

## CHAPTER 1

### THE FEDERAL HOME LOAN BANK SYSTEM

#### **Introduction**

Many Federal credit programs are targeted toward supplying credit to rural markets, which tend to be comprised of smaller borrowers, smaller businesses, and smaller banks. Wholesale funding has traditionally been made by government-sponsored enterprises<sup>1</sup> (GSEs), such as the Farm Credit System, Farmer Mac, and the Federal Home Loan Bank (FHLB) System. Each GSE has a defined and separate mission, though some inter-GSE competition exists (Barry and Ellinger, 1997).

Many legislative changes have been made to GSE operations to influence competition and market performance by expanding the financing options for small banks and small borrowers, stabilizing local credit availability, and enhancing local competitiveness. The most current is the financial modernization legislation, known as the Gramm-Leach-Bliley Act of 1999 (GLB). Many specific provisions in this Act are made to increase small bank funding by broadening small bank access to FHLB funds. This chapter describes the structure and operations of the FHLB System. It also provides descriptions of the regulatory and economic changes that have affected the System since its inception.

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<sup>1</sup> GSEs are originally capitalized by the Federal government but evolve into privately-owned corporations.

## **What is the Federal Home Loan Bank System?**

The FHLB System was created as a GSE to support residential mortgage lending and related community investment by assuring the continuous flow of funds to member thrifts that were residential lenders. It is composed of 12 district Federal Home Loan Banks<sup>2</sup> (FHLBs or Banks), almost 8000 member financial institutions, and the System fiscal agent (the Office of Finance) under the supervision of the safety-and-soundness and mission regulator (the Federal Housing Finance Board--FHFB).

In addition to providing its members with a source of liquidity and with additional funds for housing finance purposes, the System's mission also involves establishing special housing and community investment programs. Two FHLB housing programs are intended to promote community development. The Affordable Housing Program subsidizes interest rates for loans to System members and provides direct subsidies to members making loans for the purchase, construction, or rehabilitation of very low- to moderate-income owner-occupied or rental housing. This program seeks to encourage the creation of lending efforts by members to increase the stock of affordable housing. The Community Investment Program funds community-oriented mortgage lending for families with incomes not exceeding 115 percent of an area's median income. The aim is to direct lending toward economic development in low- to moderate-income neighborhoods.

Membership in the FHLB system increased 141 percent from 1989 to the year-end 2000 (3217 to 7763 total members). The most notable change in the composition of membership over the past decade has been the steady increase in the percentage of commercial banks since they were granted permission to join the System in 1989. Federal- and State-chartered commercial bank membership increased to over 73 percent of total members at the expense of thrift membership, which fell below 20 percent. Approximately 90 percent of these commercial bank members are classified as small (less than \$500 million in total assets). Credit unions (6.4 percent) and insurance companies (0.7 percent) make up the remainder of the FHLB member base<sup>3</sup>.

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<sup>2</sup> The regional FHLBs are located in Atlanta, San Francisco, Boston, Seattle, Dallas, Des Moines, Chicago, Topeka, Indianapolis, Cincinnati, New York, and Pittsburgh.

<sup>3</sup> Thrift institutions are organizations that primarily accept savings deposits and invest the proceeds in mortgage loans, although loans may also be made to businesses and consumers. Savings banks and savings and loans

### FHLB System Membership Requirements

Each of the 12 district FHLBs is a separate, member-owned corporation. To become a member of the FHLB system, a financial institution must meet minimum membership eligibility requirements. Potential members are eligible if they are organized under State or Federal laws, issue long-term mortgage loans, meet the minimum 10 percent requirement of total assets invested in residential mortgage loans/mortgage related assets, secure the approval of the FHFb by meeting and maintaining safety and soundness financial condition standards which include capital adequacy and asset quality requirements, and are regulated by either the Office of the Comptroller of the Currency, the Federal Reserve System (FRS), or the Federal Deposit Insurance Corporation (FDIC). The Comptroller regulates national banks and is their chartering authority. The FRS regulates state-chartered, FRS member banks and bank holding companies, and the FDIC regulates all FDIC-insured, state-chartered banks that are not members of the FRS.

