Federal Housing Finance Agency
Office of Inspector General

Recent Trends in Federal Home Loan Bank Advances to JPMorgan Chase and Other Large Banks

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FHFA OIG
FEDERAL HOUSING FINANCE AGENCY
OFFICE OF INSPECTOR GENERAL

At A Glance

April 16, 2014

Recent Trends in Federal Home Loan Bank Advances to JPMorgan Chase and Other Large Banks

Why OIG Did This Report

The Federal Home Loan Bank System (System) is comprised of 12 regional Federal Home Loan Banks (FHLBanks) and the Office of Finance. The FHLBanks make secured loans, known as advances, to their members and do so primarily to promote housing finance. After peaking at about $1 trillion in 2008, advances declined 62% to $381 billion by March 2012. However, since then, advances have climbed to nearly $500 billion primarily due to advances to the four largest members of the System: JPMorgan Chase, Bank of America, Citigroup, and Wells Fargo. From March 31, 2012, to December 31, 2013, advances to these four System members surged by 158% to $135 billion.

This report identifies potential causes for the surge in advances to the four largest members, identifies the associated benefits and risks, and assesses the Federal Housing Finance Agency's (FHFA/Agency) oversight of this area.

OIG Analysis and Finding

New Bank Liquidity Standards Contributed to the Recent Surge in Advances

According to officials from FHFA and an FHLBank as well as Agency documents, the surge in advances to the four largest members is attributable, in large part, to bank liquidity standards established by the international Basel Committee on Bank Supervision in December 2010. Under these standards, banks, such as JPMorgan Chase, must increase their holdings of high quality liquid assets, such as U.S. Treasury securities, to improve their ability to withstand sudden financial and economic stress. The officials said that large members of the System recently drew FHLBank advances, in part, to purchase the investment securities necessary to meet the new liquidity standards.

In written responses to our inquiries, two of the four largest System members confirmed that the new liquidity standards contributed to their increased use of advances. An official from another large System member said the liquidity standards influenced its use of advances but did not say the standards increased their borrowing. The remaining member bank did not respond to our inquiries.

Potential Benefits and Risks of Large Members' Advance Growth

The benefits of the surge in advances to the four largest members include an increase in interest income that FHLBanks earn from making advances. Further, FHFA defines all advances as "core housing mission assets." Thus, increased advances could address FHFA's concerns about the relatively high-level of System investments in "non-core" housing mission assets, such as mortgage-backed securities issued by Fannie Mae and Freddie Mac.

The risks include the significant losses an FHLBank could incur if a large member defaults on its advances, particularly if the advances were improperly

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collateralized or the value of the collateral had declined significantly. FHFA officials emphasized that FHLBank advances for the purpose of meeting recent liquidity requirements are legal and not inconsistent with the System's mission. However, they noted that this practice could create an "image risk." That is, the public might question the FHLBanks' commitment to their housing mission upon learning that large member banks may be using advances to purchase investment securities to meet liquidity standards.

FHFA Prioritized Advances to Large Members in its 2013 Examinations

FHFA officials said that the surge in advances to large members and the associated safety and soundness risks were a priority during the 2013 annual examination cycle and will remain so in 2014. After reviewing FHFA's 2013 examination documents, we determined that FHFA had covered the FHLBanks' management of risks associated with increasing advances to large members. In one examination, FHFA concluded that an FHLBank had failed to properly manage the relatively high-risk collateral pledged by one of the four large System members; and the Agency issued a supervisory directive to correct the deficiency by March 2014.

Finding: FHFA Can Enhance Transparency about Recent Advance Trends

While FHFA prioritized FHLBank advances to large members in 2013, we believe the trend presents a number of questions and implications, including:

- Will the surge in advances continue, and will it spread to other members, or has the trend already peaked?
- How effectively are the FHLBanks managing the advance concentration and other risks associated with such advances?
- What are the implications for the System's ability to achieve its housing mission if member banks increasingly draw advances to help meet their liquidity requirements?

As the FHLBanks' regulator, FHFA routinely collects and assesses information and data about the FHLBanks' advance business.

In our view, FHFA could enhance awareness and understanding of FHLBank advances across the government, financial industry, and the general public through its established reporting processes or the issuance of a special report. Such action would render more transparent the System's operations, its overall safety and soundness, and its success in achieving its housing mission.

What OIG Recommends

We recommend that FHFA publicly report on FHLBank advances to large and other members in 2014, emphasizing the consistency of such advances with the safety and soundness of the System, as well as its housing mission. FHFA agreed with this recommendation.

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ABBREVIATIONS ....

DBR	Federal Housing Finance Agency Division of Federal Home Loan Bank Regulation
FHFA or Agency	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
HQLA	High Quality Liquid Assets
LCR	Liquidity Coverage Ratio
LIBOR	London Interbank Offered Rate
MBS	Mortgage-Backed Securities
MRA	Matter Requiring Attention
OIG	Federal Housing Finance Agency Office of Inspector General
PLMBS	Private Label Mortgage-Backed Securities
System	Federal Home Loan Bank System

PREFACE

The FHLBank System was established in 1932. Its primary mission is to support housing finance in the United States. The System's 12 regional FHLBanks support housing finance primarily by making secured loans, called advances, to member financial institutions, such as banks, thrifts, credit unions, and insurance companies.[1] The members can use the proceeds to originate mortgages or for other purposes.

The System raises the funds necessary to make advances through debt issuances, known as consolidated obligations, administered by its Office of Finance. As a government-sponsored enterprise, the System can issue consolidated obligations at relatively favorable interest rates and other terms compared to other for-profit corporations.[2] In turn, FHLBanks may pass along the associated savings to their members in the form of relatively low interest rates on advances.

System advances peaked in 2008, during the financial crisis, at about $1 trillion, but dropped by about 62% to $381 billion as of March 31, 2012. Since then, however, System advances have been increasing, reaching $492 billion by yearend 2013. This growth in advances has been driven primarily by a surge in some FHLBanks' advances to the four largest members of the System: JPMorgan Chase, Bank of America, Citigroup, and Wells Fargo.[3]

This evaluation report provides information and analysis on recent trends in some FHLBanks' advances to the System's large bank members. Specifically, it:

- Describes how bank holding company subsidiaries, such as those of JPMorgan Chase, may be members of multiple FHLBank districts and, thereby, obtain advances from more than one FHLBank;

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[1] FHLBank assets must be secured by eligible collateral, such as single-family mortgages or investment grade securities, among other assets.

