

BANKING REGULATORS VIEW OF THE FHLB'S

By

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DEPRESSION BABY



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HERBERT HOOVER

- “The purpose of the system is both to meet the present emergency and to build up homeownership on more favorable terms than exist today...A considerable part of our unemployment is due to stagnation in residential construction. There has been overbuilding in certain localities in boom years, but there has been far less than normal construction of new homes for 3 years... the institution should serve to immediately increase employment.”

HOOVER CONT.

- “In the long view we need at all times to encourage homeownership and for such encouragement it must be possible for homeowners to obtain long-term loans payable in installments. These institutions should provide the method for bringing into continuous and steady action the great home loaning associations which is so greatly restricted due to present pressures.”

MARCHING ORDERS

- Provide advances to assist and enhance the members' financing of housing and community lending. 12 USC 1430(a)(2)

GSE

- FHLB predated the creation of the other government sponsored entities involved in the expansion of home ownership such as FANNIE MAE and FREDDIE MAC.
- The FHLB business model differed from its close cousins in that it was based on secured lending instead of issuing credit guarantees for pools of mortgages.

A PRIVILEGED UPBRINGING

- Treasury Secretary may purchase up to \$4 billion of FHLB securities
- FHLB securities are treated as “government securities” under the Securities and Exchange Act of 1934
- Ability to use the Federal reserve as its fiscal agent
- As a “federal instrumentality” it is exempt from the Bankruptcy Code

PRIVILEGED UPBRINGING

- Exempt from federal, state and local income taxes (although the FIRREA imposed 10% affordable housing requirement and other assessments establish a combined assessment rate of 25% on the entire system).

GROWING UP

- Until the 1990s, all federal and state thrifts insured by the FSLIC had to join the FHLB.
- FHLB advances were very important to member institutions – most thrifts assets being long-term (residential mortgages) and liabilities being short-term (deposits).
- Enter the savings and loan crisis.

GROWING UP

- In 1989, FIRREA required a \$2.8 billion commitment from the system to defease the principal on the \$30 billion in REFCORP bonds floated to pay for thrift clean-up - \$300 million per year later (up to 20% of net earnings), FHLB's REFCORP obligations are expected to end this year.
- To offset this burden, Congress opened Home Loan Bank membership at this time to other depository institutions in the mortgage business. Now, the FHLB offers thrifts, commercial banks and credit unions a wide range of products and services designed to help fund mortgage loans, manage interest rate risk and meet the other challenges of an increasingly competitive banking environment.
- The FHLB also gained a new regulator – the Federal Housing Finance Board (FHFB) – that replaced the Federal Home Loan Bank Board and would become the Federal Housing Finance Agency.
- Between 1989 and 2008: system assets grew from \$175 billion to \$1 trillion.

GSE GROWTH DURING THE 90'S COMPARE TO COMMERCIAL BANKS

- Freddie Mac) and Fannie Mae grew by 300% between 1992-1999
- FHLB System grew by 260% during the same period
- Five largest commercial banks grew by only 165% during the same time period

FHLB DIFFERENCES

- Regulators who deal across different regions notice the differences among the banks:
 - some stress advances while others emphasis mortgage purchases
 - some will accept non-traditional collateral while others do not
 - some take blanket liens while others are more focused
 - some placed more emphasis on private label issues

FHLB DIFFERENCES

- Regulators view the differences among the banks as a plus, risks are not magnified across all of the banks as it was when FANNIE MAE adopted a strategy that entailed more risk than expected.

REGULATOR OBSERVATIONS

- Although total advances have been cut almost in half, regulators have observed that concentration has increased among the top 10 borrowers from 26% in 2003 to 40% today.
 - Not as the result of a strategic move by FHLB but as a result of mergers caused by the financial crisis.

REGULATOR OBSERVATIONS

- A weak housing recovery and limited opportunities to make alternate investments poses challenges.
- Excess liquidity and new alternative financial products may decrease the need for advances by members.
- What does it mean for FHLB's future if the large commercial banks stop borrowing?

REGULATOR OBSERVATIONS

- FHLB operates with a low net interest margin (40-50 basis points) but operating expenses have been growing.
- Can the FHLB improve operating efficiencies?
- If not, how does the continued decline in earnings due to decreased advances combined with increased expenses and lack of opportunities to invest in mortgage backed securities affect the strategic plan?

SUPERVISION

- The Federal Housing Finance Board, an independent agency in the executive branch of the U.S. government, supervised and regulated the FHLBanks and the Office of Finance through July 29, 2008.
- The Housing and Economic Recovery Act of 2008 established the Federal Housing Finance Agency, which became the new independent Federal Regulator of the FHLBanks, effective July 30, 2008.

