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ARTICLES

FIRREA AND THE NEW FEDERAL HOME LOAN BANK SYSTEM

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I. INTRODUCTION

On August 9, 1989, President Bush signed into law the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA).[1] FIRREA dramatically altered the federal regulatory scheme for the savings and loan industry. This landmark financial industry legislation also significantly changed the regulation of the Federal Home Loan Banks (Banks or Federal Home Loan Bank System). This Article examines FIRREA's impact on the Banks and their shareholders (members), both key components of America's home finance system. Included in this review is a discussion of the changes wrought in the regulatory oversight of the Banks and their members, the modifications in the corporate governance and powers of the

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1. Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 101 Stat. 183 (codified as amended in scattered sections of 2, 5, 12, 15, 26, 28, 31, 40, 42 & 44 U.S.C.).

Banks, and the principal challenges facing the Federal Home Loan Bank System in the post-FIRREA environment.

The twelve district banks in the Federal Home Loan Bank System were established by the Federal Home Loan Bank Act of 1932 (FHLB Act).[2] The Banks each serve a specified geographical district and are presently headquartered in Boston, New York, Pittsburgh, Atlanta, Cincinnati, Indianapolis, Chicago, Des Moines, Dallas, Topeka, San Francisco and Seattle. As of September 30, 1990, the twelve Banks had combined total assets of $159.7 billion,[3] combined outstanding loans (advances) to member institutions of $117.8 billion,[4] outstanding capital market debt obligations (consolidated obligations) of $116.3 billion,[5] and total equity capital, including reserves, of $11.8 billion.[6]

II. THE CURRENT SYSTEM OF BANK REGULATION

A. *The Federal Home Loan Bank System Before FIRREA*

The Banks are federally chartered, privately owned corporations.[7] Before FIRREA, the Banks' two basic missions were to: (1) provide wholesale banking services to member savings and loan associations;[8] and (2) examine, supervise and regulate federally insured member institutions through Bank employees acting as agents of the Federal Home Loan Bank Board (FHLBB or Bank Board) and the Federal Savings and Loan Insurance Corporation (FSLIC).[9]

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2. 12 U.S.C. §§ 1421-1449 (1988). For additional information regarding the development and basic elements of the Federal Home Loan Bank System, see Dirk S. Adams & Rodney R. Peck, *The Federal Home Loan Banks and the Home Finance System*, 43 BUS. LAW. 833 (1988). Unless otherwise noted herein, that article's discussion of the Federal Home Loan Bank System's operations remains valid. *Id.*

3. THE DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS at XV-2 (1991) [hereinafter TREASURY DEPARTMENT STUDY].

4. *Id.* at XV-3, tbl. 2.

5. *Id.*

6. *Id.* at XV-2.

7. *Id.* at XV-1.

8. 12 U.S.C. § 1431(e) (1988). Throughout this article all pre-FIRREA code sections of 12 U.S.C. shall be designated as "former 12 U.S.C.," while current sections shall be designated simply as "12 U.S.C."

9. Former 12 U.S.C. § 1437 (repealed 1989); *see generally* Adams & Peck, *supra* note 2, at 837 (explaining the Banks' dual functions of banking and regula-

Before FIRREA, the Banks were subject to regulatory oversight by the Bank Board which, along with the FSLIC, was an independent agency in the executive branch of the federal government.[10] In addition to overseeing the operation of the twelve district Banks, the Bank Board granted federal charters to savings and loan associations and certain savings banks,[11] and regulated all federally chartered thrift institutions.[12] The FHLBB also managed the FSLIC, which in turn regulated all FSLIC insured state-chartered savings institutions.[13] Finally, the FHLBB directed the Federal Home Loan Mortgage Corporation (FHLMC).[14]

B. *FIRREA's New Regulatory Structure for the Federal Home Loan Bank System*

FIRREA abolished the FHLBB and, in its stead, established two new agencies.[15] The Office of Thrift Supervision (OTS) is vested with the authority and responsibility for carrying out the Home Owners' Loan Act of 1933 (HOLA) with respect to the examination, supervision and regulation of insured savings and loan associations.[16] Under FIRREA, the OTS serves as the primary federal regulator for state and federal savings and loan associations and possesses the federal chartering authority formerly vested in the FHLBB.[17] OTS is designated as a bureau in the Department of the Treasury, "subject to the general oversight of the Secretary of the Treasury."[18] FIRREA also established the position of the Director of the OTS and specified that "[t]he Secretary of the Treasury may not intervene in any matter or proceeding before the Di-

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tion).

10. Former 12 U.S.C. § 1437(b) (repealed 1989).

11. *See id.* § 1464(a) (amended 1989).

12. *See id.* § 1464(a), (d) (amended 1989).

13. Adams & Peck, *supra* note 2, at 836, 843.

14. Former 12 U.S.C. § 1452(a) (amended 1989). FIRREA amended the FHLB Act to provide that the Federal Home Loan Mortgage Corporation be governed by an 18 member board of directors under the regulatory oversight of the Secretary of Housing and Urban Development. *Id.* § 1452. In effect, FIRREA completed the privatization of the Federal Home Loan Mortgage Corporation. *Id.*

15. 12 U.S.C. §§ 1422a, 1462a(a) (1988).

16. *Id.* §§ 1461, 1462a(a), (e).

17. *Id.* §§ 1463-1464.

18. *Id.* § 1462a(b)(1).

rector unless otherwise provided by law."[19] The Director is charged with providing for the safe and sound operation of federally insured savings and loan associations.[20]

The second new agency created by FIRREA is the Federal Housing Finance Board (FHFB or Housing Finance Board). Like the FHLBB, the FHFB was established as an independent agency in the executive branch of the federal government.[21] The FHFB is charged with the duty of supervising the Banks to ensure that they "carry out their housing finance mission, . . . remain adequately capitalized and able to raise funds in the capital markets," and operate safely and soundly.[22] In these respects, the FHFB succeeds to the authority of the FHLBB with respect to the Banks.[23]

Management of the FHFB is vested in a five-member board of directors which includes the Secretary of Housing and Urban Development (HUD).[24] The other four directors must be citizens of the United States, appointed by the President and confirmed by the Senate.[25] Except for the first appointment, appointed directors serve staggered terms of seven years.[26] Appointed directors must have "extensive experience

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19. *Id.* § 1462a(b)(3).

20. *Id.* § 1463(a).

21. *Id.* § 1422a(a)(2). In the original bill sent to Congress by the Bush Administration, the Banks would have been regulated by the Secretary of the Treasury. S. 413, 101st Cong., 1st Sess. (1989), 135 CONG. REC. S1535 (1989). Congress rejected this approach, in part because in the past the Department of the Treasury has opposed allocating credit to housing through government cooperatives.

22. 12 U.S.C. § 1422a(a)(3) (1988).

23. *Id.* § 1422a(a)(1). The nature of the FHLBB's authority over the Banks is, therefore, suggestive. In that regard, a federal appellate court found the authority of the FHLBB over the Banks to be "sweeping and plenary" and the "broadest kind of federal control" derived from the Banks' status as "federal instrumentalit[ies]" organized to "carry out public policy" with functions which are wholly governmental in nature. Fahey v. O'Melveny & Myers, 200 F.2d 420, 443, 446 (9th Cir. 1952).

24. 12 U.S.C. § 1422a(b)(1), (3) (1988).

25. *Id.* § 1422a(b)(1)(B).

26. *Id.* § 1422a(b)(1)(B), (b)(3). Following the enactment of FIRREA, controversy surrounding whether the FHFB directors would serve in full-time or part-time positions delayed confirmation of the President's appointments to the Housing Finance Board. The FHFB directors were finally confirmed by the Senate in February 1992 after an agreement was reached with the Administration that the directors would hold part-time positions through 1993, at which time the positions would become full-time. AM. BANKER, Mar. 2, 1992, at 10.

or training in housing finance or [have] a commitment to providing specialized housing credit."[27] At least one director must "be chosen from an organization with more than a 2-year history of representing consumer or community interests [in respect of] banking services, credit needs, housing or financial consumer protection."[28] "Not more than 3 directors [may] be members of the same political party."[29] The President shall designate one of the appointed directors as chairperson of the FHFB.[30] Until such time as at least two directors are appointed and confirmed to the FHFB, the Secretary of HUD shall act for all purposes and with full powers of the board of directors of the FHFB.[31]

FIRREA also made substantial changes in the federal deposit insurance system.[32] The Act abolished the FSLIC,[33] created the FSLIC Resolution Fund to assume the outstanding nondeposit insurance obligations of FSLIC and established a new insurance fund, known as the Savings Association Insurance Fund (SAIF), to insure the deposits of savings and loan associations.[34] Commercial banks and savings banks formerly insured by the FDIC will be insured by the new Bank Insurance Fund (BIF) to which the assets and liabilities of the FDIC fund were transferred.[35] All three funds are administered by the Federal Deposit Insurance Corporation (FDIC).[36] The Board of Directors of the FDIC was restructured to consist of five members, including the Comptroller of the Currency, the Director of the OTS and three individuals appointed by the President and confirmed by the Senate.[37]

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27. *Id.* § 1422a(b)(2)(A).
28. *Id.* § 1422a(b)(2)(B).
29. *Id.* § 1422a(b)(2)(A).
30. *Id.* § 1422a(c)(1).
31. *Id.* § 1422a(c).
32. Paul T. Clark et al., *Regulation of Savings Associations Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1990*, 45 BUS. LAW. 1013 (1990).
33. Former 12 U.S.C. § 1437 (repealed 1989).
34. 12 U.S.C. §§ 1821a, 1821(a)(6) (1989).
35. *Id.* § 1821(a)(5).
36. *Id.* § 1821(a)(6).
37. *Id.* § 1812(a).

C. *Oversight of the Banks*

The FHFB, vested with the authority to supervise and regulate the Banks, may promulgate and enforce regulations and orders to carry out the provisions of the FHLB Act.[38] The FHFB is also authorized to engage and compensate employees, attorneys and agents and to suspend or remove, for cause, a director, officer, employee or agent of any Bank.[39] The FHFB may not delegate any of its nonministerial functions to employees, joint offices or administrative units of the Banks.[40]

In implementing its regulatory oversight authority over the Banks, the FHFB adopted the former FHLBB regulations at 12 C.F.R. pts. 506, 506a and 521-535 as the new regulations of the FHFB, now found at 12 C.F.R. pt. 910.[41] As before FIRREA, the Banks must obtain the approval of their regulatory agency to select, appoint and compensate officers and employees,[42] acquire offices and properties,[43] declare dividends,[44] undertake certain borrowing activities,[45] establish capital and operating budgets[46] and promulgate credit policies.[47] The FHFB also prescribes procedures to be followed by the Banks in the collection and settlement of checks, drafts or other negotiable or non- negotiable items, or instruments of

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38. *Id.* §§ 1422a, 1422b.

39. *Id.* § 1422b(a)(2).

