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The Honorable James A. Leach
Chairman, Committee on Banking
and Financial Services
House of Representatives

Dear Mr. Chairman:

This letter responds to your request for our views on proposed legislation entitled "The Enterprise Resource Bank Act of 1996," H.R. 3167 (the Bill), which would amend the Federal Home Loan Bank Act. The purpose of this proposed legislation is to expand the current mission of the Federal Home Loan Bank System (System). The System's current mission is to provide credit to member financial institutions for housing finance, including affordable housing. The expanded mission would include providing credit for community and economic development lending, including rural economic development. As agreed with your office, our comments are based on the April 17, 1996, committee print of the Bill, as adopted by the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises of the Committee on Banking and Financial Services. On the basis of your request letter and subsequent discussion with your office, we agreed to

- analyze the potential consequences of and risks posed to the System by its expanded mission and the new administrative arrangements proposed by the Bill; and

- discuss other options that might allow the System to meet the Bill's objectives, provide alternative mechanisms for meeting those objectives, or allow the System to engage in a wider range of activities.

BACKGROUND

The System was set up in 1932 to extend mortgage credit by making loans, called advances, to its member institutions, who in turn lend to homebuyers for mortgages. The advances are secured by home mortgage loans or other collateral,

including U.S. Treasury securities, deposits at a Federal Home Loan Bank (FHLBank), and a limited amount of other real estate-related collateral if it is acceptable to the FHLBank. These advances help member institutions, originally limited to thrifts, by enhancing liquidity and providing access to national capital markets. The System is a government-sponsored enterprise (GSE), consisting of 12 federally chartered, privately owned FHLBanks that raises funds by issuing consolidated debt securities in the capital market.

Congress created GSEs to help make credit available to certain sectors of the economy, such as housing and agriculture, in which the private market was perceived as not effectively meeting credit needs. As we have reported previously, the GSEs' ties with the federal government create the perception among investors and creditors that the federal government would likely assist a GSE through any significant financial difficulty.[1] While the government has no legal obligation to protect GSE creditors, the federal ties cause creditors to believe that their investments are safe. As a result, GSEs can borrow with relatively low levels of capital and at interest rates that are usually only slightly higher than those paid by the Department of the Treasury and are lower than those paid by highly rated private corporations that are not GSEs.

As of year-end 1995, the System had about $132 billion in advances outstanding and about $231 billion in consolidated System obligations. About 85 percent of advances were to members with over $500 million in assets and about 73 percent to members with over $1 billion in assets. In comparison, as of year-end 1995, about 76 percent of loans held by Federal Deposit Insurance Corporation (FDIC)-insured depository institutions were held by institutions with over $1 billion in assets.

Originally, the System's mission focused on housing finance provided by thrifts, but Congress expanded it in 1989, as part of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), to include affordable housing and community investment programs and to open membership to nonthrift federally insured depository institutions that make residential mortgages. Under current law, each FHLBank is required to have a community investment program that targets advances for community-oriented mortgage lending, including loans to finance housing for low- and moderate-income families and economic development of low- and moderate-income areas. Consistent with the housing finance mission, the law currently requires an insured depository institution to have at least 10 percent of its portfolio in

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[1]Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990) and Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991).

residential mortgage loans when it applies for membership. As of April 30, 1996, 1,933 of System members were thrifts, 3,750 were commercial banks, 148 were credit unions, and 27 were life insurance companies.

In addition to adjusting the mission and membership requirements, FIRREA established the Federal Housing Finance Board (FHFB) as the regulator of the System, charging it with ensuring that the FHLBanks carry out their housing finance mission in a safe and sound manner. The 1989 law also required the System to pay up to $300 million per year of annual earnings for 40 years to contribute towards interest payments on bonds issued by the Resolution Funding Corporation (REFCorp).

The Bill would redesignate the FHLBanks as "Enterprise Resource Banks" (ERB), expand their mission, and permit any insured depository institution with assets under $500 million, regardless of its mortgage holdings, to join the System. Insured depositories with assets of $500 million or more would be required, by July 1998, to hold a specified percentage of their assets as mortgages or other "mission-related" assets to qualify for membership. The Bill would raise the portion of real-estate-related collateral that would be allowed for advances from 30 percent to 50 percent of capital and make certain other assets, such as small business loans and certain municipal securities, eligible as collateral for advances. The System's new mission would include facilitating community and economic development lending, including rural economic development.

RESULTS IN BRIEF

Based on our analysis of the System and recommendations[2] and criteria we previously developed,[3] we believe the Bill contains some provisions that would be improvements over current law. However, we also have questions and concerns about other provisions, most notably those that would expand the System's mission, membership, and eligible collateral.