FHFA

- Just as with other financial institutions regulated by the FDIC, OCC, Federal Reserve and state banking departments, the FHFA sets capital standards, conducts examinations and is authorized to take enforcement actions to cure unsafe and unsound banking practices.

FHFA ANNUAL REPORT TO CONGRESS

- Recent consent orders with the FHLB-Chicago and FHLB Seattle
- FHFA's report to Congress dated May 2010: "The condition and performance of 6 of the 12 FHLBanks are less than adequate. At these FHLBanks, the principal supervisory issue is private-label mortgage-backed securities (MBS) investments. Half the FHLBanks incurred credit-related impairment charges of more than \$200 million on private-label MBS in 2009."

GOVERNANCE

- Effective corporate governance at the FHLBanks involves engaged, capable, and experienced directors and senior management; a coherent strategy and business plan; effective and appropriate risk limits and controls; and strong lines of responsibility and accountability. Those attributes exist to a degree among the FHLBanks...

GOVERNANCE CONT.

- Some FHLBanks paid insufficient attention to the credit risk associated with private-label MBS and relied too heavily on credit ratings in making investment decisions. Many did not adjust their retained earnings targets in response to deterioration in the credit quality of their private-label MBS holdings.

GOVERNANCE CONT.

- In some FHLBanks, the Board of Directors did not ensure risks be overseen on an enterprise- wide basis, leading to incomplete separation between risk taking and risk management, reporting, and control.

CREDIT RISK MANAGEMENT

- Examinations also concluded that the FHLBanks of Boston, New York, Pittsburgh, and Atlanta have weak credit risk management, and the remaining eight FHLBanks have adequate credit risk management. FHLBanks need more frequent and conservative assessments of member condition, and better quantitative support for collateral haircuts.

MARKET RISK MANAGEMENT

- Although the FHLBanks with declining mortgage portfolios should ultimately have an easier time managing market risk, they face potential asset and liability mismatches during the transition. Some FHLBanks with significant mortgage holdings hedge the market risk by extensive use of callable bonds, often with American call options, to fund those assets. Other FHLBanks, Chicago in particular, use a more complicated hedging strategy that involves using interest-rate swaps, swaptions (options to enter into interest-rate swaps), and options.

OPERATIONAL RISK MANAGEMENT

- The FHLBanks have addressed certain FHLBank system-level operational risks by adopting internal controls effective in detecting and preventing operational concerns. All FHLBanks have sufficient business continuity plans and back-up locations, though, in some cases, the back-up location is only several miles away. Examiners regularly evaluate these plans.

FINANCIAL CONDITION

- Net income increased in 2009 from the depressed levels recorded in 2008, but the improvement is largely attributable to changes in generally accepted accounting principles in the United States governing accounting for other-than-temporary impairment on certain investment securities.

REGULATORY OBSERVATIONS

- Where do the advances really go?
- Federal Reserve has asked: do the benefits of FHLB membership actually benefit mortgage borrowers or just FHLB stakeholders?
- Is it a bad thing if some of the benefits are retained by FHLB management and shareholders?

ONE FOR ALL, ALL FOR ONE

- Unique financing-
 - Consolidated financing for which all 12 institutions are jointly and severally liable.
 - Stronger banks support the weaker ones.

FAVORITE UNCLE STATUS

- FHLB advances are fully collateralized (some would say grossly-over collateralized) and in a bank receivership the FHLB ends up ahead of depositors
- Does the fact that the FHLB has what some refer to as a “super-lien” result in FHLB extending more credit than is “socially optimal”?

FDIC Perspective (2004)

- “Potential supervisory concerns with structured [FHLB] advances include the following:
 - (1) these products can have a significant impact on a bank's interest rate risk profile as they are used in increasing quantities;
 - (2) they often are used as part of leverage programs that tend to focus on short-term enhancement of return on equity with a concomitant increase in the institution's risk profile;
 - (3) several banks have recently paid substantial prepayment penalties to retire costly structured advances before maturity; and, in some instances,
 - (4) bank management did not possess the requisite knowledge and understanding of these products to manage the risks effectively. “
- http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/home_loan_advances.html

FDIC PERSPECTIVE (2008)

“Generally, access to FHLB lines is restricted as a bank's capital position deteriorates, and the bank's deposits at the FHLB might be frozen as a potential offset to these lines. The FHLB also might refuse to renew advances at maturity, accelerate the repayment of advances due to a covenant breach, increase collateral requirements, or reduce funding lines. Requirements to pay advances early could seriously constrain cash flow. Additional collateral requirements can limit a bank's ability to sell certain assets. Increased scrutiny and requests for physical custody of loan collateral will require greater management attention. Banks requesting access to the FHLB or increased lending must be prepared to dedicate substantial time and resources to completing applications and providing collateral documentation.”

http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin08/liquidity_landscape.html#four

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REGULATOR OBSERVATIONS

- What is the optimal mix of non-core funding such as brokered and FHLB advances?
- The breadth of FHLB security interests have had an impact on the ability of banks to seek merger partners or non loss-share investments.
- Banks with higher % of non-core funding will be expected to have a lower risk profile and a more robust liquidity contingency plan.