Each member institution is required to purchase a minimum level of stock in the regional FHLB serving the state in which the member's home office or principal place of business is located. This minimum purchase is equal to 1 percent of residential mortgage loans or 0.3 percent of total assets, whichever is greater. FHLB stock carries a fixed par value of \$100 per share, and members receive quarterly dividends from realized profits, which fluctuate with short-term interest rates (the 3-month Treasury bill rate). System stock is an attractive and safe long-term investment.

### FHLB System Advances

The proceeds from the stock sold to member institutions are used to issue/sell consolidated obligations, the primary source of funding for the FHLBs. Consolidated obligations are sold to investors such as commercial banks, foreign central banks, mutual funds, major corporations, pension funds, government agencies, and individuals. The perception of a government guarantee and other special privileges associated with their GSE status allow the FHLBs to borrow funds in capital markets at rates only slightly higher than those paid by the U.S. Treasury. Consolidated

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associations (S&Ls) are examples of thrifts. Commercial banks are full service institutions that accept demand deposits and make commercial loans. Credit unions are a type of savings institution whose depositors share a common bond, for example sharing the same employer, and most of its funds are lent to its members. Insurance companies primarily sell insurance.

obligations are primarily in the form of debt products (or securities), such as fixed rate and fixed maturity bonds, discount notes, variable rate bonds, callable bonds, and international issues. They are joint and several obligations of the System, not of the U.S. government and are not guaranteed by the U.S. government. For Securities and Exchange Commission purposes, consolidated obligations are considered government securities and are exempt from state and local income taxes. They are also eligible as collateral for deposits and for investment by national banks and thrifts.

The FHLBs use the proceeds of the consolidated obligations to extend low-cost, short- and long-term loans, referred to as advances, to member institutions within their region for residential mortgage lending purposes. The same flat rate is charged to all members for these advances, regardless of the financial position or the risk associated with a particular bank, although a member appearing more risky may have different collateral requirements. Once an institution obtains FHLB membership, it is able to borrow advances immediately, although in an amount dependent upon its financial condition and on the amount and type of collateral pledged. Many types of collateral can be used to secure FHLB advances, including home mortgage loans, U.S. Treasury securities, deposits at the FHLBs, and other real estate-related collateral.

By year-end 2000, FHLB advances to members were \$437.9 billion, up from \$79.1 billion in 1991 (an increase of over 450 percent) and over 45 percent higher than advances outstanding in 1999. From 1991 to year-end 2000, total assets increased over 300 percent to \$653.7 billion and capital stock rose to \$30.5 billion, up almost 200 percent from 1991. Total capital ratio (capital stock plus retained earnings as a percentage of total assets at period end) was down from 6.9 to 4.8 percent. Net interest margin dropped from 0.67 percent to 0.54 percent. Return on average equity and return on average assets fell from 10.54 percent and 0.73 percent to 7.32 percent and 0.36 percent, respectively (derived from FHFBS data).

## **The Evolution of the FHLB System**

During the 1930s, government policy encouraged home ownership by subsidizing deposits in savings accounts at institutions that provided home mortgage loans. The Federal Home Loan Bank Act of 1932 provided credit to savings and loans associations to meet the demand for home mortgages and withdrawals. This Act created the FHLB System as an organization of member-owned Banks, replicating the FRS for commercial banks, which consists of the 12 district Federal Reserve Banks and the member commercial banks of the FRS. The FHLB System consisted of 12 regional FHLBs, member thrifts, and the System regulator, the Federal Home Loan Bank Board (FHLBB). Each FHLB is, and remains, a separate, government-chartered, member-owned corporation (member institutions own/purchase stock in their respective Bank). All Federally chartered thrifts were required to become members of the FHLB System at their inception. The FHLBs extended short- and long-term loans to member thrifts, while the FHLBB directed and regulated the FHLBs. The System's public policy mission was to support residential mortgage lending and related community investment through its member institutions by providing readily available access to System funding (Rom, 1996; FDIC, 1984).

