Volume 8 No.1
Autumn 1999

FEDERAL HOUSING FINANCE BOARD
Building Blocks

President Clinton Signs Law

Bank Reform Legislation Offers Challenges to FHLBank System

On November 12, President Clinton signed into law long-sought banking modernization legislation that will make sweeping changes in the nation's financial services industry, including the operations of the Federal Home Loan Bank System and its members.

Though the banking modernization law centers on repeal of the Depression-era Glass-Steagall Act, it includes provisions that offer unprecedented opportunities and challenges to future operations of the FHLBank System, from a changed capital structure to greater access to capital markets for small banks through the FHLBank System. Other major provisions establish a new formula for REFCorp payments and provide for totally voluntary membership in the FHLBank System. The new law also makes significant changes in the FHLBank System collateral requirements for the benefit of community banks and in the management of the 12 FHLBanks.

Commenting on the significance of the FHLBank System provisions in the new law, Federal Housing Finance Board Chairman Bruce A. Morrison said, "I am delighted that the financial modernization reform legislation is now law, and with it the Federal Home Loan Banks will achieve long-awaited comprehensive reforms to enhance their mission of housing finance."

"Under this landmark legislation, the REFCorp obligation no longer will drive arbitrage activities of the FHLBanks; small banks will have greater access to the FHLBank System, both in terms of becoming members and in obtaining advances; and all membership will be voluntary. The capital structure includes permanence to assure safety and soundness and will be based on the risks actually undertaken by the FHLBanks. The Finance Board will also receive new tools to ensure both safety and soundness and mission performance," Morrison said.

"The package of reforms focuses the FHLBanks on their core activity of housing finance and targeted economic development, and allows them to offer better competition in the mortgage market to the ultimate benefit of homebuyers," he added.

The Finance Board is the

(See **REFORMS,** page 2)

Finance Board Expands Authorization For Single-Family MMA Programs

The Federal Housing Finance Board passed a resolution on October 4 that authorizes the FHLBanks to offer single-family Member Mortgage Asset (MMA) programs and sets the parameters, terms and conditions under which they can offer these programs. The resolution applies to existing MMA programs, such as the Mortgage Partnership Finance (MPF) pilot program, as well as future programs.

The Finance Board's action permits modifications of the basic risk-sharing structure already approved for MPF in response to increasing interest by the FHLBanks in offering MMA programs to their members. These modifications are designed to lessen the capital requirement

(See **PROGRAMS**, page 3)

(REFORMS, from page 1)

federal regulator of the FHLBank System.

PERMANENT CAPITAL

One of the most important aspects of the new law is that it replaces the existing subscription-stock structure of the FHLBank System with a risk-based capital structure more closely aligned with the regulatory capital requirements of insured depository institutions and with the other housing GSEs. This provision authorizes each FHLBank to issue two classes of stock: Class A, redeemable on 6 months notice; and Class B, redeemable on 5 years notice.

Under current law, the amount of capital that a FHLBank must hold is based on the size of its members (i.e., the amount of a member's mortgage holdings or its total assets) or on the amount of their advances borrowed from their FHLBank. Apart from those requirements, there is at present no statutory capital requirement for the FHLBanks, such as there are for insured depository institutions and the other federal housing GSEs, each of which requires a certain level of permanent capital that is based in large part on the degree or risk inherent in the portfolio of the institution.

The new law replaces the old subscription capital regime with a risk-based capital system, under which the amount of capital is determined by the credit, market and operations risks to which each FHLBank is exposed. The law also includes a 5 percent leverage requirement, which will establish a minimum amount of total capital for each FHLBank. The risk-based capital requirement must be met with permanent capital, defined as amounts paid for Class B stock (which cannot be redeemed for 5 years) and retained earnings. This arrangement is consistent with several studies by the General Accounting Office, which has long advocated a risk-based capital structure with greater permanence for the FHLBank System.