40. *Id.* § 1422b(b)(1). Prior to FIRREA, the Bank Board had delegated to the Bank presidents (known as principal supervisory agents) and to individual employees of the Banks (known as supervisory agents and examiners), but not to the Banks themselves, the authority to supervise and examine FSLIC-insured thrifts. *See* former 12 C.F.R. §§ 500.32(b), 501.10, 501.11, 561.16c (repealed 1989). While performing these delegated functions, Bank employees acted as agents of the FHLBB and the FSLIC and not as agents of the Bank. Neither the Banks nor their directors had any responsibility or liability for monitoring or supervising Bank employees performing these functions. *See* former 12 C.F.R. § 522.62 (repealed 1989). It has been held that the Banks are not liable for actions taken by their employees in their capacity as supervisory agents. Saratoga Sav. & Loan Ass'n v. Federal Home Loan Bank, 724 F. Supp. 683, 685 (N.D. Cal. 1989). In addition, prior to FIRREA, other Offices of the Banks performed certain specific functions on behalf of the FHLBB, as for example, the Office of Education.

41. 54 Fed. Reg. 36,757 (1989).

42. 12 U.S.C. § 1432(a) (1991); 12 C.F.R. § 932.41 (1990).

43. 12 U.S.C. § 1432(a) (1988)

44. 12 C.F.R. § 932.3 (1990).

45. 12 U.S.C. § 1431(a)-(c) (1991).

46. 12 C.F.R. § 934.6 (1990).

47. *Id.* §§ 935.2, 940.1.

payment drawn on or issued by members or institutions eligible to become Bank members.[48] Following FIRREA, the Banks' boards of directors may now provide for indemnification of their officers and directors without FHFB approval,[49] in contrast to prior law under which the Bank Board could prevent Banks from providing such indemnification.[50]

D. *Resolution of Thrift Cases*

The essential purpose of FIRREA is to provide a structure for resolving the huge number of troubled thrift cases which continued to confront the federal government in 1989. FIRREA was necessary because the government's first attempt to resolve the thrift crisis through recapitalization of the FSLIC under the Competitive Equality Banking Act of 1987 (CEBA)[51] had been unsuccessful in stemming the tide of thrift insolvencies. Under both CEBA and FIRREA, Congress established a major funding role for the Banks in the resolution of this most serious financial services crisis since the Great Depression.

The FSLIC Recapitalization Act of 1987, enacted as part of the CEBA, established the Financing Corporation (FICO),[52] the purpose of which was to borrow up to $10.825 billion in the public capital markets to transfer to the then insolvent FSLIC.[53] Such funds were transferred to the FSLIC in exchange, in part, for FICO receiving nonvoting capital stock in the FSLIC, and, in part, for FICO receiving nonredeemable capital certificates issued by the FSLIC.[54] FICO was to be capitalized by funds of the Banks which were to be used to purchase zero coupon bonds to defease the principal of the obligations issued by FICO.[55] The Banks were also responsible for the payment of the administrative expenses of FICO.[56] Under CEBA, funds for the interest payments on FICO obliga-

48. *Id.* § 943.1.
49. 12 U.S.C. § 1427(k) (1988).
50. *Id.*
51. Pub. L. No. 100-86, 101 Stat. 552 (1987).
52. 12 U.S.C. § 1441(c), (e) (1988).
53. *Id.*
54. *Id.* § 1441(c), (e)(3).
55. *Id.* § 1441(g)(2).
56. *Id.* § 1441(b)(7)(A).

tions and the payment of FICO's nonadministrative expenses came primarily from deposit insurance assessments against FSLIC-insured institutions.[57]

After FIRREA, the bulk of the assets and nondeposit insurance liabilities of the now defunct FSLIC were transferred to the newly created FSLIC Resolution Fund.[58] The transferred assets and liabilities arose, in large part, from the FSLIC's claims as deposit insurer against the assets of failed thrifts. Pursuant to FIRREA, FICO (and thus, indirectly, the Banks) continues to be one of the sources of funding for the FSLIC Resolution Fund.[59] However, at the request of the Treasury Department, FICO has not issued any obligations or transferred to the FSLIC Resolution Fund any proceeds since September 1989.[60] Instead, the earnings of the Banks are being used to capitalize another thrift resolution mechanism established by FIRREA, the Resolution Funding Corporation (REFCO).[61] It is unlikely that FICO will issue any future obligations because the repayment sources have been committed elsewhere by FIRREA.

The enactment of FIRREA made clear that the $600 million in capital transferred from the Banks to FICO for principal defeasance represented an investment which will not be returned to the Banks. Formerly, FICO was to terminate upon the redemption by the FSLIC of its stock held by FICO or on December 31, 2026, whichever was earlier.[62] Because of the abolition of the FSLIC and, thus, the elimination of the requirement that the FSLIC redeem its stock held by FICO, FICO is now to dissolve, as soon as practicable, either when it fully repays its outstanding obligations or on December 31, 2026.[63] Accordingly, the Banks (which until FIRREA reflected their FICO capital stock investment as a debit in the capital section of their balance sheets) have written off their investment in FICO stock.[64]

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57. *Id.* § 1441(f).

58. *Id.* § 1821a(a)(2)(A).

59. *Id.* § 1821a(b)(2), (3).

60. Letter from K. Diane Boyle, Secretary/Treasurer, Financing Corporation, to Stanley J. Poling, Interim Director, Division of FSLIC Operations, FDIC (Nov. 17, 1989) (on file with the *Santa Clara Law Review*).

61. 12 U.S.C. § 1441b(e) (1988).

62. *Id.* § 1441(j)(1).

63. *Id.* § 1441(i)(1).

64. Report of Deloitte, Haskins-Sells to Ronald R. Morphew, President, Feder-

FIRREA modified the CEBA provisions regarding the payment of interest on FICO obligations to explicitly identify the sources of funds for such interest payments. After FIRREA, the first source of such funds is insurance premiums assessed against SAIF-insured institutions, with FICO having first priority on the use of such insurance premiums.[65] However, due to the contraction of the thrift industry, and the corresponding decrease in the amount of SAIF insurance premiums collected, the amount of insurance premium funds available for interest payments on FICO obligations may continue to decline.[66] To the extent insurance premium assessments are insufficient to meet interest payments, FICO may request that the FDIC transfer to FICO the amount of liquidating dividends and payments made on receivership claims received by the FSLIC Resolution Fund, provided that such funds are not needed by the REFCO.[67] As of this writing, no such funds have been made available for FICO interest payments.

In addition to those funds it may receive from FICO, the FSLIC Resolution Fund receives other funds from income earned on the Resolution Fund's assets, liquidating dividends and receivership claims (to the extent such funds are not needed by FICO and REFCO), and, from August 9, 1989 until December 31, 1991, SAIF insurance premiums (to the extent such funds are not needed by FICO and REFCO).[68] From August 9, 1989 to September 30, 1991, the FSLIC Resolution Fund is responsible for the payment of the administrative expenses of SAIF.[69] (This administrative obligation may account for the third priority standing of the FSLIC Resolution Fund in the use of SAIF insurance premiums.)[70]

To the extent that these identified sources of funds are insufficient to cover commitments of the FSLIC Resolution Fund, the Department of Treasury is authorized to provide,

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al Home Loan Bank of Indianapolis (June 30, 1989).

65. 12 U.S.C. § 1441(f) (1988).

66. *See Thrift's Deposit Shrinkage Continued in May*, AM. BANKER 10 (August 2, 1991).

67. 12 U.S.C. §§ 1441(f)(3), 1821a(6)(D) (1991); 12 C.F.R. § 950.12(b)(2) (1989).

68. *Id.* § 1821a(b)(4).

69. *Id.* § 1821a (6)(D).

70. *Id.*

subject to appropriation by Congress, unlimited funds to the FSLIC Resolution Fund.[71]

FIRREA also established the Resolution Trust Corporation (RTC) which is, for the most part, funded by REFCO, and managed by the chief executive officer of the RTC.[72] Both REFCO and the RTC are, in turn, governed by the Thrift Depositor Protection Oversight Board.[73] The Thrift Depositor Protection Oversight Board consists of the Secretary of the Treasury who serves as Chairman, the Chairman of the Board of Governors of the Federal Reserve System, the Director of the Office of Thrift Supervision, the Chairman of the Board of Directors of the Federal Deposit Insurance Corporation, the Chief Executive Officer of the RTC, and two individuals of different political parties, appointed by the President.[74]

The RTC's mission is to resolve the troubled thrift cases placed in receivership between January 1, 1989 and August 9, 1992, three years after the enactment of FIRREA.[75] The RTC must also reevaluate all resolution cases undertaken by the FSLIC between January 1, 1988 and August 9, 1989.[76] The RTC will exist until December 31, 1996, and its funding will consist of $50 billion, the majority of which will be raised by and transferred from REFCO over a three-year period beginning on the date of FIRREA's enactment.[77] One of the most debated issues during the drafting of FIRREA was whether the capitalization of the RTC would be achieved through on-budget direct Treasury financing, or off-budget financing through REFCO.[78] In the end, a compromise was struck

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71. *Id.* § 1821a(C). For fiscal year 1990, Congress appropriated "such sums as may be necessary" under the Departments of Veterans Affairs and Housing and Urban Development, and the Independent Agencies Appropriations Act of 1990. Pub. L. No. 101-144, 103 Stat. 839, 868 (1989).

72. 12 U.S.C. § 1441a(b)(1)(C) (1991), *amended by* Pub. L. No. 102-233, §309(a), 105 Stat. 1761, 1769 (1991).

73. *Id.* §§ 1441a(a); 1441b(c)(1), (8), *amended by* Pub. L. No. 102-233, § 302, 105 Stat. 1761, 1767 (1991); § 1441 a(b)(1)(c) (1991), *amended by* Pub. L. No. 102-233, § 309, 105 Stat. 1761, 1769 (1991).

74. *Id.* § 1441a(a)(3), *amended by* Pub. L. No. 102-233, § 304, 105 Stat. 1761, 1767 (1991).

75. *Id.* § 1441a(b)(3)(A).

76. *Id.* § 1441a(b)(11)(B).

77. *Id.* §§ 1441a(b)(14)(A), (O), 1441b(e)(8), (f)(1), (4).

78. *See, e.g.*, 135 CONG. REC. S3997 (daily ed. Apr. 17, 1989), 101st Cong., 1st Sess. (remarks of Senator Riegle); *id.* at S3999 (remarks of Senator Garn); *id.* at S4006 (remarks of Senator Bryan); *id.* at S4008-4009 (reprinting various editori-

whereby $18.8 billion from the Treasury, together with another $1.2 billion from the Banks, was transferred directly to the RTC.[79] The remaining $30 billion of RTC capital is to be raised by REFCO by borrowing in the public capital markets.[80]

The structure of REFCO is similar to FICO in that it is administered by a three-person directorate comprised of the director of the Office of Finance of the Federal Home Loan Bank System and two Bank Presidents, to be selected by the Oversight Board.[81] The directorate has little discretionary authority as nearly all of its actions require the approval of the Thrift Depositor Protection Oversight Board.[82]

Similar to FICO borrowing, REFCO borrowing is to be defeased through the purchase of zero-coupon bonds which are to be purchased with funds contributed by the Banks from their aggregate retained earnings remaining after their initial contribution to REFCO (approximately $900 million) and annual contributions of up to $300 million[83] (less any Bank contributions to FICO) from aggregate current earnings. In addition, insurance premiums assessed against SAIF-insured institutions, provided that such funds are not needed by FICO, will also be used to defease REFCO borrowings.[84] To the extent these insurance assessments together with Bank earnings are not sufficient to defease REFCO debt, the FDIC is to transfer funds to REFCO from the liquidating dividends and payments made on claims received by the FSLIC Resolution Fund from receiverships.[85]

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als in issue). *See also id.* at H4976 (daily ed. Aug. 3, 1989) (remarks of Congressman LaFalce); *id.* at H4979 (remarks of Congressman Leach); *id.* at H4988-89 (remarks of Congressman Hall); *id.* at H4997-98 (remarks of Congressman Fauntroy); *id.* at H4998 (remarks of Congresswoman Oaksar); *id.* at H5001 (remarks of Congressman Gonzales); *see also id.* at S10,182-83 (daily ed. Aug. 4, 1989 pt. II) (remarks of Senator Garn); *id.* at S10,189 (remarks of Senator Exon and Senator Grassley).

