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FROM THE EDITOR

Welcome to ABA's Federal Home Loan Bank Member Insights. This is an abbreviated version of Insights, as Congress is on their August recess. We will return to our full, regular format with the next issue. If there are events you would like to see covered in ABA FHLB Member Insights, or if you'd like to comment on an article or item, please email the editor at JPigg@aba.com

NEWS

FHFA Announces that REFCorp Obligation Has Been Met

On August 5, 2011, the Federal Housing Finance Agency, the regulator for the Federal Home Loan Banks, announced that as of July 15, 2011, the 12 Federal Home Loan Banks had fulfilled their obligation to pay interest on the Resolution Funding Corporation (REFCorp) bonds issued between 1989 and 1991. The FHFA also announced that it has approved a plan developed jointly by the 12 FHLBanks to allocate the same percentage of funds going forward to create restricted retained earnings accounts to build capital within the System. The FHFA announcement can be found [here](#).

House Financial Services Chairman Bachus Cautions the FHFA on Proposal Limiting FHLB Membership

On July 7, 2011, Representative Spencer Bachus (R-AL), Chairman of the House Financial Services Committee, wrote to the Federal Housing Finance Agency urging them to be cautious in moving forward with an Advance Notice of Proposed Rulemaking (ANPR) that could potentially limit membership in the Federal Home Loan Bank System. Bachus noted that the FHFA should be "mindful of the potential unintended consequences that any changes could have on our economy and this important source of funding for so many financial institutions." The ANPR was originally published by the FHFA on December 27, 2010. The ABA has opposed the ANPR as running counter to Congressional intent and being potential harmful to the System and its members.

Read the [Bachus letter](#).
Read the [ANPR](#).
Read [ABA's comment letter](#).

Federal Home Loan Banks, Fannie Mae and Freddie Mac Credit Rating Downgraded by Standard And Poors

Following the downgrade of the United States credit rating from AAA to AA+ by Standard and Poors, S & P also lowered the credit rating for Fannie Mae, Freddie Mac and 10 of the 12 Federal Home Loan Banks along with that of the U.S. Government. Standard & Poor's said in a report that the ratings agency lowered to AA+ from AAA the credit of 10 Federal Home Loan Banks; the remaining two FHLBs already had AA+ ratings. The ratings downgrade was not unexpected as Fannie Mae, Freddie Mac and the Federal Home Loan Banks are government-sponsored enterprises and any change to the U.S. debt rating was also expected to impact the GSEs debt rating.

INSIGHT

The following is adapted from remarks made earlier in the summer by Peter Knight, Director of Government Relations for the Federal Home Loan Bank of Pittsburgh, during Bank membership meetings. Mr. Knight discusses the issues facing policy makers in Washington today and how those issues are likely to impact the Federal Home Loan Banks and their members. We appreciate his allowing ABA FHLB Member Insights to reprint them here.

I appreciate the opportunity to spend a few minutes today reviewing the policy challenges facing your Federal Home Loan Bank. The outcome of these debates will impact our ability to serve you, provide you with reliable funds at attractive rates, and protect your investment.

I know that many people today have a dim view of Washington – that is nothing new. American humorist Will Rogers said almost a century ago, “The only difference between death and taxes is that death doesn't get worse every time Congress meets.” Today, our nation's governance is not working well. The partisanship and brinksmanship are constant. It has gotten to the point that our nation's triple A credit rating is threatened.

The current showdown is over raising the nation's debt ceiling. The \$14 trillion ceiling must be raised by August 2. While both parties agree that raising the ceiling must be paired with deficit reduction, there is absolutely no agreement on the right mix of spending cuts, entitlement reform and tax increases to achieve a meaningful result. The first quarter FHLBank System Combined Financial Report warns of higher FHLBank borrowing costs if the ceiling is not raised. We all have a big stake in the outcome of this biggest of all debates, but we are pretty much relegated to the bleachers.

Having survived the tsunami known as Dodd-Frank, bankers do not need to be reminded that policy deliberations are serious business and that managing policy risk is every bit as important as managing credit or interest rate risk. You need not be reminded that vigilance and activism are in your job descriptions. For the upcoming policy contests, your place is on the field, not in the bleachers.