[2] The federal government does not explicitly guarantee the System's consolidated obligations, but creditors, and other financial participants have traditionally assumed that there is an "implied" federal guarantee on them. Thus, creditors have traditionally loaned money to the System on terms more favorable than those offered to for-profit corporations without implicit guarantees, which are viewed as presenting a higher risk of default. For more information, see FHFA-OIG, *FHFA's Oversight of Troubled Federal Home Loan Banks,* EVL-2012-001, January 11, 2012, http://www.fhfaoig.gov/Content/Files/Troubled%20Banks%20EVL-2012-001.pdf.

[3] The growth in FHLBank advances to JPMorgan Chase was cited in recent articles in the financial press. *See* "*JPMorgan Taps Taxpayer Backed Banks for Bailout,"* Bloomberg, October 10, 2013 (online at http://www.bloomberg.com/news/2013-10-10/jpmorgan-taps-taxpayer-backed-banks-for-bailout-rules.html).

- Documents the growth in advances to the four largest members of the System from early 2012 to yearend 2013;[4]
- Discusses the role played by recently adopted liquidity standards in the growth of these advances;
- Identifies some of the benefits and risks associated with the surge in advances to large members; and
- Assesses FHFA's oversight of FHLBanks' management of the risks associated with these advances during 2013.

Finally, this report recommends that FHFA publicly report on FHLBank advances to large and other members in 2014, emphasizing the consistency of such advances with the safety and soundness of the System, as well as its housing mission.

This report was prepared by Wesley Phillips, Director, Omolola Anderson, Senior Statistician, Nicole Mathers, Program Specialist, and Irene Porter, Program Analyst. We appreciate the cooperation of all those who contributed to this effort.

The report has been distributed to Congress, the Office of Management and Budget, and others, and will be posted on OIG's website, www.fhfaoig.gov.

Richard Parker
Deputy Inspector General for Evaluations

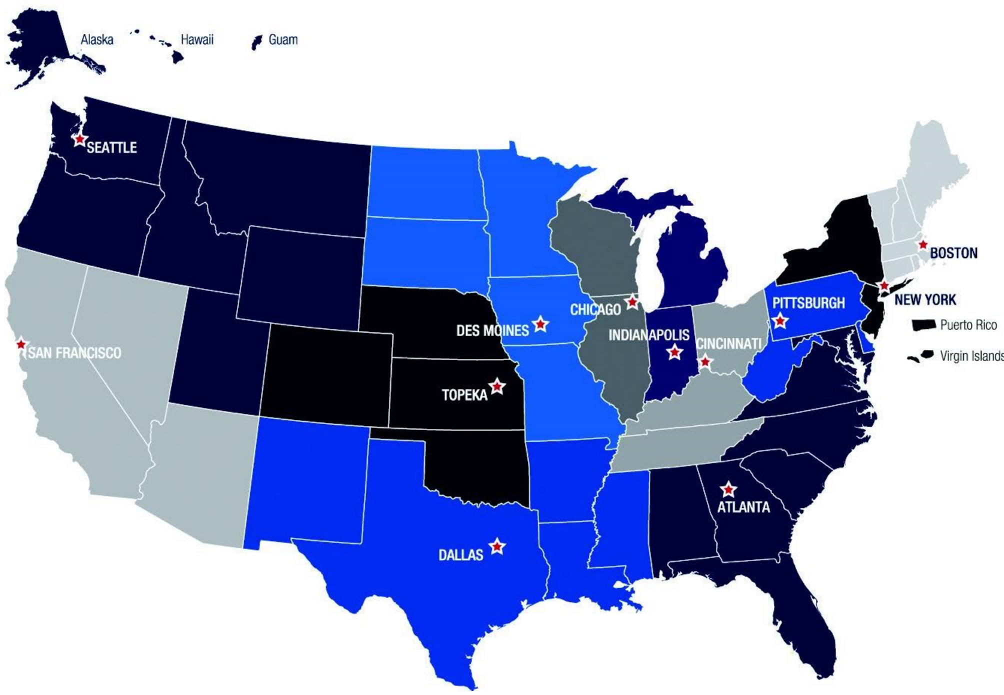
[4] In the report context section that follows, we note that the four largest bank holding companies are not themselves members at the individual FHLBanks. Rather, each has multiple subsidiaries operating in several FHLBank districts. For presentational purposes, we refer to each of these entities as a "System member."

CONTEXT

Bank Holding Companies May Own Subsidiaries that Belong to Multiple FHLBank Districts

The Federal Home Loan Bank Act (FHLBank Act)[5] provides that an eligible institution, such as a bank or thrift, may become a member of only one of the 12 FHLBank districts in which its principal business is located.[6] *See* Figure 1 (the 12 FHLBank districts). According to FHFA, there were 7,504 members of the System as of December 31, 2013.

FIGURE 1. LOCATIONS OF THE 12 FEDERAL HOME LOAN BANKS



Source: FHFA.

Nevertheless, bank and thrift holding companies may own subsidiaries situated in several FHLBank districts, and each eligible[7] subsidiary may become a member of the FHLBank in the district in which it is situated. According to FHFA, approximately 49 financial companies currently operate in two or more FHLBank districts through separately chartered subsidiaries.

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[5] *See* 12 U.S.C. § 1424, Section 4, Eligibility for Membership.

[6] The institution may become a member of an adjoining district with approval from FHFA**.**

[7] To become a member of an FHLBank, a subsidiary of a bank or thrift must be a separately chartered institution, such as a national bank or a state-chartered thrift.

The bank holding companies for JPMorgan Chase, Wells Fargo, Bank of America, and Citigroup each have multiple subsidiaries operating in several FHLBank districts. *See* Figure 2. These four holding companies are also the largest members of the System as measured by the total advances held by their subsidiaries.

