Building Blocks

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New Strategy Paying Off

Advances and Profitability Increase As FHLBanks Up Housing-Related Activities

In the past 18 months, the FHLBanks have significantly reduced their holdings of money market investments as a percentage of their assets and significantly increased the level of advances in their portfolios.

This action by the FHLBanks reflects a portfolio transformation that addresses concerns about the mission orientation of the FHLBanks' investment practices, concerns that had been raised by members of Congress, the U.S. Treasury Department, and the Federal Housing Finance Board, which regulates the FHLBanks, and others. Despite this progress, the FHFB intends to propose a regulation in the coming months for a minimal level of mission assets for the FHLBanks.

Background

During 1990 and 1991, advances (loans) declined cumulatively by $62.7 billion or 44 percent from the yearend 1989 level This decline reflected the aftermath of the thrift crisis that saw the prepayment or repayment of advances by many thrift members. As a result of the advances shrinkage, the annual $300 million Resolution Funding Corporation obligation, and the 10 percent of earnings Affordable Housing Program (AHP) obligation, the FHLBanks increased their holdings of investments and the Finance Board liberalized the limits on the holdings of mortgage-backed securities as a way to augment earnings.

While the substitution of investments for advances may have been an economic necessity when advances were declining, the FHLBanks continued to increase their holdings of investment securities in 1994, 1995, and 1997 when advances were increasing. By mid-1996, advances had reached the same level as at the end of 1989; however, the holdings of investments were far different. Investments were $124.9 billion on June 30, 1996, compared to $33.9 billion at the end of 1989. Investments peaked at $140 billion at the end of 1997.

The FHLBanks have experienced robust growth in advances since the end of 1992. Between then and September 30,

(See **ADVANCES,** page 2)

Table of Contents

Brownfields Task Force Releases Preliminary Findings. ..... see page 2

Chairman Outlines "A Third Way Home" in Speech To Housing Finance Executives ..... see page 3

New LOC Rules Allow for Greater Flexibility for Local Needs ..... see page 5

Community Lending Plans Required Under New CICA Rules. ..... see page 6

(**ADVANCES,** from page 1)

1998, advances increased by $165.8 billion or 208 percent.

Mission Orientation

One measurement of the mission orientation of the FHLBanks' balance sheets is to measure asset classes as a percent of consolidated obligations outstanding. The FHLBanks fund their operations predominantly by issuing consolidated obligations.

Advances fell from 98.9 percent of consolidated obligations at the end of 1990 to 57.2 percent at the end of 1995.

Since the end of 1995 and especially since mid-1997, the FHLBanks have dramatically changed the character of their balance sheets. From June 30, 1997 to September 30, 1998, advances increased by $84.3 billion or 52.2 percent. During this same period, advances increased to 73.1 percent of consolidated obligations from 64.2 percent.

Investments

At September 30, 1998, the non-MBS investments of the FHLBanks were $81.0 billion, up slightly from the yearend 1996 level but down $8.6 billion or about 10 percent from the yearend 1997 level.

The Finance Board limits an FHLBank's holdings of MBS to three times its capital. On November 30, 1998, aggregate MBS investments of the FHLBanks were $54.6 billion. From December 31, 1996 to September 30, 1998, the net increase in MBS holdings was $8.9 billion for the FHLBanks.

At September 30, 1998, MBS holdings of the FHLBanks were 2.6 times their aggregate capital. This multiple is down slightly from the end of 1996.

FHLBank Income

The orientation of the FHLBank balance sheets towards more housing-related assets has not had an adverse effect on FHLBank profitability. For the first nine months of 1998, FHLBank net income was $1.272 billion, compared with $1.117 billion for the first nine months of 1997. Compared with the first nine months of 1997, the dividend rate was 3 basis points lower at 6.82 percent. the return on average capital was 20 basis points higher at 8.90 percent, the return on average total assets was 1 basis point higher at 0.48 percent, and the net interest margin was 1 basis point lower at 0.57 percent. Reflecting the higher net income, the FHLBank System's AHP contribution was $120 million for the first nine months of 1998 compared with $99 million for the same period in 1997.

The complete text of the report with accompanying graphs is available at the Finance Board's web site, www.fhfb.gov under "What's New," click on "FHFB Reports on FHLBanks' Investments and Mission Character of FHLBanks' Balance Sheets (1/27/99).

