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THE COOPERATIVE STRUCTURE OF THE FEDERAL HOME LOAN BANKS: A MODEL FOR GOVERNMENT SPONSORED ENTERPRISES?

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I. INTRODUCTION

Recent financial problems at the mortgage operations of Fannie Mae and Freddie Mac and the U. S. Government's decision to place these two government-sponsored enterprises (GSEs) into conservatorship have prompted policymakers to consider what business incentives and public policy goals led these institutions to take risks that resulted in the loss of investor confidence and the need for government intervention. These institutions are similar to the Federal Home Loan Banks (FHLBanks) in that each is chartered by the United States Congress to perform the public policy mission of making housing more affordable. The FHLBanks, however, have not experienced the same financial problems as Fannie Mae and Freddie Mac, leading policymakers and regulators to consider what aspects of the FHLBanks' business model and governance structure make it different from other housing-related GSEs and whether these differences result in an overall lower risk profile.

On September 7, 2008, the Federal Housing Finance Agency (FHFA) announced the conservatorship of Fannie Mae and Freddie Mac. At the same time, the Director of the FHFA,

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James Lockhart, indicated that FHLBanks, also housing GSEs supervised by the FHFA, have a different business model from Fannie Mae and Freddie Mac, and that the FHLBanks performed remarkably well in the recent period of financial stress. More recently, despite the suspension of dividends and repurchases of excess stock by some FHLBanks, Director Lockhart affirmed the strength of the FHLBank system.

This article will review the history, structure and effect of the FHLBanks' cooperative governance structure. We will analyze whether this structure may be an important element in the lower risk profile of the FHLBanks and their consistent performance in fulfilling their public mission. We conclude that the cooperative structure may be an important element in achieving these objectives and may have potential application to the other housing GSEs.

II. HISTORICAL BACKGROUND

The FHLBanks were created during the Great Depression as one facet of a multi-pronged response to address economic circumstances that are unsettlingly similar to the present. The FHLBanks are an enduring product of the federal government's desire to combat both rising residential foreclosures and the lack of affordable wholesale credit for institutions that then were the primary source of home mortgages, savings and loan associations.

which a person or corporate entity is appointed to establish control and oversight of a company to put it in a sound and solvent condition. The powers of the company's directors, officers and shareholders are transferred to the conservator. See Press Release, Federal Housing Finance Agency, Questions and Answers on Conservatorship (Oct. 6, 2008), available at http://www.fhfa.gov/webfiles/116/FHFAMPFSTMT100708.pdf.

2. The FHFA became the FHLBanks' primary regulator on July 30, 2008, when President George W. Bush signed into law the Housing and Economic Recovery Act of 2008 (HERA). Prior to that time, the FHLBanks were supervised by the Federal Housing Finance Board (FHFB). The FHFB continues to exist until one year after passage of HERA, but solely for the purpose of winding up its operations.


A. Pre-Depression Residential Mortgage Finance

In the nineteenth century, American commercial banks generally did not extend loans for home purchases. Homebuyers purchased their homes for cash or financed their purchases through loans from wealthy individuals. Later, banks, insurance companies, and mortgage companies began to extend home mortgage loans. In the years prior to the Great Depression, home mortgage loans provided by these corporate and individual lenders predominantly comprised short-term (one- to five-year) unamortized loans that homebuyers expected to renew automatically at the end of the term.

The lending practices of savings and loan associations stood in stark contrast to the prevailing financing pattern. From the beginning of the industry in 1831, savings and loan associations pioneered the long-term, fully-amortizing residential mortgage. By the early 1930s, savings and loan associations dominated the residential lending market, holding one-third of non-farm residential mortgages.

