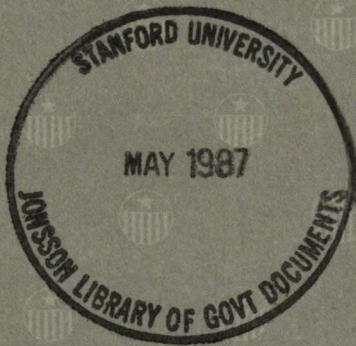


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A Guide to the  
Federal Home Loan Bank System





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# A Guide to the Federal Home Loan Bank System



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# Preface

This book describes a system that has played a key role in providing housing for Americans and a safe and convenient means for saving. Although this extraordinary system involves hundreds of billions of dollars, its most valuable resources are the people who make it work. I had the privilege of working with many of them while researching and writing this book. Collectively, they spent hundreds of hours answering my questions and allowing me to look over their shoulders as they went about their work. They helped me gather information, offered insightful comments and suggestions, and helped in countless other ways to make this book possible. It is to them that this book is dedicated, with gratitude, appreciation, and respect.

Paul H. Lockwood



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# Introduction

At one time, savings institutions were as integral to the neighborhood business community as were corner grocery stores. But the corner grocery stores have largely given way to supermarket chains, and although savings institutions remain a primary source of home mortgages, they operate in a rapidly and dramatically changing financial services market. In the 1980s, economic changes, technological advances, new competitors, and financial deregulation have created unprecedented challenges to thrift institutions. For help in meeting these challenges, thrifts must rely on an effective Federal Home Loan Bank System.

The Bank System originated with the Federal Home Loan Bank Act, passed by Congress and signed into law by President Herbert Hoover in July 1932. The act was a response to the Great Depression, which had undermined the nation's banking system and created an urgent need for a reserve credit system to ensure the availability of funds for home financing.

The system has three major components: the Federal Home Loan Bank Board; the twelve regional (district) federal home loan banks; and the individual savings institutions that make up the thrift industry.

The Federal Home Loan Bank Board, an independent agency in the executive branch of the federal government, is governed by a chairman and two board members. The name *Federal Home Loan Bank Board* refers both to that three-member panel, which determines policy, and to the federal agency, which carries out that policy.

The Bank Board is responsible for all federal regulation of the thrift industry. It charters federal thrift institutions; formulates and enforces regulations governing many thrifts' operations; and, through the Federal Savings and Loan Insurance Corporation (FSLIC), insures savers' accounts. The Bank Board and the states share regulatory responsibility for state-chartered thrift institutions insured by the FSLIC.

The FSLIC, a permanent government entity created by the National Housing Act of 1934, insures savings accounts to a maximum of \$100,000 per individual per institution. Since the FSLIC's inception, no saver has lost a cent of insured savings when an insured institution has been forced to close. The Bank Board governs the FSLIC and the Federal Home Loan Mortgage Corporation.

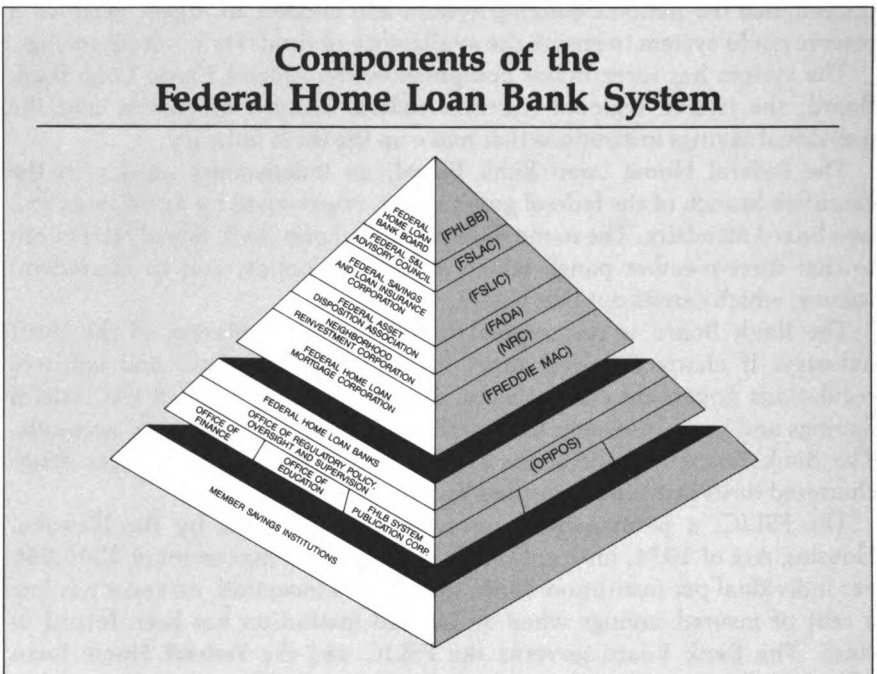
Congress established the Federal Home Loan Mortgage Corporation (Freddie Mac) in the Emergency Home Finance Act of 1970. The corporation operates a secondary, or resale, market for conventional home mortgages. ("Conventional" mortgages are those not insured by a federal agency.) By paying cash to purchase existing mortgages from the original lenders, Freddie Mac replenishes the amount of money available for new mortgages. After acquiring the mortgages, the corporation packages them as backing for investment instruments, which it sells in public capital markets.

The Bank Board, with other federal financial regulatory agencies, also has a voice in the policies of the Neighborhood Reinvestment Corporation, which seeks to revitalize older, urban neighborhoods.

The second major component of the Bank System comprises the twelve federal home loan banks. These district banks operate within guidelines established by the Bank Board and assist in carrying out the Board's responsibilities.

Each district bank is wholly owned by the member thrift institutions in its area. The district banks are controlled by their boards of directors, the majority of whom are elected by the banks' member institutions, with the Bank Board appointing the remainder.

The district banks—which are located in Boston, New York, Pittsburgh,



Atlanta, Cincinnati, Indianapolis, Chicago, Des Moines, Dallas, Topeka, San Francisco, and Seattle—serve thrift institutions in their respective geographic areas. Just as individuals turn to their neighborhood thrift institutions for loans to buy houses, the thrifts turn to their district banks for additional funds to meet unexpected savings withdrawals or seasonal needs or to expand mortgage lending when the demand for home loans exceeds local savings supplies. The district banks also accept deposits from thrift institutions and provide them with such services as economic analyses, safekeeping of securities, and processing of checks and negotiable order of withdrawal (NOW) account drafts.

One of the most important functions of the district banks is to help carry out the Bank Board's responsibility to monitor and supervise the thrift industry. In this role, certain district bank employees are empowered by the Bank Board to act as the Board's agents, examining thrift institutions and supervising corrective measures when problems are found.

The district banks accumulate funds in the form of deposits from member thrift institutions, retained earnings, and member institutions' mandatory purchases of stock. They obtain most of their funds in the public credit markets, primarily by selling consolidated bonds and discount notes that are joint debt obligations of all twelve district banks. The banks market these securities nationwide through the Bank System's Office of Finance, securities dealers, and commercial banks.

The Bank System's third major component consists of its more than 3,000 member thrift institutions. Most of these institutions are FSLIC-insured savings and loan associations; savings banks form the majority of other members of the Bank System. Approximately one-half of savings and loan associations are federally chartered (a federal charter must be reflected in an institution's name), and thus subject to all Bank Board regulations. State-chartered thrift institutions that choose to carry FSLIC insurance, or that are required by state law to carry it, are subject to some regulation by the Bank Board in addition to state regulation. Other Bank Board regulations apply to all members of the Bank System, including state-chartered thrift institutions that do not carry FSLIC insurance and the five life insurance companies that are members.

The Federal Home Loan Bank System thus blends government authority and private enterprise in a cooperative arrangement: the Bank Board and the FSLIC are government entities staffed by federal employees; the twelve district banks and the Federal Home Loan Mortgage Corporation operate under federal charters with employees who are not part of the federal civil service system; and the individual thrift institutions are private entities. This book examines how the Bank System's various components operate and interact to help make home ownership possible for Americans and to provide them with a convenient and safe means to save.



Comly Rich house, Philadelphia, Pennsylvania, was the first home in the United States to be purchased with a loan from a savings and loan association. (Photograph courtesy of Foundation for Savings Institutions.)

# History of the Bank System

The earliest thrift institutions began with a simple idea: a group of neighbors pooled their savings and, as money accumulated, each member of the group in turn received funds to buy a house.

These early groups filled an unmet need. In nineteenth-century America, banks concentrated on commercial and agricultural accounts. In those days, the banks did not cater to individual savers with small accounts, and they generally did not make home loans. To buy a house, a person had to borrow from a wealthy individual or save the entire purchase price. People hoarded savings at home, because there was no other convenient place to save.

The first cooperative home-financing society in the United States, the Oxford Provident Building Association of Philadelphia County, was organized on January 3, 1831, in Frankford, Pennsylvania (now part of Philadelphia). Modeled after building societies begun in England during the 1770s, Oxford Provident boasted 37 members, who held equal shares in the association. Each member paid an initial contribution of \$5 into the pool and pledged to continue depositing \$3 per month thereafter until all members had obtained the funds they needed.

On April 11, 1831, village lamplighter Comly Rich received the first loan. Of the \$500 he received, Rich spent \$375 to buy a frame house with less than 500 square feet of floor space and spent \$125 on refurbishing. (The house still stands, at 4276 Orchard Street, Philadelphia.) Unfortunately, Rich also became the first savings and loan customer to fall behind on his mortgage payments; a family member eventually had to assume the mortgage.

In 1836, the Brooklyn Building and Mutual Loan Association in New York became the second cooperative home-financing society in the United States. The third opened for business in South Carolina in 1843.

The early associations charged no interest on loans, and determined the order in which members would receive loans by holding drawings. Members contributed equal monthly amounts until all the original subscribers who wanted to purchase homes had done so. At that point, the mortgages were canceled and the association terminated—a practice that lent the groups the name *terminating associations*.

Before long, however, the associations began to auction loans to the highest-bidding members and to charge interest on the amounts borrowed. This arrangement allowed association members to choose not to build homes but to receive their contributions back with interest. Gradually, the associations became permanent, and new members were allowed to join and invest in shares at any time. As the associations grew, they moved out of members' homes and into offices, acquiring professional staffs and all the other accoutrements of ongoing businesses. Sometimes, entrepreneurs started associations, which retained community orientations even without the benefit of neighborhood sponsors.

These new associations adopted various names. Most called themselves "savings and loan" or "building and loan" associations. Some New England associations labeled themselves "cooperative banks," and some Louisiana groups chose to be called "homestead associations." Nonetheless, almost all associations shared two attributes that continue to characterize the thrift industry: they were safe places for individuals to deposit their savings, and they provided mortgage loans within the immediate community.

Although savings and loan associations are the nation's most prominent thrifts, another type of institution—the mutual savings bank—actually entered the thrift business earlier. The first two mutual savings banks in the United States—the Provident Institution for Savings in the Town of Boston and the Philadelphia Savings Fund Society—began operations in 1816. Mutual savings banks remain concentrated in the northeastern states.

Whereas savings and loan associations could finance only residential housing, savings banks could lend money for other types of real estate. Savings banks also invested in government and high-quality corporate bonds, as well as blue-chip stocks.

A third type of financial institution that matured during the 1800s and remains part of the Bank System is the insurance company. Since colonial times, insurance companies have invested in residential and other real estate mortgages, as well as in other types of securities. In contrast to the many thrift institutions that generally have concentrated their activities locally, the larger insurance companies very early began making mortgage loans nationwide. Five such companies are members of the Bank System.

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## **The Industry Develops**

As the nineteenth century progressed, an expanding American urban middle class provided fertile soil for the growing thrift industry. A survey conducted by the U.S. Commissioner of Labor in 1893 listed more than 5,800 institutions having nearly 1,750,000 shareholders (savers) and more than 450,000 borrowers. Thirty-five years later, at the end of 1928,

the thrift industry included 12,666 institutions with assets of just over \$8 billion.

The industry's growth encountered predictable setbacks, prospering or faltering along with the nation's economy. During the depression of 1893 to 1897, for example, hundreds of associations failed. And the industry's reputation suffered from the activities of some national savings and loan associations, known as "nationals," which sold their shares on commission in many states through local agents or by mail. Because these firms made loans on extremely risky projects at very high interest rates, and because the firms managed their assets poorly, they were among the first to fail when the 1893 depression hit. The nationals inflicted such damage on public confidence that many sound local thrifts failed when panicking savers suddenly pulled their money out.

Throughout the 1800s, government did little to regulate the thrift industry. The State of New York, the first government to move in that direction, began in 1875 to require annual reports on the financial condition of savings and loans. Yet by 1900, only half the states regulated thrifts, and what regulation existed was no more than a patchwork of rules.

### **The Need for a Central Credit System**

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As thrifts grew from small neighborhood associations to large businesses, the increasing variety of demands for mortgage funds created substantial disparities. In some areas, demand for home loans exceeded the sum of savings available from local depositors; in other areas, the reverse was true. Savings institutions needed a central credit facility to accept deposits from thrifts that had excess cash and to make loans to thrifts that needed extra funds.

New York was the first state to establish a statewide credit facility for thrift institutions. Created in 1914, the Land Bank of the State of New York (later the Savings and Loan Bank) tapped the capital markets by selling securities that were backed by mortgages held by thrifts affiliated with the bank.

The need for a nationwide credit facility, however, soon became apparent. The first serious proposal for such a nationwide system came in 1918, with the postwar boom in new housing demand, which far outstripped the amount of mortgage money available in many areas of the country. Legislation and hearings followed—in 1919, 1920, and 1927—but the proposal died each time. The country was prospering, and few people worried about mortgage money running short.

As the 1920s drew to an end, thrifts continued to operate as they had for some time, extending one-year mortgages to home buyers. The full amount

of a mortgage came due in one balloon payment at the end of the period. If the customer could not repay the loan, the thrift simply created a new mortgage. And why not? Despite scattered strains, mortgage money generally was secure, stable, and plentiful—and most people assumed it always would be.

## SHAPING THE BANK SYSTEM (1929–1939)

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The Crash of 1929 brought chaos to the thrift industry and panic to its customers. More than 1,700 thrifts failed in the Great Depression, and their depositors lost \$200 million, or about one-third of the value of their deposits. Unable to meet burgeoning demands for withdrawals, many otherwise healthy thrifts simply froze their depositors' accounts in place. Customers feared they would lose their entire savings, and many, desperate for cash, resorted to selling their passbooks at a loss in the black markets.

### **Federal Home Loan Bank Act**

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The Depression made the need for a central credit facility for thrifts overwhelmingly clear. Late in 1931, President Herbert Hoover appointed a President's Conference on Home Building and Home Ownership, which officially endorsed his proposal for such a facility on December 4, 1931. For the next seven months, Congress considered legislation to translate the proposal into reality. Savings and loan associations supported the plan, but savings banks, insurance companies, and commercial banks opposed it on the ground that it would constitute excessive government intervention. On July 16, 1932, however, Congress approved the Federal Home Loan Bank Act, which President Hoover signed into law six days later.

The Federal Home Loan Bank Act's primary purpose was to rescue the failing savings and home-financing industry by channeling cash to thrift institutions. The legislation authorized the creation of eight to twelve district banks to lend money to thrifts and established the Federal Home Loan Bank Board to oversee the district banks. The act also authorized the district banks to raise money by selling bonds. (The banks did so for the first time in April 1937, marketing a total of \$25 million worth of securities.)

The first task was to organize the district banks. The Bank Board decided to create twelve banks, determined the locations, drew the boundaries, and appointed the directors. The district banks officially opened in October 1932, although they did not make their first loans to savings and loan associations until December of that year.

The district banks began operations with \$125 million in capital provided by the U.S. Treasury, which received 125,000 shares of stock in the banks. The banks also raised money by selling their stock to the savings and loans that became their clients, or members. The 1932 Federal Home Loan Bank Act required district banks to start repaying their Treasury loans once these stock sales equaled the federally provided seed money. Repayment began in 1948 and by 1951, the district banks had completely repaid the federal government and were wholly owned by their member institutions, as they are today.

### **Home Owners' Loan Act of 1933**

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In approving the 1932 Federal Home Loan Bank Act, Congress had hoped that, in addition to helping thrift institutions, the newly flowing district bank funds would help hard-pressed individual home buyers. The act even provided for the district banks to make loans directly to home buyers who could find no other mortgage source. Some 41,000 persons applied for direct loans within a few months, but the banks granted only three such loans, and Congress eliminated the direct-loan provision a year later. The authors of the 1932 act had hoped that savings and loan associations would use some of their district bank funds to refinance delinquent mortgages, but, by and large, the thrifts did not do so. Even though the district banks could provide advances, or loans, for this purpose, the thrifts were not eager to lend additional money to home owners who had already proved themselves poor credit risks by missing numerous payments.

Yet clearly something had to be done. By 1933, 40 percent of the country's \$20 billion in home mortgage debt was in default, and, through foreclosures, Americans were losing their homes at the rate of 26,000 per month. Congress reacted quickly; before President Franklin Delano Roosevelt had been in office four months, the legislators had passed and sent to him the Home Owners' Loan Act of 1933. The act, which was the second major piece of legislation to shape development of the Bank System, authorized the Federal Home Loan Bank Board to begin granting federal charters for savings and loan associations. The act also created the Home Owners' Loan Corporation (HOLC).

The establishment of the HOLC had the most immediate effect on thrifts and their customers. The Bank Board administered the HOLC, which bought delinquent mortgages from lenders and refinanced the loans at lower interest rates, lowered the monthly payments, and extended the period for repayment, in an effort to help people keep their homes. During three years of lending activity—June 1933 to June 1936—the HOLC refinanced \$2.75 billion in home mortgages held by savings and loans,

banks, and other lenders. The HOLC further aided savings and loan associations by taking over 13 percent of their mortgage loan portfolios in exchange for \$770 million worth of HOLC bonds. Through these activities, as well as through loans to acquire, refinance, or repair and recondition property and loans made directly to lending institutions, the HOLC ultimately processed 1.8 million loans totaling \$6.2 billion and allowed one million Americans, who otherwise would have suffered foreclosure, to keep their homes.

The legislation creating the HOLC also provided for the corporation to terminate automatically. The HOLC stopped making loans in June 1936 and slowly liquidated its holdings by auctioning its remaining mortgage loans to savings and loan associations and other lenders. Most HOLC activity had ended by 1951, and the corporation's last office closed in New York in July 1953. The HOLC legally expired on February 3, 1954, having repaid all the money it had received from the federal government and having earned a small profit for the Treasury.

Although the HOLC provisions of the Home Owners' Loan Act affected thrifts immediately, the provision establishing federally chartered savings and loan associations brought about the most far-reaching changes in the industry by giving the Federal Home Loan Bank Board its first powers to regulate and supervise federal associations. These powers expanded greatly in the years that followed.

### **National Housing Act of 1934**

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Although the Federal Home Loan Bank Act of 1932 established a central credit facility, and the Home Owners' Loan Act of 1933 saved a million homes, neither act restored public confidence in the nation's thrift institutions. That task fell to a third major piece of legislation, the National Housing Act of 1934. This act created the Federal Housing Administration (FHA) to insure mortgages and the Federal Savings and Loan Insurance Corporation (FSLIC) to insure deposits.

*FEDERAL HOUSING ADMINISTRATION.* FHA insurance was designed to guarantee lenders full repayment when borrowers failed to make their mortgage payments. Recipients of FHA-guaranteed loans financed this insurance by paying fees that were added to their monthly payments. Because FHA insurance made lower down payments permissible (by removing much of the lenders' risk), many more people could qualify for home loans than had previously been able to qualify.

*FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION.* The FSLIC was established to provide insurance of deposits in savings institutions, as the Federal Deposit Insurance Corporation provided insurance of deposits in

commercial banks. Both insurance corporations began operating in 1934, and their coverage has been parallel since then. The limit on insurance—originally \$5,000 for each saver in each institution—rose steadily, to \$10,000 in 1950, to \$15,000 in 1966, to \$20,000 in 1969, to \$40,000 in 1974, and to \$100,000 in 1980.

To commence operations, the FSLIC raised \$100 million by selling its capital stock to the Home Owners' Loan Corporation in 1934. Those shares were transferred to the Secretary of the Treasury in 1948. In 1950, the FSLIC began to buy back its stock, using 50 percent of each year's net income to retire the shares. By 1958, the FSLIC had repurchased all its outstanding stock.

Despite its obvious benefits to thrifts, FSLIC insurance gained acceptance only slowly. One reason was that state-chartered institutions were reluctant to accept FSLIC insurance because doing so would subject them to federal regulation, examination, and supervision. Many state-chartered thrifts also chafed at paying the premiums required for the insurance. As a result, by mid-1936, only 1,336 thrifts, with 30 percent of thrift assets, were FSLIC-insured. All but 237 of these were federally chartered thrifts, which were required by law to carry the insurance. It took until 1951 for FSLIC-insured institutions to outnumber non-FSLIC-insured institutions. By then, however, insured thrifts held more than 90 percent of all the assets in the savings and loan industry. By the end of 1985, the FSLIC insured 2,960 savings and loan associations—92.6 percent of the total—which held 98.5 percent of the assets of the savings and loan industry.

As part of its role in insuring accounts, the FSLIC worked to stabilize insured thrifts that were verging on failure. If possible, the FSLIC provided loans to the troubled institution, arranged for it to be taken over by a stronger institution, or took other steps to prevent default. Only if the institution was beyond help did the FSLIC take it over and pay out its insured deposits to savers.

By 1939, the nation's economy was recovering, and the Bank Board had existed for seven years. During that time, the Bank Board had established the system of district banks, rescuing the thrift industry from potential collapse; had shepherded federally chartered thrifts into existence across the country; had established the FSLIC insurance program; and, through the HOLC, had enabled some one million Americans to retain their homes despite crippling economic conditions.

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## THE SYSTEM MATURES (1940–1969)

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During the early 1940s, the nation directed its economic resources toward fighting World War II. Although the volume of deposits increased for

savings institutions, few homes were built; thrifts used most of their funds to buy war bonds, and builders diverted materials for residential construction into military housing.

Nevertheless, the thrift industry changed substantially during this period. Perhaps the most significant change was a trend toward consolidation, which continues today. In 1940 alone, for instance, some 2,000 associations (most of which were small institutions) voluntarily began gradual liquidation, making no new loans and accepting no new deposits. Also, the industry began increasingly to serve specialized constituencies. In many large cities, thrifts sprang up in ethnic neighborhoods, often conducting business in the customers' native languages. Some thrifts prospered by serving employees of a single company. Others began opening branch offices, which multiplied from almost none in 1950 to nearly 3,000 in 1960.

### **Adjustment and Reorganization**

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The Federal Home Loan Bank Board also underwent substantial adjustment and reorganization. The Bank Board was originally established as an independent agency under a five-member governing panel, but in 1939 President Franklin Delano Roosevelt's Reorganization Plan No. 1 placed the Bank Board and other federal financial and credit agencies under the Federal Loan Agency. The arrangement lasted three years.

Subsequent wartime needs led President Roosevelt, on February 24, 1942, to issue Executive Order 9070, creating the National Housing Agency. The agency consolidated sixteen government agencies, including the Bank Board, all of which were involved in building housing with public funds or trying to stimulate housing with private funds. The Bank Board, as one of the National Housing Agency's three units, became the Federal Home Loan Bank Administration. A single administrator replaced the Bank Board's governing panel.

The severe housing shortage that followed World War II sparked further regulatory restructuring. In July 1947, President Harry S Truman issued Reorganization Plan No. 3, which replaced the Bank Board's single administrator with a panel of three members serving four-year terms and placed the Bank Board under the jurisdiction of the newly created Housing and Home Finance Agency (now part of the Department of Housing and Urban Development). Finally, on August 11, 1955, Congress enacted the Housing Act of 1955, restoring the Bank Board's status as an independent agency.

The early 1950s brought changes in the legislation governing the Bank System's operations. In 1950, Congress authorized the Bank Board to impose liquidity requirements on thrift institutions that were members of the Bank System. And in 1954, Congress granted the Bank Board power to

issue cease-and-desist orders against federal savings and loan associations that violated laws or regulations. The new authority lacked teeth, however, because errant institutions could use court appeals to delay compliance for years.

### **Prosperity Fades in the 1960s**

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Savings institutions had grown and prospered in the 1950s largely because of stable interest rates. In the 1960s, conditions began to change. Commercial banks began seriously courting small savings accounts and, in 1965, obtained the Federal Reserve Board's permission to pay 5.5 percent on time deposits and savings deposits, an interest rate few savings and loans could match.

In 1966, 1969, and 1970, thrifts endured periods of severe disintermediation (the flow of funds out of depositors' accounts to other investment vehicles). The problems were compounded by tight credit, rising interest rates, and higher taxes on thrift profits. As a result, many associations fell into such poor financial shape that the FSLIC had to intervene to protect insured deposits. In 1966, FSLIC assistance was required to allow ten institutions either to avoid default or to recover from default. And between 1965 and 1968, the FSLIC had to close five associations and pay off their depositors.

### **Expanding Opportunities**

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The Housing Act of 1964 took the first steps toward expanding business opportunities for thrift institutions. By permitting federal savings and loan associations to make unsecured personal loans for college or vocational education expenses, the law for the first time allowed federal associations to lend money for purposes other than acquiring real estate.

The act also expanded the geographic areas in which federally chartered thrifts could operate. Until 1964, an association could lend money for mortgages only on property within a 50-mile radius of the association's home office. The 1964 legislation extended the radius to 100 miles. (Congress in 1970 expanded the area to encompass an association's home state. In 1983, the Bank Board removed all geographic restrictions on lending, allowing federally chartered associations to make loans nationwide. Unless prohibited by state law, state-chartered associations with FSLIC insurance were permitted to do the same.)

The 1964 legislation made two other significant changes. It allowed thrifts to issue mortgages and buy property in urban renewal areas; and it permitted thrifts for the first time to buy securities issued by state and

municipal governments, and broadened their authority to invest in securities of federal agencies.

In 1966, Congress passed two major laws affecting the Bank System. The first, the Financial Institutions Supervisory Act of 1966, required thrifts to comply immediately with cease-and-desist orders issued by the Bank Board, and gave the Board power to remove officers and directors of associations that had engaged in unsafe and unsound practices or had violated the law or Bank Board regulations.

The second law, the Interest Rate Adjustment Act of 1966, authorized the Bank Board to limit the interest rates member thrifts could pay on savings accounts. However, the act provided that the Bank Board, in conference with the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System (which set commercial bank rates), could allow thrifts to pay depositors a slightly higher rate than commercial banks were allowed to pay. This provision, adopted by the Bank Board, helped hold back competition from the banks.

Finally, in 1968, Congress passed legislation allowing savings and loan associations to make loans for mobile homes; for second or vacation homes; for housing fixtures; and, in cooperation with the U.S. Agency for International Development, for housing in friendly foreign nations. With new powers, savings and loan associations began making their first forays into business areas long considered the exclusive domains of commercial banks.

### **Emergency Home Finance Act of 1970**

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In response to the tight monetary and mortgage market conditions of the late 1960s, Congress enacted the Emergency Home Finance Act of 1970. This act established the Federal Home Loan Mortgage Corporation (FHLMC), a federally chartered corporation operating under the direction of the Federal Home Loan Bank Board.

The FHLMC, popularly called Freddie Mac, was designed to establish and maintain a secondary market for conventional home mortgages so that mortgages could be sold and resold much like any other commodity. In the secondary market, original lenders, such as savings and loan associations, sell their existing mortgages to the FHLMC, generating cash with which to make new home mortgages. Freddie Mac purchases either whole mortgages or participations in mortgages from original lenders.

Freddie Mac's activities are directed toward three important goals: turning home mortgages into liquid assets; attracting new money for home loans from investors who normally did not invest in home mortgages; and providing a balancing mechanism to move funds from areas of the country with capital surpluses to areas with capital deficiencies.

## MODERN TIMES (1970–1985)

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Total assets of all savings and loan associations—both FSLIC-insured and non-FSLIC-insured—more than doubled between 1960 and 1970, rising from \$71 billion to \$176 billion. By 1980, assets topped \$629 billion, and by the end of 1985, they had reached \$952 billion.

Growth in capital did not keep pace with this impressive asset growth. The savings and loan industry's ratio of net worth to total assets declined from 7.03 percent of assets at the end of 1970 to 4.4 percent at the end of 1985. Disintermediation again plagued the thrift industry during this period. Increased competition from commercial banks and such new challengers as money market mutual funds helped to produce bouts of disintermediation in 1973 and 1974 and in 1981 and 1982. A combined net deposit outflow in excess of \$30 million was recorded for the years 1981 and 1982. Although thrifts experienced some highly profitable years—including 1978, when the industry's return on assets reached a high of 0.82 percent—the industry operated at substantial losses in 1981 and 1982, when high interest rates pushed the cost of funds higher than return on assets.

Congress reacted to these developments by significantly altering the thrift industry's legal and economic environment, in an effort to strengthen the industry's financial base and improve its ability to compete for savers' funds.

### Neighborhood Reinvestment Corporation

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In the tight mortgage markets of the 1970s, urban areas often suffered disproportionately because of a host of disincentives to mortgage investment, such as decaying properties, poor services, and the low incomes of residents. The Bank System established an office in 1970 that was designed to address these problems. Over the next few years, that office expanded into the Urban Reinvestment Task Force, transformed by Congress in 1978, through the Housing and Community Development Act, into the Neighborhood Reinvestment Corporation.

The Neighborhood Reinvestment Corporation's primary role was, and is, to help establish locally run self-help coalitions of business leaders, residents, and local government officials—collectively known as Neighborhood Housing Services (NHS) programs—to encourage communities to revitalize depressed urban neighborhoods and, thus, make lenders more willing to finance home-buying.

By 1985, NHS programs operated in 135 cities in 41 states and the District of Columbia. These programs have generated more than \$2.4

billion of reinvestment in urban neighborhoods nationwide, with funds coming primarily from residents, private lenders, and local government. Today, more than two million people live in the revitalized neighborhoods.

### **The Question of Regulation**

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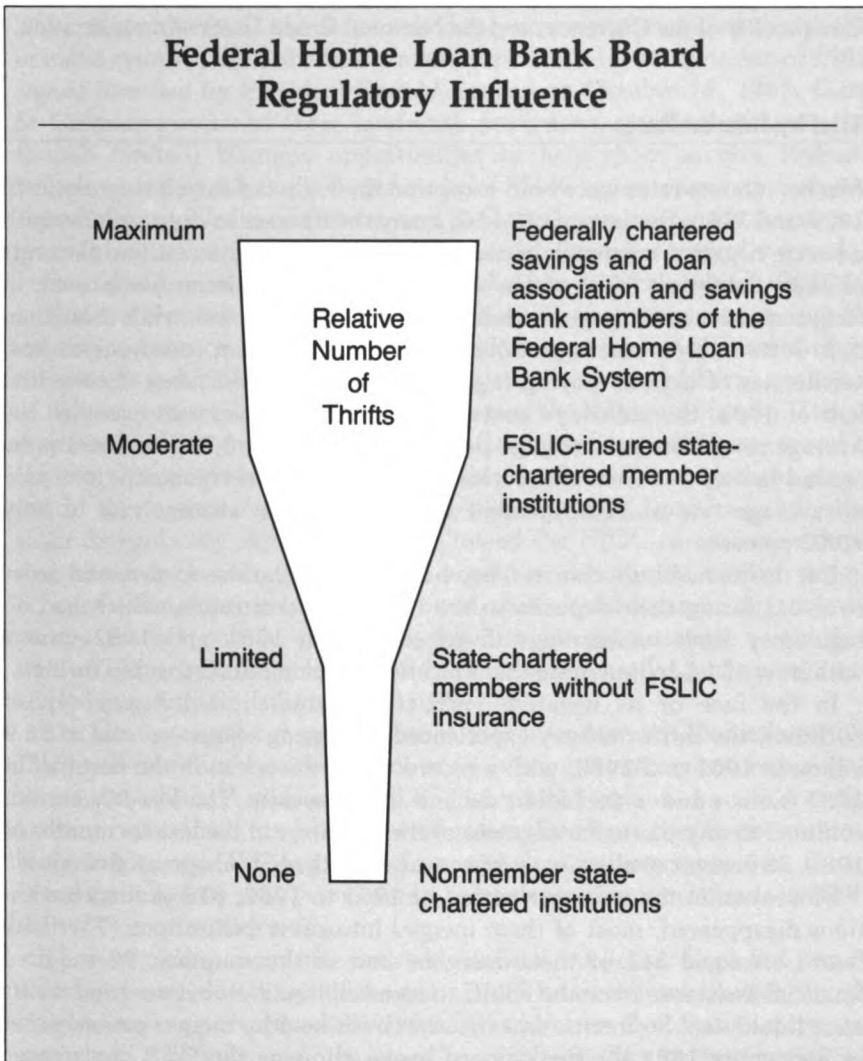
Throughout much of the 1970s, thrifts faced increasing government regulation. For instance, Congress in 1975 set into law the traditional interest rate differential, which allowed thrifts to pay an interest rate 25 basis points (one-fourth of one percent) higher than that allowed commercial banks.

At the same time that regulation was expanding for thrifts came the first ripples of what would grow into a tide of deregulation. As early as 1973, for example, the Financial Institutions Act (whose purpose was to begin deregulating interest rate controls) was introduced into Congress. The legislation was stalled until 1980, when it reemerged as the Depository Institutions Deregulation and Monetary Control Act. But by then, the Bank Board, acting with other federal financial regulators, had already begun using its regulatory authority to remove restraints on interest rates. In 1978, for example, the Bank Board permitted savings and loans to offer money market certificates with interest rates tied to Treasury bill rates, and in 1980, it authorized the 30-month Small Savers' Certificates.

The new savings instruments proved an expensive way to attract savings—the more so because thrifts' options for investing funds remained tightly regulated. In 1979, the Bank Board began allowing mortgage rates to keep pace (in a limited way) with changes in interest rates paid on savings accounts, authorizing all federally chartered associations to offer variable-rate mortgages, which had been introduced experimentally by federally chartered associations in California a year earlier. (California's large state-chartered associations had been marketing variable-rate mortgages since 1975, and her small state-chartered institutions had offered them as early as 1961.)

The 1970s were indeed a fertile ground for legislative activity. The Housing and Community Development Act of 1974 liberalized lending powers for federally chartered associations. The Real Estate Settlement Procedures Act of 1974, as amended in 1976, required lenders to inform loan customers in advance of the total estimated charges to be assessed in granting mortgages. The Equal Credit Opportunity Act of 1974 prohibited discrimination in credit transactions on the basis of sex, marital status, race, color, religion, national origin, receipt of public assistance benefits, or the borrower's good-faith exercise of rights under the Consumer Credit Protection Act.

The Home Mortgage Disclosure Act of 1975 required most depository institutions to disclose to the public the number and dollar amount of mortgage loans they originate or buy in each census tract. The Community Reinvestment Act of 1977 required federal agencies that regulate financial institutions to encourage those institutions to meet the credit needs of all segments of their communities, including low- and moderate-income neighborhoods. And the Financial Institutions Regulatory and Interest Rate Control Act of 1978 gave the FSLIC an important new tool in dealing with insolvent thrifts by authorizing it to contribute financial assistance in



arranging the merger or acquisition of a failed institution by a strong institution.

The Depository Institutions Deregulation and Monetary Control Act of 1980 mandated the gradual removal, by 1986, of all interest rate controls on federally regulated depository institutions. Authority to implement the phase-out was assigned to a new umbrella group, the Depository Institutions Deregulation Committee (DIDC), a panel composed of the Secretary of the Treasury and the heads of the federal financial regulatory agencies, including the Federal Home Loan Bank Board, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the National Credit Union Administration.

### **Trial by Interest Rates**

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Market interest rates were both exceptionally high and extremely volatile in 1979 and 1980. By the end of 1980, many thrifts were in deep trouble, with a severe negative mismatch between the yields on their assets and the costs of their liabilities. Most of the industry's interest-bearing assets were in long-term home mortgages with low, fixed rates of interest, while more than half of its interest-bearing liabilities were in short-term (one year or less) certificates of deposit paying high, deregulated market rates. By the first half of 1981, the industry's cost of funds, at 10.31 percent, exceeded the average return on its mortgage portfolio, which was 9.72 percent. By the second half of 1981, conditions had deteriorated further; associations paid an average rate of 11.53 percent while earning an average rate of only 10.02 percent.

But thrifts had little choice. They had to pay high rates to savers in order to avoid losing their deposits to the money market funds, which had no regulatory limit on earnings. Even so, during 1981 and 1982, savers withdrew \$31.8 billion more than they deposited in FSLIC-insured thrifts.

In the face of its negative yield/cost mismatch and heavy deposit outflows, the thrift industry experienced staggering losses—a total of \$8.9 billion in 1981 and 1982, with a record \$3.3 billion loss in the first half of 1982 alone—and a \$6 billion decline in net worth. The losses were not confined to any particular segment of the industry; in the last six months of 1981, 85 percent of all associations insured by the FSLIC operated at a loss.

Moreover, in the two-year period of 1981 to 1982, 813 savings institutions disappeared, most of them merged into other institutions. The Bank Board arranged 342 of those mergers, and of that number, 92 required financial assistance from the FSLIC to forestall liquidation; two other thrifts were liquidated. So intense was the search for healthy merger partners that in September 1981 the Bank Board began allowing the FSLIC to arrange

assisted interstate mergers, breaking the long-held ban on branching across state lines.

It is noteworthy that, although the industry's troubles were common knowledge, the public did not panic as it had during the depression of the 1930s. No long lines formed of people desperate to withdraw their savings; the public had faith in federal deposit insurance.

### **The Garn-St Germain Depository Institutions Act of 1982**

The crisis in the thrift industry evoked the most significant thrift legislation in half a century, the Garn-St Germain Depository Institutions Act of 1982, signed into law by President Ronald Reagan on October 15, 1982. Garn-St Germain contained three landmark provisions, giving thrifts new (although limited) business opportunities to help them survive financial storms; granting the Bank Board and the FSLIC new powers to deal with financially troubled associations; and authorizing an emergency rescue program to assist savings institutions that were troubled, but basically sound.

Garn-St Germain differed fundamentally from the reforms of the 1930s in that it deregulated rather than regulated. The act set out to correct the existing imbalance in the very strict regulation of how thrifts could invest their assets (which limited return on assets) and the more liberal regulation of deposit interest rates (which had increased thrifts' cost of funds). The act was designed to give the industry the flexibility it needed to respond to rapidly changing market conditions. The legislation mandated the phase-out of the interest rate differential by January 1984, and had two other main deregulatory aspects. First, it allowed the DIDC to authorize thrifts and banks to issue a new type of account—the money market deposit account—that bore no interest limit and, thus, could compete directly with money market mutual funds. Second, the act gave savings institutions limited authority to expand into additional business areas, such as commercial lending, traditionally reserved for banks.

The money market deposit account was introduced in December 1982. During its first four months, it proved an enormous success, attracting more than \$108 billion in savings to FSLIC-insured institutions. A portion of that amount represented funds transferred internally from other thrift accounts, but enough outside money flowed into the new instruments so that, for the first time in nearly two years, savers were depositing more funds in thrifts than they were withdrawing.

