ACTION: Notice.

SUMMARY: FEMA gives notice that the extension period for the Minnesota regular crisis counseling program for disaster survivors of Polk County is extended from 90 days to 180 days. The severity of the emotional trauma resulting from the floods warrants an extension of an additional 90 days.

EFFECTIVE DATE: April 16, 1998.

FOR FURTHER INFORMATION CONTACT: Diana Nordboe, Human Services Division, Response and Recovery Directorate, Federal Emergency Management Agency, 500 C Street SW., Washington, DC 20472, (202) 646–4026.

SUPPLEMENTARY INFORMATION: The Federal Emergency Management Agency (FEMA) is charged with coordinating Federal disaster assistance under the provisions of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the Act) when the President has declared a major disaster. FEMA provided funding for a regular crisis counseling program to help those suffering the trauma resulting from the April 1997 floods.

FEMA received a request from the State of Minnesota to extend the otherwise applicable time limitations authorized by section 416 of the Act, so that the State can provide additional mental health services that are critically needed for citizens during the recovery operation. The extent of the emotional impact on the citizens of Polk County is of such magnitude that continuation of disaster mental health counseling beyond the normal crisis counseling time period is necessary.

The Director, Center for Mental Health Services (CMHS), as the delegate to FEMA for the Secretary, Department of Health and Human Services, helps FEMA implement crisis counseling training and assistance. FEMA believes there was a well-established need for continuation of the regular crisis counseling program beyond a 90-day extension. Based upon the sound CMHS recommendation, FEMA has approved a 180-day extension to the time period for the Minnesota regular crisis counseling program in Polk County.

(Catalog of Federal Domestic Assistance No. 83.516, Disaster Assistance)

Lacy Suiter,

Executive Associate Director.

[FR Doc. 98–8804 Filed 4–2–98; 8:45 am]

BILLING CODE 6718–02–P–M

FEDERAL HOUSING FINANCE BOARD

Hearing on FHLBank Investment Practices and an Approach for Limiting Certain Non-Housing-Related Investments

AGENCY: Federal Housing Finance Board.

ACTION: Notice of public hearing.

SUMMARY: The Federal Housing Finance Board (Finance Board) is hereby announcing a public hearing on Federal Home Loan Bank (FHLBank) investment practices and an approach for limiting certain non-housing-related investments.

DATES: The public hearing will be held on May 11, 1998 beginning at 9:00 a.m.. Written requests to participate in the hearing must be received no later than Monday, April 13, 1998.

ADDRESSES: The hearing will be held at the Office of Thrift Supervision Amphitheater, 1700 G Street, N.W., Washington, D.C. 20552. Send requests to participate in the hearing, written statements, or other written comments to Elaine Baker, Executive Secretariat, Federal Housing Finance Board, 1777 F Street N.W., Washington, D.C. 20006. The submission may be mailed, hand delivered, or sent by facsimile transmission to (202) 408–2895. Submissions must be received by 5:00 p.m. on the day they are due in order to be considered by the Finance Board. Late, misaddressed, or misidentified submissions may affect eligibility to participate in the hearing.

FOR FURTHER INFORMATION CONTACT: Kerrie Ann Sullivan, External Affairs Specialist, at (202) 408–2515, or Christine M. Freidel, Associate Director, Office of Policy at (202) 408–2976, Federal Housing Finance Board, 1777 F Street, N.W., Washington, D.C. 20006

SUPPLEMENTARY INFORMATION: The Finance Board is interested in the views of System members, community groups, trade associations, federal or state agencies and departments, elected officials, and others on the implications of FHLBank investment practices for Finance Board investment policy. Specific questions that the Finance Board would like hearing participants to address and a Finance Board staff discussion paper follow:

Questions

(Question 1) Should the Finance Board limit FHLBank purchase of money market investments (MMI) beyond the level necessary for liquidity and cash management?

(Question 2) Should any limits on MMI apply to each FHLBank or to the FHLBank System? If a limit were applied to the System, should there be a mechanism allowing FHLBanks to trade the right to hold MMI beyond their pro-rata share of the System limit?

(Question 3) Could mission limits on FHLBank MMI affect the safe and sound operation of the FHLBanks? If so, how could such effects be mitigated?

(Question 4) The Finance Board is considering a definition of MMI that is total investments less mortgage and asset-backed securities and investments that support housing and targeted economic development. This definition includes fed funds, resale agreements, deposits, commercial paper, bank and thrift notes, bankers' acceptances, and U.S. government, U.S. government-guaranteed, and agency non-mortgage-backed securities (MBS) and asset-backed securities. Should all these assets be included in the definition of MMI?

(Question 5) What is the appropriate level of liquidity for the FHLBanks, taking into account their access to the government-sponsored enterprise (GSE) capital markets? Are the liquidity requirements in the Finance Board's Financial Management Policy (FMP) adequate? [1] If not, why not?

(Question 6) Are there circumstances where it is appropriate for the FHLBanks to hold MMI in levels greater than their liquidity and cash management needs?

(Question 7) What is the minimum appropriate level of advances as a percent of consolidated obligations (COs) and the maximum appropriate level of MMI funded with COs? Are there other approaches for limiting Bank MMI?

(Question 8) What should be the assumed spreads on MMI and MBS?

(Question 9) To what extent do MBS investments further the FHLBank System's housing finance mission? Should the FHLBanks be subject to additional MBS investment limitations?

(Question 10) How much of a decline in dividends would trigger a reassessment by voluntary members of

[1] The Federal Home Loan Bank Act requires each Bank to maintain an amount equal to the total deposits received from its members invested in: obligations of the United States; deposits in banks or trust companies (as defined in Finance Board regulation) which are eligible financial institutions; and advances that mature in 5 years or less to members. In addition, each Bank is required to maintain a daily average liquidity level each month in an amount not less than 20 percent of the sum of its daily average demand and overnight deposits and other overnight borrowings during the month, plus 10 percent of the sum of its daily average term deposits, COs and other borrowings that mature within one year. Certain money market investments authorized under the FMP may be used to satisfy the liquidity requirements.

the benefits of FHLBank System membership. How do institutions determine the minimum required return on FHLBank stock? What is an appropriate benchmark for FHLBank dividends and what is the minimum required spread over the benchmark?

(Question 11) Would FHLBank borrowing costs fall if CO issuance declined?

(Question 12) What is an appropriate transition rule for: (1) implementation of any new limits on FHLBank investment activity; and (2) FHLBanks that fall out of compliance due to situations such as merger activity and regional and cyclical downturns in advance demand?

(Question 13) What changes in interest rates and advances should be assumed to simulate the effects of investment limits during a cyclical economic downturn?

(Question 14) Should the FHLBank System's $300 million annual REFCorp payment be changed to a percentage of net income and should the Finance Board defer establishing limits on FHLBank money market investments until Congress has made such a change?

(Question 15) Should the FHLBanks be permitted to make a small amount of narrowly targeted investments in people and communities left behind, that would have credit quality significantly below the double-A level, and that might be more heavily weighted in evaluating the mission-related character of the overall portfolio?

Staff Analysis

Background

Prior to the thrift crisis and enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Pub. L. 101–73, 103 Stat. 183 (1989)), the assets on the Federal Home Loan Banks' (FHLBanks or Banks) balance sheets were predominantly advances. The Banks maintained relatively small investment portfolios, primarily for liquidity purposes.[2] For the period 1980 through 1988, Bank System advances represented, on average, about 84 percent of System assets, while total investments represented about 14 percent of assets.

Significant and rapid changes in the structure of the FHLBank System's balance sheet and its profitability occurred following the enactment of FIRREA in 1989. The legislation, among other things, required: (1) closure of failing thrift institutions that resulted in advance prepayments and stock redemptions; (2) new, higher statutory capital requirements for thrifts that caused many Bank System thrift members during the early 1990s to either reduce their asset size and prepay advances or to stop growing and reduce their demand for new advances; (3) transfer of $2.5 billion in FHLBank retained earnings to the Resolution Funding Corporation (REFCorp) to help pay for the cost of thrift resolutions;[3] (4) a $300 million annual payment toward interest on the REFCorp bonds; and (5) a payment, beginning in 1990, of the greater of five percent of net income or $50 million and increasing by steps to the greater of ten percent of net income or $100 million in 1995 and thereafter, to fund the newly-required Affordable Housing Program (AHP). One other important provision in FIRREA also allowed federally insured commercial banks with at least 10 percent of their assets in residential mortgage loans to join the Bank System. The changes that occurred in the Banks' assets, liabilities, net income and membership in the post-FIRREA period are shown in the attached graphs.

After growing steadily during the 1980s, Bank System advances peaked at $166.7 billion in April 1989 and then declined 15 percent to $142 billion at year-end 1989. The shrinkage continued for two years, with advances declining 18 percent in 1990 to $117 billion and then an additional 32 percent to $79 billion at year-end 1991. Beginning in 1989, the Banks began to replace repaid and prepaid advances with generally lower-yielding investments.[4] Investments doubled from 1988 to 1989 from $17 billion to $34 billion and more than quadrupled between 1988 and 1991 to $72 billion. By year-end 1991, advances comprised about 51 percent of the System assets, down from 78 percent at year-end 1989. In addition, for the reasons discussed above, Bank capital levels fell by 25 percent between 1989 to 1991. Lower capital levels resulted in lowered Bank net earnings because a greater amount of Bank assets were funded with the proceeds from the issuance of consolidated obligations (COs) instead of by FHLBank capital.

Reduced spreads on earning assets, lower capital levels, and a lower interest rate environment all contributed to a marked decline in Bank System net income during the early 1990s. Net income peaked at $1.78 billion in 1989 and fell almost 18 percent to $1.47 billion in 1990. Net income fell an additional 21 percent in 1991 to $1.16 billion, and then 27 percent in 1992 bottoming out at $850 million. Net interest margin (net interest income divided by earning assets) fell by more than half from 1989 to 1992, from 1.13 percent to 0.47 percent, although the decline in net interest income was partially offset by advance prepayment fee income. Return on assets (ROA) declined from 95 basis points in 1989 to 53 basis points in 1992.

Declining System net income and weak demand for advances raised questions about the Banks' future ability to pay their statutorily mandated REFCorp and AHP obligations, and pay an adequate return to shareholders. The $300 million REFCorp payment as a percentage of Bank System net income increased from about 20 percent in 1990, to 26 percent in 1991, and to 35 percent in 1992.

Concerns about income pressures on the Bank System led the Finance Board to increase the FHLBanks' mortgage-backed security (MBS) investment authority from 50 percent to 200 percent of capital when it adopted the Financial Management Policy (FMP) in June 1991.[5] The Finance Board attached a two-year sunset to the expanded authority, although it removed the sunset before it would have become effective. In December 1992, the Finance Board changed the Bank System's regulatory leverage limit and the components of the leverage ratio. Prior to this time, Finance Board regulations had limited FHLBank System COs to 12 times the total paid-in capital stock of the FHLBanks; the amended regulation

[2] The Federal Home Loan Bank Board's (FHLBB) Investment Policy and the subsequent Funds Management Policy, adopted in 1988, set forth authorized investments for the FHLBanks. This list of eligible investments was similar to the current list of eligible investments in the Financial Management Policy (FMP). Currently, permissible Bank investments include overnight and term fed funds, overnight and term resale agreements, deposits, commercial paper, bank and thrift notes, bankers' acceptances, securities issued or guaranteed by the U.S., agency securities, mortgage-backed securities (MBS), and certain other assets that support housing and community development. Bank investments in MBS, prior to adoption of the FMP, were limited to 50 percent of a Bank's capital; such investments, along with investments in other eligible asset-backed securities, are currently limited to 300 percent of a Bank's capital.

[3] This payment was in addition to the FHLBanks' payment of $0.7 billion in retained earnings to defease the Financing Corporation bonds as required under the Competitive Equality Banking Act of 1987. (Pub.L. 100–86, 101 Stat. 552 (1987)).

[4] The Banks had funded these advances largely with the proceeds from non-callable consolidated obligations (COs). The Banks repurchased and retired some of this debt to the extent it was economically feasible, but a large portion remained outstanding after the advances were prepaid. The Banks reinvested these CO proceeds in allowable investments.

[5] The FMP consolidated into one document the policy guidelines governing much of the FHLBanks' non-advance financial activity and also established limits on unsecured credit risk and interest rate risk. The FMP restated the eligible investments in the Funds Management Policy and expanded the list of authorized investment to include private triple-A rated MBS and commercial paper.

raised the leverage limit to 20 times total capital and included COs and unsecured senior liabilities (e.g., deposits) in the leverage ratio. The expanded leverage ratio became effective September 22, 1993.

In December 1993, the Finance Board again increased the Banks' authority to invest in MBS, raising the limit from 200 to 300 percent of capital. Financial projections indicated that the Banks would have adequate earnings to meet their financial obligations in 1994. However, prepayment income, which represented nearly 25 percent of 1993 net earnings was declining (down from 46 percent of earnings in 1992), and the Finance Board was concerned that interest income from advances might be insufficient to offset the earnings decline. In addition, the Finance Board believed an absence of a quorum to be imminent and felt obliged to provide the Banks with sufficient investment capacity to adjust to near-term structural changes in their balance sheets.

Another major change in the Bank System was the growth of commercial bank membership. Until 1989, actual membership consisted almost exclusively of thrift institutions. (Prior to 1989, insurance companies were also eligible to become members, but very few actually joined and there was minimal borrowing activity.) System membership declined from 1989 to 1990 due to the closing of failed institutions, but rose rapidly thereafter as significant numbers of commercial banks joined the System. Total Bank System membership increased from 2,855 at year-end 1990 to 6,504 at year-end 1997. The greatest growth occurred at the FHLBanks of Des Moines, Atlanta, and Dallas. The volume of residential mortgage loans held by members increased from $905 billion in 1989 to $1.24 trillion in 1997.[6]

At year-end 1997, commercial bank members comprised 69 percent of System members and held 44 percent of Bank System capital stock. About 55 percent of commercial bank members had advances outstanding. Commercial banks borrow relatively less than thrifts. However, commercial bank share of outstanding advances has increased steadily over the last five years, from 8 percent ($6.4 billion) of outstanding advances in 1992 to 29 percent ($57.4 billion) of outstanding advances at year-end 1997. At year-end 1997, commercial bank members collectively held $578 billion in residential mortgage loans, indicating a sizable pool of collateral eligible to secure advances.

After bottoming out in 1992, advance levels ended the year at slightly higher levels relative to 1991 and then increased significantly each year thereafter except for 1995. Advances increased by 154 percent between 1992 and 1997—from $80 billion to $203 billion. In second quarter 1997, advance levels surpassed the previous all-time high of $166.7 billion. Although the Banks initially grew investments as a substitute for advances, FHLBank investments have generally increased over the past five years along with advances. Investments increased by 88 percent between 1992 and 1997—from $79 billion to $149 billion. At year-end 1997, advances represented about 57 percent of balance sheet assets, compared to about 79 percent in 1989.

As a result of the increases in advances and investments, the Bank System's balance sheet assets more than doubled between 1992 and 1997, increasing from $162 billion in 1992 to $359 billion at year-end 1997. An increase in capital due to new members joining the System and the decision by the Finance Board to expand the regulatory leverage limit allowed the Banks to grow their balance sheets. Between 1992 and 1997, capital levels almost doubled, from just under $11 billion to over $19 billion, and the Bank System's ratio of capital to assets declined from 6.5 percent to 5.4 percent.

Bank System liabilities increased to fund the expanded investments and advances. Between 1992 and 1997, COs (bonds and discount notes) outstanding increased by 174 percent—from $115 billion to $314 billion. Due to the short-term of the discount notes, discount note issuance increased many times more than outstandings. From 1992 to 1997, discount note issuance increased 20 times—from $97 billion to just under $2 trillion. As a result of the rapid increase in discount notes and their shortening maturity, the Finance Board in 1994 changed the limit in the Office of Finance's 1995 debt authorization from one based on obligations issued to one based on obligations outstanding.[7] The debt authorizations for 1996 and 1997 limited the level of COs outstanding and senior, unsecured obligations to 20 times total capital, the regulatory leverage limit.

Bank System net income bottomed out at $850 million in 1992 and increased 79 percent to $1.5 billion in 1997. Spreads on advances have generally narrowed over the last several years and much of the income growth has been due to greater levels of earning assets. The Bank System's net interest margin recovered somewhat from its low in 1992 but remains lower than the levels in the 1980s. The lower net interest margin is largely due to reduced spreads on advances and significantly larger volumes of lower-yielding investments on the balance sheet. Bank System return on assets declined slightly from 1992 to 1997, from 53 basis points to 47 basis points.

Given the large increase in voluntary members since 1989, maintaining a dividend adequate to retain voluntary members has been considered necessary for ensuring a stable System.[8] Dividend payments to shareholders have varied by Bank. From third quarter 1992 through fourth quarter 1997, the Bank System average dividend was 6.5 percent; eight Banks paid average dividends above the System average dividend.

Each Bank establishes its own dividend target and dividend benchmarks vary. Since at any point in time a voluntary member can withdraw from the System with six-month notice, one dividend benchmark may be the return on a six-month maturity CO, with a spread to compensate members for the relative illiquidity of the stock investment and the additional risk associated with holding equity relative to debt. With the exception of one FHLBank, all the FHLBanks paid dividends with returns above the six-month CO coupon between 1992 and 1997. The average spread was 157 basis points, ranging from a low of 27 basis points to a high of 409 basis points. Some members may view their cost of funds as a floor on Bank dividends. From third quarter 1992 to fourth quarter 1997, Bank dividends on average exceeded System members' average cost of funds by 214 basis points. Variation among the Banks ranged from a low of 23 basis points to a high of 461 basis points.

Member perceptions of an adequate dividend clearly vary across the districts.[9] One of the Banks that has paid one of the lowest dividends in the System has been very successful at attracting new members. The on-going

[6] Residential mortgage loans include housing construction loans, mortgage loans for single- and multi-family housing, and MBS.

