October 15, 1999

Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Securities
and Government Sponsored Enterprises
Committee on Banking and Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

As you requested, the Congressional Budget Office (CBO) has prepared a cost estimate for a draft amendment to the financial modernization legislation being considered in the House-Senate conference committee. You also asked CBO to update its estimate of the minimum percentage assessment of the net income of the Federal Home Loan Bank (FHLB) System that, when substituted beginning in 2000 for the $300 million annual payment for the interest on bonds issued by the Resolution Funding Corporation (REFCORP) now made by the FHLBs, would not increase federal outlays in any of the first 10 years. The system is a government-sponsored enterprise (GSE), and its activities are not included in the federal budget. But because the Treasury pays the interest on REFCORP bonds not covered by the FHLBs, changing the system's payments to REFCORP to a percentage of its net income would change Treasury outlays.

Summary. The proposed amendment would require the Treasury to make direct loans to the FHLBs to finance an economic development program. CBO estimates that the Treasury would make loans of $3.4 billion over the program's expected life (fiscal years 2000-2021) and that the government would incur subsidy costs of $142 million over the 2000-2004 period. As drafted, the amendment's estimated cost (for the subsidies provided by the new loans) would constitute direct spending. Thus, the provision would be subject to pay-as-you-go procedures.

In addition, CBO estimates that implementing the proposed loan program would increase the minimum percentage of the net income of the FHLBs that they would have to pay to REFCORP in order to avoid increasing federal outlays in the 2000-2009 period (relative to current law). Without the new program, we estimate that the minimum assessment for avoiding an increase in outlays in that period is 18.4 percent. But with the new program, which would reduce the system's net income, we estimate that the minimum assessment would rise to 19.0 percent. Our estimates are detailed below and summarized in Table 1, which is attached to this letter.

Estimated Cost of Proposed Amendment. The draft amendment would require each FHLB to establish an economic development program, which the FHLB would use to faciliate community lending by its members and nonmember mortgagees. Each FHLB would provide grants, subsidies, and subsidized advances each year equal to eight percent of that FHLB's net earnings for the preceding calendar year. As long as the FHLBs have an obligation to make payments to REFCORP, the net disbursements for each FHLB's program would be financed by a direct loan from the Treasury that would be payable to REFCORP, which would make disbursements to designated beneficiaries on behalf of each FHLB. Once the FHLBs fulfill their obligation to pay interest on REFCORP bonds, each FHLB would be obligated to pay the Treasury an amount equal to 10.1 percent of that FHLB's net earnings for the preceding calendar year, until the total amounts lent by the Treasury, including all accrued interest, were repaid. The Federal Housing Finance Board, which regulates the system, would determine the rate at which interest on the loans would accrue, based on the rate for Treasury securities of a similar maturity.

Based on CBO's analysis of the FHLB system's balance sheet and income statement, and using CBO's baseline economic assumptions, we estimate that the Treasury would lend the FHLBs $133 million in 2000, $0.7 billion over the 2000-2004 period, and $3.4 billion through 2021, the year in which we estimate the system's obligation to pay interest on REFCORP bonds would be fulfilled if the proposed amendment was added to the House-passed version of H.R. 10. Because the FHLBs would be obligated to repay the loans, the system's liabilities would increase each year by the amount of the loans made in that year. There would be no accompanying increase in the FHLBs' assets, since the funds would be used to provide grants and other subsidies, so that the FHLBs' capital would also decrease by the amount of the loans made each year. Accrued interest on the loans would reduce the net income of the FHLBs and, therefore, also reduce their capital. We estimate this additional reduction in capital at $2.7 billion through 2021. As their capital fell, the FHLBs would have to borrow more to finance their activities, which would also increase interest expense and reduce net income. The FHLBs would not be able to stem the decline in their capital-to-assets ratios by increasing the interest rates charged on advances, since higher net income would increase their payments for REFCORP interest and the interest expense on community development program loans, which would reduce their capital more than additional interest income would increase it.

CBO estimates that the community development program would be equivalent to a federal tax on the FHLBs' capital totaling $6.2 billion through 2021. The program would reduce the FHLBs' capital-to-assets ratio from 5.2 percent at year-end 1998 to 3.6 percent at year-end 2021. Because net income would also decline, the return on equity earned by owners would also fall by about 0.4 percentage points by 2021. For the system to comply with federal capital requirements, the Federal Housing Finance Board would have to require the FHLBs to reduce dividend payments or require members to invest new capital, either of which would further reduce their return on equity, perhaps enough to make membership in the FHLBs unattractive to some current members.

The Federal Credit Reform Act of 1990 applies to the Treasury loans authorized by the amendment. CBO estimates that the subsidy cost of the Treasury loans would be $29 million in 2000 and a total of $142 million over the 2000-2004 period (see Table 1, attached). Because this cost would be direct spending, pay-as-you-go procedures would apply.