79. 12 U.S.C. §§ 1441a(b)(14), 1441b(e)(8) (1991).

80. *Id.* § 1441(b)(f)(1).

81. *Id.* § 1441b(c)(1).

82. 12 C.F.R. §§ 1510.3-1510.12 (1989).

83. Each Bank's share of the $300 million annual contribution is determined pursuant to a formula described at 12 U.S.C. § 1441b(e) (1991).

84. *Id.* § 1441b(e)(1), (e)(7)(A), (B).

85. *Id.* § 1441b(e)(7)(B).

FIRREA provided that the payment of interest on REFCO obligations will come from several sources. Those sources are: (1) earnings on REFCO assets; (2) RTC liquidating dividends and receivership proceeds, as well as payments on any warrants received by the RTC in connection with the resolution of thrift cases to the extent the Oversight Board determines such funds are not needed by the RTC; (3) the balance, if any, of the Banks' $300 million annual contribution which is not required for defeasance of REFCO bonds; and (4) proceeds received by the FSLIC Resolution Fund from the RTC's sale of the assets of failed thrifts. To the extent these funds are insufficient to cover the interest obligation on REFCO debt, the Treasury is required to make up the shortfall. Any such payment by the Treasury, however, will be considered a liability of REFCO to be repaid to the Treasury from any remaining assets after liquidation of REFCO.[86] Unlike FICO, which is statutorily limited to issuances of debt with a maturity no longer than thirty years, REFCO is not so limited.[87]

It appears that these contributions to REFCO will substantially reduce the Banks' net income, and, as a result of the adverse effect on the Banks' ability to pay dividends to members, the thrift industry's net income will decline as well. In recent years, the Banks have paid approximately seventy-five to eighty percent of their net income to members in the form of dividends on member Bank stock.[88] Since such dividend income constituted an estimated thirty-five to forty-five percent of the net profits of solvent savings and loan associations, the industry at large will undoubtedly feel the effects of this decrease in dividend income.[89] As one Federal Home Loan Bank official testified:

> Obviously, [Federal Home Loan Bank] dividends will be significantly lowered over the next four or five years. Simulations suggest a reduction of about 25%-30%. That reduc-

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86. *Id.* § 1441b(f)(2)(E)(ii).

87. *Id.* §§ 1441(e)(3), 1441b(f).

88. *Oversight Hearing to Examine the Impact of FIRREA on the Federal Home Loan Bank System: Hearings Before the Subcommittee on General Oversight and Investigation, House Committee on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. 99 (1989) (statement of Mr. Barney Beeksma, Chairman of the United States League of Savings Institutions).

89. *Id.* at 33-34 (1989) (statement of Mr. David Sullivan, Chairman, National Council of Savings Institutions).

> tion will deleteriously impact our stockholders, the nation's thrifts, who rely on those payments as an important source of their income. The legislation imposes many other burdens on the thrift industry as well. The outcome is likely to be considerable shrinkage of the thrift industry—our members and customers—and therefore, the Banks themselves. Let me be clear; none of our simulations show us operating at a loss, and, therefore, I can see no loss of interest or principal by our [Bank] bondholders.[90]

E. *Corporate Structure of the Banks After FIRREA*

As before FIRREA, the management of each Bank is vested in a board of fourteen directors, eight of whom are elected by its member institutions with the remaining six directors appointed by the FHFB.[91] At least two of the six FHFB- appointed directors must be consumer representatives chosen from organizations with more than a two-year history of "representing consumer or community interests on banking services, credit needs, housing, or financial consumer protection."[92] As before FIRREA, each elective directorship is to be designated by the FHFB as representing Bank members of a particular state, and only persons who reside in the district and who are officers or directors of a member located in that state are eligible to become directors.[93] Appointed directors may not have a financial interest in or serve as an officer or director of a member institution.[94] Elected directors serve for a two-year term and may be elected to three consecutive terms.[95] Appointed directors serve for four years.[96]

Under the FHLB Act, as amended by FIRREA, no person who is an officer or director of a member that fails to meet

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90. *Government-Sponsored Enterprises: Hearings Before the Subcommittee on General Oversight of the House Committee on Ways and Means*, 101st Cong., 1st Sess. 78 (1989) (statement of Mr. Brian Dittenhafer, President of Federal Home Loan Bank of New York).

91. 12 U.S.C. § 1427(a) (1991).

92. *Id.* Note that similar qualifications are required for one of the five members of the FHFB. *See supra* text accompanying note 28.

93. 12 U.S.C. § 1427(b) (1991).

94. *Id.* § 1427(a).

95. *Id.* § 1427(d).

96. *Id.*

any applicable capital requirement is eligible to hold the office of director of a Bank.[97] In the event of such a disqualification of an elected director, the vacancy is to be filled by an affirmative vote of the majority of the remaining Bank directors, regardless of whether they constitute a quorum.[98] In the event of a vacancy in any appointive directorship, the vacancy is to be filled through appointment by the FHFB for the unexpired term.[99]

F. *Membership in the Banks*

The FHLB Act, as amended by FIRREA, provides that any building and loan association, savings and loan, cooperative bank, homestead association, insurance company, savings bank or any insured depository institution (including a commercial bank)[100] and any insured credit union, is eligible to become a member of a Bank if: (1) the prospective member is duly organized under the laws of any state or the United States; (2) it is subject to inspection and regulation under the banking or similar laws of the state or the United States; and (3) it makes such home mortgage loans that in the judgment of the FHFB are long- term loans.[101] An insured depository institution which was not a member of a Bank on January 1, 1989, may become a member only if: (1) the institution has at least ten percent of its total assets in residential mortgage loans; (2) its financial condition is such that advances may be safely made to it by the Bank; and (3) the character of its management and home financing policy are consistent with sound and economical home financing.[102] An insured depository institution commencing operations after January 1, 1989, may become a member of a Bank if it complies with regulations and orders prescribed by the FHFB pertaining to the ten percent asset requirement within one year after commencement of its operations.[103]

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97. *Id.* § 1427(b).
98. *Id.* § 1427(f)(3).
99. *Id.* § 1427(f)(2).
100. *See id.* § 1813(c)(2) for definition of "insured depository institution."
101. *Id.* § 1424(a).
102. *Id.* § 1424(a)(2).
103. *Id.* § 1424. To date, no regulations on this subject have been promulgated by the FHFB.

With the inclusion of "any insured depository institution" in the FHLB Act, FIRREA made commercial banks and credit unions eligible, for the first time, for Bank membership.[104] At December 31, 1988, approximately 2,300 credit unions and 8,000 commercial banks were eligible for Bank membership.[105] By July of 1991, some 250 commercial banks had joined the Federal Home Loan Bank System.[106]

As before FIRREA, federal savings and loan associations are required by law to be Bank members.[107] Before FIRREA, some state-chartered thrifts were required to become Bank members as a contractual condition for FSLIC insurance of accounts; FIRREA did not amend the FHLB Act with respect to Bank membership requirements for state-chartered SAIF-insured institutions.[108]

As before FIRREA, Bank members continue to be subject to an initial minimum mandatory stock purchase requirement in an amount equivalent to one percent of the aggregate unpaid principal of the member's home mortgage loans, home purchase contracts and other similar obligations.[109] Bank members must also continue to hold Bank stock equal to at least five percent of their outstanding advances.[110] FIRREA modified the initial minimum stock purchase requirement by specifying that members in a Bank must acquire Bank stock in the amount they would be required to purchase if at least thirty percent of their assets consisted of home mortgage loans.[111] However, a member with more than thirty percent

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104. To offset some of the drain on the Banks' retained earnings as a result of FIRREA-mandated contributions to FICO and REFCO, Congress decided to broaden the Banks' potential membership base and thus, their capital base. H.R. CONF. REP. NO. 222, 101st Cong., 1st Sess. 425 (1989).

105. *Oversight Hearing to Examine the Impact of FIRREA on the Federal Home Loan Bank System: Hearings Before the Subcommittee on General Oversight and Investigations, House Committee on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. 73-74 (1989) (statement of Thurman Connell, President of the Federal Home Loan Bank of Des Moines). *See also* Mary K. Bush, Managing Director, Federal Housing Finance Board, Address Before the National Press Club Morning Newsmakers (July 18, 1990).

106. *FHFB Proposes Changes to Director Requirements; 250th Bank Joins System*, BNA BANKING DAILY (Washington, D.C.), July 24, 1991.

107. 12 U.S.C. § 1464(f) (amended 1991).

108. For a discussion of voluntary membership and deterioration of the Banks' capital position see *infra* text accompanying notes 178-82.

109. 12 U.S.C. § 1426(b) (1991).

110. *Id.* § 1426(b)(2).

111. *Id.* § 1430(e)(3). The 0.3% of total assets stock purchase requirement re-

of its assets in home mortgage loans would still be required to purchase stock in an amount equivalent to one percent of the member's actual home mortgage loans. The effect of the three provisions is to establish a new minimum stock purchase requirement which is the greater of 0.3% of total assets, one percent of mortgage loans or five percent of advances.

Under prior law, an institution withdrawing from Bank membership was ineligible to rejoin for five years.[112] As a result of FIRREA, withdrawing members will remain ineligible for ten years.[113] Other FIRREA changes require that if an institution terminates its Bank membership, the indebtedness of the member to the Bank must be liquidated in an orderly manner, as determined by the Bank, and, upon completion of the liquidation, the stock in the Bank owned by the member must be surrendered and cancelled.[114] Any such liquidation shall be deemed a prepayment of indebtedness and shall be subject to applicable prepayment fees as provided for in the credit program of the Bank.[115]

G. *Credit Activities of the Bank After FIRREA*

As before FIRREA, the primary mission of the Banks is "to provide a reliable source of credit" for their members[116] whose primary purpose is economical home finance. Each Bank is authorized to make advances to its members, so long as such advances are, in the judgment of the Bank, "fully secured."[117] Although prior to the enactment of FIRREA the Banks were authorized to grant a moderate amount of advances without security,[118] FIRREA amended the FHLB Act to eliminate the Banks' discretionary power by requiring that all Bank advances be secured.[119]

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flects a compromise between those interests that wanted minimal Bank membership eligibility requirements for commercial banks and credit unions and other interests which believed that access to the Banks should be conditioned on a significant commitment to housing finance.

112. 12 U.S.C.A. § 1426(m) (1989).
113. *Id.* § 1426(h).
114. *Id.* § 1426(e).
115. *Id.*
116. 12 C.F.R. § 940.1(a) (1990).
117. 12 U.S.C. § 1430(a) (1991).
118. Former 12 U.S.C. § 1431(g) (repealed 1989).
119. 12 U.S.C. § 1430(a) (1991).