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[2]Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/GGD-94-38, Dec. 8, 1993). Also see GAO comments on a previous bill to reform the System: Letter of Director, Financial Institutions and Markets Issues, GAO, to the Chairman, Committee on Banking and Financial Services, House of Representatives, Oct. 11, 1995, (B-260498).

[3]GAO/GGD-90-97 and GAO/GGD-91-90.

The potential improvements include provisions that would (1) change the current method of allocating the REFCorp obligation[4] to a percentage (23.7 percent) of each bank's net earnings, effective January 1, 1998, (2) change the basis for membership in the System from a mix of voluntary and mandatory to all voluntary, and (3) make FHFB a stronger regulator. In our 1993 report, we recommended a change from the current $300 million annual fixed-dollar REFCorp obligation to one more closely related to earnings because the fixed-dollar annual obligation encouraged risk taking and penalized FHLBanks for making advances to thrifts. In the same report, we identified risks associated with having both mandatory and voluntary members, such as the risk that voluntary members could exit the System if their capital investments appear to be at risk, thus leaving mandatory members to absorb any losses. In addition, we believe the Bill would make FHFB a stronger regulator because it would give it enhanced enforcement authority and would eliminate the FHFB's current role in corporate governance. In our 1993 report, we recommended that FHFB become an arm's-length regulator and end the role it plays in approving FHLBank budgets, salaries, and staffing levels. Such a change could end FHFB's role as an advocate of the system and increase its independence. FHFB would still not be a completely arm's-length regulator, however, because it would continue to appoint some directors of each FHLBank.

Despite these improvements, we are concerned that the Bill could expose taxpayers to increased risk, because it proposes to expand the System's mission, its membership, and the types of collateral eligible for System advances. Under the Bill, the new mission would include facilitating community and economic development lending, including rural economic development lending, as well as promoting residential mortgage lending, and assisting these forms of lending by making advances and providing other financial services. The Bill would expand membership by eliminating the requirement for holding mortgages for member institutions having less than $500 million in average annual assets.[5] Finally, the Bill would also expand the kinds of

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[4]Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Congress created REFCorp to provide $30 billion to finance thrift failure resolutions. It required the FHLBanks to capitalize REFCorp with $2.5 billion paid from retained earnings, and subsequently, to pay a portion of the annual interest on the bonds issued to finance the thrift failure. This requirement referred to as the REFCorp obligation, in effect is an annual fixed-dollar obligation of $300 million.

[5]For larger institutions, the Bill would require that an average annual amount of total assets be invested in whole mortgage loans or any other assets the FHFB defines as "mission-related." The amount would be 7 percent of the average annual amount beginning on July 1, 1998, and increase yearly by one percentage point until reaching 10 percent after June 2001.

collateral eligible to secure advances. Taken together, the broader mission, expanded membership, and additional eligible collateral could lead to an increase in the taxpayers' potential exposure to risk because it is likely to lead to expanded System activity, possibly in higher risk assets. Achieving the new mission may be difficult because the already tenuous link between advances and the type of lending that is facilitated would be further weakened for all but the larger institutions. Furthermore, with a new and expanded mission, new expertise may be required of ERB directors and management, which could make it difficult for them to properly monitor and manage risks. Finally, while the Bill would give FHFB additional oversight powers, it eliminates the current requirements that advances be approved by FHFB. This, plus the breadth of the new mission, makes unclear the extent to which FHFB could, under circumstances it deems appropriate, limit activities for what an ERB might consider economic development lending. In addition, the System's potential expansion could pose additional risks to FDIC's insurance funds, because repayment of System advances would receive priority over claims by FDIC in resolving failed institutions.

We identified several options that might meet the Bill's objectives or allow the System to expand its range of activities. Such options include creating a special purpose finance corporation, making System advances available to institutions specifically designated for community development lending, and eliminating federal sponsorship of the System.

SCOPE AND METHODOLOGY

To analyze the potential consequences of the proposed legislation, we reviewed government studies, statistics, and correspondence related to the System and the Bill and interviewed senior staff and the Chairman of FHFB, senior staff of FDIC, and the Assistant Secretary for Market Finance, Treasury. We have shared our characterizations of their positions with both FHFB and FDIC. Based on their responses, we made changes where appropriate.

To analyze the potential consequences for the System of providing new financial services based on its expanded mission, we used criteria that we developed in our 1993 review. At that time, we developed these criteria to help us judge whether the System should expand into new activities because of the potential risk to taxpayers of expanding the role of GSEs. These criteria were developed through discussion with System members, FHFB and FHLBank officials, and by considering criteria provided by other interested parties. We believe that these criteria are still appropriate for analyzing aspects of the Bill. The criteria can be summarized as follows:

- First, any new activity should be consistent with the System's mission.

