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Home Loan Banks Raise Fears; Losses Suggest Too Much Risk

FROM THE ARCHIVES

• Home-Bank Regulator Faces Heat[1]
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Two regional banks within the Federal Home Loan Bank system reported additional struggles related to derivatives and investments, raising a new round of concerns about whether the government-sponsored banks have been taking on too much risk during the housing boom.

In a letter sent to shareholders Wednesday, the Federal Home Loan Bank of Atlanta said it recorded a loss of $9.1 million for the third quarter. Meanwhile, in a similar letter, the Federal Home Loan Bank of Pittsburgh said it will likely post a loss of $6.5 million when its third-quarter earnings are finalized later this month. In both cases, the banks' losses were tied to hedging strategies that were intended by the banks to offset risks.

Home-loan banks aren't publicly traded, but most of their earnings are paid out as dividends to member banks -- which include public- and private-banking concerns.

The Atlanta and Pittsburgh banks said they remain financially healthy. And even some analysts believe that the third-quarter figures, which were calculated under generally accepted accounting principles, aren't the best way to measure the condition of entities that invest in mortgages or use derivatives. Using the regional banks' preferred method of measuring net income, which ignores certain fluctuations in the value of their derivatives, the Atlanta and Pittsburgh banks cited third-quarter earnings figures of $42.6 million and $13.5 million, respectively.

Still, the latest results seem to indicate that some of the home loan banks are having difficulties dealing with recent gyrations in interest rates, which can cause sudden losses for any institutions that buy and own mortgages or use derivatives. Unexpected interest-rate moves, and the need to hedge against them, played a role in the accounting debacles that derailed mortgage-finance company **Freddie Mac** earlier this year.

Created by the government in the 1930s, the 12 federal home loan banks were designed to use their government ties to borrow money at low interest rates, and then lend that cheap money to smaller lenders. In more recent years, some of the government-sponsored banks have moved to build up larger mortgage portfolios of their own, taking on more risk, in part to be more competitive with **Fannie Mae** and Freddie Mac. Those companies operate under similar government charters and have massive loan portfolios.

Late last month, the Federal Home Loan Bank of New York rattled markets when it suspended its dividend payment and disclosed a loss of $183 million from soured investments in securities backed by mobile-home mortgages. Also, the Pittsburgh bank reported an 82% drop in second-quarter earnings due to a failure to adequately hedge at a time when low interest rates were spurring a refinance boom.

To many analysts and politicians, the stumbles are evidence that the home-loan banks may not be as sophisticated at hedging interest-rate risks as Fannie Mae and Freddie Mac.

"I would argue that some of the federal home loan banks clearly are having those problems," says Mike McMahon, a financial-services industry analyst at Sandler O'Neill & Partners in San Francisco. "This is basic blocking and tackling. If you're a portfolio investor, you need to be able to perform the basic blocking and tackling of interest-rate and credit-risk management."

In his letter, the Federal Home Loan Bank of Pittsburgh's president, James D. Roy, explained that the bank's latest problems stem from continued fallout from the recent refinance boom. He said the bank had "revamped" its methods of acquiring mortgages "to assure that new assets are immediately hedged within tight parameters," and taken other steps to reduce the impact of hedging on its earnings.

The Atlanta bank's letter, meanwhile, emphasized that bank's belief that its results don't necessarily reflect its underlying financial condition.

The results at both banks reflect a 2001 change in accounting rules that requires companies to record quarterly changes in the value of their derivatives. Critics of the rule say it is flawed in part because it doesn't allow companies to record similar quarterly changes in offsetting assets and liabilities.

"The third-quarter GAAP loss will have no effect on the bank's core operating condition," the Atlanta bank president, Raymond R. Christman, said in his letter. He said all negative or positive earnings adjustments caused by the new accounting rule "will be offset fully as individual derivatives contracts mature."

A spokesman for the Atlanta bank said that bank only has $1.5 billion in mortgage loans in its portfolio, and about $12.6 billion in mortgage-backed securities. He added that unlike other home loan banks, those numbers haven't grown significantly recently. He said most of the bank's hedging was related to its core business of lending to member banks, not its mortgage portfolio assets.

The letters reflected a heightened sensitivity to disclosure within the home loan bank system, according to observers. The letters were posted promptly on the banks' Web sites, and the system's Office of Finance also announced them in a separate news release.

Such actions would have been unlikely just a couple of years ago. But the corporate scandals of recent years, Freddie Mac's accounting blowup and the recent investment problems at several of the home loan banks, have all made the home loan banks more aware of their responsibilities to investors.

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