Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

2011 Federal Home Loan Banks Directors Conference
Washington, DC
May 11, 2011

The Franchise Value of Federal Home Loan Banks

Introduction

Thank you for inviting me to speak today as part of the annual conference of the Directors of the 12 Federal Home Loan Banks (FHLBanks) and the Office of Finance.

Today I would like to review some of the issues I discussed last year regarding the role of the FHLBank System and the benefits of FHLBank membership. Then I would like to discuss how those issues, along with other changes in the business environment the FHLBanks are operating under, impact an evaluation of the franchise value of individual FHLBanks. Finally, I will review a number of public policy issues that also could have an impact on franchise value. As members of the Board and management of an FHLBank, you each have a vitally important role in evaluating these issues as you set the direction of your FHLBank and the System.

The Role of the FHLBank System and Benefits to Members

Last year I focused on the critical role of the FHLBank System in providing liquidity and other benefits to FHLBank members. The primary benefit of FHLBank System membership is access to a stable and reliable source of funds at attractive rates across the maturity spectrum. To access this funding source, FHLBank members must purchase stock from their FHLBank and be able to secure borrowings with eligible collateral.

Conceptually, a membership stock purchase requirement is a cost of joining the cooperative and obtaining access to member services, principally funding. Those stock purchases must be adequate to capitalize the assets needed to operate an FHLBank. To a degree, this arrangement is similar to obtaining a line of credit with a lender, which typically involves the payment of a commitment fee. For FHLBank membership, that commitment fee is essentially the earnings foregone by acquiring membership capital stock instead of putting those funds to some alternative use. Likewise, as advance usage increases, the additional FHLBank stock serves as a compensating balance that reflects the additional cost of making use of a line of credit.

Overall, whether it is a line of credit or access to FHLBank advances, the advantage of access to liquidity from their FHLBank allows members to hold fewer liquid assets than would otherwise be the case. In turn, this benefit is part of the return on a member's FHLBank stock investment.

In addition to these benefits, members also earn a dividend on their FHLBank stock. For member institutions that secure advances from their FHLBank, the payment of a dividend reduces the cost of the advances by offsetting the foregone earnings associated with FHLBank stock purchases. However, even with no dividend, access to a reliable liquidity facility like the advances window would be hard to replicate in a purely commercial setting.

In a cooperative structure like the FHLBanks, however, there is inevitably a trade-off between the interest rates charged on advances and the dividends paid to holders of FHLBank stock. If for the moment we ignore FHLBank investments and focus just on the income generating capacity of an FHLBank's advances business, the only way to generate dividends for members would be to charge members rates on advances that exceed the cost of funds and related expenses. In this simple FHLBank structure, benefits flow to members of the cooperative through two channels, advance rates and dividends.

Whatever the trade-off, as I stated last year, making advances is central to an FHLBank's business, but investments intended to arbitrage the FHLBanks' funding advantages are not. That issue has not receded with the passage of time. As of the end of the first quarter of this year, System-wide investments constituted 38.7 percent of total FHLBank assets. Advances, at 52.4 percent of assets, barely exceeded half the System's combined assets. At six FHLBanks, investments exceeded 40 percent of assets, and at four of those FHLBanks, investments exceeded advances. This is not a sustainable operating condition for an FHLBank.

The purpose of those investment portfolios and their effects on an FHLBank's condition and performance are fundamental questions that we all must consider. Looking back on history, two basic lessons stand out for me. First, the FHLBanks' various financial problems of the past 20 years have not come from the traditional advances business. Instead, investments and mortgage purchase programs have been the source of deterioration in the financial condition of some FHLBanks.

Second, a large investment portfolio intended to generate added earnings is inconsistent with the purposes of the FHLBank System and is a misuse of the System's preferential access to capital markets. As was the case prior to 1990, investments should be limited to those necessary to ensure sufficient liquidity and to otherwise support an FHLBank's core advances business.

Today, I would like to build on last year's discussion of the benefits of System membership to focus on questions of FHLBank franchise value and the role of the FHLBanks' boards of directors in helping their members realize the value of System membership.

Some General Thoughts on FHLBank Franchise Value

Thinking about franchise value in the context of an FHLBank is different than the standard process for other companies.

Typically, franchise value for a private sector company would be the discounted present value of the company's future earnings stream. This is a relatively standard valuation methodology, with the value typically reflected in the market price for a private-sector company.

In contrast, an equity investment in an FHLBank is different. The FHLBanks are organized as cooperatives for which stock is purchased and redeemed at par. This model, in most cases, does not lead directly to a focus on the market price of stock as for other private-sector companies. Given that FHLBank stock does not have a market price, future earnings prospects do not directly impact the price of FHLBank stock. This is certainly the case if future earnings prospects are good, but as we have seen, also if future earnings prospects are poor. However, the ability of an FHLBank to redeem and repurchase stock is affected if its financial condition deteriorates, which could raise questions about the par value of stock.

