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The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises
Committee on Banking and Financial Services
House of Representatives

The Honorable Paul E. Kanjorski
Ranking Minority Member, Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises
Committee on Banking and Financial Services
House of Representatives

Subject: Capital Structure of the Federal Home Loan Bank System

This letter responds to your July 27, 1999, request that we summarize our past positions and recommendations regarding the capital structure of the Federal Home Loan Bank System (System). As stated in your request letter, selected House and Senate members will soon confer on H.R. 10 and S. 900, the financial modernization bills (Bills) passed this year. The Bills provide for changes in the System and its regulator, the Federal Housing Finance Board (FHFB). In our previous work, we recommended that Congress reform the existing capital structure. In your letter, you acknowledged the extensive body of work we have produced on the System and its capital structure. You further stated that a summary of our past positions and recommendations regarding the capital structure of the System would be useful in reviewing and discussing H.R. 10 and S. 900 during conference.

Results in Brief

We have consistently supported the establishment of risk-based capital standards applied in combination with a leverage ratio that requires a minimum capital-to-asset ratio for the System.[1] A risk-based capital standard offers a number of benefits that include giving the

[1]See Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991); Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/GGD-94-38, Dec. 8, 1993); Bill Comment on proposed legislation entitled "The Federal Home Loan Bank System Modernization Act of 1995" (Oct. 11, 1995); and Bill Comment on proposed legislation entitled "The Enterprise Resource Bank Act of 1996" (GAO/GGD-96-140R, June 27, 1996).

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government a mechanism to influence the System's risk-taking without involving itself in the System's daily business. In supporting the establishment of risk-based capital standards, we have recommended that System capital should be made more permanent. There are a number of ways this could be achieved, including increasing the time period for repayment after terminating membership or establishing capital requirements that provide for minimum retained earnings in each Federal Home Loan Bank (FHLBank).

Background

The System is a government-sponsored enterprise (GSE) consisting of 12 federally chartered, privately owned FHLBanks located in Boston, MA; New York, NY; Pittsburgh, PA; Atlanta, GA; Cincinnati, OH; Indianapolis, IN; Chicago, IL; Des Moines, IA; Dallas, TX; Topeka, KS; San Francisco, CA; and Seattle, WA; with each FHLBank serving a defined geographic region of the country. The FHLBanks raise funds by issuing consolidated debt securities in the capital market. Each FHLBank is subject to a capital rule based on a leverage ratio that requires capital to be at least a fixed proportion of assets. Currently, the combination of statutory capital requirements and FHFB regulations results in a 4.76 percent leverage requirement. The System was set up in 1932 to extend mortgage credit by making loans, called advances, to its member institutions, which in turn lend to homebuyers for mortgages. Advances are secured by home mortgage loans and other collateral. To date, collateral has included U.S. Treasury securities, deposits at a FHLBank, and a limited amount of other real estate-related collateral. These advances help member institutions, originally limited to thrifts, by enhancing liquidity and providing access to national capital markets. In 1989, as part of the Financial Institutions Reform, Recovery, and Enforcement Act, Congress opened membership to non-thrift federally insured depository institutions that offer residential mortgage loans. As of June 30, 1999, the FHLBanks held about $330 billion in advances to members; $148 billion in investments; and $25 billion in capital, of which $550 million was in the form of retained earnings. In addition, the System had 7,101 members, which included 5,112 commercial banks, 1,618 thrifts, and 371 credit unions and insurance companies.

The Bills include a number of provisions related to the System that would, among other things, change the basis for membership in the System from a mix of voluntary and mandatory to all voluntary and expand the purposes of System advances with corresponding expansion in eligible collateral.

Scope and Methodology

We reviewed provisions concerning reforms in the capital structure of the System in H.R. 10 and S. 900. To summarize our past positions and recommendations regarding the capital structure of the System, we reviewed reports and bill comments on the System and FHFB that we issued between 1993 and 1998. We also reviewed our 1990 and 1991 reports on the government's exposure to risk from GSE activities.

We obtained oral comments from FHFB on a draft of this letter. These comments are discussed near the end of this letter. We conducted our work in Washington, D.C., during the month of August 1999 in accordance with generally accepted government auditing standards.