[7] The Office of Finance (OF) is a joint office of the FHLBanks and serves as the FHLBanks' fiscal agent. The OF also acts as agent of the Finance Board in issuing consolidated obligations.

[8] With the exception of federally-chartered savings associations, all of the Bank System's members are now voluntary. (The Office of Thrift Supervision in April 1995 ceased requiring state-chartered thrifts to maintain Bank System membership.) At year-end 1997, voluntary members represented 85 percent (5,502) of the System's membership base and held 57 percent ($10.4 billion) of total System capital stock.

[9] The Furash Group is currently surveying members about their views of an adequate dividend and the other benefits of FHLBank membership.

adequacy of Bank System dividends is suggested by the fact that large numbers of voluntary members have joined the System while only a few have exited, and that as of year-end 1996 members collectively held $2.3 billion in capital stock beyond the amount they were required by law to hold. Of course, the benefit of System membership exceeds the return on stock. Besides receiving a dividend, System members maintain on-going access to liquidity, long-term funding, and access to FHLBank programs, products, and services.

Issue

The FHLBanks, as governmentally sponsored enterprises (GSEs), can be viewed as representing a social compact between the Banks and their members and the federal government. The federal government bestows upon the Banks certain benefits through their GSE status, including: (1) an ability to borrow at rates only slightly above Treasury borrowing rates due to the perception of an implicit federal guarantee of GSE debt, as well as the ability to issue large amounts of debt, including debt with complex structures; (2) exemption from Securities and Exchange Commission registration and reporting requirements and fees; and (3) exemption from state and local income taxes. In exchange for these benefits, the Banks have a responsibility to serve the public by enhancing the availability of residential mortgage and targeted community development credit through their member institutions. As such, the federal benefits, most importantly the funding advantage, should be used to fund activities that safely and soundly further the Banks' public purpose.

During the period of rapidly declining advances and shrinking thrift membership in the early 1990s, the Finance Board took rational steps to alleviate earnings pressures by expanding the Banks' investment authority and increasing the leverage limit. However, despite the remarkable recovery that has since occurred in advances and System membership, Bank investments continue to increase. While advances at year-end 1997 were a record $202.7 billion, the System's advances to assets ratio of 56.6 percent was still slightly lower than the advances to assets ratio of 57.6 percent at year-end 1993 when advances were $103 billion.

Many of the assets in the Banks' investment portfolios—Treasury and agency securities, fed funds, resale agreements, commercial paper, bank and thrift notes, bankers' acceptances and deposits—bear little if any relationship to the Banks' mission of enhancing the provision of credit through members for housing and community development. Such investments, beyond those required for liquidity, can thus be considered non-mission related.[10]

The principal purpose of these primarily short-term money market investments has been to generate income to help the Banks satisfy their REFCorp and AHP obligations and pay a dividend sufficient to attract and retain voluntary members and offer competitively priced products. A large volume of money markets investments may have been justified during a temporary period of contracting advances, declining membership, and severe income pressures. However, now that membership and advances are at record levels and System income exceeds $1.5 billion, the need to maintain such investments—which averaged $98 billion during 1997—should be examined in light of the Banks' public mission as GSEs.

The Banks also hold substantial MBS investments—System-wide MBS investments averaged $47 billion in 1997. Although MBS are housing-related, the extent to which these investments support the Banks' housing finance mission is debatable. MBS generally are traded in large, well-established and liquid markets. The FHLBanks' presence in these markets may not result in increased availability of funds for housing, or in lower cost funds. Bank investment in MBS, therefore, could be considered as providing less ''value'' to housing than advances or other investments that provide financing that is not generally available or is available at lower levels or under less attractive terms.

However, absent any legislative reforms to the fixed $300 million REFCorp obligation and the Banks' capital structure, or any substantial and sustained increase in advances demand or other high yielding mission assets, a substantial reduction in the Banks' MBS authority would have a significant adverse impact on the Banks' net income and dividends. The Bank System's capital level is based on ''subscription capital,'' i.e., statutory member stock purchase requirements, rather than the risk of its operations.[11] As a result, the System holds more capital than it can adequately leverage in advances business with members. Capital not supporting advances must be leveraged with other assets (e.g., money market assets, MBS subject to the 300 percent of capital limit, and other investments supporting housing and targeted community development) in order to generate earnings for dividends.

Assuming a 60 basis point spread on MBS, elimination of the Banks' $47 billion in MBS would reduce System income by $282 million. Other things being equal, and assuming 1997 average capital stock balances, this would reduce the average dividend by 161 basis points. With the decline in income, the $300 million REFCorp payment would represent a larger share of System net income. On the other hand, and as discussed in more detail below, significant volumes of low yielding money market assets can be rolled-off with a much smaller reduction in income. For example, assuming a 10 basis point spread on money market assets, the Banks could reduce these assets by $50 billion and net income would fall by $50 million. Other things being equal, this would result in an average decline in dividends of approximately 29 basis points assuming 1997 average capital stock balances.

Possible Approaches to Limiting Money Market Investments

There are several possible approaches to limiting Bank money market investments. One approach would be simply to restore the more restrictive leverage limit that existed before 1993. However, while such an approach could require the Banks to shrink their balance sheets, there would be no guarantee that the shrinkage would occur in money market investments rather than in investments that add more value in terms of advancing the System's public purpose.

Another approach would be to place restrictions on the composition of the liability side of the Banks' balance sheets. After the Finance Board ceased placing limits on debt issuance effective with the 1995 debt authorization, there were substantial, contemporaneous increases in the volumes of both discount notes and short-term money market investments. In December 1997, the Finance Board authorized a three-month extension of the Office of Finance's debt issuance authority so that staff could examine the relationship between discount notes and money market investments. As discussed in the debt authorization issues paper, staff concluded that the Banks could respond

[10] It is important to note that several of the FHLBanks have recently taken action to reduce their money market investments.

[11] By law, each member is required to hold capital stock equal to the greater of one percent of residential mortgage loans, 0.3 percent of total assets, or five percent of advance. Members that do not meet the definition of qualified thrift lender are required to hold stock against advances equal to five percent divided by their actual thrift investment percentage.

to any limitations placed on the discount note issuance by funding short term money market investments with longer term COs or by creating synthetic short-term funding instruments with possibly increased risk and cost.[12]

A more direct approach to limiting the holding of money market assets would be to place constraints on the Banks' holdings of such investments. If the policy objective is to ensure that the System's principal federal benefit— its GSE funding advantage—is being used to meet the System's public purpose, there is some logic to tying allowable levels of money market investments to the levels of COs outstanding. Such an approach would constrain the use of the GSE funding advantage to finance assets, beyond reasonable liquidity needs, not related to the Banks' housing and community investment mission. Money market investments funded with deposits and capital would not be subject to these limits because these sources of funds are not raised in the GSE debt market.

Implementing limits on Bank money market investments obviously requires making a distinction between non-mission related, money market investments and other types of assets, and could be an additional step toward evaluating on a systematic basis the degree to which Bank assets and products further System mission fulfillment. Bank System assets and products can be viewed on a continuum from those that are most mission-related, that is provide the greatest benefit to users of residential and community development credit, to those that are not mission-related and held solely for purposes of liquidity and income generation. Presumably, FHLBank products and services that are not readily available in the capital markets, such as long-term advances, could be considered the most mission-related. As part of its study, the Furash group will be attempting to develop a methodology for measuring System mission achievement, which could be helpful in making further distinctions among System assets and products.

Working within this conceptual approach, staff evaluated three options that placed limits on the allowable levels of money market investments. For simplicity of exposition, System assets were classified into three categories: Advances, MBS, and money market investments (MMI).[13] The three options were as follows:

(1) Advances required to be a minimum of 65 percent of COs, with MBS limited to the maximum of either the existing 300 percent of capital limit or 20 percent of COs;

(2) Advances required to be a minimum of 70 percent of COs, with MBS limited to the maximum of the existing 300 percent of capital limit or 20 percent of COs; and

(3) Advances required to be a minimum of 80 percent of COs, with MBS limited to the maximum of the existing 300 percent of capital limit or 20 percent of COs.

The change in the MBS limit from one based solely on capital to one based on COs represents a change in how the limit should be viewed. The Finance Board initially limited MBS investments to a multiple of capital in part because it was concerned about the Banks' ability to manage the interest rate and options risk associated with these assets. However, now that the Banks have developed more effective techniques for hedging these risks, and there are policy limits in place constraining the Banks' interest rate risk exposure, the MBS limit could be viewed as more of a mission than a safety and soundness constraint. Accordingly, under this approach, MBS investments would be limited to a percentage of COs outstanding. However, to the extent that the existing 300 percent of capital limit is less restrictive, it should also be retained so that the Banks would not be required to shrink their MBS portfolios.

Under this approach, the Banks could fund MMI through capital and deposits. Assuming MBS investments equal at least 20 percent of liabilities, allowable amounts of MMI funded by COs would be no more than 15 percent of COs in option one and no more than 10 percent of COs in option two. In option three, MMI could only be funded with deposits and capital to the extent a Bank maximizes its use of the MBS authority.[14]

At year-end 1997, advance to CO ratios at the individual FHLBanks ranged from a low of 45 percent to a high of 89 percent. The System average was 65 percent, with seven Banks below the average. The ratio of advances and MBS to COs ranged from 62 percent to 99 percent. The System average was 81 percent. The ratio of MBS to COs ranged from 10 percent to 23 percent, with a System average of 16 percent. MMI to CO ratios (excluding MMI funded with deposits and capital) ranged from one percent to 39 percent. The System average was about 20 percent.

Simulations

Staff generated simulations applying the limitations under each of the options to each Bank's 1997 average balance sheet. The simulations assume that Banks not meeting the minimum requirement for advances would reduce their levels of COs and money market investments until the minimum advance to CO requirement was satisfied. Advance and capital levels were fixed at 1997 average balances. As money market investments are reduced, therefore, Bank leverage decreases and capital-to-asset ratios increase.

Because these simulations assume no behavioral responses on the part of the Banks, the results should not be considered predictions of what would have happened had these investment restrictions actually been in place in 1997. Rather, they should be considered an indication of the magnitude of the Banks' required balance sheet adjustments, and the potential impact on net income and dividends. The simulations assume that all adjustments occur instantaneously, while in reality there would be a transition period.

Based on analysis of empirical data and discussions with FHLBank staff, the simulations assume that money market investments generate a spread of 10 basis points and MBS have a spread of 60 basis points. The low return on MMI should generally allow the Banks to roll-off substantial amounts of MMI without significantly reducing net income.

Overall, Bank System MMI would fall by 50 percent or $49 billion under option two. The effects of the approach vary by Bank and are related to a Bank's advances to CO ratio. The Banks with the lowest advances to CO ratios, and correspondingly the highest ratios of MMI to COs, would be required to roll-

[13] The Finance Board on March 13, 1998, authorized the Office of Finance to issue debt through year-end 1998. The debt authorization does not contain any limits on System debt issuance.

[13] Money market investments are defined as fed funds, resale agreements, deposits, commercial paper, bank and thrift notes, bankers' acceptances, and Treasury and agency non-MBS securities. As the Banks develop investments to support housing and community development, the classifications could be refined. For example, the Finance Board recently authorized the FHLBanks to invest in federally insured deposits of all members to enhance the Banks' ability to provide liquidity to members, particularly smaller members that do not have sufficient capital or the required rating to be deemed an eligible financial institution as set forth in the FMP. To the extent it is deemed appropriate, future refinements could allow these investments to be reclassified as mission related.

[14] From 1980 through 1988, advances averaged 118 percent of COs, indicating that the Banks funded advances with deposits and capital, as well as COs.

off the greatest volume of MMI. Reductions in MMI at the individual Banks would range from no change to an 80 percent decline.[15]

Total System assets would decline by 14 percent or $47 billion under option two. Reductions in assets at the individual Banks would range from no change to a 36 percent decline. With the exception of one FHLBank, leverage at all the Banks would decrease in option two due to the reduction in assets. The average System capital to asset ratio would increase from 5.6 percent in the base case to 6.6 percent. Capital to asset ratios at the Banks would range from 5.8 percent to 8.1 percent.

The approach allows the Banks to hold MBS equal to the greater of 300 percent of capital or 20 percent of COs. In most cases, the 300 percent of capital limit would be more permissive than the 20 percent of COs constraint. In option one, two Banks would hold MBS in levels greater than 300 percent of capital; in option two, only one Bank would have MBS greater than 300 percent of capital; and in option three, no FHLBank would have MBS greater than 300 percent of capital. In general, MBS would represent a greater percentage of COs at those Banks with the least leverage.

System-wide, MBS would average 21 percent of COs, compared to 17 percent in the base case. The ratio of MBS to COs would range from a low of 11 percent to a high of about 29 percent. System MBS levels would grow modestly, $2.6 billion or 5 percent, under the three options because the model assumes that each Bank maximizes its MBS holdings subject to Finance Board or Bank board requirements.[16] The growth in MBS mitigates the reduction in earnings resulting from the roll-off in MMI. System-wide, MMI (less MMI funded with deposits and capital) would decline from 23 percent of COs in the base case to about six percent in option two.

Under option two, System net income would fall by $30 million, or two percent, to $1.49 billion. Declines in net income would range from no change to a reduction of seven percent. Under option two, the average System dividend would drop by 17 basis points. As a result of the decline in System income, funding for the AHP program would fall by approximately $3 million, slightly less than three percent.

Dividend reductions would range from no change to a 54 basis point decline. System-wide, the average dividend under option two would have a spread of 106 basis points over the six-month CO rate. This spread is 17 basis points lower than the 123 basis point spread in the base case. Spreads over the six-month CO rate would range from 16 basis points to 216 basis points. Dividend spreads over member cost of funds under option two would range from 124 basis points to 309 basis points. System-wide, the average spread would be 228 basis points.

This analysis suggests that reducing MMI would generally result in modest declines in net income, with the magnitude of the effects varying across the Banks. To the extent the resulting return on equity (ROE) at a Bank is below its target ROE, the Bank could attempt to increase its return by taking greater risk. The Finance Board's FMP contains limits on the FHLBanks' interest rate risk and unsecured credit risk exposure. These limits, as well as regular on-site examination of the FHLBanks, should constrain incentives to increase risk. Another option would be to increase the spreads on advances to generate additional income. However, increased spreads would likely reduce demand for advances, and the Banks would be limited in their ability to replace advances with MMI.

Issues Requiring Further Analysis

This preliminary analysis suggests that the investment restrictions in option two, when applied to the 1997 average balance sheet, would achieve a 50 percent reduction in MMI—$49 billion—without significantly affecting Bank System net income and dividends. It seems unlikely that the relatively small reductions in dividends would trigger widespread withdrawal by voluntary members given that dividend spreads over comparable benchmarks generally would not be significantly lower than the spreads in the base case. Transition rules would be needed to facilitate Bank adjustment to any new investment limitations, particularly for those Banks requiring the greatest reduction in MMI. Transitional rules would also be needed for Banks that fall out of compliance due to situations such as merger activity and regional and cyclical downturns in advance demand.

This analysis assumed constant levels of advances and capital. The impact of limits on Bank MMI in a period of declining advances and interest rates should be analyzed, as well as the implications of declining capital levels due to the redemption of stock held in excess of the minimum statutory requirements. Another issue involves the payment of stock dividends by the FHLBanks. Stock dividends involve a greater taxpayer subsidy because taxes are deferred, and the Banks currently may leverage the stock in investments that do not support their public purpose.

It is also important that any Finance Board limits on Bank MMI do not result in inadequate levels of liquidity at the FHLBanks. The Banks are currently subject to statutory liquidity requirements and additional liquidity requirements set forth in the FMP.[17] Preliminary analysis indicates that all the Banks would have met their requirements at year-end 1997 under options one and two. One Bank would not have met its requirements under option three. Finance Board staff will be examining the adequacy of these liquidity requirements as part of its review of the FMP.

This analysis also made no assumptions about changes in FHLBank funding costs. It has been suggested that Bank borrowing costs could fall if CO issuance declined. Staff could review the existing research that has been done is this area and incorporate expected changes, if any, into the simulations.

Conclusions

The FHLBanks, as GSEs, can be viewed as representing a social compact between the Banks and their members and the federal government. The federal government bestows upon the Banks certain benefits through their GSE status, and such federal benefits should be used to fund activities that safely and soundly further the Banks' public purpose. The System acted rationally during the transition period following the resolution of the thrift crisis when it replaced declining advance balances with increasing levels of investments. However, now that the demand for advances has rebounded and reached record levels, and System membership is at record levels as well, the on-going maintenance of large balances of MMI

[15] Discussion centers on option two since it is the middle option.the magnitude of effects should be less for option one and greater for option three.

[16] In the base case, each Bank's average MBS balance was less than either 300 percentof capital or, with one exception, 20 percent of COs.

[17] The Bank Act requires each bank to maintain an amount equal to the total deposits received from its members invested in: obligations of the United States; deposits in banks or trust companies (as defined in Finance Board regualtion) which are eligible financial institutions; and advances that mature in 5 years or less to members. In addition, each Bank is required to maintain a daily average liquidity level each month in an amount not less than 20 percent of the sum of its daily average demand and overnight deposits and other overnight borrowings during the month, plus 10 percent of the sum of its daily average term deposits, COs and other borrowings that mature within one year. Certain money market investments authorized under the FMP may be used to satisfy the liquidity requirements.

appears to be inconsistent with the Banks' mission.

With the goal that the System's principal federal benefit—its GSE funding advantage—be used to meet the System's public purpose, staff evaluated three options that tied allowable levels of money market investments to the levels of consolidated obligations outstanding. Such an approach would constrain the use of the GSE funding advantage to finance money market assets. Preliminary analysis suggests that reducing low-yielding MMI by 50 percent, while holding advances and capital constant, would generally result in relatively small reductions in dividends. In most cases, FHLBank dividend spreads over comparable benchmarks would be only modestly lower than historical averages. It appears unlikely that these dividend reductions would result in a reassessment by voluntary members of the benefits of System membership.

