THE WALL STREET JOURNAL. ONLINE

October 7, 2003

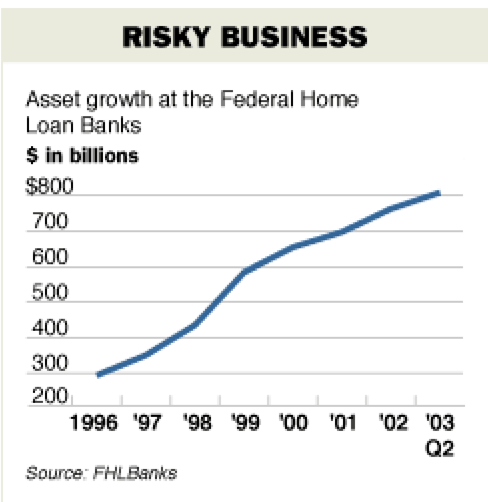
REVIEW & OUTLOOK

Flubbing It

Sometimes timing is everything. Just as political attention is focusing (finally) on two mortgage-finance giants with lots of risk, another set of problems has popped into view -- the Federal Home Loan Banks.

Like Fannie Mae and Freddie Mac, the 12 banks that comprise the FHLB system are running with lots of leverage and an implicit guarantee by taxpayers. The banks -- nicknamed the Flubs -- also suffer from poor regulatory oversight, cozy corporate governance and insufficient disclosure.

The Flubs are located in 12 districts across the country and are owned by their members -- more than 8,000 commercial banks, thrifts, credit unions and insurance companies. Because of various ties to the federal government, the Flubs are thought to enjoy government backing, allowing them to issue debt at rates slightly above Treasury rates. The banks use this low-cost debt to offer low-cost funding to their members.



Until recently, the Flubs were considered low-risk operations. But over the past several years, as their mission to provide loans to smaller lenders evanesced -- along with their profits -- they have raised their risk-profile.

The Flubs have expanded their mission by introducing new lines of business, like small business and agriculture loans. More scary, they have enlarged their practices along the same lines as Fannie and Freddie, using low-cost borrowing to buy and hold huge amounts of mortgage-backed securities for their own portfolios, exposing the banks to interest rate risk. They've also made other investments, such as unsecured money-market instruments and uninsured paper. Last year, their combined investment portfolios came to $206 billion.

The Flubs are taking on more risk to boost profitability, which, in turn, allows them to pay fatter dividends to members who are required to hold shares. The concern is that they are stuffing portfolios with high-return paper, leaving them open to unanticipated credit risk. This is exactly what happened to the Federal Home Loan Bank of New York.

In August, Standard & Poor's lowered its opinion on the bank's financial outlook, citing concerns with its investment portfolio. Sure enough, a month later, the New York Flub announced it was suspending dividend payments after being hit by $183 million in losses from its investment in mobile-home loans. S&P then responded by downgrading its rating of the New York bank's creditworthiness.

The amount of mobile-home paper held by the New York bank -- $1.7 billion -- also raised eyebrows since the rest of the Flub system holds only $45 million. "This creates real concerns about who's watching for this type of credit risk and what's being done about it," says Karen Petrou of Federal Financial Analytics, a consulting firm.

Sounds bad, but it gets worse. Last week, the New York Flub dropped another shoe, announcing an additional $6.6 million loss on $944 million of securities backed by home and business loans. These are not exactly confidence-building events, especially alongside the recent San Francisco Flub admission that it had bought fraudulent jumbo loans and the Pittsburgh Flub announcement that "improperly" hedged interest-rate risk dropped its second quarter earnings by 82%.

These events have caught the attention of several high-level regulators. Treasury Secretary John Snow and Federal Reserve Chairman Alan Greenspan are now arguing that the Flubs ought to have stronger supervision under the authority of the Treasury.

Happily, there is an immediate opportunity to do just that. The House Financial Services Committee is considering legislation to bring Fannie and Freddie under Treasury regulation. It makes perfect sense to include the Flubs. Obviously they need to improve their safety and soundness and obviously their current regulator, the Federal Housing Finance Board, is not up to the task.

We sympathize with some of the supporters of the legislation who are anxious about taking on one more politically connected Government Sponsored Enterprise. Particularly because Fannie Mae, after welcoming the move to Treasury, is now lobbying against crucial parts of it.

But it's folly to ignore the Flubs. It's not only difficult to ignore their recent difficulties, but their size alone commands attention. Their assets grew 177% between 1996 and 2003, pushing the total to more than $800 billion and putting the Flub system among the four largest domestic banking organizations. With the mortgage market showing signs of fatigue, Flub trouble could not only deck the U.S. economy, but spread to the international financial markets. It's not a moment too soon to bring all three of these high-risk housing giants under better control.

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Updated October 7, 2003