System Capital Should Be Risk-Based and More Permanent

We have consistently supported the establishment of risk-based capital standards applied in combination with a leverage ratio that requires a minimum capital-to-asset ratio for the System. For financial purposes, capital is generally defined as the long-term funding for a firm that cushions the firm against unexpected losses. Losses are caused by exposure to various risks the financial firm faces in its business activities. The federal government has no legal obligation to protect GSE creditors, but there is a widespread perception in the financial markets that during a financial emergency the U.S. government would rescue a GSE. This perception weakens private market discipline. A risk-based capital standard has a number of benefits that include giving the government a mechanism to influence the GSE's risk-taking without involving itself in the GSE's daily business. Such a mechanism could become more important for the System as it engages in new FHLBank activities initiated over the past 3 years and because of potential expansions in the purposes of System advances authorized by the Bills. In addition to supporting the establishment of risk-based capital standards, we have recommended making System capital more permanent.

FHLBank System Faces a Number of Risks

The primary risks inherent in System activities are interest-rate risk, credit risk, and operations risk. FHLBanks are exposed to interest-rate risk because they face possible losses and changes in the value of their portfolios due to changes in interest rates. Credit risk is the potential for financial loss from a borrower or counterparty failing to perform on an obligation. Operations risk is the potential for unexpected financial loss arising from inadequate information systems, operational problems, breaches in internal controls, or fraud.

Risk-Based Capital Standards Provide Incentives to Avoid Undue Risk

Requiring capital sufficient to balance a GSE's risks provides several public benefits. It gives the government a mechanism to influence a GSE's risk-taking without involving itself in the GSE's daily business. A risk-based capital standard also helps ensure that the GSE's shareholders have incentives to demand that management not take undue risks, since increased risk taking would impose costs resulting from raising additional capital to meet a risk-based capital standard. In addition, a risk-based capital standard gives some assurance of a buffer adequate to absorb unforeseen GSE losses and thus to prevent or reduce potential taxpayer losses.

The potential for moral hazard[2] exists in the System in three dimensions, with each FHLBank having an incentive to take on greater risk because some losses could be borne by others.

[2]The term "moral hazard" has been defined as "a description of the incentive created by insurance that induces those insured to undertake greater risk than if they were uninsured because the negative consequences are passed through to the insurer." In this context, the possibility that a FHLBank could become troubled would create a moral hazard, because U.S. taxpayers, the other FHLBanks, and the deposit insurance funds could in effect become the insurers of the troubled FHLBank's activities. In such a situation, the troubled FHLBank would have incentives to undertake risky activities because profits would accrue to the FHLBank's owners, whereas losses could fall on others.

First, U.S. taxpayers are at risk due to the possibility that the U.S. government would come to the rescue of the System during a financial emergency. Second, the FHLBanks are jointly and severally liable for the System's outstanding debt securities. Therefore, all FHLBanks are at risk due to the possibility that a FHLBank could become troubled and not be able to meet its debt obligations. Third, the System has lien status in which advances generally have priority over other security interests, including insured deposits, in the assets of failed insured financial institutions. Therefore, the deposit insurance funds may be at risk to the extent that a FHLBank provided advances to a troubled federally insured member that subsequently failed. Authorizing FHFB's promulgation of risk-based capital standards would provide FHFB with a mechanism to limit moral hazard.

In our 1993 report on the System, we recommended that the current capital stock requirements and the FHLBanks' debt-to-equity limit be replaced by a risk-based capital requirement analogous to that used for banks and thrifts.[3] We stated that the risk-based capital framework developed by U.S. banking regulators provides only a rough measure of credit risk and fails to account for interest rate or other risks, such as operations risk. Thus, we stated that regulators should supplement the risk-based requirement with a leverage requirement, which requires a minimum capital-to-asset ratio.

Of the methods available for setting capital standards, we have concluded that a combination of stress tests and a leverage ratio would best cover all the risks undertaken by a GSE such as the System. Stress tests are empirically based tests that can project capital levels required for measurable risks—that is, credit and interest-rate risk. These tests are especially applicable to GSEs in a single line of business, because economic conditions that are adverse to the business are more easily identified in this case.

Risks in New Activities Should Be Balanced With Adequate Capital

Currently, the principal purpose of System advances is to provide funds to any member for residential housing finance. The Bills would expand the purposes of System advances. Purposes listed in S. 900 include providing funds to any community financial institution[4] for small businesses, small farms, and small agribusinesses. Purposes listed in H.R. 10 include providing funds to any community financial institution for small business, agricultural, rural development, or low-income community development lending. The Bills specify corresponding expansions in eligible collateral for System advances.

The broader mission 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.[5]

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[3]GAO/GGD-94-38, Dec. 8, 1993, p. 69.

[4]A community financial institution is defined in the Bills as a FDIC-insured institution that has less than $500 million in assets.

[5]GAO/GGD-96-140R, June 27, 1996, p. 5.