Savings and loan associations funded their operations with customer deposits and short-term loans, secured by their mortgage loans, from commercial banks. Following the stock market crash of 1929, commercial banks called their short-term loans to the savings and loan associations and foreclosures escalated, resulting in disruption of the mortgage finance system. The dramatic

7. Id.
9. Id.
10. FEDERAL HOME LOAN BANK BOARD, THE FEDERAL HOME LOAN BANK SYSTEM: 1932-1952 3 (1952); FEDERAL HOME LOAN BANK BOARD, THE FEDERAL HOME LOAN BANK SYSTEM 13 (Cecilia M. Gerloff, ed., 1971); see also HORACE RUSSELL, SAVINGS AND LOAN ASSOCIATIONS 11 (1960) (noting that prior to 1930, nearly all lenders other than savings and loan associations provided home loans that were repayable on demand or on demand after one to five years).
13. RUSSELL, supra note 10, at 41.
increase in foreclosures was due, in part, to the inability of homebuyers to refinance their short-term mortgage loans. In the early 1930s, the rate of residential mortgage foreclosures was three to four times higher than in prior years, reaching 240,000 foreclosures per year. These circumstances underscored the need to restructure the residential mortgage finance system, both to encourage principal-reducing, long-term loans and to provide a central credit facility for mortgage lenders to better structure housing finance.

B. The Cooperative Movement in the United States

The cooperative structure of the FHLBanks, which were to become the central credit facility for savings and loan associations, was as much a social movement as a form of business organization. Following World War I, a philosophy known as "associationalism" exerted a profound influence on the structure of government regulation in the United States. Faced with new economic and social problems that the market system seemed incapable of resolving, the associationalists (Herbert Hoover being chief among them) believed that a network of cooperative associations would provide the freedom needed for continued economic and social progress.

Associationalists proposed to meet this need through the creation of a quasi-corporate bureaucracy, part public and part private, but with the private side substantially distinct from the normal agencies of the government. The theory was that a new "cooperative competition" would evolve from this regulatory structure, which in turn would serve to improve the economy as a whole.

14. Ewalt, supra note 8, at 37.
15. Marvel, supra note 11, at 19.
19. Id. at 98.
20. Hawley, supra note 18, at 100.
President Hoover applied particular emphasis to this new structure in his charter to promote commerce. However, he did not limit the application of associationalist ideology to commerce, and similar charters were used to promote agriculture, mining, and other “troubled” industries.\(^\text{21}\)

C. Creation of the FHLBanks

At least a decade prior to the Great Depression, savings and loan association leaders, construction industry representatives, and government officials recognized the need for a long-term liquidity source for home mortgage financing.\(^\text{22}\) In response to the housing shortage following World War I, due in part to a lack of affordable wholesale credit in housing finance, legislation was introduced in both the House and the Senate in 1919 proposing a national credit facility to assist associations in using their mortgage holdings as a basis for credit.\(^\text{23}\) Despite the recognized need for such a credit facility, the government took no action until the business cycle downturn culminated in the Great Depression.

In 1932, Congress created the FHLBanks to relieve immediate financial pressure on home mortgage borrowers and on the entities that funded those mortgage loans.\(^\text{24}\) President Hoover also believed that the FHLBanks would stimulate home construction and ultimately promote homeownership by strengthening the institutions that provided residential mortgage loans.\(^\text{25}\)

These new cooperative banks for housing were viewed as supplementing the existing federal lending structure. The Federal Reserve Banks served as a source of short-term credit for commercial banks, while the Federal Farm Loan Banks provided credit to farmers. The FHLBanks would play a similar role in the housing finance arena, providing a long-term source of credit for savings and loan associations.

\(^{21}\) Id.
\(^{24}\) Marvel, supra note 11, at 21.
\(^{25}\) Id.
The basic structure of the FHLBanks has not changed in the seventy-six years since their creation. The twelve FHLBanks are federally chartered, privately-owned cooperatives. They are owned by their members, who purchase capital stock and who also borrow from the FHLBanks. Initially, members comprised savings and loan associations, savings banks, and insurance companies that made home mortgage loans. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) opened membership to all insured depository institutions that hold, in most cases, at least 10 percent of their total assets in residential mortgage loans. An independent agency of the executive branch of the federal government provides regulatory oversight of the FHLBanks.

III. THE COOPERATIVE STRUCTURE OF THE FHLBANKS

The cooperative structure of the FHLBanks has contributed to their success. This section explores several aspects of this structure, including the membership requirements, the capital structure, the composition of the board of directors, and the board’s obligation of fair dealing and impartiality.