Even with those differences derived from being a cooperative, an FHLBank still must be concerned with a basic franchise value proposition. To maintain franchise value, an FHLBank must be able to deliver the benefits of System membership to its members. Those benefits, along with the FHLBank's franchise value, will fall short of their potential unless the FHLBank can satisfy several minimum conditions.

First, it is able to cover its operating costs and maintain adequate capital.

Second, it is able to price advances competitively in comparison to other funding sources.

Third, it is able to achieve the first two conditions without an over-reliance on investments.

Fourth, it is able to operate in a normal fashion consistent with board-approved policies. This includes providing advances on demand to support members' housing finance and community development activities at competitive rates and then repurchasing activity-based stock at par. Inherent in normal operations is the self-liquidating structure of an FHLBank's balance sheet.

Why is this all important?

As we have seen, advances, which should be the primary source of income to an FHLBank, have declined dramatically in recent years. At the System-level, advances reached a peak of just over $1 trillion in September and October of 2008, but they have since declined by 55 percent to $445 billion, a level that was last reached in the year 2000. For some individual FHLBanks the decline has even been more significant.

While the recent decline in advances can be attributed to the combination of weak loan demand, the expanded supply of other funding sources, and the failure of member banks and thrifts, other factors could impact the demand for advance funding in the years ahead. For example, the

Federal Deposit Insurance Corporation recently announced changes in deposit insurance pricing that could have a negative impact on the future demand for advances. In addition, other potential legislative and market developments, such as restrictions on FHLBank activities or the development of a covered bond market, could adversely affect future advance demand.

In addition, advance volume at an FHLBank is directly related to the Bank's membership base. Consolidation of depository institutions has reduced the FHLBank membership base and altered borrowing patterns across the System. While overall advance volume has decreased substantially, uneven consolidation of FHLBank members across the System has affected some FHLBanks more than others. FHLBanks that had relied heavily on certain large member institutions that either failed or no longer do business in their FHLBank due to a merger or consolidation were particularly affected.

So I propose that the basic long-run franchise value question for an FHLBank to consider is simply this: How can an FHLBank maximize the effectiveness and efficiency with which its members realize the benefits of System membership, given the uncertainties surrounding the future demand for advances and the future size of its membership base? As I have argued here and before, these benefits should be provided to members following a business model that predominantly focuses on advance lending, not investment returns.

I do not subscribe to the view that FHLBanks today need a greater share on non-advance assets than in the past. The System operated for decades focused just on advances. Some of the FHLBanks today operating closest to the model I have just described are, in fact, among the strongest and best performing FHLBanks in the System.

I would also like to emphasize that the consideration of this basic franchise value question does not mean that relatively small FHLBanks cannot exist. They can. But it does mean that a board of directors must understand what is necessary for a small FHLBank to operate profitably. For example, the board must understand how to price advances such that they generate the required yield. Moreover, a relatively small FHLBank has to carefully control costs and may have to charge higher advance rates or offer members more limited dividends to maintain value. These are fundamental choices that some of you may have to consider.

Boards of Directors, Franchise Value, and Corporate Governance

One of the noteworthy enhancements in the FHLBank System in recent years has been the strengthened quality of the boards of directors. With a new approach to selecting independent directors, which has enhanced the skill portfolio of their boards, combined with an increased emphasis on corporate governance brought by both independent and member directors, FHFA has found improved board governance across the System.

As most of you here are FHLBank board members, I would like to speak directly to the critical role you play in addressing the issues I have just presented.

Each FHLBank Board has a fundamental responsibility to chart a course for its FHLBank that best serves the interests of its members in realizing the benefits of FHLBank membership. The board is there to ensure the FHLBank serves the members, not itself.

From a safety and soundness perspective, each board should ensure that its FHLBank:

- Has sound risk management practices, including appropriate risk limits and independent reporting to the board from an internal auditor and preferably an enterprise risk officer;
- Ensures compliance with laws and regulations; and
- Establishes and follows a retained earnings policy and capital structure and capital targets appropriate for its size, risk policies, membership structure, and so on.

Each board is responsible for ensuring that the board itself has the mix of skills and backgrounds to best represent the district's members and housing needs as well as the skills needed to exercise appropriate oversight of the FHLBank's policies and risk management.

In considering the issues of franchise value I just reviewed, each board needs to continually evaluate the optimal means of delivering the benefits of FHLBank membership – to maximize the efficiency and minimize the costs of FHLBank operations. Questions your board should be asking include:

- Is each product and service or operation offered consistent with the board's strategic goals or even needed to support those goals, and is it consistent with the Federal Home Loan Bank Act?
- Are new services or operations required to better realize the core purpose of the FHLBank System?
- Is a particular service or operation best provided in-house, or from another FHLBank, or from a third-party?
- Are the FHLBank's pricing and collateral management policies appropriate and applied fairly across the membership?
- Are the executive management and staff aligned with the board's goals and objectives?
- Is the executive compensation program in place aligned with the board's goals for the FHLBank, the best interest of its membership, and safe and sound operations?

