FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices

EVALUATION REPORT: EVL-2012-005 **DATED: June 28, 2012**

FEDERAL HOUSING FINANCE AGENCY
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AT A GLANCE

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Why FHFA-OIG Did This Report

The Federal Home Loan Bank System (FHLBank System) is a government-sponsored enterprise (GSE) comprised of 12 regional Federal Home Loan Banks (FHLBanks) whose primary mission is to support housing finance. To carry out this mission, the FHLBank System's central Office of Finance issues debt at the relatively favorable rates available to GSEs. The FHLBanks use the proceeds of this debt to make secured loans, also known as advances, to member financial institutions, such as banks. These member financial institutions can then use the advance proceeds to originate residential mortgages. FHLBanks may also extend unsecured short-term credit (namely, loans not backed by collateral) to domestic and foreign financial institutions.

Extensions of unsecured credit by the FHLBanks to, among others, European banks, grew rapidly to more than $120 billion by early 2011. However, they declined sharply by the end of 2011 as the European sovereign debt crisis intensified.

The Federal Housing Finance Agency (FHFA or Agency) regulates the FHLBanks. FHFA has critical responsibilities to ensure that the FHLBanks operate in a safe and sound manner and fulfill their housing mission objectives. FHFA's Office of Inspector General (FHFA-OIG) initiated this evaluation to assess FHFA's oversight of the FHLBanks' unsecured credit risk management practices.

What FHFA-OIG Found

Extensions of unsecured credit by the FHLBanks to, among others, European financial institutions, increased substantially in 2010 and 2011, even as the risks associated with doing so were intensifying. For example, FHFA-OIG found that in 2011 one FHLBank extended more than $1 billion in unsecured credit to a European bank despite indications of increased risks associated with doing so, e.g., the bank's credit rating was downgraded and it later suffered a multibillion dollar loss. FHFA internal documents from that period also noted the rapid, system-wide growth in unsecured credit, certain FHLBanks' large exposures to particular financial institutions, and the increasing credit and other risks associated with such lending.

Although FHFA identified extensions of unsecured credit by the FHLBanks as an increasing risk in early 2010, the Agency did not prioritize it in its examination process due to its focus on greater financial risks then facing the FHLBank System. In 2011, however, FHFA initiated a range of oversight measures that focus on credit extensions, including prioritizing them in the supervisory process and increasing the frequency with which the FHLBanks report on their unsecured credit portfolios.

FHFA-OIG believes that FHFA's recent initiatives contributed to the significant decline in the amount of unsecured credit the FHLBanks were extending by the end of 2011. However, FHFA can take additional actions that will further strengthen its oversight efforts. Specifically, FHFA did not initially pursue potential evidence of FHLBanks' violations of the existing regulatory limits and take supervisory and enforcement actions as warranted. Further, FHFA's regulatory limits for unsecured credit may be outdated and overly permissive. Even when an FHLBank operates within the established limits it can amass the sort of large unsecured credit exposure that has been the source of considerable regulatory concern.

What FHFA-OIG Recommends

FHFA-OIG recommends that FHFA investigate potential violations of its regulations governing extensions of unsecured credit identified by FHFA-OIG. Further, FHFA should consider revising current regulatory limits to mitigate the risks associated with extensions of unsecured credit by the FHLBanks. FHFA agreed with these recommendations.

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ABBREVIATIONS

CDS ..... Credit Default Swap
DBR ..... Division of Federal Home Loan Bank Regulation
Fannie Mae ..... Federal National Mortgage Association
FHFA or Agency ..... Federal Housing Finance Agency
FHFA-OIG ..... Federal Housing Finance Agency, Office of Inspector General
FHFB ..... Federal Housing Finance Board
FHLBanks ..... Federal Home Loan Banks
FHLBank System ..... Federal Home Loan Bank System
Freddie Mac ..... Federal Home Loan Mortgage Corporation
GSE ..... Government-Sponsored Enterprise
MBS ..... Mortgage-Backed Security
PLMBS ..... Private Label Mortgage-Backed Security
S&P ..... Standard & Poor's

Federal Housing Finance Agency
Office of Inspector General
Washington, DC

PREFACE

The FHLBank System is a GSE that was established in 1932 and tasked to promote housing finance in the United States. A dozen regional FHLBanks and the Office of Finance comprise the FHLBank System. The FHLBanks support housing finance primarily by making secured loans, which are called advances, to member financial institutions, such as banks and thrifts. These members can use the proceeds to originate mortgages.[1] FHLBanks also make a variety of investments, including extensions of short-term (i.e., overnight to no more than 270 days) unsecured credit to domestic and foreign financial institutions.[2] The FHLBank System funds FHLBank advances and investments through its Office of Finance, which issues debt at the favorable interest rates available to GSEs.[3]

As GSEs, there is the potential that FHLBanks may engage in risky activities that could destabilize their financial conditions.[4] FHFA, in its role as the FHLBank System's safety and soundness regulator, is responsible for ensuring that the FHLBanks effectively manage their risk to minimize the potential for such negative outcomes. FHFA is also responsible for ensuring that the FHLBank System fulfills its housing mission objectives.

[1] FHLBank advances are secured by eligible collateral such as single-family mortgages or investment grade securities, among other assets**.**

[2] FHLBanks typically extend unsecured credit to domestic (U.S.) financial institutions. FHLBanks also extend unsecured credit to foreign financial institutions, e.g., branches of foreign-owned banks that do business in the U.S. and are subject to some U.S. governmental regulation. In this report, FHFA-OIG uses the terms "foreign banks," "foreign financial institutions," and "foreign borrowers" to refer to foreign financial institutions that do business in the U.S. and are subject to some U.S. governmental regulation.

[3] The FHLBank System can borrow at favorable rates due to the perception in financial markets that the federal government will guarantee repayment of its debt even though such a guarantee has not been made explicitly. This phenomenon is known as the "implicit guarantee." *See* FHFA-OIG, *FHFA's Oversight of Troubled Federal Home Loan* (EVL-2012-001, January 11, 2012).

[4] Due to the implicit federal guarantee, FHLBanks can conceivably rely indefinitely on debt issued at favorable rates to finance their activities. This would enable them to engage in higher risk transactions that could result in financial deterioration over time. Such deterioration could potentially result in the failure of an FHLBank and in the U.S. Treasury Department deciding to provide financial support to the FHLBank System as a means to stabilize financial markets.

FHFA-OIG initiated this evaluation in early 2012 after discussing the risks associated with the FHLBanks' unsecured credit practices with FHFA and reviewing Agency financial data. The data indicate that as of early 2011, the FHLBanks had extended more than $120 billion in unsecured credit to domestic and foreign financial institutions, including European banks. In light of the financial deterioration of financial institutions associated with the **European sovereign debt crisis**, FHFA-OIG's objective was to assess FHFA's oversight of the FHLBanks' risk management practices and the regulatory framework under which FHFA conducts its oversight.

The European Sovereign Debt Crisis: A continuing financial crisis prompted by concerns about rising levels of public debt in a number of European countries. Credit downgrades made it more expensive for these countries to borrow against their debt, giving rise to concerns about the possibility of defaults on sovereign debt. Many European financial institutions, particularly banks that hold sovereign debt or other potentially risky assets, have suffered significant losses, restructured, or gone out of business. The crisis has continued into 2012.

This report was written principally by Wesley M. Phillips, Senior Policy Analyst; Simon Wu, Ph.D., Chief Economist; and Jon Anders, Program Analyst. FHFA-OIG appreciates the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on FHFA-OIG's website, www.fhfaoig.gov.

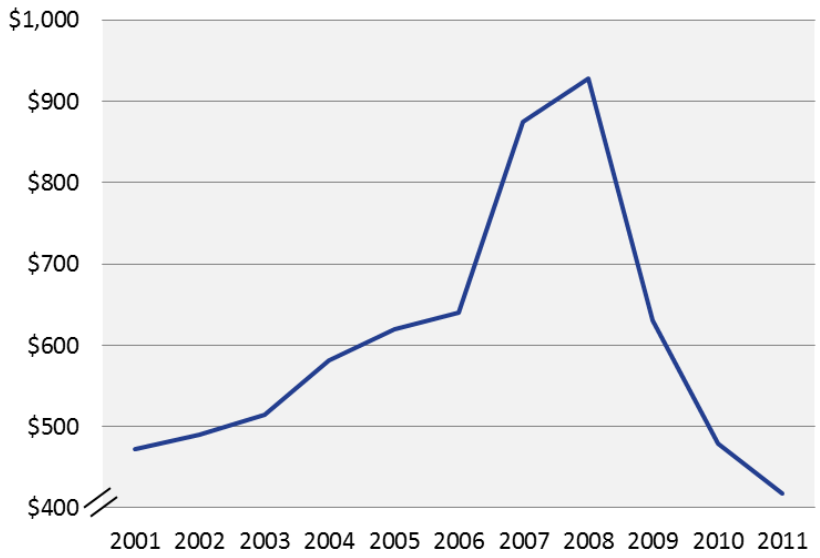
Richard Parker
Director, Office of Policy, Oversight, and Review

BACKGROUND

I. As the FHLBanks' Advances Have Declined, FHFA Has Expressed Concerns About Certain FHLBanks' Increasing Reliance on Investments, Such as Extensions of Unsecured Credit

FHLBank advances to member institutions have fluctuated significantly over the past several years (see Figure 1). At the end of 2008, member demand for advances jumped to nearly $930 billion. However, from the end of 2008 through the end of 2011, FHLBank advances declined more than 50% to $418 billion.[5] FHFA officials attribute the sharp decline in advances to a variety of factors including: (1) the wide availability of lower-cost bank funding sources, such as retail deposits; (2) the poor state of the U.S. housing market and the associated decline in mortgage demand; and (3) the mergers or failures of certain large FHLBank members, such as Countrywide and IndyMac Corporation.