A. Membership Requirements

FHLBank services, such as borrowing secured loans (called “advances”) are limited, in most circumstances, to members only. To be a member of an FHLBank, an institution must be a bank, savings and loan association, credit union, insured depository institution, insurance company, or community development financial institution (CDFI) organized under Federal or state

26. Marvel, supra note 11, at 22.
28. FHLBanks also are allowed to make advances to nonmember mortgagees approved under Title II of the National Housing Act under certain conditions. 12 U.S.C. § 1430(b) (2006).
In addition, as noted above, since the passage of FIRREA, most insured depository institutions must have at least 10 percent of their total assets in residential mortgage loans in order to become members. Since 1999, membership in an FHLBank has been voluntary for all financial institutions.

B. Capital Structure

An applicant for membership in an FHLBank must purchase stock in the FHLBank at the time it becomes a member of the FHLBank. Stock in an FHLBank may be issued to and held only by members or former members. Each FHLBank must adopt its own capital plan, which must be approved by the FHLBanks’ regulator. Each of the FHLBank capital plans must provide for a minimum stock investment by the FHLBank’s members that is sufficient for the FHLBank to meet its minimum regulatory capital requirements. Each capital plan also must provide for a continuing obligation on the part of the board of directors of the FHLBank to review and adjust the minimum investment requirement for the members of such FHLBank to ensure that the FHLBank remains in compliance with applicable minimum capital levels. Each plan must require the FHLBank’s

32. Community financial institutions (CFIs) are exempt from this requirement. CFIs have no more than $1 billion in assets and have deposits insured by the Federal Deposit Insurance Corporation (FDIC). 12 U.S.C. § 1422(10).
33. 12 C.F.R. § 925.6(b). Residential mortgage loans includes most types of mortgage-backed securities (MBS) as well. 12 C.F.R. § 925.1.
37. 12 U.S.C. § 1426(b)(1) (2006). This requirement was approved as part of the Federal Home Loan Bank System Modernization Act of 1999, which was part of the Gramm-Leach-Bliley Act of 1999 (GLB). All of the FHLBanks have approved capital plans in place, except for the FHLBank of Chicago, which is operating under pre-GLB regulations. The pre-GLB regulations provide for a minimum stock requirement equal to the greater of $500, one percent of mortgage-related assets or five percent of outstanding advances. In addition, the stock is redeemable by the member upon six months’ notice provided the FHLBank is in compliance with regulatory capital requirements.
members to comply promptly with any such adjustments to the required minimum investment.\textsuperscript{41}

FHLBanks are permitted to issue two classes of capital stock, Class A stock, which is redeemable in cash at par six months following submission of written notice of a member's intent to redeem such shares, and Class B stock, which is redeemable on the same terms after five years.\textsuperscript{42} Class B stock is considered permanent capital of the FHLBank for regulatory capital purposes, while Class A stock is not.\textsuperscript{43} An FHLBank is permitted to repurchase capital stock that is in excess of the minimum stock investment required of its members under such FHLBank's capital plan, prior to the expiration of the applicable redemption period, subject to certain exceptions, such as continuing to meet minimum regulatory capital requirements.\textsuperscript{44} The FHLBanks are subject to extensive regulatory capital requirements, including leverage requirements and risk-based capital standards.\textsuperscript{45}

Almost all of the approved capital plans of the FHLBanks provide for the issuance of Class B stock only.\textsuperscript{46} In general, the capital plans provide for capital stock to be purchased by members based on two criteria: the member's size, such as the amount of its total assets, and the amount the member uses the FHLBank's products.\textsuperscript{47} For example, a member may be required to purchase a specified amount of capital stock based on its total assets, which is recalculated periodically, and based on a percentage of the principal amount of advances outstanding from time to time.

\begin{itemize}
\item \textsuperscript{41} Id.
\item \textsuperscript{42} 12 U.S.C. § 1426(a)(4)(A) (2006). The FHLBank is not required to redeem capital stock if doing so would cause the FHLBank to be out of compliance with regulatory capital requirements or otherwise pose a safety and soundness concern. The FHFA also may prohibit an FHLBank from redeeming capital stock for safety and soundness reasons. See 12 U.S.C. § 1426(f) (2006).
\item \textsuperscript{44} 12 U.S.C. § 1426(e)(1) (2006).
\item \textsuperscript{47} See id.
\end{itemize}
C. **Board of Directors**

Each FHLBank is governed by a board of directors elected by its members. Each member is authorized to cast votes for directors equal to the number of shares of stock required to be held by such member as of the immediately preceding calendar year end. Each member’s maximum number of voting shares, however, is limited to the average number of shares required to be held by all members located within the state within the FHLBank’s district in which such voting member is located. The implications of this limitation will be explored in greater detail below.