A board should periodically assess the long-term prospects for its FHLBank – analyze the membership base and the outlook for its membership to grow or shrink. How reliant is the FHLBank on a few large members and what are the long-term prospects for those members and the likelihood they will continue to be the foundation for that FHLBank's efficient operations?

Another critical and core aspect of the FHLBanks is their support for community development and affordable housing through programs and special membership rules Congress established in support of those purposes. Boards should consider whether and how their FHLBank is focused on ensuring robust support for the System's affordable housing and community development programs and responsibilities.

In short, as FHLBank board members, you have a key role in helping to shape the future of your FHLBank and the FHLBank System. I know many of you are having such discussions, and I encourage them to continue.

To tie these important strategic issues back to the basic elements of corporate governance, answers to these challenging questions should also reflect prudent operational standards and adherence to meeting members' needs, while ensuring the FHLBank's policies and practices reflect the purpose and mission of the System.

V. Other FHLBank Issues

Before closing, let me touch on a few other topics of note.

The need for the FHLBanks to demonstrate that they are meeting a housing finance mission has also been noted by others. While the Administration's recent housing finance reform paper mostly focused on Fannie Mae and Freddie Mac, it also highlighted a number of FHLBank issues. The Administration's paper acknowledged the vital role played by the FHLBanks in providing liquidity and the enhanced regulatory oversight provided under the Housing and Economic Recovery Act. However, focusing on public policy issues, the Administration's paper suggested limiting an eligible financial institution's membership to a single FHLBank and limiting the level of advances by focusing the FHLBanks' activities on small- and medium-sized institutions. The Administration's paper also suggested, similar to what I discussed previously, that the FHLBanks' investment portfolios should be reduced and their composition altered to better meet the FHLBanks' mission.

An issue that FHFA has been moving forward is a rule for the voluntary merger of FHLBanks. We issued a Notice of Proposed Rulemaking on November 26, 2010 and expect to finalize the rule this year. However, as I noted earlier, a relatively small FHLBank can and should be able to exist in the future as long as the board and management can satisfy the conditions I set forth earlier in my remarks. Issuing this rule fulfills a statutory mandate and provides regulatory certainty with regard to the process. Whether voluntary mergers happen or not is, of course, up to the boards and their members.

FHFA is very supportive of the FHLBanks' System Voluntary Capital Initiative, which calls for each FHLBank to reserve 20 percent of its earnings in a restricted retained earnings account upon satisfaction of the System's obligation to the Resolution Funding Corporation. With the FHLBanks' payments under the Resolution Funding Corporation assessment scheduled to expire in the next few months, I commend the work of many in this room to come up with a plan that should help address the general shortage of retained earnings in the FHLBank System. At FHFA, we look forward to working with the FHLBanks to make the necessary changes to their capital plans to implement this Initiative.

The financing of FHLBank activities will also be changing. With the progression of changes required under the Dodd-Frank Act, many derivative contracts will be moving toward central clearing. This may have an impact on the cost of providing advances and on the franchise value questions I previously discussed. The central clearing of certain derivatives is a prudential matter, and we issued an Advisory Bulletin to further prepare for moving forward with this process where appropriate.

Finally, as board members, you have a responsibility to develop executive compensation packages that are appropriate and comparable to other similar financial institutions while recognizing an FHLBank, which operates with special government support, is a simpler, or less complex, entity than a similar-sized commercial bank. In addition, new executive compensation rules are in process to ensure that compensation packages do not lead to inappropriate risk taking. You all have a responsibility to develop compensation packages that meet the current and new standards. FHFA also has a responsibility to engage in a timely review of those packages and I understand we have fallen short on that score in some of these reviews. You have my commitment that we will work to improve the process on our end. But FHFA's timely review requires complete and soundly reasoned and documented packages from you and your board colleagues.

Conclusion

In closing, as I noted at the outset, you each have important roles in setting the future direction of your respective FHLBank and the System as a whole. At FHFA, we have a clear responsibility also, to see that the FHLBanks operate in a financially safe and sound manner, serve the needs of their members, and meet their public purposes.

To ensure the overall health of the FHLBank System and to continue providing benefits to members, we all -- board members, managers, and regulator -- have a responsibility to consider the basic franchise value proposition of an FHLBank. In considering that proposition, we should be mindful of the appropriate mix of FHLBank business activities and ensuring that the FHLBanks can operate normally in a world that is changing. I commit that FHFA will do its best to consider those issues, and I look forward to continued discussions with all of you as you do the same. Thank you.