### Changing Regulatory Environments

Prior to the 1930s, the banking industry followed a decentralized banking structure characterized by traditional unit banking. Many locally and independently owned banks were created and responded to local credit needs by borrowing and lending locally. When commercial banks and thrifts went bankrupt during the Great Depression, people lost their savings since deposit insurance did not exist. In response, the Banking Act of 1933 established the FDIC as a self-governing government corporation, not a component of the FRS, to insure deposits at banks. The Federal Savings and Loan Insurance Corporation (FSLIC) was established by the National Housing Act of 1934 to insure individual savings at member savings and loan associations. Although the FSLIC was modeled after the FDIC, it was created as a part of the FHLBB and was not self-governing. The FHLBB served as the board of directors to the FSLIC.

Following World War II, thrifts grew at a higher rate than commercial banks. More Federally chartered thrifts were created, so the FHLB System prospered in a growing economy. Interest rates were continuously rising, and the thrift industry was subject to extreme interest rate risk

since they were financing long-term mortgage loans with short-term savings deposits. Funds moved out of thrifts and banks when the market rate rose above the ceiling.

Suggested solutions to the disintermediation problem (the problem that individuals are less willing to deposit savings and demand deposits when there are higher-yielding alternatives) included the introduction of adjustable rate mortgages and allowing the diversification of bank and thrift investment portfolios. Adjustable rate mortgages were not permitted since it was argued that they would transfer interest rate risk from the financial institutions to the individual homeowners. Diversification of investments into other assets with shorter maturities than the traditional 30-year, fixed rate home mortgages was also denied. Diversification would introduce too much competition for banks, and potentially detract thrifts from promoting home ownership by decreasing home lending.

Instead, Congress attempted to stabilize thrift deposit, profits, and home construction by controlling interest rates in the Interest Rate Control Act of 1966. Regulation Q allowed the FHLBB to set limits on rates paid on deposits, and through collaboration with the Fed, set rates paid on savings slightly higher than the rate limits placed on banks (known as the thrift differential). The interest rate ceilings placed on deposit rates did not eliminate competition, but instead increased non-price competition and encouraged entry by unregulated financial institutions (unregulated competitors) that offered alternative investments, such as money market mutual funds. Funds continued to move out of banks and thrifts, reducing the amount available for these institutions to lend, increasing interest rates, and creating the credit crunches of 1966, 1969, 1974 and 1979. Market interest rates continued to rise during the late 1970s, further exacerbating the disintermediation problem.

The Carter Administration approved the Depository Institutions Deregulation and Monetary Control Act of 1980 to phase out the interest rate ceilings imposed by Regulation Q. Additional provisions broadened thrift institution powers, raised the deposit insurance limit from \$40,000 to the current \$100,000 level, and established negotiable order of withdrawal (NOW) accounts.

After deregulation, the thrift industry continued to suffer net outflows of deposits and diminishing profits. Under Reagan, Congress passed the Garn-St Germain Depository Institutions Act in 1982 in an attempt to attract deposits. Thrifts were allowed to invest in many assets and limits on loans to one borrower were relaxed. While thrifts were attracting funds, they were also making excessively risky loans in attempts to increase net worth. Many investments in the high-risk assets were unprofitable, leading to more insolvencies. An insolvency occurs when the value of an institution's assets are less than liabilities held in portfolio. These insolvencies created losses to the FSLIC in 1984. In 1986 and 1987, profits fell further, insolvencies increased, and thrifts failed, leading to the recapitalization of the FSLIC in 1987. Failure of state-chartered thrifts accounted for two-thirds of total FSLIC losses during this time (Rom, 1996).

During the Bush Administration, Congress passed the Financial Institution Reform, Recovery, and Enforcement Act of 1989 (FIRREA), to promote a safe and stable FHLB System for the financing of housing, by strengthening capital, accounting and supervisory standards, closing bankrupt thrifts, imposing tighter regulations, and by separating FHLB regulation from that of the thrift industry. The FHLBB was considered to be too politically weak since it was strongly influenced by the industry and by individual members of Congress, so FIRREA abolished the FHLBB and reassigned its regulation, credit, and insurance functions into different agencies.

