Federal Housing Finance Agency
Office of Inspector General

Merger of the Federal Home Loan Banks of Des Moines and Seattle: FHFA's Role and Approach for Overseeing the Continuing FHLBank

White Paper • WPR-2016-002 • March 16, 2016

FEDERAL HOUSING FINANCE AGENCY
FHFA OIG
OFFICE OF INSPECTOR GENERAL

WPR-2016-002

March 16, 2016

Executive Summary

The merger of the Federal Home Loan Banks (FHLBanks) of Des Moines and Seattle, effective May 31, 2015, was the first voluntary merger of FHLBanks. The merger was completed on schedule, with no interruption in service to members. The continuing FHLBank, headquartered in Des Moines, is now the largest of 11 FHLBank regions in both geography and number of members.

Although the FHLBanks chose each other and negotiated the merger agreement, the Federal Housing Finance Agency (FHFA or Agency) played a decisive role in encouraging the Seattle FHLBank to find a merger partner to address some of the Agency's longstanding supervisory concerns with the FHLBank.

By contrast to the Seattle FHLBank, for the past five years, FHFA found the overall condition of the Des Moines FHLBank to be satisfactory. At the same time, the Agency raised questions about the Des Moines FHLBank's operational risk, particularly with the FHLBank's multiyear plan to upgrade its core banking system. The merger compounded these operational risks.

FHFA officials generally intend to oversee the continuing FHLBank as they would any other FHLBank, while closely monitoring the situation and adding resources as necessary. In light of the post-merger challenges, the continuing FHLBank merits ongoing focus.

This white paper describes:

- The Seattle FHLBank's challenges leading up to the merger;
- FHFA's role in encouraging the merger; and
- FHFA's approach for overseeing the continuing FHLBank.

It makes no recommendations.

TABLE OF CONTENTS ....

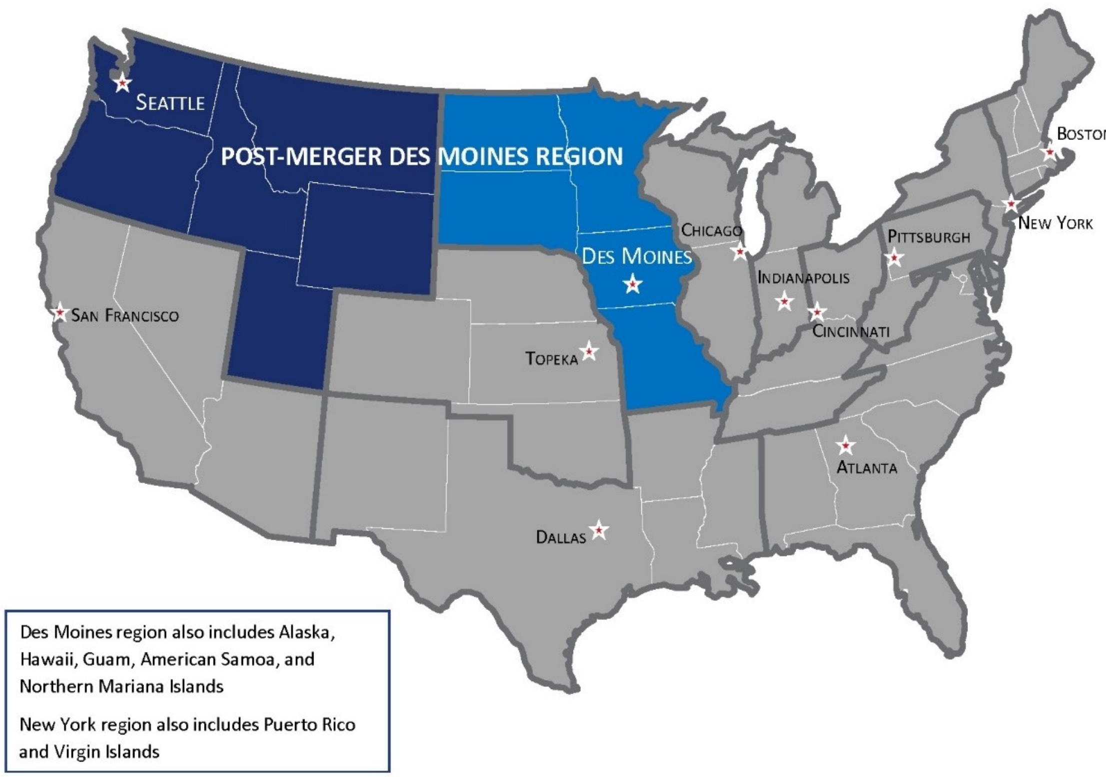
ABBREVIATIONS

CEO	Chief executive officer
FHFA or Agency	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
MBS	Mortgage-backed securities
OIG	Federal Housing Finance Agency Office of Inspector General