Joint Brownfields Task Force Releases Preliminary Findings

The Mayors and Bankers Task Force, a collaboration between the FHLBank System and the United States Conference of Mayors to develop ways of generating investment by community banks in the development of brownfields areas, released on January 27 a report of its preliminary findings.

The task force, formed in June 1998, during a joint FHLBank System/U.S.C. Mayors Brownfields Summit, is chaired by Federal Housing Finance Board Chairman Bruce A. Morrison, FHLBank of New York President Al DelliBovi, and mayors Paul Helmke of Fort Wayne, Indiana, and Jim Marshall of Macon, Georgia.

"This preliminary report highlights the variety of available financing tools, particularly those available to member institutions of the FHLBank System, for dealing with impediments to brownfields development," Morrison said.

Brownfields are defined by the Environmental Protection Agency as "abandoned, idled, or under-used industrial and commercial facilities where expansion or redevelopment is complicated by real or perceived environmental contamination." These sites are growing problems for local governments because environmental and legal problems make them unattractive to developers. By not being able to put the land back on the tax roles, local governments lose substantial revenue.

The task force has identified brownfields projects in cities where the FHLBanks, their member banks, and municipalities are working to arrange financing for redevelopment. These cities face a variety of obstacles, including liability issues, unknown clean-up costs, financing, and the small size of individual sites.

Some cities have released details on possible projects that are contained in the report, which is available by calling (202) 408-2546.

Chairman's Remarks

A Third Way Home: Competition in Housing Finance to the Public Benefit

(On Feb. 26, Federal Housing Finance Board Chairman Bruce A. Morrison addressed a luncheon of "Women in Housing and Finance" in Washington, D.C. The following is excerpted from those remarks)

It's my job to see to it that the public purposes of the Federal Home Loan Banks are advanced, which translates into two fundamental duties that we at the Finance Board have. First and foremost, safety and soundness. Thou shall never cost the taxpayers a dime -- or a penny, I guess I should say. We take that very seriously. It's number one on the list of responsibilities, the centerpiece of what we do. The System has an impeccable record in terms of safety and soundness, and there is nothing to worry about on the horizon.

Secondly, it's our job to maximize the public benefit of the System and to see to it that the public benefit of the System passes through to the public; that's the whole idea of a government-sponsored enterprise. The people of the United States, through their representatives in Congress, have repeatedly enacted a variety of laws and instruments to promote availability of housing and housing credit.

One of the ways that Congress has chosen to support housing availability is to assist housing finance. The main way that it has chosen to do that is through government-sponsored enterprises, which provide a lower cost of funds. "Government-assisted" cost of funds is a magical nonguarantee; there is no backing for the debt, but rather an implied guarantee that only America seems to have made work in the world capital markets.

Our job at the Finance Board is to see to it that this borrowing advantage passes through to the people of the United States. I've looked at the role the Federal Home Loan Banks are playing and can play, and my conclusion is that they aren't some peripheral or historical anomaly. Federal Home Loan Banks play a central role. Why? What is that central role? How is it structured or defined?

First of all, the way in which the Federal Home Loan Bank System operates is through a cooperative of depository institution members. This is very important to the System making sense. It means that the people who contribute the private capital to the Federal Home Loan Bank System are the very same people who are in the business of extending the benefit of the System -- greater accessibility and availability for housing finance in their communities.

It is through depository institutions and their role in housing finance that the Federal Home Loan Bank System operates. and, in my opinion, a competitive housing finance marketplace is absolutely dependent on the health and strength of depository institutions as players in that marketplace. If there is no competition, the public benefit will not be passed through.

"The FHLBank System is a crucial part of an adequate housing finance system for the 21st century."

When the Government confers on a public/private partnership like a housing GSE a funding advantage, the question is: who benefits, the shareholders or the customers? The answer lies in what draws the benefits through to the customers -- competition. Competition is what drives a marketplace to the lowest profitable price. In the absence of adequate competition, public benefits given to private entities will be, to some degree or other, consumed by the shareholders rather than the people they were intended to help.

Don't misunderstand:

(See **SPEECH,** page 4)

(**SPEECH,** from page **3**)

shareholders are entitled to and need an adequate rate of return, but that's different from saying that they are also entitled to the public benefit of GSE status.

Thus, in my view, as we look forward, the Federal Home Loan Bank System's most important role is to be a critical element in producing a competitive environment to maximize the public benefit that Congress intended when it set up the GSEs and provided special funding advantages for the housing industry.