Figure 1: FHLBank System Advances, Year-end 2001 Through Year-end 2011 (in Billions)[6]



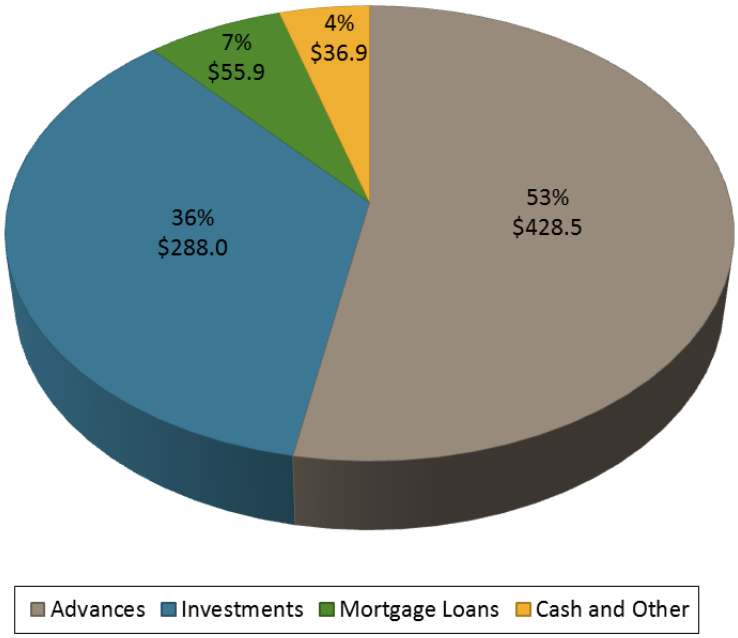
As of June 2011, advances to member FHLBank financial institutions constituted the majority of the FHLBank System's assets (53%). However, the FHLBanks also hold investments, whole

[5] At the end of 2011, total advances amounted to $418 billion – $54 billion less than at the end of 2001 on a nominal basis.

[6] Source: FHLBanks Office of Finance, *Annual Combined Financial Reports for 2001 through 2011*, available at http://www.fhlb-of.com/ofweb_userWeb/pageBuilder/fhlbank-financial-data-36.

mortgages purchased directly from their members, and cash and other miscellaneous assets (see Figure 2). Investments constituted 36% of the FHLBank System's total assets in June 2011, and these investments included mortgage-backed securities (MBS) issued by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac); private label mortgage-backed securities (PLMBS), i.e., MBS that is not issued by Fannie Mae, Freddie Mac, or the Government National Mortgage Association; and extensions of unsecured credit.[7]

Figure 2: FHLBank System Assets as of June 2011 (in Billions)[8]



The FHLBanks' investment portfolios generate interest revenue and income that enhances their financial performance. FHLBank officials have also stated that their investments help them to meet FHLBank System liquidity needs. For instance, unsecured credit is often extended on an overnight basis, which means that it can serve as a ready source of liquidity to fund potential advance demand. Although FHFA officials agreed that unsecured credit can serve as a source of liquidity for advances, they noted that FHLBanks have other, more significant sources of

[7] Like the FHLBank System, Fannie Mae and Freddie Mac are housing GSEs. To fulfill their missions, Fannie Mae and Freddie Mac purchase mortgages from lenders and hold them or package them into MBS that is sold to investors. Non-GSEs, such as banks and mortgage finance companies, may also package mortgages into securities, known as private-label MBS, or PLMBS.

[8] Source: FHLBanks Office of Finance, *Combined Financial Report for the Quarterly Period Ended June 30, 2011*, available at http://www.fhlb-of.com/ofweb_userWeb/resources/11Q2end.pdf.

liquidity. One official said that the FHLBanks should generally be able to meet advance demand through debt issuance by the FHLBank System's Office of Finance.[9]

FHFA officials also said that some FHLBanks extend unsecured credit because doing so can generate higher returns than advances, which contributes to return on their capital. FHFA has also concluded that FHLBanks may extend unsecured credit to offset the overall decline in the demand for advances by members in recent years.[10]

FHFA classifies investments in MBS and PLMBS and extensions of unsecured credit as non-core mission activities.[11] FHFA's Acting Director has expressed concern about the high level of non-core mission activities of certain FHLBanks. He has stated that "… the FHLBanks' various financial problems of the past 20 years have not come from the traditional advance business. Instead, investments and mortgage purchase programs have been the source of financial deterioration at some FHLBanks." He also stated that it "… is not a sustainable operating condition for an FHLBank" to have a large investment portfolio.[12] Indeed, in a report issued earlier this year, FHFA-OIG noted that several FHLBanks' large investments in PLMBS caused them to experience billions of dollars in losses.[13]

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[9] FHFA-OIG is not in a position to dispute the FHLBanks' view that unsecured credit is generally extended to meet FHLBank System liquidity needs. Nonetheless, this report demonstrates that from 2008 through the beginning of 2011, extensions of unsecured credit to foreign institutions rapidly increased even as the demand for advances to members plummeted (*see* Figures 7a and 7b, below). Thus, it is not clear that this increase in unsecured credit was undertaken to meet potential advance demand.

[10] FHFA plans to conduct an examination of all 12 FHLBanks' unsecured credit risk management practices in 2012. The Agency noted in its internal analysis, which substantiated the need to conduct the examination, that FHLBanks increased their levels of unsecured credit due, in part, to declining advance demand in recent years. Officials from one FHLBank concurred that from 2008 to the beginning of 2011, their FHLBank made extensions of unsecured credit, in part, to offset the decline in the demand for advances.

[11] FHFA's regulation at 12 C.F.R. § 1265.2 emphasizes that the FHLBanks' mission is to provide to their members financial products and services that assist them to finance housing and community lending. Further, FHFA has defined activities that qualify as core to the FHLBanks' mission. *See, e.g.*, 12 C.F.R. § 1265.3. Extending unsecured credit is not included within this definition and, therefore, is not a core mission activity. The regulation also specifies that investing in MBS is a core mission activity only to the extent that such investment "would expand liquidity for loans that are not otherwise adequately provided by the private sector and do not have a readily available or well established secondary market." *Id.* Accordingly, an FHFA official confirmed that the regulatory definition does not cover investment in Fannie Mae and Freddie Mac MBS; it also does not extend to investment in PLMBS.

[12] FHFA Acting Director Edward J. Demarco, *The Franchise Value of Federal Home Loan Banks*, 2011 Federal Home Loan Bank Directors Conference, Washington, DC, May 11, 2011, available at www.fhfa.gov/web-files/21197/FHLB51111Final.pdf.

[13] *See* FHFA-OIG, *FHFA's Oversight of Troubled Federal Home Loan Banks*, (EVL-2012-001, January 11, 2012).

Officials from one FHLBank also advised that in recent years its extensions of unsecured credit to foreign financial institutions have increased due to significant declines in domestic short-term lending since the 2008 financial crisis.

II. Unsecured Credit Can Be a Substantial Component of an FHLBank's Assets and Investments

Like other financial institutions, the FHLBanks participate in short-term, unsecured credit markets.[14] According to FHFA officials, the FHLBanks' extensions of unsecured credit typically involve **commercial paper**, **banknotes**, and **federal funds**.[15] Such credit extensions take place either on an overnight basis or for a term of no longer than 270 days. For example, in June 2011, 42% of all unsecured credit was extended on an overnight basis, 33% had a term limit of between 2 and 30 days, 24% had a term limit of between 31 and 90 days, and 1% had a term limit of between 91 and 180 days.

Commercial Paper: Unsecured, short-term debt instruments issued by corporations, typically for the financing of accounts receivable, inventories, and meeting short-term liabilities. Maturities on commercial paper rarely range any longer than 270 days.

Banknotes: Negotiable promissory notes issued by banks and payable to the bearer on demand. The amount payable is stated on the face of the note.

Federal Funds: Extensions of unsecured credit between financial institutions that are generally made on an overnight basis.

As shown in Figures 3a and 3b, below, extensions of unsecured credit to financial institutions accounted for 10.2% of the FHLBank System's assets in June 2011 and 28.6% of its investment portfolio in June 2011.[16] It can also vary considerably as a percentage of an FHLBank's total assets and investment portfolio (i.e., from 0.4% to 20.2% of total assets and from 0.7% to 42.4% of investments). Further, some of the smaller FHLBanks engage in relatively more extensions of unsecured credit to domestic

[14] Unsecured credit is a facet of the Interbank Market, which is vital for banks' liquidity management. Unsecured credit is offered at a premium due to the heightened credit risk that is transferred to the lender. *See* Heider and Hoerova, *"Interbank Lending, Credit-Risk Premia, and Collateral,"* International Journal of Central Banking, Vol. 5, Number 4, December 2009, p. 5-8.

[15] According to the Federal Reserve Bank of New York, federal funds are unsecured loans of reserve balances at Federal Reserve Banks between depository institutions. Banks keep reserve balances at the Federal Reserve Banks to meet their reserve requirements and to clear transactions. Transactions in the federal funds market enable depository institutions with reserve balances in excess of reserve requirements to lend them to institutions with reserve deficiencies.

Although the FHLBanks are not required to maintain their bank reserves at the Federal Reserve, they may participate in the federal funds market and offer to extend unsecured credit to domestic and foreign financial institutions.