The regulator of the thrift industry became the newly created Office of Thrift Supervision within the Department of the Treasury and so was not an independent agency like the FHLBB. All depository institutions were invited to join the FHLB System and the FHFBS was established to oversee loans made to members by the district FHLBs. The FSLIC fund was too small to cover the losses of the 1980s, consisting of shut downs, payments to depositors, liquidation of assets, and searches for buyers of savings and loan associations, which was cheaper than liquidation. The FSLIC was dissolved and taken out of the FHLBB. Its functions and responsibilities were transferred to the FDIC, so the FDIC was now authorized to insure deposits held at savings associations as well as at commercial banks.

Two separately maintained funds were created to be used, operated, and administered by the FDIC to carry out the insurance purposes of FIRREA. The Bank Insurance Fund (BIF) covered member banks and the Savings Associations Insurance Fund (SAIF) covered member thrifts. The FHLBs made loans to the FDIC for use of these funds which, in turn, were classified as direct liabilities of the Funds. FIRREA requires that funds held in either Fund must be invested in U.S. government obligations, or obligations guaranteed by the U.S. government.

Finally, the Resolution Funding Corporation was established to provide funds through the FHLBs (i.e. existing members contribute to these funds) for use by the Resolution Trust Corporation to manage and resolve cases involving insolvent thrifts that were insured by the FSLIC. The FDIC directed both temporary corporations.

A further piece of legislation affecting the financial services industry and future FHLB regulation was the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which allowed for interstate banking and branching, opening the doors for nationwide banking. It amended the Bank Holding Company Act of 1956, authorizing the Board of Governors of the Federal Reserve System to permit adequately capitalized and managed banks to acquire existing out-of-state banks (as long as it was not done primarily for deposit production purposes) and allowed for interstate mergers. These bank holding companies must continue to meet the credit needs of their local communities and market areas, and their ratio of out-of-state loans is restricted.

#### *GLB-the Financial Modernization Legislation*

The increased competition resulting from geographic liberalization and other industry changes raised concerns about whether smaller banks had access to affordable funds to meet local credit demand. The most current passed reform, commonly called the Gramm-Leach-Bliley Act of 1999 (GLB), became public law number 106-102 under the 106<sup>th</sup> Congress on November 12, 1999. GLB modernizes the financial services industry and addresses these concerns.

GLB has important implications for small borrowers and local development. Before GLB, all financial institutions interested in System membership had to meet eligibility requirements to

qualify for membership. These requirements included capital and loan quality standards, taking domestic deposits, and holding at least 10 percent of total assets in mortgage-related assets. GLB broadened access to FHLB financing by repealing the minimum percentage of total assets that must be represented by residential mortgage lending for small commercial banks (defined to be insured banks with less than \$500 million in total assets). Throughout the 1990s, this membership eligibility constraint was consistently binding for smaller banks since many of them have limited residential lending programs, resulting in insufficient amounts of mortgage loans to qualify for membership. Many more small banks will now be able to join the System and utilize FHLB advances.

Originally, the FHLBs extended advances to member institutions to improve home mortgage credit availability, accepting mortgages and government securities as collateral. GLB expanded the purposes of advances for small banks beyond residential housing finance, to include funding for small businesses, rural development, agriculture, and low-income community development. Corresponding expansions in eligible collateral to secure FHLB advances were also made. As long as loans are within the loan-to-one-borrower limit of the small bank, small business loans, small farm loans, and small agri-business loans, securities representing a whole interest in such loans, or other real estate related loans may be used as collateral for FHLB advances by small commercial banks. Existing small members can borrow more, enhancing their ability to meet community credit needs. GLB also repealed the Glass-Steagall Act of 1933, removing the separation of banking, insurance, and securities industries, and increasing the potential for competition in the financial services industry.