EMBARGOED
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Testimony
of
Jonathan L. Fiechter, Acting Director
Office of Thrift Supervision

concerning the

Federal Home Loan Bank System

before the

Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises
United States House of Representatives

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Office of Thrift Supervision
Department of the Treasury

1700 G Street N.W.
Washington D.C. 20552
202•906•6288

SUMMARY OF TESTIMONY

In your letter of invitation, Mr. Chairman, you asked that we address your specific questions, and indicated that we should feel free to address the general subject of Bank System reform.

Questions in the Invitation Letter

A. Do institutions investing in FHLBank structured debt understand the market risk associated with the instruments? How are you monitoring the exposure?

- The OTS collects detailed information on the dollar volume and interest rate sensitivity of structured debt held by savings associations. These data are used by OTS, in conjunction with an internal OTS interest rate risk model (the OTS Net Portfolio Value Model), to monitor the interest rate risk exposure of savings associations.

- OTS examiners also carefully review the securities holdings of savings associations during the course of on-site examinations and the internal processes followed by the institution in deciding to purchase the notes.

- Since instituting these supervisory measures, the OTS has not encountered any systemic problems regarding savings association investments in structured debt.

B. Does the existence of the Federal Home Loan Bank System increase the amount of total dollars available for housing?

- We believe that Bank System advances do, in fact, enhance the availability of housing credit for three reasons:

  -- advances provide a low-cost and readily available source of funds;
  -- the variety of maturities available on Bank System advances provides members with greater flexibility in managing their interest rate risk; and
  -- Bank System advances provide funding for nontraditional mortgage loans.

C. Do smaller depository institutions generally need access to the intermediate and longer-term liabilities provided by the Bank System?

- Yes, these options are especially important for small institutions. These advances enable members to manage interest rate risk without having to engage in more sophisticated hedging transactions. In this manner, the Bank System provides a vital service to lenders particularly sensitive to fluctuations in interest rates.

D. **It has been said that Bank System advances allow smaller, well-capitalized banks to leverage up their balance sheets.**

- If an institution remains well capitalized and grows wisely, then its strategy is consistent with prudent business practices. There have been instances, however, in which institutions have grown their balance sheets imprudently. The very real problems raised by such a strategy are not directly related to the source of funding such growth. Other forms of financing may also be misused in the same manner.

E. **Do you see a reliance on the system for liquidity as a positive development for smaller insured depository institutions?**

- Over 3,400 commercial banks have joined the Bank System since 1989. Most of these institutions are small, averaging only $325 million in total assets as of March 1995. These data suggest that the Bank System is viewed as a significant benefit by small institutions.

- Although many of these institutions are members of the Federal Reserve System and have access to its discount window, dual membership in the Federal Home Loan Banks provides longer-term funding sources to support mortgage lending.

Bank System Reform

As a result of the changes made to the Bank System by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") and the Competitive Equality Banking Act of 1987 ("CEBA"), the System faces a number of challenges. The costs imposed on the Bank System by FIRREA and CEBA have reduced System income and have created an incentive for the Bank System to seek new and higher-yielding products and investments. This has increased the risk in the System and has raised questions about its purpose. In addition, differences in the terms governing membership and advances for savings associations and other institutions have effectively created two distinct classes of members with the potential for different investment objectives and different levels of risk exposure. This tension among members, conflicting demands on management, raise questions of fairness and need to be addressed in the near term. In light of these difficulties, the OTS strongly supports Bank System restructuring and modernization.

I. Introduction

Good morning, Chairman Baker and members of the Subcommittee. Thank you for the opportunity to participate in this oversight hearing on the Federal Home Loan Bank System ("Bank System"). Mr. Chairman, I commend you for your continuing leadership on Bank System issues. The views I express today are those of the Office of Thrift Supervision ("OTS") and not necessarily those of the Administration.

As the regulator of savings associations, the OTS has a vital interest in the Bank System. Federal and state savings associations hold over $7 billion in Bank System capital stock. This represents more than half of all Bank System stock. For most savings associations, Bank System stock is their single largest investment. It currently constitutes 12% of savings associations' capital. Savings associations are also the Bank System's biggest customers, holding almost $76.4 billion, or nearly two-thirds, of total System advances. Thus, the operations and continued health of the Bank System are of great interest to institutions regulated by the OTS.

In your letter of invitation, Mr. Chairman, you asked that we address six specific questions, and indicated that we should also feel free to address the general subject of Bank System reform. In my testimony today, I will first address your six questions and then comment briefly on Bank System reform.

II. Questions In The Invitation Letter

A. Government sponsored enterprises ("GSEs"), such as the Federal Home Loan Banks, have issued derivative/structured debt, such as inverse floaters, which have been bought by institutions that you regulate. Do such institutions investing in the debt understand the market risk associated with the instruments? How are you monitoring the exposure to insured depository institutions of the debt issued by the GSEs?

