



Viewpoint: Home Loan Banks Can Absorb Any MBS Pain

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By Michael K. Guttau

The nation's financial crisis, and its downward effect on the value of private-label mortgage-backed securities, has suddenly thrust an obscure accounting issue into the spotlight.

The emerging "OTTI" debate revolves around the rule currently requiring banks to value their MBS investments at far less than what they are worth. That's because if the holdings are deemed "other than temporarily impaired," they must be written down to their current market value. Unfortunately, the current market stinks. In fact, it's practically nonexistent. So while anticipated credit losses are much smaller, the mark-to-market values make things look far worse than they are.

Enter the Federal Home Loan banks. Some recent news reports have spread concern that their losses on mortgage securities will exhaust the capital of these 12 regional cooperatives.

Banks are paying close attention to the developing issue for two reasons. If a bank is a member of a Home Loan bank, as more than 8,000 U.S. financial institutions are, it holds stock in its regional Home Loan bank. Even more important to member banks, Home Loan banks are a rare source of liquidity — no small matter these days. It is widely acknowledged that the Home Loan banks have provided lenders, since the beginning of the current crisis, with hundreds of billions of dollars in low-cost funding, when most other sources disappeared.

So banks big and small, not to mention Washington policymakers, are asking: Does this OTTI dust-up mean the Federal Home Loan banks are about to be the next thing to implode? The answer is a resounding no.

Let's look at three common reactions by some to OTTI stories, and then the reasons to believe in the underlying strength of the Home Loan banks.

"Here we go again." With so many dramatic failures of venerable institutions over the past year, you can hardly blame people for wondering if this OTTI issue with Home Loan banks is a harbinger of more bad things to come. But it's hardly the case.

In its report on OTTI and the Home Loan banks this month, Moody's determined that 12 regional cooperatives could absorb their respective losses through current capital without breaching minimum regulatory capital requirements.

The Home Loan banks invested in private-label mortgage securities to support their housing mission and intend to hold the securities to maturity until they received all the



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expected cash flows. In other words, a current market for the holdings — that is, if there were one — wouldn't matter to them.

Moody's concluded that the OTTI problem doesn't reflect the "true economics" of the Home Loan banks, which are fundamentally sound.

"Rules are rules." Some have suggested that the accounting requirements should be considered paramount, no matter what unintended consequences occur. That doesn't make sense. In an economy with fewer and fewer reliable underpinnings, we need to acknowledge the true condition of 12 financial institutions that will be central players in the nation's recovery.

The importance of the Home Loan banks to the U.S. banking system through the credit crisis has not gone unnoticed by the federal officials who are grappling with the economy. Still, no one should make any assumptions about what the Home Loan banks' regulator will do. Most likely, as Moody's concluded, the response by the Federal Housing Finance Agency will be measured and focused on capital preservation. Moody's assumed that regulators will agree with the rating agency that the ultimate financial losses will be less, possibly far less, than the impairment that might need to be recognized material for accounting purposes.

"They're refusing to pay dividends or pay banks back for FHLB stock they purchased. That can't be good." Actually, what Home Loan banks are doing is a good thing. Through this action, they are moving quickly and prudently to preserve and build capital. That's what regulators would expect them to do. Plus, as part of a cooperative, member banks already understand, at the time when they purchase Home Loan bank stock, that their stock is subject to a five-year redemption and repurchase period to protect their own capital structure during periods of market stress. They know that through these steps the 12 Home Loan banks are preserving their access to the capital markets in order to assure continued funding for members.

Make no mistake. As with anyone who has been harmed by the collapse in the housing market, Home Loan banks would prefer not to be dealing with the declines in their mortgage investments. But in their case, the expected economic loss is modest and can be absorbed.

The conservative business model of the Home Loan banks is quite different from other government-sponsored enterprises. The unique cooperative structure — which simultaneously makes the system's customers also its owners — accounts for how well it is functioning today as a liquidity engine.

Accounting issues will pass. The same is not true for communities' needs of low-cost funds for housing, jobs, and infrastructure. Members of Federal Home Loan banks are the conduits through which those funds flow.



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There is some good news to report: The source of those funds is strong.

Mr. Guttau is the chairman and president of Treynor State Bank in Iowa, the chairman of the Federal Home Loan Bank of Des Moines, and the chairman of the Council of Federal Home Loan Banks.