The Finance Board has one year to prescribe for the FHLBanks uniform capital regulations that include both the leverage requirement and a risk-based capital requirement, after which each FHLBank has 270 days to submit to the Finance Board an individual capital-structure plan. The Finance Board must approve each FHLBank's capital-structure plan and any modifications to it.

The law provides for a transition period that preserves the current capital structure of the FHLBank System until such time as the capital regulations are in effect and the capital-structure plan of each FHLBank has been approved and implemented.

To implement the risk-based capital requirement, the Finance Board is required to establish a stress test to determine the market risks to which the FHLBanks are subject, taking into consideration any risk-based capital test adopted by the Office of Federal Housing Enterprise Oversight (OFHEO). The law does not require the Finance Board to wait for OFHEO to finalize its rules; it only requires the Finance Board to consider whatever rules OFHEO has promulgated to date. The FHLBank System stress test will be based on interest rates, volatility of interest rates, and changes in the yield curve. Similar stress tests are already in place for Fannie Mae and Freddie Mac.

<u>The full text of S.900, the Gramm-Leach-Bliley Act is on the Finance Board website at www.fhfb.gov under "What's New."</u>

The new capital structure for the FHLBank System incorporates the following key concepts:

1. **Permanent capital**: a FHLBank's outstanding Class B stock and its retained earnings.
2. **Total capital**: a FHLBank's permanent capital, plus the amounts paid for its outstanding Class A stock, certain general loss reserves (consistent with GAAP), and other items determined by Finance Board regulations to be capable of absorbing losses.
3. **Leverage capital requirement**: a FHLBank must maintain total capital of at least 5 percent of the total assets of the FHLBank. For leverage purposes, the capital items with the most permanence (Class B stock and retained earnings) are more heavily weighted than are capital items with less permanence (Class A stock). Class A stock would count at its face value while Class B stock and retained earnings would be weighted at one and one-half times the paid-in value. However, a FHLBank's total capital, determined without taking into account any multiplier, must not be less than 4 percent of total assets.
4. **Risk-based capital requirement**: a FHLBank must maintain permanent capital in an amount that is sufficient to meet both the credit risk and the market risks (including interest rate risk) to which the FHLBank is subject as determined by the stress test to be established by the Finance Board.

Additional provisions in the law address the contents of capital-structure plans, termination of membership, redemption of excess stock, impairment of capital, rejoining after divestiture of all shares, and treatment of retained earnings.

REFCorp

When the Federal Home Loan Bank Act was amended by FIRREA in 1989, Congress required the FHLBank System to contribute $300 million annually to the interest owed on obligations issued by the Resolution Funding Corporation (REFCorp). Congress required also that the FHLBanks contribute annually the greater of 10 percent or $100 million to

(See **REFORMS,** page 3)

(**REFORMS**, from page 2)

fund an Affordable Housing Program (AHP).

The new law changes the FHLBanks' REFCorp formula, now requiring the FHLBanks to pay 20 percent of their net earnings toward the REFCorp interest, after deducting AHP expenses and operating expenses.

This change will allow contributions to REFCorp to increase and decrease with the FHLBanks' net earnings, and thus encourage the FHLBanks to reduce arbitrage activity that in the past resulted from the need to pay a fixed amount to REFCorp each year.

VOLUNTARY MEMBERSHIP

Current law mandates that federally chartered savings associations must be members of the FHLBank System. The new law removes the mandatory membership requirement and authorizes voluntary membership for federal savings associations, as is the case now for all other eligible depository institutions. This provision is effective on May 12, 2000.

SMALL-BANK ACCESS

Traditionally, banks with assets of less than $500 million constitute more than 75 percent of the FHLBank System membership, but they account for a disproportionately small amount of outstanding advances. Most smaller banks have limited residential lending programs and therefore currently do not have sufficient amounts of mortgage loans required by law for membership and which can be used as collateral for advances.