The remarkably hostile regulatory landscape of 2011 reflects Washington's collective over-reaction to a

financial crisis created by other market players. Interchange rules, a new consumer protection finance bureau, financial concentration, greater regulatory compliance costs, and a new mortgage landscape are but some of the environmental changes you face.

While not responsible for the excesses and abuses that led to the crisis, you will have to operate in a new world. We understand this and will be looking for ways to partner with you as you deal with these new challenges. As your environment changes, so does ours. We are all in this together. Our goal is to continue our partnership as you work for the growth and prosperity of the communities you serve.

I will now review the policy landscape for Federal Home Loan Banks within the context of GSE and mortgage reform. As stockholders and customers, you have a real stake in the outcome of our policy battles. In much the same way you were dragged into Dodd-Frank's regulatory overhaul, FHLBanks will be in GSE reform.

The spectacular 2008 collapse of our larger brethren, Fannie Mae and Freddie Mac, has required over \$150 billion in Treasury support and left them wards of the state. Their failures lie at the heart of a broken mortgage finance system that is on life support. Reform is necessary but care must be taken not to weaken the patient. As in most reform efforts, mortgage reform begins with everyone agreeing what they don't want, but there the consensus ends. Sounds like the deficit reduction debate.

Abusive mortgage lending spawned sky-rocketing, then exploding, home prices, toxic securities and other collateral damage that left our housing landscape in tatters. Over five million new and existing homes are on the market or in the wings. Over four million foreclosures are in the pipeline. With nationwide housing prices at 2003 levels, stunning percentages of houses are underwater. A market correction could take years.

Critical underpinnings of future mortgage markets will be determined through some of the 240 Dodd-Frank regulations, including a 376-page monster that requires securitizers to hold "skin in the game" and creates the Qualified Residential Mortgage known as the QRM. If the financial regulators that jointly developed this proposed rule stay the course, the QRM will require at least a 20 percent down payment. This has led a bipartisan group of 30 senators, including the authors of the legislation, to point out that this will put mortgage credit out of reach for many otherwise qualified buyers. The ABA and ICBA, along with all the major consumer groups, are working hard on the QRM rule which will become final this fall and take effect a year thereafter.

Another new rule governing mortgage origination known as the Qualified Mortgage rule or the QM, will establish national underwriting standards and increase lender liability. How the QM and QRM interact will have a dramatic impact on future markets.

This housing finance debate is unlike any for at least 80 years. You hear many in Congress say they want to protect taxpayers, not homeowners. Neither the Democratic President nor the Republican Speaker of the House have stated the importance of homeownership. June used to be national homeownership month, now it's national foreclosure month.

Fannie, Freddie and the FHA represent 90 percent of the mortgage market. No policymaker is happy with this but most recognize that housing is too weak to be weaned from government support at this time.

As Congress and the White House revamp our mortgage finance system, these questions will be asked: Was housing a capital glutton? Was too much emphasis placed on homeownership? Should the federal government support mortgage finance? Is the 30-year fixed rate prepayable mortgage important? And finally, will community banks be able to compete in mortgage markets that currently are dominated by a handful of the largest banks.

The new mortgage finance system will be in place for decades and will determine the cost and availability of mortgage credit and the ability of FHLBank members to participate in all aspects of the mortgage business.

As a GSE, we will be included in efforts to reform Fannie and Freddie even though our business model, governance structure, and ownership dynamics could not have been more different. Another important distinction that goes without saying, but bears repeating nonetheless, is the FHLBanks are well capitalized, never took a dime of Treasury support and reliably fulfilled our mission of providing liquidity throughout the crisis.

On February 11, 2011, the Administration released its recommendations for the reform of mortgage markets and the GSEs. The report lays out the goals of developing a robust private mortgage market by reducing government support, winding down Fannie and Freddie, addressing fundamental flaws in the markets, and focusing government support on affordable housing. It is hard to argue with this approach, but the devil is always in the details and the details have not been developed.

