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June 22, 2007

The Honorable Christopher Bond  
Ranking Member  
Subcommittee on Transportation, Housing and Urban Development, and Related  
Agencies  
Committee on Appropriations  
United States Senate

Subject: *Federal Home Loan Banks: Too Soon to Tell the Potential Impact of Excess  
Stock Rule on the Affordable Housing Program*

Dear Senator Bond:

Affordable housing organizations and Federal Home Loan Bank (FHLBank) members have raised concerns that a Federal Housing Finance Board (FHFB) rule limiting excess stock could adversely impact FHLBank earnings.<sup>1</sup> In particular, concerns have been raised regarding the FHLBanks' Affordable Housing Program (AHP), which subsidizes the cost of affordable housing with funds from the 12 FHLBanks, all of whom are required to contribute a minimum of 10 percent of their prior year's net earnings to the program, subject to a minimum annual combined contribution of \$100 million.<sup>2</sup> You asked us to examine the impact of FHFB's rule making on AHP. Specifically, this report describes (1) the results of FHFB's rule making and the provisions of the final rule on excess stock, and (2) the potential impact of the final rule on AHP. On May 22, 2007, we provided your staff with a briefing on the results of our work. Enclosure I is an updated version of the briefing we provided.

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<sup>1</sup>Excess stock is stock that is held by a member and exceeds that member's required minimum investment in FHLBank capital stock.

<sup>2</sup>Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 721, 12 U.S.C. 1430(j)(5).

## **Background**

In March 2006, FHFB issued a proposed rule that would require each FHLBank to (1) maintain a minimum level of retained earnings, (2) limit the amount of excess stock it could have outstanding, and (3) cease payments of dividends in the form of stock (referred to as stock dividends). However, in the final rule issued in December 2006, FHFB did not include a retained earnings requirement but did include limits on FHLBanks issuing excess stock and paying stock dividends.

The FHLBank System was created by the Federal Home Loan Bank Act of 1932 as a government-sponsored enterprise (GSE) to support mortgage lending and related community investment. Through AHP, the 12 FHLBanks subsidize the cost of affordable owner-occupied and rental housing targeted to individuals and families with very low, low, and moderate incomes.<sup>3</sup> From 1990 through 2006, FHLBanks awarded a total of nearly \$3 billion in AHP funds through member institutions, such as community banks, for a wide range of affordable housing projects. For 2006 specifically, FHLBanks awarded a total of about \$315 million in AHP funds.

### **Final Rule Places Limit on FHLBanks Issuing Excess Stock and Paying Stock Dividends**

The FHFB adopted a final rule in December 2006 limiting the ability of FHLBanks to create member excess stock under certain circumstances. The key features of the proposed rule were a limit on excess stock at each bank to one percent of its total assets, an absolute ban on the payment of stock dividends and sales of excess stock to members, and a requirement that banks with outstanding excess stock greater than one percent of assets develop a plan to reduce their excess stock to one percent. The effect of the final rule is that it limits the ability of FHLBanks to issue new shares of excess stock and pay stock dividends once the amount of outstanding excess stock reaches a threshold of 1 percent of a FHLBank's total assets.

The final rule addresses FHFB concerns about how excess stock could affect the FHLBanks System's mission. FHFB officials stated that FHLBanks have used cash from the sale of member excess stock to support capital market investments. They also noted that while some level of such investment is appropriate for liquidity and other purposes, high levels of excess stock can create an incentive for FHLBanks to create large portfolios of investments that are meant to provide a return on the excess stock, but which do not necessarily further the FHLBank System's public purpose of supporting mortgage lending and related community investment.

The FHFB also addressed safety and soundness concerns in its rule making. Since FHLBanks have generally redeemed excess stock upon the request of a member,

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<sup>3</sup>AHP subsidizes the cost of owner-occupied housing for individuals and families with incomes at or below 80 percent of the area median income, and rental housing in which at least 20 percent of the units are reserved for households with incomes at or below 50 percent of area median income. The subsidy may be in the form of a grant or a below-cost, or subsidized, interest rate on a secured loan from a FHLBank to a member lender.