The new asset powers also proved beneficial. Although Garn-St Germain actually removed very few of the distinctions between banks and thrifts, the new business opportunities allowed thrifts to bolster their financial strength enough so that they could continue to carry out their primary mission—

financing home ownership. To that end, Garn-St Germain allowed thrifts to broaden their holdings of short-term assets (which could be adjusted more quickly to changing interest rates) as well as hold long-term mortgages. In particular, the act gave all federal associations the power to:

- Make commercial, corporate, business, or agricultural loans, which after January 1, 1984, could constitute up to 10 percent of an association's assets.
- Increase from 20 percent to 30 percent the amount of assets that could be invested in consumer loans, and make inventory and floor-planning loans beyond existing authority.
- Offer individual or corporate demand-deposit accounts (although corporate checking accounts could be opened only by companies having other business with the association).
- Increase from 20 percent to 40 percent the amount of assets that could be invested in loans secured by nonresidential real estate.
- Invest up to 10 percent of assets in personal property for rent or sale.
- Make education loans for any educational purpose, instead of just for college or vocational training.
- Invest up to 100 percent of assets in state or local government obligations.
- Invest in other thrifts' time deposits and savings deposits and use the investments to help meet liquidity requirements.

Garn-St Germain realigned the industry's structure, eliminating differences in the kinds of business in which federal savings and loan associations and federal savings banks were allowed to engage. Moreover, the act made it easier for savings and loan associations to become savings banks and vice versa, and it allowed existing institutions to select either the stock or the mutual form of ownership.

Garn-St Germain also ended an advantage thrifts had enjoyed for nearly two decades: the privilege of paying savers a slightly higher interest rate than commercial banks could pay. In addition, the act imposed on thrifts the same anti-tying prohibitions that applied to commercial banks. This move prevented associations from requiring applicants for one type of service, such as a loan, also to use other services as a condition for receiving the original service.

Beyond giving thrifts new business opportunities, Garn-St Germain expanded federal regulators' powers to deal with financially troubled institutions. Perhaps most important, the legislation granted the Bank Board the power to override state authorities, if necessary, in order to appoint the FSLIC as receiver of bankrupt state-chartered FSLIC-insured thrifts. Garn-St Germain also reaffirmed the FSLIC's and the Bank Board's authority to cross state lines, if necessary, to merge a failed institution with another insured institution. And the act gave the FSLIC new authority to keep thrifts solvent by depositing money in them or buying their securities.

Finally, Garn-St Germain authorized a new capital assistance program for troubled thrift institutions. Under this program—called the Net Worth Certificate Program—qualifying associations with less than 3 percent net worth were permitted to secure promissory notes from the FSLIC in exchange for instruments, issued by thrifts, called net worth certificates. Because the FSLIC's promissory notes guaranteed the notes' face amounts, thrifts could use them to raise their net worth to the required minimum, and thereby hold off a FSLIC takeover. As institutions regained financial health, they would begin trading back the promissory notes for the net worth certificates, and, if all went well, the obligations eventually would be canceled out, with no cash ever changing hands.

### **The Decline in Interest Rates**

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As dramatic and far-reaching as Garn-St Germain was, the act alone probably could not have saved the thrift industry. For one thing, although thrift institutions were experts in home financing, they needed time to master other types of loans, and the act could not grant them the time.

In the second half of 1982, however, interest rates began declining, and by the end of the year associations were again earning more interest than they were paying out. During the first six months of 1983, for example, the industry's overall cost of funds was 9.81 percent, while the average portfolio yield was 11.04 percent.

Nonetheless, 35 percent of all FSLIC-insured thrift institutions were still losing money by the end of 1983, and the ratio of regulatory net worth to total assets was less than 3 percent at more than one-fourth of all FSLIC-insured institutions. The industry's earnings and net worth figures would have been even lower without certain temporary accounting techniques the Bank Board permitted thrifts to use.

During 1984, the thrift industry continued to grow rapidly. Deposits in FSLIC-insured institutions increased by 17 percent to \$784.7 billion, and assets grew by 19 percent to \$978.5 billion. By contrast, the FSLIC's reserves declined 12.7 percent to \$5.6 billion, and at the end of 1984, the ratio of FSLIC reserves to insured savings deposits had dropped to 0.78 percent.

In 1985, reined in by new Bank Board regulations, the pace of deposit growth slowed sharply, to about half that of 1984. Liability growth, which had risen by 19.4 percent over 1983 in 1984, was down to 7.5 percent above the 1984 figure. But the FSLIC's reserves dropped further, to \$4.6 billion, and the reserve ratio fell to 0.55 percent.

The FSLIC's difficulties stemmed from the continuing high levels of thrift failures. But whereas the failures during 1981 and 1982 resulted primarily

from high interest rates, the failures in 1984 and 1985 resulted primarily from poor assets—loans and investments in default. In the 35 cases the FSLIC resolved during 1985, 26 of the institutions failed because of problems related to the quality of their assets—problems that were expensive for the FSLIC to resolve and that therefore played a major role in decreasing the FSLIC's reserves. In 1984 and 1985, 19 institutions were placed in FSLIC receivership for liquidation; prior to 1983, the FSLIC had liquidated only 15 institutions in its entire 50-year history.

To reduce the FSLIC's risk of exposure to asset-related problems in the future, the Bank Board took a number of steps to curb risk-taking by insured institutions and to provide closer monitoring of their activities. In January 1985, for example, the Board adopted regulations that linked net worth requirements to growth rates. The regulations also required thrifts to get supervisory approval before undertaking potentially risky ventures—specifically, before investing more than 10 percent of their assets in equity securities, real estate, or subsidiary service corporations.

Because thrifts' freedom of choice in investing had grown, regulators found increased examination and supervision necessary. To strengthen the examination of institutions, the Bank Board in July 1985 delegated the responsibility for conducting examinations to the district banks and transferred the Board's examiners and support staff to the employ of the district banks. The move placed the examiners under the same roofs as the district banks' supervisory agents. Because the supervisory agents enforce corrective measures at thrift institutions upon the examiners' discovery of violations, the transfer has made possible faster response to early warning signals of institutions' financial problems.

As 1984 came to a close, the net worth of the Bank System's member institutions received a boost in the form of 15 million shares—with a market value of about \$600 million—of participating, preferred, nonvoting stock in the Federal Home Loan Mortgage Corporation. Freddie Mac distributed the stock as a special dividend and provided that nearly all of its future dividends would go directly to member thrift institutions, rather than to the district banks, which hold Freddie Mac's common stock. By including the dividend, FSLIC-insured thrift institutions posted earnings for all of 1984 amounting to \$1.1 billion, representing a return on assets of 0.12 percent.

In 1985, market interest rates fell, and most institutions reduced their interest rate risk and improved their profitability. Firms insured by FSLIC achieved their highest aggregate return on assets since 1979, earning net income three and a half times that of 1984. Gross mortgage lending was up, and the market value of the industry's residential mortgage holdings appeared to exceed book value for the first time since 1979.

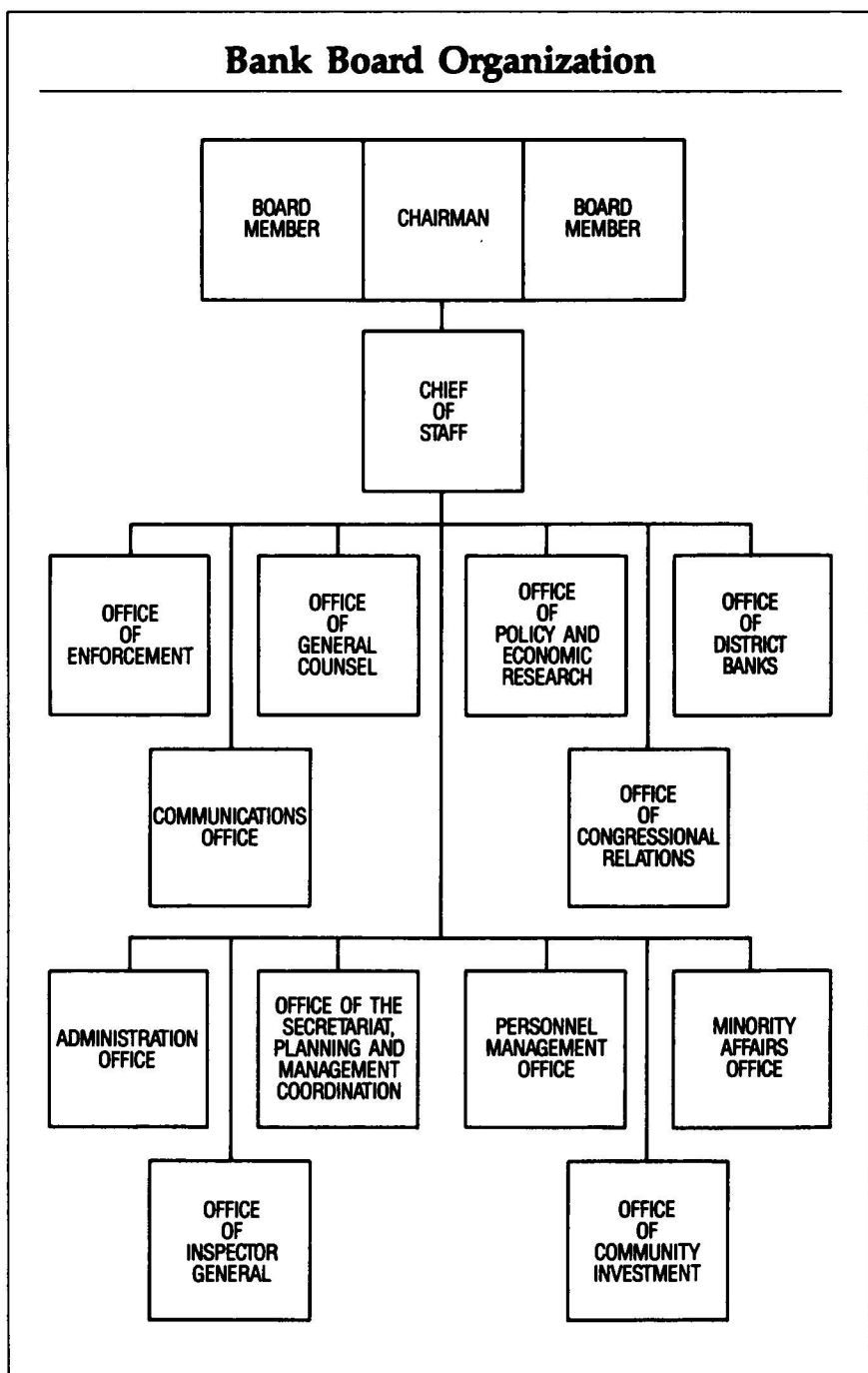
However, a significant minority of the industry, some 15 percent,

continued to experience operating losses. A much smaller number of firms encountered serious problems because of unsound lending and investment practices. And more than one-fifth of the industry had a regulatory net worth ratio below 3 percent. Still, 1985 was a good year, and the industry moved with confidence and some optimism into 1986.

### **A Steady Purpose**

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From the earliest mutual savings banks and home-financing societies, the thrift industry has grown with the nation it serves. There have been hard times and times of prosperity, years of stability and periods of rapid change, remarkable successes and noteworthy failures. The thrift industry today is structurally very different from the nascent industry of the 1830s. But as the goals of the first associations were to enable their members to buy homes and to provide a safe place to save, the Federal Home Loan Bank System today remains committed to making home ownership possible by providing thrifts with access to a national pool of credit, and to encouraging thrift by ensuring the safety of depositors' savings.



# The Bank Board

The Federal Home Loan Bank Board adopts the policies and regulations that guide the Federal Home Loan Bank System, that promote efficiency in its operation, and that ensure the safety and soundness of the nation's thrift institutions. The Bank Board consists of two elements: a governing panel that makes policy, and an independent federal agency that carries out Bank Board policy in regulating, monitoring, and supervising the savings and loan industry.

The Bank Board panel is composed of three members appointed by the President and confirmed by the Senate to serve four-year terms. The President designates one member of the panel as chairman. No more than two board members may belong to the same political party.

The agency is self-supporting and uses no tax revenues; its operating costs are paid from a Treasury account funded by assessments on the twelve district banks and by assessments on the Federal Savings and Loan Insurance Corporation (FSLIC). The district banks, in turn, charge the individual thrift institutions fees when they are examined.

The Bank Board members meet in formal session as often as necessary, usually once a week. During these meetings, the Board adopts or amends regulations affecting the entire thrift industry and also rules on matters affecting individual thrift institutions. The types of decisions the Bank Board makes include creating new savings institutions by granting federal charters, granting new FSLIC deposit insurance, telling associations how they must keep their books, how they may invest their assets, and so on. The Bank Board also decides when to close or merge failing institutions. In any single year, the Board makes hundreds of decisions of all types that affect the safety and soundness of the Federal Home Loan Bank System's member institutions as well as the thrift industry in general.

In addition, the Bank Board members sit as directors of the Federal Home Loan Mortgage Corporation; direct the policy and make final administrative decisions for the Federal Savings and Loan Insurance Corporation; and oversee and regulate the twelve district banks. Specific responsibility for carrying out the Board's numerous missions and supporting its needs is vested in one or more of its offices, each of which is responsible to the Bank Board chairman.

## **Office of the General Counsel**

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The Office of the General Counsel (OGC) functions as the Bank Board's lawyer. The Office employs some hundred or more attorneys to handle the Bank Board's legal affairs.

The OGC staff prepare the final drafts of all Bank Board regulations, advise Bank Board members on agency regulations and interpretation of laws affecting the Bank System, and draft the legislation the Bank Board submits to Congress. In addition, the OGC staff prepare legal opinions on applications submitted by thrift institutions to the Bank Board and the FSLIC, and conduct all litigation involving the agency. The Office also provides legal services to other Bank Board offices.

## **Office of District Banks**

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The Office of District Banks (ODB) operates as the Bank Board's primary liaison with the twelve federal home loan banks. As such, the ODB works with the district banks to develop and implement Bank Board policy, reviews the district banks' performance and operating procedures, monitors the district banks' processing of thrift institutions' applications, and processes certain other applications that require Bank Board action.

One of the ODB's primary responsibilities is to oversee the district banks' operations to ensure their conformity with federal law and Bank Board regulations and policies. To this end, the ODB coordinates the twelve district banks' operations, evaluates the district banks' budget requests, and monitors the district banks' service charges to member institutions. In addition, the ODB assists the Bank Board in selecting and appointing the district banks' public interest directors and conducts the elections of other district bank directors, who are chosen by Bank System member institutions.

The ODB's Application Analysis Division reviews, analyzes, and recommends final action on the various thrift institutions' applications that require Bank Board approval, including applications for new federal savings and loan associations or savings banks, for new branch offices, for FSLIC insurance, and for permission to merge with other institutions. The division also reviews applications that the district banks have approved under authority from the Bank Board to verify that the applications have been handled in accordance with Bank Board policy and regulations.

In addition to these supervisory responsibilities, the Office of District Banks collects financial and operating data on the twelve district banks, which it then incorporates into the Bank Board's various financial reports and into the district banks' combined financial statements, which the ODB publishes.

## **Office of Policy and Economic Research**

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The Office of Policy and Economic Research (OPER) studies the workings of the financial marketplace in order to advise the Bank Board on regulatory policies. The OPER looks backward, evaluating the results of previous policies under historical conditions, and looks forward, simulating what would be likely to happen if the Bank Board followed a given policy under various economic circumstances. Such information is vital to the Bank Board's understanding of how its regulations have affected the district banks and their member thrift institutions in the past and how proposed regulations might affect them in the future.

The Office's staff members review, analyze, and aggregate monthly and quarterly reports filed by every FSLIC-insured savings institution. The resulting compilations, along with special surveys that OPER conducts, give a comprehensive picture of what has happened and is happening in the housing finance industry. To gauge future economic trends and to provide tools for planning, the OPER uses a variety of econometric techniques and computerized models.

The Office sponsors or participates in a number of seminars each year, including the annual Thrift Industry Outlook Conference, and publishes research papers. The OPER also publishes several monthly statistical series and several annual financial compilations.

## **Office of Community Investment**

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The Office of Community Investment (OCI) seeks to stimulate thrift industry investment in older communities. Created in 1977, the OCI expanded programs begun in the 1960s by the Bank Board's former Office of Housing and Urban Affairs. One of the most important of OCI's programs has been the Community Investment Fund. In its five years of operation, from 1978 to 1983, the Community Investment Fund helped underwrite the construction of 571,515 housing units in older urban and rural communities. In 1984, following the termination of the national program, the Bank Board gave each district bank the option of initiating such a program on its own.

The Office of Community Investment also supplies training materials and technical assistance to the district banks to encourage the growth, safety, and soundness of minority-owned savings institutions. The OCI monitors and helps enforce industry compliance with civil rights and consumer legislation and guides the district banks' supervisory agents in investigating complaints against individual savings and loan associations.

The OCI coordinates the Bank Board's technical assistance to other

nations, administering a contract funded by the U.S. Agency for International Development to assist other countries in developing their own thrift and home financing systems, and handles arrangements for the several hundred foreign visitors who come to the Bank Board annually. The OCI also represents the Bank Board in coordinating the thrift industry's compliance with the Home Mortgage Disclosure Act.

### **Office of Enforcement**

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Created in 1986, the Office of Enforcement (OE) helps the Bank Board ensure that FSLIC-insured institutions and their managers, directors, and other officials comply with laws, regulations, and safe and sound operating practices. The Office accomplishes its task by issuing temporary and final cease-and-desist orders, removing wrongdoing or negligent officers or directors, entering into various kinds of enforceable agreements, and, in the most serious cases, establishing conservatorships or receiverships.

When it cannot find a remedy on an informal or consent basis, the OE prosecutes such matters in administrative enforcement proceedings or in a U.S. District Court. To determine if formal action is needed, the OE often investigates suspected violations or unsound practices by thrift institutions, their officials, or persons doing business with the institutions.

The OE also serves as counsel to the supervisory agents at the district banks and to the Office of Regulatory Policy, Oversight and Supervision. In addition, OE attorneys prepare detailed criminal referral letters to the U.S. Department of Justice when information developed during investigations reveals evidence that crimes have occurred.

### **Office of Congressional Relations**

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The Office of Congressional Relations (OCR) serves as the primary link between the Bank Board and Congress. The OCR works closely with the Senate Banking, Housing, and Urban Affairs Committee and the House Banking, Finance and Urban Affairs Committee, which generally handle legislation affecting the Bank System.

Among its other duties, the OCR coordinates the submission of the agency's budget to Congress. Because funds for the Bank Board's operating expenses come from the industry it regulates, Congress does not appropriate any funds from the U.S. Treasury for Bank Board use. However, the House and Senate Appropriations Subcommittees on HUD-Independent Agencies review the Bank Board's annual budget, and Congress approves an authorization bill containing limits on the total funds the Bank Board may spend.

### **Communications Office**

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The Communications Office informs the news media and the public about the Bank Board and its policies, programs, and decisions. It accomplishes the spread of information by circulating press releases, scheduling press conferences, and arranging for news reporters to interview Bank Board members and staff. The Office also circulates texts of new or amended Bank Board regulations as they are adopted, texts of speeches and public testimony delivered by Bank Board members, and other public statements. The Communications Office also handles hundreds of telephoned and written inquiries from the news media and the general public each month. The Office also provides graphic, photographic, audiovisual, and video services to the Bank Board.

### **Office of the Secretariat, Planning and Management Coordination**

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The Office of the Secretariat, Planning, and Management Coordination maintains the official records of the Bank Board, as well as of the former Home Owners' Loan Corporation and Federal Home Loan Bank Administration.