BACKGROUND

FHFA serves as the regulator and supervisor of the FHLBank System, which is now comprised of 11 regional FHLBanks, as shown in Figure 1, and the Office of Finance.[1] The FHLBank System had 12 regional FHLBanks until the FHLBanks of Des Moines and Seattle merged effective May 31, 2015. This was the first voluntary merger of FHLBanks and the first FHLBank merger since 1946.[2] Overseeing the merger and the continuing FHLBank therefore represents uncharted waters for FHFA.

FIGURE 1: MAP OF FHLBANK REGIONS



The FHLBank System is a government-sponsored enterprise, which is a business organization chartered by the federal government. The FHLBanks are cooperatively owned by their more than 7,000 members, including financial institutions such as commercial banks, thrift institutions, insurance companies, and credit unions. Members must own capital stock

---

[1] For more information about the FHLBank System, see OIG, *An Overview of the FHLBank System's Structure, Operations, and Challenges* (Oct. 31, 2012) (online at www.fhfaoig.gov//Content/Files/FHLBankSystemOverview.pdf).

[2] In 1946, the then-regulator of the FHLBanks required the FHLBanks of Portland and Los Angeles to merge, becoming the FHLBank of San Francisco. In 1964, the FHLBank was again split, creating what became the FHLBank of Seattle.

in their FHLBank and may receive dividends on their stock from their FHLBank. Each FHLBank has a board of directors comprised of officers or directors from member institutions and independent directors.

The FHLBank System's mission is to support residential mortgage lending and community investment through its member financial institutions. To fulfill that mission, FHLBanks make collateralized loans, called advances, to their members. The members, in turn, may use the proceeds for residential mortgages, community investments, and other services for housing and community development.[3] FHLBanks also maintain investment portfolios for liquidity purposes and to generate income. The investments may include mortgage-backed securities (MBS). In the past, some FHLBanks incurred substantial losses on their investments in private-label MBS, which are MBS that are not issued or guaranteed by Fannie Mae, Freddie Mac, or a government entity. FHFA regulations limit FHLBanks' investments in MBS.

The FHLBanks principally fund their activities through debt, known as consolidated obligations, issued through the Office of Finance for all the FHLBanks in the System. Each FHLBank is primarily liable for the payment of principal and interest on the portion of the debt issued on its behalf. Each FHLBank also has "joint and several liability" for the payment of principal and interest on all consolidated obligations across the FHLBank System. Accordingly, if one FHLBank is financially weak and unable to make its payments, the other FHLBanks must make the payments.

FHFA Regulations for Approving Voluntary FHLBank Mergers

The Housing and Economic Recovery Act, which created FHFA in 2008, required the Agency to issue regulations establishing procedures for approving voluntary mergers of FHLBanks.[4] FHFA issued these regulations in 2011.[5] The regulations outlined at a high level the steps that must be followed for a voluntary FHLBank merger. The required steps included: (1) execution of a merger agreement authorized by each FHLBank's board, (2) joint submission of a merger application by the FHLBanks to FHFA, (3) approval of the merger by the FHFA Director with any conditions, and (4) ratification by the merging FHLBanks' members.

---

[3] By statute, generally: (1) long-term advances must be made for residential housing finance and (2) to maintain access to long-term advances, members must meet standards of community investment and service. For more information, see OIG, *FHFA's Oversight of Two Mission-Related Requirements for Federal Home Loan Bank Long-Term Advances* (Mar. 31, 2015) (ESR-2015-005) (online at www.fhfaoig.gov/Content/Files/ESR-2015-005.pdf).

[4] *See* 12 U.S.C. § 1446(b)(1), (2).

[5] FHFA, *Voluntary Mergers of Federal Home Loan Banks*, 76 Fed. Reg. 72823 (Nov. 28, 2011) (final rule codified at 12 C.F.R. Part 1278).