Current law requires all insured depository institutions to have at least ten percent of their total assets in residential mortgage loans in order to be eligible to join the FHLBank System. The new law eliminates that requirement for any "community financial institution (CFI)," which is defined as "a member of the FHLBank System, the deposits of which are insured by the FDIC and that has average total assets (over the preceding 3 years) of less than $500 million." CFIs must demonstrate that their financial condition is sufficiently sound that the FHLBank safely can make advances, and that the character of their management and home financing policy is consistent with safe and economical home financing.

Current law allows a FHLBank to accept "other real estate related collateral" from the member as collateral for its advances, so long as the collateral has a readily ascertainable value and the FHLBank can perfect its security interest. The maximum amount of advances that a member may obtain with this collateral, however, cannot exceed 30 percent of the member's capital, which greatly limits the use of such collateral.

The new law deletes the 30 percent cap, allowing a FHLBank to accept such collateral so long as it has a readily ascertainable value and the FHLBank can perfect its security interest. As with all other types of eligible collateral, the FHLBank would have the discretion to determine the terms under which it would accept such collateral, including the appropriate amount for the discount, or "haircut," to be used with the collateral.

The law also allows CFIs to obtain long-term advances for the additional purposes of funding loans for small businesses, small farms, and small agri-businesses, and to post as collateral for its advances any secured loans for small business, agriculture or securities representing a whole interest in such loans. Both of these changes provide CFIs greater access to the FHLBank System.

The new law also eliminates all provisions that discriminate against members that are not qualified thrift lenders (QTL), thereby providing equal access to FHLBank System advances for all members without regard to QTL status.

FHLBANK MANAGEMENT

Other important provisions in the new law mandate a variety of changes in the management of the FHLBanks. Those changes include eliminating a number of Finance Board approval requirements, such as for officer compensation, dividends, and routine advance matters, and authorizing each FHLBank's board to designate its chairperson and vice-chairperson.

A complete text of the Bank Act can be found at *www.fhfb.gov;* click on "What's new," click on "S.900 Gramm-Leach-Bliley Act," click on "Title VI - Federal Home Loan Bank System Modernization."

(**PROGRAMS**, from page 1)

burden of members, in a safe and sound manner. The resolution authorizes an additional risk-sharing structure for MPF and a new MMA program recently proposed by the FHLBanks of Cincinnati, Indianapolis and Seattle.

"This action is an indication of the continuing success and evolution of pilot programs such as MPF," said Finance Board Chairman Bruce A. Morrison. "These programs are attractive to FHLBank members, because they offer an alternative to taking all the risks of holding loans in portfolio or selling all the risks to the secondary market."

The single-family MMA structure allows for a risk-splitting concept that utilizes the different risk management capabilities of the FHLBanks and their members. The FHLBanks, being capital market specialists, are adept at bearing market risk while member institutions, who know their customers best, are expert in managing credit risk. Volume in the MPF program, which pioneered the risk-sharing concept, is now at $1.5 billion in outstanding loans, and $3.8 billion in master commitments.

The October 4 resolution reflects the Finance Board's view that the pilot MMA programs are already proving to be sound business practice and have significant potential to grow in the future. The resolution helps provide the FHLBanks with a blueprint for the development and implementation of these MMA programs.

Time to Take Risk in Indian Country

(On July 8, Federal Housing Finance Board Chairman Bruce A. Morrison addressed participants at the Native American Homeownership and Economic Development Summit in Rapid City, South Dakota, held in conjunction with President Clinton's "New Markets Initiative" visit to the nearby Pine Ridge Indian Reservation. The following is excerpted from his remarks.)

Thank you, Secretary Cuomo.

I am very proud to have been invited to share this occasion with you. This conference, the President's visit yesterday at Pine Ridge, the New Markets Initiative being developed, the work that is going on at HUD under Secretary Cuomo's leadership, all of these initiatives converge to form a very critical moment in our history. To be a part of it is a challenge, and it is the only place one ought to be . . . .

