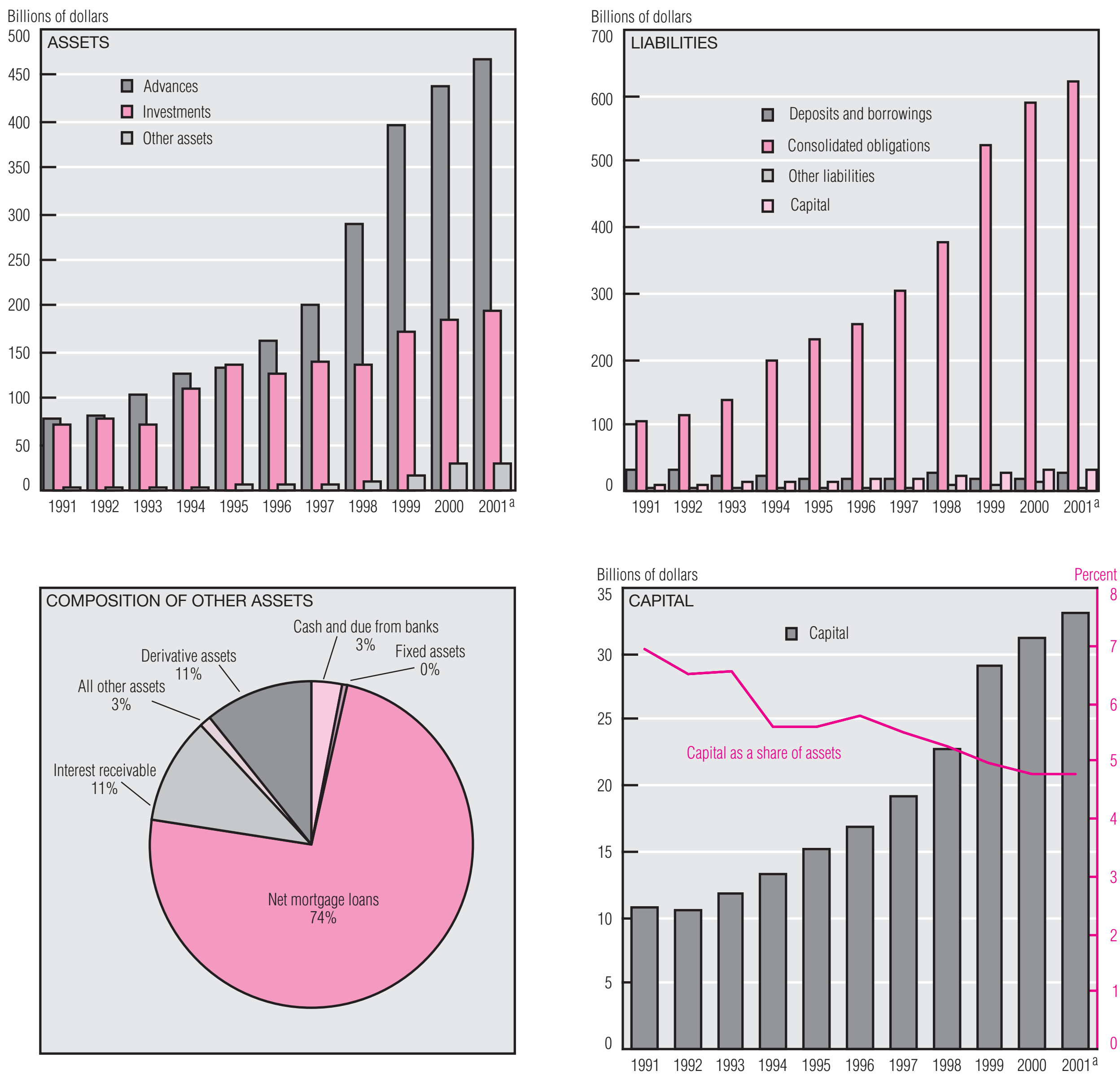
Federal Home Loan Banks



a. Data through the third quarter.
SOURCES: Federal Home Loan Bank System, annual reports and *Quarterly Financial Report*, September 30, 2001.