FHFA retained flexibility in the regulations regarding how the Agency would evaluate potential mergers. According to the regulations, in determining whether to approve a merger of FHLBanks, FHFA must consider the financial and managerial resources of the FHLBanks, the future prospects of the continuing FHLBank, and the effect of the proposed merger on the safety and soundness of the continuing FHLBank and the FHLBank System. However, the regulations do not specify how the Agency should consider those factors.

LOOKING BACK: THE SEATTLE FHLBANK FACED CHALLENGES AND FHFA ENCOURAGED A MERGER ....

2008-2009: FHFA's Early Supervisory Concerns with the Seattle FHLBank

Beginning with its first annual report to Congress for 2008, FHFA reported supervisory concerns with the Seattle FHLBank.[6] In that report, the Agency said it considered that FHLBank "less than satisfactory overall." It found that weakened housing and financial markets had affected several areas of the Seattle FHLBank. FHFA specifically noted supervisory concerns with the FHLBank's private-label MBS portfolio. Many of the securities had been downgraded, some below investment grade. FHFA also found that this FHLBank's information systems were antiquated and relied heavily on user-developed applications. User-developed applications are internally developed spreadsheets and databases, which can add risk, including from manual errors.

Additionally, the Seattle FHLBank failed to meet risk-based capital standards as of year-end 2008. The Agency subsequently declared the FHLBank "undercapitalized" as of March 31, 2009, and required it to develop a capital restoration plan. (See Appendix A for a timeline of events.) FHFA "locked down" capital at that FHLBank: it prohibited the Seattle FHLBank from redeeming or repurchasing capital stock or paying dividends as a way to conserve the FHLBank's capital.[7] Technically, the Seattle FHLBank met its capital requirements as of September 30, 2009, but FHFA used its discretion to continue to classify the FHLBank as undercapitalized. FHFA reported that it took this action due to the risk of further deterioration in the FHLBank's private-label MBS portfolio and the FHLBank's lack of

---

[6] Prior to the 2008 creation of FHFA, the FHLBanks were overseen by the Federal Housing Finance Board. For more information about the Seattle FHLBank's challenges, see OIG, *FHFA's Oversight of Troubled Federal Home Loan Banks* (Jan. 11, 2012) (EVL-2012-001) (online at www.fhfaoig.gov/Content/Files/Troubled%20Banks%20EVL-2012-001.pdf).

[7] FHLBanks have two classes of capital stock. Generally, Class A stock is redeemable at par six months after submission of a written notice, and Class B stock is redeemable at par five years after submission of a written notice. FHLBanks generally can repurchase excess stock—the excess above the amount that the members must hold.

adequate plans for addressing that risk. According to the Seattle FHLBank, FHFA also expressed concern that the value of property underlying mortgages owned by the FHLBank had decreased substantially.

The Seattle FHLBank reported full-year losses for both 2008 and 2009, primarily due to investments in private-label MBS. At the same time, the FHLBank's advance volume was declining, falling 40 percent in 2009 after the FHLBank's largest borrower was acquired and its advances rolled off.

As early as 2009, FHFA encouraged the Seattle FHLBank to consider options to address the Agency's supervisory concerns. FHFA rejected the FHLBank's initial capital restoration plan in October 2009. In doing so, the Agency told the FHLBank to explore the full range of options, including strategic alliances with other FHLBanks, as it developed a revised plan.

2010-2012: Consent Order and Continued Weak Performance

While the Seattle FHLBank met its capital requirements as of September 30, 2009, and returned to profitability in 2010, its financial condition and performance remained weak. FHFA took enforcement action. It entered into a consent order with the Seattle FHLBank on October 25, 2010. The consent order required plans for mitigating risk, increasing advances, and remediating examination findings. A related supervisory letter from FHFA set thresholds for the FHLBank to meet to resume repurchasing or redeeming stock or paying dividends. In its 2010 Report to Congress, FHFA said that the overall condition of the Seattle FHLBank presented supervisory concerns. Key factors affecting the overall condition included unacceptable levels of credit risk, substantial weaknesses in financial condition and performance, and significant deficiencies in corporate governance. Other concerns included insufficient information technology systems.