Credit is granted pursuant to the terms of a Bank's credit policy, which, consistent with pre-FIRREA rules, is established by each Bank's board of directors within the parameters set by the relevant statute and the FHFB.[120] A Bank's board of directors is charged with administering its credit policy in a fair and equitable manner, and the board of directors may extend credit only if it can be done "safely and reasonably with due regard" for the claims and demands of other institutions and for "the maintenance of adequate credit standing for the [Bank] and its obligations."[121] The first standard that credit must be managed so that it is available for all eligible members is somewhat unusual. By comparison, commercial banks are not required to consider the loan requests of all customers when making lending decisions with respect to a particular borrower. This standard was imposed at a time when federal corporate entities were established as cooperatives and may reflect the original FHLB Act drafters' pro-cooperative philosophy.[122]

Consistent with its statutory mandate, each Bank's credit program must protect the financial integrity of the Bank.[123] Accordingly, interest rates on advances must be set "within a range of rates . . . that is above the current replacement cost of [consolidated Bank] obligations of comparable maturity,"[124] and "prepayment and commitment fees" are generally required to protect the Bank from undue interest-rate risk.[125]

Although members may generally use advances for any authorized business purpose, *e.g.*, "making residential mortgage, consumer and commercial loans, covering savings withdrawals, accommodating seasonal cash needs, restructuring liabilities, and maintaining adequate liquidity,"[126] in a change made by FIRREA, long-term advances may only be used for housing finance purposes.[127] Advances may be made for periods of up to twenty years.[128] Further, members that do not

120. 12 C.F.R. § 935.2 (1990).
121. 12 U.S.C. § 1427(j) (1991).
122. THOMAS K. MCCRAW, PROPHETS OF REGULATION 147-49 (1984).
123. 12 U.S.C. § 1427(j) (1991); 12 C.F.R. § 940.1(a) (1990).
124. 12 C.F.R. § 940.1(b) (1990).
125. *Id.*
126. *Id.* § 940.1(c).
127. 12 U.S.C. § 1430(a) (1991).
128. 12 C.F.R. § 940.1(b) (1990).

meet the "qualified thrift lender" criteria may only apply for advances to support a housing finance purpose,[129] regardless of term.

As was the case prior to FIRREA, each Bank continues to have broad discretion to deny an application for credit.[130] "Advances may be limited or denied if a member engages in unsafe or unsound practices, has inadequate regulatory capital, is sustaining operating losses, or has other financial or managerial deficiencies . . . ."[131]

H. *Collateral Requirements*

FIRREA eliminated the broad authority which was formerly vested in the Bank Board to prescribe the types of eligible collateral for Bank advances pursuant to regulations.[132] FIRREA amended the FHLB Act to provide that eligible collateral shall consist of property falling only within the following categories: (1) whole first mortgages on improved residential property; (2) government securities; (3) deposits at a Bank; or (4) other real estate related collateral, provided that the aggregate amount of advances secured by such other real estate related collateral does not exceed thirty percent of the borrowing member's capital.[133] As before FIRREA, each member's Bank stock continues to be subject to a statutory lien as further security for all indebtedness of the member to the Bank.[134]

FIRREA also eliminated FSLIC receivership claims from the categories of eligible collateral, as formerly prescribed by regulation by the FHLBB.[135] Although in obvious conflict with the new statute, these former FHLBB regulations were carried forward by the Housing Finance Board when it adopted the former FHLBB regulations.[136] Presumably, the FSLIC

129. 12 U.S.C. § 1430(e)(1) (1991).

130. *Id.* § 1429; *see* Fidelity Fin. Corp. v. Federal Home Loan Bank, 792 F.2d 1432 (9th Cir. 1986).

131. 12 C.F.R. § 940.1(d) (1990).

132. *See* former 12 U.S.C. § 1430(a) (repealed 1989).

133. 12 U.S.C. § 1430(a) (1991).

134. *Id.* § 1430(c).

135. Former 12 C.F.R. § 525.7(b) (repealed 1989).

136. 12 C.F.R. § 935.7 (1990).

receivership claims provision will be eliminated when the Housing Finance Board adopts new collateral regulations.

These changes in the law governing eligible collateral advances presumably were intended to ensure that the Banks are adequately protected against credit risk, and to prevent a recurrence of the situation which affected the Dallas Federal Home Loan Bank with respect to loans secured by FSLIC obligations. In 1988 and 1989, at the urging of the FHLBB, the Dallas Bank granted significant amounts of advances to members, which advances were collateralized by FSLIC notes and future cash flows from FSLIC assistance agreements arising out of Southwest Plan transactions.[137] These advances exceeded the capital of the Dallas Bank by a substantial amount.[138] Because the ability of these thrift members to repay their advances was dependent on the ability of an insolvent FSLIC to honor its assistance agreements, the Banks' independent accountants determined that such repayment was uncertain and that the uncertainty could significantly affect the financial condition of the Dallas Bank.[139] The accountants further determined, and noted in each Bank's 1988 Annual Report, that because of the joint and several nature of the Banks' consolidated obligations, the potential inability of the Dallas Bank to repay its participation in consolidated obligations could result in additional liability to the other Banks.[140]

FIRREA attempted to address this problem in two ways. First, the legislation restructured the Bank System by removing the insurer of thrift institutions from regulatory control over the Banks, thereby reducing the temptation for the Banks' regulator to exert pressure on the Banks to make questionable advances to their member institutions. Second, FIRREA

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137. The FHLBB created a 1988 program for the expeditious consolidation of several failed thrifts located primarily in Texas which became known as the "Southwest Plan." *FHLBB Officially Launches Southwest Plan; Consolidates Thrifts in Houston, Dallas*, BNA Banking Daily, May 23, 1988, at 7.

138. *See Notes to Financial Statements*, 1988 FHLB ANN. REP. 13.

139. *Id.*

140. *See, e.g., Independent Auditors' Opinion*, 1988 FHLB ANN. REP. In the past, the Banks have generally all been audited by the same national accounting firm. The firm has been selected by the FHLBB in the past, and presumably will be selected by the FHFB in the future, for the purpose of discharging the statutory requirement of an annual "examination . . . and report . . . of condition of all the Federal Home Loan Banks." 12 U.S.C. § 1440 (1991).

amended the FHLB Act to eliminate FSLIC obligations as eligible collateral for advances granted after enactment of the legislation[141] and to require any member with advances "secured by . . . insufficient eligible collateral [such as FSLIC obligations to] reduce its level of outstanding advances promptly and prudently."[142]

FIRREA also confirmed the special status of Bank advances in the context of a failed savings institution. As a result of FIRREA, the FDIC or RTC, as receiver of a failed financial institution, including a thrift, was expressly given the power to repudiate burdensome contracts to which the failed institution was a party before the receivership.[143] However, excluded from the types of contracts subject to such power are those involving any extension of credit from a Bank or Federal Reserve Bank or any security interest in respect thereof.[144] This provision is consonant with the lien priority given Bank advances by the provisions of the FHLB Act.[145]

I. *Advances to Non-Qualified Thrift Lenders*

Although FIRREA amended the FHLB Act to open Bank membership to those commercial banks and credit unions with "at least ten percent of its total assets in residential mortgage loans,"[146] it also recognized that providing Bank advances to institutions which have not made a substantial commitment to home finance would not further the purposes of the FHLB Act. Therefore, FIRREA made further amendments to the FHLB Act to: (1) impose additional stock purchase requirements on borrowing members which do not meet the qualified thrift lender (QTL) test;[147] (2) permit such non-QTLs access

141. 12 U.S.C. § 1430(a) (1991). For additional information regarding collateral requirements and the priority of Bank security interests, see Adams & Peck, *supra* note 2, at 847-48.

142. 12 U.S.C. § 1821(e)(1) (1989).

143. *Id.*

144. *Id.* § 1821(e)(13).

145. This statutory lien priority section provides that notwithstanding any other provision of law, any security interest granted to a Federal Home Loan Bank by any member or any affiliate of any member is entitled to priority over the claims and rights of any party (including a receiver) other than claims and rights which would be entitled to priority under otherwise applicable law and which are held by actual bona fide purchasers for value or by actual secured parties that are secured by actual perfected security interests. *Id.* § 1430(f).

146. *Id.* § 1424(a)(2).

147. *Id.* §1430(e). Under FIRREA, "any savings association shall have the status

to advances only "for the purpose of obtaining funds for housing finance;"[148] (3) require the FHFB to establish a regulatory priority for Bank advances to members that are QTLs;[149] and (4) require each Bank to limit the aggregate amount of its advances to non-QTLs to not more than thirty percent of its total advances.[150]

J. *Role of the Banks in Supporting Troubled Institutions*

Although the Banks were never required by statute to act as a lender of last resort to member institutions, the FHLBB often attempted to cast the Banks in that role with respect to troubled thrift institutions.[151] FIRREA addressed the Banks' liquidity role with respect to troubled thrift institutions by amending the FHLB Act to permit the Banks to provide, upon the request of the Director of the OTS, short-term "liquidity advances" to troubled, but solvent, savings associations which demonstrate reasonable prospects of returning to a satisfactory financial condition.[152] Any Bank advance made pursuant to this provision must comply with all applicable collateral requirements of the FHLB Act, must comply with the Bank's credit program and must bear an interest rate no less favorable than the rate applicable to short-term liquidity advances

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of qualified thrift lender if (A) the qualified thrift investments of such savings associations exceeds 60 percent of the total tangible assets of such association; and (B) the qualified thrift investments of such savings association continue to equal or exceed 60 percent of the total tangible assets of such association on an average basis in 3 out of every 4 quarters and 2 out of every 3 years." *Id.* § 1467a(m)(1). The director of the OTS may grant temporary or limited exceptions from the minimum actual thrift investment percentage requirement under certain circumstances. *Id.* § 1467a(m)(2). The term "qualified thrift investments" is defined to mean loans made to purchase, refinance, construct, improve or repair domestic residential housing or manufactured housing, home equity loans, securities backed by or representing interests in mortgages on domestic residential housing or manufactured housing, and certain obligations of the FDIC or the FSLIC and the FSLIC Resolution Fund and the RTC. *Id.* §1467a(m)(4)(B). In addition, certain other housing-related assets may be included in the definition of qualified thrift investments subject to certain percentage limitations. *See id.* § 1467a(m)(5).

148. *Id.* § 1430(a)(1).

149. *Id.* § 1430(a)(2).

150. *Id.*

151. *See* Adams & Peck, *supra* note 2, at 849.

152. 12 U.S.C.A. § 1430(h)(1) (1991).

made available by the Bank to savings associations that do not present a supervisory concern.[153]

These statutory provisions appear to be superfluous since the Banks are permitted to grant only those advances which can be made safely and reasonably[154] and which are fully secured.[155] Such provisions apparently remain from an earlier proposed version of FIRREA in which the liquidity advances provision had been mandatory, rather than permissive in nature. Recognizing that FIRREA would remove its regulatory control over the Banks, the FHLBB lobbied unsuccessfully for a provision in FIRREA to *require* the Banks to make such loans when requested to do so by the Director of OTS.[156] Such a provision would have been anomalous in light of congressional intent to restructure the Bank System to ensure its safe and sound operation and specifically to prevent the savings institution regulator from interfering with the Banks and their lending function.

Another aspect of the Banks' role in supporting troubled institutions is whether the Banks should lend to the agency which insures the accounts of their member institutions. Prior to the enactment of FIRREA, the Banks were authorized to make loans to the FSLIC.[157] FIRREA amended the FHLB Act to *permit*, but not to *require*, the Banks to make loans to the FDIC for the use of FSLIC's successor, the SAIF.[158] FIRREA further provides that any such loan is a direct liability of the SAIF.[159] In order to protect the safety and soundness of the Banks, the interest rate on any such loan must be no less than the Bank's current marginal cost of funds, and must be "adequately secured."[160]

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153. *Id.* § 1430(h)(2).