- Second, the FHLBanks should have the expertise needed for the new activity.

- Third, competition should be avoided between FHLBanks and their members.

- Fourth, any new activity should be properly priced after any risk adjustments.

- Fifth, the System should be able to maintain its high credit rating for its consolidated obligations to help protect taxpayers against loss.

To identify and examine options, we surveyed the existing literature on GSEs, including Congressional hearings, proposed legislation affecting other GSEs, and policy options developed in government reports and correspondence.

For the purposes of this review, we did not evaluate whether there is an unmet credit need for community and economic development, including rural economic development. We also did not evaluate what capital requirements for the ERBs would be appropriate.

We conducted our work in Washington, D.C., during April and May 1996 in accordance with generally accepted government auditing standards.

SOME PROVISIONS OF THE BILL COULD IMPROVE SOUNDNESS OF SYSTEM, WHILE OTHER PROVISIONS RAISE CONCERNS

The Bill contains some provisions that would be improvements over current law because they could reduce System risk taking and the current bias against mandatory members, as well as making FHFB a stronger regulator. However, we have concerns with other provisions, most notably those that would expand the System's mission, membership, and eligible collateral.

Improvements Could Reduce Risk Taking and Make Membership All Voluntary and FHFB a Stronger Regulator

Provisions of the Bill that represent potential improvements include (1) changing the method of paying the System's REFCorp obligation, (2) changing the basis for membership, and (3) providing FHFB additional regulatory tools. The Bill would change the method for paying the System's REFCorp obligation from a fixed amount allocated among the FHLBanks to a proportion of each ERB's income, thus reducing incentives for ERBs to take on undue risk. Membership in the System would become completely voluntary, which would eliminate the existing imbalance against mandatory members. FHFB would be given greater enforcement powers and its present direct

prohibiting FHFB management of ERB operations as well as community investment and affordable housing programs. However, FHFB still would have indirect influence over the ERBs because the Bill would continue FHFB's role in appointing 6 of the 14 directors of each ERB.

Other Provisions Raise Concerns

Despite these improvements, the Bill raises concerns about possible increased risk to the government because it proposes to transform the System's mission and expand both its membership and eligible collateral. Expanding the System's mission and investment authority could increase the overall amount of System activity and therefore the potential risk to the taxpayer if the System were to encounter financial difficulty. The Bill would expand the System's original role of supporting housing finance to include community and economic development lending. It is not clear, however, whether there would be a close link between any additional activity and the new mission. Moreover, ERBs would be permitted to take new types of assets--small business loans and infrastructure loans--as collateral for advances, yet they may not have the expertise needed to properly evaluate or manage the associated risks.

System expansion is not linked to a well-defined mission

The Bill's proposed mission is broader than the System's original mission and does not comport well with the rationale Congress has historically followed in establishing GSEs. The FHLBank System as presently structured reflects Congress' traditional objective of focusing GSE activity on specific sectors of the economy in which there was thought to be some failure of the market, in this case housing finance.[9] Because of the loose connection between advances and lending activities, as well as the potential expansion in System membership and eligible collateral that would result from the Bill, there is little assurance that ERB advances would channel significant amounts of additional credit to economic activities that may be included in the proposed mission as opposed to other activities that typically receive credit from depository institutions.

Current laws governing the System contain a number of restrictions that help target the System to its current mission. Among these are (1) minimum residential mortgage portfolio requirements for membership, (2) eligible collateral requirements to receive

[9]GAO/GGD-91-90.

FHLBank advances, and (3) a cap on advances to non-QTL members.[10] The first requirement increases the likelihood that members will use advances to finance residential mortgages. The second requirement also increases this likelihood to the extent that eligible collateral, which includes mortgage assets, constrains members from obtaining advances. The third requirement also increases this likelihood, but it creates the side effect of creating unequal terms of membership. In the past, we have favored using minimum residential mortgage portfolio requirements to limit System size and emphasize the housing finance mission of the System over approaches that create unequal terms of membership.

Both the membership and the collateral links that help to tie the current system of advances to mission-related activity would be loosened under this Bill. The Bill does not set generally applicable membership requirements linked to the proposed mission, so the System would lack such an element to increase the likelihood that advances extended by ERBs would be used by members to meet credit needs that are consistent with the System's newly defined mission.[11] For banks with less than $500 million in assets who want to be members of the System, there would no longer be a minimum required mortgage asset holding.