The OTS has taken a variety of steps designed to improve the understanding by management of savings associations of the risks presented by structured debt and other complicated financial instruments. We also monitor the exposure of thrifts under our supervision to this type of instrument.

On August 15, 1994, the OTS issued Thrift Bulletin 65, Structured Notes, which provides guidelines to be followed by savings associations considering an investment in structured debt. The bulletin contains straightforward investment advice, including the admonition that institutions should carefully review and understand the terms and provisions of such debt prior to purchase. The bulletin also requires institutions to conduct a sensitivity analysis, or stress test, of structured debt instruments prior to purchase so that they have a clear understanding of the risk and return characteristics of the instruments.

As part of our monitoring program, the OTS also collects detailed information every three months on the dollar volume and interest rate sensitivity of structured debt and derivatives held by savings associations on Schedule CMR of the Thrift Financial Report. These data are used by OTS, in conjunction with an internal OTS interest rate risk model (the OTS Net Portfolio Value Model), to monitor the interest rate risk exposure of savings associations. The OTS shares the results of its interest rate risk testing with management of the savings associations on a quarterly basis. In addition to computer-based monitoring and surveillance, OTS examiners also carefully review the securities holdings of savings associations during the course of on-site examinations and the internal processes followed by the institution in deciding to purchase the notes.

When structured debt was a relatively new product, several OTS-regulated institutions made investments of a type or in an amount that OTS considered inappropriate, largely because the institutions did not fully understand the characteristics of the product. Since the issuance of Thrift Bulletin 65 and the institution of our reporting system for structured debt, however, the OTS has not encountered any systemic problems regarding savings association investments in structured debt.

B. Does the existence of the Federal Home Loan Bank System increase the amount of total dollars available for housing?

As of June 30, 1995, Bank System advances totaled $119 billion. We are unaware of any hard data on the marginal effect of these advances on the flow of credit to housing markets. Nonetheless, we believe that Bank System advances do, in fact, enhance the availability of housing credit. Member institutions have a variety of sources available to fund mortgage loans, including insured deposits, reverse repurchase agreements and the secondary mortgage market. Bank System advances, however, offer at least three distinct advantages not available through these alternative sources of funding.

First, advances provide a low-cost and readily available source of funds. The overall cost of advances is often comparable to the overall cost of deposits once deposit insurance premiums and operating costs required to maintain branches are factored in. The cost of advances compares favorably to alternative sources of wholesale funding, such as reverse repurchase agreements and financings obtained through correspondent relationships. To the extent that advances provide a lower-cost source of funding, they enhance the profitability (and, thus, financial condition) of member institutions and enable them to offer loan products to the public at lower rates.

Second, the variety of maturities available on Bank System advances provides Bank System members with greater flexibility in managing their interest rate risk when funding their mortgage activities. It reduces pressure on institutions to engage in sophisticated hedging strategies. Approximately 60% of all Bank System advances are intermediate or long-term advances. It would be difficult to replicate these liabilities outside the Bank System. The availability of these longer-term maturities enhances the appeal of originating and holding long-term mortgages.

Third, Bank System advances may provide funding for nontraditional mortgage loans that could not easily be sold into the secondary market. Loans in this category might include those designed for low- and moderate-income households. At least one survey conducted several years ago indicated that almost half of all loans held in portfolio by savings associations were loans that were not typically securitizable. Bank System advances provide an important source of funding for these types of loans, particularly in areas of high loan demand and scarce insured deposit inflows.

Our present system of community-based portfolio lenders is, I believe, advantageous to the U.S. economy and our housing markets. Most thrift institutions tend to be small community-based lenders. The median size of OTS-regulated thrifts is just over $100 million.

As part of their ongoing business, community-based portfolio lenders acquire specialized knowledge of the creditworthiness of their customers. As a result, they are able to make credit decisions and establish terms and conditions on loans based on a history of having worked with their borrowers and their knowledge of the borrowers' unique needs. While these loans might not meet national standards required for securitization, they remain an important component of the financial system. Access to Bank System advances provides an important source of liquidity to institutions holding such non-conventional loans in their portfolio.

C. What if the available collateral to support advances from the Bank System included other types of government-related collateral, e.g., FHA, SBA, and Sallie Mae?

Under current law, members can pledge whole first residential mortgages, deposits at a Federal Home Loan Bank, Treasury (or agency) securities, and "other real estate" as collateral for advances. Other real estate collateral can be either residential or commercial, but must have a readily ascertainable market value. Advances secured by other real estate collateral cannot exceed 30% of a member's capital.