Setting limits on Bank MMI could be viewed as another near-term step in restructuring the Banks' balance sheets. Longer-term efforts could involve Finance Board consideration of additional limits on Bank MBS investments, as well as the Banks' continued development of new and innovative investments that support housing and targeted community development.

Persons wishing to participate in the hearing should send a written request to the address listed in the **ADDRESSES** portion of this notice, to be received no later than Monday April 13, 1998. A request to participate in the hearing must include the following information:

(A) The name, title, address, business telephone and fax number of the participant; and

(B) The entity or entities that the participant will be representing.

Depending on the number of requests received, participants may be limited in the length of their oral presentations. All submissions will be included as part of the record, including written testimony not presented orally, although extraneous material may be deleted from the printed record to reduce printing costs. The Finance Board will notify those selected to make oral presentations if more requests are received for participation than may be accommodated in the time available.

Participants will be required to submit 100 copies of their written statements in advance of the hearing date. These written statements should incorporate the major points to be presented at the hearing and should be accompanied by an executive summary of no more than two pages. Written statements must be received no later than Friday, May 1, 1998, and should be sent to the address listed in the ADDRESSES portion of this notice. Anyone selected for an oral presentation whose testimony has not been received by Friday, May 1, 1998 may not testify except by special permission of the Finance Board.

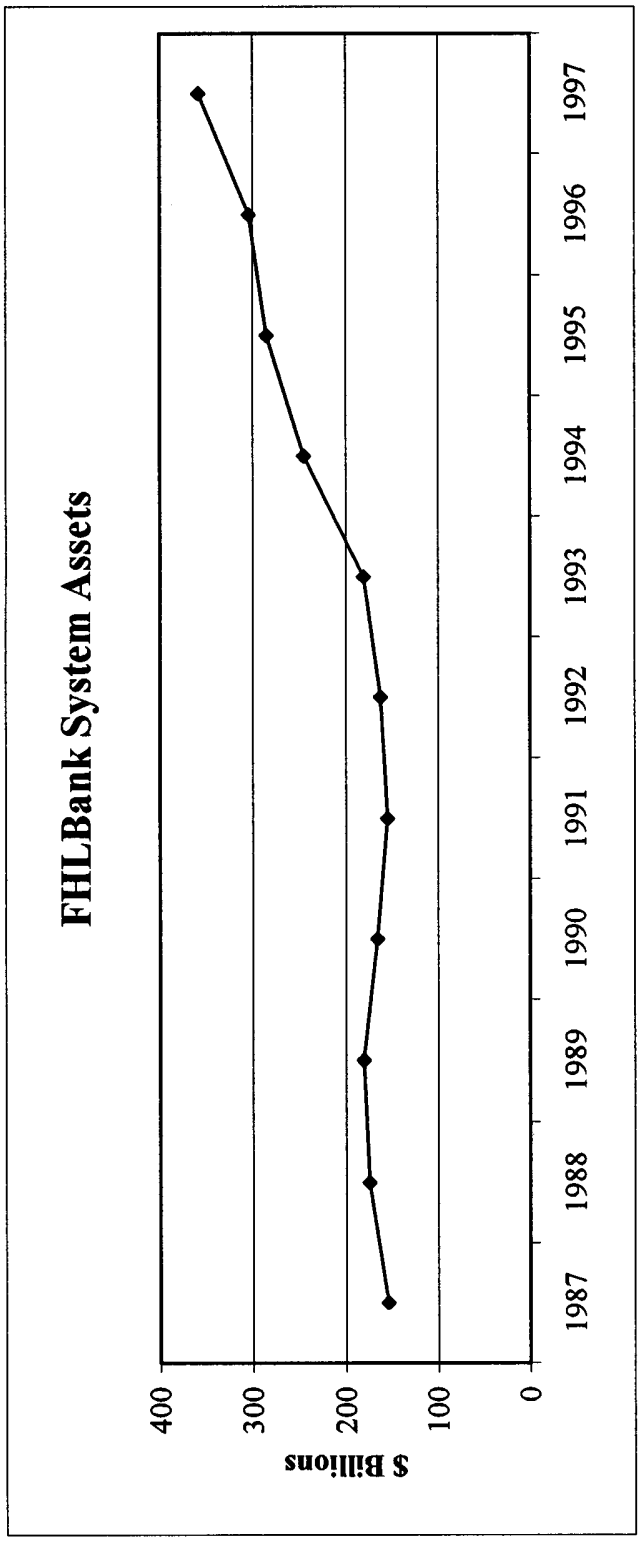
By the Federal Housing Finance Board.

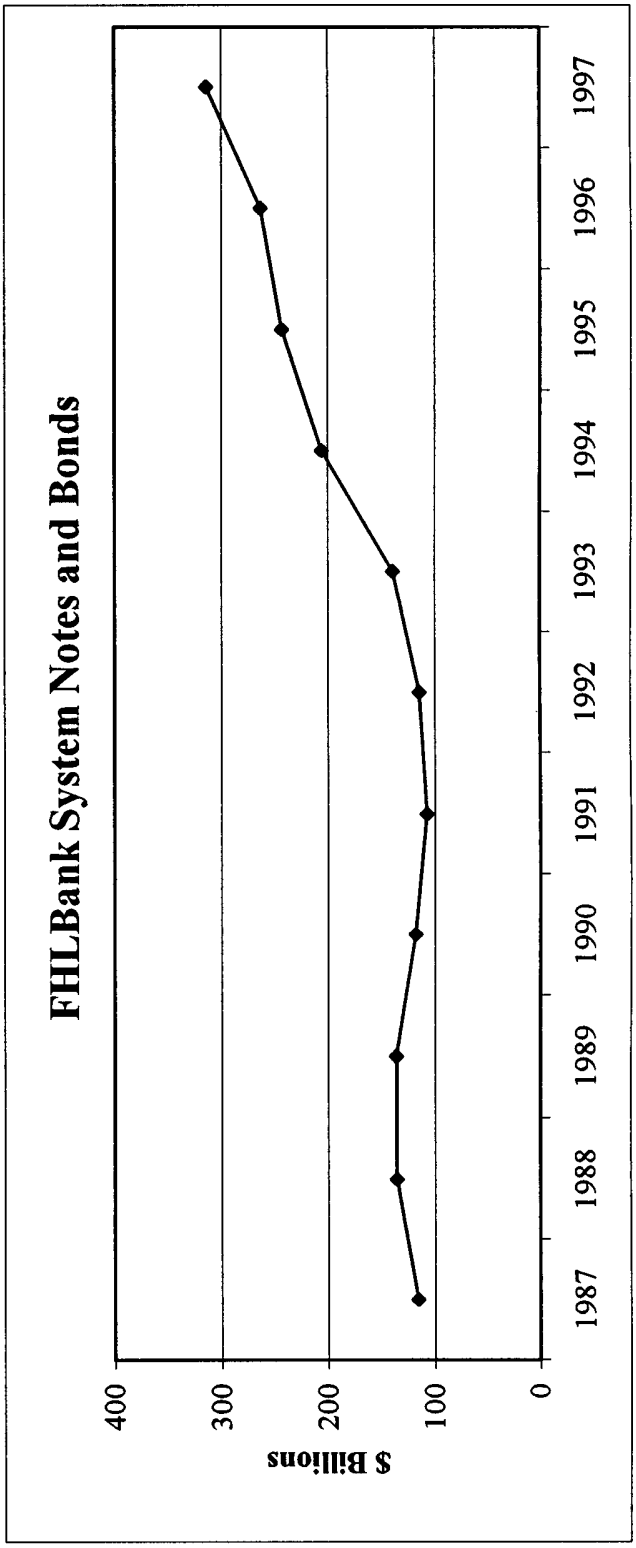
Bruce A. Morrison,

Chairman.