The size of each FHLBank’s board is determined by the FHFA. The board of directors is composed of “member directors,” who must comprise at least a majority of each board, and “independent directors,” who must comprise no fewer than two-fifths of each board. Member directors are directors who are officers or directors of a member institution of that FHLBank. Member directors are nominated and elected on a state-by-state basis, and voting for such directors is limited to members located in a particular state within each FHLBank’s district. Independent directors are directors who are not member directors, but who are residents of the district in which the FHLBank on whose board they serve is located. Independent directors are nominated pursuant to each FHLBank’s bylaws and elected by all of the members under the procedures described above.

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48. See 12 U.S.C. §§ 1427(a)(1) and (a)(3)(A)(i) (2006). Previously, certain directors were appointed by the FHLBanks’ regulator, rather than being elected by the membership. The Housing and Economic Recovery Act of 2008 (HERA), as enacted on July 30, 2008, made substantial changes in the FHLBanks’ corporate governance, particularly with respect to the method of selection of independent directors. We have not delineated separately the changes made by HERA, primarily because we do not believe these changes substantively affected the cooperative structure of the FHLBanks or the benefits accruing from this structure.


50. See id.


D. Section 7(j) and Requirements of Fair Dealing

Consistent with the FHLBanks' cooperative structure, section 7(j) of the FHLBank Act requires that the board of directors administer the affairs of the FHLBank fairly and impartially, and without discrimination in favor of or against any member. In addition, such directors are charged with extending to each member such credit as may be safely and reasonably made with due regard for the claims and demands of other members and with due regard to the maintenance of adequate credit ratings for the FHLBank and its obligations.

In effect, the directors of an FHLBank are charged with two primary duties: overseeing the Bank's mission of extending credit to members, and protecting the safety and soundness of the FHLBank. Furthermore, the FHLBank Act provides for procedural rules in administering that mission, namely treating members fairly, impartially and without discrimination. These rules, together with the capital requirements and method of electing directors, have provided the foundation for successful operation of the FHLBanks.

IV. The Benefits of the Cooperative Structure

The Chairman of the Board of Governors of the Federal Reserve System, Ben S. Bernanke, in a recent speech on the future of mortgage finance in the United States, speculated on alternative models of organizing Fannie Mae and Freddie Mac. One approach that Mr. Bernanke considered "worth exploring" was a cooperative ownership structure, "analogous to the current

58. Id.
59. It is important to note that when considered by the courts, section 7(j) has not been found to require identical treatment of member institutions, only fair treatment. See Fidelity Fin. Corp. v. Fed. Home Loan Bank of San Francisco, 589 F. Supp. 885, 897 (N.D. Cal. 1983). An FHLBank is permitted to make reasonable, credit-based distinctions among its membership in connection with its lending program.
structure of the [FHLBanks]." Other commentators have proposed restructuring the other housing GSEs as cooperatives as well, and some have suggested that the FHLBanks assume all or some of the business functions of Fannie Mae and Freddie Mac. These comments reflect a growing recognition of the advantages associated with the cooperative structure for a GSE. We believe those advantages include capital stability, better execution of the public mission within appropriate risk tolerances, and flexibility and innovation associated with private ownership and management.

One previous professional article has considered this question in depth. In 2006, finance professor Mark J. Flannery and financial economist W. Scott Frame considered whether the FHLBanks’ cooperative structure made them inherently less risky than publicly-traded corporations, such as Fannie Mae and Freddie Mac. Although Flannery and Frame acknowledge the prior literature finding that financial cooperatives and mutuals are less risky due to the “bundling” of their debt and equity, the authors discount this analysis in the case of the FHLBanks because the equity and debt holders of an FHLBank are distinct. Flannery and Frame also argue that the joint and several liability structure of the FHLBanks may create additional moral hazard because borrowing costs for the FHLBanks are determined on a system-wide basis and may encourage individual FHLBanks to take on higher levels of risk relative to the other FHLBanks. In