FIGURE 2. ADVANCES HELD BY FOUR LARGEST BANK HOLDING COMPANIES' SUBSIDIARIES AS OF DECEMBER 31, 2013

District Memberships by Holding Company	Advances ($Millions)	% of Holding Company's Total Advances
JPMorgan Chase	**$61,831**	**100%**
Pittsburgh	$9,975	16.1%
Cincinnati	$41,700	67.4%
Chicago	$4,100	6.6%
San Francisco	$5,960	9.6%
†Seattle	$96	0.2%
Bank of America Corp.	**$28,938**	**100%**
Boston	$98	0.3%
Atlanta	$17,263	59.7%
San Francisco	$7,750	26.8%
†Seattle	$3,827	13.2%
Citigroup	**$25,202**	**100%**
New York	$22,200	88.1%
Des Moines[8]	$0	0%
†Dallas	$1	0.0%
San Francisco	$3,001	11.9%
Wells Fargo	**$19,141**	**100%**
Des Moines	$19,000	99.3%
Dallas	$0	0%
†San Francisco	$141	0.7%
Total	**$135,112**	

† Denotes the FHLBank districts in which a subsidiary of the holding company still has an advance balance but is no longer a member. The subsidiary may not take out any new advances from the FHLBank.

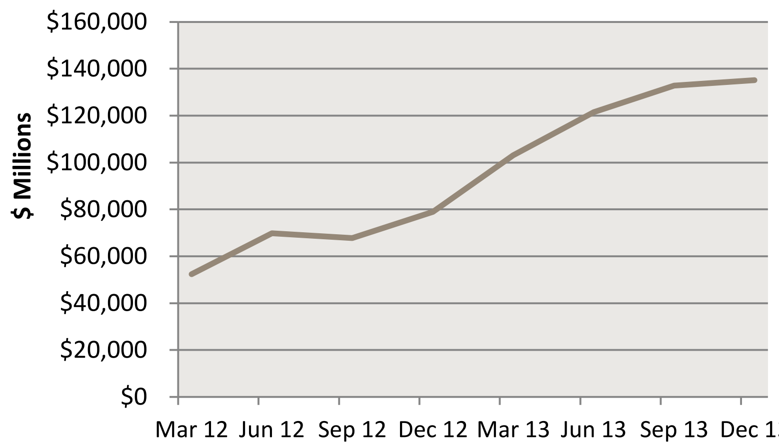
Source: FHFA.

8 A subsidiary of Citigroup maintained an active membership in Des Moines during the time period covered by the table. In January 2014 the subsidiary withdrew its membership with FHLBank of Des Moines.

FHLBanks Have Significantly Increased Advances to the Four Largest System Members since Early 2012

FHLBank advances to the four largest System members – the holding company subsidiaries of JPMorgan Chase, Wells Fargo, Citibank and Bank of America – collectively increased by 158% to $135 billion between March 30, 2012, and December 31, 2013. *See* Figure 3.

FIGURE 3. COMBINED FHLBANK SYSTEM ADVANCES TO JPMORGAN CHASE, WELLS FARGO, CITIBANK, AND BANK OF AMERICA



Source: FHFA. Data in table represents the total combined advances of JPMorgan Chase, Wells Fargo, Citibank, Bank of America, and all of their subsidiaries throughout the FHLBank system.

While advances to each of the four largest System members have increased significantly since early 2012, JPMorgan Chase and Wells Fargo accounted for the fastest growth. *See* Figure 4. They grew at triple digit rates while Bank of America and Citigroup increased at double digit rates. Further, JPMorgan Chase's increase in advances of $48 billion accounted for the majority (59%) of the total increase of nearly $83 billion in advances to the four System members during the period.

FIGURE 4. COMPOSITION OF FHLBANK SYSTEM ADVANCES TO THE FOUR LARGEST SYSTEM MEMBERS ($MILLIONS)

Holding Company	As of March 31, 2012	As of December 31, 2013	$ Change	% Change	% of Change in Advances to Top 4
JPMorgan Chase	$13,259	$61,831	$48,572	366%	59%
Wells Fargo	$2,552	$19,141	$16,589	650%	20%
Bank of America	$20,036	$28,938	$8,902	44%	11%
Citigroup	$16,508	$25,202	$8,694	53%	11%
Top 4 Total	**$52,356**	**$135,115**	**$82,756**	**158%**	**100%**

Source: FHFA. Numbers may not add exactly due to rounding.

Surging FHLBank Advances to the Four Largest System Members Contrasts with Generally Flat Advances to All Other Members

The surge in advances to the four largest System members contrasts sharply with the relatively stable rate at which advances were made to the other approximately 7,500 FHLBank members over the same period, i.e., March 31, 2012, to December 31, 2013. *See* Figure 5. While advances to the four largest bank members increased by 158% over this period, advances to other System members rose by just 9%. Conclusively, the growth in advances to the four largest members was primarily responsible for the 29% increase (from $381 billion to $492 billion)[9] in overall System advances during this 21-month period.[10]

FIGURE 5. CHANGE IN FHLBANK SYSTEM ADVANCES TO THE FOUR LARGEST BANK MEMBERS VERSUS OTHER MEMBERS ($MILLIONS)

System Member	As of March 31, 2012	As of December 31, 2013	$ Change	% Change
Top 4	$52,356	$135,112	$82,756	158%
Others	$328,280	$357,329	$29,049	9%
FHLBank System Total	**$380,636**	**$492,444**	**$111,808**	**29%**

Source: FHFA. Numbers may not add exactly due to rounding.

We note that the 9% increase in advances to other members occurred entirely in the last three months of 2013. Between March 31, 2012, and September 30, 2013, advances to System members apart from the top four actually declined by 1%. According to FHFA data, the growth in advances during the fourth quarter of 2013 was largely attributable to System members other than the four largest.[11]

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9 The advance totals presented are at par value. The par value of an advance is the amount of funds that the borrower owes the FHLBank after various accounting adjustments are made to the book value. The book value – the value at which an asset is carried on a balance sheet – of System advances was $498.6 billion at December 31, 2013.

