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Federal Home Loan Bank Debt and the Subprime Mortgage Debacle

Overview: The current subprime mortgage debt debacle has some wondering about the safety of debt issued by the Federal Home Loan Bank (FHLB) system. Because the FHLB system purchases mortgages from its member institutions, some believe its debt may be a risky investment. The following describes the FHLB system and demonstrates why we believe it remains a safe investment.

The opening line of a *USA Today* article from August 23 summed up the problem succinctly: “U.S. banks reported the biggest jump in delinquent loans in 16 years, largely because of the troubled real estate sector.”¹

Much of the turmoil is being caused by subprime mortgages made during the recent housing boom. These mortgages are resetting at higher rates, causing more and more people to default.

The term “subprime” is subjective and has a number of different meanings. On one hand, it describes borrowers who have little or no income and might not be in a good position to buy a house. The term also describes the types of loans that these borrowers would receive. Lenders can have different definitions of what financial situations qualify as subprime.

Such debt has caused many headaches, not only for homeowners with subprime mortgages, but also for institutional and individual investors. “Concern about the subprime mortgage meltdown exploded into a worldwide crisis of confidence in credit markets in the past several weeks, also affecting business lending.”²

Such concerns have also led investors to wonder about the financial strength of debt-issuing institutions with connections to the housing market. One institution in particular is the Federal Home Loan Bank (FHLB) system. However, the debt issued by the FHLB system should not be adversely affected by the current problems stemming from subprime mortgages and remains a good investment for prudent investors.

The FHLB System

The FHLB system is a network of 12 district banks and serves more than 8,100 member/owner financial institutions. The 12 banks are linked by regulatory oversight and have joint and several liability for repayment of all FHLB senior debt. Although it

is often assumed that the district banks make home loans, their primary duty is making advances to the member institutions.

Debt issued by the FHLB system has come into question because while the banks primarily make advances to member institutions, the banks also purchase mortgages from members.

The Problem

Some questions regarding institutions such as the FHLB system are being spurred by what is happening elsewhere. Other institutions connected to the housing market are taking a tumble during the recent turmoil. Perhaps the best example would be Countrywide Financial Corp.

Countrywide, the nation's largest mortgage lender, has seen its stock price cut in half this year and, according to *The New York Times*, was forced to draw down on its \$11.5 billion credit line "because it could no longer sell or borrow against home loans it has made."

"Homeowners, meanwhile, drawn in by Countrywide sales scripts assuring 'the best loan possible,' are behind on their mortgages in record numbers. As of June 30, almost one in four subprime loans that Countrywide services was delinquent, up from 15 percent in the same period last year, according to company filings."³

When a company such as Countrywide suffers due to conditions in the housing market, it is only natural to question if other institutions may experience the same downturn. The FHLB system, however, appears to be in much better shape.

Limited Exposure

First, the FHLB system debt enjoys the highest credit rating from both Moody's and Standard & Poor's (Aaa/AAA) due to the banks' government-sponsored enterprise (GSE) status and inherent financial strength.

As previously stated, the FHLB system purchases mortgages from its member institutions. However, the mortgage purchases account for only 9 percent of combined assets, with the FHLB system having a priority lien on the collateral (even over the U.S. Treasury). By comparison, the advances to member institutions make up nearly 62 percent of FHLB system assets. It is important to note that in its 75-year history, the FHLB system has never experienced a loss on a member loan.

Another positive to the FHLB system's standing is that it is prohibited by federal regulation from owning non-investment grade mortgages or investments. As of June 30, 99.5 percent of the GSE securities, commercial paper and mortgage-backed securities were rated AAA/Aaa or the short-term equivalent.⁴

Keeping a Watchful Eye

In addition, the FHLB system has said it will continue monitoring the volume of subprime mortgage loans and nontraditional residential mortgage loans pledged by its members.

In a bulletin to FHLB system shareholders, it said, "If the Bank determines that the level of subprime or nontraditional residential mortgage loans pledged by a member represents a potentially heightened risk to the Bank, the Bank will perform an extended credit review of the member. Depending on the results of that extended credit review, the Bank may conclude that no further action is needed; that a change to the member's collateral status may be required; or that some other action may need to be taken to address any potential increase in the Bank's credit risk exposure."⁵

Summary

According to the FHLB system's second quarter financial report, each district bank "believes it has limited exposure to subprime loans due to its business model, conservative policies pertaining to advances collateral and investments, and low credit risk due to the design of its mortgage loan program(s)."⁶

One of the purposes of the fixed income portion of an investor's portfolio is to provide stability. Even in light of the current subprime mortgage problems plaguing the housing market, FHLB system debt remains a prudent choice.

¹ Sue Kirchhoff, **Delinquent Loans Surge at Highest Rate Since 1990**. *USA Today*, August 23, 2007.

² Ibid.

³ Gretchen Morgenson, **Inside the Countrywide Lending Spree**. *The New York Times*, August 26, 2007.

⁴ **Office of Finance Publishes the Federal Home Loan Banks Second Quarter 2007 Combined Financial Report**. Federal Home Loan Banks Office of Finance, August 14, 2007. Available at http://www.fhlf-of.com/analysis/press_rls/2007q2CFR-81407.pdf. Accessed August 28, 2007.

⁵ Terry Smith, **Policies for Subprime and Nontraditional Mortgage Collateral**. Federal Home Loan Bank of Dallas, July 12, 2007.

⁶ **Office of Finance Publishes the Federal Home Loan Banks Second Quarter 2007 Combined Financial Report**.

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