Over the next two years, FHFA continued to identify serious supervisory concerns with the Seattle FHLBank. In its 2011 Report to Congress, FHFA reported that the overall condition of that FHLBank presented supervisory concerns, noting low earnings, high credit risk related to private-label MBS, and deficiencies in corporate governance. In its 2012 Report to Congress, FHFA repeated that the overall condition of the Seattle FHLBank presented supervisory concerns. The Agency noted that the FHLBank's credit risk was high and its earnings were low. FHFA also reported that improvement to the FHLBank's infrastructure would require significant resources. While advances in a healthy FHLBank would generate sufficient earnings to support that FHLBank's operations, consonant with its mission, advances at the Seattle FHLBank had declined to an FHLBank System low, making that FHLBank more reliant on investments to generate earnings. FHFA estimated that a return to normal operations could take more than five years. FHFA reported that the Seattle FHLBank continued to merit heightened supervisory attention.

2013: Merger Discussions with another FHLBank and Amended Consent Order

In January 2013, FHFA officials met with Seattle FHLBank leadership, encouraging the FHLBank to consider a range of strategic options to address its challenges. Between February and November 2013, the Seattle FHLBank pursued a voluntary merger with another FHLBank, without success.

In its 2013 Report to Congress, FHFA repeated supervisory concerns about the overall condition of the Seattle FHLBank. Although that FHLBank had positive earnings, FHFA advised that it had continuing concerns about the sustainability of earnings derived from the FHLBank's advance business. The Agency said that the small scale of advances coupled with relatively high expenses contributed to uncertainty about that FHLBank's ability to eventually return to normal operations. Also, the FHLBank's information technology infrastructure continued to create an unacceptable level of operational risk. FHFA again found that the FHLBank merited heightened supervisory attention.

In November 2013, FHFA amended the consent order, to reflect improvement in the Seattle FHLBank's situation as well as FHFA's continuing supervisory concerns with the FHLBank's financial condition and operations. Prior to the amendment, FHFA deemed the FHLBank to be adequately capitalized, approved a plan for repurchasing small amounts of capital stock, and allowed payment of a nominal dividend for two quarters. However, FHFA expressed continued concerns that the FHLBank's capital position could be adversely affected by negative changes in economic conditions and believed some restrictions on stock were still needed. The amended consent order required FHFA's non-objection before the Seattle FHLBank paid dividends or repurchased or redeemed capital stock.

The Seattle FHLBank's market value of equity exceeded the par value of its outstanding capital stock by year-end 2013, and FHFA said that this made a merger a more viable option.[8] The Acting FHFA Director, on behalf of FHFA, recommended to the Seattle FHLBank that it find a merger partner.

2014 (January-September): Merger Discussions with the Des Moines FHLBank

The Des Moines FHLBank's board chair had approached the Seattle FHLBank's Chief Executive Officer (CEO) in 2013 about the possibility of a combination. (Since 2010, FHFA had found the overall condition of the Des Moines FHLBank to be satisfactory.) The Seattle FHLBank's CEO previously held a leadership position at the Des Moines FHLBank, and both FHLBanks believed that they had compatible cultures. On February 4, 2014, the two

[8] The market value of equity is the estimated market value of assets less the estimated market value of liabilities.

FHLBanks' board chairs and vice chairs agreed that their respective CEOs should discuss a possible combination, with information technology collaboration as a potential first step. On February 6, 2014, at the direction of the recently confirmed FHFA Director, FHFA set a timeframe for action. On February 21, 2014, the Des Moines and Seattle FHLBanks entered into a confidentiality agreement related to a potential merger. In April 2014, FHFA staff met with the Seattle FHLBank's board and CEO to discuss FHFA's position that the FHLBank must consider strategic alternatives, including a potential merger.

In the second half of 2014, with the continued involvement of FHFA, the Des Moines and Seattle FHLBanks reached agreement on a merger. In September 2014, FHFA responded to requests from the FHLBanks, such as that the board of the continuing FHLBank would initially have all 29 directors from both FHLBanks, the consent order with the Seattle FHLBank would be terminated at the time of a merger, and the FHLBanks' Affordable Housing Programs could remain separate for 2015. Within a week, the boards of the Des Moines and Seattle FHLBanks unanimously approved the proposed merger. They executed a merger agreement on September 25, 2014, subject to the approval of FHFA and the FHLBanks' members.