154. *Id.* § 1427(j).

155. *Id.* § 1430(a).

156. This proposal was reflected in § 717(c) of FIRREA as reported by the House Committee on Banking, Finance and Urban Affairs. *See* H.R. REP. NO. 54, 101st Cong., 1st Sess. 383 (1989).

157. Former 12 C.F.R. § 531.2(a) (1987).

158. 12 U.S.C. § 1431(k)(1), 1437(a) (1991).

159. *Id.* § 1431(k)(2).

160. *Id.* § 1431(k)(3). The Conference Report, in discussing this section of the legislation, states: "As is the case with all advances by the Banks, loans to the FDIC for the SAIF must be adequately secured." The Conference Report language would appear to support the argument that in this context the words "adequately secured" have the same meaning as the words "fully secured" in 12 U.S.C. §

These statutory changes strongly suggest that Congress intended that the Banks should not function as lenders of last resort to troubled thrift institutions. Indeed, by diverting all of the Banks' retained earnings to REFCO (which retained earnings had been available as a capital cushion against Bank credit losses) and by imposing stringent new collateral requirements upon advances made by the Banks, Congress appears instead to have intended that the Banks should focus upon their role in supporting economical home finance through the making of secure loans to strong insured insured depository institutions.[161]

K. *Interest Rate Swaps and Letters of Credit*

In addition to making advances, Banks are permitted to enter into interest rate swaps, caps, collars, floors and other hedging transactions with their members,[162] and to issue irrevocable standby letters of credit for their members' accounts.[163] These sophisticated financial devices are merely additional tools to be used in safely and soundly making loans to fund members' home mortgages. Except with respect to the collateral requirements discussed above, FIRREA did not affect the authority of the Banks to engage in these transactions.[164]

L. *Community Lending Programs*

FIRREA expanded upon the Banks' traditional role of providing funds for housing finance by establishing two new lending programs: a Community Investment Program and an Affordable Housing Program.[165] Although the Banks had participated in various forms of community investment fund

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1430(a). H.R. CONF. REP. NO. 222, 101st Cong., 1st Sess. 426 (1989). As of this writing, no loans to the FDIC for the use of the SAIF have been made by any of the Banks.

161. *Cf.* H.R. REP. NO. 54, 101st Cong., 1st Sess. 454 (1989) ("the principal function of the Federal Home Loan Banks is to promote economical housing finance by serving as lending facilities for their member institutions").

162. FHLBB, FEDERAL HOME LOAN BANKS INTEREST RATE SWAP, CAP, COLLAR, AND FLOOR POLICY GUIDELINES (Aug. 28, 1987).

163. FHLBB, OFFICE OF DISTRICT BANKS, POLICY GUIDELINES FOR ISSUANCE OF FHLB LETTERS OF CREDIT (Nov. 21, 1985).

164. For additional information regarding Bank swaps and letters of credit, see Adams & Peck, *supra* note 2, at 850-51.

165. 12 U.S.C. § 1430(i), (j) (West Supp. 1991).

programs prior to FIRREA,[166] no mandatory program had existed since the expiration in 1983 of the five-year "Community Investment Fund" program established by the former FHLBB.[167]

FIRREA amended the FHLB Act to require that each Bank establish a program to provide funds for members' use in undertaking community-oriented mortgage lending.[168] Such lending would finance (1) home purchases by families with income at or below 115% of the area median income, or the purchase or rehabilitation of housing for occupancy by such families; or (2) commercial and economic development activities that benefit low and moderate income families or neighborhoods.[169] Advances under this program are to be priced at the cost of consolidated Bank obligations of comparable maturities, plus reasonable administrative costs.[170]

While the Community Investment program requires the Banks to make advances at no profit, another FIRREA addition, the Affordable Housing Program, requires that the Banks provide subsidized advances (or direct subsidies) to members engaged in lending for long-term, low and moderate income, owner-occupied and affordable rental housing.[171] The Banks are required to provide subsidies equal to five percent of earnings, or $50 million, whichever is greater, for each year from 1990 through 1993; six percent of earnings or $75 million in 1994; and ten percent of earnings or $100 million in each year thereafter.[172] The Banks' contribution to the Affordable Housing Program during 1990 was $78.8 million; their allocation in 1991 is $59.5 million.[173]

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166. *See, e.g.*, 1989 FHLB ANN. REP. 5-6. *See also* TREASURY DEPARTMENT STUDY, *supra* note 3, at XV-9.

167. TREASURY DEPARTMENT STUDY, *supra* note 3, at XV-9.

168. 12 U.S.C. § 1430(i) (West Supp. 1991). The Conference Report expressed Congressional dissatisfaction with the Banks' past performance in this area, stating: "The conferees are mindful of the uneven use of similar special advance programs maintained by the Federal Home Loan Banks in the past and the reluctance of some of the Banks to actively encourage their member institutions to address critical community investment and affordable housing needs." H.R. CONF. REP. NO. 222, 101st Cong., 1st Sess. 429 (1989).

169. *Id.*

170. *Id.*

171. 12 U.S.C. § 1430(j) (West Supp. 1991). *See also* TREASURY DEPARTMENT STUDY, *supra* note 3, at XV-9.

172. *Id.* § 1430(j)(5) (West Supp. 1991).

173. Thus, the first year of the Affordable Housing Program created affordable

Funds advanced under the Affordable Housing Program generally may be used by members to finance (1) home ownership for families with income at or below eighty percent of the area median income; or (2) the purchase, construction or rehabilitation of rental housing in which at least twenty percent of the units will be occupied by very low-income households (at or below fifty percent of the area median income) for the remaining useful life of such housing or the mortgage term.[174]

If a Bank fails to fund or commit all of its required subsidy in any year, ninety percent of the unused amount must be deposited by the Bank in an Affordable Housing Reserve Fund administered by the FHFB.[175] The remaining ten percent of the unused amount must then be utilized by the Bank during the following year, with any remaining portion to be deposited in the Reserve Fund.[176] Moneys from the Reserve Fund may be made available to any Bank to meet additional affordable housing needs.[177]

The statute provides that the FHFB may approve a temporary suspension of contributions under the program if it finds that the payments are contributing to a Bank's financial instability.[178] In determining the financial instability of a Bank, the FHFB must consider such factors as whether the Bank's earnings are severely depressed, whether there has been a substantial decline in member capital, and whether there has been a substantial reduction in advances outstanding.[179] The FHFB may not approve a suspension of payments if the reduction in earnings is a result of changes in terms of advances which are not justified by market conditions, inordinate operating and administrative expenses, or mismanagement.[180] FIRREA requires that the FHFB notify the House and Senate Banking Committees at least sixty days prior to the effective

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housing valued at $1.2 billion, leveraged by the $78.8 million from the Banks. *See* TREASURY DEPARTMENT STUDY, *supra* note 3, at XV-10.

174. 12 U.S.C. § 1430(j)(2) (West Supp. 1991).

175. *Id.* § 1430(j)(7).

176. *Id.*

177. *Id.*

178. *Id.* § 1430(j)(6).

179. *Id.*

180. *Id.*

date of any approved suspension.[181] By joint resolution, Congress may disallow any such suspension.[182]

In order to assist the Banks in meeting the affordable housing needs of their districts, FIRREA requires that each Bank appoint an Affordable Housing Advisory Council.[183] Each Advisory Council consists of seven to fifteen persons drawn from community and nonprofit organizations which provide or promote low and moderate income housing in the relevant Bank's district.[184] The Advisory Council is required to meet quarterly with representatives of the Bank's board of directors to provide advice on stimulating affordable housing programs, and is responsible for submitting to the FHFB an annual report analyzing the low- income housing activity of its Bank.[185] The FHFB, in turn, must report annually to Congress and to each Advisory Council with respect to the Banks' performance under the Affordable Housing Program.[186] After the program has been operational for two years, the Comptroller General will audit, evaluate, and recommend to Congress any improvements or modifications to the program.[187]

Contrary to the "open window" approach followed by most Banks with respect to their Community Investment Program lending (as well as lending under regular advances programs), the Affordable Housing Program regulations promulgated by the FHFB require that each Bank conduct district-wide competitions for program funds during two of four quarterly application periods each year.[188] The regulations specify a thirty-day review period by the relevant Bank, with final funding decisions to be announced by the FHFB within thirty days following the Bank's review period.[189] The regulations establish uniform priorities for project funding, and they specify the relative weights to be accorded each priority.[190]

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181. *Id.*
182. *Id.*
183. *Id.* § 1430(j)(11).
184. *Id.*
185. *Id.*
186. *Id.* § 1430(j)(12).
187. *Id.*
188. 12 C.F.R. § 960.4 (1990).
189. *Id.* § 960.5.
190. 12 C.F.R. § 960.5 (1991); 12 U.S.C. § 1422(a)(3) (1991).

In operation, the Affordable Housing Program subsidizes projects proposed to the Banks by their members. The first year of the Program awarded funds to create affordable housing valued at $1.2 billion, leveraged by the $78.8 million from the Banks. These funds will be used to generate approximately 24,000 single and multi-family units in some 382 projects. Similarly, in the first round of competition in 1991, the Banks awarded $33.2 million which will leverage $430 million in housing construction, rehabilitation and mortgage financing.[191]

M. *Other Bank Services and Powers After FIRREA*

The FHLB Act, both before and after FIRREA, has provided that the Banks may "do all things necessary for carrying out the provisions of the [FHLB Act] and all things incident thereto."[192] However, before FIRREA, the FHLB Act provided that no Bank may transact any banking or other business not authorized by the FHLB Act.[193] In 1977, a federal district court held that the Banks may not issue money orders[194] and the Sixth Circuit Court of Appeals, in *Association of Data Processing Service Organizations (ADAPSO) v. Federal Home Loan Bank Board,*[195] held that five Banks may not sell on-line data processing services to members. Thus, under prior law, the Banks' authority to engage in correspondent services was significantly constrained.

FIRREA made a significant, though little discussed, change in the scope of the authorized correspondent service activities of the Banks. As amended, the FHLB Act now provides: "No Federal Home Loan Bank shall transact any banking or other business not *incidental to activities* authorized by [the FHLB Act]."[196] The phrase "incidental to activities" was inserted by FIRREA and appears to be intended to give the Banks broader

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191. *See supra* note 171; *see also* FHFB, FEDERAL HOUSING FINANCE BOARD ANNOUNCES FIRST ROUND AFFORDABLE HOUSING AWARDS (Press Release No. 91-21; June 18, 1991).

192. 12 U.S.C. 1431(a) (1990).

193. *Id.* § 1431(e)(1).