Among its other duties, the Office schedules Bank Board meetings, organizes the agendas, coordinates transmission of staff papers, prepares minutes, records decisions, transmits new regulations to the Office of the Federal Register for official publication, briefs new Bank Board members, advises the Bank Board on compliance with the Sunshine Act, releases information under the Freedom of Information Act and Privacy Act, and maintains a research facility the public may use to inspect records and documents that are open to public view. The Office also organizes the Bank Board's planning meetings; provides inter-office coordination of issues being developed for Bank Board consideration; prepares, distributes, and records federal thrift charters, FSLIC insurance certificates, Bank System membership certificates, and certifications of the election and appointment of directors of the federal home loan banks.

### **Office of Inspector General**

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The Office of Inspector General (OIG) functions as the Bank System's internal watchdog. At the Bank Board's direction, the OIG conducts audits and investigations within the Bank Board, the Federal Savings and Loan Insurance Corporation, the district banks, the Office of Finance, and the Neighborhood Reinvestment Corporation to promote efficiency, economy, and effectiveness and to uncover any fraud or abuse. The OIG also

administers contracts with the district banks' outside auditors, and serves as liaison between the Bank Board and the U.S. General Accounting Office.

### **Personnel Management Office**

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The Personnel Management Office (PMO) advises Bank Board members and staff regarding personnel management practices, programs, recruitment, and compliance with the regulations of the Bank Board and the U.S. Office of Personnel Management. The PMO also coordinates staff training programs and other developmental activities.

### **Office of Minority Affairs**

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The Office of Minority Affairs works closely with the Personnel Management Office, the Bank Board members, and other Bank Board offices to develop and implement the Bank Board's equal employment opportunity (EEO) policies, which include an affirmative action program, federal women's program, a process for handling and resolving EEO complaints, and other actions designed to remove barriers to equal employment and advancement opportunity.

### **Administration Office**

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The Administration Office helps develop and deliver many services needed by the Bank Board and the FSLIC. These services include accounting, preparing budgets, data processing, and managing facilities.

The Administration Office's Information Systems Division designs and operates computer systems allowing the Bank Board, the FSLIC, and the district banks to process and store the vast amounts of financial data generated by the Bank Board, the district banks, and member institutions across the country. The Office's Budget Division plans, develops, and controls the Bank Board's budget and helps implement programs mandated by the federal Office of Management and Budget. The Controller's Division prepares bills for the agency's services, receives and disburses agency funds, and safeguards securities and other valuable documents. The Controller's Division also makes arrangements for personnel traveling on agency business.

The Administrative Services Division is responsible for property management, including supervising the agency's building and equipment; procuring supplies and services; and operating a copy center, a library, and a mail

room. The responsibilities of the Office's management analysis staff include ensuring agency compliance with the Paperwork Act, controlling the forms used by the agency, and standardizing the agency's word processing operations.

### **The Federal Savings and Loan Advisory Council**

Congress established the Federal Savings and Loan Advisory Council in 1935. Although it is not part of the Bank Board, the Council brings the concerns of the thrift industry to the Board's attention, providing a bridge between the regulated and the regulator.

The Council's twenty-four voting members represent a broad cross-section of the thrift and housing industries and the public. The council includes one member from each of the twelve district banks, elected annually by the district bank's board of directors. The Bank Board annually appoints the other twelve members to represent the public interest. The Council meets at least twice a year to consider major issues facing the savings and loan industry and to make recommendations to the Bank Board.



## The District Banks

The district banks are the thrift industry's bankers. Whereas most commercial banks rely on one of the twelve federal reserve banks for bank-like services, the majority of savings and loan associations and savings banks turn to one of the twelve federal home loan banks for financial and technical assistance. The district banks link the Bank System's other two key elements—the Bank Board, in Washington, and the more than 3,000 federally chartered and state-chartered savings and loan associations and savings banks throughout the country.

The district banks opened for business in October 1932, at the lowest point of the Great Depression. They came into being under the Federal Home Loan Bank Act, which authorized eight to twelve district banks. The Bank Board created twelve district banks, now located in Boston, New York, Pittsburgh, Atlanta, Cincinnati, Indianapolis, Chicago, Des Moines, Dallas, Topeka, San Francisco, and Seattle.

The district banks' primary mission has not changed: to channel money into the housing finance industry by making loans to individual thrift institutions, which use the funds to make loans to home buyers or to meet demands for deposit withdrawals. The district banks work to balance funds according to local needs, transferring money from areas with surplus deposits to areas with insufficient savings to meet mortgage demands. The twelve-bank network is thus responsive to economic variations in different regions of the United States.

The district banks normally make advances available at interest rates that are lower than those of the commercial market, particularly on longer-term funds. This practice helps member savings institutions manage their interest rate gaps (the differences between the rates the institutions pay on the funds they borrow and the rates they earn on the funds they lend). The district banks also provide thrifts with such services as check clearing, safekeeping of securities, demand and time deposit accounts, technical assistance, economic analysis, and access to the federal funds markets. By design, the district banks are profit-making intermediaries, which provide earnings that can return dividends to the banks' stockholders. And, by examining and supervising their member institutions, they ensure that thrifts comply with federal law and Bank Board regulations.

## **Structure of the District Banks**

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The district banks are hybrid organizations, wholly owned by their members—savings and loan associations, savings banks, and insurance companies—but ultimately controlled by the federal government. Every federally chartered thrift institution must become a member of a district bank. Membership is optional for state-chartered institutions, but nearly all of them become members, in part because the Federal Savings and Loan Insurance Corporation (FSLIC) will not insure any institution that is not a member. A thrift joins the district bank that serves the state in which the thrift's home office or principal place of business is located.

A thrift institution becomes a member of a district bank, and hence of the Bank System, by purchasing the district bank's stock. Unlike most common stock, district bank stock is not traded on any exchange; the banks may sell stock only to their member institutions. A member institution of one district bank may not buy stock in another district bank, nor can the district banks buy each other's stock. Moreover, a member that finds it holds more than the required amount of district bank stock may sell the excess back only to the district bank. (On rare occasions, some district banks have permitted their stock to be exchanged directly between member institutions within the same district.) Each share of stock entitles its owner to one vote in the district bank corporation. To prevent the largest institutions from dominating the district banks, no one institution is permitted more votes than the average number of shares held by all members in that institution's home state.

Each district bank is governed by a board of at least fourteen directors, two of whom are designated by the Bank Board each year to serve as the district bank's chairman and vice-chairman. The district bank's member institutions elect eight of the directors, and the Bank Board in Washington appoints six. (In districts that include more than five states, the Bank Board may increase the number of directors on the district bank's board as long as there are no more than thirteen elected members, and the elected members must outnumber the appointed members by a ratio of four to three.) Although each bank has more locally elected directors than federally appointed directors, the appointed directors serve longer terms—four years, compared with two years for the elected directors.

The elected directors are chosen by state. Member institutions in each state are entitled to at least one director, but not more than six directors; the number of elected directors is proportionate to the percentage of the district bank's stock held by member thrift institutions in the state. The Bank Board chooses the directors it appoints, called public interest directors, to represent various community groups, including business, law, academia, and religion. The directors must reside in the district they serve.

The Bank Board has final authority over the actions that each district bank's board of directors takes, such as adopting the district bank's annual budget. The Bank Board has delegated to the individual district banks the authority to set dividend rates on their capital stock and to appoint the district banks' officers. In theory, nearly every action by district banks technically comes under Bank Board review, although in practice the Bank Board delegates substantial operating authority to the banks.

Some of the most important of these delegated functions are those involving supervisory responsibilities. The Bank Board designates a number of employees at each district bank as supervisory agents, who are responsible for instituting corrective measures at thrift institutions and for providing day-to-day supervisory oversight. The district bank's president usually serves as the Bank Board's principal supervisory agent (PSA), holding district-level authority on such matters as approving some types of applications from member institutions and enforcing federal law and regulations. Because of the importance of this position, the district bank president, although appointed by the district bank's board of directors, must be approved by the Bank Board.

The Bank Board also gives district banks broad authority for providing services to member thrifts. Thus, while functioning within the Bank Board's guidelines and regulations, the district banks can develop services according to the needs and wishes of the local thrift industry. As long as the banks meet the Bank Board's basic requirements, the district boards of directors are generally free to decide which additional services to offer members and what to charge.

### **Bank System Offices**

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The following four offices are funded by the district banks to serve specific needs of the Bank System.

*OFFICE OF FINANCE.* The Office of Finance (OF) issues consolidated debt, manages investments, clears securities, conducts financial planning and research, develops computer programs, and provides support services to aid the banks in their financial management. The Office's director is responsible to the Bank Board as well as to the twelve district bank presidents. In carrying out its tasks, the OF acts as liaison between the district banks, the FSLIC, and the Bank Board.

As fiscal agent for the district banks, the OF sells consolidated bonds generally having terms of from one year to ten years and discount notes with terms of from one month to one year. In addition, the OF investigates and uses alternative debt sources to meet the needs of the district banks. For instance, during the period from 1984 to 1986, the OF several times

reopened previously issued bonds for sale as a means of satisfying the district banks' demand for additional maturities, placed an issue in the Eurodollar market, and issued bonds denominated in yen and in European Currency Units.

The OF's research and product development go beyond searching for alternative debt instruments. The OF has been active in establishing policies, programs, and reporting systems for the district banks in a variety of areas, including futures options and cash hedging, interest rate swaps, and asset-liability management. The OF also undertakes financial research projects at the request of the Bank Board, the district banks, and the FSLIC, as well as for its own purposes.

The Office of Finance manages both a centralized portfolio (the Consolidated Securities Fund), comprising approximately 20 percent of each district bank's liquidity portfolio, and the FSLIC portfolio. The OF also provides securities clearing and reporting services for the district banks and the FSLIC.

*OFFICE OF REGULATORY POLICY, OVERSIGHT AND SUPERVISION.* The Office of Regulatory Policy, Oversight and Supervision (ORPOS), located in Washington, D.C., was established by the Bank Board on October 1, 1986. It took over all of the functions and most of the personnel of the former Office of Examinations and Supervision (OES), which was then abolished. Like the other Bank System offices, the ORPOS is not an office of the federal government, and so the transformation ended civil service constraints on staffing, salaries, and personnel practices. The privatization of the OES followed by just over a year the transfer of federal OES thrift examiners to the employ of the district banks.

The ORPOS monitors the activities of Bank System examiners, who ensure that individual thrift institutions follow federal law and Bank Board regulations. Bank System examiners check the books and operations of all FSLIC-insured savings institutions. Each institution must pay a fee for its examination.

Bank System examiners bear sole responsibility for examining federally chartered institutions. Federal and state examiners work side by side to examine state-chartered thrifts in more than half the states, undertaking joint examinations and issuing joint reports. In a few states, federal and state examiners examine institutions at the same times and share the work, but issue separate reports. And in other states, federal and state examiners take turns conducting examinations and share the results.

If an examination uncovers a problem, a supervisory agent from the district bank will work with the institution to solve the problem, usually in informal meetings between supervisory officials and the association's management. But if necessary, the Bank Board may issue a cease-and-desist order, which the institution must obey. The ORPOS may recommend other

corrective action, including removing a thrift institution's officers or directors. The ORPOS also may help arrange the merger of a troubled thrift with a healthy financial institution; by taking such action early enough, the ORPOS often can prevent the need to involve the FSLIC.

How often an institution is examined depends on its condition. Those institutions in the best financial shape may be subject to full-scale examinations every 18 to 22 months, whereas those with serious problems may be examined every 6 months or—in the worst cases—on a continuous basis. Continuous monitoring, however, is relatively rare; normally, only about 3 percent to 5 percent of thrift institutions at any given time require continuous federal supervision.

The ORPOS also instructs Bank System staff on how thrift institutions should comply with Bank Board regulations and drafts examination and supervision procedures. And the ORPOS helps formulate proposed regulations dealing with the examination and supervisory process, the operation of the thrift industry, and the determination of accounting standards.

*FHLB SYSTEM PUBLICATION CORPORATION.* The FHLB System Publication Corporation, established in August 1984 and operated by the district banks, publishes the Bank System's bimonthly magazine, *Outlook of the Federal Home Loan Bank System*. The corporation's headquarters are in Washington, D.C.

*FHLB SYSTEM OFFICE OF EDUCATION.* The Office of Education provides comprehensive and specialized education and training to employees of the Bank Board and the district banks to help managers and staff learn new policies and procedures and become more effective. Established in June 1984, the Office of Education maintains its headquarters near Dallas, Texas. In 1985, the Office began training examiners, who were transferred that year from the federal civil service system to the district bank staffs.

## SOURCES OF FUNDS

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The federal home loan banks obtain funds from three principal sources. The largest source is the sale of the federal home loan banks' own obligations (bonds and discount notes). At the end of 1985, the outstanding balance of the district banks' obligations totaled \$74.4 billion. The district banks' next largest source of funds is member institutions' deposits, which totaled \$25.2 billion at the end of 1985. The third major source is the sale of district bank stock to member institutions; at the end of 1985, outstanding capital stock totaled \$8.3 billion.

Far smaller portions of the district banks' resources derive from retained earnings; the interest earned on money lent to member institutions, other district banks, and other borrowers; and fees for various services the district

banks perform for members. Under unusual circumstances, the district banks could also obtain funds from the U.S. Treasury or the Federal Reserve System.

### **Consolidated Obligations**

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The district banks borrow money in the capital markets by selling consolidated debt obligations—bonds and discount notes jointly offered by the twelve district banks—that combine all of the district banks' borrowing needs at a given time. Because these instruments are the "joint and several obligations" of the district banks, each bank is legally responsible for repayment of its own debt plus the debt of all the other district banks.

The consolidated debt obligations are marketed by the Bank System's Office of Finance, which serves as the banks' fiscal agent. The Office of Finance does not sell directly to investors; instead, it places the debt through a primary network of securities dealers and banks. The primary network then sells to investors or to banks and other dealers that acquire the securities for sale. The agents in the primary network also maintain a secondary market in which already marketed obligations may be bought and sold an unlimited number of times.

Under certain circumstances, the Bank Board may authorize private placement of consolidated bonds or discount notes. In these cases, the obligations are sold to specific investors and are not offered to the public. Such transactions are normally placed through a securities dealer. Regardless of the kind of debt sold by the banks, approval for the sale must be obtained from the Bank Board, and, under the Government Corporation Control Act, from the Secretary of the Treasury.

The district banks' outstanding consolidated obligations may not exceed twelve times the aggregate of the district banks' capital stock and their reserves. And the district banks must secure their consolidated obligations with at least an equal amount of unpledged assets, consisting of a combination of cash; obligations of the United States or obligations that are guaranteed by the United States; secured advances to member institutions; and mortgages guaranteed or insured by the United States or an agency of the United States.

Consolidated obligations, then, are supported by the combined assets of the twelve district banks and, indirectly, by the assets of their member institutions. Although these instruments are not obligations of the United States and do not carry government guarantees, the instruments' solid financial backing means that they are considered exceptionally safe in the securities markets. Moreover, the tax status of district bank obligations is comparable with that of federal government securities. Income from district

bank securities is exempt from state and local taxation but is subject to federal taxes. (Gains from sale or other disposition of the obligations, as well as transfers by gift or inheritance, are subject to federal and state taxation.)

Bonds and discount notes, the two types of securities district banks use to raise capital, have different characteristics and are used to meet different credit needs.

*CONSOLIDATED BONDS.* To raise long-term funds, the district banks issue consolidated bonds whose maturities range from less than one year to twenty years. The district banks generally sell bonds once each month, subject to Bank Board and Treasury approval. The minimum bond issue is \$300 million for issues of less than five years, and \$200 million for longer issues. These are the minimum sizes required for eligibility for Federal Reserve purchases.

Interest on domestically issued consolidated bonds is paid semiannually, at rates somewhat higher than those offered on U.S. Treasury obligations. Bonds may be redeemed at any commercial bank that belongs to the Federal Reserve System, at a federal reserve bank, or at the U.S. Treasury.

*DISCOUNT NOTES.* The district banks issue discount notes to raise short-term funds. The banks sell discount notes as often as necessary, which means nearly every business day, subject to overall approval from the Bank Board and the U.S. Treasury.

Because the notes are discounted, investors buy them for less than their face amount and redeem them at par (face value) when they mature. The OF sets slightly higher rates on notes with maturities that coincide with the district banks' current needs. If, for example, the district banks wish to borrow money for 160 to 180 days, the Office of Finance offers its most attractive interest rates on notes in that maturity range and offers lower rates on notes of other maturities. Registered securities dealers described above conduct the actual sales to the public. Investors may redeem the notes at any commercial bank that belongs to the Federal Reserve System.

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## **Member Deposits**

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Deposits by member thrifts constitute the district banks' second largest source of funds. Under certain circumstances, the district banks may also accept deposits from institutions that are applying for federal home loan bank membership. And a district bank may accept deposits from another district bank.

Deposit accounts give member institutions a safe, interest-bearing form in which to hold their liquid assets. The accounts also afford the thrifts a convenient means of satisfying the Bank Board's liquidity requirements.

And the deposits can quickly be converted into cash to meet deposit withdrawal demands.

The Bank Board imposes reserve requirements on deposits in district banks, meaning that the district banks must hold a percentage of deposits in liquid form and not use the funds for long-term advances. Prior to 1975, the reserve requirement was stringent. Since 1975, the Bank Board has varied the percentage of deposits that must be held as reserves from zero percent to 50 percent. The reserve ratio thus has been issued as a tool for stimulating or discouraging the accumulation of member deposits as economic conditions warrant.

The kinds of deposit accounts offered vary from one district bank to another. In general, however, the district banks are authorized to offer four categories of accounts: demand deposits, overnight deposits, term deposits, and special series deposits.

*DEMAND DEPOSITS.* Demand deposit accounts permit member institutions to write checks on their deposits whenever they have to pay out money—when a thrift depositor withdraws funds from a savings account, for example, or when the institution makes a mortgage and must pay the amount of the loan to the person selling the property. Demand deposit accounts carry no withdrawal penalties and, since 1980, have generally earned interest.

*OVERNIGHT DEPOSITS.* When a member institution finds itself holding excess cash and does not want the funds to remain idle even for a few hours, the institution can place the funds in an overnight deposit account at the district bank. In this type of account, the thrift may withdraw the funds at any time. Normally, the interest rate on overnight deposits changes daily, although district banks may maintain an interest rate for longer periods. More funds are placed in overnight deposit accounts than in any other type of district bank deposit account.

*TERM DEPOSITS.* Accounts into which funds are deposited for a specified period of time are called term deposits. The depositing thrift receives a certificate of deposit that either is nonredeemable until maturity or is subject to an interest penalty upon early redemption. The maturities of most term deposits range from thirty days to one year, although some term deposits mature in as few as seven days or in as long as five years.

*SPECIAL SERIES DEPOSITS.* The special series deposit program, introduced in 1973, was designed to bring lenders and borrowers into direct contact by matching specific advances and deposits. Under this program, thrift institutions that have money to lend may negotiate the interest rate and other terms directly with institutions that wish to borrow money. The individual district banks serve as brokers: when the respective thrifts reach agreement, the district banks accept the deposits and issue the corresponding advances. The district banks also guarantee the loans' repayment and, thus, the safety

of the deposits, in exchange for small portions of the interest. Special series deposits count as liquid funds for the lending institutions. This program is more often used when interest rates are high.

## **Capital Stock**

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Sale of stock to thrifts constitutes the district banks' third greatest source of funds. Every institution that belongs to the Bank System must purchase stock in its district bank. Since the first issue in 1932, the price of the stock has remained \$100 per share. The Bank Board has the authority to raise (but not lower) the price of new stock issues.