We've taken this challenge of maximizing the public benefit very seriously. One way is through pilot programs -- and the largest, fastest-growing, and the most controversial is Mortgage Partnership Finance, or MPF.

It currently is offered not only through the Chicago Bank, but also through the Dallas and Atlanta Banks. It is in the process of being developed for offering by the New York and Pittsburgh FHLBanks, and discussions are under way with many of the other Banks to offer this product as well.

It's still a pilot. It still has a limit on the mortgages that can be originated through it, $9 billion. It is still being studied in order to determine both operational and risk issues that surround it. But it is an ongoing, growing activity that we at the Finance Board think is extremely important.

To steal a line from Fannie Mae, which does so well in its own marketing, let me say that the Federal Home Loan Bank System, with the support of the Federal Housing Finance Board, is looking to help Americans find "a third way home."

In the pilot, we are developing something that represents the third phase of the development of housing finance in the United States. The Federal Home Loan Bank System was at the heart of the first phase, and the Federal Home Loan Bank System is at the heart of the third. The first phase, as you know, was the development of the S&L industry, the creation of a capital-market partner to the retail banking institutions so that together they could provide long-term, amortizing mortgages to Americans.

The FHLBank System's most important role is to be a crucial element in producing a competitive environment to maximize the public benefit that Congress intended. --

Along the way, the development of such an extensive and successful primary market for housing finance allowed for the next stage, the development of the secondary market. It started with government-guaranteed instruments through Ginnie Mae, allowing for the development Of a conventional mortgage purchase program that grew into a secondary market through Fannie Mae and Freddie Mac.

The development of the secondary market did not spell the end of the existence of the primary market. The development of the second generation of tools didn't mean the displacement of the value of the first generation of tools. The two generations have coexisted, and they continue to coexist. The idea of MPF is a new way to manage the risks that come with mortgage finance.

Instead of transferring both the market risks and the credit risks from the primary market to the secondary market, MPF is designed to retain the bulk of the credit risk in the primary market and to move the market risks to the capital market through the Federal Home Loan Banks. The primary market institutions. depository institutions, hold the credit risk.

What is the advantage? The first and most important advantage, assuming this model works, is creation of competition in credit-risk management. That is, it creates opportunity for profit for depositories and competition in the marketplace. Sixty-eight-hundred potential credit-risk pricers -- all of the members of the Federal Home Loan Bank System -- offer plenty of competition. Whatever is true about Fannie Mae and Freddie Mac and their pricing -- and I don't have an opinion about it -- they will no longer have any monopoly or duopoly, triopoly, or any such market power when there are thousands of credit-risk pricers in the conventional, conforming market.

The whole idea of

(See **SPEECH,** page 7)

New LOC Rules Allow for Greater Flexibility for Local Needs

(The Winter 1998 edition of Building Blocks Vol. 7 No. 2, reported that the Finance Board had approved the final rule for standby letters-of-credit. The following provides a more detailed description of this instrument and its uses.)

A FHLBank standby letter-of-credit (LOC) is a financial instrument issued by an FHLBank on behalf of its financial institution member or nonmember mortgagee in which the FHLBank agrees to honor drafts or other demands for payment from a third party beneficiary in compliance with the terms of the LOC. The FHLBank LOC serves to guarantee the obligations or performance of the member or nonmember mortgagee and is AAA-rated. The FHLBanks have issued LOCs for several years under a policy provided by the Federal Housing Finance Board, the safety and soundness and mission regulator for the 12 FHLBanks.

The Finance Board amended and codified its LOC policies in October 1998 to provide the FHLBanks with greater flexibility to respond to member needs for LOCs as long as LOC uses are consistent with the FHLBank System's housing and community development mission.

The codified policy establishes uniform standards for the issuance of standby LOCs that address eligible purposes, collateral requirements, nonmember use of LOCs, maturity limits, and other policy requirements.

Uses of LOCs

A standby LOC is designed to be used as a tool for housing finance and community lending for economic development, which includes commercial, industrial, manufacturing, social service, public facility projects and activities, and public or private infrastructure projects.

Finance Board regulations allow the use of standby LOCs for both FHLBank System members and nonmember mortgagees, though collateralization requirements are different for each group. Standby LOCs may be issued to FHLBank System members and, under certain circumstances, to nonmember mortgagees to:

- facilitate residential housing finance;
- facilitate community lending;
- assist with asset/liability management; and
- assist with liquidity and other funding.