10 System advances increased by $111.8 billion over this period. Advances to the top four System members accounted for $82.8 billion, or 74%, of this total increase. The growth in advances that began in early 2012 reversed a System-wide decline that began in 2008 after advances peaked at about $1 trillion.

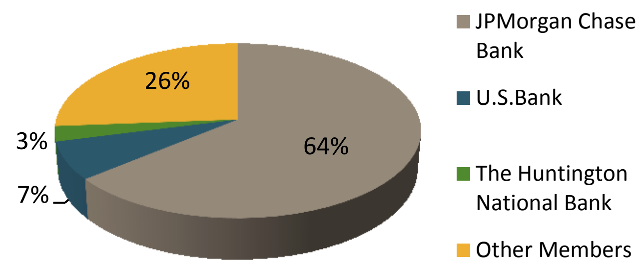
11 FHFA data indicate that the growth in advances during the fourth quarter extended to System members other than the four largest, which are the focus of this evaluation report. The reasons for this increase are not clear, but several, including "depositor run-off" and Basel III requirements, are discussed in the next section of this evaluation report.

Concentration of FHLBank Advances to Four Largest Members Has Increased Significantly

As these four largest members have increased their total advances, they have also increased their relative share of all System advances. In other words, more of the Systems' total advances have been concentrated in the four largest members. As of December 31, 2013, JPMorgan Chase, Wells Fargo, Citibank, and Bank of America accounted for 27% of total System advances, compared to 14% on March 31, 2012.

FHLBank of Cincinnati's advances to a JPMorgan Chase subsidiary in its district represented the most significant concentration of advances to a top member. At the end of the second quarter of 2012, the FHLBank's advances of about $4 billion to the JPMorgan Chase subsidiary accounted for 11.6% of all its advances. However, by yearend 2013 such advances accounted for 64% of all of the FHLBank's advances to its members. *See* Figure 6.

FIGURE 6. COMPOSITION OF ADVANCES AT THE FHLBANK OF CINCINNATI, AS OF DECEMBER 31, 2013



Source: FHFA.

Basel III Liquidity Requirements Contributed to the Surge in FHLBank Advances

According to officials from FHFA's Division of Federal Home Loan Bank Regulation (DBR) and an FHLBank[12] as well as Agency internal records,[13] some large FHLBank members have increased their use of advances as part of an overall strategy to comply with regulatory requirements established by the international **Basel Committee on Bank Supervision**[14] (the Committee).[15] In December 2010 the Committee issued what is known as the Basel III accord (Basel III).[16]

Basel Committee on Bank Supervision: The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision, and practices of banks worldwide with the purpose of enhancing financial stability.

Among other things, Basel III establishes international **liquidity requirements**[17] for commercial banks to help ensure financial stability. To meet these liquidity standards, banks may have to increase their holdings of high quality liquid assets, such as U.S. Treasury securities. FHFA and FHLBank officials said that bank members may use FHLBank advances as a source of funds to purchase Treasury or similar high quality liquid

Liquidity Requirements: The Basel III liquidity requirements are intended to ensure that commercial banks are fiscally stable and responsible in the event of a future financial crisis. Banks are directed to increase their liquidity via obtaining high quality liquid assets, such as cash and U.S. Treasury securities.

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[12] Officials from another FHLBank that had recently increased its advances to a large System member said that it was not their policy to inquire about the use to which their members put their advances.

[13] We note that determining how FHLBank members use advances is challenging. Financial institutions use various sources to fund their operations, and tracing the uses to which specific funds are put is difficult. Nevertheless, the sources cited in this report, and the analysis of the information provided by them, indicate that the requirements set forth in Basel III have likely played a significant role in the surge of FHLBank advances to the four largest members of the System.

[14] See Bank for International Settlements website. http://www.bis.org/bcbs/about.htm.

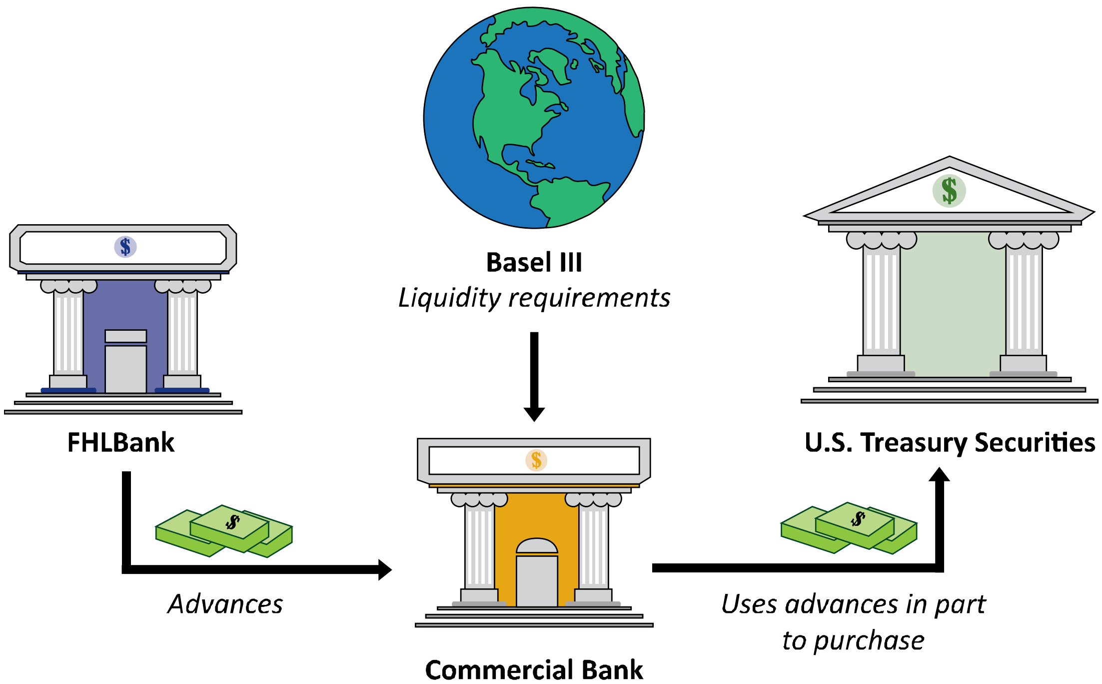
[15] Moody's Investors Services has also observed that banks may draw on FHLBank advances to meet Basel III requirements. See *FHLBank System, FAQ,* August 1, 2013.