When we talk about addressing new markets, the focus is on the capital markets, the people who have all the money. You know what Willie Sutton said about why he robbed banks: "Because that's where the money is." So there's no surprise and no mistake in focusing on Wall Street. We want capital to come to those communities that are being left behind in this otherwise prosperous land. It makes total sense to go to where the money is, to where the billions, even trillions of dollars are -- in the capital markets. But no one should believe that just because you create tax advantages and guarantee programs that the money on Wall Street will end up on Main Street.

On Main Street, in Pine Ridge, and in other reservations around the country, it is even harder for that money to be found. It's never been there for Indian country before, and it doesn't know the way. It won't come here through just the macro approach of giving guarantees and lowering risks. That doesn't mean we don't need to do those things as well -- those things are essential. It is absolutely essential to improve the opportunity that goes with the risk-taking. But that's only step one.

And step two is to build the local institutions, the local intermediaries to stand in the middle and pull the strands together and tie them so that money ends up where it was intended to go. That is a critical role I would like to see the Federal Home Loan Bank System perform. I would like it to take on the challenge of tying together the new opportunities for people with money and the willingness to take risk to the needs of local people and local communities in Indian country all across America. I don't think that's an impossible idea, but I do think we're all going to have to work very hard to bring it about.

Let me be a little more specific about some of the things the Federal Home Loan Banks do now, and what they can do in the future, and how the System can deliver to Indian tribes and Indian people in their communities.

There are 12 Federal Home Loan Banks around the country. They are not banks that you can go and visit, or take a loan from. They're wholesale banks, not retail; they don't deal with individuals, they deal with members. The members are 7,000 local banking institutions from some of the largest in America to some of the very smallest.

The System is a cooperative, which means that it is owned by its customers. It succeeds by making its customers more profitable and successful lenders. So if the Federal Home Loan Banks can help their members open a new market in Indian country, the profit motive is satisfied. There's nobody sitting on Wall Street looking for a dividend. There is no third-party shareholder. There is just a banking institution looking for better lending from its Federal Home Loan Bank, so that it can make more aggressive loans in its community, which in turn means more profits.

I didn't understand, before I had this job, how important that cooperative incentive was to getting things done. In the same law that created the Federal Housing Finance Board, Congress also created for the Federal Home Loan Banks a program called the Affordable Housing Program. Some of you have taken advantage of that program already. It is a very flexible housing grant program. It has been very successful because it is so flexible, but also because it runs through local banks.

The Federal Home Loan Bank System was not the first place people thought you would put a grant program, but it's built a tie between banking institutions and the development of affordable housing. In other words, it introduced bankers to affordable housing developers.

We've tried to expand on the Affordable Housing Program and make it more flexible, but it's only $150 million a year, and it can only do so much.

In the Federal Home Loan Bank System as a whole there are $450 billion in assets. That's a huge number. We're working on ways in which those assets -- which means loans that are made -- can be leveraged more effectively and go to banks for programs and for lending that haven't been done before. We've targeted economic development and job-creating loans as a critical growth area.

Indian housing authorities are eligible to be nonmember borrowers from the Federal Home Loan Bank System. Only a few have joined. They should all join. They should all use this tool to get cheaper money to support housing activities in Indian country. Through a Federal Home Loan Bank, you can get what are called letters of credit, which are a form of guarantee, which can allow deals to get done with cheaper money in the capital markets. These are activities we are working on, but no one can take advantage of these activities unless they join the System. So please, if you're associated with an Indian housing authority and you haven't thought about this, think about it now, and then talk to Roberta Youmans from our staff who is here today and will tell you about how to get things done.