The Farmers' Home Administration ("FHA"), the Small Business Administration ("SBA"), and the Student Loan Marketing Association ("Sallie Mae") all have statutory authority to guarantee loans to their particular constituents. Guarantees issued by Sallie Mae typically cover the entire principal amount of the loans to which they apply. By contrast, FHA and SBA guarantees are typically capped at 90% of principal. Clearly, the guaranteed portion of any of these loans poses no credit risk to the originating institution or to the Bank System. Moreover, the credit risk presented by the nonguaranteed portion of these loans can be mitigated if adequately secured by other forms of collateral. If these loans were added to the list of acceptable collateral, the Federal Housing Finance Board ("FHFB") would presumably promulgate implementing regulations requiring the unguaranteed portion of the loans to be covered by adequate collateral. Under these circumstances, allowing FHA, SBA, and Sallie Mae guaranteed loans to be offered as collateral for Bank System advances would not appear to present safety and soundness concerns.

The fundamental issue raised by the question relates to whether the nature of funding provided by the Bank System should be broadened beyond residential mortgage lending to support other types of lending. As of June 30, 1995, Bank System members held about $2 trillion in assets of which about half were residential mortgage loans. By contrast, members held only about $119 billion in advances. Thus, for most Bank System members, there appears to be no shortage of qualified collateral.

Some commercial banks that are Bank System members may not hold substantial portfolios of mortgage loans and other qualifying collateral but may hold significant amounts of FHA, SBA, and Sallie Mae loans. If the decision were made to expand the list of qualifying collateral to include these loans, it would be logical to modify the Bank System rules that restrict the purposes for which advances can be used. Changing the System's mission away from a focus on residential mortgage financing, however, raises policy issues that might more appropriately be addressed by the Administration and the Congress. The OTS concern would relate only to ensuring that any modification does not adversely affect the performance and capital position of institutions supervised by OTS.

D. Do smaller, i.e., less than $250 million in assets, insured depository institutions generally need access to the intermediate and longer-term liabilities which can be provided by the Bank System?

Smaller institutions generally have fewer wholesale funding options than larger institutions; most importantly, they do not have ongoing access to the domestic and international capital markets. As a result, the funding flexibility provided by Bank System advances may be of particular value to smaller institutions.

Intermediate and long-term Bank System advances provide Bank System members with important options for managing interest rate risk. These options are especially important for small institutions. Large institutions may have the technical expertise and resources that enable them to engage in sophisticated hedging strategies. Few small institutions have these resources. Moreover, small institutions have a tendency to hold a significant amount of long-term fixed-rate mortgages in their portfolios funded by short-term liabilities -- a position that exposes them to potentially greater interest rate risk.

One way to mitigate this risk is to use a liability that better matches the duration of the loans. Intermediate and long-term Bank System advances can be used in this manner. As already noted above, the capital markets do not offer small institutions a low-cost alternative source of intermediate- and long-term funding.

The Federal Home Loan Banks also help their members reduce interest rate risk by intermediating interest rate swap transactions between their members and third parties. Interest rate swaps allow institutions to reduce their interest rate risk exposure by exchanging the interest payments on short- and long-term financial instruments. Thus, institutions that are exposed to interest rate risk from long-term fixed-rate mortgages held in portfolio may be able to swap the interest payments received from their loans for a variable-rate payment stream owned by a counterparty, thereby enabling institutions to hedge their balance sheets.

Thus, both through intermediate and longer-term advances and by intermediating interest rate swap transactions, the Bank System provides an important service to lenders particularly sensitive to fluctuations in interest rates.

E. It has been said that Bank System advances allow smaller, well-capitalized banks to leverage up their balance sheets. Do you see instances of this happening and how are you monitoring the situation?

Small institutions sometimes find themselves with capital well in excess of both regulatory requirements and, more importantly, what they need to operate their business prudently. In an effort to increase their return on equity, an overcapitalized institution may seek to grow its assets rather than return some portion of the excess capital to its owners. If the institution remains well capitalized and grows wisely, then its strategy is consistent with prudent business practices.

There have been instances, however, in which institutions have grown their balance sheets imprudently. Institutions may have sought to expand their loan growth by lowering credit standards and documentation requirements. Others may have purchased mortgage-backed securities ("MBSs") or collateralized mortgage obligations ("CMOs") and other securities in a manner that increased their interest rate risk exposure.

The very real problems raised by such a strategy, however, are not directly related to the source of funding such growth. While OTS examiners monitor the rapid growth of any portion of the balance sheet, I am not aware of any systemic problem in the industry we supervise that is directly linked to Bank System advances.

F. Many insured depository institutions have joined a Federal Home Loan Bank to gain access to the liquidity provided by the System. Do you see this reliance on the system for liquidity as a positive development for smaller insured depository institutions?