Estimating the subsidy cost of the loans requires an assessment of the default risk that they would pose to the federal government in each year. In 1991, Standard & Poor's Corporation found that, as of the end of 1990, the FHLBs posed a risk to the government equivalent to the risk that a wholly private corporation with a triple-A credit rating poses to its creditors. (At that time, the capital-to-assets ratio of the system was 7 percent). CBO estimates that the initial loans to the FHLBs would pose a risk to the government that is equivalent to the risk of lending to a wholly private firm with a double-A credit rating. This assumption is based on the significant decline in the FHLBs' capital-to-assets ratio and retained earnings that has occurred since 1990, as well as new programs that have begun to increase the system's exposure to credit risk. By reducing the system's capital-to-assets ratio from 2000 through 2021, the community development program would gradually increase further the risk to the government posed by loans to the FHLBs. CBO expects that by the end of the 10-year projection period the risk of loans to the system would be equivalent to the risk of lending to a wholly private firm with a low investment-grade credit rating.

This estimate assumes that the amendment would be attached to the House-passed version of H.R. 10, which includes provisions that would require the Federal Housing Finance Board to issue regulations imposing new capital requirements applicable to each FHLB that CBO estimates would lead the system to reduce its capital ratio. If those or other provisions of H.R. 10 were changed, CBO's estimate of the volume and subsidy cost of the direct loans by the Treasury to the FHLBs could also change.

The FHLBs' new community development program would have an additional cost to the federal government beyond the subsidy cost of the direct loans by the Treasury. Government sponsorship of the FHLBs transfers a portion of their risk of insolvency to the federal government. The government would bear a portion of the increase in the risk of the system resulting from the decline in its capital and return on equity and the resulting greater uncertainty in its ability to attract and retain members. The federal budget would not record any cost associated with this increase in risk, however, because federal credit support of the FHLBs and other GSEs is implicit rather than explicit.

The amendment would impose a new private-sector mandate as defined by the Unfunded Mandates Reform Act of 1995 (UMRA) on the FHLBs. CBO estimates that the net direct costs of the mandate would not exceed the statutory threshold for private-sector mandates ($100 million in 1996 dollars, adjusted annually for inflation) in any one year for the first five years that the mandate would be effective. However, by 2010 the 11th year after the amendment would become effective, the cost of the mandate would amount to over $100 million dollars.

Federal Home Loan Banks' Payments to REFCORP. The inclusion in a conference agreement on financial services legislation of the proposed amendment establishing a new community development program would affect the minimum percentage assessment of the FHLBs' net income that would not increase federal outlays in the 2000-2009 period. CBO estimates that, if the legislation does not include the community development program amendment, the minimum percentage assessment that would not increase outlays in that period would be 18.4 percent. If the legislation includes the amendment, the minimum percentage assessment would be 19.0 percent. The percentage with the amendment is higher because the community development program would reduce the FHLBs' net income. An assessment of 18.4 percent of the system's net income, without the amendment, would increase its payments to REFCORP by $19 million in 2000 and a total of $38 million over the 2000-2004 period (see Table 1). An assessment of 19.0 percent of the system's net income, with the amendment, would increase its payments to REFCORP by $28 million in 2000 and a total of $53 million over the 2000-2004 period.

Under H.R. 10 and S. 900, CBO expects that the estimated reduction in Treasury outlays in the near term resulting from the change in REFCORP payments to a percentage of net income would be offset by an increase in outlays of an equal amount (on a present-value basis) in future years. Each bill would authorize the Federal Housing Finance Board to extend or shorten the period over which the FHLBs make payments to REFCORP such that, over time, the average payment would equal $300 million a year on a present-value basis. Thus, CBO expects the change in the REFCORP payments would have no long-term effect on the government's financial condition. With the inclusion of the economic development program, these provisions would therefore result in a net cost to the government, both in the short term and the long term.

I hope this information is useful. If you have any questions, feel free to give me a call or have your staff contact Robin Seiler.

Sincerely,

Dan L. Crippen
Director

Attachment: Table 1

Identical letter sent to: Honorable Paul E. Kanjorski

TABLE 1. Projections of the Subsidy Cost of Treasury Loans to the FHLBs and of the FHLBs' Payments for REFCORP Interest Under an Annual Assessment Equal to a Fixed Percentage of Net Income (by fiscal years, in millions of dollars)

		FHLBs' Payments for REFCORP Interest [a]	
Fiscal Year	Subsidy Cost of Treasury Loans	18.4 Percent of Net Income[b]	19.0 Percent of Net Income[c]
2000	29	319	328
2001	30	311	317
2002	29	301	304
2003	27	302	301
2004	27	305	303
2005	27	327	321
2006	31	340	331
2007	32	334	322
2008	36	344	329
2009	36	359	340

Source: Congressional Budget Office.

Notes: FHLBs = Federal Home Loan Banks
REFCORP = Resolution Funding Corporation

a. Under current law, such payments are fixed at $300 million a year. Assumes enactment of reform in FHLBs' capital requirements under the House-passed version of H.R. 10. Percentage is the minimum necessary to keep payments to REFCORP above $300 million per year.

b. Does not assume enactment of draft amendment establishing community development program.

c. Assumes enactment of amendment establishing community development program.