2014 (October-December): Merger Application Submitted, Considered, and Approved

The Des Moines and Seattle FHLBanks submitted their joint merger application to FHFA in October 2014. The Agency considered a number of factors in approving the merger, pursuant to its governing regulations. FHFA's analysis included benefits to members, financial impacts, operational risk, corporate governance, and benefits to the FHLBank System.[9]

Members

In analyzing the merger, FHFA anticipated that the merger would benefit the members of both FHLBanks. After the merger, members of the Seattle FHLBank would receive dividends and have their stock redeemed, which had been restricted for years, and members of the Des Moines FHLBank would benefit from the cost savings and efficiencies of larger and more diverse membership. Each FHLBank received an opinion from its financial advisor that the terms of the merger were fair to stockholders from a financial perspective.

Financial Impacts

Based on its analysis, FHFA projected that the continuing FHLBank would meet its capital requirements and generate adequate earnings, and it would avoid costs to upgrade the Seattle

[9] FHFA also considered legal, accounting, and other matters. In addition to FHFA, other regulators were pertinent to the merger, including the Securities and Exchange Commission for accounting treatment applicable to the merger and the Federal Trade Commission for potential anti-trust considerations.

FHLBank's information technology systems. In addition, with the approval of FHFA, the Seattle FHLBank planned to replace private-label MBS with MBS backed by government agencies in advance of the merger, reducing risk to the continuing FHLBank.

Operational Risk

In most mergers, operational risk is a concern because of the integration of systems and personnel. The Agency considered the planning and work stream integration efforts by both FHLBanks that already were underway. Because the Des Moines FHLBank's systems would serve as the base for the continuing FHLBank and, in the view of FHFA examiners, the Des Moines FHLBank had stronger information technology and operational risk management systems than the Seattle FHLBank, the merger would address FHFA's longstanding concerns with the Seattle FHLBank's systems. Separately, the Agency had expressed supervisory concerns about operational risk for the Des Moines FHLBank caused in part by its multiyear efforts to upgrade its core banking system. Those concerns would not be resolved by the merger.

Corporate Governance

FHFA also considered corporate governance matters associated with the merger. As noted above, the Agency approved an initial board for the continuing FHLBank comprised of all 29 directors on the boards of both FHLBanks. While FHFA recognized that corporate governance experts recommended smaller boards, it acknowledged factors working against a smaller board. Based on the number of states in the combined FHLBank region, the statutory minimum number of directors would be 22. FHFA took into account the proposal from the FHLBanks for a committee structure for the combined board to bring efficiencies to the operation of a large board. While FHFA projected that the board size for the continuing FHLBank would be reduced over time, it determined that the board size of 29, upon completion of the merger, was acceptable. Additionally, FHFA reviewed the proposed bylaws for the continuing FHLBank.

FHLBank System

FHFA also considered the impact of the merger on the FHLBank System as a whole. In FHFA's view, the FHLBank System would benefit from replacing a weaker FHLBank with one that was likely, over the long term, to perform better than either of the FHLBanks would have performed absent a merger. Because debt issued to fund FHLBank operations represents a joint and several obligation of all the FHLBanks, FHFA found that the other FHLBanks would benefit from such a merger.

In December 2014, FHFA approved the Des Moines and Seattle FHLBanks' merger application subject to conditions including ratification by the FHLBanks' members.

2015: Completion of the Merger

Members of the Des Moines and Seattle FHLBanks began voting on the merger in January 2015, and the FHLBanks announced the ratification of the merger in February 2015. Both FHLBanks worked together to plan and execute the merger work streams, test the efficacy of the systems, and prepare for day-one readiness. FHLBank teams agreed that initial integration testing identified fewer concerns than anticipated but, as a precaution, developed high-level contingency plans. An FHFA official reported to us that more had been accomplished than he anticipated.

FHFA conducted pre-merger field visits to assess the FHLBanks' readiness for merger, with teams on site at Seattle from January to February 2015 and at Des Moines from February to March 2015. Generally, FHFA found that the FHLBanks' preparations for systems readiness were extensive.