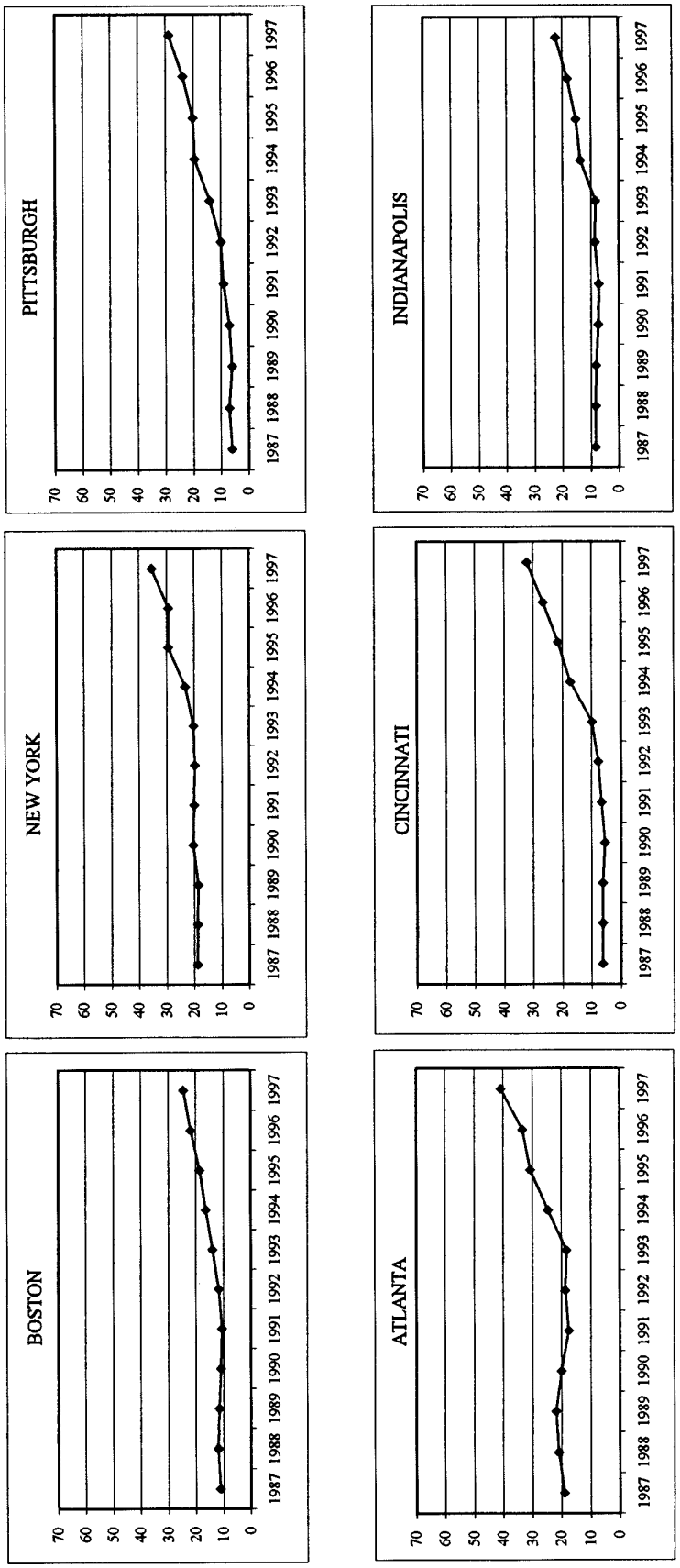
BILLING CODE 6725–01–P

FHLBank System



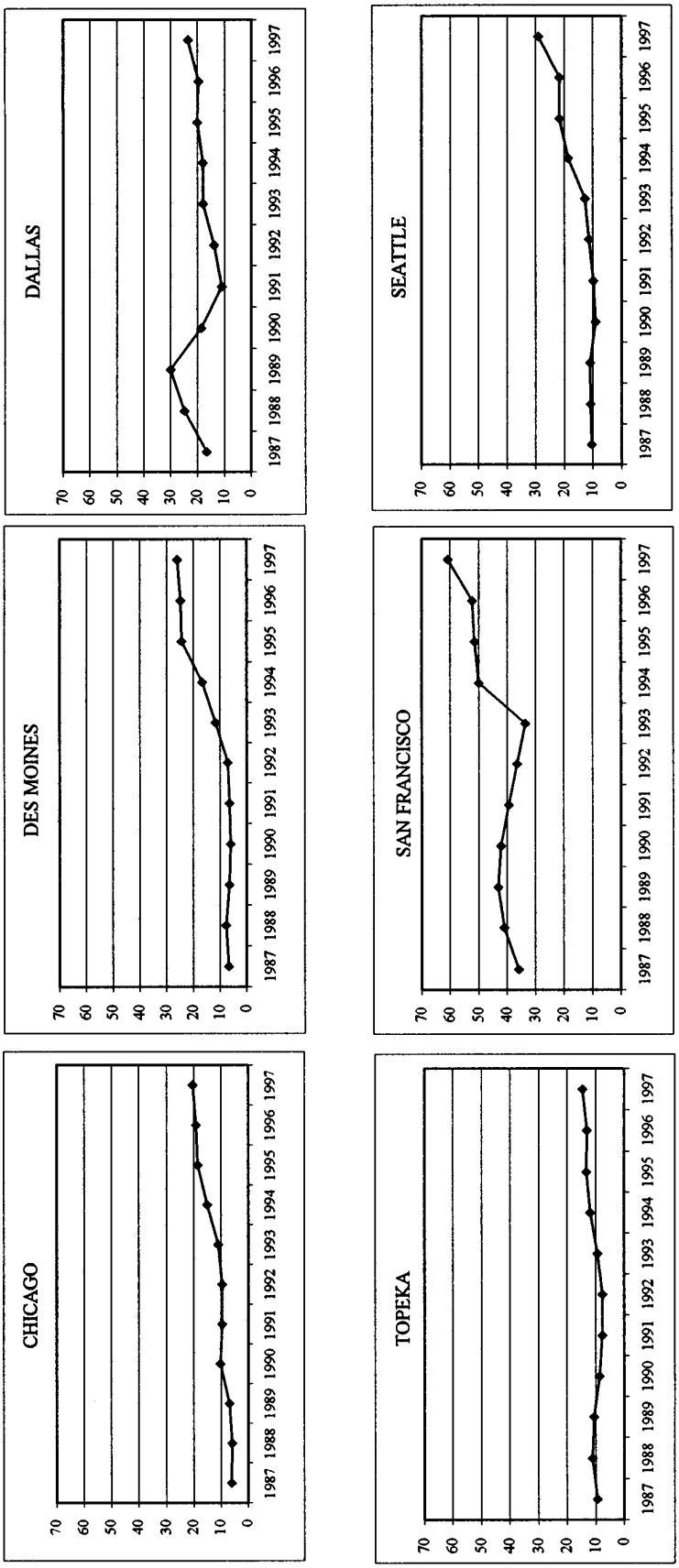


Assets of the FHLBanks



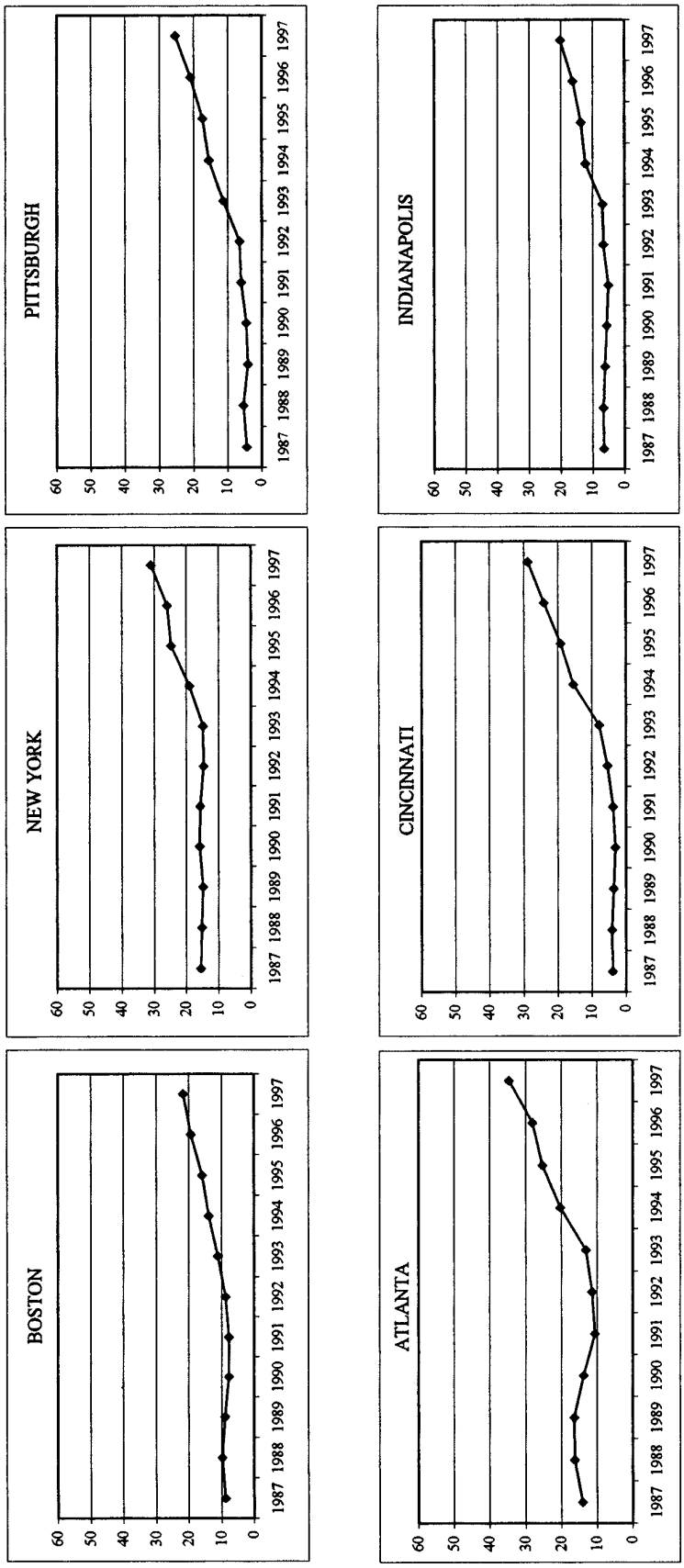
* Billions of Dollars

Assets of the FHLBanks



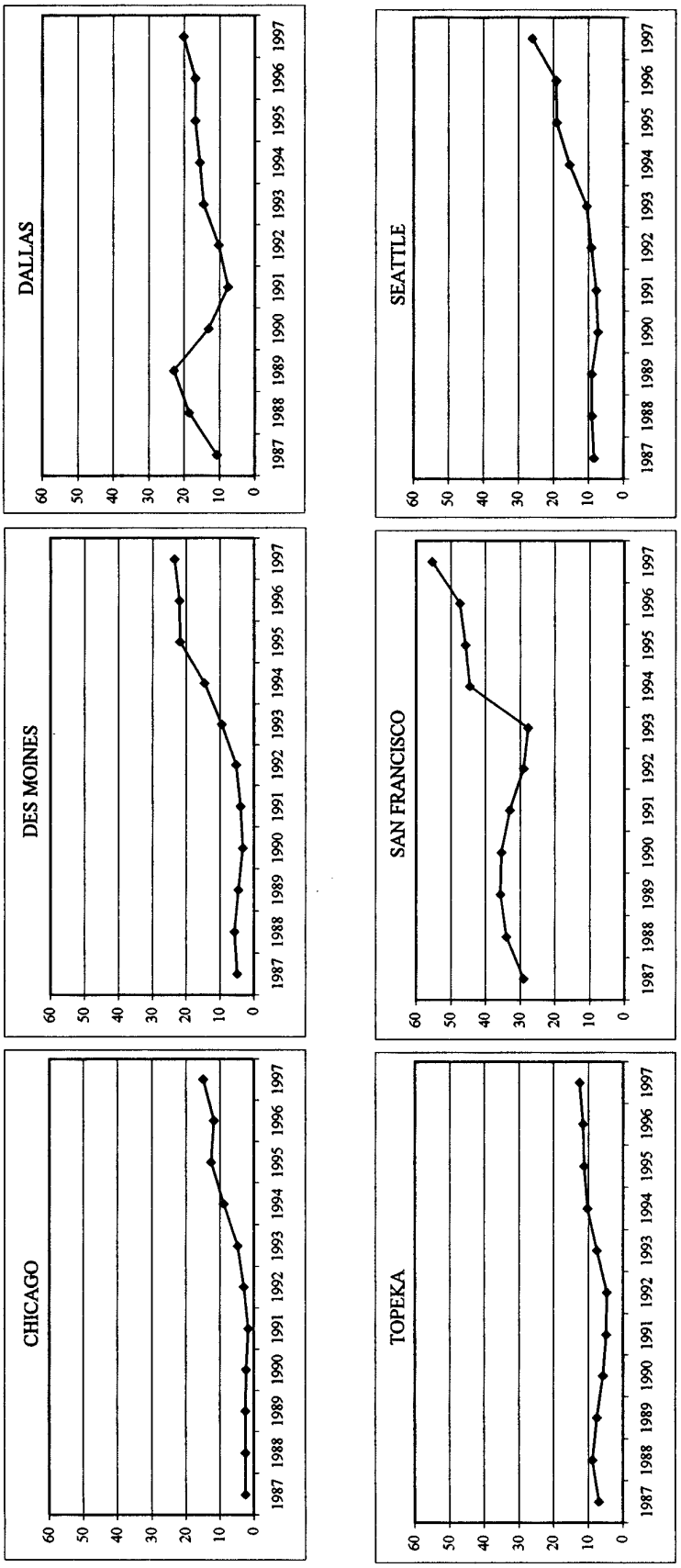
* Billions of Dollars

Notes and Bonds of the FHLBanks



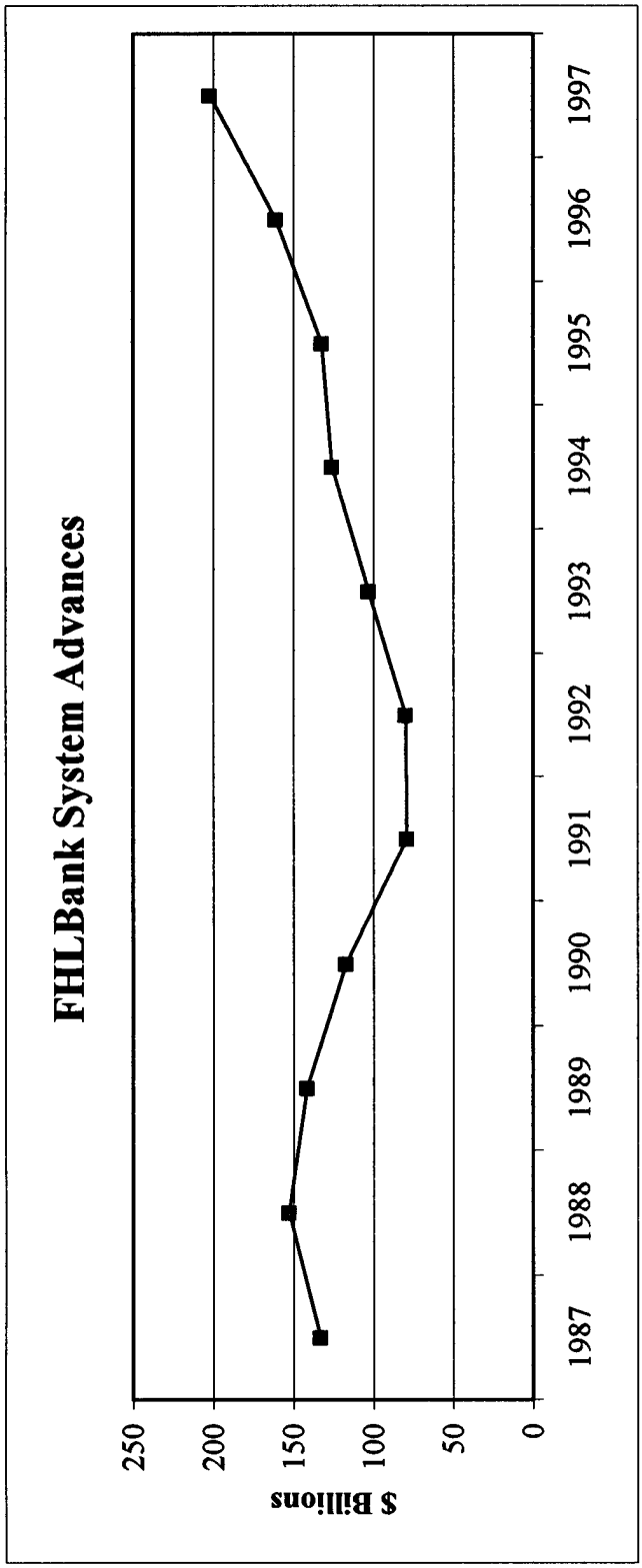
* Billions of Dollars

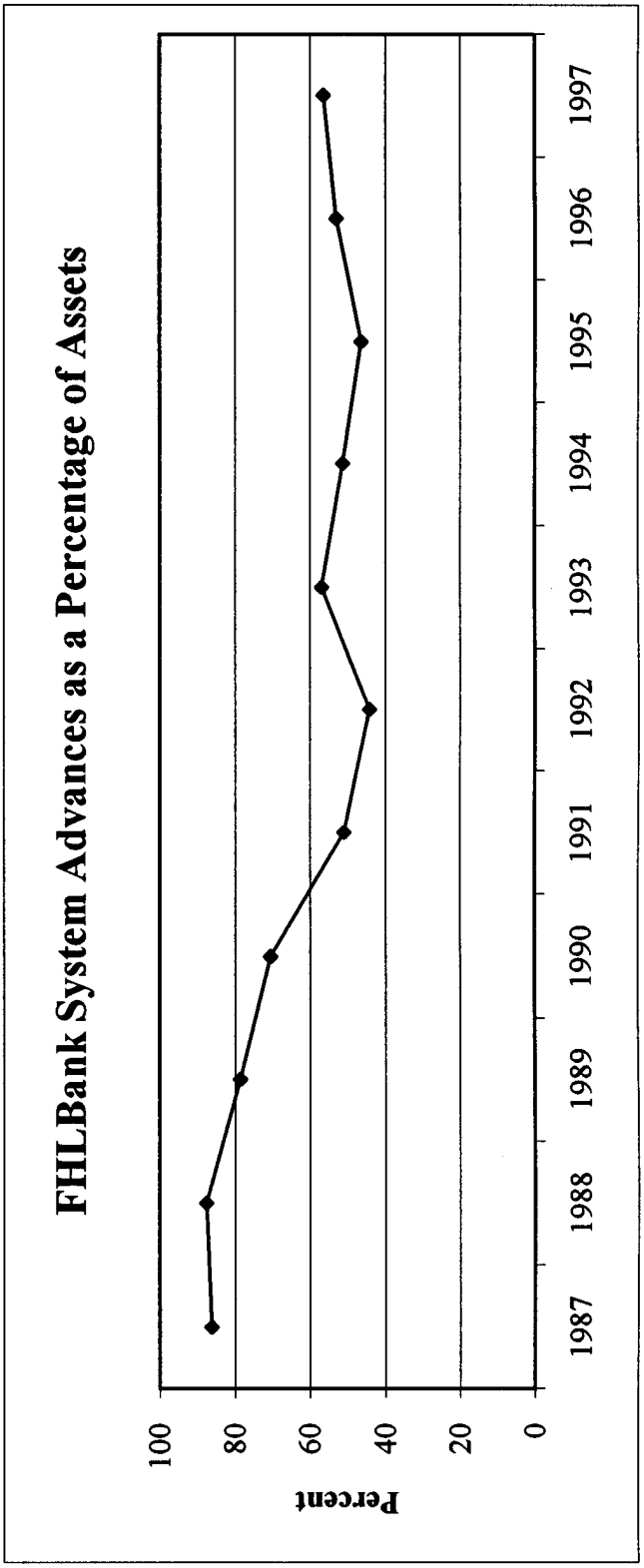
Notes and Bonds of the FHLBanks