The amount of stock a thrift is required to purchase is based on the amount of its investments in residential real estate financing and the amount of its borrowing from its district bank. The stock held by a member institution must equal at least 1 percent of the unpaid principal of loans the institution has made to finance residential real estate (including mortgages and mortgage-backed securities), calculated on the basis of an institution's portfolio at the end of each year. In addition, an institution must purchase more stock whenever its outstanding advances from a district bank exceed 20 times the amount of stock the institution holds in the district bank. Each institution must own a minimum of \$500 worth of stock. The dividend paid to shareholders varies from one year to the next and from one district bank to another, depending on economic conditions and the particular district bank's profitability.

Through the 1950s, sale of stock was a major source of funds for the district banks. Since then, the amount of funds raised through the sale of consolidated obligations has far outpaced the amount raised by selling stock. The excellent credit standing consolidated obligations have enjoyed in the capital markets, however, exists partly because of the large amount of outstanding district bank capital stock. Investors find security in the district banks' being owned by financial institutions that hold large portfolios of home mortgages, because mortgages traditionally are solid, safe investments.

## **Retained Earnings**

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A growing source of funds for district banks is the interest they receive on their accumulated earnings. The total retained earnings of district banks grew almost 200 percent through the 1950s, and grew at an even faster pace in the 1960s. Retained earnings quadrupled to nearly \$1 billion by the close of the 1970s and were nearly \$1.8 billion by the end of 1985.

Under the Federal Home Loan Bank Act, a district bank's first obligation

in apportioning its earnings is to transfer 20 percent of its net income into a legal reserve account. The district bank must make the transfers semiannually until the amount of reserves equals the amount of the bank's outstanding capital stock. Thereafter, 5 percent of the district bank's net income must be placed in its legal reserve account.

After transferring 20 percent of net earnings into the legal reserve account, the district banks use part of the remaining 80 percent to pay dividends to their stockholders. The rest is split between two other accounts, the dividend stabilization reserve and the undivided profits account.

District banks may use funds from the dividend stabilization reserve account to supplement dividend payments in years of low earnings. (Prior to 1978, the district banks could make dividend payments only from current year's earnings.) The Bank Board has, under special circumstances, let the district banks also use funds from the undivided profits accounts to help pay dividends.

The total amount of funds in the legal reserve, dividend stabilization reserve, and undivided profits accounts constitutes a district bank's retained earnings. The district banks often invest the funds in these accounts in short-term, liquid securities. Under federal law, the district banks are exempt from taxes on earnings because any income earned by the district banks strengthens the Bank System's ability to provide financing for home ownership.

## **Other Sources**

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Congress has given the Bank System access to lines of credit with the U.S. Treasury and the Federal Reserve System.

The Federal Home Loan Bank Act of 1932 authorized the Secretary of the Treasury to lend up to \$4 billion to the federal home loan banks by purchasing their consolidated obligations. The district banks drew on this line of credit for the first time in May 1974, when they raised \$1.6 billion and advanced it to the Federal Home Loan Mortgage Corporation, which used the funds to buy mortgages in an effort to stimulate a slack mortgage market. The district banks repaid the Treasury by early 1978.

Under a 1974 agreement, reaffirmed in 1981, between the Federal Home Loan Bank Board and the Board of Governors of the Federal Reserve System, the district banks also have access to an emergency line of credit with the federal reserve banks. There is no upper limit to this line of credit, but it is available only after the district banks have exhausted all other sources of funds, including the \$4 billion line of credit that can be arranged with the Treasury.

## USES OF FUNDS

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In creating the district banks in 1932, Congress's main intent was to help thrifts by providing them with the cash they needed. The federal home loan banks, therefore, use their funds primarily to advance loans to member institutions.

### Advances

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The Federal Home Loan Bank Board sets the overall policy governing advances. Within those federal guidelines, each district bank's board of directors is free to determine loan policies for its district.

The Federal Home Loan Bank Act of 1932 requires the district banks to offer advances authorized by the Bank Board. Each district bank also must apply loan criteria uniformly, without discrimination, but the district bank has the right to ration available funds and the right to turn down specific loan applications. The Bank Board reserves the right to approve individual advances (which it does automatically in practice), but the Bank Board cannot overturn a district bank's decision to reject an application for an advance.

Thrifts may use advances for a variety of purposes, such as to meet unexpected savings withdrawals, to make more mortgage loans than local savings can fund, or to obtain longer-term funds than available from deposits. The demand for advances closely follows economic conditions. For instance, the demand rises sharply during times of heavy withdrawals, which occurred in 1966, 1969, 1973–1974, and 1978 through 1982. The demand also rises when there is a sharp increase in consumer spending, especially spending on housing.

The time of year also affects the balance between savings deposits and mortgage demand. Savings volume traditionally drops off during the summer months, which is when mortgage demand generally reaches its yearly high. Finally, geography influences the savings-mortgage balance. New, rapidly expanding communities need more mortgage money than do older, well-established communities. Therefore, thrift institutions sometimes use their advances to purchase mortgage loans—or interests in loans, called participations—in locations outside their normal marketing area. Indeed, the advances themselves may be funded by deposits from institutions that, because of geography, season, or marketing ability, have accumulated excess savings funds. Advances, then, can help right the imbalances that occur between local savings and home mortgage lending, and between geographic areas with surplus savings and areas where mortgage money is in short supply.

In 1974, the Bank Board required the district banks to link the pricing of advances to prevailing market interest rates, and to insist on collateral for advances. The collateral could consist of first-lien mortgages, obligations of the U.S. government or guaranteed by the U.S. government, consolidated obligations of the district banks, time deposits in district banks, or participation certificates of the Federal Home Loan Mortgage Corporation.

At one time, the Bank Board required that all such collateral be physically delivered to the district banks. Currently, member institutions generally act as trustees for their district banks and simply hold the collateral in trust. The most common collateral arrangement is a blanket lien on all assets, followed by the segregation and listing of specific collateral. In some circumstances, a district bank may require that the institution physically transport the collateral to the district bank as a condition for granting an advance.

*SPECIAL PROGRAMS.* The district banks have participated in several special advances programs, such as the special series deposit program, that were designed to address particular needs. These special programs have included the offering of advances at below regular rates and advances earmarked for certain uses, such as the financing of housing for low- and moderate-income families.

### **Current Advances Policy**

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The Bank Board significantly revised its advances policy most recently in December 1982. These and subsequent changes returned to the district banks and their member thrifts several decisions on granting and using advances, and discarded many rigid constraints that had been imposed at the federal level. The revised policy emphasized two principal goals: preserving the district banks' long-term viability by maintaining adequate net worth and sufficient liquidity to meet the needs of member thrifts; and providing member thrifts with as broad a range of advance programs as is prudent, profitable, and practical.

*INTEREST RATES.* Under the new policy, district banks are to price advances to reflect actual conditions in the credit markets. For advances that mature in more than six months, the policy permits each district bank to set prices within specified ranges above the estimated costs of issuing new consolidated obligations. The range is intended to promote pricing uniformity among the district banks while giving them necessary flexibility in managing assets and liabilities.

Thrifts may borrow as much as is permitted by federal and state law—the Bank Board no longer limits a thrift's borrowing to a percentage of assets, but delegates limit-setting to the district banks—and they may borrow the

funds for up to 20 years. Restrictions on how member thrifts may use their advances have also been removed; thrifts may use advances for any sound, authorized business purpose authorized by their charters. And member thrift institutions may pay off their advances ahead of time, although there may be certain conditions, such as a fee, attached to the prepayment.

*FSLIC ADVANCES.* Early in 1983, the Bank Board authorized the district banks to make collateralized advances to the Federal Savings and Loan Insurance Corporation. The Bank Board also authorized the FSLIC to guarantee district bank advances to member thrifts experiencing financial difficulties.

*COMMITMENTS.* Under the new advances policy, the Bank Board authorized the district banks to offer commitments to advance specific amounts of money to member thrift institutions on specific future dates or within ranges of dates (usually up to 90 days). In this type of agreement, the interest rate may be fixed at the time the commitment is made, or it may be established at market levels on the date that funds are actually transferred to the borrower (takedown). Depending on the commitment's terms, the borrowers may or may not have the option to cancel the advance prior to the actual transfer of funds.

### **Interest Rate Swaps**

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The district banks are authorized to offer member institutions interest rate swap programs. These swaps are used as asset-liability management tools, mechanisms to reduce interest rate risk.

An interest rate swap is an agreement between two parties to exchange interest payments on an amount of funds (notional principal) for an agreed-on period of time. Each party to a swap is trying to match interest it receives on assets to interest it must pay on liabilities. Typically, one party agrees to make floating-rate payments tied to a specific short-term index, and the other party agrees to make fixed-rate payments set at the inception of the swap. Less frequently, the parties swap floating-rate interest payments that are tied to different indexes.

The district banks' interest rate swap programs, developed during 1984, made it possible for small thrift institutions to participate in the swap market. Before that, the normal swap offering of some \$5 million or more was far beyond the financial capacity of most smaller thrifts. The district banks, however, may enter into interest rate swap agreements with member institutions for notional principal amounts of as little as \$500,000. The district banks are also authorized to provide standby letters of credit to nonmembers on behalf of member thrift institutions that wish to enter into interest rate swap agreements on their own.

## CASH AND INVESTMENTS

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The district banks' cash on hand, their investments, and their demand deposits in other institutions constitute the district banks' operating funds and deposit reserves, collectively known as liquidity or liquid assets. Liquid assets provide cushions against deposit withdrawals by member savings institutions. They also can be used to supply funds for making advances to member thrifts and, as such, afford district banks some flexibility in timing their sales of discount notes and bonds in the capital markets.

The Bank Board restricts the type and average maturity of investments the district banks may hold. Prior to the 1970s, most district bank investments were in U.S. Treasury bills. Since then, the Bank Board has allowed the district banks to invest in obligations of the United States or federal agencies, obligations guaranteed by the United States or federal agencies, federal funds sold, resale agreements (repurchase agreements sold), bankers' acceptances, and commercial bank certificates of deposit. In practice, the majority of the funds are invested overnight in the federal funds market.

District banks' investments are grouped into two types of portfolios. Each district bank manages its own securities portfolio, which contains approximately 80 percent of its investments. The Office of Finance manages the District Banks' Consolidated Securities Fund, which contains the remaining 20 percent of each bank's investments.

Although the twelve federal home loan banks are bound by the same authority and under the same rules, they do differ according to the needs of the region they serve. Each bank is responsible to the Bank Board in its duties as supervisor and responsive to its members in its role as financier; as problems and opportunities change across the country, so too do the district banks' choices and decisions. But the federal home loan banks, with the Bank Board and the other elements of the Federal Home Loan Bank System, share a common purpose: to make home ownership possible.

# The Federal Savings and Loan Insurance Corporation

**Y**our Savings Insured to \$100,000." More than 100 million American savers trust these words and the guarantee they represent. The gold-and-black emblem indicating an institution's membership in the Federal Savings and Loan Insurance Corporation has symbolized safety since the insurance corporation's creation in 1934.

To the general public, the Federal Savings and Loan Insurance Corporation (FSLIC) is by far the most visible federal presence in the thrift institutions system. The FSLIC's primary mission is to ensure consumer confidence in thrift institutions by guaranteeing that insured savings will be available to depositors even if savings institutions become insolvent. And the FSLIC has succeeded. Despite periodic failures of savings institutions, no saver has ever lost a penny of FSLIC-insured deposits.

## **A Brief History**

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Congress created the FSLIC to restore the public confidence lost in the chaos and panic of the Great Depression, when many thrifts failed. The National Housing Act of 1934 established the FSLIC as a permanent government instrumentality and placed it under the supervision and authority of the Federal Home Loan Bank Board. President Roosevelt signed the legislation into law on June 27, 1934, and on September 29, 1934, the Bank Board approved insurance for the first ten savings associations to be covered.

The savings institutions industry initially resisted the new insurance. Although all federally chartered associations by law had to carry it, it was optional for state-chartered institutions, most of which initially refused to sign up for the insurance and the federal regulation that came with it. By mid-1936, only 237 state-chartered associations, along with 1,099 federally chartered associations, held FSLIC coverage. It was not until 1940 that half of all savings associations held FSLIC insurance, and not until 1951 that FSLIC-insured thrifts outnumbered non-FSLIC-insured thrifts.

The FSLIC began operations in 1934 with \$100 million in capital, which the FSLIC raised by selling its stock to the federal Home Owners' Loan Corporation (HOLC). When the HOLC was phased out in 1948, the FSLIC

stock was transferred to the Secretary of the Treasury. In 1950, the FSLIC began to buy back its stock, using 50 percent of its income each year for that purpose. By 1958, the FSLIC had repurchased all of its outstanding stock.

Today, although it receives some income from the earnings on its investment portfolio, the FSLIC receives its funding primarily from the insurance premiums it levies on insured institutions. In 1934, the initial premium rate was 0.25 percent of an institution's total deposits. The next year, the premium was reduced to 0.125 percent. Since 1950, each insured savings institution has paid a regular premium of approximately 0.083 percent of total deposits. In 1985, the Bank Board exercised its authority to make special premium assessments totaling as much as 0.125 percent of deposits per year, imposing quarterly assessments of approximately 0.031 percent of insured deposits in addition to the normal premium.

The amount of insurance coverage has gradually been increased. In 1934, the insurance limit per individual account was established at \$5,000 dollars. The limit was increased to \$10,000 in 1950, to \$15,000 in 1966, to \$20,000 in 1969, to \$40,000 in 1974, and to \$100,000 in 1980.

## Reserves

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The FSLIC's commitment to protect savers' deposits is backed by its reserve funds. As of December 31, 1985, the FSLIC's reserves totaled \$4.6 billion, or about 0.55 percent of the \$844 billion in deposits held by FSLIC-insured institutions. (Historically, the reserve ratio, or total FSLIC book reserves as a percentage of total deposits, has averaged 1.2 percent, peaking at 2.12 percent in 1970.)

The federal government directly supports the FSLIC's commitment to protect insured deposits. Congress restated this federal guarantee when, on March 16, 1982, it passed H.R. 290, a resolution "... reaffirming that deposits up to the prescribed coverage limits in federally insured depository institutions are backed by the full faith and credit of the United States." The FSLIC established a \$750 million line of credit with the U.S. Treasury in 1950 but had not used the line of credit as of the end of 1985. The FSLIC also may borrow from the district banks, which it did for the first time in 1984.

*SECONDARY RESERVE.* Of the \$4.6 billion in FSLIC reserves at the end of 1985, \$774 million was held in the secondary reserve.

Congress created the secondary reserve in 1961. During the 1950s, savings deposits had grown at an annual rate of 15 percent to 20 percent, but FSLIC reserves had grown much more slowly, and, by 1959, stood at only 0.63 percent of insured savings deposits. Public Law 87-210, which

took effect January 1, 1962, required each FSLIC-insured savings institution to pay an additional premium to the FSLIC. The law specified that when the combined primary and secondary reserves of the FSLIC reached 2 percent of the total amount of all savings accounts in insured institutions, the additional premium would be suspended and institutions could draw on what they had contributed to the secondary reserve to pay current premiums to the primary reserve. Prepayments to the secondary reserve would resume if combined FSLIC reserves dropped below 1.6 percent of savings.

Congress reduced the 1.6 ratio to 1.25 percent in 1973, and also halted payments to the secondary reserve. In 1974, Congress scheduled a ten-year payback of the secondary reserve, on the condition that the combined total of the primary and secondary reserves continue to exceed 1.25 percent of insurance deposits. In 1979, the reserve ratio fell below 1.25 percent and the payback was suspended, although interest continues to accrue.

### **When Institutions Fail**

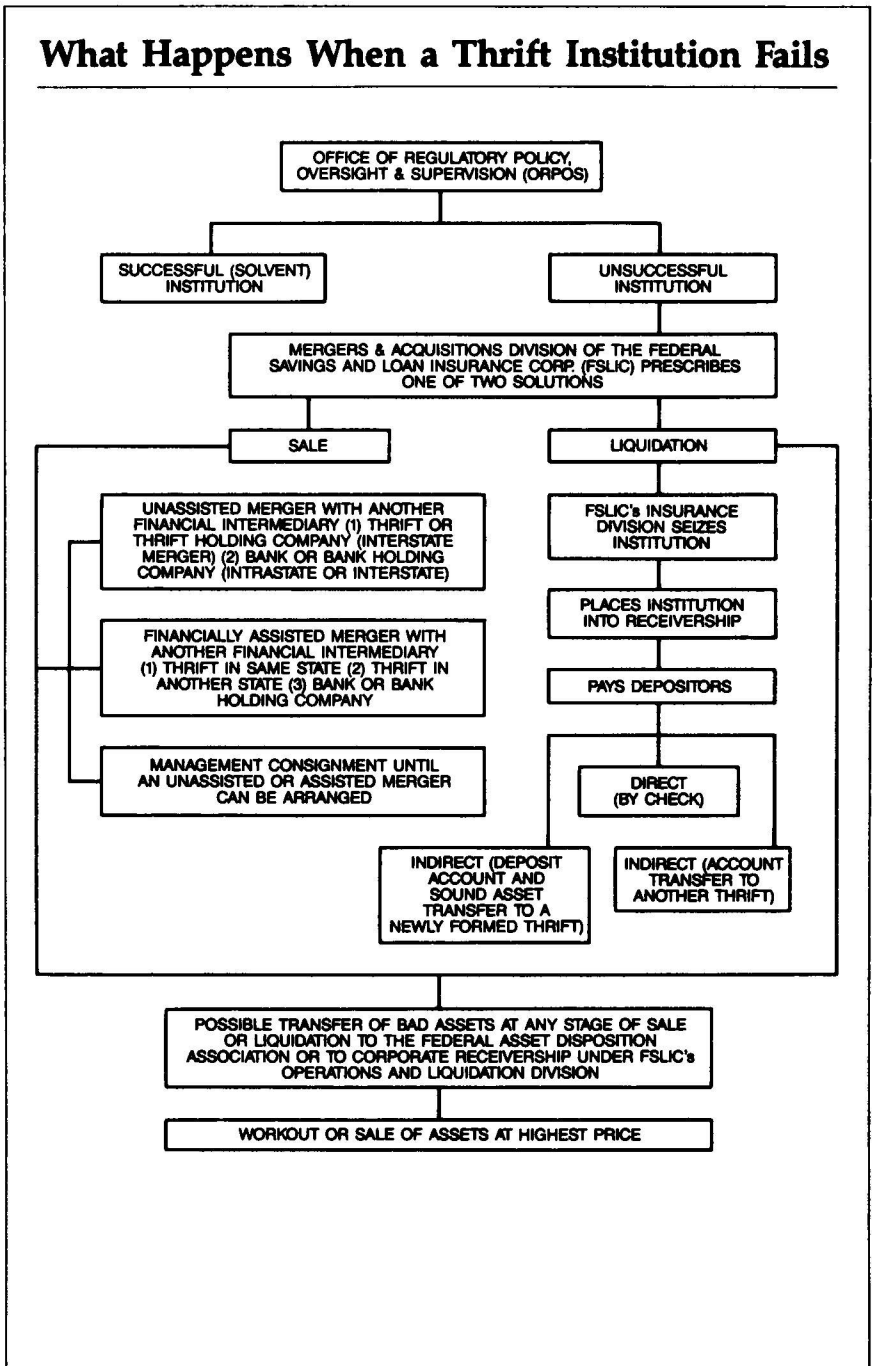
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To minimize losses to the insurance fund, the Federal Home Loan Bank Board, the Bank System's Office of Regulatory Policy, Oversight and Supervision, and the regulatory staffs of the federal home loan banks carefully monitor trends within the thrift industry, seeking to ensure that all thrifts operate in a safe and sound manner. Even with careful monitoring and regulation, however, some savings institutions cannot meet their debts. When this happens, the Federal Home Loan Bank Board declares the institution insolvent and places it in FSLIC receivership, transferring to the FSLIC the responsibility for managing the thrift.