[16] FHFA-OIG chose June 2011 for this comparison because it represents a period of time during which FHLBank lending raised considerable risk management concerns. As noted later in this report, such lending declined significantly by the end of 2011.

and foreign financial institutions than larger FHLBanks. For example, as of June 30, 2011, the ninth and eleventh largest FHLBanks (as measured by their total assets), Seattle and Topeka, had the highest percentage of unsecured credit to total assets within the FHLBank System (see Figure 3a). Topeka also had the largest percentage of unsecured credit in its investment portfolio, but Atlanta and San Francisco, the two largest FHLBanks, ranked second and third in this category (see Figure 3b).

Figure 3a: Unsecured Credit to Domestic and Foreign Financial Institutions as a Percentage of FHLBank Total Assets, June 30, 2011[17]

FHLBank	Unsecured Credit to Financial Institutions (in Millions)	Percentage of Assets	FHLBank Size[18]
Seattle	$8,695	20.2%	9
Topeka	$5,560	15.5%	11
Boston	$7,786	14.9%	6
Pittsburgh	$7,331	14.1%	7
San Fran.	$20,196	14.0%	1
Atlanta	$15,155	13.0%	2
Cincinnati	$5,701	8.6%	5
Indianapolis	$2,905	7.3%	10
Dallas	$1,948	6.2%	12
New York	$4,475	4.6%	3
Des Moines	$2,280	4.4%	8
Chicago	$274	0.4%	4
Total	**$82,306**	**10.2%**	-

Figure 3b: Unsecured Credit to Domestic and Foreign Financial Institutions as a Percentage of FHLBank Investments, June 30, 2011

FHLBank	Unsecured Credit to Financial Institutions (in Millions)	Percentage of Investment Portfolio	FHLBank Size[18]
Topeka	$5,560	42.4%	11
Atlanta	$15,155	41.0%	2
San Fran.	$20,196	39.4%	1
Boston	$7,786	38.3%	6

[17] The sources for Figures 3a and 3b are FHFA and FHLBank Office of Finance, *Combined Financial Report for the Quarterly Period Ended June 30, 2011*, available at http://www.fhlb-of.com/ofweb_userWeb/resources/11Q2end.pdf.

[18] Ranking within the FHLBank System based on total assets, as of June 30, 2011.

Pittsburgh	$7,331	38.2%	7
Seattle	$8,695	33.4%	9
New York	$4,475	27.3%	3
Cincinnati	$5,701	21.7%	5
Dallas	$1,948	21.0%	12
Indianapolis	$2,905	19.9%	10
Des Moines	$2,280	14.9%	8
Chicago	$274	0.7%	4
Total	**$82,306**	**28.6%**	-

III. FHLBank Unsecured Credit Exposures Involve Primarily Credit, Housing Mission, and "Image" Risks

A. Credit Risk

According to FHFA and FHLBank officials, the key financial risk associated with unsecured lending is credit risk; that is, the risk that an FHLBank's borrower will fail or otherwise default on its obligations.[19] Generally, the credit risk associated with extensions of unsecured credit is viewed as being higher than the risk associated with cash advances. This is because cash advances are secured by eligible collateral such as single-family mortgages or investment grade securities, among other assets, and – as the name implies – unsecured credit is not backed by any collateral.

In general, however, FHFA officials consider the credit risk associated with FHLBank unsecured lending to be a manageable one. In 2003, one of FHFA's predecessor agencies, the Federal Housing Finance Board (FHFB), held a one-day review session on the risks associated with unsecured credit and it periodically revisited the issue. Its overall conclusion was that the credit risk associated with unsecured lending was mitigated by the short-term nature of it. Moreover, FHFA officials said that the FHLBanks typically restrict their extensions of unsecured credit to highly rated private institutions, i.e., institutions rated at the "A" level or above.

Nonetheless, not all FHFA officials fully concur that credit risk is largely mitigated by short maturity terms and the focus on such lending to highly rated counterparties. One senior

[19] Extensions of unsecured credit may also involve market liquidity risk, i.e., the risk that an FHLBank could not liquidate its positions if the need to do so arose. But FHFA said that the market liquidity risk associated with unsecured credit is very low due to the fact that it is typically conducted on an overnight or short-term basis. As with any loan, there is also operational risk associated with unsecured credit, including technical difficulties, such as computer malfunctions. It is virtually impossible to quantify such operational risks, but FHLBanks should have internal controls in place to mitigate them.

examiner stated that FHLBanks do not always appropriately consider the risk and return trade-off inherent in their unsecured credit practices. That is, FHLBanks do not always price unsecured credit sufficiently to offset the increased risk that it poses. The examiner further stated that large unsecured credit losses could potentially eliminate an FHLBank's retained earnings – a component of capital – and thereby compromise its capacity to meet the housing mission needs of its members.[20]

In order to examine FHFA's oversight of the FHLBanks' unsecured credit practices and the risks associated with it, FHFA-OIG contacted representatives of four FHLBanks (several of which have relatively large unsecured credit exposures). All of the FHLBanks' representatives stated that they have policies and practices in place to manage and mitigate the risks associated with extensions of unsecured credit. According to the officials, these policies and practices include periodic reviews of borrowers and limits on borrower exposure that may be more restrictive than those permitted by FHFA. The FHLBank officials further stated that they continually monitor market indicators of prospective borrowers' financial health, such as credit default swap (CDS) spreads, and that they immediately limit or eliminate such exposure as warranted.[21]

B. Housing Mission and "Image" Risks

FHFA officials also said that, in addition to credit risk, a high level of unsecured credit extensions could expose an FHLBank to housing mission and "image" risks. As previously mentioned, FHFA classifies unsecured credit extensions as non-core mission activities. In other words, FHFA does not view these investments as contributing to the FHLBank System's overall goal of promoting housing finance; and the housing mission may be jeopardized by an FHLBank's emphasis on non-core mission activities. FHFA officials also said that FHLBanks with large unsecured exposures may face challenges in explaining to Congress how such lending is consistent with their core domestic housing finance mission. Agency officials and documents refer to this as image risk.

[20] Retained earnings – profits that are not paid out as dividends to members – are a relatively small component of an FHLBank's overall capital structure, with member contributions constituting a far larger component. But the FHFA examiner's view is that FHLBanks should consider the risk to their retained earnings when deciding on the appropriate size of their unsecured credit exposures. This is because retained earnings constitute the primary source of capital that an FHLBank could lose on such extensions of unsecured credit without jeopardizing its ability to meet member advance demand.

[21] A CDS is a bilateral contract that transfers credit risk from one party to another. A seller, which is offering CDS protection, agrees, in return for a periodic fee, to compensate the buyer if a specified credit event, such as a default, occurs. Rising CDS spreads (*i.e.*, an increasing difference between a bench-mark investment's return – such as the prevailing interest rate for U.S. Treasury securities – and the CDS's periodic fee) indicate increasing credit risks.

IV. FHFA Regulations Establish the FHLBanks' Unsecured Lending Exposure Limits, Which Some Agency Officials Consider Outdated and Overly Permissive

In 2002, one of FHFA's predecessors, FHFB, finalized a regulation that was intended to limit the risks associated with extensions of unsecured credit by the FHLBanks.[22] The regulation sets limits on the amount of unsecured credit that can be extended to an individual borrower based upon the borrower's overall credit rating.[23] The higher a borrower's credit rating, the more exposure that an FHLBank can have to it; conversely, the lower a borrower's credit rating, the less exposure permitted. The exposure limits established in the regulation apply to the lesser of the FHLBank's **regulatory capital** or the borrower's total capital.[24] Using this method, FHFA seeks to limit the potential for, and severity of, unsecured credit losses in the event of a borrower's failure or default on its financial obligation.

Regulatory Capital: FHFA requires each FHLBank to maintain regulatory capital that is equal to at least 4% of its total assets. According to FHFA requirements, regulatory capital includes the capital investments of FHLBank members (i.e., proceeds of stock purchases); retained earnings (i.e., profits not paid out as dividends to members); a general allowance for losses, consistent with generally accepted accounting principles; and any other funds available to absorb losses.

Figure 4, below, shows the amount of unsecured credit as a percentage of its regulatory capital (or the borrower's total capital) that an FHLBank may extend to a single borrower.

[22] The regulation remains in effect today. *See* 12 C.F.R. § 932.9.

[23] FHFA-OIG notes that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), Pub. L. No. 111-203, § 939A, requires FHFA to revise any regulation that contains compliance and implementation strategies based on ratings issued by Nationally Recognized Statistical Ratings Organizations (*i.e.*, credit rating agencies), and its regulation of FHLBank unsecured lending falls squarely within this Dodd-Frank requirement. FHFA's Deputy Director of the Division of FHLBank Regulation, who is directly responsible for FHLBank oversight, advised that FHFA will address unsecured lending exposure limits when it amends its regulations in compliance with Dodd-Frank, but no decisions have been made.

[24] In general, financial institution capital requirements, such as FHFA's regulatory capital requirement, are an important means by which regulators seek to ensure the financial soundness of banks and other regulated entities. Capital serves as a cushion that protects against unanticipated losses and asset declines that could cause a bank to otherwise fail.

Figure 4: Maximum Limits on Unsecured Credit to a Single Borrower[25]

Credit Rating of Borrower	Term Lending Limits (percent of regulatory capital)	Total Exposure Limits (percent of regulatory capital)
Highest Investment Grade (AAA)	15	30
Second Highest Investment Grade (AA)	14	28
Third Highest Investment Grade (A)	9	18
Fourth Highest Investment Grade (BBB)	3	6
Below Investment Grade or Other	1	2

FHLBanks may offer term extensions of unsecured credit up to the limits provided in the regulation, which are set forth in Figure 4, above. The regulation also permits the FHLBanks to extend additional unsecured credit, i.e., overnight extensions, as long as the total exposures do not exceed twice the regulatory limit for term extensions. Thus, for example, an FHLBank may lend up to 14% percent of its regulatory capital to a AA-rated institution (assuming the AA-rated institution's total capital is greater than the FHLBank's regulatory capital) on a term basis, and may lend up to an additional 14% – for a total exposure of 28% – on an overnight basis.[26]

Although they were not speaking on behalf of the Agency, some senior FHFA officials characterized the limits established in the regulation as outdated and overly permissive. They expressed particular concern about what they called the "kicker" provision in the regulation, i.e., the provision under which the FHLBanks may double their exposures to individual institutions so long as 50% of the total exposure is lent on an overnight basis. According to these officials, the regulation should be revised because it permits FHLBanks to establish sizeable unsecured credit exposures that increase their credit, mission, and image risks.

