



**table of contents**

page 2 legislation proposed for single GSE regulator

page 3 FHLBank of Des Moines logs SBIC successes

**Volume 8 No. 3**

**Spring 2000**

FEDERAL HOUSING FINANCE BOARD

# Building Blocks

## MPF Moves Beyond Pilot Status

# Finance Board Approves Rule on Acquired Member Assets and Core Mission Activities

The Federal Housing Finance Board on April 12 approved a proposed rule that would authorize the Federal Home Loan Banks to acquire assets of their members through risk-sharing arrangements and define which activities are "core mission activities." The rule would also end the pilot status of the Mortgage Partnership Finance (MPF) program.

Specifically, acquired member assets (AMA) will mainly include whole mortgage loans originated by or held by a FHLBank member institution, provided that the credit risk is shared between the FHLBank and the member. These transactions would be in keeping with the FHLBanks' mission to promote housing finance and economic development through activities that assist and enhance lending by their members.

"MPF is a success, and should move beyond the pilot stage," said Finance Board Chairman Bruce A. Morrison.

"The proposed rule aims to maximize this type of value-added, mission-related investment activity by FHLBanks, which offers new opportunities

for local lenders to compete in housing finance. We're also proposing to define core mission activities so that there will be clear standards for the FHLBanks in determining what types of core mission assets should be addressed in their strategic plans," he added.

Besides acquired member assets, the rule specifies which FHLBank activities qualify as core mission activities, including such activities as: advances to members, standby letters of

credit, targeted investments that support affordable housing and economic development activities and small business investment corporations (SBICs).

Government-insured AMA such as FHA loans would count as core mission activities if purchased under a commitment executed prior to April 12, 2000, or in an amount up to one-third of the total AMA acquired by an FHLBank in a given year.

(See **AMA/CMA**, page 3)

## Proposed Rule Approved on Expanded Collateral for FHLBank Advances

The Federal Housing Finance Board on March 22 approved a proposed rule implementing provisions of the Gramm-Leach-Bliley Act (GLB) that would enable Community Financial Institutions (CFIs) to pledge additional classes of collateral and would increase the amount of non-mortgage collateral that can be pledged

for Federal Home Loan Bank advances.

The proposed rule sets guidelines for the FHLBanks for accepting new types of collateral that can be pledged by CFIs (FDIC-insured institutions with less than \$500 million in assets) to include: small business loans, agriculture loans, or securities rep-

(See **RULE**, page 3)

# Legislation Would Create Single GSE Regulator; Morrison Emphasizes Retaining Borrowing Efficiencies

*(On March 22, Finance Board Chairman Bruce A. Morrison testified before the House of Representatives' Subcommittee on Capital Markets and Government Sponsored Enterprise of the Committee of Banking and Financial Services. The testimony concerned the Housing Finance Regulatory Improvement Act of 2000, which would create a single GSE regulator. Below are excerpts from that testimony.)*

The issue of consolidating the regulators of the housing-finance GSEs was before this subcommittee most recently in July 1997. At that time, I testified that I agreed with the underlying premise of the legislation: that a single independent agency regulating safety and soundness and mission for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks is preferable to the current structure. Since my views are substantially unchanged, I have attached a copy of my testimony previously delivered to this Subcommittee on July 24, 1997. My further comments presented here will expand upon those views and discuss provisions specific to H.R. 3703.

Congress long ago decided that promoting homeownership is desirable and worth the cost of granting special advantages to homebuyers, such as the mortgage interest tax deduction, and the establishment of specially advantaged GSEs to facilitate housing finance and other socially desirable activities. In exchange for public support, the American taxpayer has the right to expect responsible behavior by the GSEs. It is obvious that it is critically important to protect the taxpayer from potential loss by monitoring and regulating GSE financial risk. It is also critically important to ensure that the low cost-of-funds and other advantages entrusted to the GSEs are well directed and ultimately reach their intended beneficiaries. There is a risk that much of the government's benefit is absorbed as profits in the GSE conduit. Mission regulation en-

ures that this valuable GSE benefit passes through to its rightful beneficiaries and makes the difference between helping consumers and enabling corporate welfare.

GSEs are created to accomplish statutorily prescribed missions and are provided with advantages, including state and local corporate tax exemptions and a

A single regulator for the housing GSEs [could create] a level playing field for the three GSEs and by design create equalizers such as competitive capital levels and competitive product authorizations.

Bruce A. Morrison  
Chairman,  
Federal Housing Finance Board

U. S. Treasury line of credit, which taken together produce lower cost of funds and operations. It is up to the regulator to ensure a public benefit at the rightful price for that lower cost and to enforce the mission prescribed by Congress.