Section 406(f) of the National Housing Act of 1934 empowers the FSLIC to use the least expensive way of carrying out its primary obligation of guaranteeing that depositors do not lose their insured savings. In particular, the FSLIC is authorized to provide loans or contributions to troubled institutions, or to acquire their assets or liabilities, as long as the estimated costs of doing so are lower than the costs of liquidating the institutions. The FSLIC can financially assist the merger of failed thrifts into other institutions or the acquisition or consolidation of institutions following their default. The FSLIC is also empowered to convert troubled institutions from mutual to stock ownership as a means of infusing new capital.

When a troubled FSLIC-insured thrift institution appears to be in imminent danger of default and requires financial assistance from the FSLIC as part of a supervisory arranged solution, the Office of Regulatory Policy, Oversight and Supervision calls on the FSLIC's Mergers and Acquisitions Division to devise a way of dealing with the problem thrift that minimizes

## What Happens When a Thrift Institution Fails



the cost to the insurance fund. The division works to make each solution fit the individual case. Sometimes, the division arranges for the FSLIC to pay a healthy institution to take over the failed institution (and all the problems that accompany it). Sometimes, the division arranges for the FSLIC to take over the failed institution's worst assets or to guarantee the acquiring institution a certain spread, or return, on those assets. And sometimes the division arranges for the FSLIC to indemnify the acquiring association against any losses that might arise out of lawsuits stemming from the merger or acquisition, or to reimburse the surviving institution for losses that might be uncovered as the failed institution's books are analyzed.

If a merger is the answer, the division tries to find a merger partner that is the same kind of financial intermediary (i.e., savings and loan association or savings bank) as the failed institution, and that is located in the same state. There have been times, however, when this has not been possible, and in May 1981 the Bank Board began allowing mergers and acquisitions by out-of-state institutions when no in-state partner could be found. In 1982, the Bank Board allowed the first FSLIC-assisted acquisition by a company outside the thrift industry.

As an alternative to arranging a merger or acquisition, the FSLIC may give direct financial assistance to the troubled institution. The sharp increase in problem cases that resulted from the abnormally high interest rates of the early 1980s led the FSLIC to develop the income capital certificate (ICC) program in 1981. Under this program, a problem thrift sells ICCs to the FSLIC, with an agreement that the institution eventually will buy them back. The FSLIC can pay cash for the ICCs, but is more likely to give the thrift a promissory note in which the FSLIC promises to pay a fixed amount of money at a specified future date, usually five years. In buying ICCs, the FSLIC acquires an equity interest in the institution, and the institution can list outstanding ICCs as part of its regulatory capital. At maturity, the FSLIC is obligated to pay the face amount of its promissory note or to negotiate another note. The institution, however, does not have to begin repaying its ICCs until it begins to earn profits.

The Garn-St Germain Depository Institutions Act of 1982 authorized distressed thrifts to issue net worth certificates (NWCs) to the FSLIC in exchange for the FSLIC's promissory notes. A thrift may use a promissory note in computing net worth, thus raising the thrift's capital level and buying time to strengthen the thrift's financial base.

In spring 1985, the FSLIC adopted a new technique for handling troubled savings institutions: the Management Consignment Program, which allows early intervention in situations where institutions' assets are being dissipated. Under the program, the FSLIC replaces an institution's management with new managers hired temporarily from other thrift institutions or other types of firms. The FSLIC may also provide financial assistance as the new

managers seek to keep the institution from deteriorating further.

The first question, then, when a thrift fails is whether the Mergers and Acquisitions Division can find an alternative to liquidation. If it can, and if the Bank Board approves, the case moves to the FSLIC's Financial Assistance Division, which oversees the implementation of the solution. But if the Mergers and Acquisitions Division can devise no solution other than liquidation, the case moves to the FSLIC's Insurance Division for payment of insured savings to depositors.

*INSURANCE DIVISION.* When FSLIC has no other choice but to liquidate a failed savings and loan association or savings bank, the Insurance Division seizes the institution and pays the depositors.

Seizure of a failed savings institution is a complex operation, which the Bank Board must carry out precisely and secretly. Secrecy is especially important, in order to avoid saver panic, last-minute maneuvers by the thrift's managers to better their own financial positions, or the destruction of records. At the moment of takeover, which usually occurs just before closing time, team members enter the insolvent institution's home office and all branch offices and present the institution's senior manager on the premises with the Bank Board's written order of seizure. The written order may appoint the FSLIC as receiver, to dispose of the institution, or it may appoint a conservator to conserve the institution's remaining assets until a permanent solution can be found. Normally, the Bank Board relieves the failed association's senior managers of their duties at once. Then, within minutes, the seizure team seals the doors, and federal officials explain what has taken place to the association's staff.

The managers of any institution that the FSLIC seizes are generally well aware of the institution's financial problems, because Bank Board officials typically have spent months or even years working with the institution's managers in an effort to resolve the problems. Nonetheless, the moment of actual takeover almost always comes as a shock to the institution—and to the community it serves. Today, if an association is seized on a Friday afternoon, its insured savings—including interest, which stops being paid on the day of seizure—will probably be available to depositors the next Monday morning.

Once the payout orders are drawn up, the Insurance Division returns funds to depositors either directly, issuing checks drawn on an account established at a federal home loan bank, or indirectly, providing funds through a third party in a technique called transfer of accounts.

Under the indirect method, the Insurance Division transfers the failed thrift's savings accounts to another insured savings institution (selected at a bidders' conference held just before or just after the failed thrift is seized). The Insurance Division pays the acquiring institution the dollar value of the insured funds, less a premium of a few percentage points that the acquiring

institution contributes. The transfer-of-accounts procedure offers a number of advantages to all parties. The acquiring institution may gain the savers from the failed institution as new customers; with them, it gains a new marketing area. The FSLIC saves the premium paid by the acquiring institution, and thus reduces the cost to the insurance fund. The savers receive immediate access to their accounts, up to the insurance limit, and can either keep their accounts open with the acquiring institution or withdraw their money. If the savers keep their accounts in place, the accounts retain their original interest rates and other terms. And, in many cases, the acquiring institution keeps the failed institution's office open, maintaining an important sense of continuity for the community.

In addition to the above methods of liquidation, the FSLIC has adopted a new technique—the asset-backed transfer. An asset-backed transfer is a variation of the transfer-of-accounts method whereby the FSLIC transfers the insured accounts to a newly created mutual thrift institution. To offset this liability on the new institution's balance sheet, the FSLIC purchases, at fair market value, the good assets from the closed institution and places them on the books of the new mutual association. The FSLIC may also purchase and transfer other good assets from any of its other receivership portfolios. It is expected that this infusion of good assets will make the new thrift more attractive to potential acquirers down the road. When appropriate real estate assets cannot be found in other receiverships, the FSLIC places cash or notes into the new mutual association. Nonperforming assets remain with the receivership for disposition.

### **Federal Asset Disposition Association**

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In every case, the FSLIC's primary concern is to minimize the cost to its insurance fund. One way of minimizing loss is to ensure that the assets that the FSLIC has been forced to take over are managed as well and liquidated as advantageously as possible. To that end, the Bank Board in November 1985 chartered the Federal Asset Disposition Association (FADA), a private company owned by the FSLIC. The FADA's board of directors includes some of the most highly respected leaders of the thrift industry; and its staff are expert, not only at the management of difficult assets, but also in the specialized art of handling the complex real estate workout negotiations that so many of these assets demand.

While it has a ten-year charter, FADA is committed to fulfilling its task in far less time through cost-effective operating efficiencies and by supplementing its staff of professionals with subcontractors in local markets. In addition to its headquarters in San Francisco, California, FADA has offices in Washington, D.C.; Denver, Colorado; Los Angeles, California; and

Atlanta, Georgia. Temporary offices are being established as needed in other cities as well.

The FADA's creation not only helps ensure that the FSLIC will receive the best possible return on the assets it has had to acquire, but also frees some of the FSLIC's limited resources for use in other areas of need. Fittingly, the FADA was created under provisions of section 406 of the National Housing Act of 1934—the same law that created the FSLIC. The FADA is meant to help ensure that the FSLIC's work of the past fifty years—insuring deposits while fostering home ownership—continues into the future.

# The Federal Home Loan Mortgage Corporation

A mortgage is a loan, secured by real property, that generates a monthly flow of interest and principal payments to its maker. In addition to being backed by property, a mortgage loan, itself, is property; like other valuable property, it too can be traded. A home owner may be able to pass the original mortgage agreement on to a new buyer, who assumes the mortgage and continues making the same kind of payments as the previous holder made. The original lender might sell an investor the mortgage and the right to collect interest and principal payments on it.

The market in which lenders sell mortgages to investors is called the secondary mortgage market. This market is the province of the Federal Home Loan Mortgage Corporation (FHLMC), more commonly known as Freddie Mac, and other mortgage traders.

## Market History

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The first formal secondary mortgage market emerged in 1938, when Congress created the Federal National Mortgage Association (FNMA), or Fannie Mae, initially as a subsidiary of the Reconstruction Finance Corporation. Fannie Mae began as a corporation wholly owned by the federal government but, in 1954, became a mixed corporation owned partly by the federal government and partly by private shareholders.

In 1968, Congress split Fannie Mae into two organizations. One part became a federally chartered private corporation, which retained the name Fannie Mae. Its mission was, and is, to purchase mortgages at interest rates that are competitive in the open market. The second part of the original Fannie Mae became a government-owned and -operated corporation called the Government National Mortgage Association (GNMA), or Ginnie Mae, which became part of the U.S. Department of Housing and Urban Development.

In February 1970, Ginnie Mae created the first publicly traded mortgage-backed pass-through securities. The securities, nicknamed Ginnie Maes, give investors proportionate undivided shares of pools of FHA or VA mortgages and provide income from the mortgage payments. Private

dealers sell the securities, and Ginnie Mae guarantees them.

Until 1970, Congress generally limited Fannie Mae to purchasing mortgages subsidized under programs administered by the Federal Housing Administration or the Veterans Administration. In 1970, Congress expanded Fannie Mae's authority so that the corporation could routinely purchase conventional mortgages as well. And that was the year that Congress passed the Emergency Home Finance Act of 1970, which created the Federal Home Loan Mortgage Corporation expressly to establish a secondary market for conventional mortgages. The chairman and the two members of the Federal Home Loan Bank Board were designated to serve as the chairman and directors of Freddie Mac.

Freddie Mac began its operations with \$100 million raised by selling nonvoting common stock to the twelve federal home loan banks. Since then, Congress has not authorized Freddie Mac to sell any additional common stock, and the district banks continue to hold all original shares. Although the price of each share remained fixed at its initial level of \$1,000, the corporation's capital base (including stockholders' equity, reserves for uninsured principal losses, retained earnings, and subordinated borrowings) grew from \$100 million in 1970 to \$1.99 billion by the end of 1985.

In 1981, the Federal Home Loan Mortgage Corporation began paying dividends on its common stock. In 1982, Congress authorized Freddie Mac to issue preferred stock, and in December 1984, Freddie Mac distributed 15 million shares of participating, preferred, nonvoting stock through the district banks to individual member savings institutions around the country. Each institution received stock in proportion to the amount of district bank stock it held, and in proportion to the amount of Freddie Mac common stock its district bank held. Although the preferred stock had a face value of \$10 per share, for a total offering of \$150 million, the market value was conservatively estimated at \$600 million, which thrifts could list as earnings. Furthermore, preferred stockholders received the right to the first \$10 million of future dividends declared by Freddie Mac and 90 percent of any dividends over that amount. The preferred stock began trading on the New York Stock Exchange on January 23, 1985, with trading limited to institutions that are members of the Federal Home Loan Bank System.

Although it is a corporate instrumentality of the United States, the Federal Home Loan Mortgage Corporation is not considered a federal agency. Its employees are not government employees, and it uses no tax funds. As a government instrumentality, it historically had been exempt from all federal, state, and local taxation. Legislation signed into law on January 18, 1984, however, repealed Freddie Mac's exemption from federal income tax, effective January 1, 1985. (The securities Freddie Mac sells continue to be subject to federal and state taxes.)

Initially, in 1970, Freddie Mac established twelve regional offices, many of which borrowed space and staff from the district banks. In 1975, the corporation reorganized its field operations into five regional offices, located in Los Angeles, Dallas, Chicago, Atlanta, and Arlington, Virginia. The corporation's headquarters will move to Reston, Virginia in August 1987.

### **Freddie Mac's Role**

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Freddie Mac buys mortgages from original lenders and sells investment securities backed by those mortgages. Freddie Mac's securities are more valuable than the original mortgages for several reasons. The securities are more liquid; they can easily be sold and traded in the financial marketplace. The securities are safer, because Freddie Mac guarantees them, and because any risk is spread over a large pool of mortgages. And the securities permit investment in mortgages without imposing the responsibility for collecting and servicing monthly payments.

By deciding what kinds of mortgages it will purchase, Freddie Mac has also influenced what kinds of loans primary lenders offer. In addition, in cooperation with Fannie Mae, Freddie Mac has introduced uniform legal documents and loan forms that have helped standardize the criteria used to evaluate the creditworthiness of loan applicants and the condition of property to be mortgaged. By the end of 1981, an estimated 80 percent of all conventional mortgages were originated on these standardized documents—a remarkable achievement in an industry that ten years earlier had nearly as many kinds of mortgage forms and underwriting standards as it had lenders.

### **Purchase Programs**

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Freddie Mac purchases either whole mortgages or participations in mortgages from savings and loan associations, savings banks, and other original lenders. It is not unusual for the corporation to purchase \$100 million worth of mortgages in a given day.

Freddie Mac is authorized to buy conventional home mortgage loans, second mortgages, and mortgages on manufactured homes that are principal residences of the borrowers. Freddie Mac can also buy FHA and VA home loans that are seasoned—that is, at least one year old. All loans that Freddie Mac purchases must meet its requirements concerning the condition of mortgaged properties and the creditworthiness of borrowers. New loans must be written on standardized forms approved by Freddie Mac, and loan

## Trading Mortgages for Cash in Secondary Markets



### LENDING INSTITUTIONS

- Thrifts
- Commercial banks
- Mortgage bankers



### SECONDARY MARKETS

- Private conduits
- FHLMC, FNMA, GNMA
- Mortgage broker-dealers
- Security dealers



### INVESTORS

- Thrifts
- Commercial banks
- Life insurance companies
- Pension funds



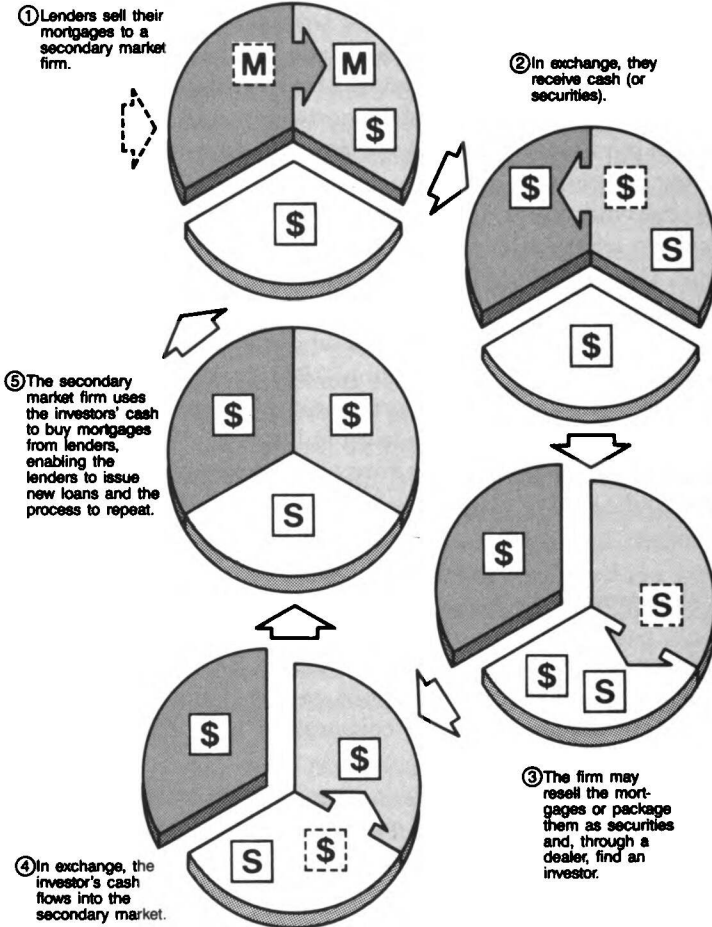
CASH



MORTGAGE



SECURITY



servicers must abide by Freddie Mac's rules for matters such as setting fees when the mortgage is assumed by a new home buyer.

By law, Freddie Mac may purchase a mortgage only if the loan amount does not exceed the limits established each year. In 1987, the dollar limits on loans were \$153,100 for a single-family dwelling; \$195,850 for a two-family dwelling; \$236,650 for a three-family dwelling; and \$294,150 for a four-family dwelling. (The mortgage limits are 50 percent higher for properties in Alaska, Hawaii, and Guam.) And the loan-to-value limits are 95 percent for one- and two-family units and 90 percent for three- and four-family units.

Lenders may arrange a commitment with Freddie Mac to sell loans already on their books as well as loans that have yet to be closed, and the lenders may take as long as 120 days to deliver the loans to Freddie Mac regional offices. Lenders may negotiate the terms of sale on very large mortgage pools (generally those in excess of \$10 million) through the regional offices, which process all loan sales.

Freddie Mac's loan-purchase programs offer savings and loan associations, savings banks, and other lenders several incentives for selling the mortgage loans they have made. The incentives include increased liquidity, reduced exposure to interest rate risk, higher yields, and increased profits.

- **Increased liquidity.** Rather than wait up to 30 years to get their money back, lenders can immediately convert illiquid mortgages to cash by selling them, thereby replenishing the lenders' supplies of lendable funds.

- **Reduced exposure to interest rate risk.** By turning over mortgage money rapidly, lenders can adjust the interest rates they charge on new mortgage loans, making them more closely match the rates the lenders must pay on savings and borrowed funds.

- **Higher yields.** When interest rates are rising, lenders can sell off their older, low-interest loans and reinvest in mortgages at higher interest rates. When rates are declining, lenders can reap the difference between the high interest rates the lenders collect from borrowers and the lower rates the lenders often pass on to Freddie Mac or other secondary market loan purchasers.

- **Increased profits.** By selling off mortgage loans in the secondary market and using those funds to originate new mortgages, lenders can generate additional origination fees, thereby increasing effective yields on their investment funds. Lenders also can continue to service the loans they sell and receive a fee from Freddie Mac for doing so.

Freddie Mac buys mortgages under two programs: the Standard Program, in which Freddie Mac pays cash for the mortgages it buys; and the Guarantor Program, in which the original lender swaps mortgages for an equal amount of Freddie Mac Participation Certificates (PCs). The choice of

whether to receive cash under the Standard Program or Participation Certificates under the Guarantor Program is the seller's.

## Sales Programs

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Freddie Mac sells its interest in most of the loans it buys, often within 24 hours. Freddie Mac sells its interests through securities that provide direct ownership of a portion of each mortgage in a pool, as in the case of Participation Certificates, or securities that are backed by the mortgages, as in the case of Collateralized Mortgage Obligations (CMOs). Freddie Mac uses the cash it receives from investors to buy still more mortgages. The sales program transforms illiquid mortgages, with payback schedules locked into place for many years, into liquid financial instruments that can be sold.