Additionally, FHFA-OIG observes that the Agency's decision to regulate the FHLBanks' unsecured credit business by limiting the amount that an FHLBank may extend to an individual borrower means that so long as an FHLBank stays within the limits established for each borrower, its overall exposure can be unlimited. In other words, although the exposure of an FHLBank's regulatory capital may be limited with respect to specific borrowers (for instance to 28% for a single borrower in the example set forth above), there is no limit on the number of

[25] Source: 12 C.F.R. § 932.9(a).

[26] Alternatively, FHLBanks may lend up to the total unsecured exposure limits on an overnight basis. Thus, for example, an FHLBank could extend overnight unsecured credit equal to 28% of its regulatory capital to an AA rated borrower.

borrowers that the FHLBank may lend to, and, thus, there is no overall limit on the FHLBank's exposure to unsecured lending.

The regulation's lack of an overall limit on the amount of unsecured credit that an FHLBank may extend differs materially from the manner in which the Agency regulates other non-core mission activities of the FHLBanks. Specifically, the Agency has limited each FHLBank's overall MBS investments to 300% of its regulatory capital.[27] The stated purpose of the overall limit on MBS investments is to ensure that they are safe, sound, and consistent with the FHLBank System's housing mission. Further, FHFA has stated that, even at 300% of regulatory capital, it still harbors concern about the overall limit from both a safety and soundness and housing mission standpoint. In fact, the Agency has stated that it will revisit the matter in a future rulemaking.

V. Unsecured Credit to Borrowers Rose to More than $120 Billion by Early 2011 but Declined Significantly by the End of the Year

A. Fluctuations in the Extension of Unsecured Credit

FHFA financial data indicate that from 2010 through much of 2011, as the sovereign debt crisis in Europe was intensifying, the FHLBanks substantially increased their lending to foreign financial institutions. However, as 2011 progressed, FHLBanks began to appreciate fully the risks associated with such extensions of credit and significantly reduced their exposures. Meanwhile, unsecured lending to domestic financial institutions remained relatively static.

As Figure 5, below, indicates there was significant fluctuation in the total amount of unsecured credit extended within the FHLBank System from the end of 2008 through the end of 2011. The FHLBank System had approximately $66 billion in total unsecured credit outstanding as of December 2008. By early 2011, however, the total had risen to about $123 billion before declining to about $57 billion by the end of 2011.

[27] *See* 12 C.F.R. § 1267.3(c)(1).

Figure 5: Unsecured Credit Exposure to Borrowers (in Billions)[28]

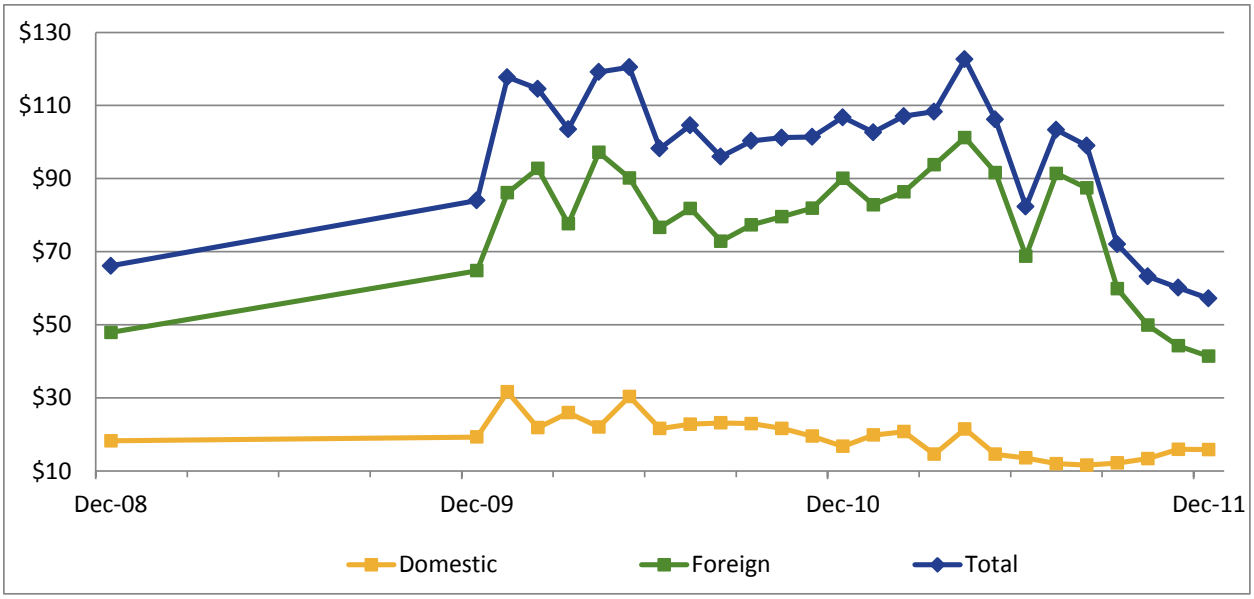


Figure 5 also shows that although extensions of unsecured credit to domestic borrowers remained relatively static between December 2008 and December 2011, such credit extensions to foreign financial institutions fluctuated in a pattern that mirrored the FHLBanks' total unsecured lending. That is, it more than doubled from about $48 billion at the end of 2008 to $101 billion as of April 2011, and then fell by 59% to slightly more than $41 billion by the end of 2011.[29] In other words, unsecured credit to foreign borrowers was the driving force behind the FHLBanks' increased unsecured credit extensions in 2010 and early 2011.

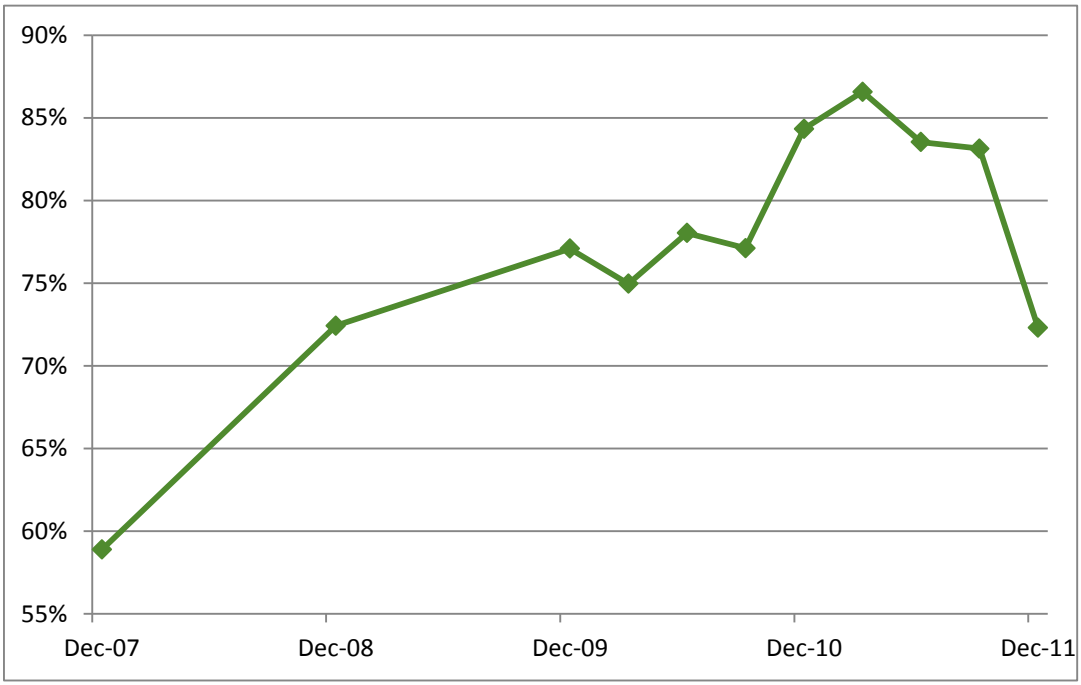
Figure 6, below, illustrates the fluctuations in FHLBank unsecured credit extensions to foreign borrowers relative to domestic borrowers. FHLBank extensions of unsecured credit to foreign financial institutions rose from 59% of total unsecured lending at the end of 2007 to 87% in the spring of 2011, before falling back to 72% by the end of 2011.

FHLBank officials said that as 2011 progressed they reduced their exposure to foreign borrowers in light of the rising concerns about the financial turmoil in Europe.

[28] Source: FHFA. For 2008 and 2009, data are available only for the end of the year. Monthly data are shown for 2010 and 2011.

[29] FHLBank unsecured credit extensions to foreign financial institutions were approximately $43 billion at the end of the first quarter of 2012 and total unsecured lending approached $60 billion. FHLBank unsecured credit extensions in 2012 and FHFA's oversight thereof were outside the scope of this study.

