FHLBank
Topeka
Building Communities Together

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The Honorable John T. Korsmo
Chairman
Board of Directors
Federal Housing Finance Board
1777 F Street, N.W.
Washington, DC 20006-5210

Dear Chairman Korsmo:

The Federal Housing Finance Board (Finance Board) requested the FHLBanks to identify their specific concerns arising from ongoing changes in the financial services industry and suggest any appropriate supervisory or regulatory responses. Subsequent statements you made suggested that a central theme of the discussion prompted by the request is a long-range vision for the FHLBank system. In other words, where do we see the system ten to 15 years down the road. We appreciate the opportunity to share our views and help you frame the issues as this discussion continues.

Suggestions of multi-district membership have elicited very different responses from the FHLBanks as to whether it would contribute to a more effective system. We believe that these different views can by explained in part by the distinct vision each FHLBank holds for itself. We are aware that there exists a range of views held by the FHLBanks, and these varying philosophies leads each to adopt different strategies in serving their members. And we also believe that this is as it should be, a tribute to the true value and strength of the system's regional structure.

Ultimately the FHLBanks, individually and collectively, must serve an important public purpose to justify their existence. Their status as government-sponsored enterprises, including the resulting benefits such as lower borrowing costs flowing from an implicit federal guarantee, carries a serious responsibility to which the FHLBanks must be sensitive.

It seems undeniable that the rationale for the existence of the FHLBanks has evolved over the years as financial markets have changed. Whereas the FHLBanks initially served a critical role as the liquidity source for housing lenders (and still continue to serve in that important role), it's difficult to argue that that role is absolutely necessary for the housing finance industry to function effectively today. Do the FHLBanks bring value to the housing finance market? Absolutely. But clearly the degree of value in light of the existence of an enormous, sophisticated secondary market for residential mortgages is something less than it was in 1932. While the FHLBanks have an important ongoing role to play in providing liquidity to this country's primary residential mortgages originators; it is difficult to justify the existence of the FHLBanks on this basis alone.

The adoption of Gramm-Leach-Bliley was a watershed event for the system. This legislation was a confirmation by Congress that the role of the FHLBanks has expanded to include providing liquidity to the nation's community banks, the local lenders found in small and large communities throughout the country. They provide funding for housing, but also for small business (including farmers and ranchers), consumers and community development. The local lender is the lifeline for the small town. We've seen the same scenario repeat itself across our district. Without readily available, reasonably priced credit, communities typically struggle and eventually die. With an active local lender leading the charge for economic development, affordable housing and community improvement, communities grow and prosper. Our tag line "Building Communities Together" is more than idle talk; it accurately describes the relationship between FHLBank Topeka and its members. While the FHLBank system has an important role in serving large housing lenders, serving those institutions should not be allowed to overshadow the indispensable role the FHLBanks play in serving small, full-service community banks.

Being acutely aware of the philosophical differences between the FHLBanks, our members place a very high value on maintaining an independent regional FHLBank whose products and services, marketing strategies and operations are tailored to sustaining and strengthening our members' role as community leaders and lenders. While we are aware that some academics have suggested it would be wise to simply let the central plains become a vast wasteland devoid of people, we and our members respectively disagree.

At FHLBank Topeka, our typical member is not Washington Mutual. While Washington Mutual is an outstanding organization that provides impressive benefits to the American public, we sincerely doubt that the extinction of the FHLBank system would lead to the demise of Washington Mutual. We feel equally confident that such may not be the case for the thousands of small community banks throughout our country for whom access to reasonably priced wholesale funds has become an absolute necessity to maintain the flow of credit to their communities. And sadly, we are not naïve enough to believe that the services community banks provide today would be replaced by the mega institutions that thrive on conformity and efficiency, and seem to be the driving force behind the push for multi-district membership. Several decades of experience in our district have amply demonstrated that the large mega banks have little interest in serving rural America.

