The Future Role of Federal Home Loan Banks in Housing Finance

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Introduction

Thank you for inviting me to speak today as part of the annual conference of the Directors of the 12 Federal Home Loan Banks. As members of the Board of a Federal Home Loan Bank (FHLBank or Bank), you each have a vitally important role to play in shaping the future of your Bank and the FHLBank System.

Last year, among other things, I touched on the benefits of FHLBank membership, the importance of a business model that focuses on advance lending, and the role of FHLBank Directors in corporate governance.

Today I would like to focus on a topic that we all have been thinking about -- the future role of the FHLBanks in housing finance. In today's environment, thinking about the future of the FHLBanks and their role in housing finance is clearly a challenge because there are so many unknowns, and so many different perspectives on what the future should be.

While none of us knows how the future will play out, we do know that there are $10 trillion of mortgages that need to be funded and that the FHLBanks are poised to play a critical role in that mortgage market -- one that leverages off their unique relationship with nearly 8,000 financial institution members, the vast majority of which are community financial institutions.

Before discussing how the FHLBank System might change in the years ahead, I would like to begin by reviewing the evolution of the FHLBank System from its origins to where it is today. Then I would like to conclude with some thoughts on the important role that each of you have in shaping the future of the FHLBank System.

Evolution of the FHLBank System

The FHLBank System was created in 1932, in the midst of the Great Depression, to increase the supply of credit to a deeply troubled housing market. At the outset, FHLBanks were advance-focused with a community orientation, and membership was generally limited to savings and loan institutions. Since then the FHLBank System has changed in fundamental ways.

Banking crises invariably bring about changes in the banking system. And the first major change to the FHLBank System came in the wake of the thrift crisis of the 1980s when Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). FIRREA expanded FHLBank membership to include commercial banks and credit unions with a connection to housing finance. FIRREA also abolished the Federal Home Loan Bank Board and created the Federal Housing Finance Board to oversee the activities of the FHLBanks and the Office of Finance.

Along the way, the product offerings of the FHLBanks also expanded. Most notably, in the late 1990s, the Federal Housing Finance Board approved a pilot program that allowed the FHLBank of Chicago to hold mortgage assets. The mortgages acquired by the FHLBanks through this program, referred to as acquired member assets or AMA, are held in portfolio. The AMA were deemed by the Finance Board, and upheld in the courts, to be the "functional equivalent of advances," but differed in two critical ways from advances. First, managing a portfolio of fixed-rate mortgages involved interest rate risk management significantly more challenging than that associated with advances. Second, AMA assets, unlike advances, were not "self-capitalizing" at most FHLBanks. Nevertheless, following "success" of the pilot program, the AMA program became permanent at a number of FHLBanks.

The range of investment opportunities available to the FHLBanks also expanded over time, and holdings of mortgage securities and other investments grew relative to assets. Part of this was driven by the FHLBanks' obligation to the Resolution Funding Corporation (RefCorp) bonds issued as part of the savings and loan debacle. Through the 1990s the mortgage-backed security (MBS) investment authority expanded to three times capital at the FHLBanks. As I have noted in past speeches before this group, the need for an FHLBank to maintain a significant investment portfolio raises fundamental questions about franchise value and the purpose of the FHLBank System.

Impact of Recent Financial Crisis

With the onset of the financial crisis in late 2007, the FHLBanks became a key provider of liquidity as the demand for advances rose dramatically. In 15 months, FHLBank advances grew by more than 50 percent and resulted in advances reaching a record level in excess of $1 trillion in the third quarter of 2008. Importantly, during the crisis, the FHLBanks demonstrated they were a reliable source of credit to their members, and that they could meet member liquidity needs safely and soundly.

Following the acute phase of the financial crisis, the demand for advances has fallen dramatically as FHLBank members found other sources of liquidity – including expanded deposits – and diminished demand for loans by their customers. As a result, advances are down over 60 percent, to $377 billion in April. This is the lowest level of advances since the third quarter of 1999.