Figure 6: Percent of Unsecured Lending Exposure to Foreign Financial Institutions – FHLBank System[30]



B. Advances Decrease as Unsecured Credit Exposures Increase

From the end of 2008 through mid-2011, there was an inverse relationship between the trends in FHLBank lending to foreign financial institutions and FHLBank advances to their members (see Figures 7a and 7b, below). Specifically, as advances to member banks declined, extensions of unsecured credit to foreign financial institutions increased. Since mid-2011, however, extensions of unsecured credit to foreign financial institutions have declined sharply. While advances also continued their longstanding decline in the latter half of 2011, they did so at a more gradual pace than unsecured credit. Based upon this and other information, it appears that in the aftermath of the domestic financial crisis some FHLBanks extended unsecured credit to foreign financial institutions in order to offset declining advance demand. Further, they curtailed their extensions of unsecured credit to such institutions in late 2011 as they began to appreciate fully the risks associated with them.

[30] Source: FHFA. Data are only available for the ends of years 2007, 2008, and 2009. For 2010 and 2011, data are available for each month.

Figure 7a: FHLBanks' Advances to Members, 2008 Through 2011 (in Billions)[31]

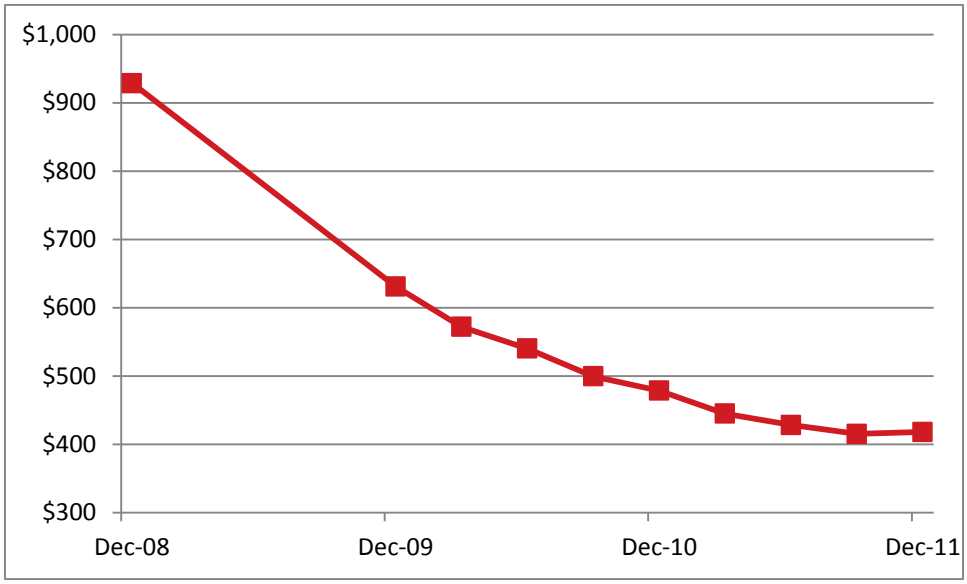
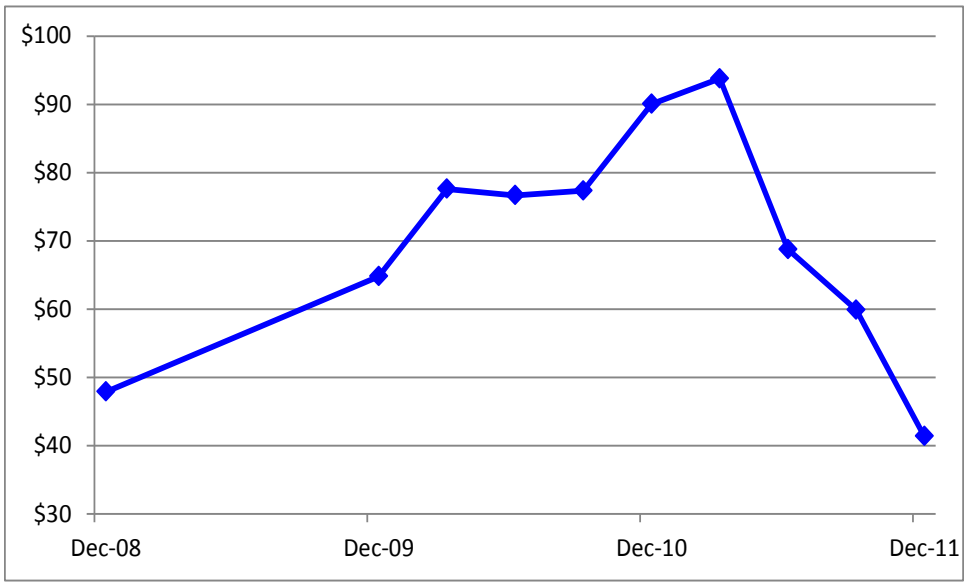


Figure 7b: FHLBanks' Extensions of Unsecured Credit to Foreign Financial Institutions, 2008 Through 2011 (in Billions)[32]



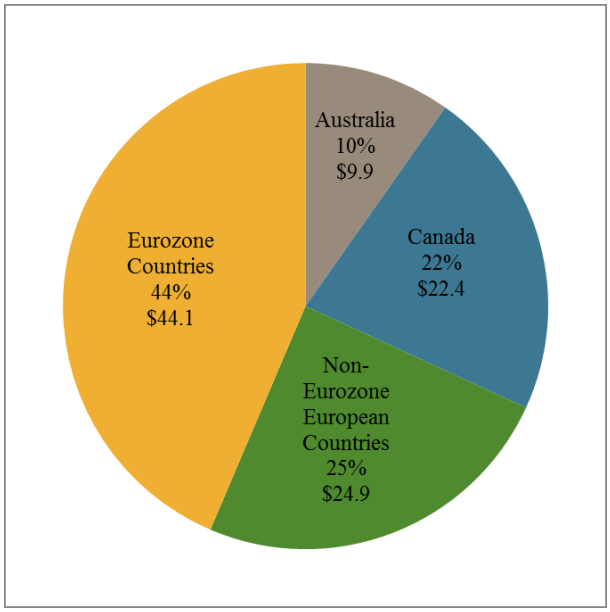
[31] Source: FHLBank Office of Finance, *Quarterly Combined Financial Reports for 2008 Through the Third Quarter of 2011*, available at http://www.fhlb-of.com/ofweb_userWeb/pageBuilder/fhlbank-financial-data-36 (accessed March 14, 2012). The data for 2008 and 2009 are end of the year data, and the 2010 and 2011 data are quarterly.

[32] Source: FHFA. The data for 2008 and 2009 are end of the year data. For 2010 and 2011, data are available for each quarter.

C. Identity of Foreign Borrowers

As of April 2011, the substantial majority (about 70%) of the FHLBank System's $101 billion in unsecured credit to foreign borrowers was made to European financial institutions (see Figure 8). Specifically, 44% of the short-term unsecured credit extensions were made to financial institutions in Eurozone countries, e.g., Germany and France, and 25% went to financial institutions in non-Eurozone countries, e.g., Sweden.[33] The remaining exposures were made to institutions based in Canada and Australia.

Figure 8: Breakdown of FHLBank Unsecured Credit Exposure to Foreign Financial Institutions as of April 2011 (in Billions)[34]



FHFA data provide insights into the increasing risks faced by FHLBanks that extended unsecured credit to European financial institutions in 2010 and 2011. For example, as of March 2010, FHLBanks had extended a total of about $6 billion – about 8% of all foreign extensions of unsecured credit – to financial institutions located in Spain. This is potentially significant because credit rating agencies such as Standard & Poor's (S&P) rated the sovereign debt of

[33] The euro is a single currency shared by 17 European Union member states: Austria, Belgium, Cyprus, Estonia, France, Finland, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. Collectively they are known as the Eurozone or euro area.

[34] Source: FHFA.

Spain as riskier than that of other European countries in 2010 and 2011.[35] However, by the end of 2011, the FHLBanks had ended their unsecured lending to Spanish financial institutions.

Finally, FHFA data also indicate the extent to which particular FHLBanks had unsecured exposures to foreign institutions in 2011 (see Figure 9, below). For example:

- The Seattle FHLBank's unsecured exposure to foreign borrowers as a percentage of its regulatory capital was more than 340% in March 2011, but it declined to 190% at the end of 2011.

- The Boston FHLBank, which like the Seattle FHLBank has faced significant financial and operational challenges since 2008, had unsecured credit exposure to foreign borrowers as a percentage of regulatory capital of nearly 300% in March 2011, before the ratio declined to about 51% at the end of 2011.[36]

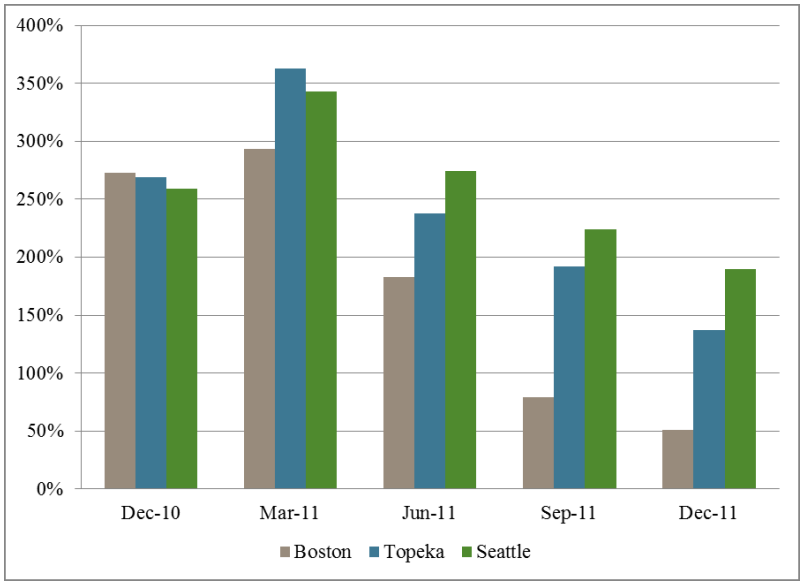
- The Topeka FHLBank's unsecured credit exposure to foreign financial institutions as a percentage of regulatory capital rose to over 360% in March 2011, before the ratio fell to under 140% at the end of 2011.