61. Id.
64. Id. at 48.
65. Id. The FHLBanks issue most of their liabilities in the form of consolidated obligations which are backed jointly and severally by all 12 of the FHLBanks. 12 U.S.C. § 1431(b) (2006). Flannery and Frame fail to consider adequately the negative impact on the shareholders of an FHLBank pursuing such relatively risky strategies, and the corresponding discipline that likely would be imposed by such FHLBank’s directors and shareholders. The shareholders, in the case of a failure, could lose their interest in the retained earnings of the FHLBank, which in recent years has been an
addition, Flannery and Frame contend that the ability to exchange
common stock in an FHLBank at par may dilute the incentive of
equity owners (the members) to monitor management
performance. Finally, the authors note that the management
incentive compensation plans for several of the FHLBanks are
based primarily on performance and growth criteria, much like a
publicly-traded stock corporation.

As we will discuss in greater detail below, we do not believe
that Flannery and Frame's conclusions accurately capture the role
of the cooperative structure in mitigating risk and enhancing
performance by the FHLBanks, particularly in light of the
experience of the FHLBanks during the recent credit crisis. In the
more than two years since the Flannery and Frame article was
published, the United States has entered perhaps its most severe
financial crisis since the Great Depression, a crisis which had its
genesis in the U.S. housing market. The two large, publicly-traded
housing GSEs, Fannie Mae and Freddie Mac, have been placed in
conservatorship for, among other reasons, concerns about capital
adequacy and financial performance and condition. Many large
financial institutions effectively have failed or have required
extensive government rescues. In the midst of this environment,
the FHLBanks have performed their mission of providing liquidity
to members and remain fundamentally strong as a system,

increasing item on the balance sheets of the FHLBanks. Furthermore, although
consolidated obligations are the joint and several obligations of all of the FHLBanks,
any FHLBank making a payment on behalf of another FHLBank that fails to satisfy
a consolidated obligation would have a right of reimbursement from the failing
FHLBank. 12 C.F.R. § 966.9(d)(2). The reimbursement obligation to the paying
FHLBank presumably would be satisfied ahead of any obligations to the
shareholders of the failing FHLBank. Clearly, the shareholders and directors of an
FHLBank have very strong incentives to prevent excessive risk taking by an
FHLBank despite the joint and several nature of consolidated obligations in order to
protect the shareholders' capital investment.

66. Id. at 49.
67. Id. at 50-51.
68. Statement of FHFA Director James B. Lockhart, supra note 1.
69. From December 31, 2006 to September 30, 2008, advances by the FHLBanks
increased from approximately $641 billion to approximately $1.012 trillion, and total
capital of the FHLBanks increased from approximately $45 billion to approximately
$57.1 billion. From December 31, 2006 to December 31, 2007, net income increased
from approximately $2.6 billion to approximately $2.8 billion, but net income has
flattened slightly for the first nine months of 2008, decreasing by approximately 3% over
the first nine months of 2007. See FHLBanks, COMBINED FINANCIAL REPORTS.
according to the FHFA. Given this experience, it seems an appropriate time to revisit the conclusions of the Flannery and Frame article, and whether the cooperative model is a more important attribute for successful achievement of the GSE mission than those authors believed.

A. Capital Stability

The first benefit we attribute to the FHLBanks' cooperative structure is capital stability. This feature was cited by FHFA Director Lockhart at the time of Fannie Mae's and Freddie Mac’s conservatorship and more recently after some of the FHLBanks suspended excess stock repurchases in order to build capital. Most of the FHLBanks’ capital is contributed by members as a result of their use of FHLBank products, such as advances. Because advances are by far the largest asset class owned by the FHLBanks, this structure permits the FHLBanks’ capital base to grow and shrink with their asset size and has sometimes been referred to as capital “on demand.” At the time that it adds advance assets to its balance sheet, an FHLBank also obtains corresponding capital from the borrowing member. Conversely, as advances are repaid, an FHLBank may repurchase the corresponding capital, to keep its leverage ratio in balance. Furthermore, as described above, members are required to contribute capital to the FHLBank as necessary to maintain regulatory capital requirements, and an FHLBank must suspend capital repurchases and redemptions if necessary to remain in


