticated, thus complicating any analyses of benefits and costs. Nevertheless, assessing the outcomes of the FHLBank System's activities is important for Congress and others to determine

---

whether the risks associated with the System are offset by the potential benefits.

I would now like to highlight information and data limitations that hamper any assessment of mission achievement:

- We are not aware of any studies on the extent to which FHLBank advances, mortgage purchase, and other activities directly benefit homebuyers through lower mortgage costs. In contrast, several studies have estimated the potential savings to homebuyers associated with the mortgage purchase activities of Fannie Mae and Freddie Mac. Some of these studies estimate a substantial savings to homebuyers while others conclude that the savings are small and that Fannie Mae and Freddie Mac as well as their shareholders are the primary beneficiaries. Although the studies' findings may differ, they provide an empirical basis for discussing the costs and benefits of Fannie Mae and Freddie Mac's activities.
- Similarly, there is minimal empirical evidence on the extent to which the FHLBank System's advance business encourages lenders to expand their mortgage business. We have identified one existing study on this subject: a 2002 report by the Federal Reserve Bank of Cleveland.<sup>13</sup> The study found that there is a significant positive relationship between an FHLBank member's use of advances and its mortgage finance activity. However, we believe the report has certain methodological limitations and should be interpreted with caution. For example, the report does not demonstrate that members increased their mortgage assets as a result of joining the System, it only shows that System members have relatively high mortgage assets compared to non-System members (We are also aware that the FHLBank Council recently released two reports on this subject but we have not had time to analyze them in preparation for this testimony).
- There is limited information as to why the placement of small business and agricultural collateral by small community financial institutions (CFI) to secure FHLBank advances has been minimal. GLBA expanded the types of collateral (including small business and agricultural collateral) that CFIs could pledge to secure FHLBank advances in the view that doing so would allow the System to better meet the needs of small institutions. However, FHFBS data indicates that such collateral represents less than 1 percent of all collateral pledged to secure System advances. On the one hand, it may

---

<sup>13</sup>James B. Thompson, "Commercial Banks' Borrowing from the Federal Home Loan Banks," Federal Reserve Bank of Cleveland, July 2002.

---

be the case that very few institutions are willing to pledge such collateral to secure advances. However, the potential also exists that FHLBanks have established such strict underwriting standards—for example by applying significant haircuts to the collateral—that CFIs have been discouraged from pledging it.<sup>14</sup> We understand that FHFBS is planning a conference later this year to gather additional information on the use of CFI collateral.

---

### Questions Have Been Raised About the Impact of Large Holding Companies on the FHLBank System

In recent years, questions have been raised about the potential impacts of holding companies who may have mortgage subsidiaries that are members of two or more FHLBank districts on the FHLBank System structure, which traditionally involved each financial institution belonging to one FHLBank. In a 2003 report, we noted that there are about 100 holding companies that had subsidiaries who were members of two or more FHLBank districts.<sup>15</sup> Some observers have expressed concerns that such large financial institutions could pressure the FHLBanks to compete with one another on advance pricing terms—such as interest rates and collateral requirements—and that this competition could impair the overall safety and soundness of the FHLBanks. Our report noted significant differences in advance term pricing among the 12 FHLBanks and that the opportunity existed for holding companies to obtain advances from the FHLBank that offered the most favorable advance terms. Some FHLBank officials also said that holding companies seek to play one FHLBank off another creating competition within the System. However, we also found that FHFBS had not identified any material safety and soundness issues related to FHLBanks' advance-term pricing. I would reiterate a statement in our 2003 report that FHFBS has a continued responsibility to monitor the FHLBanks to help ensure that any competition within the System does not result in unsafe and unsound practices.

Concerns have also been raised that the activities of large financial institutions such as holding companies are having negative affects on the AHP program in certain FHLBank districts. Under FIRREA, FHLBanks

---

<sup>14</sup>Haircuts refer to the discounts that FHLBanks apply to collateral that is used to secure advances. For example, if the FHLBank has a 40 percent haircut for single-family mortgage loans, an FHLBank member could borrow up to 60 percent of the value of the single-family mortgages loans that it pledged as collateral.

<sup>15</sup>See GAO, “*Federal Home Loan Bank System: Key Loan Pricing Terms Can Differ Significantly*,” [GAO-03-973](#) (Washington, D.C.: Sep. 8, 2003).

---

must contribute 10 percent of their previous year's earnings to subsidize housing finance for targeted groups. In some cases, financial institutions located in one FHLBank district have purchased banks or thrifts in other FHLBank districts. As such financial institutions grow through out-of-area acquisitions, they may be able to increase their business relations with their local FHLBank thereby increasing its profitability. For example, such financial institutions may take out additional advances or sell additional mortgages to the FHLBank. With potentially increased profits from doing business with a larger member, the FHLBank would have additional funds to devote to the AHP program. In contrast, FHLBanks whose members were acquired potentially lose net income and AHP funding dollars. According to one FHLBank president, such acquisitions have hurt AHP funding in his bank's district. However, according to FHFBS officials, recent research they conducted shows that mergers may have a short-term impact on AHP funding, but these effects seem to balance out over time. For example, financial institutions in a FHLBank district that lost members through acquisitions may purchase financial institutions in other FHLBank districts thereby recapturing AHP funds. FHFBS officials also said that they may develop a regulation to address any concerns associated with mergers on AHP funding.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions that you or other members of the committee may have at this time.

---

## Staff Contacts and Acknowledgments

For further information regarding this testimony, please contact me at 202-512-8678 or [mccoolt@gao.gov](mailto:mccoolt@gao.gov) or William B. Shear, Director, at 202-512-8678 or [shearw@gao.gov](mailto:shearw@gao.gov), or Wesley M. Phillips, Assistant Director, at 202-512-5660 or [phillipsw@gao.gov](mailto:phillipsw@gao.gov). Individuals making contributions to this testimony include Rachel DeMarcus, Austin Kelly, Jill M. Naamane, Andy Pauline, Mitchell B. Rachlis, and Barbara Roesmann.

---

---

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



---

## GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

---

## Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site ([www.gao.gov](http://www.gao.gov)). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to [www.gao.gov](http://www.gao.gov) and select "Subscribe to Updates."

---

## Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office  
441 G Street NW, Room LM  
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000  
TDD: (202) 512-2537  
Fax: (202) 512-6061

---

## To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: [www.gao.gov/fraudnet/fraudnet.htm](http://www.gao.gov/fraudnet/fraudnet.htm)

E-mail: [fraudnet@gao.gov](mailto:fraudnet@gao.gov)

Automated answering system: (800) 424-5454 or (202) 512-7470

---

## Congressional Relations

Gloria Jarmon, Managing Director, [JarmonG@gao.gov](mailto:JarmonG@gao.gov) (202) 512-4400  
U.S. Government Accountability Office, 441 G Street NW, Room 7125  
Washington, D.C. 20548

---

## Public Affairs

Paul Anderson, Managing Director, [AndersonP1@gao.gov](mailto:AndersonP1@gao.gov) (202) 512-4800  
U.S. Government Accountability Office, 441 G Street NW, Room 7149  
Washington, D.C. 20548