Community Lending

Community lending, as defined by the Finance Board, is providing financing for economic development projects for targeted beneficiaries, which include geographically defined beneficiaries, individual beneficiaries, activity beneficiaries, and other targeted beneficiaries.

A. Geographically defined beneficiaries include projects that qualify for assistance under another

(See **LOC**, page 6)

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For further information, please contact Mark Zelermyer,
Director of Corporate Communications,
FHLBank of Boston (617) 330-9850

(LOC, from page 5)

federal or state targeted economic development program, approved by the Finance Board, or that are located in:

- neighborhoods where the median income is at or below a targeted income level;
- a Champion Community, an Empowerment Zone, or Enterprise Community;
- an area impacted by federal military base closings;
- a designated community under the Community Adjustment and Investment Program benefiting communities impacted by the North American Fair Trade Act;
- a federally declared disaster area;
- an area eligible for a federal Brownfield Tax Incentive;
- an Indian area; or
- a state declared disaster area.

B. Individual beneficiaries means generally projects where at least 51 percent of the salaries created or retained by a project are at or below targeted income levels or at least 51 percent of the individuals and families who benefit from or are provided services from the project are at or below a targeted income level.

C. Activity beneficiaries are those projects that assist a small business concern or entity;

D. Other targeted beneficiaries are those designated by the FHLBank with prior Finance Board approval.

E. Targeted income levels range from 80 to 115 percent of the area median income or another income limit established by a FHLBank and approved by the Finance Board.

The Finance Board has published a brochure on LOCs that contains additional information on collateralization, typical transfers, maturities, and renewals. Copies of the publication are available by calling Diane Dorius at (202) 408-2576. □

Required Under CICA Rules

FHLBanks Asked to Prepare Plans for Community Lending

In connection with the recently approved rule governing Community Investment Cash Advances (CICA) programs, the FHLBanks are required to develop a Community Lending Plan. The Finance Board's Community Support Regulation already requires that the FHLBanks provide technical assistance and engage in outreach to their members for affordable housing and certain community lending. The new CICA regulation expands upon this and requires the FHLBanks to develop plans to determine if such programs are needed and how they should be designed.

Effective next year, each FHLBank must conduct research on community lending needs. For this, the FHLBank must consult with its Housing Advisory Council, its members and nonmember borrowers, and public and private economic development organizations in the FHLBank's district.

This year the FHLBanks are required to submit to the Finance Board by July 1, an initial assessment of local credit needs and opportunities. No formal methodology is required by the regulation, instead each FHLBank is responsible for determining what market research activity will be sufficient to enable it to identify credit needs and opportunities. Several of the FHLBanks have already begun to convene focus groups throughout their districts to determine these needs.

Beginning on or before January 31, 2000, and annually thereafter, each FHLBank must submit a plan describing how it will address identified credit needs and market opportunities. The plan also must establish quantitative community lending performance goals.

Community lending is defined in the CICA regulation as providing financing for economic development projects for targeted beneficiaries. Targeted beneficiaries are those determined by: the geographic area in which a project is located; by the individuals who benefit from the project as employees or service recipients; or by the nature of the project itself.

For additional information contact Roberta Youmans at (202) 408-2581, or refer to (63 Fed. Reg. 65,536 (November 27, 1998)).

(SPEECH, from page **4)**

"conventional, conforming" actually goes away in the MPF concept. The reason for conforming rules is, as I said, inherent in the insurance structure, with its guarantee of credit risk. When the primary underwriter takes the credit risk, there is no moral hazard. In the absence of moral hazard, conformity is not required because the primary, originating institution guarantees the credit risk.

What does that mean in practical terms? It means many transactions that are difficult to securitize can be done through MPF. These kinds of problems can be directly addressed through the MPF model, and that's why this is a third generation, a third way home for America. It works in the conforming market. It works beyond the conforming market. And, in fact, it also works for multifamily housing as well. All of the strictures that are necessary in an insurance model become unnecessary when you have this risk-splitting model, so this is a very important innovation.

It's important to say that the three generations of housing finance are not in any sense mutually exclusive. They are self-reinforcing, they compete with each other, and they do the most important thing: they ensure that the benefits to the American public will be as broad as possible, and that they will pass through to consumers rather than stick to the GSEs and their shareholders.