[16] Each country that belongs to the Committee is responsible for enacting laws or regulations that implement its standards, such as Basel III liquidity requirements.

[17] For more information regarding the Basel III liquidity requirements, see the Bank for International Settlements website. http://www.bis.org/publ/bcbs238.htm.

securities and hold them on their balance sheets in order to meet the liquidity standards.[18] *See* Figure 7.

FIGURE 7. EXAMPLE OF HOW A BANK MAY SATISFY LIQUIDITY REQUIREMENTS THROUGH FHLBANK ADVANCES



Source: OIG Analysis.

DBR officials also emphasized that the FHLBanks did not violate the law by extending advances to their large commercial bank members that, in turn, used the proceeds to purchase U.S. Treasury securities to comply with Basel III's requirements. They observed that FHLBanks are authorized to make advances to their members consistent with collateral requirements, lending limits, and other statutory, regulatory, and internal standards. The DBR officials also noted that there are no restrictions on the uses to which members may put the proceeds of advances other than those that already exist in law and regulation.

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[18] According to the Bank for International Settlement's January 2013 publication entitled "*Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*," the purpose of the liquidity requirements is to ensure that banks have sufficient high quality liquid assets (HQLA) to meet their liquidity needs for at least 30 days in the event of a stress scenario such as the 2008 financial crisis. Such HQLAs may consist of cash or assets that can readily be converted into cash in private markets. See http://www.bis.org/publ/bcbs238.pdf, p.4, item 16.

JPMorgan Chase's Filings with the Securities and Exchange Commission also Indicate that it Used Advances to Meet Basel III Requirements

We reviewed JPMorgan Chase's filings with the Securities and Exchange Commission (SEC). They suggest that Basel III liquidity requirements have played a role in its recent large draws of FHLBank advances.[19] In its December 2012 annual financial statement, JPMorgan Chase reported that efforts were underway to fully comply with the new Basel III liquidity requirements by the end of 2013. JPMorgan Chase describes FHLBank advances as one of several sources available to provide funding. It also subsequently reported a 53% increase in its holdings of high quality liquid assets such as U.S. Treasury securities in a matter of a year – from $341 billion at December 31, 2012, to $522 billion at December 31, 2013 – during the period it drew $48.6 billion in FHLBank advances.

Views of Officials from Three of the Four Largest System Members

We spoke with officials from three of the four largest members of the System regarding their increased use of FHLBank advances since early 2012.[20] Officials from two of these three banks confirmed in writing that Basel III's liquidity requirements contributed to their increased use of FHLBank advances.[21] In fact, officials from one of the banks said that the Basel III requirements were the "primary driver" for its increased use of advances.[22]

An official from the third bank said that Basel III's liquidity requirements may influence its use of advances. However, the official did not specifically state that the liquidity requirements directly contributed to the bank's increased FHLBank borrowing since early 2012.

DBR Officials Believe "Deposit Run Off" May Have Contributed to Growth of Advances to Other Members in the Fourth Quarter of 2013

DBR officials also noted that the significant increase in advances to members other than the largest four during the fourth quarter of 2013 may have been due, in part, to deposit run off at member institutions. That is, since the members' depositors were earning low rates, they may

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[19] JPMorgan Chase & Co., 2012 Annual Report, Dec. 31, 2012, p. 71 and108, from JPMorgan Chase & Co investor relations website, http://investor.shareholder.com/jpmorganchase/secfiling.cfm?filingID=19617-13-221 and JPMorgan Chase & Co., 2013 Quarterly Report, September 30, 2013, p. 68 and 71, http://investor.shareholder.com/jpmorganchase/secfiling.cfm?filingID=19617-13-400.

[20] Officials from one of the four largest members did not respond to our requests for information about its use of advances.

[21] We do not disclose the identities of these banks so as to facilitate their willingness to speak with us.

[22] See Appendix A for the complete text of the banks' responses to our questions.

have withdrawn some of their funds and reinvested them in the stock market where returns were higher. This, in turn, may have caused the members to increase their advances to help fund their own operations. However, DBR officials said that the growth in advances to these members in fourth quarter of 2013 may also be attributable to their efforts to meet Basel III's requirements.

Benefits and Risks Associated with the Surge in FHLBank Advances to Large Members

Our discussions with officials from FHFA and the FHLBanks identified both benefits and risks associated with the recent surge in advances to the four largest members of the System. *See* Figure 8 (summary of benefits and risks). In this section we analyze them in more detail.

FIGURE 8. SUMMARY OF BENEFITS AND RISKS ASSOCIATED WITH THE FHLBANKS' RISING ADVANCES TO LARGE MEMBERS

Benefits	Risks
Potentially Higher Advance Interest Income	Advance Concentration Risk
Increased Focus on Housing Core Mission Assets	FHLBanks May Favor Large Members over Smaller Members in Advance Term Pricing
	Housing Mission "Image" Risk

Source: OIG Analysis.

Potential Benefits

Increased Interest Income

The interest income generated by surging advances could help stabilize the finances of individual FHLBanks and, potentially, the System as a whole. FHLBanks also may pay both cash and stock dividends to their large and small members alike based on quarterly or annual profits. Moreover, increased interest income generated by advances would cause the FHLBanks to contribute more to their Affordable Housing Programs (AHP), which receive 10% of each FHLBank's net income each year.[23]

However, FHLBank data indicate that the surge in advances to the largest members has not yet translated into materially higher interest income. For example, the FHLBank of Cincinnati saw modest advance interest income increases in 2012 and 2013, the period in which JPMorgan Chase's advances increased significantly. Specifically, advance interest

[23] AHP funds are awarded through both a homeownership set-aside program and a competitive application program. At least one-third of an FHLBank's aggregate annual set-aside contribution must be used to assist first-time homebuyers. See, *FHFA's Oversight of the Federal Home Loan Banks' Affordable Housing Programs* (EVL-2013-04) (April 30, 2013) (online at http://www.fhfaoig.gov/Content/Files/EVL-2013-04.pdf).

income at the FHLBank of Cincinnati increased by only 31% to $308 million between 2011 and 2013 despite the 134% growth in their advances during that time period. *See* Figure 9. Moreover, the FHLBank's yield on its assets, which is a measure of profitability, actually declined from 0.81% to 0.50% from 2011 to 2013.