The merger closed on May 31, 2015, and the continuing FHLBank commenced operation on June 1, 2015. In this process, the FHLBanks selected their own partner and hammered out the terms as part of a voluntary merger. As discussed, FHFA played a decisive role that was critical to the fruition of the merger, and the merger resolved some longstanding FHFA supervisory concerns with the Seattle FHLBank.

CURRENT STATUS: MERGER RESULTS TO DATE ....

The continuing FHLBank has been in operation a relatively short time, and it is too early to draw conclusions about the long-term implications of the merger. Upon the closing of the merger, the continuing FHLBank operated without any interruptions in service, and to date the merger has produced some positive results for the FHLBank System and provided valuable lessons learned for FHFA.

Key Features of the Continuing FHLBank

The continuing FHLBank is headquartered in Des Moines with a small office in Seattle. Des Moines now comprises the largest FHLBank region in membership and geography, serving about 1,500 members in 13 states and the U.S. Pacific territories.[10] As of June 30, 2015, the continuing FHLBank was the third largest FHLBank in assets and fifth largest in advances.

[10] Before the merger, the Des Moines FHLBank had more members than any other FHLBank, and the Seattle FHLBank district included more states than any other FHLBank district.

The continuing FHLBank is led by individuals from both prior FHLBanks: the president and CEO of the Des Moines FHLBank became CEO of the continuing FHLBank; and the president and CEO of the Seattle FHLBank became president of the continuing FHLBank. The current CEO of the continuing FHLBank is scheduled to retire by 2017, and the current president will take on the additional CEO responsibilities.

Results for the Continuing FHLBank

As of June 1, 2015, the continuing FHLBank was operational, as scheduled, without interruption in services to members. FHFA's consent order for the Seattle FHLBank was lifted, and there were no capital restrictions on the continuing FHLBank. Accordingly, former Seattle FHLBank members could once again receive dividends and have their stock redeemed. The continuing FHLBank filed its financial statements on time. As FHFA had anticipated, most of the Seattle FHLBank's legacy technology systems were eliminated and the continuing FHLBank largely adopted the Des Moines FHLBank's technology and processes, removing a significant supervisory concern.

The merger produced cost efficiencies that could continue into the future. The continuing FHLBank's expenses for systems, staff, and office space were lower than what they would have been for the two FHLBanks without a merger. The continuing FHLBank projected that its 2016 operating expenses would be $35 million less than the combined expenses for the two FHLBanks in 2014.[11]

Results for the FHLBank System

Beyond redrawing the district lines, the merger held other implications for the FHLBank System, as FHFA considered when approving the merger. In FHFA's view, the absorption of a weaker FHLBank into a stronger FHLBank yields enhanced stability for the FHLBank System and reduces risk to the other FHLBanks because, if the continuing FHLBank can meet its obligations, the risk is reduced that the other FHLBanks will be called upon to make payments under their joint and several liability.

FHFA advised us that it proceeded with care on a potential merger when the Seattle FHLBank's market value of equity was low because of possible significant adverse impacts on the FHLBank System. The merger also demonstrated to the other FHLBanks that a voluntary merger could be accomplished without disruption to members.

[11] Not surprisingly, both FHLBanks incurred costs in connection with the merger. The expenses totaled at least $55 million.

Lessons Learned for FHFA

FHFA reported to us that the merger of the Des Moines and Seattle FHLBanks went smoothly. The Agency noted a number of elements contributing to its successful closing. FHFA noted the benefit of extensive planning, including detailed work streams, simulations to identify potential integration problems to address in advance of the merger, and frequent communication between the two parties. FHFA advised us that it has a clear understanding of the milestones necessary to complete a merger and the critical role of regulatory oversight of systems integration.

FHFA advised us that some aspects of this merger were unique to the two FHLBanks and would not likely be replicated in a future merger. For example, the president and CEO of the Seattle FHLBank, who subsequently became president of the continuing FHLBank, previously held a leadership position at the Des Moines FHLBank. As a result, he understood the cultures of both organizations, as well as knew the boards and staff. Both FHFA and the FHLBanks believed that the Des Moines and Seattle FHLBanks had compatible cultures. Additionally, the same FHFA associate director covered the Des Moines and Seattle FHLBanks, which meant the Agency had individual examiners who were familiar with both FHLBanks.

In addition, this merger was aided by external events that may not occur in the future. For example, the value of the Seattle FHLBank's private-label MBS portfolio rose, which facilitated the sale of the securities before the merger. In addition, the market value of the Seattle FHLBank's equity rose, making the merger more feasible.