There is one last thing, though, that we need to address as we look forward to housing finance in the 21st century. It's perhaps the biggest thing. It's the critical element for a level playing field in terms of housing finance, and that is to end the housing tax on depository institutions as represented by the excessive capital requirement that they have in comparison to the secondary market institutions.

There is a reason for this disparity, and it's historical. The Basle Accords, which have given the depository institutions their capital system, came from left field, and the capital system for the secondary market GSEs came from right field, and they had nothing to do with each other. Congress didn't think much about one when doing the other, and they ended up coexisting in the marketplace. But the fact is that these capital requirements are not all the same for all, with respect to holding the risks of home mortgages. At the present time, the amount of capital depository institutions have to hold against a given package of mortgage risk is much greater than the amount that has to be held by the GSEs for the same risk.

It is wrong that we have these disparities. It's not my place, and it's not my job, to figure out what the right capital structure is for depositories or for Fannie Mae and Freddie Mac, but it is important for me to point out, as the regulator of institutions that serve the depositories, that we don't have a level playing field now. We need a capital system that assesses the risk of the mortgage instrument on the credit side accurately. We know more about this asset class than any other asset class except perhaps U.S. Treasuries, which we certainly hope we can rely on having no credit risk at all.

Accurate assessment of market risks needs to be part of the capital system, and there is a lot of work to be done in that area. But it would be a mistake if we continue what has gone on in the past, which is capital rules being written for the GSEs, on the one hand, and for the depositories on the other, when they play in the same marketplace as competitors.

I think, from all the numbers I've seen, that Fannie Mae's and Freddie Mac's capital is a lot closer to right than that for depositories, and I assume it will be even more right when OFHEO finishes its risk-based activities. I don't think we're talking about a situation in which a greater capital load has to be placed on the pricing of mortgages for American consumers, but the fact that the amount of capital the depositories have to hold should come down. And if it does come down, prices will come down, and competition will go up, and we'll all be the winners.

Thank you very much. □

Closing Dates Set For AHP Applications

First and second round closing dates for AHP applications have been set. For the first round, the dates are **Boston**, May 3; **New York**, April 15; **Pittsburgh**, past; **Atlanta**, past; **Cincinnati**, past; **Indianapolis**, April 15; **Chicago**, past; **Des Moines**, April 15; **Dallas**, April 15; **Topeka**, April 15; **San Francisco**, past; and **Seattle**, April 15.

For the second round, the dates are **Boston**, **October** 1; **New York**, October 15; **Pittsburgh**, September 15; **Atlanta**, September 15; **Cincinnati**, August 1; **Indianapolis**, October 15; **Chicago**, October 1; **Des Moines**, October 15; **Dallas**, October 15; **Topeka**, October 15; **San Francisco**, October 1; and **Seattle**, October 15. □

Resources

"Housing in Rural America: Building Affordable and Inclusive Communities," a new **Sage** publication, combines academic and practical analysis of rural housing issues. To order the $22 paperback, call (805) 499-9774, or visit *www.sagepub.**com.***

"Accessing Capital: Start to Finish" is a publication from the **Federal Reserve Bank of Richmond** that provides information about gaining access to capital for small businesses. To order, call (804) 697-8447 or visit www.rich.frb.org.

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"Community Development in the 1990s" is a new report published by **the Urban Institute** and is available from their website at www.urban.org.

"The Single Family Affordable Housing Market: Trends and Innovations" is a new publication from the **Office of the Comptroller of the Currency.** For information, call (202) 874-4940.

"Capital Access Programs: A Summary of Nationwide Performance" is published by the **Department of the Treasury** and is available from the Government Printing Office under reference ISBN 0-16-049846-5. For more information, call (202) 622-0016.

"Strengthening Rural Economies: Program That Target Promising Sectors of a Local Economy" is published by the **Center for Community Change** and discusses approaches to increasing jobs and economic opportunities for low-income families. For more information, call (202) 342-0567.

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"Building Strong Neighborhoods: A Study Circle Guide for Public Dialogue and Community Problem Solving" is published by the **Study Circle Resource Center**. For more information, call (860) 928-2616, or email them at scrc@aeca.com.

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"Encyclopedia of Housing," a new **Sage** publication covers 500-plus topics with definitions, background, statistics, and policy analysis. To order the $149.95 book contact Yvonne Konneker at (805) 499-9774.

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Chairman
Bruce A. Morrison

Editor/Writer
Dennis O. McGee