FIGURE 9. FHLBANK OF CINCINNATI ADVANCE INTEREST INCOME AND YIELD ($MILLIONS)

Yearend	Total Advances	Interest Income	Annual Yield
2011	$27,838	$236	0.81%
2012	$53,621	$261	0.80%
2013	$65,093	$308	0.50%

Source: FHFA.

FHFA officials observed that overall interest rates have declined over the past several years.[24] That is, the interest rates that large members pay on their advances have declined even as their advance balances have grown significantly. Additionally, officials from an FHLBank said that many of the advances to larger members were floating rate advances that were at very low initial market rates at the time the advances were taken. These low rates reduced the relative interest income.

Increased Focus on Housing Core Mission Assets

FHFA and FHLBank officials also said that the surge in advances to large bank members can help the System increase its focus on what are known as core housing-mission related assets. Per FHFA regulations, core housing mission assets are defined as advances and mortgage assets purchased from members, among others. Thus, FHLBank investments in private-label mortgage-backed securities (PLMBS) and mortgage-backed securities (MBS) issued by Fannie Mae and Freddie Mac are not core-mission assets.

In previous reports, we have discussed the FHLBanks' investment in non-core mission assets and the criticisms leveled by some FHFA officials at their having done so. Specifically, we noted that the relatively large investments in PLMBS made by some FHLBanks have generated significant losses and led to questions about those FHLBanks' focus on their housing mission.[25] The surge in advances to large members may serve to offset some of the System's non-core mission assets.

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[24] FHLBank short-term and floating rate advance rates are indexed on the London Interbank Offered Rate (LIBOR). The LIBOR averaged 0.43% in 2012 and 0.27% in 2013. FHFA says the decline in the LIBOR primarily contributed to a lower yield on advances in 2013. They also note that as old, high-rate advances gradually mature or are prepaid, they are replaced with lower yielding assets or not replaced at all.

[25] See, *FHFA's Oversight of Troubled Federal Home Loan Banks* (EVL-2012-001) (January 11, 2012) (online at http://www.fhfaoig.gov/Content/Files/Troubled%20Banks%20EVL-2012-001.pdf) and *FHFA's Oversight of the Federal Home Loan Banks' Compliance with Regulatory Limits on Extensions of Unsecured Credit* (EVL-2013-008) (August 6, 2013) (online at http://www.fhfaoig.gov/Content/Files/EVL-2013-008.pdf).

We asked DBR officials how the FHLBanks' use of advances to meet Basel III's liquidity standards was consistent with the System's housing mission. They said that all advances are considered to be core mission assets. They noted that, as a matter of statute and regulation,[26] only long-term advances, i.e., those with maturities of five years or more, must be used for housing purposes. Finally, they said that using FHLBank advances to meet a member bank's liquidity requirements is not "necessarily inconsistent" with the System's mission. Having said all that, however, the officials noted, as described below, that the practice of using advances to meet Basel III's liquidity requirements could create a housing mission "image risk" for the System.

Potential Risks

Advance Concentration Risk

FHFA officials noted there are concentration risks associated with some FHLBanks' advances to their large members. Under some scenarios, an FHLBank could experience substantial losses if a large member defaulted on its advances. This could occur if an FHLBank failed to ensure that its advances were fully collateralized or failed to determine timely that the collateral securing an advance had declined substantially in value.[27] However, both FHFA and FHLBank officials we contacted said that collateral management is a high priority within the System, and FHFA evaluates the FHLBanks' risk management controls at every annual examination. FHFA examinations of the FHLBanks' advance collateral risk management are discussed in the next section of this report.

There is also the possibility that FHLBanks could become overly dependent on the interest income generated by advances to their large members, according to FHFA. Consequently, some FHLBanks may face significant financial challenges if a large member sharply reduced its advances or withdrew its membership from the district entirely. A DBR official said that some FHLBanks are better able to "scale" their advance activity than others and thereby mitigate such risks.

FHLBanks May Favor Large Members over Smaller Members in Advance Term Pricing

FHFA officials also said there is a potential that FHLBanks could favor large members over smaller members to gain their business. Doing so would constitute a violation of Section 7(j) of the FHLBank Act.[28] FHLBanks could accomplish this by lowering advance rates, or

[26] 12 U.S.C. 4526 and 12 CFR § 1266.3.

[27] We note that each FHLBank is jointly and severally liable for the System's consolidated obligations. Thus, the financial difficulties of one FHLBank could have financial implications for all 12 FHLBanks.

[28] *See* 12 U.S.C. § 1427(j) (2006). Section 7(j) requires FHLBank directors to administer the affairs of the bank impartially and without discrimination in favor of or against any member.

easing collateral and capital requirements for some members. Furthermore, there is some potential that if a large member borrower is part of a multi-bank holding company with subsidiaries in multiple FHLBank districts, then it could redirect funding from one FHLBank to another, causing price competition for advances among FHLBanks.[29] Such price competition among FHLBanks could affect the System's safety and soundness.[30] As discussed in the next section, FHFA reviewed the FHLBanks' advance term pricing during examinations conducted in 2013.

Housing Mission "Image" Risk

Lastly, FHFA officials said there may be an increased "image risk" associated with some FHLBanks' advances to their large members. Specifically, concerns about the System's housing mission focus could be raised in response to large banks drawing advances to purchase Treasury securities to meet Basel III requirements. This, the officials conceded, could occur despite the fact that FHFA considers all FHLBank advances to be core housing mission assets, and only those with maturities of five years or more must be used specifically for housing purpose.