FHFB officials do not believe that member excess stock is a stable source of capitalization, particularly when it is used to capitalize long-term assets, and because FHLBanks could experience large-scale repurchase (stock redemption) requests in a short period of time. FHFB officials also stated that while investments funded through the issuance of excess stock are intended to generate bank income, they add risk to a bank's balance sheet and must be managed appropriately in order to be profitable. Further, other factors, such as the type of investment and degree of leveraging, also affect the level of earnings generated by each FHLBank's investments through excess stock.

### **Too Soon to Tell Potential Impact of Excess Stock Final Rule**

The final rule may have an impact on the FHLBanks' AHP, but FHLBank and trade group officials stated it is too early to tell. Officials at two FHLBanks told us that the final rule could limit the ability of FHLBanks to increase capital over time since FHLBanks can no longer pay stock dividends or issue excess stock once they reach the 1 percent threshold. Paying cash dividends in place of stock dividends lowers the amount of funds available to generate income through FHLBank investments. Since FHLBanks are required to contribute 10 percent of the prior year's net earnings to AHP, lower levels of FHLBank investments could lower net earnings, which in turn reduce FHLBank contributions to AHP. As of the end of September 2006, four FHLBanks had excess stock with a value greater than 1 percent of total assets, and one of these was paying stock dividends. This FHLBank paid a total of \$205 million in stock dividends to members during 2006. According to the FHLBank's officials, if this amount had been paid in cash dividends, the resulting reduction in annual AHP funding would have been about \$1.2 million since the bank would have had lower levels of investments to generate income. Overall, FHLBank and trade group officials we interviewed said it is too early to tell what the exact impact of the final rule on AHP will be. FHLBank officials stated that it is too early to make an accurate assessment whether FHLBank capital growth may decrease, by how much, and to what extent this could affect earnings and contributions to AHP. Trade group officials stated there has not been a noticeable impact on AHP subsidies for projects, but the situation could change based on what happens to the banks over time.

### **Agency Comments and Our Evaluation**

We provided a draft of this report to the Chairman of FHFB for his review and comment. We received informal comments that are summarized in this section. We also received technical comments that we incorporated into the report where appropriate. In its comments, FHFB stated that our description in the report that it's too soon to tell the potential impact of the excess stock rule repeats, without independent analysis, arguments made by certain FHLBank officials and trade group representatives. Further, FHFB stated that the estimate presented in the report of the potential reduction in AHP contributions at one FHLBank depends on a number of assumptions, including a fixed leverage ratio, the pricing of products, and the types of investments the FHLBank makes. FHFB also noted that this estimate amounts to less than 1 percent of AHP funding by all the banks in 2006. In the absence of a rule in place over a period of time that limits the issuing of excess stock to members, we

lack a basis for determining to what extent the rule may affect each FHLBanks' use of excess stock in financing investments, and to what extent earnings could be affected by those investments. While the final rule places limits on excess stock, we believe that the impact of actions taken by FHLBanks to date based on the rule cannot be determined given that the rule has been in effect only since the end of January 2007. Further, in our report, we note that various factors, including the degree of leveraging and type of investment, affect the level of earnings generated by investments made through the sale of excess stock. Finally, the estimate of the potential reduction in AHP contributions we report is for one FHLBank. Rather than making a direct comparison to either system-wide or FHLBank specific AHP funding, we provided the 2006 level of system-wide AHP funding in the background section of our report.

FHFB also noted that two FHLBanks had income problems arising from mortgage loans capitalized by excess stock and were operating under written agreements in 2006, and that this capitalization of long-term assets was one of the concerns it addressed in restricting excess stock. We inserted in our report that one of the primary concerns FHFB had in its formulation of the rule is the capitalization of long-term assets.