Advances offer member institutions a readily accessible, convenient, and low-cost source of funding. As noted in the answer to question B., access to System advances allows institutions to originate and hold long-term mortgage loans that can be used as collateral against advances but might not be easily securitized.

Over 3,400 commercial banks have joined the Bank System since 1989. Most of these institutions are small, averaging only $325 million in total assets as of March 1995. These data suggest that the Bank System is viewed as a significant benefit by small institutions. Although many of these institutions are members of the Federal Reserve System and have access to its discount window, dual membership in the Federal Home Loan Banks provides longer-term funding sources to support mortgage lending.

III. Bank System Reform

I will now turn briefly to the subject of Bank System reform.

In recent years, most observers -- including the Federal Housing Finance Board, the Treasury Department, the Department of Housing and Urban Development, the Federal Home Loan Banks, and most members of the Banks -- have concluded that the Bank System should be reformed. Most of the issues driving the call for reform arise out of changes made to the Bank System by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") and the Competitive Equality Banking Act of 1987 ("CEBA").

Because thrifts comprised virtually all of the membership of the Bank System prior to FIRREA, Congress looked to the Bank System as a source of funds to cover a portion of the costs of the thrift crisis in the 1980s. When CEBA was enacted in 1987, $680 million in Bank System retained earnings were used to cover start-up costs for the Financing Corporation ("FICO"). (FICO was created to issue bonds to fund the former Federal Savings and Loan Insurance Corporation.) When FIRREA was enacted in 1989, another $2.5 billion of Bank System retained earnings were used to fund start-up costs for the Resolution Funding Corporation ("REFCORP"). (REFCORP was created to issue bonds to provide funding to the Resolution Trust Corporation.)

FIRREA also imposed two additional levies on the Bank System. First, the Banks must pay $300 million annually to cover interest payments on bonds issued by REFCORP. Second, they must contribute the greater of $100 million or 10% of net income annually into a FIRREA-mandated Affordable Housing Program ("AHP").

FIRREA authorized commercial banks to become members of the Bank System. This has also placed stress on the System because different standards apply to different member depository institutions. Key differences include:

- Federally chartered thrift institutions are required to be members of the Bank System and cannot withdraw. By contrast, membership for commercial banks and state-chartered institutions is voluntary.

- Commercial banks and FDIC-regulated thrifts that hold as little as 10% of their assets in mortgage-related investments can join the Bank System, whereas federal and state savings associations are required to meet the statutory Qualified Thrift Lender ("QTL") test. This effectively requires a minimum mortgage investment by OTS-regulated thrifts that is many times higher than the level specified for banks and FDIC-regulated thrifts.

- Savings associations generally must acquire far more Bank System stock (as a percentage of total assets) than other institutions to become members of the Bank System. This results from the formula governing the amount of Bank System stock that members must hold, which is tied primarily to an institution's level of mortgage loans.

- Institutions that are not QTL lenders, however, are generally subject to additional stock purchase requirements if they draw down a substantial amount of advances. Thus, heavy users of advances that are not QTL lenders can end up purchasing more stock than QTL lenders.

- The Federal Home Loan Banks are required to give priority to making advances to QTL lenders. Moreover, the aggregate advances of any Federal Home Loan Bank to non-QTL lenders may not exceed 30% of the Federal Home Loan Bank's total advances.

- The prescribed formula for determining each Federal Home Loan Bank's share of the Bank System's annual $300 million contribution to REFCORP consists of two prongs. Under the first prong, each Bank must first pay up to 20% of its annual net income. The second prong is computed on the basis of the twelve Banks' average outstanding advances to members insured by the Savings Association Insurance Fund ("SAIF"), i.e., primarily savings associations. Thus, Banks that lend heavily to savings associations may pay a higher proportion of their income to REFCORP.

As a result of the changes made to the Bank System by FIRREA and CEBA, the System faces a number of challenges. The demand for traditional System advances from thrift institutions has fallen since the late 1980s. The costs imposed on the Bank System by FIRREA and CEBA have reduced System income. This has created an incentive for the various Federal Home Loan Banks to seek new and higher-yielding products and investments. This has increased the risk in the System and has raised questions about the purpose of the System and how to ensure adequate capitalization and safety and soundness. In addition, the differences in the terms governing membership and advances for savings associations and other institutions have effectively created two distinct classes of members with the potential for different investment objectives and different levels of risk exposure. This creates tension among members, conflicting demands on management, and raises questions of fairness.

In light of these difficulties, the OTS strongly supports Bank System restructuring and modernization. The housing finance system has undergone dramatic restructuring over the last two decades and the structure and operations of the Bank System should reflect these changes. Earlier this year, Mr. Chairman, you and the Treasury Department released reform bills that were quite similar in substance. These bills provide a solid basis for Bank System reform. As this Subcommittee moves forward in the reform process, the OTS stands ready to work with you.

Thank you.