194. Central Bank v. Federal Home Loan Bank, 430 F. Supp. 1080 (N.D. Cal. 1977).

195. Association of Data Processing Serv. Orgs. (ADAPSO) v. Federal Home Loan Bank Bd., 568 F.2d 478 (6th Cir. 1977).

196. 12 U.S.C. § 1431(e)(1) (1991) (emphasis added).

authority to engage in activities incidental to their express powers. The language would also appear to overrule the *ADAPSO* case. Indeed, the legislative history of FIRREA suggests that the drafters specifically intended to overrule the *ADAPSO* case. The Conference Committee's explanation of the amendment provides that incidental activities include:

> [T]he collection and settlement of checks and related services that the banks can provide to or for members. The banks can also provide courier and custody services for, and can process and transmit information related to, these services. The banks are also able to provide other correspondent banking services for members. This includes the reconciliation of customer accounts and servicing payrolls, as well as the analysis and transmission of such information.[197]

The services referred to in the Conference Committee report, *i.e.*, the reconciliation of customer accounts, servicing payrolls and analysis and transmission of information, are essentially the same as those on-line data processing services at issue in *ADAPSO*.[198]

The House Report also states:

> The Federal Home Loan Banks may engage in all activities authorized under the Federal Home Loan Bank Act. Notwithstanding the authority to engage in corresponding [sic] banking activities, the principal function of the Federal Home Loan Banks is to promote economical housing finance by serving as lending facilities for their member institutions.[199]

The amendment's sponsor also emphasized that it broadened the scope of incidental activities permissible under the FHLB Act:

> [T]he amendment is intended to permit the Federal Home Loan Banks to engage in activities incidental to their express statutory powers, and that Congress contemplated this incidental power to be broadly read.

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197. Joint Explanatory Statement of the Committee of Conference, 135 CONG. REC. H5288 (daily ed. Aug. 4, 1989).

198. *See ADAPSO*, 568 F.2d at 481-82.

199. H.R. REP. NO. 54, 101st Cong., 1st Sess., pt. 1 454 (1989).

> Congress intended the amendment to allow a wide variety of incidental activities, these would include, for example, the collection and settlement of checks and related services, courier and custody services. The Federal Home Loan Banks can also provide services like the reconciliation of customer accounts, servicing of payrolls and other corresponding banking services. Incidental services would extend to the analysis and data processing and transmission of information related to all of these services.
>
> Incidental activities do not need to be strictly necessary to the home loan banks' exercise of their express powers. Neither are they limited to activities that only the banks can engage in, or services only they can perform. The amendment is intended to ensure that the banks may provide a variety of products and services. This variety makes membership in the banks appealing to eligible institutions. By sustaining membership, the banks are better able to meet the financial obligations that the act imposes on them.[200]

To date, most of the Banks have not attempted to expand their incidental activities as authorized by FIRREA. As before FIRREA, they continue to offer a variety of deposit products, to act as trustee of trusts affecting their members' business, to hold mortgage loans and securities in safekeeping for their members, and to provide limited correspondent services (as previously authorized by the FHLB Act) for both member institutions and those institutions "eligible to make application to become members."[201]

N. *Future Challenges to the Home Loan Bank System: The Banks' Challenges Now Differ From Those of the Past*

Perspective on the formidable challenges confronting the Banks can be gained by considering the Banks' historical role. During the Great Depression, mortgage loan defaults, declines in the value of collateral, and heavy savings account withdrawals resulted in the failure of 1,700 savings institutions.[202] In

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200. 135 CONG. REC. H4994 (daily ed. Aug. 3, 1989) (remarks of Congressman Garcia).

201. For additional information regarding other Bank services to member thrifts, see Adams & Peck, *supra* note 2, at 852-53.

202. *See* PAUL H. LOCKWOOD, FHLBB, A GUIDE TO THE FEDERAL HOME LOAN BANK SYSTEM 8 (5th ed. 1987).

response to this liquidity crisis, Congress created the Federal Home Loan Bank System in 1932.[203] Initially capitalized by the federal government, the Banks' members eventually capitalized the Banks and repaid the government's capital.[204] The Banks were to advance funds to their members on the security of home mortgage loans, thereby liquifying these institutions' portfolios and enabling them to meet savings withdrawals.

By 1933, forty percent of the nation's $20 billion of home mortgages were in default.[205] Although the Banks could meet the liquidity needs of solvent members with adequate collateral, the Banks were neither capitalized for, nor competent to fund the liquidity needs of, thrifts with few or no performing home mortgages. Thus, Congress created the Home Owners' Loan Corporation (HOLC) to purchase defaulted mortgages from thrifts.[206] The combination of loans from the Banks and purchases of defaulted mortgages by the HOLC was a major factor in permitting savings institutions to meet the liquidity crisis of the Great Depression.[207] With the creation of the FSLIC in 1934,[208] customer anxiety about the safety of their deposits was reduced, thereby slowing the heavy deposit withdrawals and the concomitant need for liquidity.

HOLC and the FSLIC enabled the Banks to concentrate on their role of making loans to solvent members for the purpose of furthering economical housing finance. The Banks successfully fulfilled their role as the central bank for housing finance in America until the emergence of the second national thrift crisis in the late 1980s. When it became apparent that the FSLIC had insufficient resources to resolve the myriad problems of the savings and loan industry, the Banks became a tempting source of funds to deal with this challenge.[209]

Initially, efforts to tap Bank resources were modest. As the FHLBB became increasingly aware of the degree to which failed institutions depended on brokered deposits in the

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203. *See generally id.*

204. *Id.* at 9.

205. *Id.*

206. 12 U.S.C. § 1463 (1947).

207. *See* LOCKWOOD, *supra* note 202, at 9-12.

208. Pursuant to Title IV of the National Housing Act ch. 847, 48 Stat. 1246 (1934).

209. Telephone Interview with Gary L. Curly, Senior Vice President, Federal Home Loan of Bank of San Francisco (Aug. 1, 1991).

mid-1980s, the FHLBB looked to the Banks as a liquidity source to replace such deposits at failed or failing institutions.[210] Since the failure of an institution due to illiquidity is the principal risk that deposit insurance is designed to address,[211] the FSLIC was understandably reluctant to seize such institutions, fearing that a series of seizures could cause systemic shocks to the industry which would shatter depositor confidence. Although from time to time, the FSLIC did close institutions as a result of an inability to honor savings withdrawals (including the notorious example in the early 1980s of Fidelity Savings and Loan Association of Oakland, California), in most cases the FHLBB preferred to have the Banks extend credit to these institutions to the maximum extent possible.

Typically, as an institution began to fail and money started to flow from the institution, those funds were replaced by borrowings from the appropriate Bank.[212] As collateral for such borrowings, the Bank would first take a security interest in the institution's eligible collateral, including one-to-four family home mortgages and mortgage- backed securities. However, as the institution's liquidity needs continued and its eligible collateral was exhausted, the Bank would take a security interest in "ineligible" collateral, such as commercial real estate loans, land loans, acquisition, development and construction loans, consumer loans and ultimately even real estate and furniture and fixtures.

When a failing institution totally exhausted its supply of both eligible and ineligible collateral, the FSLIC sought to have the Bank extend credit based upon the creditworthiness of the FSLIC. Thus, the FSLIC would "guarantee" the repayment of

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210. An early and characteristic example was provided by American Savings and Loan of California (American), at the time the largest savings and loan association in the United States. In August 1984, American's parent was required to reduce its reported profitability by the SEC. Approximately 70% of American's deposits were brokered deposits which began to be withdrawn. The withdrawal amounted to hundreds of millions of dollars per day. Advances by the Federal Home Loan Bank of San Francisco were used to meet this extraordinary withdrawal demand. *See* R. DAN BRUMBAUGH, JR., THRIFTS UNDER SIEGE, RESTORING ORDER TO AMERICAN BANKING 129-30 (1988).

211. TREASURY DEPARTMENT STUDY, *supra* note 3, Discussion Chapter I, at I-4 to I-5.

212. *See MCP Program Doomed if FSLIC Recap Plan Is Scuttled*, THE BANK BOARD WATCH, Jan. 30, 1987, at H-4.

Bank advances that were not adequately secured by appropriate collateral.[213] Initially, the FSLIC was prepared to extend guarantees to the Bank without seizing the failed institution.[214] The practice soon ceased because the FSLIC decided that such guarantees constituted a form of "open bank assistance" which was not appropriate public policy.[215] As a result, the government began to take control of these failed institutions, and then to guarantee repayment of Bank advances in order to ensure a continuing source of liquidity for the FSLIC, as receiver or conservator for the failed institution, to meet the continuing withdrawal demands of its depositors.

When the FSLIC recognized that it did not have sufficient funds to resolve all such failed institutions in this manner and that the large number of insolvent thrifts would bankrupt the FSLIC before it could sell the deposits of such institutions, the FSLIC began to utilize the device of the so-called "pass-through" receivership to allow failed institutions to continue in operation, but under stringent government limitations. In a pass-through receivership, the FSLIC would organize a new federal mutual savings association to which it would transfer certain of the assets and liabilities of the failed thrift. Although essentially a holding action until time and resources could be found to sell or liquidate the deposits of the failed institution, the FSLIC apparently had hoped that the mutual form of organization, combined with close government supervision, would restore depositor confidence until the thrift could be sold. However, since these institutions typically were required to pay higher interest rates than solvent thrifts in order to attract deposits, they continued to incur substantial losses. The financial condition of the failed thrifts worsened, as did that of the FSLIC since its deposit insurance responsibilities increased with the growing operating and asset losses of the failed thrifts. Accordingly, the Banks became increasingly

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213. Telephone Interview with Gary L. Curly, Senior Vice President, Federal Home Loan Bank of San Franciso (Aug. 1, 1991).

214. *Id.*

215. The FDIC was authorized by the Garn St. Germain Depository Institutions Act to make loans to, make deposits, purchase the assets or securities of, or make contributions to an insured bank in order to prevent the bank from closing or reopen a closed bank. *See* 12 U.S.C. § 1823(c)(1). These various forms of activity are often referred to as "open bank assistance."

reluctant to accept FSLIC guarantees alone as eligible collateral for advances.

At the same time that the FSLIC was seeking substantial liquidity support from the Banks, the FSLIC staff proposed new conservatorship and receivership regulations[216] which attempted to give the FSLIC broad powers to avoid or set aside security interests in the assets of failed thrifts, including Bank security interests protecting Bank advances. The FSLIC staff also threatened to use federal common law lien avoidance theories, such as are available under the federal bankruptcy law, to set aside the interests of the Bank in collateral pledged to secure Bank advances.[217]

This juxtaposition of the FSLIC's requests of the Banks for assistance in dealing with the thrift crisis coupled with threatened attacks on the Banks' collateral position arose from the FSLIC's understandable temptation to tap the Bank's resources for the FSLIC's own purposes, while at the same time attempting to treat the Banks as any other creditor. Not unexpectedly, as the FSLIC's financial condition deteriorated, the Banks grew increasingly skeptical that the FHLBB would protect them from the FSLIC's ever-expanding need for cash. Consequently, by year-end 1988, many of the Banks sought additional assurances from the FHLBB about the future of the FSLIC and their rights in the collateral securing their advances.[218]

Early in 1989, this temptation to use the Banks to solve the FSLIC's problems also apparently led the Treasury Department to direct the FHLBB to institute an "interim lending program."[219] Prior to the enactment of FIRREA, but as part of its effort to resolve the thrift crisis, the Bush Administration devised a plan to step up the pace of conservatorship and receiverships for insolvent savings and loan associations. Anticipating that such action would precipitate savings outflows at these institutions and that the increased volume of liquidating receiverships would increase the cash needs of government receivers, the Administration's plan contemplated that the Banks would provide liquidity for these institutions.[220] Pursuant to

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216. *See* 50 Fed. Reg. 48,970, 48,976, 48,990 (Nov. 27, 1985).