The System's lien status would mitigate, to some extent, each FHLBank's credit-risk exposure resulting from expansion into new advance activities and associated collateral. 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. However, the System's lien status increases potential credit risk to the deposit insurance funds to the extent that a FHLBank provided advances to a troubled federally insured member that subsequently failed.

As well as being providers of advances, the FHLBanks have large investment portfolios. In addition, over the past 3 years, FHFB has approved pilot programs that have authorized the FHLBanks to make new types of investments and share risks with System member institutions. FHLBank investments do not have the same priority over other security interests as advances, and therefore investments can increase credit risk as well as interest-rate risk. According to testimony by the FHFB Chairman, FHFB began to follow a strategy "...to encourage the development of additional mission-related assets..." as an outgrowth of concerns about nonmission-related investments.[6] Thus far, FHFB has authorized four pilot programs ranging in size from $25 million to $9 billion. In general, the programs involve FHLBank funding or financing for housing in new ways. For example, in one program, the FHLBank purchases participation interests in affordable multifamily housing loans originated by a consortium of small banks that are mostly FHLBank members. Another program offers FHLBank members a different alternative to holding loans in their own portfolios. In this program, the FHLBank is to fund and retain in its portfolio the loans originated, serviced, and credit-enhanced by members. The risks are to be shared between the members and the FHLBank.

Taken as a whole, expansion in new FHLBank activities and the expansion in eligible collateral authorized by the Bills could lead to an increase in the taxpayers' potential exposure to risk. In previous work, it appeared to us that new expertise would be required of FHLBank management in an environment with expanded mission and collateral, because without a thorough understanding of the risks associated with the new collateral and lending activities, it may be difficult to properly monitor and manage the risks.[7] Here we also note that each of the 12 FHLBanks serves a defined geographic region of the country. Such geographic containment may contribute to concentration of credit risk.[8] Based on these observations and on our past positions and recommendations, establishment of risk-based capital standards, in addition to a leverage ratio, could become more important for the System, considering the potential for increased risk-taking by each of the 12 FHLBanks.

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[6]Statement of Bruce Morrison, Chairman of the Federal Housing Finance Board, Before the Subcommittee on Financial Institutions and Regulatory Relief of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, September 24, 1997.

[7]GAO/GGD-96-140R, June 27, 1996, p. 11.

[8]Concentration of credit risk could increase risk for (1) all FHLBanks due to the possibility that a FHLBank could become troubled and not be able to meet its debt obligations and (2) the deposit insurance funds to the extent that a FHLBank provided advances to a troubled federally insured member that subsequently failed. However, concentration of credit risk would not likely increase risk for U.S. taxpayers because the FHLBanks are jointly and severally liable for the System's outstanding debt securities.

Designing a stress test for the System, given the mix of different types of business activity the Bills would authorize, would be a difficult task. For example, evaluating the value of collateral for commercial loans, such as those to finance multifamily housing, small business, and agricultural activities, can be difficult due to the heterogeneity of the business activities. For FHLBank investments in such activities, it may not always be possible to design a stress test to quantify the credit risk. In this and other situations where risks cannot be quantified, we have concluded that a leverage ratio is still necessary to cover such risks.[9] Given the challenge FHFB would likely have in quantifying credit risk from new activities, the appropriate role and level for a leverage ratio would logically be inversely related to the extent to which such credit risk could be quantified.

To Provide a Suitable Cushion Against Unexpected Losses, Capital Should Be More Permanent

Common equity capital provides a cushion against unexpected losses, because individual stockholders cannot demand that the firm redeem the stock. In contrast, System capital from voluntary members does not provide a cushion against unexpected losses, because voluntary System members may withdraw from the System and redeem their stock. Current requirements for FHLBank capitalization are based on stock purchase requirements by member institutions. A voluntary member that wishes to withdraw from the System must give 6 months' notice. If impairment of the FHLBank's capital is likely, FHFB can withhold a portion of a withdrawing member's capital stock. In our 1993 report, we raised the possibility that if pending losses threaten the value of a FHLBank's stock, the FHLBank's voluntary members may try to withdraw their stock before the losses impair its value. We also concluded that, as a practical matter, the degree to which FHFB's authority makes FHLBank stock a buffer for absorbing losses depends on the extent to which FHFB exercises its authority to withhold stock redemption. We stated that for FHFB to use this authority in a way that makes capital stock a meaningful buffer, FHFB would have to recognize potential future losses in a timely manner and be willing to withhold proceeds from stock redemption requests.