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REGULATOR OBSERVATIONS

- Banks have not been very savvy borrowers, they did not understand the downside risks of the broad security interests given to the FHLB.
- Bankers did not understand the long term costs of not having bigger core deposits-many failed banks had no “value” at all to a potential acquirers.
- How should the banking regulators address bank management that does not understand the implications of obtaining FHLB advances?

REGULATOR OBSERVATIONS

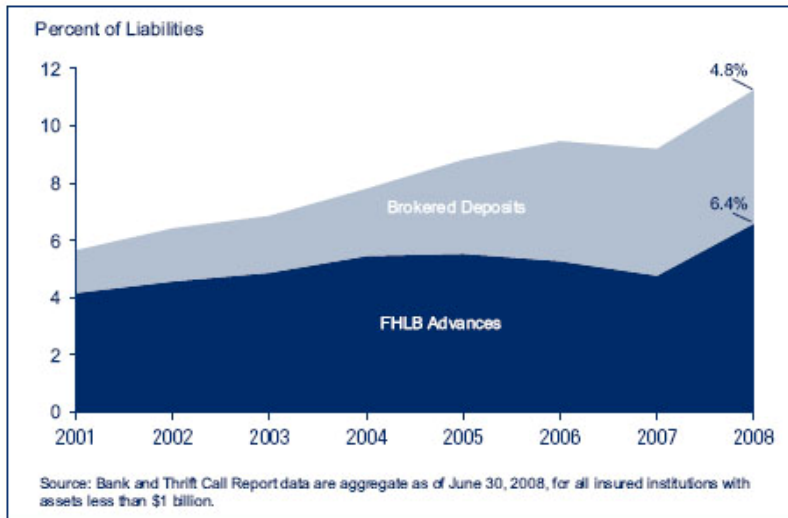
- FHLB should expect that regulators will put increased pressure on banks to manage non-core funding sources much more carefully, non-core funding is considered to be the fuel that fed the flame of the overheated housing market.
- Will regulators continue to share information with FHLB to the extent they may have done so in the past?

REGULATOR OBSERVATIONS

- FHLB is not a regulator but sometimes expects state and federal bank regulators to treat it as one.
- FHLB helped fuel the fire and then expects the regulators to assist it as it tightens its “hooks” in a troubled bank when in fact the FHLB has never suffered a loss on an advance due to its practice of overcollateralization and the impact of the superlien.

FDIC OIG REPORTS

- “**Liquidity.** Integrity relied on *volatile sources of funding, such as brokered deposits and Federal Home Loan Bank (FHLB) advances*, to support its asset growth. In 2008, these sources of funding were not readily available as Integrity’s condition deteriorated. Although new bank management was closely monitoring liquidity, management was not able to obtain sufficient funds on reasonable terms to meet liquidity needs.



http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin08/liquidity_landscape.html#four

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Federal Reserve Perspective (2001)

- “[Federal Reserve Bank researchers’] evidence suggests that banks increase risk-taking after joining the [Federal] Home Loan Bank System, and that risk-taking increases with dependence on advances. These differences, while statistically significant, were not large during the 1990s. The authors argue that high capital ratios kept member bank risk-taking in check. Nonetheless, they feel that bank supervisors should remain vigilant to ensure that risk-taking does not increase should capital ratios weaken.”

<http://www.stlouisfed.org/publications/cb/articles/?id=1460>

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FAVORITE UNCLE

- Unlike other bank regulators the FHFA does not impose loan to one borrower limits on the FHLB's
- Internal limits, when set, have been in the range of 30-50% of member total assets. A national bank on the other hand would not be able to lend to one borrower in excess of 25% of the bank's total equity.

FHLB VS. FEDERAL RESERVE DURING THE LIQUIDITY CRISIS

- At the inception of the liquidity crisis the Federal Reserve noted that there was very little demand for borrowings from the Federal Reserve Discount Window.

LENDER OF LAST RESORT?