217. *See* 11 U.S.C. §§ 547-548 (1991).

218. Telephone Interview with Gary L. Curly, Senior Vice President, Federal Home Loan Bank of San Francisco (Aug. 1, 1991).

219. *See supra* text accompanying notes 135-38.

220. *See* FHLBB Res. 89-323NP (Feb. 21, 1989) and letter of Feb. 21, 1989,

the plan, the Banks were asked to: (1) increase the borrowing capacity attributable to collateral currently considered "eligible" under their credit programs;[221] (2) expand the definition of "eligible collateral" under their credit programs;[222] (3) accept "ineligible collateral" as security for borrowings when an insolvent member had no "eligible collateral;"[223] and (4) limit lending to healthy members to ensure availability of funds for lending to insolvent thrifts.[224] The plan further contemplated that when an insolvent thrift had exhausted all of its collateral security (both eligible and ineligible), subsequent loans to the institution would be made pursuant to a shared lending arrangement involving the Bank, the local Federal Reserve Bank and the FSLIC.[225] Under this "interim lending program," the Bank and the Federal Reserve Bank would each provide forty-five percent of the funds to the institution,[226] with the FSLIC providing the remaining ten percent.[227] The FSLIC would obtain its funds by accessing its $750 million line of credit at the Treasury (up to a maximum of $700 million).[228] Once the FSLIC had exhausted the entire $700 million, the Bank and the Federal Reserve Bank would increase their funding shares to fifty percent each.[229] Collateral for advances funded under the shared lending program would be whatever the FSLIC could provide, such as FSLIC notes and subrogated interests in FSLIC receivership assets. In addition, the insol-

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from Alan Greenspan, Chairman of the Federal Reserve Board, and M. Danny Wall, Chairman of FHLBB, to Nicholas F. Brady, Secretary of the Treasury. *See also* Michael A. Robinson, *S & L Regulators for West Coast Head to Capital*, AM. BANKER, Mar. 3, 1989, at 1; Alan Murray & G. Christian Hill, *California Home Loan Bank Rejects Role in Bush's Back-up Funding Plan for S & L's*, WALL ST. J., Feb. 24, 1989, at A-3; Jim McTague & Robert M. Garrson, *Fed Will Provide Funds to Thrifts Facing Deposit Runs*, AM. BANKER, Feb. 23, 1989, at 3.

221. FHLBB Res. 89-323NP (Feb. 21, 1989), and Greenspan and Wall letter, *supra* note 220.

222. FHLBB Res. 89-323NP (Feb. 21, 1989), and Greenspan and Wall letter, *supra* note 220.

223. FHLBB Res. 89-323NP (Feb. 21, 1989), and Greenspan and Wall letter, *supra* note 220.

224. FHLBB Res. 89-323NP (Feb. 21, 1989), and Greenspan and Wall letter, *supra* note 220.

225. FHLBB Res. 89-323NP (Feb. 21, 1989), and Greenspan and Wall letter, *supra* note 220.

226. Murray & Hill, *supra* note 220.

227. 1988 FHLB ANN. REP. 52 (1989).

228. FHLBB Res. 89-323NP (Feb. 21, 1989), *supra* note 220.

229. FHLBB Res. 89-323NP (Feb. 21, 1989), *supra* note 220.

vent FSLIC would guarantee repayment of loans made under the interim lending program.[230]

Upon introduction of the plan, eleven of the twelve Banks, and all twelve of the Federal Reserve Banks, agreed to participate in the program.[231] The San Francisco Bank, however, initially would not agree to participate in the program as it was proposed.[232] Concerns were expressed that making such loans would expose the Bank to substantial losses, in contravention of its statutory mandate to make only such loans as can be made "safely and reasonably."[233] In addition, it was recognized that any losses suffered by the Bank pursuant to the program would directly injure the Bank's members because such losses would be charged against the members' paid-in capital. Finally, there was concern that participation in the program could prevent the Bank from fulfilling its statutory mission to provide funds for housing finance by diverting substantial liquidity to insolvent thrifts which had largely abandoned making home loans.[234]

After extensive discussions with the FHLBB and Bush Administration officials, and after receiving assurances that the Bank could maintain its existing collateral requirements, the directors of the San Francisco Bank determined that, consistent with their statutory and fiduciary duties, they could authorize the Bank's participation in the program up to an aggregate amount of $100 million. The San Francisco Bank funded advances to one institution to the limit imposed by its directors. The Dallas Bank also funded a small amount of advances under the program. Advances which remained outstanding following enactment of FIRREA were subsequently repaid by the RTC pursuant to FIRREA.[235]

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230. Murray & Hill, *supra* note 220; Greenspan and Wall letter, *supra* note 220; Robinson, *supra* note 220.

231. Murray & Hill, *supra* note 220; Robinson, *supra* note 220; McTague & Garrson, *supra* note 220.

232. Murray & Hill, *supra* note 220; Robinson, *supra* note 220; McTague & Garrson, *supra* note 220.

233. *See supra* note 220.

234. *See supra* note 220.

235. 12 U.S.C. § 1441a(h) (West Supp. 1991).

III. THE BANKS' NEW CHALLENGES

Now that the deposit insurer for the thrift industry has no supervisory relationship with the Banks, nor any legal ability to compel liquidity lending that will endanger the financial position of the Banks, the Banks' primary focus will be that of a financial intermediary for housing finance lenders. The substantial FIRREA-created burdens facing the Banks, in addition to other of the FIRREA requirements adversely impacting the thrift industry, will challenge the Banks in fulfilling this housing finance mission.

First, FIRREA confiscated the entire retained earnings of the Banks (as of December 31, 1988, $2.1 billion), by requiring that these earnings, in addition to $300 million per annum thereafter, be contributed to REFCO.[236] This obligation, which will span a period of at least forty years, is in addition to the Banks' obligations under CEBA to capitalize FICO (which obligations have thus far totaled approximately $680 million). Second, Congress decided to require the Banks to fund new low income housing programs at subsidized rates.[237] The amount of annual Bank contributions to these programs will increase over time from an aggregate five percent of earnings (approximately $78.8 million in 1990 and $59.5 million in 1991), to ten percent of earnings (or a minimum aggregate of $100 million) in 1995 and thereafter.[238] These FIRREA-imposed burdens of approximately $400 million annually are, in effect, a tax which will result in a direct loss of capital and reduced earnings for the Banks.

In the recent past, the earnings of most Banks enabled them to pay dividends in the range of approximately ten to twelve percent per annum.[239] These dividend rates made Bank stock an attractive investment, and generated additional, "voluntary" stock purchases. After FIRREA, the dividend rate will most likely approximate the six-month Treasury bill rate

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236. *Id.* § 1441b(c)(3), (f)(2)(C).

237. *Id.* § 1430(f).

238. TREASURY DEPARTMENT STUDY, *supra* note 3, at XV-10.

239. *Oversight Hearing to Examine the Impact of FIRREA on the Federal Home Loan Bank System: Hearings Before the Subcommittee on General Oversight and Investigations, House Committee on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. 84 (1989) (statement of Thurman Connell).

which, although still an attractive rate (especially given that taxes on dividends paid in stock, as has been the Banks' long-standing practice, are deferred until redemption of such stock) is likely to attract fewer voluntary stock purchases, and thus, less additional capital for the Banks. Moreover, many members have withdrawn their voluntary stock holdings following the enactment of FIRREA. Historically, roughly ten to twenty percent of the stock of the Banks has been held by members in excess of statutory requirements, given the attractiveness of such stock as an investment.[240] Since August 1989, the great majority of that excess stock has been redeemed, with system-wide redemptions of over $2 billion through early April 1990.[241]

In addition, if certain state-chartered thrifts are not required to maintain Bank membership (and, therefore, their investment in Bank stock), further deterioration in the capital positions of the Banks may occur. Although all federally chartered savings institutions are required by statute to be members of a Bank, state-chartered savings institutions have no statutory membership requirement.[242] Historically, many state-chartered savings institutions which were formerly insured by the FSLIC were required, as a condition for insurance of accounts, to become members of a Bank.[243] However, certain savings institutions, many of whom were already Bank members upon obtaining FSLIC insurance, were not explicitly required by the FSLIC to maintain Bank membership as a condition of insurance of accounts. Several such institutions in various Bank districts requested that the FDIC confirm that their deposit insurance is not conditioned upon Bank membership. On August 28, 1990, the FDIC responded to one such request by advising that it could not assure that federal deposit insurance would be available to a thrift withdrawing from membership in a Federal Home Loan Bank.[244]

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240. *Id.* at 33 (testimony of Barney Becksma).

241. Gordon Matthews, *Banks' Shares Resist Market Trend, But Analyst's Opinion Hurts*, AM. BANKER, Apr. 25, 1990, at 24.

242. 12 U.S.C. § 1464(f); *see also* 12 U.S.C. § 1424(c) (1989).

243. LOCKWOOD, *supra* note 202, at 64.

244. *See FDIC Offers No Guarantee of Deposit Insurance for S&L's Leaving the FHLBs*, 55 BNA BANKING REP. 379 (Sept. 10, 1990).

A reduction in the number of thrift institutions due to failure, merger and, particularly, acquisition by nonthrift acquirors also has the potential to adversely affect the Banks. The resolution of the thrift crisis could well result in a reduction in the number of thrift institutions from over 3,000 to approximately 800 to 1,200. Moreover, the assets of many failed thrifts have been purchased by commercial banks which, to date, have generally not indicated an interest in Bank membership. This has resulted in additional stock redemptions.[245]

Decreased demand for advances will also adversely affect Bank earnings. At year-end 1990, aggregate advances totaled $117.1 billion, down from $141.8 billion at year-end 1989.[246] Advance levels are likely to drop even further as regulators seize more thrifts.[247] In addition, the more stringent capital provisions of FIRREA have required many thrifts to shrink in size. By reducing Bank advances, such an institution often can effect shrinkage without damage to its core deposit base. This downward trend in advance demand is, therefore, likely to continue until (1) the industry meets its capital standards so that it can support additional growth; (2) other well-capitalized financial institutions join the Bank System; or (3) the government once again turns to the Banks as a liquidity lender to the thrift industry.

New regulatory relationships also affect the post-FIRREA environment facing the Banks. The regulatory bodies now entrusted with receivership authority (and, therefore, lien avoidance authority) have no previous relationship with the Banks.

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245. For example, as of December 31, 1988, total Bank capital was $15.5 billion, while as of September 30, 1990, total capital was $11.8 billion, a reduction of over 20%. 1988 FHLB ANN. REP. 69; TREASURY DEPARTMENT STUDY, *supra* note 3, at XV-2. However, approximately $1 billion of the capital reduction represents sums contributed to REFCO, rather than capital stock redemptions. Interview with Jerry Hartzog, Senior Vice President and Chief Financial Officer, Federal Home Loan Bank in San Francisco, CA (August 2, 1991). During 1990, 362 thrifts (11% of memberships as of January 1, 1990) left the Home Loan Bank System due to government assisted resolutions or other acquisitions. WORLD SAVINGS AND LOAN, CAN THE FEDERAL HOME LOAN BANKS REMAIN VIABLE UNDER EXISTING LAW 4 (June 17, 1991) (unpublished manuscript).

246. SECRETARY OF THE TREASURY, REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT SPONSORED ENTERPRISES, at A-22 (Apr. 1991).