Broadening eligible collateral to include small business loans, infrastructure loans, and a larger percentage of other real estate-related collateral could increase the likelihood that existing members would use advances for such activities if those members are currently constrained from obtaining additional advances because of insufficient eligible collateral. In our 1993 report, we stated that the System's collateral base was not an apparent constraint on advances and current data indicate that this is still true. Although there may be existing members that would borrow more advances with the broader collateral, the primary source of any increased demand for advances is likely to be new members who do not currently qualify for membership. How many of these newly qualifying financial institutions would become members and how large their demand for advances would be is difficult to predict. As of December 31, 1995, there were over 9,000 FDIC-insured commercial banks with assets less than $500 million. In addition, the extent to which such advances would spur new mission-related activity is not clear both because there is generally no way to trace how advances are used and because the new collateral is only broadly related to the new mission.

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[10]There is also a requirement that long-term advances be made for the purpose of providing funds for residential housing finance.

[11]The System currently requires members to hold 10 percent of assets in residential mortgage loans, as defined by the FHFB. This minimum requirement creates a link between membership and the public purpose of the System.

The Chairman of FHFB told us that because funds are fungible between uses, FHFB cannot track how advances are used under current law, nor would it be required to do so under the proposed Bill. He said, however, that the Bill's mortgage holding requirements would somewhat limit membership by depository institutions with $500 million or more in assets, but most of these institutions currently are, and would continue to be eligible for System membership. In his view, because smaller institutions generally focus on lending to, and have specialized knowledge about, the communities in which they are located, these institutions' lending operations have a greater likelihood of serving economic development purposes and meeting credit needs in underserved areas.

While the 1989 expansion to affordable housing goals appeared to be consistent with the original housing-related mission, we do not believe that the Bill represents a similar targeted expansion. Rather, it would essentially change the mission of the System without limiting its activities to one defined basic market sector as has been the case with other GSEs. If passed, H.R. 3167 would allow ERBs to raise funds in the private markets at preferential rates due to the System's government affiliation and advance those funds to a potentially large number of financial institutions for a broad range of lending activities.

ERBs would need new expertise to accomplish the new mission

It would appear that new expertise would be required of ERB management due to the expanded mission, collateral, and membership. Without a thorough understanding of the risks associated with the new collateral and lending activities, it may be difficult for ERB directors and management to properly monitor and manage the risks. The Bill would authorize new types of assets as acceptable collateral to support advances for newly authorized purposes:

(1) small business loans generally with principal of $750,000 or less, as provided under Section 7(a)(3)(A) of the Small Business Act;

(2) general local government maintenance and infrastructure improvement loans with principal amounts of less than $2.5 million; and

(3) investment grade municipal securities.

Evaluating collateral backed by such businesses or projects would require expertise that is different from that used to evaluate the home mortgages and other real estate-related collateral underlying the System's traditional business. The Bill does address qualifications of the 14 directors of the banks to a limited extent by requiring 2 board

members to have backgrounds in areas that may be related to the expanded mission. It proposes that 2 of the 6 directors appointed by FHFB have experience representing consumer or community interests in banking services, credit needs, housing, or financial consumer protection. The 8 directors elected by bank members would be presidents, chief executive officers, or other senior officers of member institutions. The Bill does not require that any of the elected directors have experience relevant to managing bank business related to the new activities.

In addition, the combination of expanded collateral, membership and services could further stress ERB management. The expanded eligible collateral and possibility of obtaining funds at lower costs is likely to prompt more financial institutions to join the System. The expanded membership could also bring an increase in volume to ancillary services the System provides its members.

Since year-end 1992, the number of commercial bank, insurance company, and credit union members has increased from 1,333 to 3,925 as of April 30, 1996, representing 67 percent of the System's 5,858 members. At the end of 1995, there were 9,941 FDIC-insured commercial banks including 6,659 with assets less than $100 million and 2,593 with assets between $100 million and $500 million. This represents a large pool of potential new members for the System.

Currently, the FHLBanks may accept deposits from members, other System banks, or other instrumentalities of the United States. All System banks now hold such deposits; they represented about $19 billion of the System's approximately $260 billion in total liabilities at the end of 1995. FHLBanks may also engage in the business of collection and settlement of checks and drafts or other instruments of payment on behalf of members or institutions eligible to become members (i.e., processing services). All FHLBanks provide this service; four do the actual processing themselves and the other eight contract for the work and thus perform an exchange function only. Potential increases in such activity not only raise questions about the ability of a bank's systems and personnel to safely manage increases in workload, but also about pricing of those services.

Regulator's role in proper pricing is unclear

According to the criteria we developed for analyzing new or expanded System activities, the proper pricing of products and services offered by FHLBanks should provide an adequate rate of return to the FHLBank after adjustments for any risks. Underpricing fails to produce an adequate risk-adjusted rate of return, which could eventually threaten the capital of the System. Further, underpricing may have anticompetitive effects by inhibiting private sector firms that offer the same service or

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product.[12] According to data provided by FHFB, the services the FHLBanks provided their members generated 4 percent of their combined net income in 1995. Such services included custodial services, trading services on investment transactions, and Federal Reserve settlement.