70. Hagerty, supra note 4.
71. Statement of FHFA Director James B. Lockhart, supra note 1.
Although Fannie Mae raised approximately $7.4 billion in new capital in the months before its conservatorship, Freddie Mac was unable to do so despite promises made to its regulator. This lack of sufficient capital contributed to the GSEs' inability to fulfill their public mission. By contrast, as the demand for FHLBank advances grew during the recent credit crisis, the FHLBanks were able to meet the need for additional advances, and still maintain their required regulatory capital levels. The cooperative structure means that the FHLBanks are not dependent on market timing to raise capital. This is of enormous importance when a GSE is attempting to fulfill its public mission in times of extreme capital market stress, as we recently have witnessed.

B. Better Execution of the Mission within Acceptable Risk Tolerances

In addition to capital stability, the cooperative structure better fulfills the public mission assigned to a GSE. Because the FHLBanks' customers are also its shareholders (members), the income derived from the customers' business with the cooperative are continuously cycled into the FHLBanks' public mission. The primary purpose of the FHLBanks is to provide a readily available, competitively-priced source of funds, such as advances, to their member institutions. The interest on advances earned by an FHLBank contributes to its earnings, while the advances to members directly support the FHLBank's mission. An

74. See Statement of FHFA Director James B. Lockhart, supra note 1.
75. Id.
FHLBank’s members also purchase capital in the FHLBank, and the FHLBank earns income on this invested capital. The FHLBanks use the income from invested capital and the interest on advances to pay dividends to members. The members, in turn, may use the dividends to extend additional credit in their communities or to purchase FHLBank capital to support additional advances, each of which furthers the FHLBanks’ mission. In the publicly-traded corporation model, dividends are paid to diffuse shareholders who do not necessarily use those funds to further the corporation’s mission.

The cooperative model also provides enhanced risk management features and reduced incentives for excessive risk taking by managers, directors, and shareholders. Because FHLBank stock is traded at par and may be issued only to members, FHLBank managers do not have an incentive to manipulate quarterly financial information in order to impact the price of the company’s stock and, consequently, their bonuses. Flannery and Frame noted at the time of their article that the incentive compensation structure at many of the FHLBanks looked much like that of a publicly-traded corporation and was focused primarily on growth and profitability. In order to provide dividends, and to further the FHLBanks’ mission as described above, growth and profitability are important to FHLBanks, as they are to other types of business organizations. In recent years, however, the FHLBanks’ incentive compensation plans have provided an increased focus on risk management. A review of the FHLBank Forms 10-K filed with the Securities and Exchange Commission indicates that most of the FHLBank incentive compensation plans in effect as of December 31, 2007, included some type of risk management component. One FHLBank had earnings and risk management goals each weighted at 45% of the total incentive compensation goal, noting that an equal weight for these goals would motivate management to take a balanced approach to managing risks and returns.78

The FHLBank cooperative structure also better aligns the

interests of shareholders and directors. The breakdown in communication and alignment of interest between shareholders and directors has been cited as a major weakness in the typical corporate structure. In particular, corporate governance experts have cited two serious flaws in the shareholder-director relationship: poor exchange of information between shareholders and directors, and failure of shareholders to influence boards. There are several ways in which the FHLBank cooperative structure rectifies these weaknesses.

A majority of FHLBank directors are nominated by members and must be officers or directors of members. This creates a direct relationship between the shareholders and a majority of the directors. Typically, the member directors are “C-level” executives, such as the chief executive officer or the chief financial officer of the relevant member, with extensive financial knowledge and sophistication, who are able to capably oversee the FHLBank’s operations. The members are regulated financial institutions that have substantial investments in FHLBank capital stock. For some smaller community banks, this investment may be one of their largest assets. Thus, the member directors have an extremely powerful incentive to oversee their institutions’ investments in the FHLBank and ensure that the FHLBank remains safe, sound, profitable, and a stable source of funding for their institutions into the future. Similarly, the members have an incentive to oversee the performance of the directors, and they do so through participation in director elections and by providing feedback to the directors.