### **Scope and Methodology**

To describe the results of the FHFB's rule making and the provisions of the final rule on excess stock, we obtained and analyzed information on FHFB's rule making for the proposed and final rule. We also reviewed comment letters submitted by FHLBanks and trade associations addressing the proposed rule and interviewed FHFB officials. To describe the potential impact of the final rule on the FHLBanks' AHP, we reviewed documentation on the possible impact of the final rule on the AHP. We also interviewed officials from two FHLBanks, one of which was the most affected by the rule, and officials from three trade associations—the Council of FHLBanks, the Mortgage Bankers Association, and the National Low-Income Housing Coalition. We conducted our work from February 2007 through June 2007 in accordance with generally accepted government auditing standards.

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We are sending copies of this report to the Chairman of the Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, Senate Committee on Appropriations; the Chairman and Ranking Member of the Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, House Committee on Appropriations; and the Chairman of the FHFB. We will also make copies available to others upon request. In addition, the report will be available at no charge on the GAO Website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or [shearw@gao.gov](mailto:shearw@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs can be found on the last page of this report. Major

contributors to this report were John Wanska, Assistant Director; Tarek Mahmassani; Barbara Roesmann, and Paul Thompson.

Sincerely yours,

A handwritten signature in black ink that reads "William B. Shear". The signature is written in a cursive style with a large initial 'W' and a long, sweeping tail on the 'r'.

William B. Shear,  
Director, Financial Markets and Community Investment

Enclosure

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program**



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Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program

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Briefing for:

The Honorable Christopher Bond

Ranking Member, Subcommittee on Transportation, Housing and Urban Development, and Related Agencies

Committee on Appropriations

United States Senate

May 22, 2007

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**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



Overview

- Introduction
- Objectives
- Scope and Methodology
- Background
- Discussion of Objectives

## Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)



- Through the Affordable Housing Program (AHP), the 12 Federal Home Loan Banks (FHLBanks) subsidize the cost of affordable owner-occupied and rental housing targeting individuals and families with very low, low, and moderate incomes.<sup>1</sup>
  - From 1990 through 2006, FHLBanks awarded a total of nearly \$3 billion in AHP funds through member institutions for a wide range of affordable housing projects.
  - By statute, each of the 12 FHLBanks is required to contribute at least 10 percent of its previous year's net earnings to AHP, subject to a minimum annual combined contribution by the 12 banks of \$100 million.<sup>2</sup>
1. AHP subsidizes the cost of owner-occupied housing for individuals and families with incomes at or below 80 percent of the area median income, and rental housing in which at least 20 percent of the units are reserved for households with incomes at or below 50 percent of area median income. The subsidy may be in the form of a grant or a subsidized interest rate on a secured loan from a FHLBank to a member lender.
  2. Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 721, 12 U.S.C. 1430(j)(5).



**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- Affordable housing organizations and FHLBank members have raised concerns that a Federal Housing Finance Board (FHFB) rule limiting FHLBank member excess stock (stock that is held by a member that exceeds that member's minimum investment in FHLBank capital stock) could adversely impact FHLBank earnings, and consequently funding for the FHLBanks' AHP.
- The FHFB issued a proposed rule in March 2006 that would have required each FHLBank to maintain a minimum level of retained earnings, limit the amount of outstanding excess stock it could have, and prohibit FHLBanks from paying dividends in the form of stock (referred to as stock dividends).
- The December 2006 final rule did not include a retained earnings requirement; the rule primarily focused on limiting the ability of FHLBanks to issue new shares of excess stock and pay stock dividends.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



Objectives

1. Describe the results of FHFB's rulemaking process and the provisions of the final rule on excess stock.
2. Describe the potential impact of the final rule on the AHP.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



Scope and Methodology

- Obtained and analyzed information on the proposed and final rule, the AHP, and the potential impact of the final rule on the AHP.
- Reviewed comment letters submitted by FHLBanks and trade associations about the proposed rule.
- Interviewed officials from FHFB and two FHLBanks, one of which was the most affected by FHFB's final rule.
- Interviewed officials from three trade associations:
  - Council of FHLBanks
  - Mortgage Bankers Association
  - National Low Income Housing Coalition
- We conducted our work from February 2007 through June 2007 in accordance with generally accepted government auditing standards.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