The report is clear on the regulatory glide path on which the Administration will place Fannie and Freddie but the implementation will await the strengthening of the housing markets. The descent will be governed by increased guarantee fees, higher downpayments, reduced mortgage limits, and tightened underwriting.

The Administration's report advocates significant changes to the FHLBanks. One would expect changes of this magnitude to be considered in legislation, and that may happen, but we should also be ready for regulatory action. The Administration wants to:

Allow holding company subsidiaries to be a member of only one FHLBank;

- Allow holding company subsidiaries to be a member of only one FHLBank;
- Limit advances to large members; and
- Reduce FHLBank investment portfolios.

I will briefly discuss these issues, but first I want to review a major regulatory initiative that was not part of the Administration paper. Last December, our regulator, the Federal Housing Finance Agency issued an advanced notice of proposed rulemaking that raises the possibility that FHLBank lending to existing members be conditioned on ongoing mortgage lending and portfolio tests. This would change a basic tenet of the co-op that members always know that FHLBank liquidity is available based on collateral. This new regulatory hurdle would change that certainty and bring back mortgage asset tests that are a relic of bygone days. The Federal Housing Finance Agency received 123 comments in opposition to this and all our state banking trades wrote letters. For that we are very grateful. While this issue has not received any discussion on the Hill, House Financial Services Committee Ranking Member Barney Frank recently sent a letter to the agency asking that the regulation be withdrawn. We will monitor this closely as we expect a proposed regulation to be issued later this year.

Forcing single FHLBank membership could destabilize the System by concentrating business in a few districts. Preventing this concentration is integral to maintaining the regional structure of the System and promoting safety and soundness.

Restricting lending to large members would weaken the industry as a whole and diminish the value that individual FHLBanks deliver to members of all sizes. Advances to large institutions bring commensurate amounts of invested capital across which to spread the impact of operating expenses, which allows FHLBanks to operate on narrower interest margins, reducing the cost of credit. Higher advance balances increase FHLBank income which increases retained earnings and support for the Affordable Housing Program and community development efforts. Advances to large members also result in a critical mass of debt issuance which contributes to the FHLBanks' market presence and the extension of credit at

reasonable cost in all phases of the business cycle.

The unique governance rules of the System also ensure that large banks will not dominate the boards. Since the rules for member director elections cap large member votes, smaller members are well-represented with 63% of all member directors from institutions with less than \$1 billion in assets.

Simply put – while large and small banks may be competitors in some instances, in this case, all members of the co-op benefit from the participation by large members in the System.

Finally, the Administration and our regulator are advocating a reduction of FHLBank investments. It is a fair issue to raise, but if it is approached in an overly rigid manner, the System could be unnecessarily hurt. In the summer of 2011, FHLBanks are very much like a utility in the off-peak season. Demand for advances is cyclical, but the fixed costs of doing business have continued to rise year after year. We cannot turn a dial and increase advances just like you cannot create loan demand. Advances will grow when you and your peers need them, not before. In periods such as this, investment portfolios bridge the gap and generate sufficient income to help cover costs, provide a reasonable return on capital and ensure we are able to provide advances at attractive rates when the economy recovers.

As policy makers focus on GSE reform and look at FHLBanks, we tell them – do not include provisions that could adversely affect our ability to serve as a reliable source of funding and financial services for our members.

I believe the FHLBank System will emerge from this reform process playing a vital role as your partner in building a strong economy, but we will all have to be vigilant and active. We all have to be on the field. Please consider joining the Bank's Public Policy Network (PPN) and encourage others from your bank to join. The PPN is committed to keeping you apprised of important policy developments impacting GSEs, mortgage finance and housing. We will, from time to time, invite you to events in your area so you can get to know elected leaders better and let you know when weighing in on FHLBank policy debates will have the greatest positive impact.

In closing, I have to say I do not know how Congress and the Administration will meet the many policy challenges ahead. However, I will leave you with this great insight of Winston Churchill who once said, "You can always count on Americans to do the right thing - after they've tried everything else."

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American Bankers Association, 1120 Conn. Ave NW, Wash. DC 20036



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