The collection and settlement of checks and drafts or other instruments of payment (i.e., processing services) for members, or those eligible to be members, is among the services the FHLBanks can now provide. Currently, only four FHLBanks provide processing services directly; the other eight FHLBanks contract for this work. The FHLBanks that engage in processing are required to price these services in a manner consistent with the law applicable to Federal Reserve Banks that provide such services.[13] The law essentially requires that the FHLBanks recover all direct and indirect costs in the pricing. FHFB reviews this activity for compliance with the requirements. Its review for 1994 pricing and projected pricing for 1995 found that the FHLBanks were in compliance.

The Bill states that ERBs would set the charges for the collection and settlement of checks consistent with section 11A(c) of the Federal Reserve Act and that FHFB would have the right to issue regulations regarding related rights, powers, responsibilities, duties, and liabilities. Although it may be reasonable to assume FHFB, as safety and soundness regulator, would monitor pricing and take action if warranted, this may be open to interpretation as the Bill now stands. Under current law, the FHFB's oversight authority with regard to charges is clear. Such authority would also be important with the potential System expansion that would result from the Bill for two related reasons. First, the larger membership base raises the potential revenue and, thus, the banks could have a greater profit incentive to provide such services. Second, the resulting ERBs could potentially become such general providers of products and services to member depository institutions, they could end up competing more directly with large money center banks (i.e., where activities are not

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[12]GSE status provides benefits to FHLBanks that lower their costs, most notably borrowing costs on debt. The greater the proportion of benefits passed through to borrowers targeted by the System's mission, the higher is the likely benefit cost ratio generated by the System. FHLBank use of GSE benefits for other purposes, including those that may pose anti-competitive effects, generally lower that benefit cost ratio.

[13]The law currently requires the FHLBanks to charge for their services consistent with the principles set forth in section 11A(c) of the Federal Reserve Act, which was enacted as part of the Monetary Control Act of 1980 (P. L. No. 96-221). These principles call for recovering the direct and indirect costs of providing the services, including imputed taxes and a return on capital.

necessarily tied to a specific public purpose) who provide similar services to smaller depository institutions.

In addition, if the Bill were enacted, the System's expanded mission and collateral would likely generate new pricing challenges. For example, prices for advances secured by collateral associated with community and economic development, including rural economic development, would need to be priced to adjust for the risks the collateral could present, but the Bill contains no requirement in this regard. In addition, the Bill does not provide FHFB authority to restrict or regulate new products based specifically on pricing.

ERB subsidiaries could lead to competition between ERBs and their members

Provisions of the Bill that would permit ERBs to establish subsidiaries raise questions about competition both within the System and between the System and the private sector. In addition, the role of FHFB in approving and overseeing such subsidiaries is not clear.

The Bill's provision to permit ERBs, subject to FHFB approval, to establish subsidiaries that could provide unspecified "products and services to shareholders" raises questions about whether the subsidiaries would be competing with or inhibiting competition from the banks' own members. According to our criteria, ERBs, with their funding advantage, should not be allowed to compete with their member institutions. In addition, the Bill requires that all of an ERB's investments in, and extensions of credit to, a subsidiary shall be deducted from ERB capital. This provision for extending credit raises the question of whether a subsidiary could engage in direct lending with credit extended by the ERB. Any such competition would create serious conflicts of interest for the ERBs and could damage the financial health of their federally insured members.

If enacted, the Bill would allow a subsidiary to provide products and services to shareholders that

- "assist shareholders in providing credit for housing and other mission-related purposes;
- facilitate the mission of the enterprise resource banks; and
- do not duplicate credit products and services otherwise readily available in the district of the enterprise resource bank."

In deciding whether to approve a subsidiary, the Bill directs FHFB to consider a subsidiary's effect on ERB's safety and soundness. This raises a question as to the extent to which FHFB would be able to deny approval of a subsidiary without clear evidence that it would impair a bank's safety and soundness. The Bill does not provide additional criteria for approval. The approval process aside, it appears that this Bill would allow a subsidiary to be established to provide a product or service not currently provided by private businesses due to insufficient demand. The potential advantages such a subsidiary could derive from its government connection might discourage private business from providing the product or have it compete on unfavorable terms, even if demand were to increase.

The Bill provides FHFB the power to oversee the subsidiaries to ensure that they operate in accordance with the law and in a financially safe and sound manner. Whether or not this provision gives FHFB complete access to the books and records of a subsidiary may be questionable. By comparison, the statute applicable to the Farm Credit Administration (FCA) explicitly states its right to regulate and examine service organizations established, subject to FCA's approval, by Farm Credit System banks.