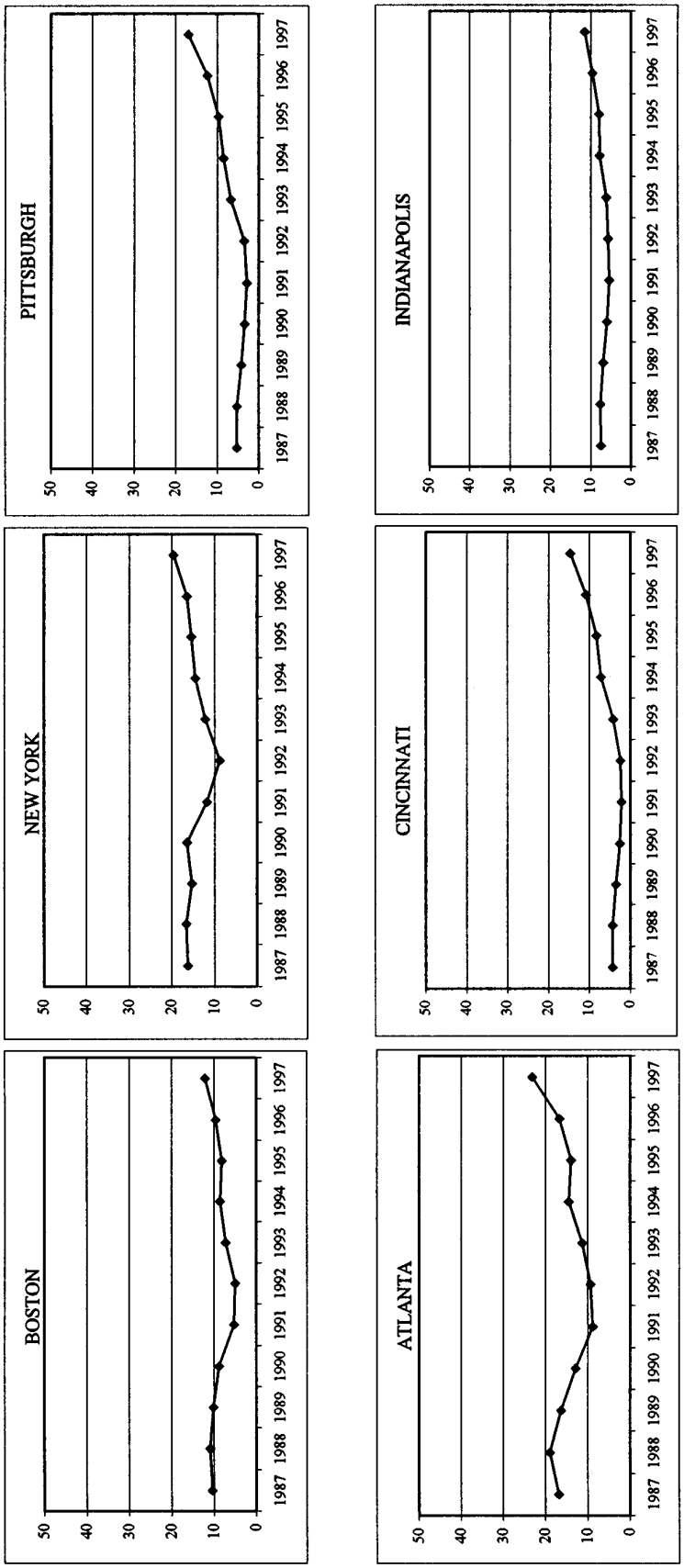
* Billions of Dollars

FHLBank System Advances



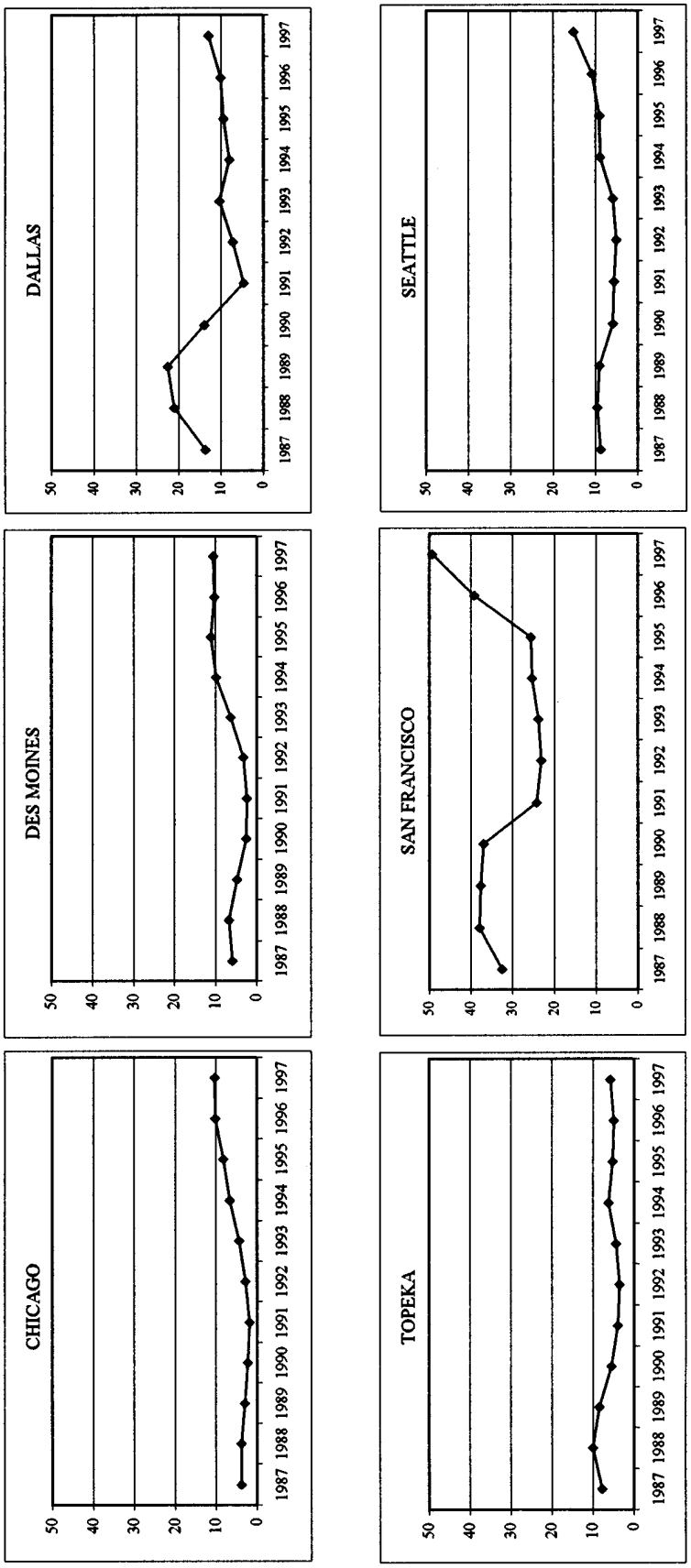


Advances of the FHLBanks



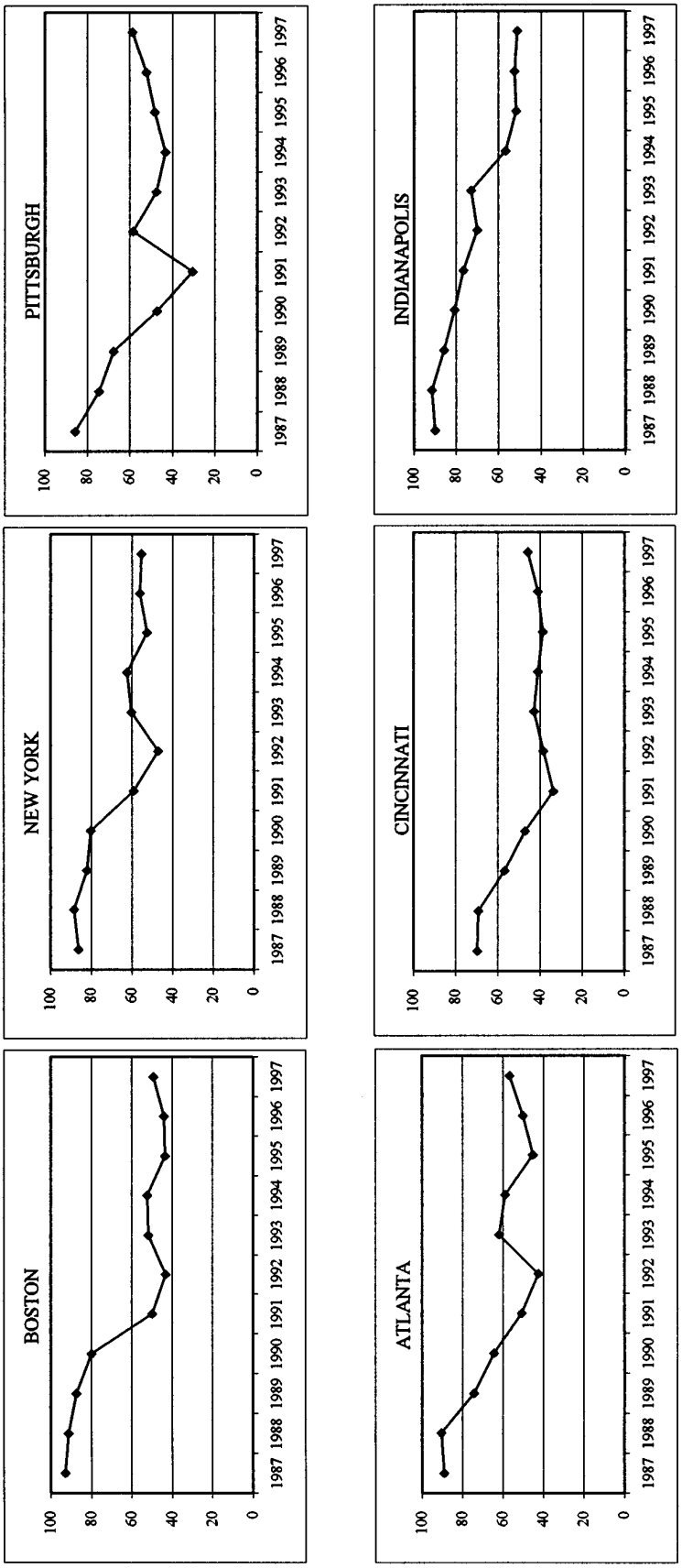
* Billions of Dollars

Advances of the FHLBanks



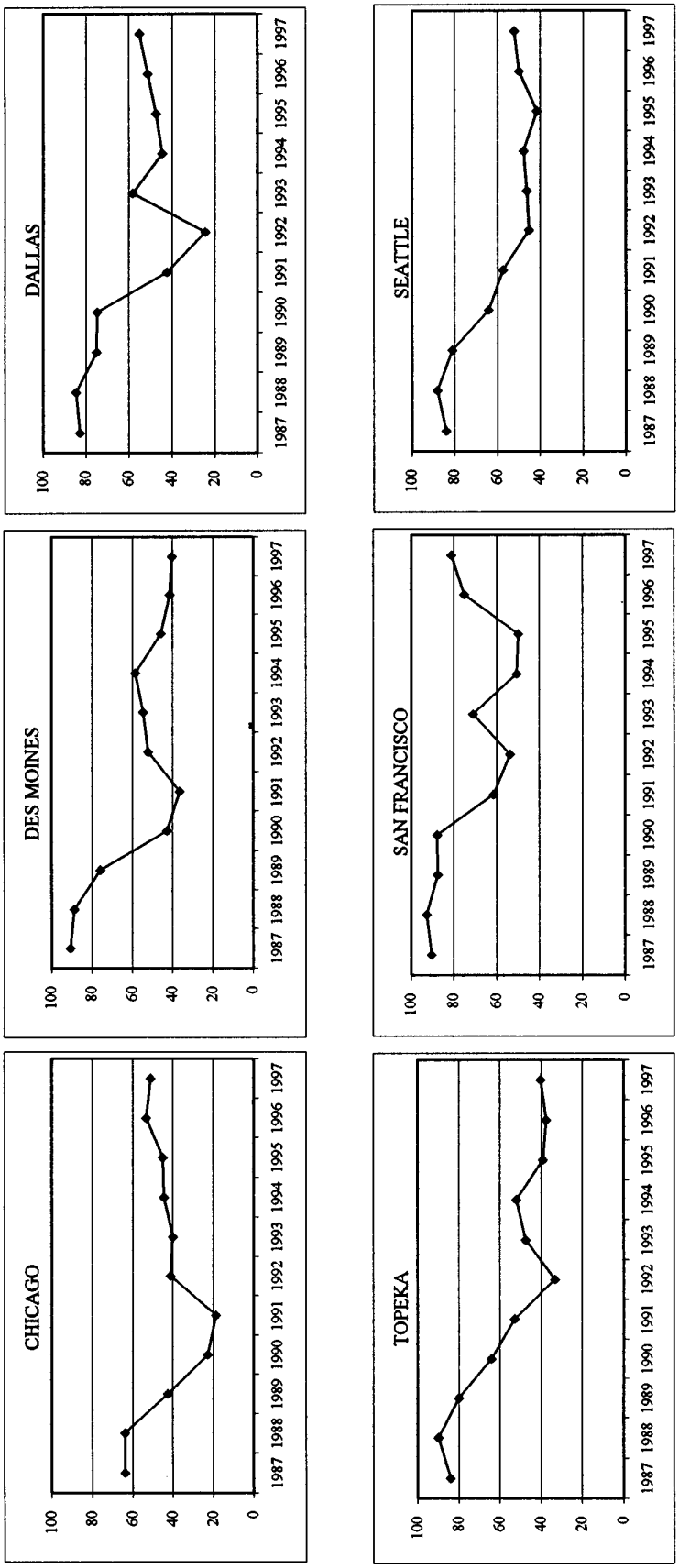
* Billions of Dollars

Advances of the FHLBanks as a Percentage of Assets



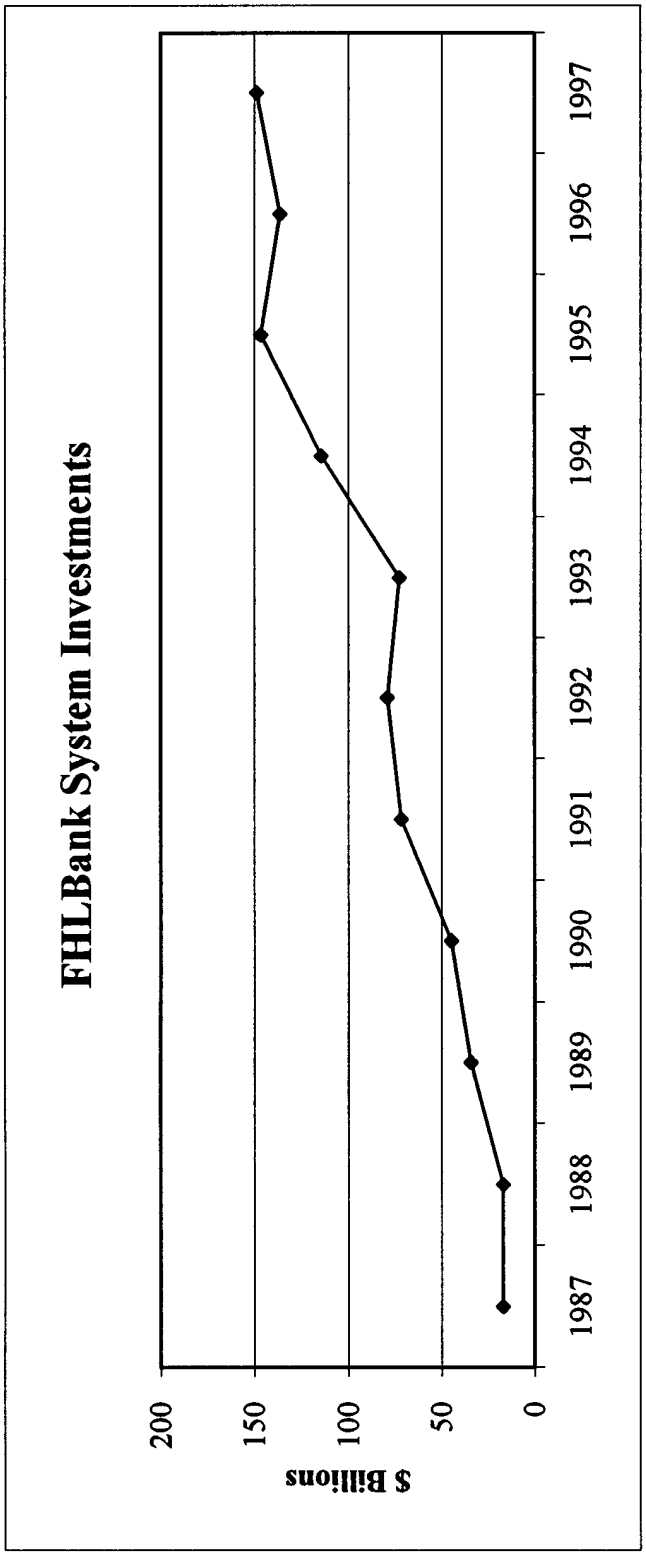
** Percent

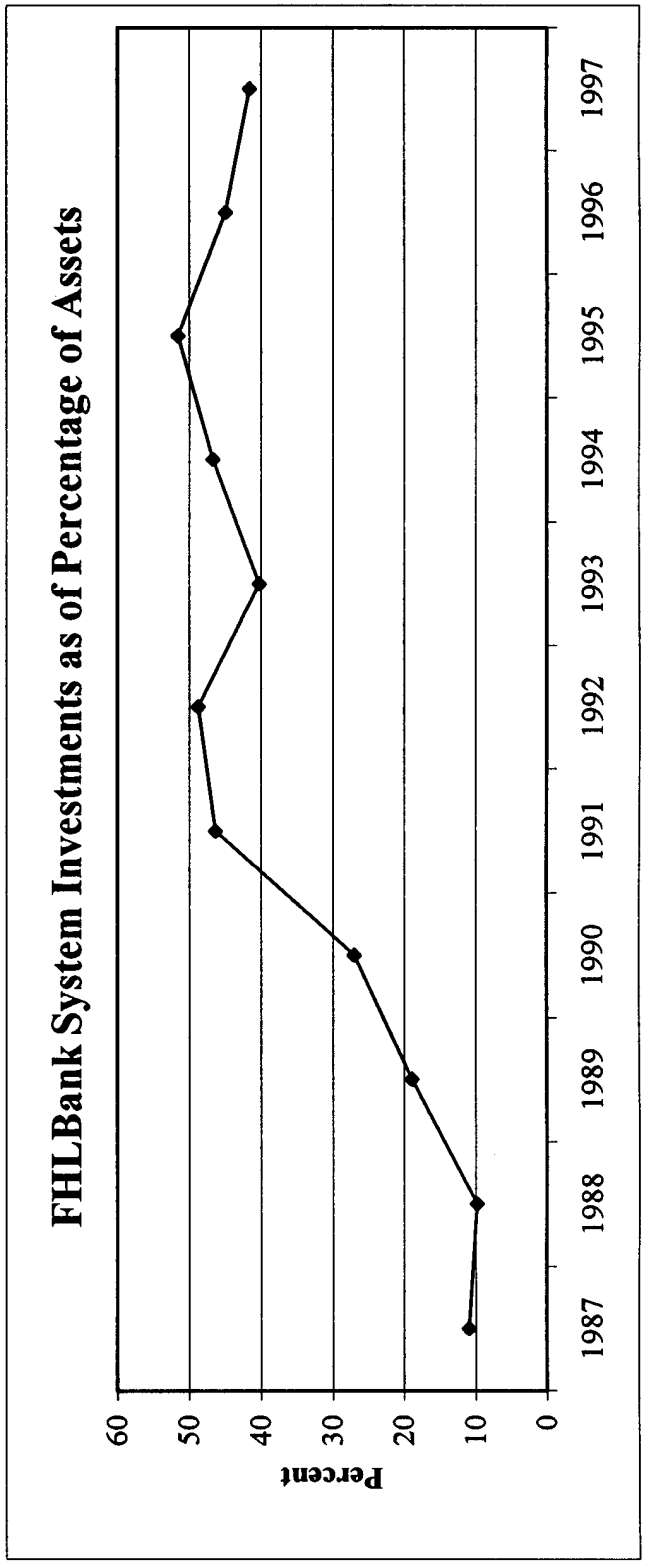
Advances of the FHLBanks as a Percentage of Assets



