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Statement No. 232

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Statement of the Shadow Financial Regulatory Committee on

Strengthening the Capital Structure of Federal Home Loan Banks

May 8, 2006

Federal Home Loan Banks (FHLBs) are member-owned government-sponsored enterprises (GSEs) whose mission of encouraging home ownership resembles that of Fannie Mae and Freddie Mac. Their traditional and still-principal business is to make “advances” (i.e., loans) to member institutions against the collateral of mortgage-related assets. Federal sponsorship means that FHLBs can fund any assets they hold with liabilities whose interest costs are reduced by implicit government guarantees. The interest-rate reduction that federal sponsorship generates allows FHLBs to act as a source of subsidized funding to housing lenders. To constrain FHLB member institutions’ access to these subsidies and to control the FHLBs’ ability to shift risk to taxpayers, the Federal Housing Finance Board (FHFB or “Board”) is charged with assuring that each FHLB maintains an appropriate level and structure of stockholder capital.

In recent years, FHLB activities have outgrown their bureaucratic design. Their membership and balance sheets have expanded markedly in size, scope, and complexity. FHLBs have enlarged their span of owner-members from savings institutions and insurance companies to include commercial banks and credit unions. The FHLB System as a whole -- and especially a few individual FHLBs-- have substantially increased their holdings of mortgages and mortgage-backed securities.

Using two separate definitions of capital, each FHLB is required to hold total capital equal to 4 and 5 percent of its total assets. In March of this year, the Board proposed a rule that focuses on how FHLB capital must be defined in determining these leverage tests. The proposed rule restricts the amount of so-called “excess stock” each FHLB may have outstanding and sets targets for retained earnings. Excess stock is stock owned by a member institution beyond the minimum amount that is required for it to become an owner-member or to transact business with its FHLB. Unlike ordinary stock shares, holdings of excess stock can be redeemed at par after appropriate notice as long as the issuing FHLB’s permanent-capital ratio is above 4 percent. Although labeled as “stock,” these instruments are a hybrid form of debt. These positions are, in effect, member-optionable stock and are vulnerable to a run if and when the imputed market value of the stock is perceived to slide below par.

Historically, excess stock has been redeemed at par at the owner’s request with minimal delay and has proved especially attractive to large institutions. Holders of excess stock earn subsidized returns—especially when market interest rates are low—and can plan to redeem their investment at par if adverse events occur or better investment opportunities emerge. For this reason, optionable funds cannot be relied upon to absorb losses that exceed the non-optionable capital of an FHLB and should not count as capital for regulatory purposes. Nevertheless, at yearend 2005, excess stock equaled about 16 percent of the FHLBs' combined total capital of $46 billion.

The Board's proposed rule aims at reducing the role of optionable excess stock and building up the FHLB stock of retained earnings instead. The rule prohibits FHLBs from selling stock to institutions that would constitute excess (i.e., optionable) stock at the time of sale. It also caps the aggregate amount of excess stock for each FHLB at one percent of its total assets. At year end 2005, four FHLBs (Chicago, Cincinnati, Indianapolis, and Seattle) exceeded this level.

To assure a prompt replacement of member-optionable capital, the rule imposes a minimum retained-earnings requirement on each FHLB (at least $50 million plus 1% of nonadvance assets) and restricts the amount of dividends that a FHLB could pay when retained earnings fall short of the minimum level. The rule also prohibits the FHLBs from paying dividends in the form of FHLB stock.

As proposed, it is estimated that across the System the FHLBs would have to increase retained earnings by about $3 billion, or about 75% above current levels. As the FHLBs build retained earnings, dividend levels are expected to be cut significantly, perhaps by 50% for 18 to 36 months. Irrespective of the proposed restrictions on excess-stock issuance, the reduced dividends would make the cap on excess stock easier to obtain by decreasing demand for these instruments, especially at very large member institutions.

To member institutions and the real-estate industry, the proposed constraints are unwelcome news. Consequently, they are already lobbying for mitigating adjustments. It is important that the public understand what is at stake. The danger is that, because of accounting lags, members can withdraw excess stock before unbooked losses from FHLB activities are explicitly recognized and can formally make excess-stock positions nonwithdrawable. Such an instrument does not provide taxpayers with the protection that capital requirements on GSEs are designed to generate. The Committee applauds the Federal Housing Finance Board for calling attention to this problem. However, the Committee urges the Federal Housing Finance Board to add to the rule a requirement that FHLB accounting statements recategorize excess stock as a form of debt. Moreover, studying this issue has convinced the Committee that a piecemeal approach to restructuring capital requirements for the FHLBs is inadequate. The entire structure of capital management across the FHLB system needs a thorough overhaul.