We have another idea, a legislative idea about how to create a fund similar to

(**SPEECH** from page 4)

(See **SPEECH** on page 5)

the affordable housing fund, but for economic development. You'll probably be hearing more from us about that program. Why is it important? For the same reasons that the affordable housing program has been important: to enable banks to give some money away and to partner with the economic development people in Indian country, and elsewhere where that kind of work needs to be done.

The bottom line is that the Federal Home Loan Bank System is a network of banking institutions. Indian country is dramatically underserved by banking institutions. We are committed to pushing our Federal Home Loan Banks to assist their member banks to reach out to bring services into Indian country.

Indian country needs to create its own financial institutions, too. Credit unions are a particularly powerful vehicle. Credit unions can be members of Federal Home Loan Banks -- local institutions serving local needs with sophisticated financial tools. That's how it's always been done. Risk-taking is how it's been done, by market-driven institutions.

I think we at the Finance Board and the Federal Home Loan Banks have a partnership. It's a partnership with HUD, it's a partnership with other parts of the Federal Government, but, most importantly, it's a partnership with you, in your communities.

The last thing that I want to focus on is the critical challenge that faces Indian leadership in taking advantage of these new opportunities for partnership with private sector players. You all know about all the barriers that come with the trustee relationship and the trust status of your land. Everyone spends most of the time at these conferences going over all of those barriers and how many bureaucrats have to sign a piece of paper before a deal can get done. Yes, we have to solve that problem.

But I said at the beginning that this was all about risk-taking. Indian people have been deprived of many things over the centuries, but you have ultimately, still, all your skill and ingenuity, and you still have land and resources.

You can't turn those lands and resources into wealth if you can't leverage them, in other words if they can't be offered as collateral to borrow on. Every time this subject comes up people are threatened. The history of Indian peoples in America is about stolen land. That makes my suggestion a difficult one to hear. But the story of how all people in America were able to build wealth is based on leveraged land -- borrowing on land to create wealth.

Figuring out how to put up that land as collateral to borrow successfully is a critical step that we all have to take together. It doesn't have to violate anybody's sovereignty. It doesn't have to threaten Indian ownership of Indian land, but it does require all of us to change our ways of doing business. Otherwise that land will stay locked up and your great resources and great ingenuity will not produce increased wealth.

I know how hard the people at HUD are working on this. I know that there are a lot of disagreements. But the one thing that I can tell you from working with bankers is that they demand collateral for their risk-taking. We need to work together to make sure all your collateral can be lent on, that you can borrow on it.

And then I promise you that the 7,000 members of the Federal Home Loan Bank System will see the business opportunity in Indian country. They're sometimes conservative; they're sometimes looking in the rear-view mirror rather than out of the windshield. But they're in business to make a profit and there's profit to be made. Profit is not a dirty word as long as it works for you, and it can work for you.

So let us be your partner. There's no magic here. It will take year upon year of work, but we can start today. Some work has already been started. Please get to know your local banking institutions; there are ones that want to do business. And remember the one Morrison rule: if anyone ever tells you that they can't do something because the Federal Housing Finance Board in Washington says it's not allowed, don't take their word for it. Call me first.

Thank you very much.

Rev. Jesse Jackson Keynote Speaker

Economic Development Conference Draws Large National Audience

Approximately 250 bankers and economic development professionals from across the country attended a three-day Community and Economic Development Conference last month in Washington, DC sponsored jointly by the American Bankers Association and the Federal Housing Finance Board.

The keynote speaker at the conference was the Rev. Jesse Jackson, president of the Rainbow/PUSH coalition, who announced that he will "go to the mat" to prevent any easing of the requirements of the Community Reinvestment Act (CRA).

"The CRA is to economic justice what Brown vs. the Board of Education is to public accommodations," Jackson told the crowd.

"The CRA is the starting point and the end point for bridging the capital gap. I will fight with every last ounce of energy I have to preserve the CRA, I will battle those who wish to undo it or weaken it. I will go to the mat on this one," he added.