So our long-term vision for the FHLBank system is clear. We see 12 FHLBanks that each have a regional focus with products and services tailored to the needs of their members and the communities in which they do business. For FHLBank Topeka, we see continued specialization in helping our members deal with the challenges faced by rural America. We still believe it is vitally important, and we are committed, to providing excellent value and service to our large housing lenders. But we also recognize the need to provide services and products critical to our small rural members.

We don't expect, nor would we ask, other FHLBanks to follow our lead. Each should individually, through the representation on their boards, assess what are the priorities in their districts and adjust the focus of their products and services appropriately. We applaud the regional differences that exist and the efforts of each FHLBank to determine how to appropriately address those differences.

Having articulated our vision for FHLBank Topeka as well as the FHLBank system, we turn to the issue of multi-district membership. We see multi-district membership as a prescription for conformity in the system. Multi-district membership, no matter how carefully structured and regardless of the limits imposed, will increase competition among the FHLBanks. And competition, because FHLBanks share the same funding source, will necessitate conformity. For example, the FHLBanks will quickly realize that competition in terms of collateral requirements is a recipe for disaster. Consistency in collateral requirements across the FHLBanks is the only prudent response. Regional diversity will be sacrificed to ensure inter-FHLBank competition doesn't adversely affect the system.

We acknowledge that some level of competition exists today because numerous holding companies have subsidiaries that are located in different FHLBank districts. However, we don't understand the logic in declaring that some existing disruptive competition actually justifies promoting competition through implementing a multi-district membership scheme.

In response to your specific inquiry, it is our conclusion that current trends in the financial services industry do not pose any imminent safety or soundness concerns for the FHLBanks and does not warrant any type of regulatory or supervisory action of the magnitude of allowing multi-district membership.

Consolidation of financial institutions arguably presents three issues that potentially raise safety and soundness concerns for the FHLBanks: (1) a serious reduction in membership at a single FHLBank could render that FHLBank too small to operate effectively; (2) mergers and acquisitions can create major shifts in advances from one FHLBank to another, creating financial issues for the FHLBank losing advances and creating concentration issues for the FHLBank gaining advances; and (3) movement of membership and assets between and among FHLBanks can create changes in each FHLBank's total income and therefore the distribution of AHP funds among the districts.

Although these three issues should be evaluated, we don't believe any of them pose serious safety and soundness concerns for the FHLBanks in the foreseeable future.

FHLBank Viability. We acknowledge that there exists a theoretical size at which it is impossible for any organization, including an FHLBank, to continue to operate effectively. Some argue that permitting multi-district membership would allow a FHLBank to better moderate the effect of the loss of a large member by retaining some of the member's existing and perhaps future advances. The argument suggests that the loss of significant advances may drop the FHLBank below the asset size at which it can profitably operate and adequately serve its members. The problem with this argument is that the FHLBanks have never been stronger in their entire history. Membership, assets and advances in the system are at record levels, and product offerings have never been broader.

It's true that the financial services industry has witnessed significant consolidation over the last few decades resulting in the creation of ever-larger entities and higher concentrations of assets. FHLBank members are often acquired by institutions outside the district, resulting in fewer members and fewer in-district assets. Notwithstanding this consolidation, the experience of the FHLBanks would question any concerns. Total FHLBank system membership is at record levels and continues to increase. Total membership in the system is approaching 8,000, a magnitude that has only been seen in recent years in a system that has been around for more than 70. While the percentage of total commercial banks that belong to the system is relatively high, there still exists a large number of commercial banks who are not members. In addition, the system has only begun to tap potential members in the credit union industry.

Asset growth in recent years has been nothing less than impressive. Comparing year-end assets for the system from 1996 to 2002, the system grew from $303 billion to $766 billion, an increase of 169 percent. Some may suggest that the question isn't system growth but the growth in assets at individual FHLBanks. Growth at every single FHLBank over that same time period was also impressive. At the end of 2002, FHLBank Topeka (the smallest bank) had $38 billion in assets. That asset size in 1996 would have made FHLBank Topeka the second largest FHLBank.