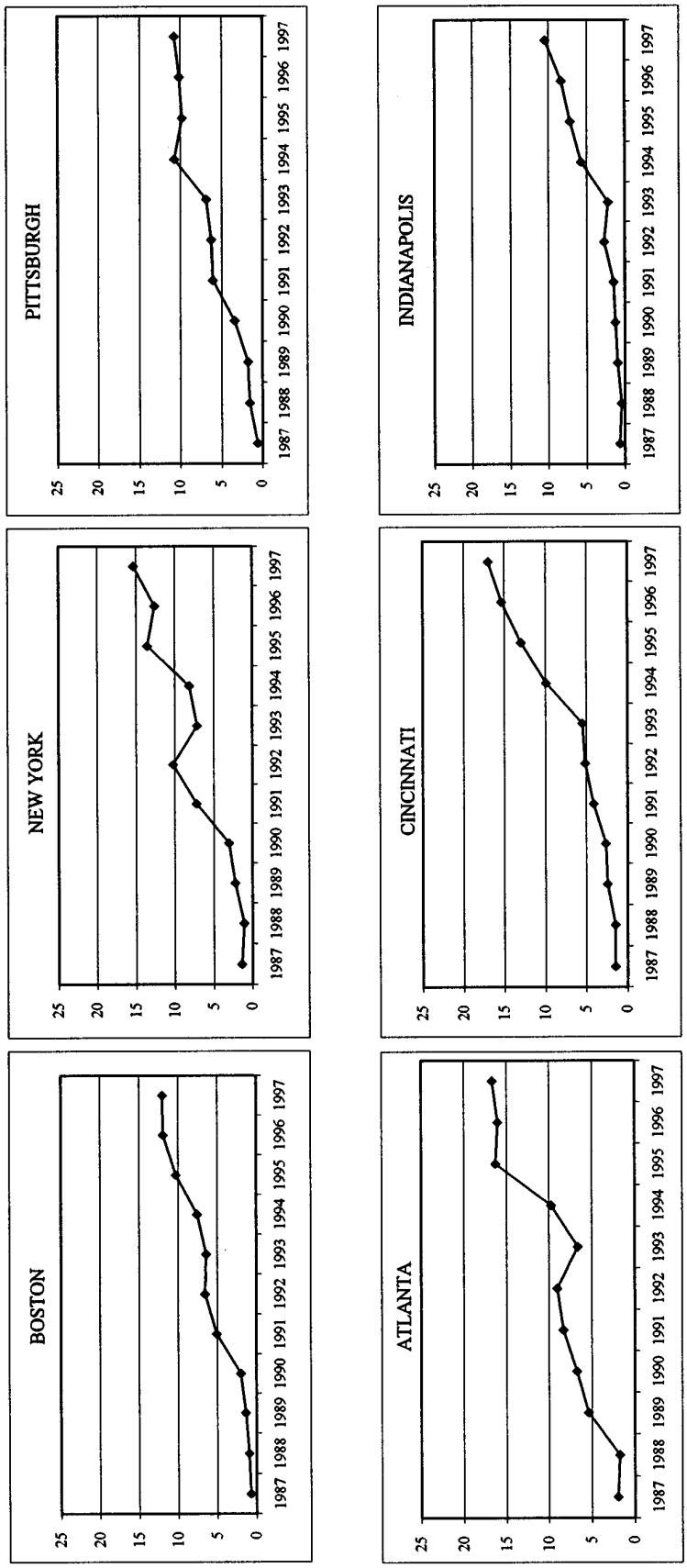
** Percent

FHLBank System Investments



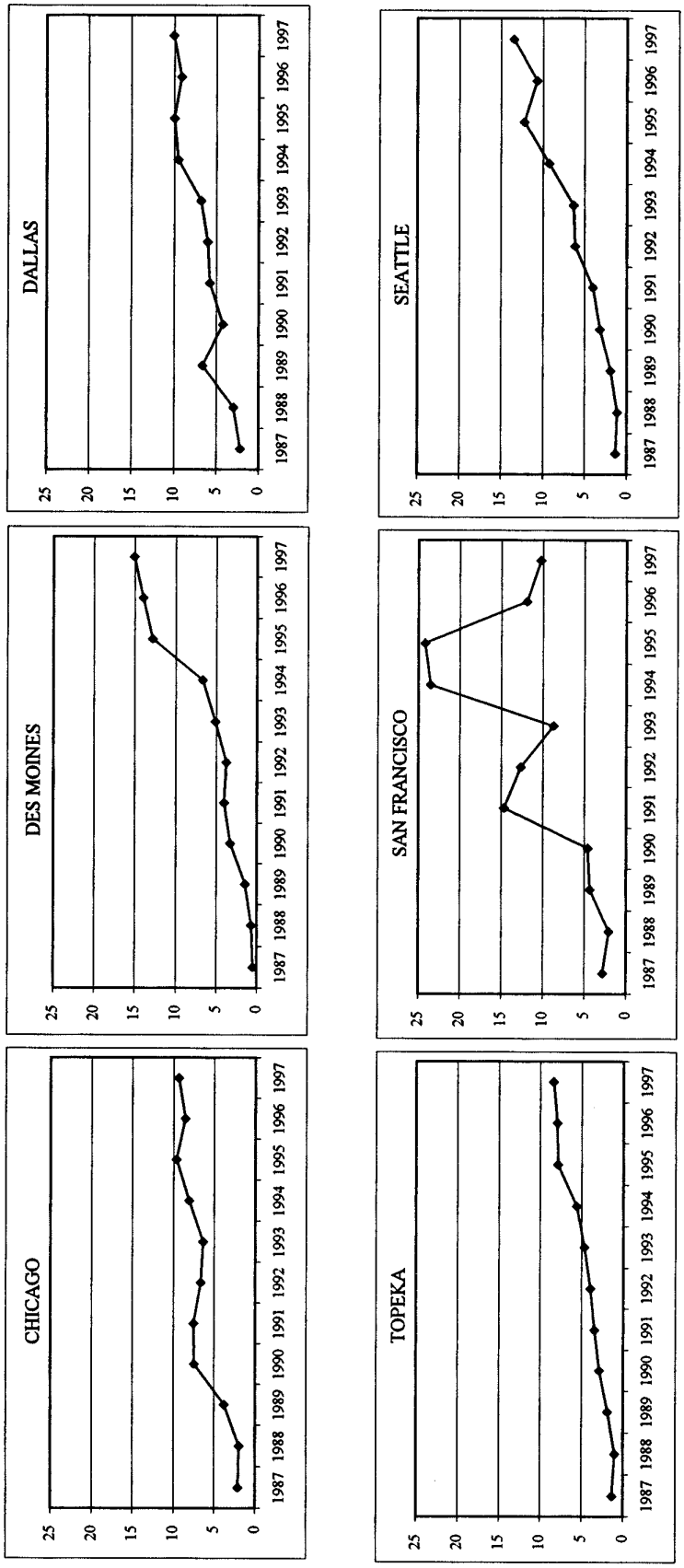


Investments of the FHLBanks



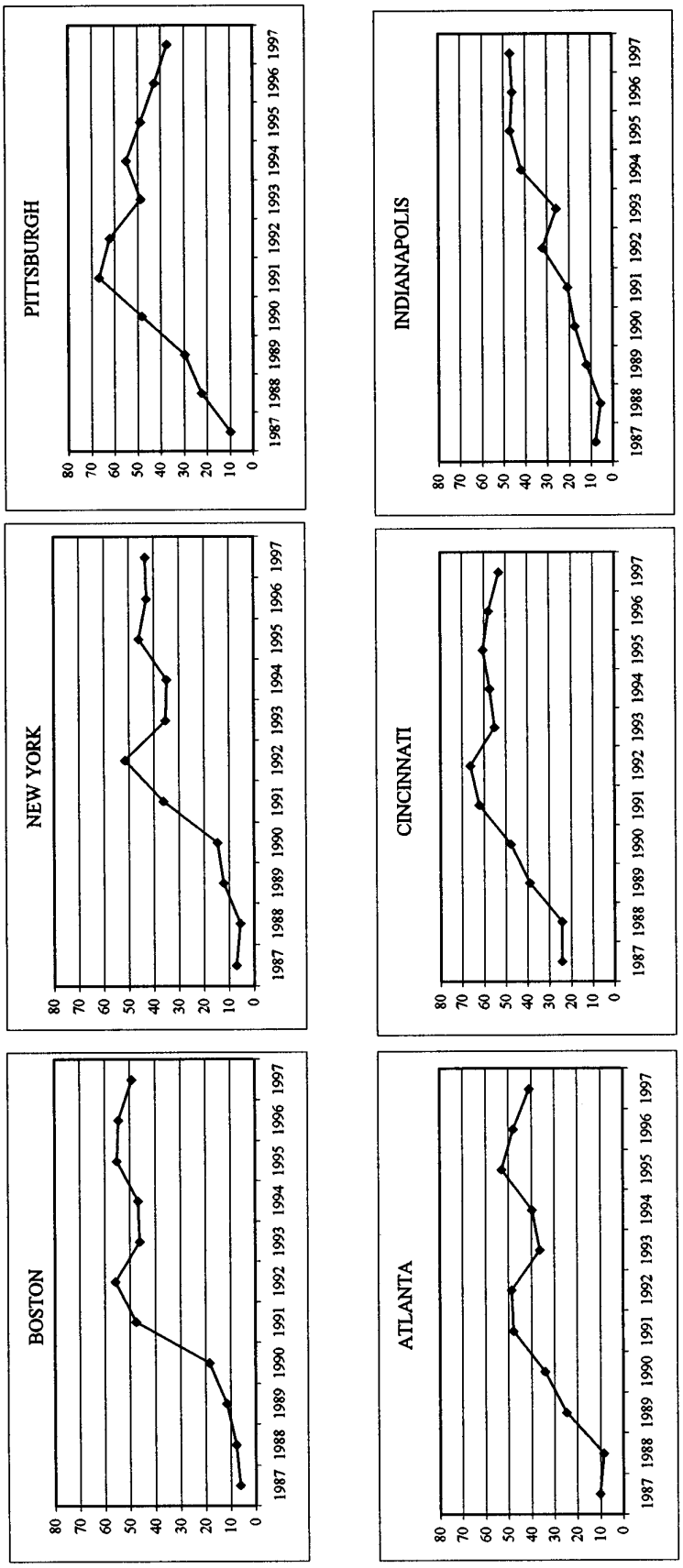
* Billions of Dollars

Investments of the FHLBanks



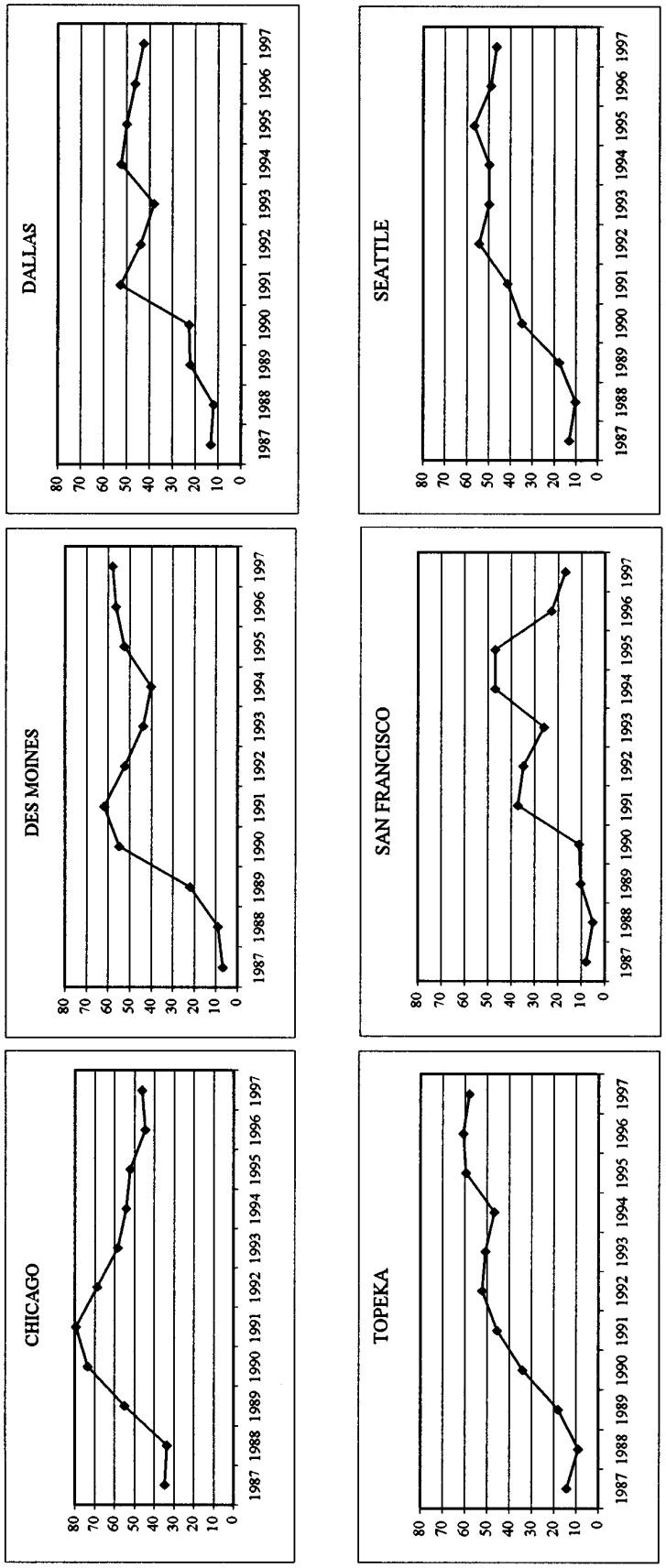
* Billions of Dollars

Investments of the FHLBanks as a Percentage of Assets

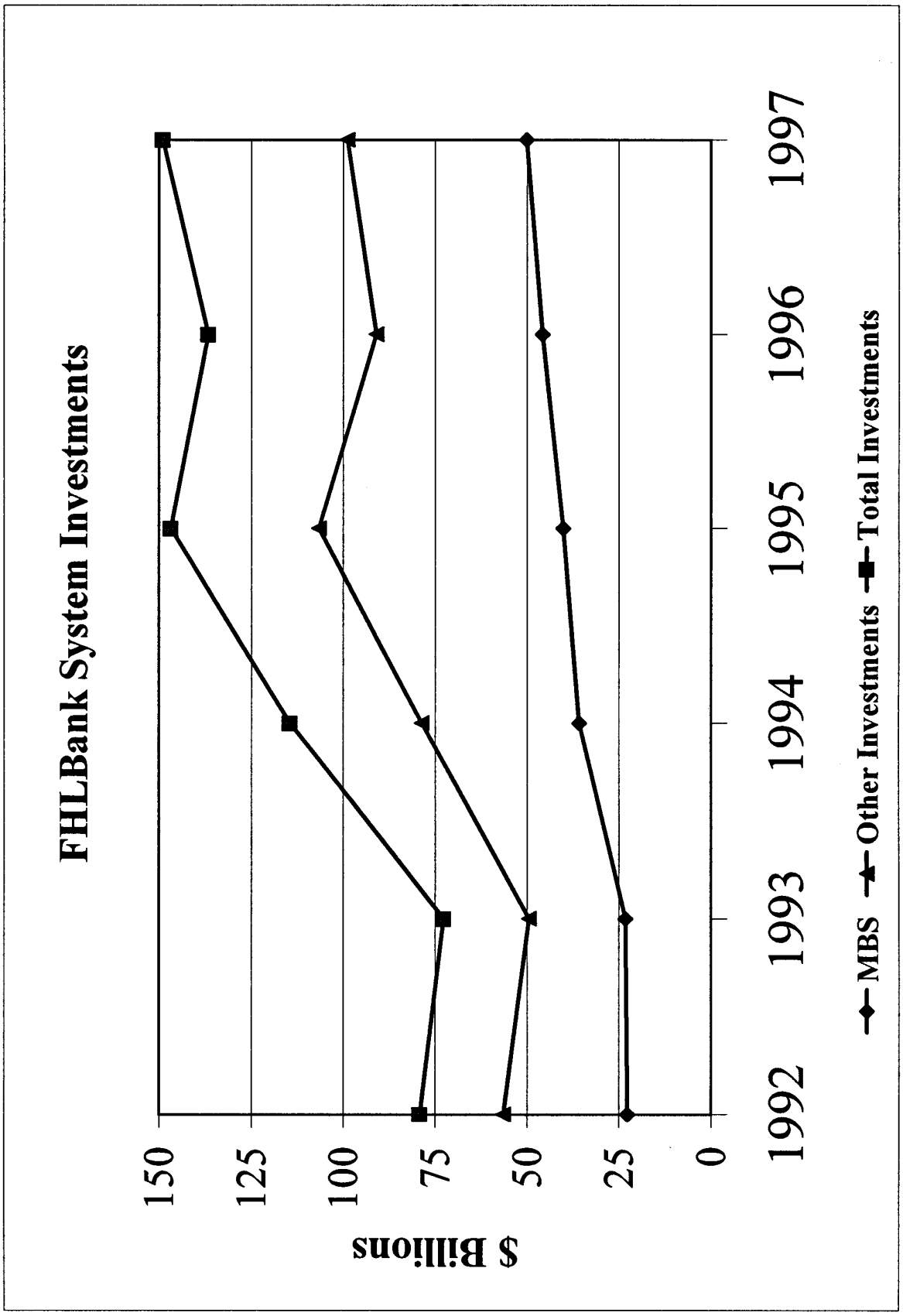


* Percent

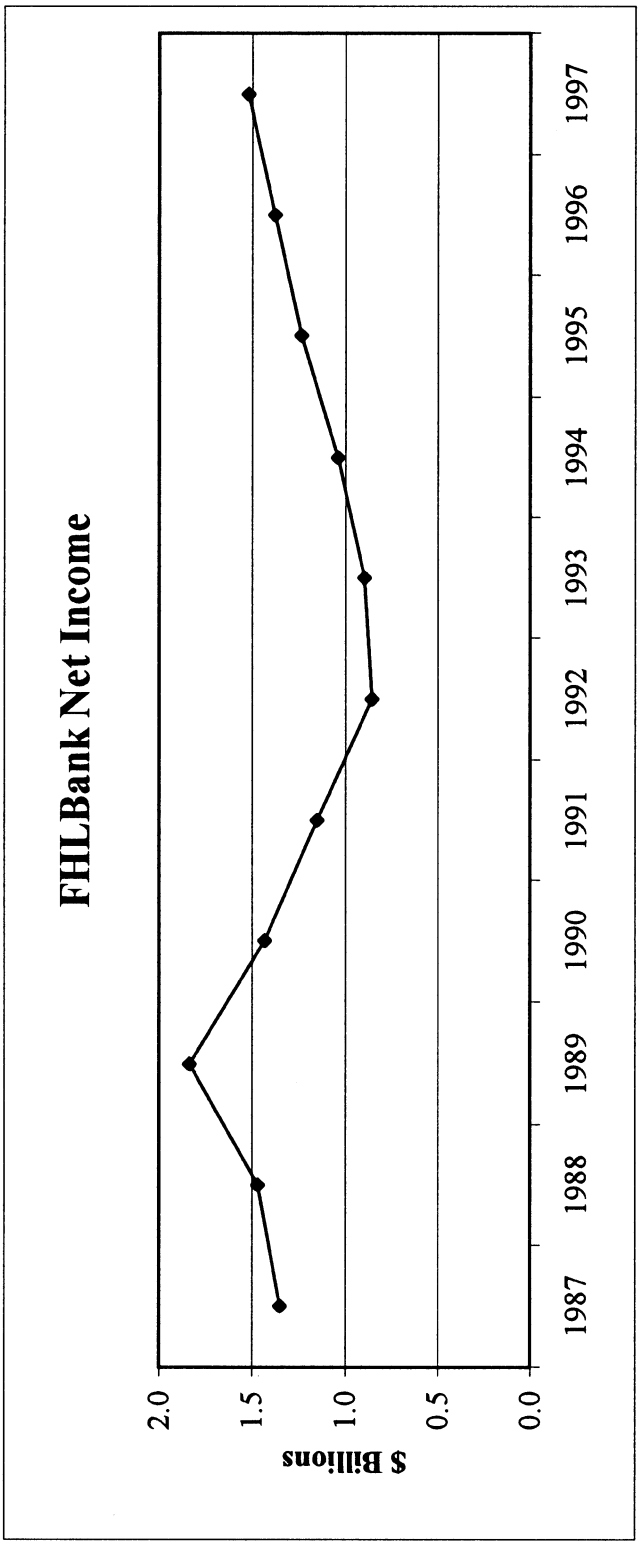
Investments of the FHLBanks as a Percentage of Assets

