

Whose Interests Do FHLBank Directors Represent?

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Mr. Chairman and members of the Federal Housing Finance Board:

I am pleased to have this opportunity to testify this morning, and to discuss with the Board the fiduciary duties of the directors of the Federal Home Loan Banks—what they are and to what purpose they should be directed. This issue seems to me to be particularly relevant as the Board considers reforms in the corporate governance rules applicable to the FHLBanks.

From the inception of the Federal Home Loan Bank system in 1932, the boards of directors of the FHLBanks have been divided into elected and appointed classes. The Federal Home Loan Bank Act (the Act) initially specified that elected directors were to “represent” certain groups of member institutions, while directors appointed by the Federal Home Loan Bank Board or its successor, the Federal Housing Finance Board (FHFB), were not designated as representing any group. Over the years, Congress has gradually increased the number of appointed directors so that they now comprise six of the 14 board members, and redesignated the elected directors so that they are now said to “represent” the member institutions in the various states within an FHLB district. In 1989, in the last major change, Congress specified that two of the six appointed members should “represent” consumer or community interests.

In effect, then, there are three classes of directors on the Bank boards: (i) directors elected to represent the institutions in their respective states; (ii) appointed directors who are not designated as representing anyone; and (iii) appointed directors who represent consumer and community groups.

Although the Federal Home Loan Bank Act speaks in terms of elected directors “representing” groups, this language should not in my view be taken to mean that an individual director’s decisions—as a director—are to reflect the interests of the group that he or she is deemed to represent. This is because the Act also contains language that applies standard corporate law concepts to the FHLBanks, and in corporate law the directors of a corporation owe a duty of loyalty to the corporation that transcends their role as representatives of any individual or group.

In an ordinary business corporation, for example, a majority shareholder may elect all the directors, but those directors are not permitted to act in such a way as to harm the interests of the minority shareholders. The directors are deemed to have fiduciary duties to the minority shareholders which they discharge by acting in the best interests of

the corporation itself, irrespective of the specific interests of the majority shareholder. In effect, all the directors must act in the interests of the corporation as an entity, and those interests are seen as distinct from the majority shareholder or shareholders, and from the interests of any other shareholder or group of shareholders.

What does this say about whose interests are to be served in managing the FHLBanks?

First, according to the statute, the FHLBanks are corporate bodies—i.e., they have perpetual life even though their members will change. This points up the fact that a corporation has a legal existence that is distinct from the existence of its members.

Second, the Act says that the management of the Banks is “vested” in the directors. This is very much like an ordinary business corporation, where the board of directors is charged with the management of the corporation, even though this function is in effect delegated to professional managers.

Third, and most important, since the inception of the Act section 7 has made it clear that the directors—like the directors of an ordinary business corporation—are to act on behalf of the FHLBank and not in the interests of any member. The board, says the Act, [1] “shall administer the affairs of the bank fairly and impartially and *without discrimination in favor of or against any member*, and [2] shall...extend to each institution authorized to secure advances such advances as may be made *safely and reasonably with due regard for the claims and demands of other institutions*, and with due regard for [3] *the maintenance of adequate credit standing for the Federal Home Loan Bank and its obligations.*” [emphasis supplied]

This is the only language that spells out the duties of FHLB directors, and it makes no distinction between elected and appointed directors. Moreover, it emphasizes in three separate places that the interests of the FHLBank are distinct from and are to be preferred over the interests of the individual members. First, it prohibits discrimination in favor of or against any member, indicating that no representative of a member or group of members may act to prefer the interests of those it represents over the interests of any other member or group. Second, it requires that advances to any member or group of members be made only in a manner that is consistent with the safety of the FHLBank and the claims of other members. And third, it requires that all advances be made with due regard for the credit standing of the FHLBank, again emphasizing that it is the FHLBank and not the members that should be the focus of the directors’ attention.

Thus, the directors of the FHLBanks—including the elected directors and those appointed to represent various interests—are fiduciaries for the member institutions in just the same way that directors of ordinary business corporations are fiduciaries for shareholders. The fiduciary obligations of the directors of a business corporation are discharged by taking steps to assure that the corporation operates profitably and creates value for the shareholders, and the fiduciary obligations of FHLBank directors are discharged when the directors take steps to assure that the FHLBank acts in the most efficient and effective way to perform its mission—a matter I will discuss later.