The 12 Federal Home Loan Banks (FHLBs) are stock-chartered, government-sponsored enterprises whose original mission was to provide short-term advances to member institutions, funded by deposits from those institutions. Membership initially was open to specialized housing finance lenders, mostly savings and loan associations and mutual savings banks. As their traditional clientele has shrunk and the financial system has consolidated, FHLBs have re-invented their role in financial markets. FHLB advances, which are now an important source of funding for member institutions' mortgage portfolios, rose to \$466.77 billion by the end of 2001:IIIQ, far outstripping all other FHLB investments and assets.

Most of the funding for assets comes from \$622.34 billion of consolidated FHLB System obligations—bonds issued on behalf of the 12 FHLBs collectively. Market participants view these bonds as implicitly backed by the U.S. government, so FHLBs can raise funds at much lower rates than those that AAA-rated corporations pay. Member institutions' deposits, short-term borrowings, and other liabilities are only a miniscule source of funds. FHLBs have added capital as they have grown, although the asset growth rate has outstripped the capital growth rate since 1996, and the capital-to-asset ratio fell to 4.79% at the end of 2001:IIIQ.

In 1997, the Chicago FHLB initiated a mortgage partnership finance program, by which it began investing directly in mortgages in addition to supporting members' own mortgage portfolios through advances. Currently, all 12 FHLBs purchase mortgages directly from member institutions. The \$22.64 billion of

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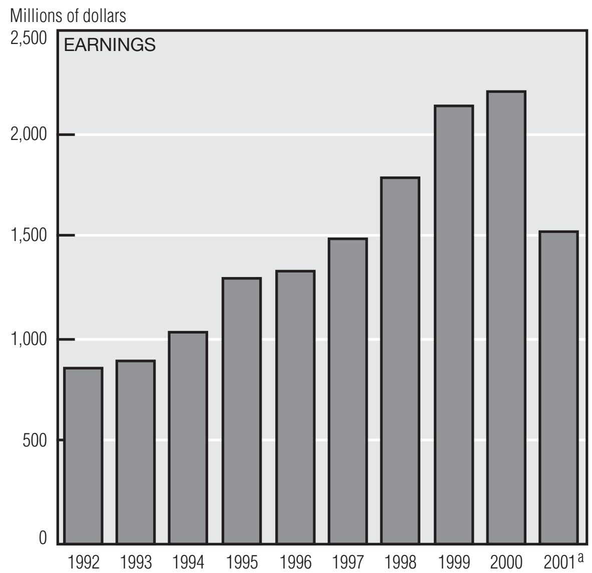