Current State of FHLBank System

Most FHLBanks emerged from the crisis in relatively good condition. All 12 FHLBanks were profitable last year. Retained earnings have increased dramatically in the past five years and now top $9 billion. Retained earnings will continue to increase as a result of capital plan provisions adopted last year to set aside 20 percent of income in restricted retained earnings. Asset quality has also improved as the FHLBanks' holdings of private label MBS have declined steadily. Credit-related other than temporary impairment (OTTI) charges on those securities also declined in each of the last three quarters. In a reversal from just a few years ago, the market value of equity exceeds the par value of capital stock at most FHLBanks.

Although the FHLBanks have made progress by building retained earnings, allowing their private-label MBS to run off, they still face some headwinds. By far the biggest headwind is the decline in the volume of advances, and the outlook for advances growth is not promising in the short-term as members remain flush with cash and loan demand remains slack. And while advances and total assets of the System have contracted, operating expenses have not fallen as fast as assets. Persistent record-low interest rates reduce the return on invested capital, also contributing to weakened earnings.

Meanwhile, in the past year, growth of FHLBank membership has been concentrated among insurance companies, which have collateral arrangements with the Banks that differ in some critical ways from those with insured depository institutions. These arrangements bear watching. Market risk also bears watching, particularly at Banks with large holdings of mortgages and MBS relative to assets.

Future of Federal Home Loan Bank System

With the housing crisis ongoing and affecting the national economy as a whole, housing finance reform is a critical concern, although the complex political and economic environments make the timing of such reform uncertain. The conservatorships of Fannie Mae and Freddie Mac will end. While we do not know how this will play out or what the end result will be, it is useful to consider what we do know and what part the Federal Home Loan Banks could play in the housing finance system of the future.

In February, FHFA submitted to Congress a strategic plan for the next chapter of the conservatorships. This document sets forth a roadmap for work FHFA, Fannie Mae, and Freddie Mac will undertake while the companies remain in conservatorship. This work is focused on building a new secondary mortgage market infrastructure for the future, one that can continue to serve the marketplace after the conservatorships end, without regard to the ultimate fate of Fannie Mae and Freddie Mac. Clearly, resolving the conservatorships of Fannie Mae and Freddie Mac are central to remaking the secondary mortgage market. But the FHLBanks can and should be part of the larger discussion of the future of the country's housing finance system. The FHLBanks have long been a conduit to global capital markets. As such, they have enhanced the liquidity and funding of mortgages for decades. Expanding, maintaining, or refining that role will be the focus of the conversation as it pertains to the FHLBanks.

There are more than $10 trillion in single-family mortgage loans in the nation. Effectively financing this volume of long-term lending requires access to global capital markets. There are not enough deposits in the country to fund all these mortgages, and the risk management challenges for domestic financial institutions to manage all the associated risks in portfolio are substantial. The U.S. housing market in the future, like the market today, needs access to global capital markets.

A critical question for policy makers is how to build, or rebuild, the plumbing necessary to connect global capital market investors with individual families seeking a mortgage to buy a house. With this in mind, consider for a moment the potential roles for the FHLBanks. Already the FHLBanks have demonstrated their scalability. They have also demonstrated their ability to access global capital markets. This was even evident during the height of the liquidity crisis, when the FHLBanks continued to successfully access capital markets, albeit at shorter maturities for a time.

By issuing debt into global capital markets, the Federal Home Loan Banks raise funds that support housing. This access to global capital markets funds advances, which, in turn, provides a source of funding for mortgages held in members' portfolios. The ready availability of advances also makes those mortgages more liquid than they would otherwise be, thereby reducing the liquidity risk in FHLBank members' mortgage portfolios. It also allows the FHLBanks to issue market-worthy letters of credit, which, in turn, allows members to attract their own funds for use in housing finance. Furthermore, as market intermediaries, the FHLBanks now serve as facilitators in the securitization process, collecting mortgage loans from members for sale in the secondary market.

As policy makers ponder the future, the FHLBanks will certainly be part of the discussion on the future of housing finance. The FHLBanks already have strong relationships—including a cooperative ownership structure—to their nearly 8,000 front-line, local lenders.   These relationships put the FHLBanks in an important role as housing market intermediaries. This role makes the FHLBanks well suited to be part of an evolving housing market, especially when considering the role of community-based depository institutions in that evolving market.