FHFA Prioritized FHLBank Advances to Large Members in its 2013 Examination Oversight Process

DBR officials told us that oversight of the surge in advances to large System members was a priority during the 2013 examination cycle and that it will remain so in 2014.[31] The officials said that examiners have focused on assessing the FHLBanks' risk management practices, such as the manner in which they ensure that advances are properly collateralized. Further, DBR officials said that they have maintained regular communications with FHLBank officials about the surge in advances to large members.

Our review of DBR's 2013 planning materials for three FHLBanks confirmed that the examiners prioritized the surge in advances to large members and the concentration and collateral management risks they created.[32] The planning materials also identified the steps that the examiners would take to assess the FHLBanks' management of these risks.

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[29] See Government Accountability Office, *Federal Home Loan Bank System: Key Loan Pricing Terms Can Differ Significantly* (GAO-03-973) September 8, 2003.

[30] FHFA regulations permit differential pricing when an FHLBank adopts reasonable criteria and applies them to all members. *See* 12 CFR 1266.5(b)(2).

[31] DBR conducts annual on-site safety and soundness and housing mission compliance examinations of each FHLBank as well as the Office of Finance.

[32] FHFA's 2013 examination of another FHLBank that has made significant advances to a commercial bank member did not focus on the FHLBank's risk management practices as the advances did not start until after the

DBR's examination of an FHLBank in 2013 revealed weaknesses in its management of relatively risky collateral pledged by a large member to secure advances.[33] Accordingly, a supervisory directive was instituted. Under it, the FHLBank must correct these deficiencies by March 31, 2014. In two other examinations conducted in 2013, DBR assessed whether a large bank member of the System had double-pledged collateral to obtain advances from two FHLBanks.[34] DBR concluded that the FHLBanks had controls in place to prevent such double pledging.

Moreover, DBR exams did not identify evidence indicating that the FHLBanks offered favorable advance pricing to their large bank members in violation of section 7(j) of the FHLBank Act.[35] Specifically, the examiners assessed whether advances made to the large members were transparent and consistent with established policies. In one examination a test was conducted to determine whether the term pricing offered to a large member differed from that offered to smaller members. No discrepancies were identified.

Finally, DBR officials said that they plan to study at least one of the largest members in the System to evaluate the risks associated with the concentration of advances. Officials said that they initiated the study in 2013 given that some holding companies have subsidiaries that are members of multiple FHLBanks and that advances to these subsidiaries have increased substantially recently. Officials said that the study would likely assess such members' advance activity, pricing, and the FHLBanks' risk management procedures. The DBR officials noted that the study is intended to inform the Agency's supervisory processes and will likely not be made available to the public as it may include proprietary information.

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examination was complete. However, FHFA officials said they would review the FHLBank's risk management practices during its 2014 examination.

[33] FHFA concluded that the FHLBank did not have adequate controls in place for relatively high-risk collateral that a large commercial bank member had pledged to secure advances.

[34] Double pledging occurs when a banking organization with subsidiaries in multiple FHLBank districts pledges the same collateral to secure advances from separate FHLBanks. This creates risks because if the banking organization's subsidiaries defaulted on both advances there would not be sufficient collateral to secure the advances, which would likely result in credit losses for one or both FHLBanks.

[35] *See* n. 27, *supra*.

FINDING ....

FHFA Can Make Recent FHLBank Advance Trends More Transparent

While FHFA conducted targeted studies of FHLBank advances to large members in 2013, we believe the trend presents the following important questions and implications for the FHLBank System:

- Has the surge peaked, or will it continue and expand to other member banks?[36]
- Will Basel III's liquidity standards be a primary driver of increasing advances to smaller members as appears to have been the case with large members?
- Will the FHLBanks compete, or plan to compete, for large member bank advance business on terms such as interest rates and collateral requirements?
- How effectively do FHLBanks manage risks, such as concentration risk, which are associated with their advances to large members?
- What are the implications for the System's ability to achieve its housing mission goals if member banks increasingly draw advances to help meet their liqudity requirements?

As the System's regulator, FHFA routinely collects and assesses data by which these matters may be addressed. Specifically, the Agency:

- Collects and reviews advance information, including trend data, on advances to large members and FHLBank concentration levels;
- Discusses advance trend information with FHLBank officials, including the reasons that advances are made to large members;
- Examines the FHLBanks to assess their compliance with safety and soundness and housing mission requirements;
- Reviews FHLBank advance pricing terms;
- Consults with other financial regulators on matters such as the reasons large commercial banks draw FHLBank advances; and
- Conducts reviews of the roles of at least one large bank within the System.

[36] As discussed earlier, members, other than the four largest, accounted for the increase in System assets in the fourth quarter of 2013. It is possible, but not clearly demonstrated, that Basel III's liquidity requirements contributed to this increase in advances to smaller members.

In our view, FHFA could enhance awareness and understanding of FHLBank advances across the government, financial industry, and the general public through its established reporting processes or the issuance of a special report.[37] Such action on FHFA's part would render more transparent the System's operations, its overall safety and soundness, and its success in achieving its housing mission.

CONCLUSION..

Although System advances plummeted by about 62% to $381 billion from 2008 through March 2012, they subsequently increased to $492 billion by yearend 2013 due primarily to a surge in advances to the four largest members. This trend, if it continues and spreads to other members, offers potential benefits to the System, including higher interest income and an increased focus on regulatory-defined core housing mission assets. However, the surge in advances to the four largest members also presents safety and soundness risks, such as concentration risk, that must be mitigated. Further, the increasing use of advances by members to meet Basel III's liquidity requirements could raise public concerns about the System's commitment to its housing mission obligations. We believe that FHFA can take steps to enhance transparency about recent trends in FHLBank advances and their potential implications.

RECOMMENDATION...

We recommend that as FHFA collects and analyzes information on FHLBank advances to large and other members in calendar year 2014, it report publicly on such items as advance trends, the reasons for such advances, the effectiveness of FHLBank risk management practices, the consistency of such advances with the System's housing mission, and other topics as deemed appropriate.

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[37] FHFA has discussed critical risks in its previous annual reports to Congress. For example, the 2009 annual report discussed the risks of the FHLBanks' PLMBS investments and advances to insurance companies. See *FHFA 2009 Annual Report to Congress* (online at http://www.fhfa.gov/webfiles/15784/FHFAReportToCongress52510.pdf).