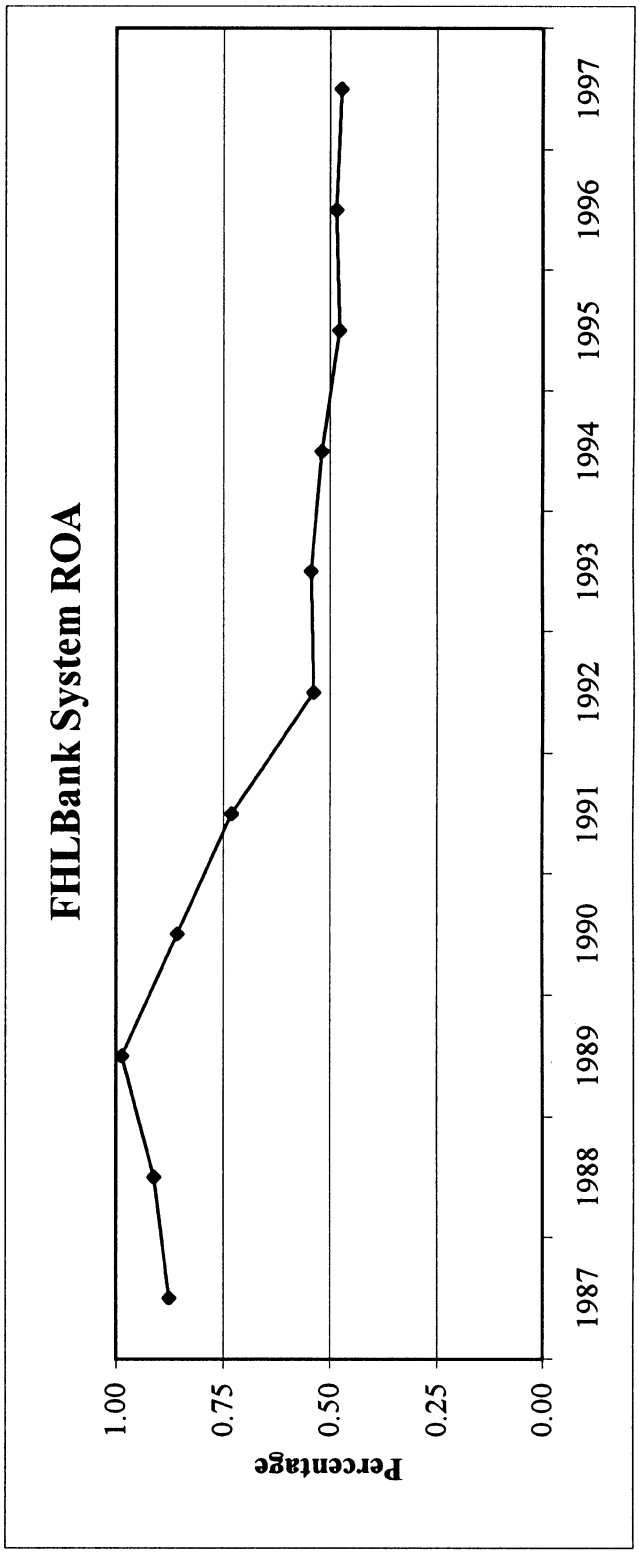


* Percent

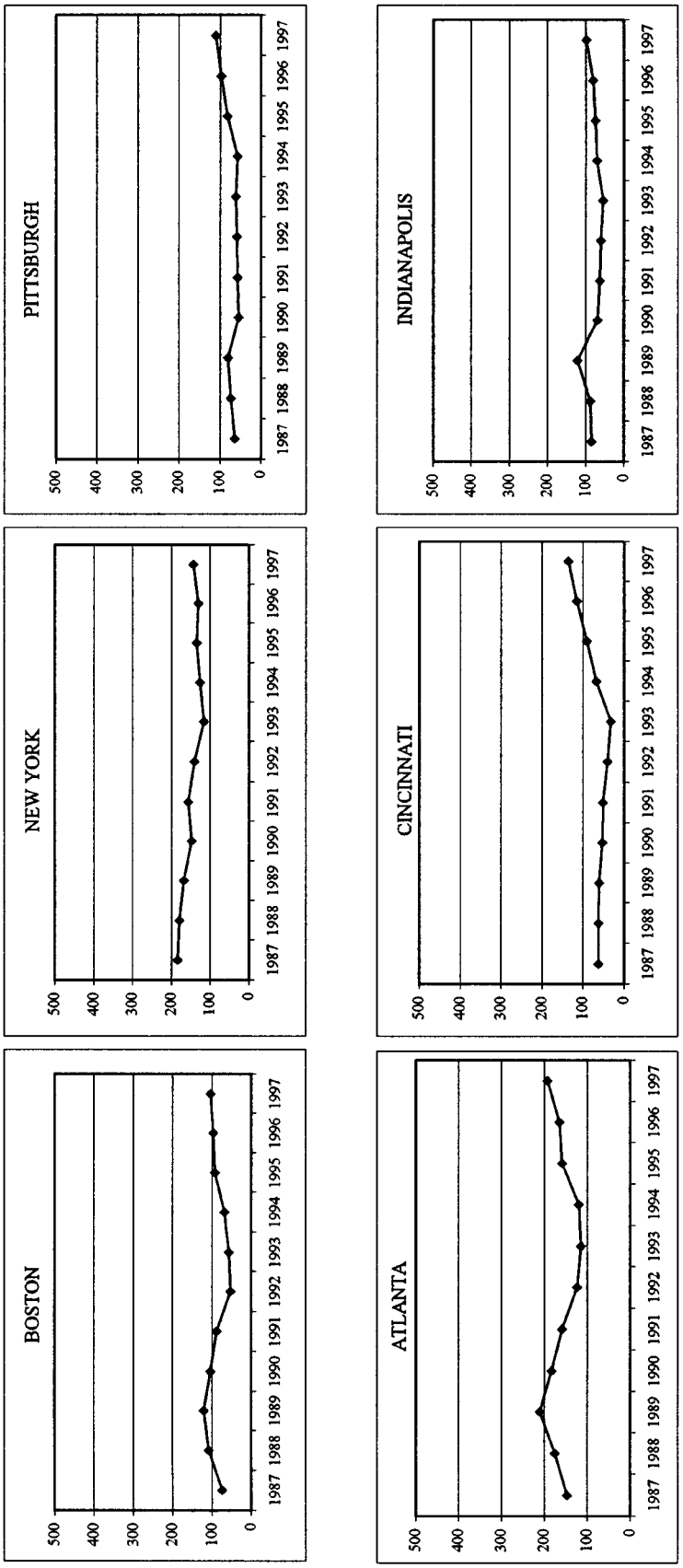

FHLBank System Investments
$ Billions
150
125
100
75
50
25
0
1992
1993
1994
1995
1996
1997
MBS
Other Investments
Total Investments