Background

- The FHLBank System (the System) was created by the Federal Home Loan Bank Act of 1932 as a government-sponsored enterprise (GSE) to support mortgage lending and related community investment.
  - The System comprises 12 FHLBanks with more than 8,000 member financial institutions, and the Office of Finance, which issues debt on behalf of the FHLBanks.
  - Each FHLBank is a separate, government-chartered, member-owned corporation.
  - As GSEs, FHLBanks are able to borrow in capital markets at favorable rates and provide secured loans, known as advances, at favorable rates to their members.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



Background

- FHFB is the regulator for the FHLBank System.
- FHFB ensures that the 12 FHLBanks:
  - Operate in a safe and sound manner;
  - Carry out their housing and community development finance mission;
  - Remain adequately capitalized; and
  - Are able to raise funds in the capital markets.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



Background

- The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 established AHP and expanded the FHLBank System's mission to include affordable housing and community development lending.
- 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.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



Background

- Over the years, AHP has provided assistance to groups such as:
  - Low- and moderate-income homeowners and first-time homebuyers;
  - Very low-income residents of rental housing;
  - Residents in rural communities; and
  - Residents in urban areas.
- AHP funds are awarded through FHLBank members under two programs.
  - AHP competitive program:
    - Members submit applications on behalf of sponsors and developers of affordable housing projects.
    - Projects must meet certain eligibility requirements and those that achieve the highest scores on their applications obtain funding.

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**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



Background

- AHP homeownership set-aside program:
  - Each FHLBank may set aside up to the greater of \$4.5 million or 35 percent of its AHP funds each year to assist low- and moderate income-households in purchasing homes, provided that at least one-third of each FHLBank's set-aside allocation is made available to assist first-time homebuyers.
  - The FHLBanks allocate funds to members that in turn use them to make grants to eligible households.
  - Set-aside funds may be used for down payment, closing cost, counseling, or rehabilitation assistance.
- In 2006, FHLBanks awarded a total of about \$315 million through both programs, with the competitive program accounting for about \$265 million.

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**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- Excess stock defined:
  - The members of each FHLBank must buy stock in the FHLBank, usually redeemable at par or face value, as a prerequisite for obtaining advances and other FHLBank services.
  - Excess stock is any FHLBank stock held by a member that exceeds that member's required minimum investment in capital stock.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- In the past, FHLBanks have issued excess stock and paid stock dividends to members.
  - Members may receive tax benefits from stock dividends versus cash dividends.
  - FHLBanks are able to use cash from the sale of excess stock and from paying stock instead of cash dividends to finance investments that provide another source of income.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- Rationale for rule (mission concerns):
  - FHFB had concerns about FHLBanks using member excess stock to support capital market investments, such as mortgage backed securities and other investments, that;
    - Exceeded the level of such investments required for liquidity and other purposes; and
    - Did not necessarily further the FHLBank System's mission.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- Rationale for rule (safety and soundness concerns):
  - FHLBanks have generally redeemed excess stock upon the request of a member, and therefore FHFB did not believe that member excess stock was a sufficiently stable source of capitalization for FHLBanks, particularly because FHLBanks could experience large-scale repurchase (stock redemption) requests in a short period of time.
  - FHFB also believed that while FHLBanks have a 5-year statutory redemption period for Class B stock (6 months for Class A stock), waiting the entire 5-year period to honor the redemption request could be interpreted by members as a sign of a weak financial position, which could precipitate more redemption requests.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- Rationale for rule (safety and soundness concerns):
  - FHLBanks that use excess stock to capitalize long-term investments with significant market risk may not be able to sell the investment, in response to a redemption request prior to the 5-year waiting period, without realizing a loss in market value.
  - FHFB officials also explained that while FHLBanks may expect investments through excess stock to generate Bank income, these investments bear risk, and consequently excess stock has to be invested appropriately to be profitable.
  - In addition, FHFB officials cited other factors, such as type of investment and degree of leveraging, that can also affect the level of earnings generated by each FHLBank's investments through excess stock.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- The proposed rule would have placed limitations on member excess stock:
  - Limited the amount of member excess stock that a FHLBank could have outstanding to 1 percent of its total assets.
  - Required a FHLBank with excess stock greater than 1 percent of assets to submit a plan to FHFB describing how the FHLBank would come into compliance.
  - Prohibited a FHLBank from paying stock dividends regardless of how much excess stock it had outstanding and issuing any additional shares of excess stock to members.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- The proposed rule also would have required each FHLBank to achieve and maintain a minimum level of retained earnings.
  - The retained earnings provision would have also barred FHLBanks not meeting the minimum level from distributing more than 50 percent of net income as dividends, unless permitted by FHFB.
  - The retained earnings provision was not included in the final rule due to concerns by FHLBanks, their members, and trade groups that it would adversely affect the value of FHLBank membership.
- FHFB officials stated that they plan to address the retained earnings requirement in the future, but not earlier than 2008.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- Main provisions of the final rule that became effective on January 29, 2007:
  - A FHLBank may not issue new shares of excess stock once the value of its total excess stock is greater than 1 percent of its total assets.
  - A FHLBank also may not pay stock dividends once its total excess stock is greater than 1 percent of its total assets.
  - FHLBanks with excess stock below the threshold are not limited in issuing additional excess stock or paying stock dividends, unless doing so would result in the value of the bank's excess stock exceeding 1 percent of its total assets.
  - FHLBanks with excess stock exceeding the 1 percent barrier are not required to develop a plan to bring their level into compliance, but may not increase their level of excess stock.