OBJECTIVES, SCOPE, AND METHODOLOGY ....

The primary objectives of this report were to document the surge in advances made to the System's four largest members, discuss possible reasons for it, identify associated benefits and risks, and assess FHFA's oversight activities.

To address these objectives, we interviewed officials in DBR and at two FHLBanks that have made significant advances to large members.

We also reached out to the four largest System members to obtain their views. Two of the members responded in writing and their responses are provided in attachment A to the report. We conducted a telephone interview with a representative from another large member. Officials from the fourth member chose not to respond to our inquiries. We did not pursue additional actions to obtain the bank's views as doing so was not considered critical for the purposes of this evaluation.

We also reviewed FHLBank advance data provided by DBR, FHLBank financial summaries and memoranda, financial statements for several large members of the FHLBanks, FHLBank planning and examination reports, and findings memoranda and supervisory directives associated with FHLBank examinations.

This study was conducted under the authority of the Inspector General Act and is in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which was promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require OIG to plan and perform an evaluation that obtains evidence sufficient to provide reasonable bases to support its findings and recommendations. OIG believes that the finding and recommendation discussed in this report meet these standards.

A draft of this report was sent to FHFA for comment. As presented in Appendix A, FHFA agreed to OIG's recommendation.[38]

The performance period for this evaluation was December 2013 and March 2014.

[38] OIG also provided sections of this report, respectively, to the FHLBanks and large System members whose statements were cited in the report. Some responded with their comments and others did not.

ATTACHMENT A ....

Large Member Responses to OIG Questions about Their Use of System Advances

1. **We understand that your bank (through all your subsidiaries) has taken about $X billion in FHLBank advances since March 31, 2012, which is an X% increase in that period of time. Can you tell us what your Bank's primary purpose was in drawing these advances?**

   Bank A's Response: There are actually two factors at play here: 1 – Our borrowings from the FHLB's [sic] were historically low the past two years as we were in a program of reducing our "wholesale" funding footprint, both long and short term. The Federal Reserve's long standing program of providing liquidity to the banking system had resulted in an outsized accumulation of deposits as a percentage of our aggregate funding need (thus reducing the need for wholesale funding). 2 – The increase in FHLB advances since our historically low levels of the past two years has been driven specifically by legal entity liquidity coverage ratio (LCR) requirements and our desire to build high quality and long term funding.[39]

   Bank B's Response: The mission of the FHLB is to provide stable, low cost funding to mortgage originators in local markets. Bank B is a member of the FHLB system and is dedicated to supporting its customers by providing financing of local housing and community lending. Mortgage assets originated in local communities are eligible to collateralize competitively priced FHLB borrowings. The benefits of competitive FHLB pricing are incorporated in the rates offered to Bank B's customers and support the FHLB's mission to maintain affordable mortgage financing for U.S. consumers. FHLB borrowings also provide a diversified source of funding for Bank B.

2. **To what extent, if at all, did Basel III's liquidity and other requirements play a role? Please explain.**

   Bank A's Response: Basel III's legal entity LCR was the primary driver in our increasing FHLB advances in the past year. The increase in outstandings and the lengthening of our book directly relates to LCR and not the need for cash.

   Bank B's Response: Bank B regularly evaluates the mix of liabilities on its balance sheet. The evolving liquidity rules under the Basel III regime generally require longer

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[39] OIG note: The Liquidity Coverage Ratio (LCR) is the standard that banks must meet to be in compliance with Basel III liquidity requirements. The LCR establishes the level of high quality liquid assets, such as Treasury securities, that banks must hold.

tenor funding to be used to fund assets, including mortgages. As a result, Bank B has modified the funding mix of its balance sheet and increased issuance across multiple markets to diversify funding sources and improve its liquidity position as required by Basel III. FHLB borrowings have expanded over the past 12-18 months to support the mortgage business under the new liquidity regime.

APPENDIX A ....

FHFA's Comments on FHFA-OIG's Findings and Recommendation

Federal Housing Finance Agency

MEMORANDUM

TO: Richard B. Parker
Deputy Inspector General for Evaluations

FROM: Fred Graham
Deputy Director, Division of Federal Home Loan Bank Regulation

SUBJECT: Evaluation Report: *Recent Trends in Federal Home Loan Bank Advances to JP Morgan Chase and Other Large Banks*

DATE: March 27, 2014

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendations in the report prepared by FHFA-OIG, *Recent Trends in Federal Home Loan Bank Advances to JP Morgan Chase and Other Large Banks*. We appreciate the opportunity to provide feedback on this draft report and the FHFA-OIG findings.

The report describes recent trends in FHLBank advance and the role of large borrowers in those trends. While it does not opine on our general supervision of advances or the FHLBanks, it does recommend that we disseminate some or our data and views on the subject. The text of the FHFA-OIG recommendation and our formal response are provided below.

FHFA-OIG recommendation

We recommend that as FHFA collects and analyzes information on FHLBank advances to large and other members in calendar year 2014, it report publicly on such items as advance trends, the reasons for such advances, the effectiveness of FHLBank risk management practices, the consistency of such advances with the System's housing mission, and other topics as deemed appropriate.

FHFA Management Response

FHFA agrees with the recommendation. FHFA will augment its 2014 Annual Report to Congress with a section specifically dedicated to FHLBank advances, which will discuss trends, business concentrations, potential reasons for changes in advance activity, and other issues that warrant discussion at that time.

The agency has several monitoring programs for FHLBank advances and regularly assesses the effectiveness of FHLBank risk management practices through its annual examination program. While much of the information on advances to large borrowers is made public through the SEC filings of the individual FHLBanks and through the combined financial reports prepared by the FHLBanks' Office of Finance, we agree that we can further increase transparency through our own reporting.

FHFA expects to have a draft of the FHLBank section of the Annual Report to Congress by March 31, 2015. FHFA will release a final document within a few months thereafter.

cc: Richard Hornsby, Chief Operating Officer
John Major, Internal Controls and Audit Follow-Up Manager

ADDITIONAL INFORMATION AND COPIES……………………………

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