Mission regulation and safety and soundness regulation are closely related. H.R. 3703 recognizes this by giving the new board authority to limit nonmission-

related assets. Many assets are perfectly safe and sound from a financial point of view. But, because the GSEs were created for very specific purposes, only some assets are consistent with the mission of those GSEs. A GSE may be less profitable if certain assets are prohibited and this could have safety and soundness consequences. A combined safety and soundness and mission regulator can weigh the tradeoffs between profit and mission suitability to determine the proper policy much more safely and efficiently than can two separate regulators where the responsibilities for safety and soundness and mission are housed in different agencies.

Some in the GSE community believe that mission regulation should be left entirely to congressional oversight, but I believe that is unworkable. As much as we would like statutes to unambiguously prescribe behavior in every circumstance, the reality is that financial sector regulators face questions of statutory interpretation on an almost daily basis. Legislation alone can never be nimble enough to handle the day-to-day realities of regulating multi-billion dollar businesses.

Additionally, the best way to ensure that the GSE benefit is passed through to consumers is to create a structure where market competition forces the distribution of subsidy through the GSE conduit. A single regulator for the housing GSEs would facilitate this by creating a level playing field for the three GSEs and by design create equalizers such as competitive capital levels and competitive product authorizations. H.R. 3703 allows for this by specifying a common new activity approval process for the three GSEs.

I recommend the FHFB's pilot approval process as a model. Starting in mid-1995, the Finance Board encouraged the FHLBanks to engage in activities aimed at improving housing finance and

(See **TESTIMONY**, page 4)

## Referrals Have \$22 Million Investment Potential

# SBICs Prove Successful for FHLBank of Des Moines

SBICs are Small Business Investment Companies licensed by the U. S. Small Business Administration that are privately organized and privately managed investment firms. They are participants in a vital partnership between government and the private sector economy. Utilizing their own private capital, plus funds obtained on favorable terms from the federal government, SBICs provide financing to small businesses for growth, modernization and expansion.

After researching opportunities and receiving approval from the Federal Housing Finance Board, regulator of the FHLBank System, the FHLBank of Des Moines invested in a SBIC in 1999. The FHLBank's board of directors had adopted policies and procedures that govern the FHLBank's investment and ensures that it has the necessary controls in place to regularly assess the status of the

investment. For example, the Des Moines FHLBank has a seat on the SBIC's Advisory Board as a condition of the its equity investment as a limited partner. As a member of the Advisory Board, the FHLBank is able to review operations, provide general guidance and promote the coordination of SBIC investments with member lending activities.

The investment in the SBIC has provided direct benefit to the FHLBank's financial institution members and their customers. To date, the FHLBank and its members have committed to invest a total of \$8 million as limited partners in the SBIC.

The SBIC is not in competition with the FHLBank's members but provides another source of funding for a member's customer that wants to borrow under terms and conditions not available from the member. Members of the Des Moines

FHLBank have referred nine commercial customers to the SBIC with an investment potential totaling over \$22 million and one referred small business has already received an investment of \$2.4 million. Another FHLBank member has developed an ongoing business relationship with a new customer that was referred to it by the SBIC. Clearly, the FHLBank's investment in the SBIC has benefited both members and small businesses.

SBICs were created specifically to address a shortage of venture capital and the longer term financing necessary to start-up or expand a small business. Investing in an SBIC can be one more opportunity for a Federal Home Loan Bank to support economic development and promote the cooperative nature of the FHLBank System.

*(This article was provided by the FHLBank of Des Moines.)*

---

### (RULE from page 1)

representing a whole interest in such loans. The rule requires the FHLBanks to demonstrate that, before accepting the new collateral, they have the proper procedures in place to enable them to value, discount and manage the risks associated with it.

"Implementing these changes will help bring the economic power of Wall Street to 'Main Street', said Finance Board Chairman Bruce A. Morrison. "We hope to move the rule-making process quickly, so that community banks can take advantage of this enormous opportunity, but with all the right procedures in place to ensure the safety and soundness of the FHLBanks

The rule defines small business loans,

small farm loans, and small agri-business loans that can be used as collateral for advances. The definitions are based on the size of the loan: small business loans are business loans of up to \$1 million, while agriculture loans (farm and agri-business) can be up to \$500,000. Also eligible as collateral are loans of any size made to small businesses or to small farms or agri-businesses, as these entities are defined by the Small Business Administration (SBA).

The proposed rule also implements a provision in GLB that removes a limitation on the amount of non-mortgage collateral that an FHLBank can accept. Currently, FHLBanks can accept real estate-related collateral other than mortgages

(such as home equity loans and commercial real estate loans) from their members. However, the maximum amount of advances that a member may obtain with this collateral cannot exceed 30 percent of the member's capital. Under the proposed rule, the 30 percent cap would be deleted.

The proposed rule also would eliminate from the Finance Board's advances regulations all provisions that disadvantage members that are not qualified thrift lenders, thereby providing access to FHLBank advances without regard to the percentage of housing-related assets a member holds. Following publication of the rule in the Federal Register, there will be a 30-day period for public comment.

---

### (AMA/CMA from page 1)

"The FHLBanks should be encouraged to participate not just in the government-insured market, but the conventional market as well," said Chairman Morrison.