Risks in new activity should be balanced with adequate capital

Our questions concerning the proposed changes in the System's mission and eligible collateral are heightened by the difficulty in creating risk-based capital standards for GSEs. Requiring capital sufficient to balance a GSE's risks provides several public benefits. It gives some assurance of a buffer adequate to absorb unforeseen GSE losses and thus, to prevent or reduce potential taxpayer losses. An adequate capital standard also helps ensure that the GSE's shareholders have incentives to demand that management not take undue risks. In addition, a capital standard gives the government a mechanism to influence the GSE's risk-taking without involving itself in the GSE's daily business.

The Bill would require FHFB to develop uniform capital standards applicable to each ERB that would include a permanent capital requirement, a risk-based capital requirement, and a leverage limit. The Bill would require core, or permanent, capital in an amount required by FHFB but not less than 1 percent of assets. FHFB could allow an ERB to use any combination of retained earnings, a risk-insurance pool, its nonredeemable stock or stock that cannot be redeemed when the ERB is undercapitalized to meet the minimum. Risk-based capital standards would require total capital to be the greater of either 10 percent of risk-adjusted assets or an amount which enables the bank to maintain positive equity when a FHFB-developed risk-based test is applied. The leverage ratio would require total capital to be at least 4 percent

of total assets when the bank meets the 1 percent permanent capital ratio and is still obligated to make REFCorp interest payments.[14]

In our 1991 report to Congress on how to limit the government's exposure to risks, we developed principles that we believe a GSE capital standard needs to follow to accomplish its governmental purposes.[15] These include:

(1) a minimum capital requirement should be based on all risks undertaken, both measurable and nonmeasurable;[16] and

(2) all capital considered in meeting the standard should be available to protect the government's interest, that is, serve as a buffer for possible GSE losses.

Our 1991 report also recommended the principle that capital standards for Farm Credit System institutions should be comparable to those of the commercial banks with which they compete. This principle could become relevant to setting capital standards for ERBs to the extent they could compete more directly with large money center banks.

Of the methods available for setting capital standards, we concluded that a combination of stress tests and a leverage ratio would best cover all the risks undertaken by a GSE. Stress tests are empirically based tests that can project capital levels required for measurable risks--credit and interest-rate risk. They are especially applicable to institutions in a single line of business, such as GSEs, because economic conditions that are adverse to the business are more easily identified. Designing a stress test for a GSE with a mix of different types of business activity, as would be required of FHFB under the Bill, would be a more difficult task. A leverage ratio should be used to cover all other risks, and the Bill provides a leverage ratio.

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[14]If ERBs have less than 1 percent of assets in permanent capital, the leverage ratio would be higher; 4.5 percent for ERBs with permanent capital between 0.5 and 1 percent of assets, and 5 percent for ERBs with permanent capital below 0.5 percent of assets. The REFCorp obligation does not affect the applicability of these categories.

[15]In our report, we developed two other principles: capital standards should be (1) clear and prospective and (2) equitable across GSEs serving the same market. See chapter 4 of GAO/GGD-91-90.

[16]Nonmeasurable risks include management, operations, and business risks. They are nonmeasurable in the sense that data on past performance cannot be readily used to estimate future results.

Analyzing the adequacy of the proposed percentages was beyond the scope of our work for comment on the Bill.[17]

Either stress tests or a leverage ratio alone would be inadequate to protect the government's interest. Because measurable and nonmeasurable risks can both contribute to large losses simultaneously, to cover risks adequately, the total minimum required capital level for a GSE should be the sum of the amounts needed to pass each stress test and the amount determined by the leverage ratio. The Bill would require FHFB to set the standard for permanent capital at not less than 1 percent of a bank's total assets.

Permanent capital should be available to protect the government's interest. The Bill specifies a combination of sources for an ERB's permanent capital including retained earnings, which are normally a preferred source for permanent capital. However, the Bill also provides that ERBs, and indirectly, the voting shareholders, would retain both an ownership interest and a property right in the retained earnings of the ERB. Thus, the availability of an important potential source of permanent capital could be questionable in times of financial stress.

The Bill would authorize each ERB to establish a capital structure plan best suited to its own conditions and operations within certain parameters specified in the Bill, in compliance with any capital standards and regulations FHFB issues, and subject to FHFB approval. Unless disapproved by FHFB, each ERB could issue more than one class of stock and set its own terms. ERB would have to establish uniform "standards, criteria, and requirements" for the issuance, purchase, trading, and transfer of any class of its stock. In approving the capital structure plans, FHFB is to ensure, among other things, that the capital instruments and their "characteristics" are consistent among ERBs and that each plan contains a process for orderly redemption of redeemable stock and other equity interests. The Bill does not define "characteristics" and it is not clear to us if "characteristics" refers to the "standards, criteria, and requirements" of ERB stock.