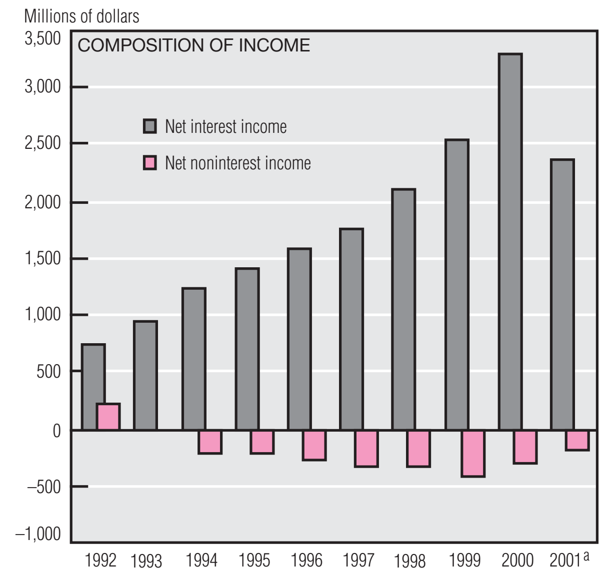

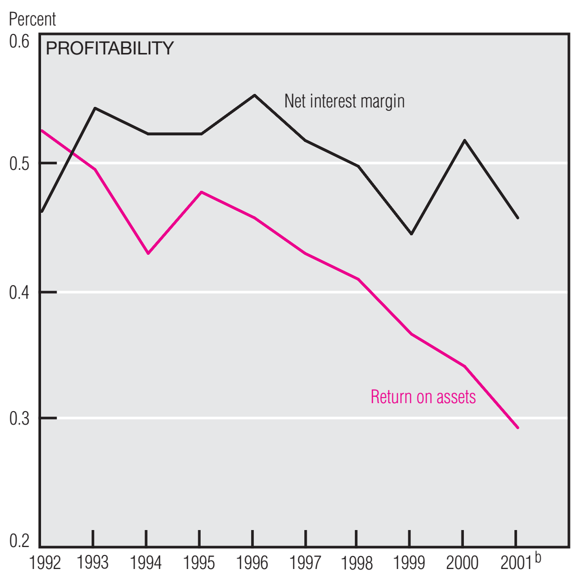

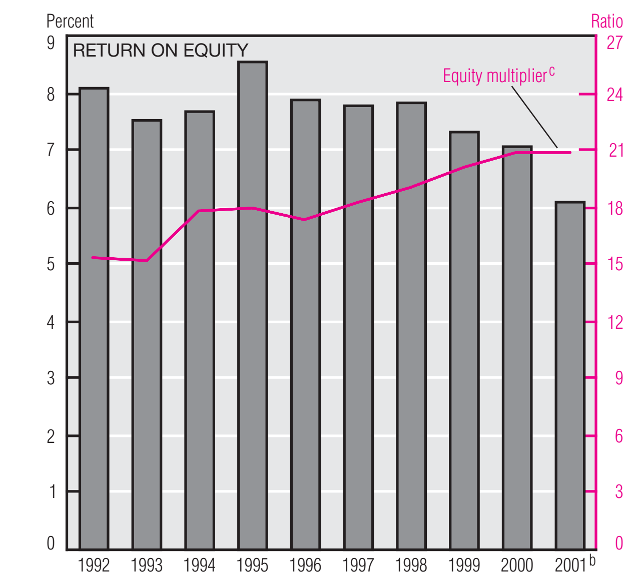

a. Data through the third quarter.
b. Data for 2001:IIIQ are annualized.
c. The equity multiplier is the ratio of total assets to equity.
SOURCES: Federal Home Loan Bank System, annual reports and *Quarterly Financial Report*, September 30, 2001.

mortgages that FHLBs hold represents almost three-fourths of their other assets and is projected to be a major source of future asset growth.

FHLBs' earnings grew each year from 1992 through 2000. Their net income was lower for the first nine months of 2001 than for the same period in 2000 ($1,515 million compared to $1,634 million). Net interest income (interest income less interest expense) grew from $735 million in 1992 to $3,311 million at the end of 2000. Net interest income of $2,358 million for the first nine months of 2001 was down from $2,437 million for the same period in 2000.

The increasingly negative spread between noninterest income and noninterest expenses after 1993 resulted primarily from the steady increase in FHLBs' operating expenses, especially employee compensation and benefits. Unfortunately, improvements in earnings and net interest income resulted from strong asset growth rather than improvements in underlying profitability. Return on assets declined from 52 basis points (bp) in 1992 to 34 bp at the end of 2000. Annualized return on assets through 2001:IIIQ was 29 bp. Profitability suffered from a decline in the net interest margin from 52 bp at the end of 2000 to an annualized 46 bp for the first nine months of 2001. Moreover, FHLBs' net interest margins are small compared to the 300–400 bp typical of depository institutions. Finally, despite continued increases in leverage since 1996, return on equity fell slightly during the first nine months of 2001 (from 7.07% to 6.10%). These persistently weak returns on assets and equity oblige FHLBs to undertake further nontraditional lines of business in search of higher returns.