FHLBank System



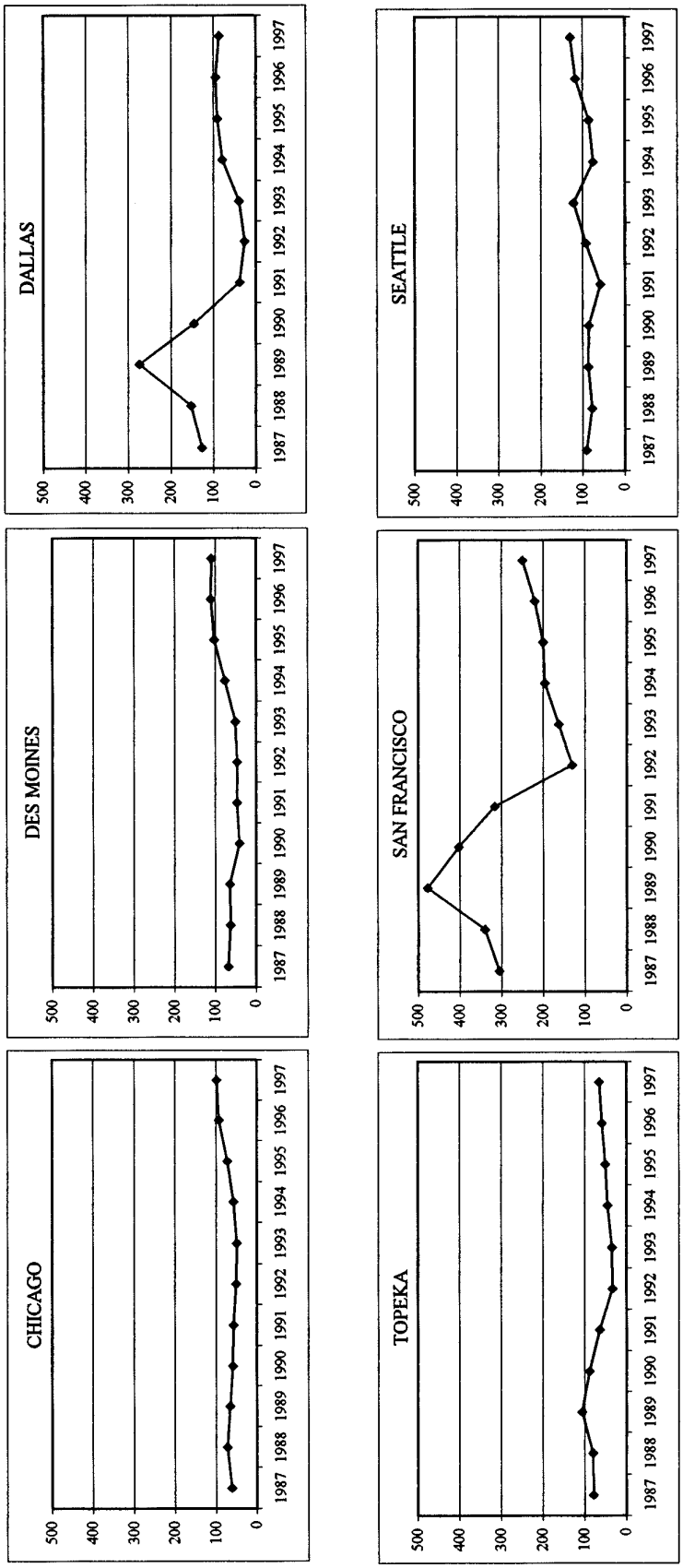


Net Income of the FHLBanks



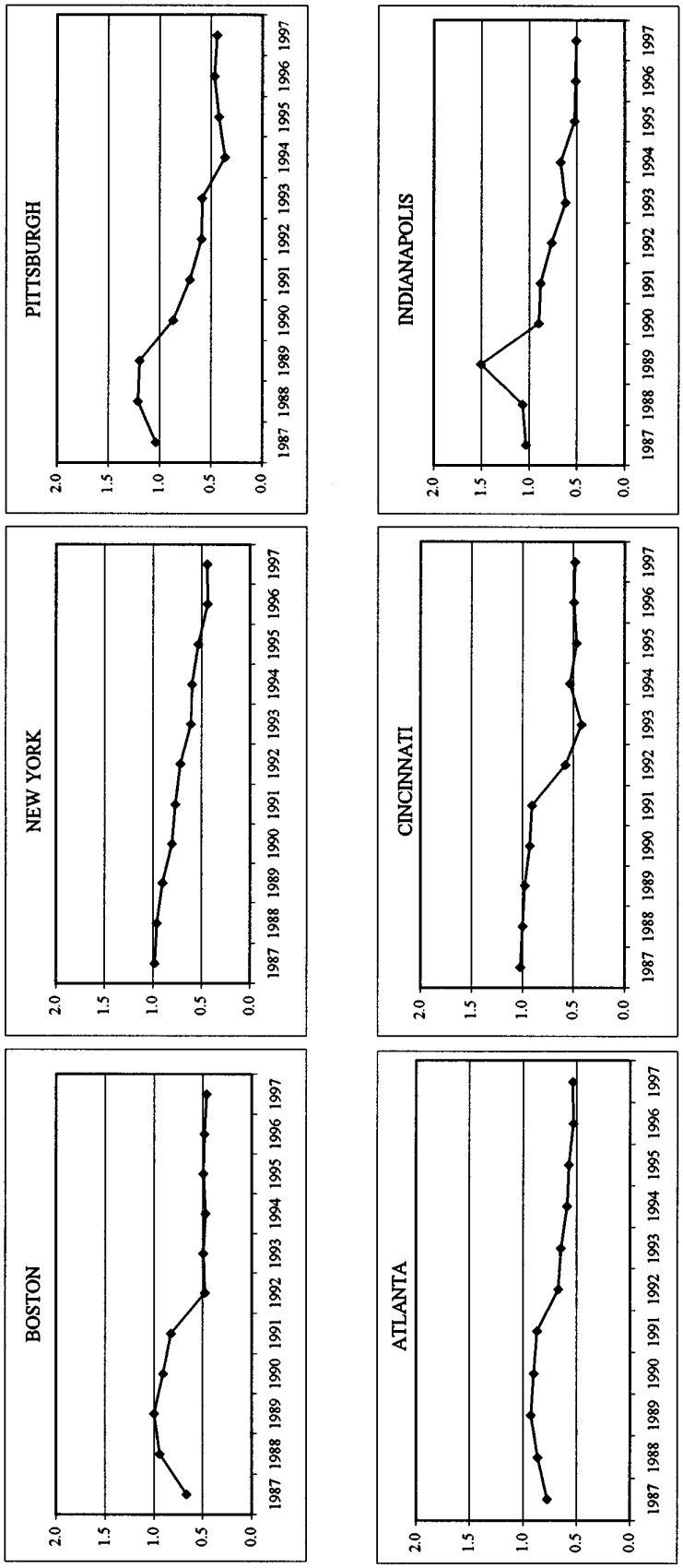
* Millions of Dollars

Net Income of the FHLBanks



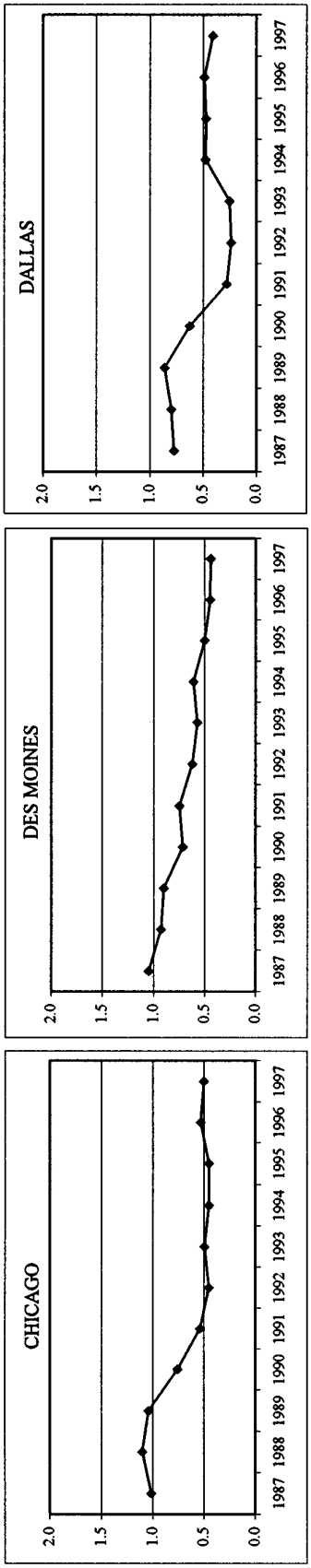
* Millions of Dollars

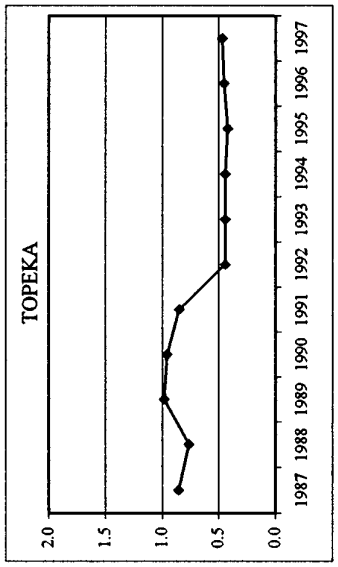
ROA of the FHLBanks

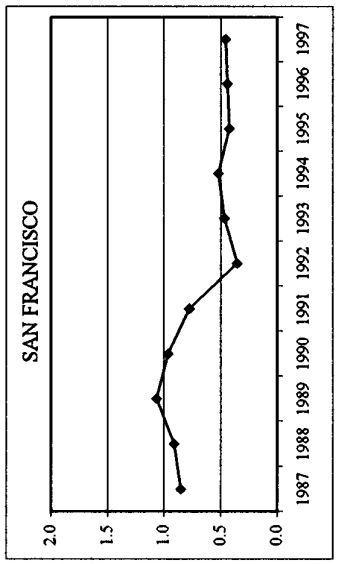


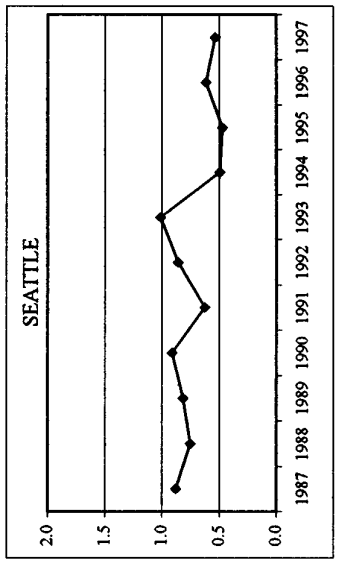
* Percent

ROA of the FHLBanks



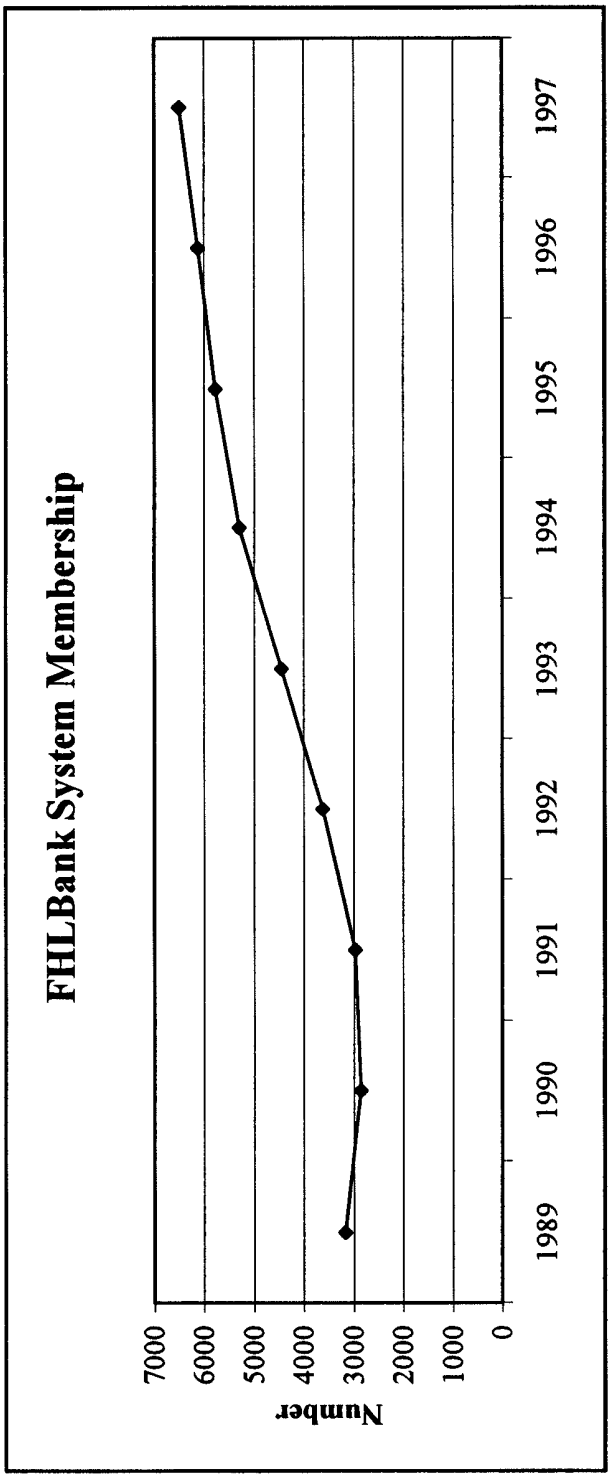


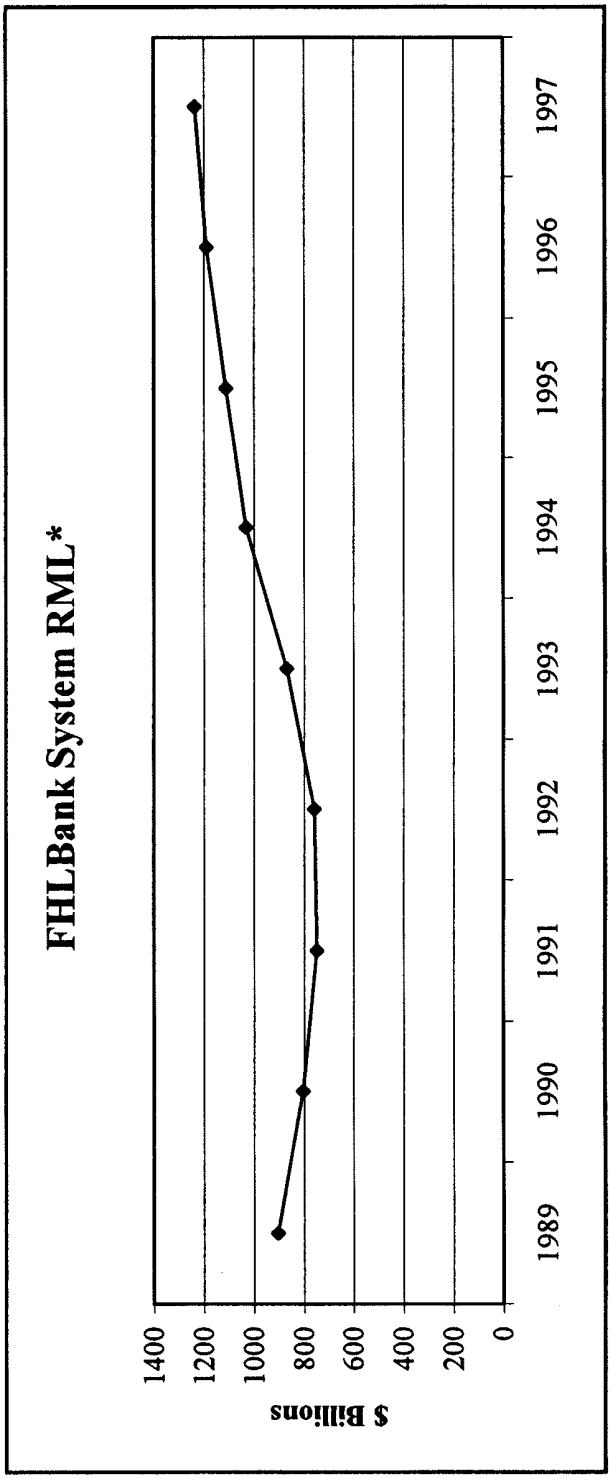




* Percent

FHLBank System

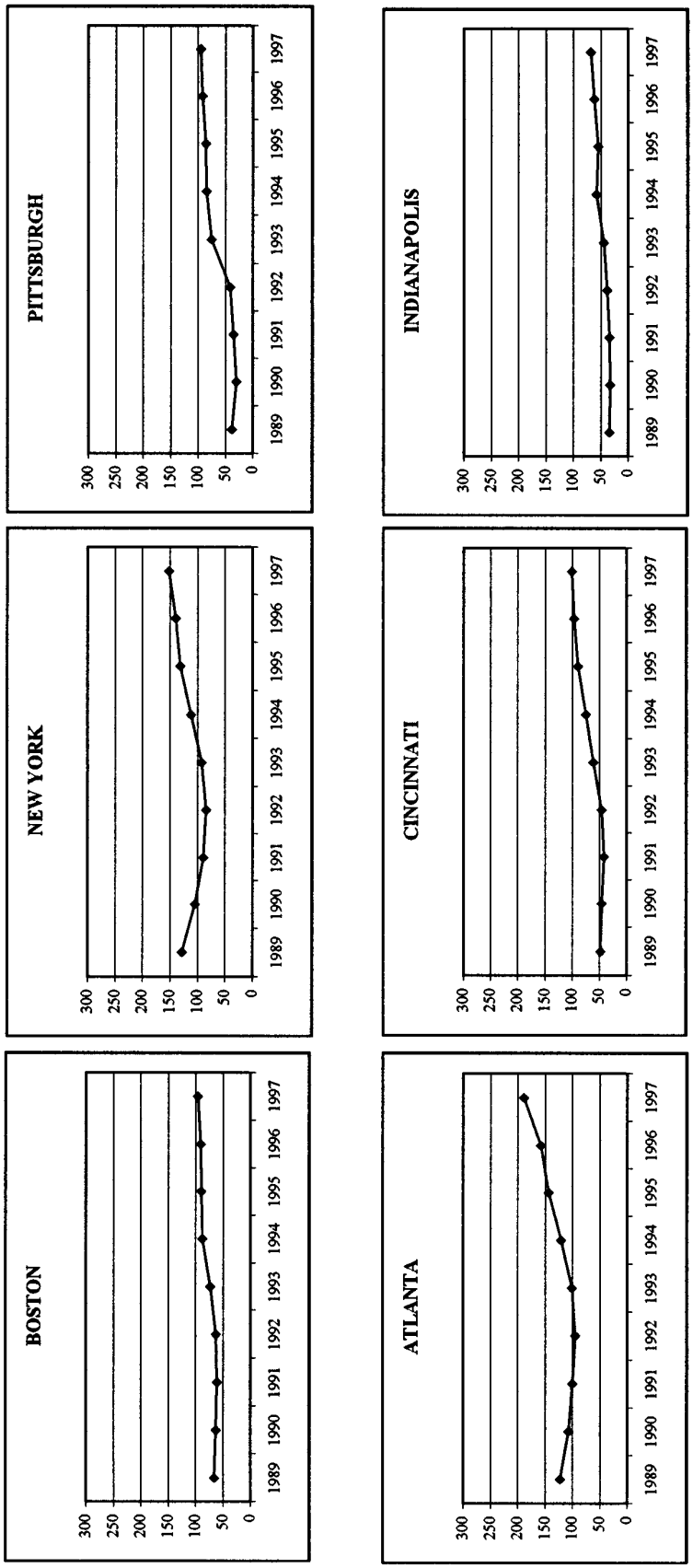




* Residential Mortgage Loans (RML) include housing construction loans, permanent mortgages, and mortgage backed securities.

FHLBank System Residential Mortgage Loans (RML*)

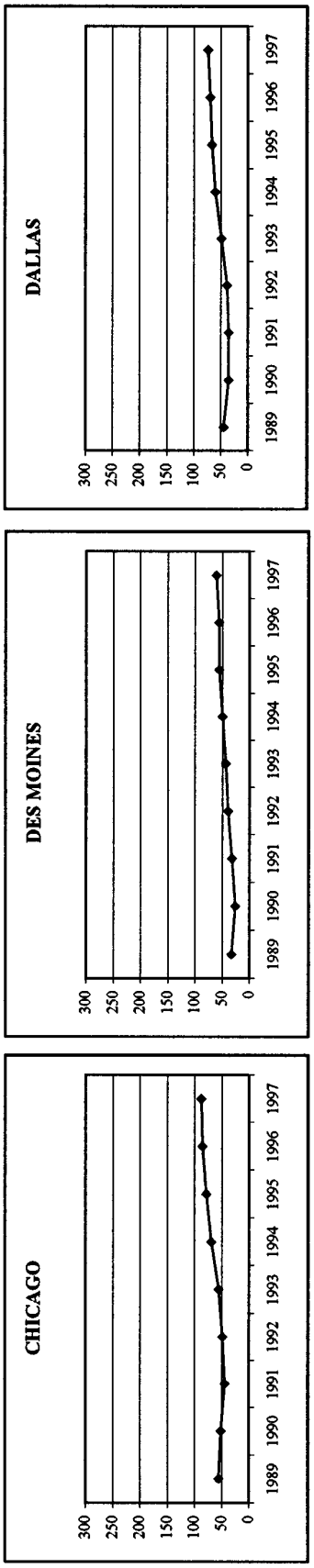
($Billions)

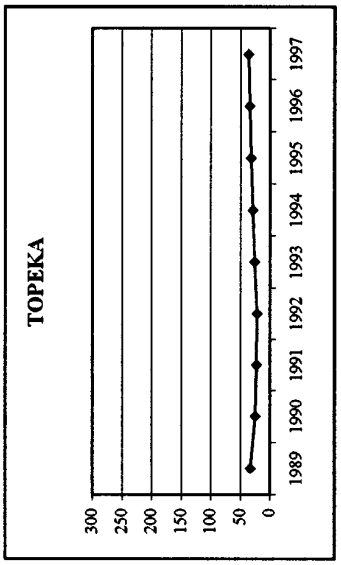


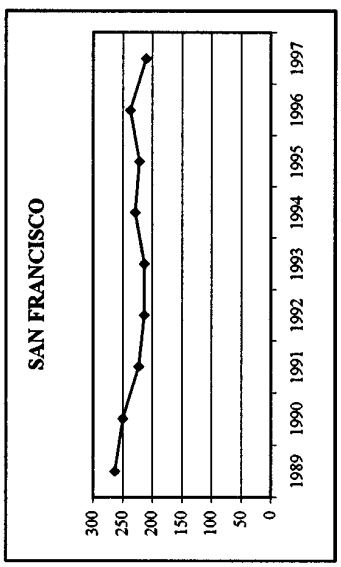
* Residential Mortgage Loans (RML) include housing construction loans, mortgages for single- and multi-family housing, and mortgage backed securities.

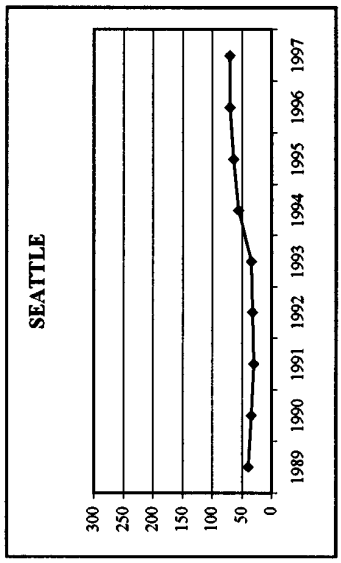
FHLBank System Residential Mortgage Loans (RML*)

($Billions)



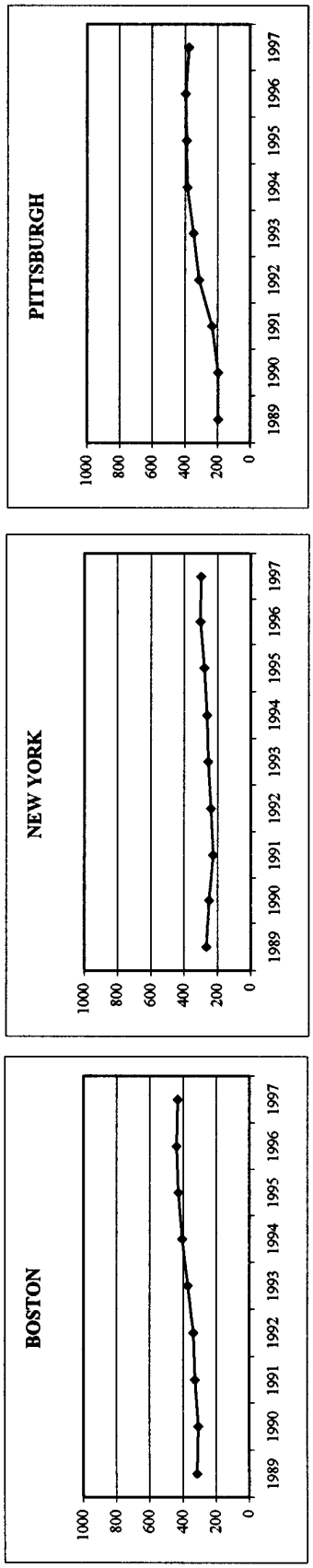


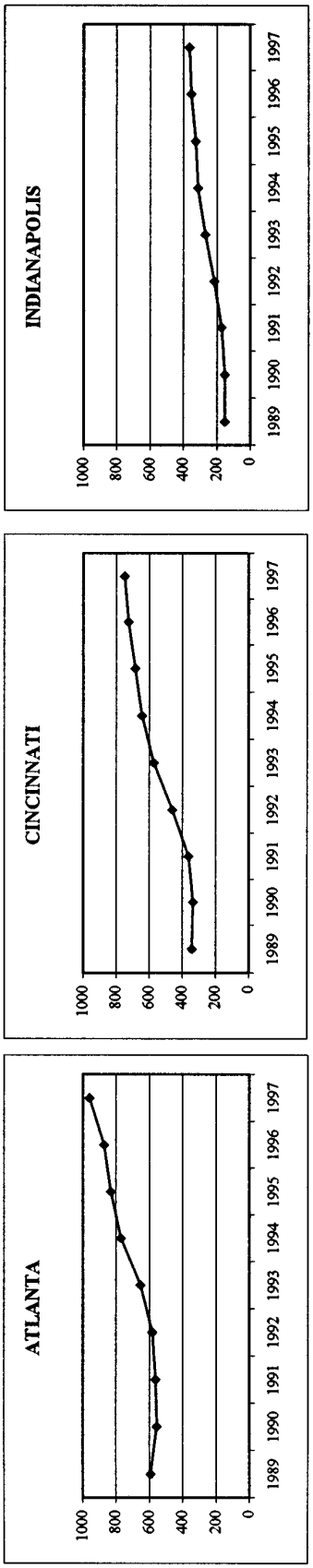




* Residential Mortgage Loans (RML) include housing construction loans, mortgages for single- and multi-family housing, and mortgage backed securities.

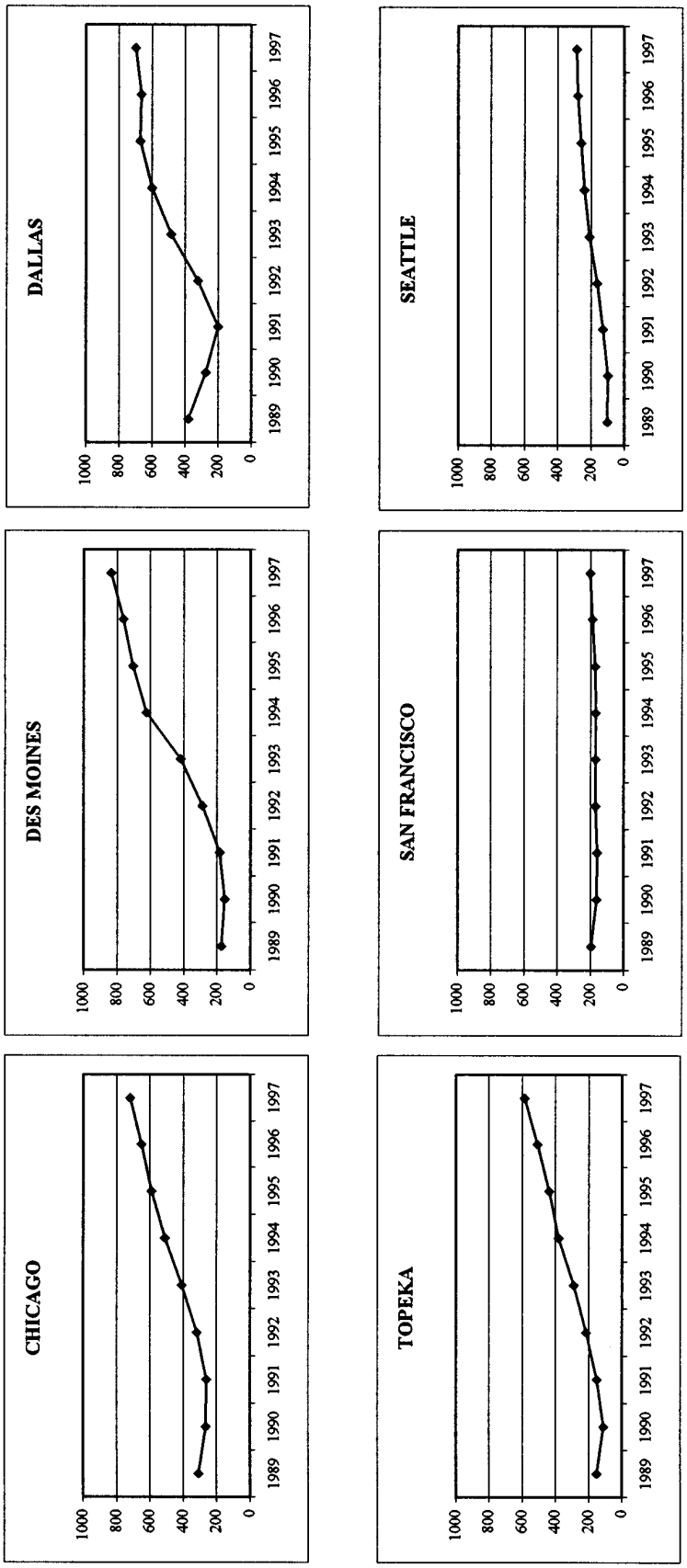
FHLBank System Membership





* Number of Members

FHLBank System Membership



* Number of Members

[FR Doc. 98–8508 Filed 4–2–98; 8:45 am]

BILLING CODE 6725–01–C