- In the last half of 2007 the FHLB increased its advance lending by over 36% to \$875 Billion by year end (68% of its total assets)
- Advances totaled \$915 Billion by the end of 2008 (69% of total assets) and at the end of 3Q 2010 they totaled \$500 Billion (55% of total assets; residential mortgages about 7% of total assets).

http://www.fhlb-of.com/ofweb_userWeb/resources/financialsummary.pdf

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LENDER OF LAST RESORT

- Investors in money market funds ran as fast as they could away from debt issued by commercial banks and into investments guaranteed, expressly or impliedly, by the US Treasury. The FHLB was able to step up and provide advances to banks.

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LENDER OF LAST RESORT

Later in the crisis, after creating seven separate liquidity facilities the Federal Reserve pulled ahead of the FHLB in providing liquidity to deal with the crisis.

US TREASURY VIEW

- The financial crisis also exacerbated fundamental flaws in the FHLBs, which help mostly insured depository institutions access liquidity and capital to compete in an increasingly competitive marketplace. Prior to the crisis, the FHLBs suffered from inadequate regulatory oversight, and were allowed to build large investment portfolios that subjected them to excess risk, while providing concentrated funding to banks engaging in unsound business practices. Today, eight of the twelve banks are under regulatory orders with respect to their capital or have voluntarily suspended dividends or the repurchase of excess stock.

TREASURY VIEW

- Because each of the twelve FHLBs is also liable for the losses of other FHLBs, additional losses could adversely affect the entire FHLB system, damaging the mortgage finance market and potentially constraining access to capital for financial institutions. Reforms to the FHLB system are necessary to restore its important primary role of providing a stable source of mortgage credit for financial institutions of all sizes.

WHITE HOUSE VIEW

- *Focusing on small- and medium-sized financial institutions.* The Administration supports allowing each financial institution to be an active member in only a single FHLB Bank. We also support limiting the level of advances, which would only have an impact on large financial institutions that can access capital markets already.

WHITE HOUSE VIEW

- *Reducing portfolio investments.* Similar to Fannie Mae and Freddie Mac, several of the FHLBs were allowed to build up large investment portfolios. These portfolios should be reduced and their composition altered to better serve the FHLB's mission of providing liquidity and access to capital for insured depository institutions. We support FHFA's efforts to address this issue, and we will work with Congress to provide clarity to the FHLB's investment authority.

ABA RESPONSE

- ABA has not endorsed a specific structure for the GSEs going forward, but instead has considered the mechanisms to be employed to reduce governmental involvement and to foster private sector financing – and to ensure that such financing can involve private sector banks of all sizes.

ABA VIEW

- ..policymakers may want to consider the creation of a well-regulated covered bond market, as well as enhancements to the Federal Home Loan Banks which better help them continue to meet and capitalize their mission of providing advances to private market portfolio lenders with minimal taxpayer exposure.

ABA VIEW

- It is also important to ensure that any actions taken with regard to FannieMae and Freddie Mac do not harm or destabilize the Federal Home Loan Banks, which provide a key source of liquidity to our nation's banks, especially community banks.

FHLB Capital Shortfall

- In early 2009 Moody's was projecting that eight of the twelve FHLBanks would fall below regulatory capital requirements due to unrealized market value losses on residential mortgage bonds.

EXAMPLE: SEATTLE FHLB

- Suspended dividend payments and excess stock repurchases at the end of 2008.
- Washington Mutual and Merrill Lynch were the two largest stakeholders and borrowers in the Seattle FHLB.

SEATTLE CONSENT ORDER

- The Federal Housing Finance Agency (FHFA) and the Federal Home Loan Bank of Seattle's board announced on October 25th that the FHLBank has entered into a consent order requiring it to make capital management, asset composition, and other operational and risk management improvements. The agreement also states the bank will retain its "undercapitalized" status until the filing of its June 30, 2011 financial statement, at which time the bank may begin repurchasing member stock at par as long the bank reaches and maintains certain financial thresholds.

ACCOUNTING TREATMENT OF FHLB STOCK

- ..according the AICPA Audit Guide, FHLB stock does not have readily determinable fair value for purposes of FASB Statement No. 115 .. and the equity ownership rights are more limited than would be the case for a public company because of the FHFA's oversight role in budgeting and approving dividends. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost. **Thus, when evaluating FHLB stock for impairment, its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value.**

MOODY'S AND OTTI

- FHLBs “are currently facing the potential for substantial accounting impairments” on their private label mortgage-backed securities (MBS) portfolios. Moody’s assessment is that although the gross unrealized losses related to these securities was \$13.5 billion, “the true economic losses embedded in these securities total less than \$1 billion and are manageable given the FHLBanks’ capital levels”.