**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- As of the end of September 2006, four FHLBanks had excess stock with a value greater than 1 percent of total assets, and one of these was paying stock dividends.
- Officials at two FHLBanks told us that the final rule could limit the ability of FHLBanks to increase capital over time because:
  - When a FHLBank exceeds the 1 percent threshold, it can no longer pay dividends in the form of stock.
  - Paying cash dividends lowers the amount of funds available to generate income through FHLBank investments, such as mortgage-backed securities that could generate earnings over time.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- FHLBank and trade group officials we interviewed said this could have an impact on AHP.
  - Since FHLBanks are required to contribute a minimum of 10 percent of net earnings to AHP, lower levels of FHLBank investments could lower net earnings, which in turn reduce FHLBank contributions to AHP.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- For example, during 2006, one FHLBank paid \$205 million in stock dividends to members.
  - According to the FHLBank's officials, if this amount had been paid in cash dividends, the FHLBank would have realized lower net income for the year since the money would not have been available to invest in interest-earning assets.
  - Based on the bank officials' estimates, the resulting reduction in annual AHP funding would have been about \$1.2 million.
- The FHLBank in the example is the only one that as of September 2006 had excess stock that exceeded 1 percent of total assets and was paying a stock dividend. This FHLBank can no longer issue excess stock or pay stock dividends until the value of its excess stock drops to 1 percent or less of its total assets.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- As of September 2006, three FHLBanks had excess stock that exceeded 1 percent of total assets but were not paying a stock dividend to members.
- Had the final rule been in effect during 2006, these three FHLBanks would have been prohibited from issuing additional excess stock.

**Enclosure I: Potential Impact of Excess Stock Rule on the Federal Home Loan Banks' Affordable Housing Program (cont'd.)**



- FHLBank and trade group officials we interviewed said it was too early to tell what the exact impact of the final rule on AHP will be.
  - FHLBank officials stated that while the final rule could reduce the ability of banks to increase capital, it is too early to make an accurate assessment whether FHLBank capital growth may decrease, by how much, and to what extent this could affect earnings and contributions to AHP.
  - Officials from two trade groups stated that the final rule has not had a noticeable impact on AHP subsidies for affordable housing projects, but that this could change since the rule has only been in effect since the end of January 2007.

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