Directors of financial institutions that are very similar to FHLBanks are subject to similar standards. In a Guide for Directors Responsibilities issued by the Office of Thrift Supervision in 1999, the directors of federally chartered savings and loan associations—many of which are mutual organizations that are similar in structure to the cooperative form of the FHLBanks—are charged with the following duties:

As a fiduciary, you must think and act independently and in the best interests of the association. When acting in an official capacity, your personal interests and those of your family and associates must be subordinate to the best interests of the association....You have fiduciary duties of care, loyalty and candor to your association. These duties override your obligations as a director of a holding company or other affiliate.

Savings and loan associations, of course, are business corporations, so the duty of directors is reasonably clear: the directors serve the interests of all the shareholders by managing the corporation so as to increase its profitability—economic profit being the reason why the members or shareholders of the association have become affiliated in that capacity.

But the FHLBs are cooperative organizations; their purpose is not strictly to increase profitability. This raises a question about how the fiduciary obligations of FHLBank directors are to be discharged. If simple profitability is not the standard, what standard should FHLBank directors use?

In this connection, it is important to note that when the directors of savings and loan associations or ordinary business corporations attempt to assure that their institutions are operating profitably they are fulfilling the *purposes* of their respective organizations.

What, then, is the purpose of the FHLBanks? Most cooperative organizations exist solely to serve the needs of the members, so it would be logical to conclude that the directors of the FHLBanks fulfill their fiduciary duties when they manage the Banks in such a way as to most efficiently and effectively serve the needs of the member institutions. However, in the case of the FHLBanks, this seems not to be entirely true.

Under the statutory scheme established by the Act, the Home Loan Bank Board, the predecessor of the FHFB, was the first entity created and was given authority by Congress to create the districts and FHLBs themselves. This is very important to an analysis of the question of how the directors of the FHLBs are supposed to manage the FHLBanks. The fact that the FHLBanks were created by the Board, rather than the FHLBanks and the Board being created simultaneously—or the FHLBanks created first and the Board created later to regulate them—has significant implications.

Among other things, it means that the members of the FHLBanks did not create the FHLBanks to serve their interests, and are not the successors to anyone who did. In reality, the Banks were created by a government agency under authority from Congress, to perform a *government mission*. They were not created to serve the needs of the

member institutions, except insofar as those needs are consistent with the FHLBanks' government mission.

Although that mission is not described in the statute, we know generally what it is—to provide financing for residential housing by making that financing available to member institutions.

Thus, in any case where there is tension between the *mission* of the FHLBanks and the *interests of the members* of the FHLBanks, the directors would appear to have a duty to vote in favor of the mission. And this is true even if that is not necessarily in the interests of the members whom the elected directors are supposed to represent.

As an example, if there were before an FHLBank board a proposal that would be costly to the members—say, by increasing the Bank's costs—but would materially improve the Banks' mission, the elected directors, who in principle represent the members, would nevertheless be obligated in my view to approve it, even if that approval were inconsistent with the interests of the member institutions. The mission of the Banks takes precedence. It is, in effect, a higher duty than the interests of the member institutions, even though the Federal Home Loan Bank system is an enterprise that is structured in cooperative form. This would certainly be true for the directors appointed by the Board, but it would also be true for the directors who are supposed to represent consumers or community groups.

What, then, did Congress mean when it provided in the Act that certain directors should “represent” various interests? This is a difficult question, but not an unusual one. It comes up in the context of a business corporation quite frequently, and I mentioned it in passing earlier in this testimony. The directors of a business corporation have a fiduciary duty of loyalty to the corporation, even though all of them might have been elected by a single majority shareholder. In a case where there are minority shareholders, these directors are not relieved of their duty of loyalty to the corporation in order to pursue the interests of the majority shareholder; they must discharge their duty of loyalty by managing the corporation in such a way as to enable it to fulfill its profit-making mission. In this way, they serve the interests of the minority as well as the majority shareholders.

In the case of the FHLBanks, this inherent conflict is resolved by interpreting the term “represent” to describe the process of bringing a particular perspective or expertise to the attention of the board when it deliberates about a proposed course of action. Thus, Congress wanted certain expertise or perspectives to be represented on the boards of directors of the FHLBanks, but did not intend that the director's ultimate duty of loyalty to the corporation be in any way impaired.

That concludes my testimony, Mr. Chairman.