FASB AND OTTI

- On April 9, 2009, FASB issued updated accounting guidance to improve presentation of and disclosures around impairments. The new guidance made several changes to impairment accounting. It changed the threshold for recognizing impairments to one that compares expected future cash flows to those expected at purchase. The previous model considered events that had occurred that made future losses probable.

FASB AND OTTI

- The new guidance requires only the present value of expected cash flow shortfalls (credit loss) be written off through net income and the balance (the fair-value loss minus the credit loss) be recorded in other comprehensive income. (See Figure 41.) This change had a significant impact on the entities FHFA regulates, increasing net income (or reducing net losses) by billions of dollars in 2009.

FHLB AND THE COURTS

**GUIDING PRINCIPLES OF
AMERICAN LAW**

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MISTAKES WERE MADE

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SOMEONE ELSE IS RESPONSIBLE

FOLLOW THE MONEY

FHLB IN COURT

- FHLB OF PITTSBURGH
 - Bought eight mortgaged backed security certificates issued by five separate trusts between May 2006 and December 2007 for a total purchase price of \$1.7 billion. Bank claims that the securities are now worth 60% of the purchase price.
 - Two classes of defendants, three rating agencies (Moody's McGraw-Hill and Fitch) and transaction entities (JP Morgan)

FHLB IN COURT CONT.

- The securities were given AAA ratings. Judge dismissed Securities Act claims against rating agencies since they were not “underwriters” but allowed fraudulent misrepresentation claim to proceed while dismissing the negligent misrepresentation cause of action.

FHLB IN COURT CONT.

- Allegations in the complaint are sufficient to support a finding that JP Morgan was aware that the Agencies had abandoned their underwriting standards
- What about the disclosures made in the offering materials?
- Has the Bank actually suffered actual damages since it cannot allege that it has failed to receive any pass-through payments on the certificates??

FHLB IN COURT CONT.

- Court rejected defendants claim that the bank could not assert a claim for fraud and should have been restricted to repurchase or replacement of the loans in question.

FHLB IN COURT

- FHLB of Indianapolis filed a 300 page lawsuit in November 2010 against 37 defendants including Bank of America, Wells Fargo and JP Morgan Chase relating to the sale of 32 issues of mortgage backed securities having a total face value of \$2.96 billion.
- Indianapolis follows suits filed by Pittsburg, Seattle, San Francisco and Chicago.

FHLB RESPONSE TO REGULATORY CONCERNS

FHLB JOINT CAPITAL ENHANCEMENT AGREEMENT

- The Agreement provides that, upon full satisfaction of the FHLBanks' obligations to REFCORP, which currently requires each FHLBank to contribute 20 percent of its earnings toward payment of interest on REFCORP bonds, each FHLBank will contribute 20 percent of its future net income to a restricted retained earnings account until the balance of that account equals at least one percent of that FHLBank's average balance of outstanding consolidated obligations ("COs") for the previous quarter. These restricted retained earnings will not be available to pay dividends, but will remain on an FHLBank's balance sheet as an additional capital buffer against potential losses.

CAPITAL CONT.

- The Agreement requires each FHLBank to submit a capital plan amendment or supplement to the Federal Housing Finance Agency ("FHFA") incorporating the provisions of the Agreement. Amending the FHLBanks' capital plans in conjunction with the Agreement is intended to enable the FHFA to take an active role in monitoring compliance with the Agreement.

AMERICAN BANKER

- American Banker: Is the FHLB System relevant today?
 - Advances fell to \$402 Billion well below the \$1 trillion reached in October 2008
 - Attempting diversify by purchasing mortgage backed securities backfired

AMERICAN BANKER

- The simple reality is that the extent to which the banks are going to be growing or contracting advances is largely going to be dependent upon the demand of their member institutions," said Stephen Cross, the acting senior deputy director and chief operating officer of the FHFA's division of Federal Home Loan Banks. "Advances fill a gap," he said, "and what has happened is, the gap is smaller because of the relatively weak economy, high levels of deposits and liquidity at the member institutions and relatively weak demand on the part of their customers for loans."

We enjoy being able to say that whatever problem a banker may have, we have a lawyer who has worked on a similar problem for a banker!

The members of our financial institutions group offer clients across the United States a broad spectrum of practical experience and legal knowledge of the governance, structure and regulation of financial institutions.

We emphasize hands-on experience. Our team includes numerous 25-year+ veterans of banking law, many of whom have prior real world experience as investment bankers, regulators, bank officers and CPA's who formerly audited banks.

Our broad experience, coupled with our innovative solutions and our long standing ties to regulators, trade associations and service providers, make us an invaluable asset to our clients



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