To address this concern, we have recommended that System capital from voluntary member institutions should be more permanent in order to provide a suitable cushion against unexpected losses in the System. There are a number of ways greater permanence could be achieved, two of which were addressed in our previous work. In our 1995 bill comment, we noted that the pending legislation would have increased the time period for repayment after a member terminated membership from 6 months to a minimum of 12 months. This is one way of increasing the permanence of System capital.

Another way of increasing the permanence of System capital was addressed in our 1993 report. We recommended that the new capital requirements provide for minimum retained earnings in each FHLBank, and that these retained earnings should, at a minimum, protect against the measurable risk undertaken by each FHLBank as well as the associated

[9] GAO/GGD-96-140R, June 27, 1996, p. 16.

management and operations risks. Since retained earnings represent funds that are not distributed to members, they would provide a source of permanent at-risk capital held by FHLBanks.

Conclusions

We have consistently supported the establishment of risk-based capital standards applied in combination with a leverage ratio for the System. Such a mechanism could become more important for the System considering new FHLBank activities initiated over the past 3 years and expansions in the purposes of System advances authorized by the Bills. At the same time, some of these additional credit risks may be difficult to quantify, and therefore the role of the leverage ratio, in combination with a new risk-based capital standard, could also become more important. Finally, we have also concluded that System capital would have to become more permanent if it is to provide a cushion against unexpected losses.

Agency Comments and Our Evaluation

We provided a draft of this letter to FHFB for comment. FHFB's Director, Office of Policy, Research, and Analysis, provided comments in two areas discussed below and also provided a number of technical comments, which we incorporated where appropriate. First, he stated that real risks need to be backed by real, permanent capital. He cited a principle from our May 1991 report stating that the elements of regulatory capital should include only those items that protect the government's interests. He added that our December 1993 report noted that capital requirements must ensure an adequate amount of permanent at-risk capital based on measurable risk and that retained earnings were the only source of permanent capital in the System. He suggested our letter emphasize that retained earnings are not necessarily the only source of permanent capital and that Congress could act to create a nonredeemable class of stock that, in their view, could also serve as a permanent buffer against loss and provide a positive incentive for building retained earnings.

We added statements to clarify that there are a number of ways to make capital more permanent in addition to those discussed in our previous work. In our 1993 report, we stated that, from 1987 through 1991, Congress appropriated most of the System's retained earnings to help cover deposit insurance fund losses resulting from savings and loan failures. Therefore, we emphasized retained earnings as a source of permanent capital. In our 1995 bill comment, we noted that the pending legislation would have increased the time period for repayment after a member terminated membership from 6 months to a minimum of 12 months. At that time, we emphasized the impact of the legislative proposal on the permanence of System capital. While a nonredeemable class of stock could also serve as a permanent buffer against loss, there are tradeoffs between establishing permanent capital and creating incentives for the System to provide their members with value. In our 1996 bill comment, we stated that all-voluntary membership should give System managers a stronger incentive to provide their members with value for their membership, lest the members redeem their stock and invest their funds elsewhere.

Second, he stated that statutory capital requirements for GSEs should not create "uneven playing fields." He cited a principle from our May 1991 report stating that a minimum capital requirement should avoid giving any GSE an undue advantage or disadvantage in competing with other market participants. He added that the capital provisions in H.R. 10 would establish equal statutory minimum capital leverage requirements for the FHLBanks, Fannie Mae, and Freddie Mac.

The minimum capital requirement principle discussed in our report addressed the combination of leverage and risk-based requirements. We have also supported the principle that capital requirements should take into account differences in the lines of business and associated risks among financial institutions. Thus, our principles do not necessarily support the establishment of equal statutory minimum capital leverage requirements for the FHLBanks, Fannie Mae, and Freddie Mac.

As agreed with your offices, we plan no further distribution until 30 days from the date of this letter unless you publicly release its contents earlier. We will then send copies to Representative Jim Leach, Chairman, and Representative John LaFalce, Ranking Minority Member, House Committee on Banking and Financial Services; Representative Tom Bliley, Chairman, and Representative John Dingell, Ranking Minority Member, House Committee on Commerce; Senator Phil Gramm, Chairman, and Senator Paul Sarbanes, Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs; and the Honorable Bruce Morrison, Chairman of FHFB. Copies will be made available to other interested parties upon request.

Please call me or Bill Shear, Assistant Director, at (202) 512-8678 if you or your staffs have any questions concerning this letter. M. Kay Harris and Orice Williams also contributed to this letter.

Thomas J. McCool

Thomas J. McCool
Director, Financial Institutions and Markets Issues

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