Although it has not issued regulations capping overall exposure, FHFA considers heavy exposure to financial institutions, i.e., a high ratio of unsecured lending to regulatory capital, to be an indicator of risk. Figure 9, below, depicts the three FHLBanks that had the largest unsecured credit exposures to foreign financial institutions as a percentage of their regulatory capital.

[35] Sovereign credit ratings can serve as an indicator of the risks associated with lending to financial institutions located in a particular country. During the period of 2010 and 2011, the majority of the European nations in which the FHLBank System's foreign borrowers were located maintained AAA sovereign credit ratings according to S&P. The exceptions were Belgium, Italy, and Spain.

[36] In its evaluation of FHFA's oversight of troubled FHLBanks, FHFA-OIG noted that the Agency has a special responsibility to monitor the risks taken by these FHLBanks. Significant risks exist for troubled FHLBanks because they can continue to fund themselves at favorable rates due to the FHLBank System's GSE status while they also make potentially risky investments in an effort to restore their financial condition. Such actions by the FHLBanks could prove counterproductive and result in additional losses. *See* FHFA-OIG, *FHFA's Oversight of Troubled Federal Home Loans* (EVL-2012-001, Jan. 11, 2012).

Figure 9: Foreign Unsecured Credit Exposures as Percentages of Regulatory Capital for Three FHLBanks, 2010 to 2011[37]



VI. Several FHLBanks Violated FHFA's Regulatory Limits or Extended Unsecured Credit Despite Indicators of Heightened Risks

During this study, FHFA-OIG identified examples of increased credit risks associated with some of the FHLBanks' unsecured credit practices through much of 2011. Specifically, several FHLBanks violated FHFA's regulation that sets maximum exposures for unsecured credit. Additionally, several FHLBanks extended unsecured credit to particular foreign banks despite indications of heightened risks associated with doing so. These examples suggest that some FHLBanks' risk management practices and controls should be improved. They also indicate the need for strong FHFA oversight to ensure that unsecured credit risks are adequately and properly mitigated.

A. Several FHLBanks Violated FHFA's Unsecured Credit Limits Due to Inadequate Systems and Controls

Although the vast majority of the FHLBanks' extensions of unsecured credit appear to take place within current regulatory limits – which, as discussed in this report, may be already outdated and overly permissive – FHFA-OIG's analysis of FHFA data for 2010 and 2011 indicate that, from time to time, some FHLBanks have exceeded the limits. As illustrated in Figure 10, below, one FHLBank, FHLBank A, exceeded the regulatory limits on loans to individual institutions by an

[37] Source: FHFA.

average of nearly ten percentage points over a three month period in 2010. For example, in one month in 2010, the FHLBank extended unsecured credit equal to 28% of its regulatory capital to a borrower that was eligible for credit of no more than 18% of FHLBank A's regulatory capital per FHFA's regulatory requirements (the borrower was an "A"-rated institution and the total exposure limit for such borrowers is 18%).[38] For one month in 2011, moreover, FHLBank A exceeded the limit by 8.3 percentage points. Meanwhile, FHLBank B exceeded regulatory limits in eight months in 2010 and in five months in 2011, and it did so by an average of two percentage points above the regulatory threshold. FHFA reviewed FHFA-OIG's analysis and concluded that both FHLBanks – as well as a third FHLBank – had violated the regulatory limits.

Figure 10: FHLBanks that FHFA Data Indicate Exceeded the Agency's Unsecured Credit Limits per Counterparty, 2010 and 2011[39]

FHLBanks	2010[40]			2011[39]		
	Number of Months Exceeding Limits	Number of Incidents	Average Percentage Points Above Threshold	Number of Months Exceeding Limits	Number of Incidents	Average Percentage Points Above Threshold
A	3	3	9.9	1	2	8.3
B	8	11	1.7	5	8	2.0

According to FHFA, the three FHLBanks exceeded the limits because they lacked adequate controls or systems to ensure compliance. For example, FHLBank A failed to identify that one

[38] FHFA asserts that identifying specific FHLBanks would constitute a disclosure of confidential information and could result in adverse financial effects.

[39] Source: FHFA-OIG analysis of FHFA data. FHFA-OIG first observed potential violations of FHFA's regulatory ceilings on unsecured exposures in internal Agency documents prepared in early- to mid-2011. FHFA officials offered several explanations for these potential violations, including that the Agency's 2011 internal reports employed an incorrect measure of regulatory capital for determining compliance. As a result, FHFA-OIG requested that FHFA provide the appropriate regulatory capital measure for each FHLBank for 2010 and 2011. FHFA-OIG then used the procedure described by FHFA to assess compliance with its regulation. Specifically, FHFA-OIG compared each FHLBank's regulatory capital to its unsecured exposure for each borrower. FHFA-OIG excluded cases in which the reported exposure was less than one percentage point above the established threshold. As part of FHFA-OIG's quality control procedures, it provided the results of its analysis to FHFA for its review and comment in early 2012. FHFA's subsequent analysis concluded that three FHLBanks had indeed violated the applicable regulation.

[40] Figures represent the total number of borrowers in all of the months when the FHLBanks were above the regulatory threshold. The same borrower may be counted more than once.

of the borrowers to which it extended unsecured credit had been subject to a credit rating downgrade. Consequently, the FHLBank failed to reduce the borrower's unsecured exposure as required by the regulation.[41] FHFA attributed the regulatory breach to the FHLBank's use of a manual system that is being replaced. FHFA stated that FHLBank B failed to recognize that it was extending unsecured credit to two U.S. branches of a single foreign bank parent. For regulatory compliance purposes, FHFA said that the FHLBank should have considered these unsecured exposures to the separate branches of the same foreign bank to be a single exposure. By failing to do so, FHFA said the FHLBank violated the regulatory limits.[42]

FHFA officials stated that they are following up on the regulatory violations at the three FHLBanks through ongoing or planned examinations of them during 2012. For example, FHFA officials explained that the Agency started the 2012 examination of FHLBank A during the course of FHFA-OIG's evaluation, and that its unsecured credit counterparty rating system will be a focus of the examination. FHFA also said that an employee of FHLBank A, who was responsible for the regulatory violation, is no longer employed there.

Although FHFA has taken supervisory steps in response to FHFA-OIG's discovery of these potential violations, FHFA-OIG is concerned that FHFA did not discover the violations at an earlier juncture.

B. Several FHLBanks Extended Unsecured Credit to Foreign Financial Institutions Despite Indications of Heightened Risks

In 2008, a European bank was provided with a multibillion dollar governmental assistance package due to substantial losses that it incurred during the financial crisis. Concerns about the bank's stability persisted as the European sovereign debt crisis intensified. In 2011, a credit rating agency placed the bank on a **credit watch** and then downgraded its credit rating several months later due to its continued financial deterioration. Later in the year the bank suffered another multibillion dollar loss and received further European governmental assistance.

Credit Watch: If circumstances or events occur that could affect an institution's credit rating in the near term, such as the reporting of significantly increased losses, a credit rating agency may undertake a review of the rating, which is also known as placing the rating on "credit watch." A rating can be reviewed while on credit watch for upgrade, downgrade, or with the direction uncertain.

Throughout 2010, four FHLBanks extended credit to the European bank in question, but three of them ceased doing business with it by the end of the

[41] In this case, the FHLBank did not realize the borrower had received a credit downgrade and kept extending credit to it at the prior and incorrect exposure level.

[42] FHFA officials said that the FHLBank identified this error in December 2011 and corrected it.

year. Officials from one of the four FHLBanks told FHFA-OIG that the FHLBank stopped extending credit to the bank due to heightened risk. For example, an FHLBank official said that in late 2010 the bank's CDS spread reached an unacceptably high level in comparison to U.S. Treasury securities.

Despite the increased risk involved in extending unsecured credit to the bank in question, one of the four FHLBanks continued to do so during much of 2011 – at times lending more than $1 billion. Although the FHLBank suspended credit extensions to the European bank while it was subject to the credit watch, it resumed such credit extensions after the bank's credit rating was downgraded. Further, the FHLBank continued to extend credit to the bank after it announced that it had suffered a multibillion dollar loss. The FHLBank stopped extending credit to the bank shortly before it received a second round of state-sponsored financial assistance.

Officials from the FHLBank that continued to do business with the European bank in question said that in 2011 the FHLBank had an effective unsecured credit risk management process for foreign financial institutions. Under its process, the FHLBank restricted its overnight lending portfolio and carefully monitored market indicators of risk, such as CDS spreads, on a daily basis. An FHFA examiner took note of the FHLBank's risk management process as well as the fact that it cancelled all of its unsecured credit to the European bank shortly before it received additional governmental financial assistance. However, FHFA officials said that FHLBank's unsecured credit extensions to the bank were an outlier among the FHLBanks in 2011, and that the Agency counseled the FHLBank's management about the risks involved.[43]

During 2011, several FHLBanks also extended unsecured overnight and short-term credit – that at times exceeded $2 billion – to a second European bank that was also facing financial challenges. Similar to the case of the first bank discussed above, the second bank received substantial state-sponsored financial assistance in 2008. Although the second bank was not subject to a credit downgrade in 2011, it was placed on a credit watch after posting a large and unexpected financial loss. Yet, it was not until after the second bank reported this large and unexpected financial loss in 2011 that all of the FHLBanks that had extended unsecured credit to it discontinued doing so.