247. In July of 1991, the Chairman of the FHFB predicted that 1991 advance levels will drop to 50% of 1990 levels. *FHFB Chairman Forecasts 50 Percent Decline in FHFB Advances to Members*, BNA BANKING DAILY, July 25, 1991, at 1.

Those agencies, the RTC and the FDIC, are likely to view their own responsibilities to reduce the cost of the FSLIC bailout and to preserve the deposit insurance funds as paramount to the protection of the Banks. The Banks can expect, therefore, a more unambiguously hostile environment in their dealings with institutions in conservatorship or receivership. The RTC and the FDIC will not hesitate to assert their rights as conservator or receiver, even to the detriment of the Banks. This contrasts with the pre-FIRREA environment, in which the FSLIC either eventually repaid Bank advances to a failed institution or transferred such advances to another creditworthy member. As a result of these practices, no Bank has ever been required to foreclose upon and liquidate the collateral securing its advances.[248]

Will the admission of commercial banks to the Federal Home Loan Bank System be sufficient to offset these adverse factors? Through July of 1991, the Federal Home Loan Banks had added 250 commercial banks to the System, including approximately sixteen with $1 billion or more in assets.[249]

In summary, the Banks' obligations under FIRREA, the overall decline in advance demand and the redemption of Bank stock all affect the most critical Bank account—the capital account. Like any other corporate entity, the Banks cannot survive without sufficient permanent capital. In spite of these adversities, the Bank System currently remains well-capitalized but will need to reposition itself in order to maintain adequate capital and meet the ongoing demands imposed by FIRREA.

The Banks have several options to enhance capital and earnings, although the risks, likelihood of success and public policy issues vary with each option. For example, the Banks could attempt to reduce operating expenses in order to in-

248. Telephone interview with Gary L. Curly, Senior Vice President, Federal Home Loan Bank Of San Francisco (Aug. 1, 1991).

249. *See FHFB Proposes Changes to Director Requirements; 250th Bank Joins System*, BNA BANKING DAILY, July 24, 1991, at 5. It has been suggested by the chairman of the Federal Housing Finance Board that new applicants could bring the total commercial banks to join the system to approximately 350 by year- end 1991. *See Seven Regionals Join Home Loan Bank System*, AM. BANKER, May 20, 1991, at 2. However, it remains to be seen whether borrowings from new commercial bank members will be sufficient to offset substantial declines in advance levels due to the contraction of the thrift industry. *Id.* Through May 1991, new commercial bank members had borrowed approximately $1 billion from the System. *Id.*

crease the profit made on advances. One of several ways to reduce such expenses which has been discussed in the press is to reduce the number of Banks by consolidation.[250]

Some Banks believe that expanding the list of entities eligible to become members and borrow from the Banks could help offset the problem of reduced earnings.[251] This proposal has not been endorsed by all of the Banks.

Another proposal to increase capital adequacy is to afford the Banks the opportunity to leverage further their capital through the increased issuance of debt.[252] The Banks believe that by increasing leverage, the Banks will be able to reduce the rate of interest they must charge on advances. Such a reduction in advance rates would make the Banks a more competitive source of funds for those commercial banks and credit unions able to become Bank members, and would also make the Banks a more attractive source of funds for healthy thrift institutions which presently only fund approximately ten percent of their assets with Bank advances.

In July of 1991, the Chairman of the Housing Finance Board suggested that the Banks are in fact over-capitalized at a total of $11.2 billion (7.7% of total assets) and said that the present capital requirements limit the ability of the Banks to offer housing finance to their support of members.[253] The Chairman also suggested that lower mortgage rates from system members could be achieved if the capital requirements for the Federal Home Loan Bank System are lowered.[254] At about the same time, an industry trade group issued a warning that the balance sheet of the Federal Home Loan Bank System at the end of May 1991, had "revealed further weakening" of the System which demanded immediate legislative action.[255]

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250. *See The Issue of Consolidating the FHL Banks Triggers Heated Debate in S&L Industry*, THE THRIFT REGULATOR, Apr. 27, 1990; *Bailout Blues: Home Loan Banks Can't Turn the Corner*, INSTITUTIONAL INVESTOR, INC., BANK LETTER, at 1 (June 25, 1990).

251. *See Federal Home Loan Bank System Needs Change to Attract More Commercial Banks*, BNA BANKING DAILY, Oct. 12, 1990, at 10.

252. Letter from Thurman C. Connell, Chairman, Bank Presidents' Caucus, to Mary K. Bush, Managing Director of the Federal Housing Finance Board (May 1, 1990).

253. *See FHFB Chairman Forecasts 50 Percent Decline in FHFB Advances to Members*, BNA BANKING DAILY, July 25, 1991, at 1.

254. *Id.*

255. *Id.*

The trade group urged Congress to drop the $300 million annual payment from the Federal Home Loan Bank System to help pay for thrift resolutions and suggested instead a change to a percentage of earnings of the Banks rather than the fixed payments.[256] The trade group also noted that the stock in the Federal Home Loan Banks represents about one quarter of the net worth of the entire U.S. savings and loan industry and that as Federal Home Loan Bank income falls, so does the stock dividend on which many thrifts depend for profitability.[257]

Currently, the Banks are subject to certain regulatory restrictions in the issuance of consolidated debt obligations, the only public debt now issued by the Banks.[258] The regulations adopted by the FHLBB, in 1946, and carried forward by the FHFB, establish two specific restrictions on the issuance of consolidated Bank debt: (1) that the FHFB will not issue consolidated Bank bonds in excess of twelve times the total paid-in capital stock and reserves of all of the Banks and (2) that the Banks shall at all times maintain assets of the following types, free from any lien or pledge, in a total amount at least equal to the amount of consolidated bonds outstanding—(a) cash; (b) obligations of or fully guaranteed by the United States; (c) secured advances; and (d) mortgages as to which one or more Banks have any guaranty or insurance, or commitment therefor, by the United States or any agency thereof.[259]

The efficacy of the twelve-to-one leverage ratio has been the subject of debate, with recent regulatory actions suggesting that other indicia better reflect capital adequacy. According to regulations promulgated by the OTS and the Office of the Comptroller of the Currency (OCC) attention should focus on the relation of capital to asset utilization in assessing a financial institution's capital adequacy.[260] The regulations promulgated by the OCC and OTS recognize that default risk is not determined by the relative split between debt and equity in the capital structure; rather, it is determined by the credit risk and

256. *Id.*
257. *Id.*
258. 12 C.F.R. § 910.1 (1989).
259. *Id.*
260. 12 C.F.R. § 3, 567.2 (1990).

interest rate risk associated with asset deployment.[261] In contrast, the Bank System's use of a forty-four year old debt-to-equity ratio does not appear to be a reliable measure of default risk and the Banks have suggested that the leverage ratio be increased or replaced with a more financially sophisticated risk-based capital measure of default risk.[262]

The proposal to amend the leverage ratio comes at an interesting time in the Banks' history as mixed-ownership government corporations, also referred to as government- sponsored enterprises (GSEs). GSEs, generally, carry out functions of public concern in a manner that does not have a direct impact on the federal government's budget. The Banks' public function is to promote the government's goal of supplying economical housing finance.

Due to the proliferation of capital market financing by GSEs, Congress required both the Treasury Department and the Comptroller General of the United States (GAO) to conduct studies of GSEs, which include, among others, the Banks, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Farm Credit System. The GAO study was to focus on the risks undertaken by all GSEs and to ascertain the appropriate level of capital for such enterprises.[263] The Treasury studies are to be conducted semi-annually on an ongoing basis and will focus on the financial safety and soundness of GSEs.[264]

The final draft of the first Treasury study cited the Banks as conservatively managed institutions, subject to minimal credit and interest rate risk.[265] (Only one of the Banks was the subject of adverse comments due to interest rate risk brought about by the rapid changes in that Bank's balance sheet. The RTC has liquidated many insolvent institutions in this Bank's district.) Indeed, the second Treasury study of GSEs' reported data indicated that, on average, the Banks were the best-capitalized of all the major providers of mortgage credit

261. *Id.*

262. Letter from Thurman C. Connell, Chairman, Bank Presidents' Caucus to Mary K. Bush, Managing Director, Federal Housing Finance Board (May 1, 1990).

263. FIRREA § 1004; 103 Stat. 183, 509-11 (1989).

264. *Id.* § 1404; 103 Stat. 551-53.

265. REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT SPONSORED ENTERPRISES, at c-46, and -47 (May 1990).

including not only GSEs' but also private financial institutions.[266] A study prepared by Standard & Poor's, appended to the Treasury Report, assigned a credit rating to each of the GSEs'; the Banks as a whole and the Student Loan Marketing Association received the highest available credit rating of "AAA." Other GSEs received lower credit ratings.[267] Currently, all GSEs receive a triple-A rating, notwithstanding their capital positions, due to a perceived "moral obligation" of the government to support the GSEs' debt issuances.[268] It is widely believed that the Bank System would receive a triple- A rating, absent any implicit government guarantee. However, not all of the Banks are currently rated by the rating agencies, and the ability of certain of the Banks (given minimal advance demand and declining membership) to obtain this rating is uncertain.

In spite of the critical national focus on the undercapitalization of most GSEs, the favorable findings of these studies with respect to the Banks may add support to the proposal to amend the twelve-to-one leverage ratio and permit the Banks to leverage their capital further.

IV. CONCLUSION

For almost sixty years, the Banks have successfully fulfilled their housing finance mission. In the present environment, however, the Banks will be challenged to demonstrate that they should continue to play an integral role in providing housing financing for this nation. The recent success of the initial offerings of Affordable Housing Program funds should provide support for the Banks' continued housing finance role.[269] Nevertheless, given the legislated taking of the Banks' retained earnings and the FIRREA-imposed burdens on current earnings, some members have begun to express concern about the

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266. *See* REPORT OF THE SECRETARY OF THE TREASURY, ON GOVERNMENT-SPONSORED ENTERPRISES, Chart 2, at 12 (Apr. 1991).

267. *Id.* at A-18, A-46.

268. MOODY'S SOVEREIGN CREDIT REPORT, Fannie Mae (Jan. 1990); MOODY'S BANK CREDIT REPORT, Freddie Mac (Oct. 1989); MOODY'S SOVEREIGN CREDIT REPORT, Federal Farm Credit Banks (Oct. 1989).

269. As previously noted, the 1990 allocation of funds for the Affordable Housing Program was $78.8 million which helped create affordable housing valued at $1.2 billion. TREASURY DEPARTMENT STUDY, *supra* note 3, at XV-10.

continued value of their investment in the Banks.[270] However, testimony of the Secretary of Treasury has indicated that the Banks would not be a source of further funds for the thrift bail-out.[271]

Although FIRREA provides a five-year moratorium on exit from the SAIF,[272] thus ensuring mandatory Bank membership for at least federal savings institutions until August 9, 1994, it is likely that, upon expiration of the moratorium, a number of savings institutions will convert from thrift charters to bank charters, or to insurance under the BIF. Such institutions will retain Bank membership only if such membership provides value to them. Thus, the Federal Home Loan Bank System must devise ways to enhance the value of Bank membership if it is to continue to play a leading role in housing finance in the future.

270. *See supra* text accompanying notes 87-89.

271. *Hearings Before the House Committee on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 33 (1990) (statement of Secretary Nicholas F. Brady on behalf of the Oversight Board of the RTC).

272. 12 U.S.C. § 1815(d)(2)(A)(ii) (West Supp. 1990).