*PARTICIPATION CERTIFICATES.* Freddie Mac began selling Participation Certificates in 1971. The PC was the first pass-through security ever offered for conventional mortgages, although Ginnie Mae had created a pass-through security for FHA and VA mortgages one year earlier. As its name implies, a pass-through security passes monthly interest and principal mortgage payments through to the investor who buys the security.

An investor who purchases PCs secures an undivided interest in a specific group or pool of mortgages. In other words, an investor who purchases a PC owns a fixed percentage of every mortgage in the pool, and thus is entitled to a pro rata share of the unpaid principal balance of each mortgage. The investor receives monthly checks for the pro rata share of the principal and interest paid each month by the borrowers.

Participation Certificates pay investors fixed rates of interest, normally in increments of 0.25 percent. The PC rate is slightly less than that generated by the underlying pool of mortgages. Freddie Mac retains the difference, or spread, which is usually less than 0.50 percent. Typical PC purchasers include savings and loan associations, savings banks, commercial banks, pension funds, life insurance companies, credit unions, state and local governments, and corporations.

Freddie Mac guarantees the timely payment of interest at the stated rate, and the eventual full payment of principal. But Freddie Mac does not guarantee any set maturity for a PC, because the borrowers represented in the pool may pay off their mortgages early. Thus, although the holder of a PC is guaranteed payment of a pro rata share of the outstanding principal in the mortgage pool, nothing prevents that principal from being passed through to the PC holder faster than scheduled. For some investors, this inability to lock in a set yield for a predetermined number of years is a drawback. For this type of investor, Freddie Mac created another security, called a Collateralized Mortgage Obligation (CMO).

*COLLATERALIZED MORTGAGE OBLIGATIONS.* Unlike purchasers of PCs, investors who purchase CMOs do not buy ownership of the mortgages themselves. Instead, the investors buy bonds backed by pools of mortgages, the income from which is used to make payments on the CMOs. Thus, as its name implies, CMOs are obligations of Freddie Mac that are backed, or collateralized, by mortgages.

In addition to providing the high yields and safety of pass-through mortgage securities, the CMOs offer a limited form of call protection—that is, they are less likely than PCs to be paid off before they mature.

The call protection comes from the CMOs' structure. These securities comprise two or more classes of maturities, which are retired in sequence. All principal payments are first diverted to the CMO's class-one holders. No principal payments are made to any other classes until all class-one holders have been paid in full. When that occurs, say in three years, principal payments are made to class-two holders until their CMOs are retired, in perhaps five years. At that time, class-three CMO investors receive their principal payments, with a guarantee that their CMO bonds will be fully paid within, say, ten years, and so on. This allows investors to choose the terms of investment that most closely match their requirements.

For most classes, Freddie Mac makes interest payments throughout the life of the CMO, generally twice a year. But the longest-term class may be structured as an accrual class, whose CMO is similar to a zero-coupon bond. Under this scheme, holders accrue interest but do not receive it until all other classes of the CMO have been paid off. At that point, interest as well as principal payments begin.

Freddie Mac guarantees a minimum, or floor, payment to CMO holders that holds good even if the income from the underlying mortgage pool falls below the minimum payment amount. (This could happen if, for example, economic conditions in a particular region of the country were such that many people could not make their mortgage payments.) Purchasers include insurance companies, pension funds, commercial banks, and thrifts.

*GUARANTEED MORTGAGE CERTIFICATES.* Freddie Mac also is authorized to issue a security called a Guaranteed Mortgage Certificate (GMC). Like the CMO, the GMC is a bond-like instrument backed by a pool of mortgages and guaranteed by Freddie Mac. Investors own the GMC, not its underlying pool of mortgages. Freddie Mac makes principal payments annually and interest payments semiannually.

Unlike the CMOs, the GMCs are not divided into different maturity classes and thus do not offer the kind of call protection available with CMOs. Freddie Mac issued GMCs periodically from 1975 through 1979, selling a total of some \$2.95 billion of these securities.

### **Other Sources of Funds**

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In addition to selling PCs, CMOs, and GMCs, Freddie Mac is authorized to issue long-term debt in the form of debentures. Until the early 1980s, the corporation also participated in the sale of Federal Home Loan Bank System bonds; at the end of 1985, Freddie Mac's outstanding Federal Home Loan Bank System bond debt totaled \$1.2 billion. For short-term cash management, Freddie Mac may use reverse repurchase agreements, discount notes, and lines of credit from commercial banks.

In the first sixteen years of its existence, Freddie Mac has succeeded, through its securities, in drawing new capital into the housing markets. Like the federal home loan banks, Freddie Mac's operations also help redistribute capital from areas with a surplus to areas where the available money cannot meet mortgage demand. The corporation has become an important part of the Bank System, a strong support for home ownership in the United States.

# The Member Savings Institutions

**S**avings institutions are financial intermediaries, the crucial financial links between savers and home buyers. The individual thrifts form the foundation that supports the Federal Home Loan Bank System and much of U.S. home financing.

The Federal Home Loan Bank Act of 1932 provided Bank System membership for three types of mortgage-making financial intermediaries;

- *Savings and loan associations*, (also called building and loan associations, cooperative banks, and homestead associations), to accept deposits from savers and lend money for home mortgages.

- *Saving banks*, to accept deposits, make residential mortgages, and lend money for other types of real estate development, including commercial projects. Savings banks could also invest in high-quality corporate and government bonds and in stocks.

- *Insurance companies*, to take in premiums from policyholders and invest some of the money in residential financing.

Whatever their other functions, all three types of institutions have always shared a common characteristic—their investment in home ownership. The passage of the Garn-St Germain Depository Institutions Act of 1982 blurred the differences between federal savings and loan associations and federal savings banks. The legislation permitted the two types of institutions to engage in the same activities and allowed savings and loan associations to become savings banks, or vice versa, as long as federal supervisory agents did not object within 30 days of being notified.

Garn-St Germain also enlarged the scope of activities savings and loan associations and savings banks could undertake, allowing them to invest portions of their assets in financial services traditionally restricted to commercial banks. Thrifts may now make commercial, corporate, business, and agricultural loans; offer checking accounts; and issue consumer loans, educational loans, and nonresidential real estate loans, much as commercial banks do. Despite the new business opportunities for thrift associations, however, their principal activity remains home financing. The basic intent of the Garn-St Germain Act's provision for limited expanded powers is to allow savings institutions to diversify their asset portfolios and thereby strengthen their balance sheets against the next period of economic adversity.

## **Creating a Federal Thrift**

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Until 1933, the states chartered all thrift institutions. The Home Owners' Loan Act of 1933 gave the Bank Board the power to grant federal charters to savings and loan associations, and an amendment in 1978 extended this authority to allow the Bank Board to grant federal charters to savings banks.

A federal thrift institution may be created by converting an existing state-chartered institution to a federal charter, or by creating a new thrift, which requires an application by at least seven U.S. citizens who are of good character and who reside in the proposed institution's home state. Their application must show that the community to be served needs the proposed institution, that the institution has a reasonable probability of success, and that it would not cause undue injury to existing local thrift and home financing institutions. The application is first submitted to a district bank, with a final decision made by the Bank Board in Washington. Before it can open its doors, a new federal thrift must raise required amounts of capital, and obtain FSLIC insurance.

Between 1933 and the end of 1985, the number of federally chartered thrifts (savings and loan associations and savings banks) in the Bank System grew to 1,756, or 50.4 percent of all the thrifts that belong to the Bank System. The remaining 1,731 thrifts had state charters. Among FSLIC-insured institutions, the federally chartered thrifts tend to be larger than the state-chartered thrifts. Of the \$843.9 billion in deposits held by all thrift institutions insured by the FSLIC at the end of 1985, federally chartered thrifts held about \$539.2 billion, or 63.9 percent.

## **Bank System Membership**

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The primary qualification for membership in the Federal Home Loan Bank System has always been the making of long-term mortgages, and most thrifts join. The organization and management of member thrifts must meet relevant legal requirements, and the thrifts are subject to regular state or federal inspection and regulation.

Federal law requires federally chartered savings and loan associations to carry FSLIC insurance and to belong to the Bank System. Some states require FSLIC insurance for their state-chartered institutions, but other states allow thrifts to choose whether to join the Bank System and whether to accept FSLIC deposit insurance. (The FSLIC will not insure institutions that are not members of the Federal Home Loan Bank System.) Federally chartered savings banks that belong to the Bank System have deposit insurance from either the FSLIC or the Federal Deposit Insurance Corporation.

## Organization

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Savings and loan associations and savings banks may be organized either as mutuals or as stock companies, which differ in ownership.

*MUTUAL INSTITUTIONS.* Mutual institutions are mutually owned by all of the institution's savers and borrowers, who elect the institution's board of directors. Traditionally, a saver is entitled to one vote for every \$100 or fraction thereof in savings, and a borrower is entitled to one vote. In practice, most depositors and borrowers have no desire to vote or attend the institution's annual meeting, so when they first do business with the institution, most individuals sign proxies authorizing the institution's management to exercise their voting rights. Savers and borrowers may revoke such proxies at any time.

Throughout most of the thrift industry's history, savers were called shareholders rather than depositors. Every time savers put money into a mutual thrift institution, they technically bought shares in the association. Periodically, the institution declared dividends on the shares. To the savers, these earnings looked just like interest, but legally they were dividends.

This practice changed in the late 1960s. The Housing and Urban Development Act of 1968 authorized all federally chartered savings and loan associations to offer deposit accounts, rather than share accounts, to savers. Federally chartered institutions began offering deposit accounts on June 1, 1969. Over the years, most states also passed laws allowing state-chartered thrifts to offer deposit accounts.

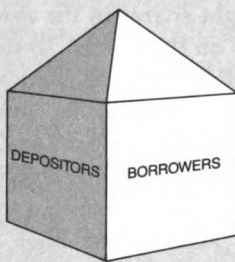
To savers, the change from share accounts to deposit accounts was hardly noticeable; earnings were earnings, whether labeled interest or dividends. Although, under the new legislation, depositors earned at stated interest rates and technically owned the mutual companies, the depositors did not receive shares of the companies' profits. Legally, however, savers gained one important advantage: they were guaranteed a known rate of return.

*STOCK INSTITUTIONS.* Stock thrift institutions belong to persons who buy stock in the corporation and who may or may not be depositors or borrowers; ownership of stock is not a condition for doing business with the institution. Stockholders may receive a share of the institution's earnings in the form of a dividend, determined by the size of the firm's overall profits.

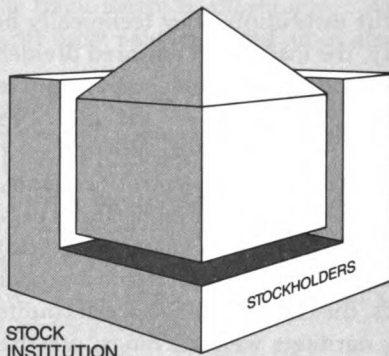
The Garn-St Germain Act permitted new thrift institutions to receive federal charters and organize as stock corporations. Previously, all new federally chartered savings and loan associations had to begin as mutual companies, and most stock associations had been state-chartered. The 1982 legislation also made it easier for a federally chartered mutual thrift to convert to stock ownership (or vice versa), although the institution had to obtain the FSLIC's approval and to offer the new stock first to the thrift's current owners—that is, to its depositors and borrowers.

**HOLDING COMPANIES.** The Bank Board defines a holding company as a corporation, partnership, or similar entity that controls a FSLIC-insured institution, usually by owning, or holding, more than 25 percent of its voting stock. A holding company may own one or more savings and loan associations or savings banks, provided, normally, that they are in the same state as the holding company. (Holding companies also may own other types of companies, but holding companies that have more than one subsidiary with FSLIC account insurance may own only companies that are in lines of business related to the thrift industry.) A holding company must have Bank Board approval to acquire thrift institutions, and the Bank Board

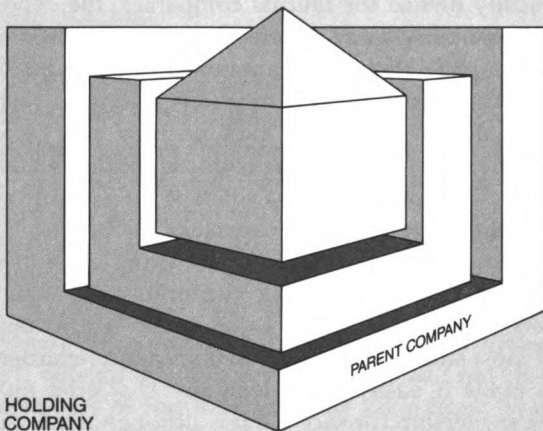
### Three Forms of Thrift Institution Ownership



MUTUAL INSTITUTION



STOCK INSTITUTION



HOLDING COMPANY

then regulates the holding company as well as its subsidiary thrifts. A relatively small number of thrift institutions are owned by holding companies, and most thrift holding companies are located in California, Texas, and Ohio.

*SERVICE CORPORATIONS.* A thrift institution may itself own one or more subsidiary companies, called service corporations. Service corporations may belong to a single parent company or to several parent companies. Many were originally formed to offer financial services that the law prohibited the parent institutions from offering directly. Bank Board regulations govern the operation and permissible activities of service corporations and limit the percentage of assets that a federally chartered thrift institution can invest in its one or more service corporations.

*MERGERS.* One way a thrift institution can grow is to merge with another institution, and voluntary mergers are fairly common. FSLIC-insured thrift institutions that wish to merge must obtain approval from the Bank Board. The Bank Board or, in a routine case, a principal supervisory agent at a district bank, must determine that the proposed merger would not create a monopoly or otherwise violate antitrust laws, and that the merging institutions are in compliance with the Community Reinvestment Act and Bank Board regulations.

*BRANCH OFFICES.* Branching is one area in which thrift institutions have an advantage over commercial banks in some states. Under federal law, a national (federally chartered) bank cannot open branches if it is located in a state that bans branches for state banks. But there is no comparable federal law concerning federal thrift institutions—the Bank Board decides where and when to permit federal thrift associations to open branch offices. With approval, federal thrift institutions may establish branches anywhere within their home states. Crossing state lines to open branches is allowed for federal thrifts only if they are located in a state that permits interstate branching for its state-chartered thrifts, or in cases where thrifts—with Bank Board approval—take over failing institutions in other states. State-chartered savings and loan associations, however, must apply to state authorities, not the Bank Board, for permission to open new branches, even if the institutions are members of the Bank System or have FSLIC insurance.

## **Regulation**

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Despite deregulation, the federal laws and regulations governing savings and loan associations and savings banks fill a book more than three inches thick. The rules tell an institution everything from how it may advertise to how much it may lend its top officers. The rules are numerous and complex, and different ones apply to different classes of institutions.

Authority to regulate thrift institutions stems primarily from three statutes. The Federal Home Loan Bank Act of 1932 authorized limited Bank Board regulation of institutions that became members of one of the twelve district banks (and thus members of the Bank System). The Home Owners' Loan Act of 1933 gave the Bank Board broad authority over federally chartered institutions. And the National Housing Act of 1934 provided for limited Bank Board regulation of institutions insured by the FSLIC. Roughly 92 percent of all operating savings and loan associations come under some Bank Board jurisdiction.

Because Bank Board regulations are based on legislated authority, they fall into three primary categories. Regulations that apply to federally chartered institutions are called federal regulations; regulations that apply to FSLIC-insured institutions are called insurance regulations; and regulations that apply to federal home loan bank member institutions are called Bank System regulations. Additional regulations include general regulations, holding company regulations, and several other types. Among the most important are those that deal with liquidity, net worth, and interest rates.

*LIQUIDITY.* Each thrift institution must keep a portion of its assets in liquid form, that is, in cash or in a form that can easily be converted into cash. Federal law directs the Bank Board to determine a minimum required level of liquid assets within a range of 4 percent to 10 percent of a thrift institution's liquidity base (the sum of all savings deposited with the institution, less the unpaid balance of any loans secured by those savings plus short-term borrowings). In practice, the required rate has fluctuated between 5 percent and 7.5 percent.

An institution may use a wide range of assets, generally with maturities of up to five years, to meet its liquidity requirements. Assets that qualify (as long as they are not pledged as collateral) include cash; U.S. government securities; securities of federal agencies; demand deposits and time deposits at federal home loan banks, commercial banks, and thrift institutions that are members of the Bank System; bankers' acceptances; general obligations of state and local governments; certain commercial paper and corporate debt securities; certain mutual funds; eligible liquid assets, which are held subject to repurchase agreements; accrued interest on liquid assets; unsecured federal funds; and certain federally guaranteed public housing authority notes.

Since 1972, the Bank Board has also required institutions to maintain minimum levels of short-term liquid assets. The same kinds of securities that may be used to meet the regular liquidity requirements also qualify for the short-term liquidity needs, except they must mature in no more than six months, or, for obligations of the United States or its agencies, no more than twelve months.

*NET WORTH.* Net worth is the value of a thrift's total assets less its total liabilities, or the amount of money that would remain if the institution paid all its obligations in full. All thrift institutions that carry FSLIC insurance must maintain specified levels of net worth. The Bank Board adjusts the net worth requirements from time to time to meet changing economic conditions, generally relaxing them when the industry as a whole experiences severe economic pressure.

Such was the case in the early 1980s, when the thrift industry struggled to survive high and volatile interest rates. In response, the Bank Board in 1980 lowered the minimum net worth requirement to 4 percent of liabilities plus 20 percent of scheduled items (loans with payments in arrears). In 1982, the Bank Board further reduced the net worth requirement to 3 percent of liabilities and set the minimum reserve requirement at 3 percent of insured accounts.

As the thrift industry regained financial health, the Bank Board moved to increase the minimum level of capital that institutions must maintain as a cushion against possible losses. In January 1985, the Bank Board directed that institutions that engage in high-risk, fast-growth operations must maintain higher levels of net worth—up to 5 percent of new liabilities. Beginning January 1, 1987, the Bank Board began phasing in higher net worth requirements for all institutions, gradually raising minimum net worth (which the Bank Board renamed "regulatory capital") from 3 percent to 6 percent of an institution's liabilities.

The Bank Board ruled that the length of the phase-in period was to be determined by the overall profitability of the thrift industry—higher profits resulting in faster increases in required regulatory capital. The Bank Board anticipated that the phase-in period would last from six to twelve years. All increases in an institution's liabilities after January 1, 1987, were to be immediately capitalized at 6 percent. To encourage prudent thrift management and to minimize claims against the FSLIC insurance fund, the Bank Board ruled that the required regulatory minimum capital can be reduced somewhat for institutions that reduce their interest rate risk (the risk that they will have to pay more on liabilities than they earn on assets). The required capital level can be increased for those institutions that have higher-than-average-risk investments.

An institution's regulatory net worth, or regulatory capital, may or may not be the same as its net worth measured under generally accepted accounting principles (GAAP), as established by the accounting industry's Financial Accounting Standards Board. The Bank Board may permit, under regulatory accounting principles (RAP), accounting procedures not sanctioned under GAAP. The Bank Board uses these accounting procedures to achieve certain policy objectives, such as helping the thrift industry build up its capital base.

*INTEREST RATES.* Until 1966, thrifts had been free to pay whatever interest rate they chose on savings. By contrast, commercial banks and savings banks insured by the FDIC had been subject to interest rate ceilings since 1933.

The Interest Rate Adjustment Act of 1966 empowered the Bank Board to establish interest rate ceilings on various types of accounts at thrift institutions. The act left it to federal financial regulators to decide whether to establish an interest rate differential between thrifts and commercial banks—and in fact, such a differential was in effect from 1966 to 1983. (Congress incorporated the existing differential in the Home Mortgage Disclosure Act of 1975.) While it lasted, the differential helped thrifts to compete with banks by permitting thrifts to pay slightly higher rates for savings.