In FHFA-OIG's view, these examples raise questions about FHLBanks' recognition of the totality of the risks associated with extending unsecured credit. Despite the various controls that

[43] In this regard, an FHFA examiner said that he maintained ongoing contacts with the FHLBank and expressed his concern about its exposure to the European bank. He also forwarded to the FHLBank's managers a copy of a popular business magazine article on the risks of European banks during 2011, and he said that the FHLBank's 2011 examination concluded that its extension of unsecured credit to European counterparties warranted close monitoring.

the FHLBanks employed to monitor regulatory compliance and unsecured credit risks, undetected violations and risky practices occurred.

VII. FHFA Internal Reports Identified Deficiencies in FHLBanks' Unsecured Credit Risk Management Practices

In connection with the preparation of this report, FHFA-OIG reviewed a variety of internal Agency documents prepared in 2010 and early- to mid-2011. During this period, the Agency expressed a growing concern about several of the FHLBanks' unsecured exposures to foreign financial institutions and the potential risks associated with such lending. Specifically, the Agency's documents indicate that, although the FHLBanks were generally extending unsecured credit within permitted limits,[44] FHFA officials were concerned about the growth of such lending; the relatively high exposures as a percentage of regulatory capital; increasing housing mission and image risks; and other risk management issues. For example, a first quarter 2010 financial analysis of the FHLBank System states:

> The large investment portfolio, specifically liquidity investments … has increased unsecured credit risk exposure for the System. Private counterparty credit … was at $103 billion at the end of the first quarter of 2010… [This included] ... significant exposure to foreign banking entities with US operations.

Further, the analysis stated that:

> As of March 31, 2010, notable European exposure included $5.6 billion to … two Spanish banking entities that could experience significant problems if the European debt crisis extends to Spain.

Likewise, a second quarter 2011 financial analysis of the FHLBank System states:

> The FHLBanks' liquidity portfolio raises some concerns, particularly credit risk and image risk. Fed funds, CDs, and commercial paper comprise 91.3 percent of the liquidity portfolio and are unsecured investments, adding credit risk to the balance sheet. The image risk arises from the FHLBanks' lending to foreign counterparties. As of June 30, 2011, the FHLBanks had $82.3 billion of unsecured credit outstanding to private counterparties, $68.8 billion of it to foreign counterparties. Providing credit to foreign institutions is a non-mission related activity.

[44] As discussed in this report, FHFA-OIG has identified evidence that several FHLBanks may have, from time to time, exceeded FHFA's current unsecured credit limits. FHFA-OIG has also determined that the vast majority of all unsecured credit exposures appear to fall within regulatory limits.

Similarly, a 2010 FHFA examination of an FHLBank that had a large unsecured credit portfolio states, in relevant part, that "[t]he FHLBank carries a sizeable liquidity portfolio that exposes the FHLBank to unsecured credit risk and the size of the portfolio has grown markedly in the past year." The report concludes that although the FHLBank had taken some steps to respond to emerging risks in its unsecured lending to private foreign institutions, "… [the FHLBank's] Board needs to ensure that the FHLBank's activities, including the level of unsecured investments, are consistent with the System's housing mission and do not arbitrage the benefits of a government sponsored charter beyond its housing mission." A 2011 examination of another FHLBank noted the relative size of its unsecured lending to foreign entities and concluded that "[t]he … [investment] portfolio's size … is inconsistent with normal operations for an FHLBank and represents an inappropriate use of the GSE funding advantage as it exposes the bank to excessive credit risk."

Finally, during early- to mid-2011, FHFA prepared internal analyses on a monthly basis that signaled varying degrees of concern about several aspects of the FHLBanks' unsecured credit exposures to foreign financial institutions, as well as the ratio of some FHLBanks' unsecured credit to their regulatory capital, which ranged from 150% to 400%. For example, in an FHFA report prepared in April 2011, FHFA states that "the FHLBanks may be indirectly exposed to Greece as the French and other European banks have direct exposure to Greece, which has been downgraded to junk status."

In discussions with FHFA-OIG staff, the Deputy Director, Division of Federal Home Loan Bank Regulation (DBR), and senior DBR officials expressed their belief that the internal Agency reports were thorough and indicated their emerging recognition of rising credit and mission risks among some FHLBanks from 2010 through mid-2011. These officials added that FHFA developed an oversight program to respond to the increasing risks, and that FHLBanks responded to European market developments during the latter half of 2011 by reducing their European exposures.

VIII. FHFA Oversight Activities of FHLBank Unsecured Credit

FHFA believes that its management of the risks associated with unsecured lending has been reasonable under the circumstances. FHFA implements a risk-based supervisory strategy, and an FHFA official explained that in 2010 the Agency did not view the risk associated with the FHLBanks' unsecured lending to be greater than, or equal to, other risks then facing the FHLBank System. Specifically, FHFA was more concerned with the billions of dollars in losses that many FHLBanks were suffering on their housing boom-era PLMBS investments. FHFA consequently considered examination of the FHLBanks' PLMBS portfolios to be a higher priority than examining unsecured credit offered to foreign financial institutions.

FHFA, however, recognized that risks existed. Records of internal assessments made by FHFA in 2010 contain discussions of the risks to the FHLBank System associated with the FHLBanks' extensions of unsecured credit, and these risks were also addressed in several 2010 reports of examination.[45] Further, the FHFA documents discussed above reveal that by 2011 the Agency increasingly identified unsecured credit as a significant risk for FHLBanks, and FHFA examiners increasingly focused on it during their examinations.[46]

FHFA officials agreed that in 2011 the Agency's awareness of the risks associated with extensions of unsecured credit had sharpened, and they pointed to steps undertaken by FHFA to enhance its oversight of the FHLBanks' related activities. Specifically, the Agency:

- Required the FHLBanks to report their unsecured counterparty exposures on a weekly basis rather than on a monthly basis (the enhanced reporting was required as of November 2011). FHFA officials said that more frequent reporting permits the Agency to make more timely and qualitatively better assessments of the risks associated with unsecured credit. They also said that the reporting requirement permits the Agency to better detect potential violations of regulatory limits.[47]

- Determined that it will direct examiners to consider unsecured credit at all 12 FHLBanks in a "horizontal review" to be conducted during calendar year 2012. The review will permit FHFA officials to develop a comprehensive assessment of the FHLBanks' unsecured credit risk management processes and determine whether system-wide corrective actions are necessary.

[45] Unsecured credit was mentioned in 5 of the 12 FHFA examinations of FHLBanks conducted in 2010. FHFA officials said that examiners may have assessed unsecured credit during the other seven examinations without necessarily mentioning their findings in their reports. It was not within the scope of this study to assess the comprehensiveness of FHFA's coverage of unsecured credit in its examinations.

[46] Unsecured credit was specifically addressed in 10 of the 12 FHFA examinations of FHLBanks conducted in 2011. An FHFA official said that unsecured credit was not specifically addressed in the first two exams that were completed in early 2011, i.e., before unsecured credit was prioritized as a high risk area. It was not within the scope of this study to assess the comprehensiveness of FHFA's coverage of unsecured credit in the 2011 examinations.

[47] Prior to November 2011, FHLBanks reported their exposures as of the end of each month. FHLBanks must now report their average exposures to each borrower on a weekly basis. FHFA officials said that the new reporting requirements provide a better basis for assessing FHLBank unsecured exposures.

FINDINGS

FHFA-OIG finds that:

I. Although FHFA Did Not Initially Prioritize FHLBank Unsecured Credit Risks, It Has Recently Developed an Increasingly Proactive Approach to Oversight in This Area

As early as the first quarter of 2010, FHFA internal analyses identified the growing credit and housing mission risks associated with the FHLBanks' extensions of unsecured credit. Yet, the Agency did not immediately prioritize the increasing risks in its examination program or through other supervisory means. For example, FHFA-OIG's analysis indicates that only 5 of 12 FHLBank examination reports completed in 2010 specifically addressed the risks associated with extensions of unsecured credit.[48]

FHFA officials said that they appreciated the risks associated with unsecured credit in 2010 and noted that these risks increased in 2011. An FHFA official also stated that at that time the Agency was dealing with large PLMBS losses that had been incurred by several FHLBanks, and that extensions of unsecured credit were not viewed as an item of equal or greater risk. FHFA-OIG notes that the Agency's capacity to assess the risks associated with extensions of unsecured credit also may have been diminished by its lack of examiners.[49]

In 2011, FHFA developed a proactive and ongoing approach to oversee the risks associated with the FHLBanks' unsecured credit exposures. FHFA's approach includes:

- Preparing a monthly internal analysis of the FHLBanks' exposures and foreign borrower risks;
- Specifically addressing FHLBank unsecured credit extensions in 10 of 12 examination reports;
- Communicating with FHLBanks about their foreign borrower exposures;
- Establishing comprehensive unsecured lending reporting requirements; and

[48] FHFA officials said that the fact that an examination report does not specifically mention an FHLBank's extension of unsecured credit does not necessarily mean that it was not covered during the course of the examination.

[49] For more information on the Agency's examiner shortage see FHFA-OIG's evaluation of Agency examination capacity, *Whether FHFA Has Sufficient Capacity* to *Examine the GSEs* (EVL-2011-005, September 22, 2011).

- Prioritizing FHLBank unsecured lending risk management in a horizontal review of the FHLBank System to be conducted in 2012.

FHFA-OIG believes that the Agency's oversight efforts during 2011 likely contributed to the significant decline in the FHLBanks' unsecured exposures to European borrowers by the end of that year.