MOVING FORWARD: FHFA'S APPROACH FOR OVERSEEING THE CONTINUING FHLBANK...

Post-Merger Challenges for the Continuing FHLBank

Through the efforts of the FHLBanks and FHFA, the merger closed on schedule and without disruption to members. Nevertheless, the merger presents challenges for the continuing FHLBank and FHFA going forward. Before the merger, FHFA had significant supervisory concerns about operational risk for the Seattle FHLBank, and FHFA reported to us that the merger largely resolved those concerns. Separately, the Agency had expressed supervisory concerns about operational risk for the Des Moines FHLBank caused in part by the FHLBank's multiyear efforts to upgrade its core banking system. The merger compounded the Agency's existing concerns, for example, those upgrades were delayed as the FHLBank diverted personnel to support the merger.

Like most financial institutions, the continuing FHLBank relies heavily on its information infrastructure to collect, store, and process data. In November 2015, the Des Moines FHLBank's Chief Business Technology Officer resigned effective in December 2015. The turnover in this key position may complicate the systems and merger follow-up work that the continuing FHLBank must complete. As of late January 2016, the FHLBank was conducting a search to fill the position.

The merger also presents governance and other challenges for the continuing FHLBank. The President of the continuing FHLBank recently observed that cultural integration is a challenge for any merger. FHFA and the continuing FHLBank have acknowledged that the current 29-person board is large, and the FHLBank is finalizing a plan to reduce the size of the board to the statutory minimum of 22. FHFA advised us that the large size of the continuing FHLBank, geographically and in member count, may pose challenges in the future.

FHFA's Oversight of the Continuing FHLBank

FHFA typically examines each FHLBank and the Office of Finance each year, and also conducts periodic visits and off-site monitoring. FHFA was onsite for its first post-merger examination of the continuing FHLBank from September to November 2015, and planned to discuss the report of examination with the FHLBank's board in February 2016. FHFA intends to oversee the remaining integration of operations by the continuing FHLBank as part of its supervisory activities.

FHFA officials advised us that FHFA is prepared to conduct extra site visits and add resources, as needed, to oversee the continuing FHLBank. For example, FHFA must oversee the reduction of the board size and the combination of Affordable Housing Programs and continue to monitor the continuing FHLBank's ongoing core banking system conversion. The operational risks previously identified by FHFA, deferred technology upgrades, governance challenges, and significant growth and change at the continuing FHLBank create additional supervisory challenges for FHFA.

CONCLUSIONS

The merger of the Des Moines and Seattle FHLBanks—the first voluntary merger of FHLBanks—went more smoothly than even FHFA officials expected. It was completed on schedule without interruption of service to members. FHFA played a decisive role in urging the Seattle FHLBank to explore a merger, and the merger resolved some longstanding FHFA supervisory concerns with the FHLBank.

At the same time, the Agency had previously raised operational risk concerns about the Des Moines FHLBank, particularly with the FHLBank's multiyear upgrade of its core banking system. The merger compounded these operational risks.

FHFA intends to oversee the continuing FHLBank much as it does the other ten FHLBanks, standing ready to increase examination resources as needed. Considering the post-merger challenges, the continuing FHLBank merits FHFA's ongoing focus.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this report was to describe:

- The Seattle FHLBank's challenges leading up to the merger;
- FHFA's role in encouraging the merger; and
- FHFA's approach for overseeing the continuing FHLBank.

To achieve this objective, we interviewed personnel at FHFA with responsibilities for FHLBank examination. We reviewed: publicly available documents, such as FHFA's annual reports to Congress and the public disclosures of the Des Moines and Seattle FHLBanks; internal FHFA documents, such as the Agency's reports of examination for the Des Moines and Seattle FHLBanks; and other non-public information provided by FHFA. The information spanned from FHFA's first examination of the Seattle FHLBank in 2008 through its first report of examination for the continuing FHLBank in 2016. In addition, we reviewed information about the FHLBank merger in 1946 and the FHLBank split in 1964. We also reviewed FHFA data on its staff resources for examinations of the Des Moines and Seattle FHLBanks since 2014. We did not independently test the reliability of FHFA's data.