The end of interest rate restrictions advanced with the Depository Institutions Deregulation and Monetary Control Act of 1980. That act established the Depository Institutions Deregulation Committee (DIDC), composed of the Secretary of the Treasury, the Comptroller of the Currency, and the chairmen of the Federal Home Loan Bank Board, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration. The DIDC's deregulatory mandate was to phase out interest rate ceilings by 1986; the last federal restrictions on deposit interest rates ended in March 1986.

## **Taxation**

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Section 7701(a)(19) of the Internal Revenue Service Code, as amended by the Tax Reform Act of 1986, provides a special tax deduction, called the bad-debt deduction, for savings and loan associations and savings banks. To qualify for the deduction, a thrift institution must meet certain tests, including having 60 percent of its assets invested in financing home ownership or such other qualifying assets as mortgage-backed securities, cash, certain government obligations, student loans, and so-called passbook loans.

An institution that invested 60 percent or more of its assets in qualifying assets could shield 8 percent of its income from tax liability. The institution need not experience actual losses of this amount.

Once it determines the amount to deduct, the thrift places that money in a reserve fund, which the thrift may then use only to reimburse itself for losses suffered in foreclosures. The annual deduction may not increase the institution's reserve fund to more than 6 percent of the outstanding principal balance in its mortgage loan portfolio.

## Sources of Funds

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Like most financial institutions, savings and loan associations and savings banks conduct most of their business using other people's money—money borrowed from savers who deposit funds with the institution and money from lenders who provide funds in the form of loans and advances or who purchase the securities the institution sells. All of these borrowed funds count as liabilities for the institution, because the thrift is liable for paying them back.

By far the biggest source of funds is deposits, which accounted for \$843.9 billion, or 82.5 percent of the more than \$1.0 trillion in aggregate thrift liabilities at the end of 1985. The more common deposit accounts offered by thrifts include passbook (or statement) accounts, money market deposit accounts, negotiable order of withdrawal accounts, and certificates of deposit.

When a thrift institution needs more money than is supplied by deposits, it borrows, often from its district federal home loan bank. A thrift can also secure funds by selling stock, selling mortgage loans or mortgage-backed securities, and selling commercial paper. And a sizable amount of funds flows into thrifts each month, as customers make payments on mortgages and other loans. Thrifts also generate income from retained earnings; various reserve funds; profits from operations of service corporations; and interest on funds deposited with district banks, commercial banks, or other thrift institutions.

## Uses of Funds

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Thrift institutions use their funds primarily to finance home ownership, both through construction loans allowing builders to erect housing and through mortgages allowing buyers to purchase housing. Outstanding loans are considered part of a thrift institution's assets, because they are investments placed with borrowers that are expected to be repaid with interest.

Nearly all mortgages written in the early 1980s by thrifts have been conventional loans, that is, loans not insured or guaranteed by an agency of the U.S. government. During 1985, for example, 97.6 percent of the dollar amount of mortgages originated by savings and loan associations for one-to four-family dwellings was in conventional loans, 1.2 percent was guaranteed by the Veterans Administration, and 1.2 percent was insured by the Federal Housing Administration.

For years, thrifts relied on the long-term, fixed-rate, fully amortized (paid off) mortgage. But the fixed-rate mortgage crippled the thrift industry in the early 1980s, as the deregulated interest rates that institutions paid out on savings rose far higher than the fixed interest rates they earned on the

mortgages they held.

So that thrifts could better match mortgage (asset) rates and maturities with the rates and maturities of their deposits (liabilities), and so that borrowers could afford mortgages at a time of unusually high interest rates, the Bank Board in the early 1980s authorized thrift institutions to offer a wide assortment of mortgages. Many of these mortgages were variations of the adjustable-rate mortgage (ARM), under which the interest rate rises or falls depending on a national or regional financial index. Today's mortgages often combine features from several of the common types of mortgage loans.

Some 65 percent of American households own their own homes, and thrift institutions financed more than 40 percent of those homes. The thrift industry thus holds a special place, not only in the U.S. financial industry, but also in the lives of the nation's citizens. Home ownership has been an American ideal from the beginning—and from the beginning, thrift institutions have helped to make that ideal reality.

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# APPENDIXES

Appendix A

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## Addresses and Telephone Numbers

### FEDERAL HOME LOAN BANK SYSTEM

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#### **Federal Home Loan Bank Board**

1700 G Street, N.W.  
Washington, D.C. 20552  
Telephone: 202/377-6000

#### **Federal Savings & Loan Insurance Corporation**

1700 G Street, N.W.  
Washington, D.C. 20552  
Telephone: 202/377-6000

#### **Office of Finance, Federal Home Loan Banks**

655 15th Street, N.W., Suite 850  
Washington, D.C. 20005  
Mail: P.O. Box 28323  
Washington, D.C. 20038  
Telephone: 202/272-4900

#### **Office of Regulatory Policy, Oversight and Supervision**

900 19th Street, N.W., 6th floor  
Washington, D.C. 20006  
Telephone: 202/887-0145

#### **Federal Asset Disposition Association**

One Market Plaza  
Spear Street Tower, 38th floor  
San Francisco, California 94105  
Telephone: 415/543-3232

**FHLB System Publication Corporation**

655 15th Street, N.W., Suite 510  
Washington, D.C. 20005  
Telephone: 202/272-4800

**FHLB System Office of Education**

580 Decker Drive, Suite A-1-101  
Irving, Texas 75062  
Telephone: 214/258-0464

**Neighborhood Reinvestment Corporation**

1325 G Street, N.W., Suite 800  
Washington, D.C. 20005  
Telephone: 202/376-2400

**Federal Home Loan Mortgage Corporation**

1776 G Street, N.W.  
Washington, D.C. 20013  
Telephone: 202/789-4700

**FEDERAL HOME LOAN BANKS**

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**Federal Home Loan Bank of Boston**

One Financial Center, 20th Floor  
Boston, Massachusetts 02111  
Mail: P.O. Box 9106 GMF  
Boston, Massachusetts 02205-9106  
Telephone: 617/542-0150

Connecticut  
Maine  
Massachusetts  
New Hampshire  
Rhode Island  
Vermont

**Federal Home Loan Bank of New York**

One World Trade Center, Floor 103  
New York, New York 10048  
Telephone: 212/912-4600

New Jersey  
New York  
Puerto Rico  
Virgin Islands

**Federal Home Loan Bank of Pittsburgh**

One Riverfront Center  
20 Stanwix Street  
Pittsburgh, Pennsylvania 15222-4893  
Telephone: 412/288-3400

Delaware  
Pennsylvania  
West Virginia

**Federal Home Loan Bank of Atlanta**

1475 Peachtree Street, N.E.  
 Atlanta, Georgia 30309  
 Mail: P.O. Box 105565  
 Peachtree Center Station  
 Atlanta, Georgia 30348  
 Telephone: 404/888-8000

Alabama  
 District of Columbia  
 Florida  
 Georgia  
 Maryland  
 North Carolina  
 South Carolina  
 Virginia

**Federal Home Loan Bank of Cincinnati**

2000 Atrium II  
 221 East Fourth Street  
 Cincinnati, Ohio 45202  
 Mail: P.O. Box 598  
 Cincinnati, Ohio 45201  
 Telephone: 513/852-7500

Kentucky  
 Ohio  
 Tennessee

**Federal Home Loan Bank of Indianapolis**

1350 Merchants Plaza, South Tower  
 115 West Washington Street  
 Indianapolis, Indiana 46204  
 Mail: P.O. Box 60  
 Indianapolis, Indiana 46206-0060  
 Telephone: 317/631-0130

Indiana  
 Michigan

**Federal Home Loan Bank of Chicago**

111 East Wacker Drive, Suite 800  
 Chicago, Illinois 60601  
 Telephone: 312/565-5700

Illinois  
 Wisconsin

**Federal Home Loan Bank of Des Moines**

907 Walnut Street  
 Des Moines, Iowa 50309  
 Telephone: 515/243-4211

Iowa  
 Minnesota  
 Missouri  
 North Dakota  
 South Dakota

**Federal Home Loan Bank of Dallas**

500 E. John Carpenter Freeway  
 Irving, Texas 75062  
 Mail: P.O. Box 619026  
 Dallas/Ft. Worth, Texas 75261-9026  
 Telephone: 214/659-8500

Arkansas  
 Louisiana  
 Mississippi  
 New Mexico  
 Texas

**Federal Home Loan Bank of Topeka**

No. 3 Townsite Plaza  
120 East 6th Street  
Topeka, Kansas 66603  
Mail: P.O. Box 176  
Topeka, Kansas 66601  
Telephone: 913/233-0508

Colorado  
Kansas  
Nebraska  
Oklahoma

**Federal Home Loan Bank of San Francisco**

600 California Street  
San Francisco, California 94108  
Mail: P.O. Box 7948  
San Francisco, California 94120  
Telephone: 415/393-1000

Arizona  
California  
Nevada

**Federal Home Loan Bank of Seattle**

1501 4th Avenue  
Seattle, Washington 98101-1693  
Telephone: 206/340-2300

Alaska  
Hawaii  
Idaho  
Montana  
Oregon  
Utah  
Washington  
Wyoming  
Guam  
Pacific Islands

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**Appendix B**

**Legislative Milestones**

**1932 Federal Home  
Loan Bank Act**

Established the Federal Home Loan Bank System—the Bank Board and district banks—to serve as a reserve credit system for member savings and loan associations, savings banks, and life insurance companies.

**1933 Home Owners'  
Loan Act**

Permitted granting of federal charters to savings and loan associations; established the Home Owners' Loan Corporation, allowing lending institutions to exchange delinquent mortgages for Home Owners' Loan Corporation bonds.

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<b>1934 National Housing Act</b>	Established the Federal Savings and Loan Insurance Corporation to insure savings accounts and to prevent default of insured institutions.
<b>1964 Housing Act</b>	Permitted federally chartered associations to offer unsecured loans for educational expenses, the first time federally chartered thrift institutions had been authorized to lend money for purposes other than real estate financing. Expanded the area in which an institution could lend from a radius of 50 miles to 100 miles from the institution's main office. Permitted associations to purchase securities issued by federal agencies, states, and municipalities.
<b>1966 Interest Rate Adjustment Act</b>	Allowed the Federal Home Loan Bank Board to establish ceilings on interest rates paid by member institutions on various types of savings accounts.
<b>1966 Financial Institutions Supervisory Act</b>	Required immediate compliance by thrift institutions with cease and desist orders issued by the Bank Board to correct unsafe or unsound practices of the institution. The act also authorized the Bank Board to remove officers and directors of associations which engage in such practices, or which violate law or federal regulation.
<b>1968 Consumer Credit Protection Act (Truth in Lending) (Regulation Z)</b>	Required lenders to disclose to borrowers all terms of credit arrangements, including the cost of financing over the life of a loan.
<b>1968 Housing Act</b>	Amended the charter of the Federal National Mortgage Association (FNMA) to turn the former government agency into a private organization to purchase mortgages in the secondary market. The act transferred FNMA's housing subsidy function to the newly formed, government-owned Government National Mortgage Association.

**1968 Housing and Urban Development Act**

Gave federally chartered associations the authority to invest in mobile home and home equipment loans. The law also permitted federal associations to issue a wide variety of savings plans, notes, bonds, and debentures.

**1970 Emergency Home Finance Act**

Created the Federal Home Loan Mortgage Corporation to increase the supply of funds for housing. The corporation established and fostered a secondary market for conventional mortgages, allowing new mortgages to be made with funds from the sale of existing mortgages. The act also permitted federally chartered savings and loan associations to make loans anywhere in their home states.

**1974 Equal Credit Opportunity Act (Regulation B)**

Prohibited discrimination in credit transactions on the basis of sex, marital status, race, color, religion, national origin, receipt of public assistance benefits, or the borrower's good faith exercise of rights under the Consumer Credit Protection Act.

**1974 Real Estate Settlement Procedures Act**

As amended in 1976, the act required lenders to inform loan customers in advance of the total estimated charges to be assessed in granting mortgages.

**1975 Home Mortgage Disclosure Act**

Required most depository institutions to disclose to the public the number and dollar amount of mortgage loans they originate or buy in each census tract.

**1977 Community Reinvestment Act**

Required financial institutions to meet the credit needs of all segments of their communities, including low- and moderate-income neighborhoods.

**1978 Financial Institutions Regulatory and Interest Rate Control Act**

Gave the Federal Savings and Loan Insurance Corporation (FSLIC) an important new tool in dealing with insolvent thrift institutions. The act authorized the FSLIC to contribute financial assistance in arranging the merger or acquisition of a failed institution by a strong institution.

**1978 Housing and  
Community  
Development Act**

Created the Neighborhood Reinvestment Corporation which institutionalized the development of Neighborhood Housing Services programs begun by the Urban Reinvestment Task Force to revitalize decaying neighborhoods.

**1980 Depository  
Institutions  
Deregulation  
and Monetary  
Control Act**

Created the Depository Institutions Deregulation Committee made up of the heads of the federal financial regulatory agencies. The committee was charged with phasing out ceilings on all interest rates offered by financial institutions, by 1986.

**1982 Garn-  
St Germain  
Depository  
Institutions Act**

Gave the Federal Savings and Loan Insurance Corporation new power to deal with financially troubled institutions, including the authority to overrule state authorities in seizing insolvent, state-chartered, FSLIC-insured institutions, and if necessary, to merge them with out-of-state institutions. Authorized an emergency federal assistance program to help qualifying FSLIC-insured institutions survive a period of severe economic pressure. Removed all differences between savings and loan associations and savings banks in the kinds of business activities in which they may engage. Permitted thrift institutions to offer checking accounts, business, agriculture, and consumer loans, and a money market deposit account with a floating market rate of interest to attract savings. Ended the interest rate differential under which thrift institutions had been authorized since 1966 to pay a slightly higher interest rate than commercial banks.

## Members of the Federal Home Loan Bank Board

	Name	Tenure on the Board
<b>MEMBERS OF THE FEDERAL HOME LOAN BANK BOARD</b>	1. John M. Gries (R)	8/32-3/33
	2. William E. Best (R)	8/32-3/33
Federal Home Loan Bank Board, July 22, 1932, to February 24, 1941 (five members; six-year terms)	3. Franklin W. Fort (R) Chairman 8/32-3/33	8/32-3/33
	4. Nathan Adams (D)	8/32-11/32
	5. Morton Bodfish (D)	8/32-3/33
	6. William F. Stevenson (D) Chairman 3/33-11/33	3/33-7/38
	7. T.D. Webb (D)	3/33-2/42
	8. Carroll B. Merriam (R)	4/33-6/33
	9. Russell Hawkins (R)	6/33-1/34
	10. John H. Fahey (D) Chairman 11/33-2/42	6/33-2/42
	11. Walter H. Newton (R)	6/33-7/34
	12. Fred W. Catlett (R)	4/34-2/42
	13. Henry E. Hoagland (R)	9/34-10/37
	14. William H. Husband (R)	11/37-2/42
	15. Frank W. Hancock, Jr. (D)	1/39-2/42
<b>FEDERAL HOME LOAN BANK ADMINISTRATION</b>	16. John H. Fahey (D) Commissioner	2/42-7/47
February 24, 1942, to July 26, 1947 (one commissioner)		
<b>MEMBERS OF THE FEDERAL HOME LOAN BANK BOARD</b>	17. John H. Fahey (D) Chairman 7/47-12/47	7/47-12/47
	18. J. Alston Adams (R)	8/47-6/53
Federal Home Loan Bank Board July 26, 1947, to August 11, 1955 (three members, four-year terms)	19. Nathaniel Dyke, Jr. (D)	8/47-12/47
	20. William K. Divers (D) Chairman 12/47-8/53	12/47-12/54
	21. Oscar K. LaRoque (D)	4/48-3/51
	22. Kenneth G. Heisler (D)	8/51-6/53
	23. Walter W. McAllister (R) Chairman 8/53-9/56	8/53-9/56
	24. Ira A. Dixon (R)	9/54-6/62
	25. William J. Hallahan (D)	8/55-8/60

FEDERAL HOME LOAN  
BANK BOARD

Independent Agency—  
August 11, 1955, to  
present (three mem-  
bers; four-year  
terms)

26. Albert J. Robertson (R) Chairman 9/56-1/61	9/56-1/61
27. Joseph J. Williams, Jr. (D)	9/60-6/63
28. Joseph P. McMurray (D) Chairman 5/61-1/65	5/61-1/65
29. John de Laittre (R)	9/62-6/66
30. John E. Horne (D) Chairman 1/65-12/68	8/63-12/68
31. Michael Greenebaum (D)	4/65-6/65
32. Robert L. Rand (R) Acting Chairman 11/68-3/69	9/66-3/69
33. Preston Martin (R) Chairman 3/69-12/72	3/69-12/72
34. Thomas Hal Clarke (D)	7/69-6/73
35. Carl O. Kamp, Jr. (R) Acting Chairman 12/72-6/73	5/69-8/73
36. Thomas R. Bomar (R) Chairman 6/73-6/75	6/73-6/75
37. Garth Marston (R) Acting Chairman 6/75-12/76 Chairman 12/76-8/77	3/74-10/78
38. Grady Perry, Jr. (D)	5/73-6/77
39. Robert H. McKinney (D) Chairman 8/77-6/79	8/77-6/79
40. Anita Miller (D) Acting Chairman 7/79-9/79	7/78-11/79
41. Andrew A. DiPrete (R)	6/79-7/82
42. Jay Janis (D) Chairman 9/79-12/80	9/79-12/80
43. John H. Dalton (D) Chairman 12/80-4/81	2/80-7/81
44. Richard T. Pratt (R) Chairman 4/81-4/83	4/81-4/83
45. James Jay Jackson (D)	3/82-8/83
46. Edwin J. Gray (R) Chairman 5/83-	3/83-
47. Donald I. Hovde (R)	6/83-10/86
48. Mary A. Grigsby (D)	2/84-8/86
49. Lee H. Henkel, Jr. (R)	11/86-4/87
50. Lawrence J. White (D)	11/86-

## Abbreviations and Acronyms

ADC	acquisition, development, and construction (loan)
ARM	adjustable-rate mortgage
CD	certificate of deposit
CFR	Code of Federal Regulations
CFTC	Commodity Futures Trading Commission
CMO	collateralized mortgage obligation
CPI	Consumer Price Index
DIDC	Depository Institutions Deregulation Committee
EFTS	electronic funds transfer system
FADA	Federal Asset Disposition Association
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHA	Federal Housing Administration
FHLB	federal home loan bank
FHLBB	Federal Home Loan Bank Board
FHLB System	Federal Home Loan Bank System
FHLMC	Federal Home Loan Mortgage Corporation
FmHA	Farmers Home Administration
FNMA	Federal National Mortgage Association
FSLAC	Federal Savings and Loan Advisory Committee
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	generally accepted accounting principles
GNMA	Government National Mortgage Association
HOLC	Home Owners' Loan Corporation
ICC	income capital certificate
MACRO	management, asset quality, capital adequacy, risk management, and operating results
MCC	mutual capital certificate
MMC	money market certificate
MMDA	money market deposit account
NCUA	National Credit Union Administration
NHS	Neighborhood Housing Services
NRC	Neighborhood Reinvestment Corporation
NOW	negotiable order of withdrawal
NWC	net worth certificate
OCC	Office of the Comptroller of the Currency
PC	participation certificate
PITI	principal, interest, taxes, and insurance

PMI	private mortgage insurance
PSA	principal supervisory agent
RAP	regulatory accounting principles
REIT	real estate investment trust
REMIC	real estate mortgage investment conduit
REO	real estate owned
USC	United States Code