II. FHFA Did Not Actively Pursue Evidence of Potential FHLBank Violations of the Limits on Unsecured Exposures Contained in Its Regulation

Despite FHFA's 2011 initiatives, FHFA-OIG believes that the Agency can further strengthen its oversight of the FHLBanks' unsecured credit exposures. Specifically, FHFA did not pursue through its supervisory processes the suggestion contained in its 2011 internal reports that several FHLBanks exceeded the Agency's regulatory limits on extensions of unsecured credit. When FHFA-OIG informed the Agency of these potential violations in early 2012, the Agency's subsequent analysis concluded that three FHLBanks had violated the regulatory limits largely due to inadequate systems and controls.

FHFA-OIG believes that the Agency has a critical responsibility to ensure compliance with its regulatory limits on unsecured credit and to pursue actively evidence of potential violations. Otherwise, FHLBanks may not be deterred from violating the Agency's regulations in the future. Moreover, by not initially pursing evidence that FHLBanks may have violated its regulation in 2011, FHFA missed an opportunity to determine at an earlier stage that some FHLBanks lack adequate systems and controls to ensure compliance. FHFA-OIG notes that the Agency has, through the 2012 examination process, started to follow up with the FHLBanks on these violations.

III. FHFA's Current Regulation Governing Unsecured Lending by the FHLBanks May Be Outdated and Overly Permissive

During the period 2010 through the end of 2011, some FHLBanks amassed large unsecured lending exposures that subjected them to potentially high levels of credit, housing mission, and image risks. Although FHFA-OIG identified the fact that several FHLBanks violated FHFA's unsecured credit limits, such violations are not necessary components of large unsecured lending exposures. In other words, FHLBanks may be able to continue to engage in the sort of unsecured credit practices that have been the source of considerable supervisory concern because the vast majority of such activity falls within the bounds of the existing regulation.

The following summarizes specific weaknesses noted in the existing regulation:

- There are no limits on overall counterparty risk: Internal Agency documents reveal FHFA's concern about the overall ratio of unsecured exposure to capital at certain FHLBanks, particularly when exposures ranged from 150% to about 400% of regulatory capital. However, large overall exposures are permissible under the current FHFA regulation because of two interrelated aspects: (1) the lack of an overall limit on counterparty risk; and (2) the lack of an overall limit on the number of institutions to which an FHLBank may extend unsecured credit. As it stands, an individual FHLBank may increase its credit risk by lending the maximum permissible amount to as many borrowers as it wishes. By contrast, FHFA has established an overall limit on an FHLBank's MBS investments, capping it at 300% of the bank's regulatory capital.

- The maximum permissible exposures to individual institutions may be excessive: Some FHLBanks had significant unsecured exposures to foreign institutions experiencing financial challenges even though the lending to such institutions was still within regulatory limits. This did not go unnoticed by FHFA officials who have expressed concerns about the regulation's current exposure limits.

- It does not account for housing mission and image risks: FHFA officials and documents indicate that housing mission and image risks can be a considerable concern associated with non-mission activities such as unsecured lending.

In future rulemakings, FHFA has the opportunity to consider whether to adjust its existing regulation in order to control better the risks associated with extensions of unsecured credit by the FHLBanks.

CONCLUSIONS

From 2010 through at least mid-2011 the levels of unsecured credit extended by some FHLBanks, particularly to foreign financial institutions, increased their credit, housing mission, and image risks. In response, FHFA initiated progressively more comprehensive oversight efforts, including requiring the FHLBanks to report additional information on their unsecured exposures and planning a horizontal review of unsecured lending during the 2012 examination cycle. This likely contributed to the significant decline in the extension of such unsecured credit by the end of 2011.

However, FHFA's current regulation continues to permit FHLBanks to build large unsecured credit portfolios that may produce unreasonable risk. FHFA should, therefore, reassess the counterparty risk limits associated with its existing regulation to determine whether its revision is warranted.

RECOMMENDATIONS

As part of FHFA's ongoing horizontal review of unsecured credit practices at the FHLBanks, FHFA-OIG recommends that the Agency:

- Follow up on any potential evidence of violations of the existing regulatory limits and take supervisory and enforcement actions as warranted; and
- Determine the extent to which inadequate systems and controls may compromise the FHLBanks' capacity to comply with regulatory limits, and take any supervisory actions necessary to correct such deficiencies as warranted.

To strengthen the regulatory framework around the extension of unsecured credit by the FHLBanks, FHFA-OIG recommends, as a component of future rulemakings, that FHFA consider the utility of:

- Establishing maximum overall exposure limits;
- Lowering the existing individual counterparty limits; and
- Ensuring that the unsecured exposure limits are consistent with the FHLBank System's housing mission.

SCOPE AND METHODOLOGY

The objective of this study was to assess FHFA's oversight of FHLBank unsecured credit risk management practices, including the regulatory framework under which the Agency conducts such oversight.

To address this objective, FHFA-OIG interviewed officials in FHFA's DBR, the Office of Systemic Risk Oversight, and other units. Further, FHFA-OIG interviewed officials at four FHLBanks.

FHFA-OIG also reviewed FHFA's regulation that pertains to FHLBank unsecured lending, internal Agency reports on unsecured risk, the 2010 and 2011 examinations of the FHLBanks, and Agency correspondence with FHLBanks regarding their unsecured exposures.

Further, FHFA-OIG reviewed FHFA financial data on the FHLBanks, as described in the report. FHFA-OIG held discussions with Agency staff on the tests made to verify the reliability of the data. On the basis of these discussions, FHFA-OIG concluded the data were reliable for the purposes of the report.

In the course of the evaluation, FHFA-OIG identified internal Agency reports suggesting that certain FHLBanks may have, at times, exceeded the unsecured lending limits established by FHFA's regulation. FHFA-OIG independently analyzed the FHFA data for 2010 and 2011 to verify these potential regulatory violations. FHFA-OIG also provided the results of its analysis to FHFA for its review and comment as described in the body of the report.

This study was conducted under the authority of the Inspector General Act, and is in accordance with the *Quality Standards for Inspection and Evaluation* (January 2011), which was promulgated by the Council of Inspectors General on Integrity and Efficiency. These standards require FHFA-OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support its findings and recommendations. FHFA-OIG believes that the findings and recommendations discussed in this report meet these standards.

The performance period for this evaluation was 2010 and 2011.

FHFA-OIG provided FHFA staff with briefings and presentations concerning the results of its fieldwork, and provided FHFA an opportunity to respond to a draft report of this study. FHFA's Deputy Director of DBR provided the Agency's written comments, which are reprinted below. FHFA agreed to implement the report's recommendations within one year. FHFA also provided technical comments on the draft report that were incorporated as appropriate.

FHFA'S COMMENTS ON FHFA-OIG'S FINDINGS AND RECOMMENDATIONS

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Director
FHFA-OIG Policy, Oversight, and Review

FROM: Stephen M. Cross, Deputy Director
FHFA Division of FHLBank Regulation

SUBJECT: FHFA comments on the FHFA-OIG draft Evaluation "FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices"

DATE: June 15, 2012

Thank you for the opportunity to respond to the draft Evaluation Report "FHFA's Oversight of the Federal Home Loan Banks' Unsecured Credit Risk Management Practices" (Report). This memorandum transmits the Federal Housing Finance Agency's (FHFA) management responses to the recommendations in that Report and complements our previously provided technical comments.

As described in the Report, FHFA supervision of unsecured credit at the FHLBanks has been proactive and increasingly detailed. FHLBanks may not extend unsecured credit to a foreign entity's U.S. branch or subsidiary unless it is subject to federal, state, and/or local regulation by U.S. authorities. Nevertheless, underwriting of FHLBank credit to domestic offices of foreign-owned counterparties was and is a concern to FHFA. FHFA examiners have generally concluded that as troubles in certain European economies became more apparent, risk management practices at the FHLBanks appropriately resulted in less lending to US branches of foreign counterparties. Credit to US branches of foreign counterparties dropped by more than 50 percent in the twelve months through March 31, 2012, totaling less than 6 percent of FHLBank assets.

Recommendation 1: *Follow-up on any potential evidence of violations of the existing regulatory limits and take supervisory and enforcement actions as warranted; and determine the extent to which inadequate systems and controls may compromise the FHLBanks' capacity to comply with regulatory limits; and take any supervisory actions necessary to correct such deficiencies as warranted.*

Management Response: FHFA agrees with this recommendation. FHFA has alerted the FHLBanks of violations to existing regulatory limits identified by the FHFA-OIG evaluation. Factors that led to those violations are being addressed by those FHLBanks, and FHFA will follow-up on the adequacy of those efforts through its FHLBank examination program. That program includes in 2012 a targeted review of unsecured credit as part of each of the

examinations scheduled during the year. FHFA will assess the FHLBank systems and controls that led to any identified violations and will take supervisory or enforcement actions if warranted.

The follow-up review is already underway at one of the FHLBanks for which a violation had been identified through the FHFA-OIG evaluation. The remaining reviews will occur over the next 12 months as part of regularly scheduled on-site examinations of those FHLBanks. That work will be completed by June 15, 2013.

Recommendation 2: *That FHFA consider the utility of establishing maximum overall exposure limits; lowering the existing individual counterparty limits; and ensuring that unsecured exposure limits are consistent with the FHLBank System's housing mission.*

Management Response: FHFA agrees with this recommendation. FHLBank regulatory limits on extensions of unsecured credit to private counterparties are based primarily on capital and on counterparty credit ratings. As mentioned in the Report, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) requires a review and modification of FHFA regulations that rely on such ratings. This effort is currently underway, and FHFA will consider the factors recommended by FHFA-OIG as part of its review and modification of the regulation governing unsecured credit at the FHLBanks.

FHFA will complete its assessments and propose revisions to its rule governing unsecured credit at the FHLBanks by April 15, 2013.

ADDITIONAL INFORMATION AND COPIES

For additional copies of this report:

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