The flexibility the Bill appears to grant ERBs in setting their capital structure plans, although subject to FHFB approval, would make the FHFB's task of setting capital adequacy standards and monitoring compliance difficult. If the capital structure is

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[17]If the Bill's proposed change in allocating the REFCorp obligation were considered alone without taking into account other provisions in the Bill, this change could increase the System's safety and soundness for any given leverage ratio. See, Federal Home Loan Banks Capital Study Task Force Report, Capital Adequacy and Capital Structure Recommendations for the Federal Home Loan Bank System (Dec. 1994).

allowed to differ significantly among the 12 ERBs, development of consistent regulatory capital requirements could be hampered and opportunities could be created for an ERB to manipulate the terms of its capital to the advantage of its own stockholders and potentially, to the detriment of the other ERBs. In approving the capital plans and in monitoring ERBs, FHFB would have to consider this potential for moral hazard because the FHLBanks currently, and ERBs potentially, are jointly and severally liable for the System's approximately $231 billion in debt securities. That is, all FHLBanks are liable for the consolidated debt of the entire System.

The FHFB's role in setting capital standards, approving the ERBs' capital structure plans, and examining and monitoring each ERBs' performance makes it critical that the FHFB be an arm's-length regulator and, therefore, not involved in corporate governance of the System. As we discussed previously, the Bill maintains the FHFB role of appointing some directors of each ERB's board and, as we stated in our 1993 report, we believe such a link is inappropriate for a regulator.

Advances pose risk to the Federal Deposit insurance funds

The Bill does not alter current statutory and regulatory requirements that result in FHLBank advances generally having priority over other security interests, including insured deposits, in the assets of failed financial institutions. FHFB regulations require that advances be fully secured and subject to a written security interest in the collateral. Current law provides that the FHLBank's security interest generally has priority over the claims and rights of any party, including receivers, conservators, and trustees. This preference has the potential to result in increased costs to the FDIC in resolving a possible bank or thrift failure. Potential expansion in System membership, advances, and collateral could also increase potential risks to the FDIC's insurance funds.

The FDIC Chairman expressed the same opinion in September 1995 to the Chairman of the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, Committee on Banking and Financial Services of the House of Representatives. The FDIC Chairman said that the existence of the FHLBank System should increase the amount of total dollars available for housing and that the access to liquidity through the System is beneficial to well-managed, adequately capitalized small banks. The Chairman also said that instances of institutions using FHLBank advances to expand their securities portfolios are not considered widespread and are carefully scrutinized as part of the supervisory process. The Chairman noted, however, the potential negative effects of System advances, some of which are related to the System's lien status, on FDIC as insurer, supervisor, or liquidator of insured depository institutions. For example, advances, as non-deposit funding, can enable a

depository to grow even when the regulator has acted to constrain the institution's use of brokered deposits for such growth. Liquidity advances may be used to offset the outflow of uninsured deposits caused by customers' beliefs that a depository is failing. The use of advances might also affect FDIC's choice of resolution strategy when FDIC considers the least costly way to resolve the institution's problems. Under such circumstances, a failing institution could remain open longer with the result that the value of the institution's assets and what is available to pay depositors might be further reduced.

In our discussions with FDIC officials, they emphasized their concerns with the FHLBank System's lien status and the problems FHLBank collateralized advances can have on the cost and time required to resolve a failed depository institution. They said that the potential expansion in System membership, advances, and collateral heighten their concerns of the potential negative effects System advances can have on the deposit insurance funds. In particular, they said that the FHLBank practice of requiring overcollateralization on System advances, the expansion of eligible collateral, and the lien status on that collateral (i.e., including the overcollateralization) could increase the liquidity pressure on weak institutions.[18]

Current version of the Bill would limit Treasury's role in managing government agency debt

As written, the Bill would limit Treasury's ability to manage government agency debt. Treasury's Assistant Secretary for Market Finance told us that Treasury does not support the Bill's termination of Treasury's role in scheduling System borrowing. The current reporting requirements are minimal, with all GSEs except the Farm Credit System, required to provide data quarterly. The Farm Credit System voluntary provides the information. The Assistant Secretary said that the information provided benefits Treasury by helping it to plan the timing of auctions of Treasury securities.

