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Saving Troubled Banks

There's another quasi-governmental agency that's lending hundreds of billions to troubled banks. Fortunately, it's not a mess. Yet.

Daniel Gross

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The Federal Reserve's extraordinary efforts to help investment banks have effectively put the taxpayer on the hook for enormous potential losses. If borrowers can't make good on their debts, we could end up paying tens or hundreds of billions to cover losses tied to Bear Stearns, mortgage-backed securities at other banks, and the Fannie Mae and Freddie Mac debacle.

But the actual amount of credit extended so far through these public-rescue efforts pales in comparison with the credit that has quietly been extended to banks in the past year—another lifeline that taxpayers could end up paying dearly for. Here's the story: Last summer, as the subprime rot spread throughout the credit market, the process through which banks make loans to borrowers and then package and sell them to investors came to a screeching halt. For the past 12 months, an obscure agency created by President Herbert Hoover during the Great Depression has come to the rescue of the banking industry. It is called [the Federal Home Loan Banks](#).

Like Fannie Mae and Freddie Mac, the FHLB (here's Hoover's [July 1932 signing statement](#), a [brief history](#), and an [overview](#)) is a government-sponsored enterprise. But it differs from the wounded giants in some significant ways. Instead of being owned by public shareholders, as Fannie and Freddie are, the 12 independent regional FHLBs are owned by their 8,100 members. Banks large and small, representing about 80 percent of the nation's financial institutions, own shares in the FHLB and share in the profits.

The FHLB has a simple [business model](#) (PDF). Basically, it funnels cash from Wall Street to banks on Main Street. Member banks present mortgages they've issued—high-quality ones, not junky subprime ones—as collateral to the FHLB and borrow money so they can have more cash to lend. To finance its activity, the FHLB sells debt to big investors in the capital markets. As with Fannie and Freddie, the FHLB benefits from a unique status. The FHLB doesn't pay federal income tax, and it borrows "at rates just slightly higher than Treasury bonds," thanks in part to the high ratings of its debt. While the FHLB takes pains to note that "Federal Home Loan Bank debt is not guaranteed by, nor is it the obligation of, the U.S. government," there's an assumption afoot in the marketplace that were the FHLB to encounter serious trouble, the government would step in. In return for this special treatment, the FHLB provides some vital public services. Twenty percent of its net earnings are used to help cover interest on debt issued by the [Resolution Funding Corp.](#), which paid for the Savings & Loan bailout. The FHLB also channels one-tenth of its profits to affordable-housing loans and grants.

During the mortgage boom, FHLB quietly did its job and avoided many of Fannie and Freddie's excesses. A year ago, loans to member banks accounted for only 62 percent of total assets. The rest was held in safe investments like the government bonds and bonds issued by Fannie Mae and Freddie Mac. Subprime holdings were minimal. And since commercial banks were able to raise capital from Wall Street to make any kinds of loans they wanted, they didn't have all that much need for the FHLB's services. As the chart below shows, the number of loans extended to member banks rose modestly in the boom years, up 7 percent in 2005 and only 3 percent in 2006. As of June 30, 2007, the FHLB had \$640 billion in loans outstanding to members.

But last year the mortgage house of cards began to collapse. And as Wall Street's securitization machine, which had enabled banks to raise cash with alacrity, broke down, banks staged their own run on the FHLB. In its [2007 third-quarter report](#), the FHLB noted that "in light of the extraordinary events affecting the credit markets during the third quarter," loans to members soared by 28.6 percent from the first quarter, to \$824 billion—an increase of \$184 billion. Since then, as the broken-down Wall Street mortgage securitization machine was sold for scrap, FHLB loans to member banks continued to rise: to \$875 billion at the end of 2007 and to \$914 billion at the [end of this June](#). In the past 12 months, FHLB loans to its members have risen by 43 percent, representing an additional \$274 billion in real credit provided by the system to its member banks. That sum dwarfs the actual amount of credit extended to investment banks by the Fed—or by the government to Fannie and Freddie.

Does the increase in FHLB's balance sheet mean taxpayers may be on the hook for another trillion dollars in mortgage debt? It's unlikely. FHLB has a much better track record than Fannie and Freddie. Because it maintains high standards, it has never suffered a credit loss on a loan extended to a member. It doesn't spend hundreds of millions of dollars each year on executive compensation or lobbying, as Fannie and Freddie did. And it didn't lower standards or shift into riskier markets as a way of increasing market share, as Fannie and Freddie did. Seventy-six years after it was created by a president whose administration was hostile to government intervention in markets, the FHLB stands as an enduring and (so far) effective example of socialism among capitalists.

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