While the value of FHLBank capital stock cannot exceed its par value, its value could fall below par on a fair value basis. Accounting rules may require a member to recognize this diminution in value, or impairment, if the member determines that such impairment may affect the ultimate recoverability of the par

80. See id.
81. Under 12 U.S.C. § 1426(h)(1) (2006), the holders of the Class B capital stock for each FHLBank own the retained earnings, surplus, undivided profits and equity reserves, if any, of such FHLBank.
Avoiding such impairment in the par value of the stock gives members and directors another strong incentive to monitor FHLBank fiscal health. Further, the banking regulatory agencies currently assign a weighting of 20% to FHLBank obligations for risk-based capital purposes. If the FHLBanks were to engage in more risky activities, this risk-weighting could be increased, thereby increasing members’ capital requirements, including those of the institutions on whose boards or management teams the member directors sit.

The FHLBank Act limits the number of shares that a member may vote for a directorship in an election of FHLBank directors to the average number of shares held by all members within the voting member’s state of domicile. This provision also acts to further the effective implementation of the FHLBanks’ mission. Because most capital stock is purchased as a result of the use of FHLBank services, the voting limitation ensures that large members do not elect a disproportionate number of the member directors and thereby dominate FHLBank policy, including lending provisions, to their benefit. The effectiveness of this limitation is borne out empirically. While advances and stock ownership at the FHLBanks are somewhat concentrated, most FHLBanks have few, if any, directors associated with their largest members.

Another risk mitigation feature of the board composition is the competitive nature of the members. As mentioned above, a majority of directors are employed by, or serve on the boards of,
member financial institutions. The member directors may represent different types of institutions, such as large commercial banks or small community banks. These financial institutions often are competitors. Together with the requirements of Section 7(j) of the FHLBank Act described above, this creates an incentive for the member directors to ensure that FHLBank lending policies are sound, fair, and do not favor one type of member institution over another, such as larger members and borrowers over their smaller community bank competitors.

Finally, most FHLBank capital stock is held by members for a long period of time, until the member is merged or otherwise ceases to exist. Very few institutions voluntarily withdraw from membership and request redemption of their capital stock.\(^86\) Thus, most members anticipate a long-term relationship with their FHLBank. The directors have a strong incentive to protect that relationship by ensuring that the FHLBank will continue to be a stable source of funding in the future.

C. Private Management and Control

Finally, the cooperative model retains the benefits usually associated with private ownership and control, such as flexibility, innovation and resistance to political control.\(^87\) During the recent financial crisis, it has been noted that the FHLBanks were an especially important stabilizing force during the early months of the crisis, particularly the latter half of 2007.\(^88\) Early in the crisis, the FHLBanks' role as a liquidity provider was much more significant than that of the Federal Reserve Banks.\(^89\) Part of this may be attributable to the FHLBanks' private management and control, which makes them more attuned, and more nimble in responding, to member needs.

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\(^{86}\) As stated above, there is a five-year redemption period for stock repurchases upon withdrawal. Additionally, a withdrawing member may not reapply for membership in any FHLBank for five years. 12 C.F.R. § 925.30(a) (2008).

\(^{87}\) See Bernanke, supra note 60.

\(^{88}\) See Ashcraft, Bech and Frame, supra note 77, at 28-29.

\(^{89}\) Id.
V. Conclusion

For over seventy-five years, the FHLBanks have provided a readily available, competitively-priced source of funds to their member institutions in a safe and sound manner, thereby enhancing the availability of residential mortgage and community investment credit. No FHLBank has ever experienced a credit loss on an advance. During the recent credit crisis, the FHLBanks proved an invaluable source of liquidity and stability to the nation’s banking system. We believe that at least part of this success may be attributable to the cooperative model of the FHLBanks.

The cooperative structure is particularly well-suited to GSEs and the execution of their public missions. The structure blends the flexibility and innovation associated with private ownership and management within a system that maximizes the benefits of the organization to the intended beneficiaries of the public mission while maintaining proper risk management incentives. Under this structure, benefits are transferred to the members through competitive pricing of services and the distribution of dividends, both of which support the underlying public mission. As policymakers reevaluate the roles of the housing GSEs in the coming months and years, they should consider the conceptual advantages and empirical performance of the FHLBanks and their cooperative structure.