Titled "Building from a Position of Strength," the conference offered 25 separate workshops that provided the participants with new tools and cutting-edge information to use in their local development lending plans. Topics included the FHLBank System's financing programs, small business strategies, HUD programs, creating partnerships in rural areas, using tax credits to revitalize a community, and effective ways to

(See **CONFERENCE** on page 6)

RESOURCES

"Strengthening Rural Economies: Programs That Target Promising Sectors of a Local Economy" examines how concentrating economic development efforts can expand economic opportunities and produce jobs. Prepared for HUD by the **Center for Community Change**, the report is free at *www.huduser.org* or for $5 from HUD user at 1-800-245-2691.

* * *

The Bazelon Center for Mental Health has just released a booklet, "What 'Fair Housing' Means for People with Disabilities," which explains how federal law bans housing discrimination on the basis of physical or mental disability. The 48-page booklet is available for $4, plus $2 for shipping, by contacting the center at Publications Desk, Bazelon Center, Suite 1212, 1101 15th Street NW, Washington DC 20005; email is pubs@brazelon.org; and fax is (202) 223-0409.

* * *

"A Study of the GSE's Single-Family Underwriting Guidelines" is an **Urban Institute** report that looks at how well Fannie Mae and Freddie Mac are serving low- and moderate-income borrowers. To obtain the report call HUD's Office of Policy Development and Research at (202) 708-1464, x-5873.

* * *

"The 1999 Advocate's Resource Guide" from the **National Low Income Housing Coalition** is now available on the NLIHC website at *www.nlihc.org/advocates/*. The guide consists of chapters for every major housing program and issue in the field. A print version of the guide is available for $15 by contacting the organization by email at info@nlihc.org.

* * *

"Priced Out in 1998: The Housing Crisis for People with Disabilities" is a March 1999 report by the **Technical Assistance Collaborative, Inc** and the **Consortium for Citizens with Disabilities Housing Task Force**. For information, call Michael Allen at (202) 467-5730.

* * *

"Making Connections: A Study of Employment Linkage Programs" illustrates how cities can provide development incentives for private sector employers to make jobs accessible to low-income residents. The publication is available from **HUD User** at 1-800-245-2691.

* * *

The second edition of "Principles & Practices of Community Development Lending" explains to lenders and their community development partners how to evaluate and make community development loans. The guide is available from the **Federal Reserve Bank of Minneapolis** for $25 by writing to the bank at Community Affairs, PO Box 291, Minneapolis MN 55480-0291.

* * *

"Homelessness: State and Local Efforts to Integrate and Evaluate Homeless Assistance Programs," is a new study by the **General Accounting Office**. The publication is free at *www.gao.gov,* or by calling (202) 512-6000 and asking for publication GAO/RCED-99-178.

* * *

"Waiting in Vain: An Update of America's Rental Housing Crisis" is a March 1999 report from the **Department of Housing and Urban Development**. For more information on the report, visit HUD's website *www.huduser.org*.

(**CONFERENCE** from page 5)

build partnerships with community groups.

Finance Board Chairman Bruce A. Morrison said he was pleased with the both the quantity and quality of participants at the conference and their response to issues presented by the Finance board and ABA.

"We are fortunate to have attracted to this conference some of the major leaders in the economic development field. The feedback they provided is invaluable and will be used to further refine our existing programs," Morrison said.

Attendees also participated in tours of community development projects in Washington, DC to witness how once dormant communities have sprung back to life. The economic development tour of Washington's Columbia Heights community included several housing rehabilitation projects and the first community development bank established in the area. The housing development tour focused on Edgewood Terrace in Northeast Washington, a multi-building project combining community development with social services.

The full text of Rev. Jackson's speech is available by writing to Rainbow/PUSH Coalition National Headquarters, 930 E. 50th St., Chicago IL 60615, or by calling (773) 373-3366.

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*.

Chairman
Bruce A. Morrison

Editor/Writer
Dennis O. McGee