The proposed rule would not restrict beyond current law the FHLBanks' in

vestment in non-mission-related assets such as mortgage-backed securities (MBS). The rule also specifies that any limit on MBS that might be imposed by the Finance Board in the future would allow the FHLBanks to hold to maturity

any MBS that they held as of April 12, 2000.

The proposed rule is expected to be published in the Federal Register in May and will have a 30-day public-comment period.

(TESTIMONY, from page 2)

community lending opportunities in their respective districts through limited scale, and therefore limited risk, pilot programs. The most visible success resulting from this initiative is the Mortgage Partnership Finance (MPF) product developed by the FHLBank of Chicago. The Finance Board's role was to ensure oversight of safety and soundness, legality, and mission suitability, and to require appropriate control, regulatory review, and examination procedures at all stages of development.

Regardless of the particular structure of GSE regulation, certain characteristics are crucial if independent regulatory judgments are to be made. H.R. 3703 contains some improvements in this area, but could do more.

The proposed legislation removes the Office of Federal Housing Enterprise and Oversight from the appropriations process. I fully endorse this provision. OFHEO is dependent on Congress to set the formula for its funding, a process that could prevent the agency from responding rapidly to emerging problems, and limits its flexibility and resources in ensuring that Fannie Mae and Freddie Mac are operated safely under changing economic scenarios.

The proposed legislation also calls for the President to designate an appointed director to serve as chairperson of the board, with this privilege expiring with a change of administrations. I would favor a provision to allow the chairman to be nominated by the President and confirmed by the Senate as chairperson for the duration of his or her term. Such a provision would increase the independence and credibility of the new board and add prestige to the position, which would, I think, result in more effective regulation of the GSEs.

I also recommend expanding the board from five to seven members. The Administration is amply represented by

HUD and Treasury. An expanded board would allow for a more diversified view and a wider range of expertise. The positions other than the Chairman should be part-time. This not only saves money in salaries, but it also encourages more prominent and experienced individuals to accept these positions than would normally be the case given the sacrifices of full-time government service.

Some aspects of H.R. 3703 acknowledge the reality that the government has created special GSE benefits which must be safely administered and directed toward public benefit. Other provisions seem intended to reduce the benefit, but do not achieve any real reduction in public sector risk. Such changes impose costs without real benefits.

H.R. 3703 would eliminate the so-called "superlien" that is granted by statute to the FHLBanks. I believe this would impose a cost on the FHLBanks, which could raise prices to members with no real benefit.

The superlien was created by Congress under the Competitive Equality of Banking Act of 1987. This provided that any security interest granted by a member to a FHLBank would be entitled to priority over the claims and rights of any other party, including the Federal Deposit Insurance Corporation (FDIC) as a receiver or conservator. The only exception is with regard to claims of other creditors of a member that have been secured by a more senior perfected security interest. Prior to 1987, the FHLBanks could achieve the same priority status by perfecting their security interest in specific assets of the member, but doing so would have been time consuming, cumbersome, and expensive. But since the FHLBanks and the insurer of most of their members, the Federal Savings and Loan Insurance Corporation (FSLIC), were both under the control of the Federal Home Loan Bank Board, there was little concern over com-

petition between the two in liquidations.

If the superlien were eliminated, the FHLBanks would be forced to perfect their security interests on an asset-by-asset basis rather than using a "blanket lien" as they do for most of their lending today. The expense of this process would not result in any benefit to the FDIC insurance funds, because the perfected security interests of the FHLBanks still would be entitled to a priority over the claims of other creditors, including those of the FDIC.

As deposits are disintermediated from banking institutions to the capital markets, FHLBank advances serve to recapture those funds and return them to local use. It would seem that a member bank's use of safe and nonvolatile FHLBank advances would be preferable to relying on brokered deposits and other sources of "hot money" that caused the industry and the taxpayer so much grief in the past. Borrowing from the FHLBanks should remain as efficient and inexpensive as possible.

The proposed legislation also would eliminate the lines-of-credit the GSEs have with the U. S. Treasury. This, I believe, would send a wrong message to purchasers of GSE debt. Granted, the \$4 billion FHLBank System line of credit is insignificant when viewed in the context of the \$500-plus billion in outstanding obligations of the System. But, the line-of-credit now exists and it contributes to the lower funding costs supplied by capital market pricing of FHLBank System consolidated obligations. Removal of the line-of-credit could adversely affect these costs with no reciprocal reduction in government exposure. These increased costs will raise the prices of FHLBank products.

That concludes my testimony for today. I will be happy to answer any questions you may have. Thank you.

*Building Blocks* is published quarterly by the Federal Housing Finance Board, Office of Public Affairs, 1777 F Street, Washington, DC 20006. The telephone number is (202) 408-2810 and the email address is [mcgeed@fhfb.gov](mailto:mcgeed@fhfb.gov).

**Chairman**  
Bruce A. Morrison

**Editor/Writer**  
Dennis O. McGee