In the strategic plan for conservatorship that I mentioned a moment ago, we described three strategic goals centered on building, maintaining, and contracting Fannie Mae and Freddie Mac. Those same terms provide a simple framework for the option set available to Congress in thinking about the FHLBank System in rebuilding the country's housing finance infrastructure.

Congress could choose to expand the FHLBanks' permissible business activities. Depending on the details, such expansion could also require a review of the System's capital structure and capital requirements and its approach to risk management. Congress could choose to add some limits or restrictions on the FHLBanks, essentially requiring some degree of contraction. For example, the Administration's housing finance reform white paper last year suggested adding certain restrictions on the access of larger members to advances. Or Congress could decide the System was working well as it is and leave its role largely unchanged from where it is today.

Let me say a few more words about staying the current course. Under this scenario, FHLBanks would remain focused on providing advances to members and promoting competitive and balanced mortgage finance and servicing systems. For members interested in retaining mortgages in portfolio, FHLBanks can continue to provide liquidity in the form of advances collateralized by those loans. For members interested in selling those mortgages, FHLBanks have already demonstrated an ability to serve as a conduit between the member and the securitization market. And by serving as aggregator in this process, Banks are doing two very important things: they are enabling community financial institutions to obtain better pricing than would be available on a stand-alone basis and they are providing quality control by ensuring mortgages that are securitized meet the standards of the AMA programs. Of course, these characteristics could remain, perhaps in somewhat changed form or degree, should policymakers choose to expand or limit the System in the future.

The Role of FHLBank Directors in Preparing for an Uncertain Future

One of your chief responsibilities as FHLBank directors is to oversee and advise on the strategic planning process at your FHLBank. This means planning for the future. As such, you should be thinking about the ways your Bank can survive and thrive regardless of which scenario might unfold in the years ahead.

For an organization to compete effectively in a competitive environment it must build its strategic plan around its competitive advantage. For FHLBanks, their competitive advantage lies in providing advances to members at a low cost. Your competitive advantage is your government-sponsored enterprise borrowing privilege. And it is your responsibility to protect that privilege by using it to fund core mission activities safely and soundly. Of course, to remain competitive you must also continue to drive down costs, keep up with technology, and grow revenues. To do this you must consider a range of options in your planning, including reassessing margins, changing fee structures, or optimizing operations through outsourcing or strategic merger.

Leadership, of course, matters as well. You need to structure incentive compensation packages that will promote the types of outcomes you are planning to achieve. All FHLBanks should be focused on building low-risk, sustainable businesses, and compensation should reflect this goal. When constructing strategies, we need to learn from our mistakes and avoid what hasn't worked, such as risky investments and excessive interest rate risk exposures. Because we cannot know the future, it makes sense to select a strategy that works across a range of scenarios – including optimistic and pessimist scenarios. As Directors, you must take an active role in controlling risk taking at your FHLBank.

The key to planning is to envision the future before it arrives. Unfortunately, almost everything about the future is uncertain and unpredictable – the economy, technological innovations, competitive developments, Congressional reform, and so on. Planning for the future is a dynamic process, and it is therefore imperative to stay active in the process of forming and reforming the strategic direction of your FHLBank. You need to stand ready to revise your strategy when more information is available, or when conditions change. As Peter Drucker put it, "The question that faces the strategic decision-maker is not what his organization should do tomorrow. It is 'What do we have to do today to be ready for an uncertain tomorrow?' " [1] This is your role.

[1] Drucker, *Management*: *Tasks, Responsibilities, Practice*. New York Harper-Business, 1973, p125.

Conclusion

The FHLBank System has experienced fundamental changes over the last few decades, but it has consistently played an important role in housing finance. Over this time, by providing member institutions with reliable funding and other important products and services, the FHLBanks have built a competitive advantage in delivering member value.

There are many opportunities and challenges ahead, but building on competitive advantages will help the FHLBanks deliver more value to member institutions in an uncertain tomorrow. As I a mentioned from the start, there are still many unknowns and different views of what the future of housing finance will be.

Yet in your role as directors of an FHLBank, you are stewards of this future. And by building strategy and planning for the future, your leadership will drive the performance of the system in the years, if not decades, ahead.