We also question the factual support for the proposition that there is a clear correlation between asset size and profitability for an FHLBank. Between 1995 and 2001 the FHLBank San Francisco – the largest FHLBank in terms of asset size over the entire time period – ranked 12th in average ROE. During that same period FHLBank Topeka, the smallest bank during that entire time period, ranked fifth. And FHLBank Topeka consistently outperformed system averages in terms of profitability during this period. This at a minimum suggests that the asset size of an FHLBank may not be a significant determinant of profitability, at least not at the asset levels observed in recent years.

And finally, as a direct result of the Mortgage Partnership Program and the Mortgage Purchase Program, the ability of an FHLBank to withstand the loss of its largest members seems much stronger today than at any time in the past. These programs have the potential, and indeed already have added at more than half the FHLBanks, billions to the amount of assets an FHLBank holds. As of September 30, 2002, eight FHLBanks each held more than a billion dollars in mortgage assets acquired from members. System totals for such assets stood at $47 billion, a number larger than the total assets of nine of the FHLBanks. We expect that the growth of these relatively new programs will accelerate in the future. We also note that these assets typically have a much longer life span than advances, suggesting that the increase in core assets and earnings at the FHLBanks will persist far into the future.

Rather than embark on a fundamental shift in the entire structure of the FHLBank system, we believe that the concerns raised by member consolidation can be addressed with relatively minor steps. As to the viability issue, each FHLBank should develop contingency plans to address the loss of several of their largest members. Provided that a FHLBank develops and executes such plans, viability should not be realistically threatened. The Finance Board should ensure that this planning is taking place as part of the FHLBanks' regular annual examinations.

Movement of Large Members From One District to Another. The acquisition of a large borrower can create issues for the FHLBank that is losing significant advances as well as for the FHLBank that gains significant advances as result of such an acquisition. For the FHLBank that loses the large borrower, the regulations provide the FHLBank with a great deal of latitude in determining how to liquidate the former member's outstanding indebtedness. The regulation, 12 CFR 925.29, merely requires that the FHLBank is to "determine an orderly manner for liquidating all outstanding indebtedness". There is no statutory or regulatory time limit established for this liquidation.

Because the loss of a large member will also remove a proportionate amount of capital from the affected FHLBank, such a circumstance will ordinarily not serve to affect significantly the core profitability of the FHLBank. Throughout their history, the FHLBanks have shown the ability to increase and decrease in size without any major adverse financial implications. Indeed, even though some FHLBanks have experienced the loss of their largest, or one of their largest, borrowers, each has been able to respond to the loss without serious financial consequences.

Gaining assets from consolidation may increase an FHLBank's concentration with a single member. However, spreading those advances among a number of FHLBanks under a multi-district membership scenario would not change the system's total exposure to that member. We strongly believe that having a single point of credit management relating to a single financial institution charter creates significantly less risk than would a situation where multiple FHLBanks are trying to manage competing credit relationships with the same institution.

AHP Funding. The allocation of Affordable Housing Program funds across the country has since the inception of the program been somewhat arbitrary, depending on where institutions are located solely in terms of their charter or principal place of business. Concentration of large institutions in one FHLBank, and the lack of large borrowers in another FHLBank, results in some FHLBank districts benefiting from a disproportionate allocation of the total amount of AHP funding. AHP funding provides critical support for the development of affordable housing.

We recognize that the allocation of AHP funding is important. However, we also believe that the Finance Board can effectively dilute the effects of continued member consolidation on AHP funding by prohibiting FHLBanks from: (1) placing a prohibition on out-of-district project applications; and (2) capping the total amount of AHP funding any one member can receive. This would permit members and affordable housing developers to seek funding from any FHLBank system member across the country, regardless of the FHLBank district in which the institution's charter or principal place of business is located. This would better allow AHP funding to be driven by the quality of projects across the country, rather than where financial institutions choose to locate their charters.

We appreciate the opportunity to provide you with our thoughts and look forward to a continuing dialogue on these matters.

Sincerely,

Andrew J. Jetter