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[18]When a FHLBank provides an advance to a member, it requires collateral in excess of the dollars advanced. The FHLBank has claim to the collateral if the member defaults on its advance. If the member fails and is closed by regulators, the FHLBank's lien status enables it to recover all outstanding principal, interest, and other amounts owing, which may exceed 100 percent of the original principal amount of the advance. FDIC officials told us that the FHLBanks' policy of requiring collateral in excess of the dollars advanced could inhibit an institution's ability to secure other lines of credit, particularly liquidity lending by the Federal Reserve. Inability to obtain critically needed liquidity lending could lead to institution failure, they said.

The Chairman of FHFB told us that the discussion draft of the Bill did continue Treasury's role in scheduling System borrowing, but that the legislative language continuing this role was not contained in the Committee print. The Chairman and other FHFB officials told us that they support this continued Treasury role and have provided language that they believe would restore it. We see no reason why the System should not be subject to the same Treasury reporting requirements as the other GSEs.

OTHER OPTIONS TO EITHER ADDRESS THE BILL'S OBJECTIVES OR ALLOW FHLBANKS TO BROADEN THEIR ACTIVITIES

Other options Congress has pursued in directing credit to specific sectors of the economy include creating special-purpose finance companies and designating certain banks as special community development financial institutions. In addition, Treasury has suggested that eliminating federal sponsorship of the FHLBanks would remove the current limits on the System and allow the FHLBanks to provide a broader array of products and services. The first two are options Congress could consider in exploring how best to provide credit for housing finance and/or community and economic development lending, including rural economic development lending. The third option would not attempt to direct activity; it would instead remove current restrictions on what the FHLBanks can do.

On at least one occasion, Congress has created a special purpose finance corporation to provide credit to a specific market sector, like a GSE, but with few of the risks associated with GSE status. Congress established the National Consumer Cooperative Bank (NCCB) in 1978 as a mixed-ownership government corporation and instrumentality of the United States and converted it in 1981 to a federally chartered, private financial institution that is owned and controlled by its cooperative stockholders. NCCB's mission is to support eligible cooperatives (essentially those other than agricultural cooperatives) with credit and technical assistance. It initially received federal funding through Treasury purchases of its stock, and Treasury still retains some subordinated debt that NCCB is obligated to repay.[19] The Congressional Budget Office cited the NCCB as a model for an off-budget, special-purpose finance company that Congress could charter to provide credit to municipal infrastructure borrowers.[20] It might be useful to consider if such an entity, or group of entities,

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[19]In case of bankruptcy, subordinated debt is repaid after all other debt has been repaid. See National Consumer Cooperative Bank: Oversight Adequate But Federal Loan Repayment Needs Monitoring (GAO/GGD-95-63, Feb. 24, 1995).

[20]"An Analysis of the Report of the Commission to Promote Investment in America's Infrastructure," Congressional Budget Office Papers, February 1994.

could address the rural economic development, infrastructure, or other non-housing lending envisioned in the Bill.

Another option would be to explore how the System could provide credit to community development financial institutions (CDFI) created by H.R. 3474, the Riegle Community Development and Regulatory Improvement Act of 1994. Under the act, depository institutions and other institutions devoted primarily to community development can be designated CDFIs and become eligible for funds to provide development services, lending, and investment in distressed urban and rural areas.

Congress directed us, the Congressional Budget Office, the Department of the Treasury, and the Department of Housing and Urban Development (HUD) to each study the potential impacts of eliminating the federal sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the enterprises).[21] The concerns that prompted Congress to direct these studies included questions about the continued need for the enterprises' role as GSEs in residential mortgage markets and the associated potential risks to taxpayers posed by their government-sponsored status. Similar concerns, including whether there is a need for government-sponsorship to achieve the new expanded mission, also could apply to changing the FHLBank System into an Enterprise Resource Bank System.

In addition, Congress has been considering eliminating federal sponsorship of two other GSEs, the Student Loan Marketing Association (Sallie Mae)and the College Construction Loan Insurance Association (Connie Lee). This issue was addressed in joint hearings in May 1995[22] and draft legislation (H.R. 1617) that proposes to phase in privatization of Sallie Mae and Connie Lee.

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[21]Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996); and Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac, Congressional Budget Office, May 1996. The studies by Treasury and HUD are not yet available.

[22]Hearings of the Subcommittees on Postsecondary Education, Training, and Life-Long Learning and on National Economic Growth, Natural Resources and Regulatory Affairs of the House Committee on Economic and Educational Opportunities, May 3, 1995.

As agreed with you, unless you publicly announce its contents earlier, we plan no further distribution of this letter until 14 days from the date of the letter. At that time, we will send copies to interested parties and make copies available to others upon request.

Mr. Chairman, we appreciate the opportunity to comment on the proposed legislation. In the event you or your staff have further questions, please contact me at (202) 512-8678.

Sincerely yours,

James L. Bothwell
Director, Financial Institutions
and Markets Issues

(233495)

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