Our work was conducted under the authority of the Inspector General Act of 1978 and in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation* (January 2012). These standards require us to plan and perform a report based on evidence sufficient to provide reasonable bases to support its findings. We believe that this report meets these standards. The performance period for this report was from December 2015 to February 2016. We provided FHFA with the opportunity to respond to a draft of this report.

This report was led by Beth Preiss, Senior Investigative Evaluator, in collaboration with Omolola Anderson, Senior Statistician, and Christine Eldarrat, Senior Policy Advisor. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.

This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov.

APPENDIX A ....

Timeline Leading to the Merger of the Des Moines and Seattle FHLBanks

2009

August 3: The Seattle FHLBank received notice from FHFA that it was undercapitalized as of March 31, 2009, and had to submit a capital restoration plan

October 1: FHFA rejected the Seattle FHLBank's initial capital restoration plan and told the FHLBank to explore the full range of options, including strategic alliances with other FHLBanks

2010

October 22-23: The FHFA Acting Director and staff met with the Seattle FHLBank's board

October 25: FHFA issued a consent order to the Seattle FHLBank

2013

January: FHFA met with Seattle FHLBank leadership about the FHLBank considering strategic options

February: The Seattle FHLBank began considering a voluntary merger with another FHLBank

August 6: The chair of the Des Moines FHLBank asked the president and CEO of the Seattle FHLBank if the Seattle FHLBank would be interested in discussing a combination

November: The Seattle FHLBank determined that continued exploration of a transaction with the other FHLBank was not in the Seattle FHLBank's best interest

November 22: FHFA amended the consent order

December 16: FHFA's Acting Director urged the Seattle FHLBank's board chair to find a merger partner

2014

January 6: Melvin Watt sworn in as Director of FHFA

February 6: FHFA set deadlines for the Seattle FHLBank to make progress on merger talks

February: The Des Moines and Seattle FHLBanks began serious discussions about a merger

April 16: FHFA staff met with the Seattle FHLBank's board and discussed FHFA's position that the FHLBank must consider strategic alternatives, including a potential merger with another FHLBank

May 1: A letter from the Seattle FHLBank's board chair to FHFA said the FHLBank is in discussions with a potential merger partner

May 7: The Seattle FHLBank's board authorized the Seattle FHLBank to develop a plan to merge with the Des Moines FHLBank, and also requested additional information regarding other potential merger partners

May 30: FHFA responded to the Seattle FHLBank's May 1, 2014, letter, noting FHFA's expectation that the FHLBank make meaningful progress on merger discussions by mid-August 2014

July 11: The Des Moines FHLBank sent a letter of intent that it had executed regarding a merger to the Seattle FHLBank

July 17: The Seattle FHLBank executed the letter of intent

July 22: The FHFA Director and staff met with the presidents of the Des Moines and Seattle FHLBanks to discuss the merger

July 31: The Des Moines and Seattle FHLBanks announced that they had entered into an exclusivity arrangement to potentially merge the two FHLBanks

September 19: FHFA responded to requests from the Des Moines and Seattle FHLBanks concerning certain aspects of the merger

September 23: The board of the Des Moines FHLBank unanimously approved the merger

September 24: The board of the Seattle FHLBank unanimously approved the merger

September 25: The boards of the two FHLBanks executed a merger agreement

October 31: The FHLBanks submitted a joint merger application to FHFA

December 19: FHFA approved the merger application subject to conditions including ratification by the members of both FHLBanks

2015

January 12: The Des Moines and Seattle FHLBanks each sent information to members to vote on the merger

February 27: The FHLBanks jointly announced the ratification of the merger by their members

May 31: Merger closed

June 1: The continuing FHLBank was operational as one FHLBank

ADDITIONAL INFORMATION AND COPIES ....

For additional copies of this report:

- Call: 202-730-0880
- Fax: 202-318-0239
- Visit: www.fhfaoig.gov

To report potential fraud, waste, abuse, mismanagement, or any other kind of criminal or noncriminal misconduct relative to FHFA's programs or operations:

- Call: 1-800-793-7724
- Fax: 202-318-0358
- Visit: www.fhfaoig.gov/ReportFraud
- Write:

  FHFA Office of Inspector General
  Attn: Office of Investigations – Hotline
  400 Seventh Street SW
  Washington, DC 20219