The Time for Federal Home Loan Bank (FHLBank) Reform has Come

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The Federal Housing Finance Agency (FHFA) has undertaken the very heavy lift of starting a national dialogue on Federal Home Loan Bank (FHLBank) reform. The FHFA is first and foremost the system's prudential regulator, but it is also the steward of the public interest. These two roles are the foundation of the FHFA's recently issued report that draws upon 600 written submissions and testimony from over 100 interested parties in listening sessions and roundtables from Alaska to Puerto Rico.

This year-long review has focused attention on how effectively this government sponsored enterprise (GSE) has used its subsidized debt, tax exemption and other special benefits to meet the nation's unmet credit needs. The evidence would suggest that FHLBanks can do more. The report lays out a roadmap to reform that incorporates affordable housing and community development into the planning and execution of FHLBank activities while neither weakening the system's safety and soundness nor its role as a reliable and low-cost source of member liquidity to members that support housing and community development.

The issues raised by this report are not new. Twenty-five years ago, Richard S. Carnell, then Assistant Secretary of the Treasury for Financial Institutions, offered congressional testimony[1] that should be required reading for policy makers today. These points from his testimony still ring very true.

- "FHLBanks are using their government sponsorship to benefit their shareholders even if doing so may not necessarily serve the Bank System's public purpose."
- "The System is conducting government-subsidized arbitrage to attract -- through high dividends or low-cost overnight funding -- depository institutions that have ample access to other funding sources."
- "The System should increasingly focus its use of government subsidized advances on meeting more difficult affordable housing and targeted community development needs that are not being effectively met by other market participants."

Market Changes Support Need for Reform

Mortgage markets and FHLBank membership today are unrecognizable when compared to those of 1932 after the FHLBanks were created. The drift of FHLBanks and their members from housing finance can be measured in a number of ways. Consider these data in the FHFA report that nonbank (non FHLBank member) mortgage originations went from a 33 percent market share in 2013 to 78 percent in

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[1] https://home.treasury.gov/news/press-releases/rr2705

September 2023. A recent Bloomberg analysis[2] of FHLBanks revealed, "By the end of last year, 42 percent of the more than 6,400 banks, credit unions and insurers that could borrow from the system hadn't reported making a single mortgage in the past five years."

Consider insurance companies who no longer play the major role in residential mortgage finance they did at the FHLBanks' creation. Insurance company FHLBank membership was specifically authorized in the 1932 statute. By 1989, there were only 4 insurance company FHLBank members. This number has risen to 570 in the second quarter of 2023. Insurance company residential mortgage activity did not increase since 1989. As reported in recent Reuters article[3], FHLBank lending has been "predominantly used by life insurers, because they need to boost their investment returns with cheap funding to meet long-term liabilities." Clearly this does not support affordable housing or community investment.

FHLBanks Focus on Member Value, the FHFA Focuses on Equitable Balance

As markets change, the FHLBank System has focused on making membership very profitable. Attention to affordable housing and community development has not been a top priority. The FHLBanks have been open about this. The FHLBanks' 2021 SEC annual financial statement[4] said "The FHLBanks seek to manage their primary objective of fulfilling their public purpose by enhancing the value of membership for member institutions. The value of membership includes access to readily available credit and other services from the FHLBanks and the value of the cost differential between an FHLBank's advances and other potential sources of funds, as well as the potential for dividends received on a member's investment in an FHLBank's capital stock."

In the past twelve years, FHLBanks have retained the largest share of the government-supported earnings while the general public has gotten much less. According to the FHFA report, "The FHLBanks distribute a significant amount of earnings in the form of dividends every year. The System paid out an average of $1.3 billion in dividends each year from 2020 to 2022 and paid out $1.5 billion in the first half of 2023." New data since the issuance of the report shows that in the first 9 months of 2023, FHLBanks earned $5 billion and paid $2 billion in dividends to members.

The report promises that "FHFA also will conduct additional research to further document the extent to which consumers and communities benefit from the FHLBank System." "Based on its additional research and analysis, FHFA may propose regulatory changes to correct imbalances in the relative value of the public and private benefits provided by the FHLBank System."

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[2] https://www.bloomberg.com/news/articles/2023-10-20/savvy-financiers-tap-billions-meant-for-mortgages-from-1-4-trillion-fhlb-system

[3] https://www.reuters.com/markets/us/life-insurers-binge-us-financing-aimed-helping-housing-2023-12-05/

[4] 2021 FHLBank Combined Financial Report, page 7

FHLBank Response to Reform

To date, the FHLBanks have offered no reform suggestions. Signs that the FHLBanks system and its members want to play a constructive role in reform are not encouraging.

- In a recent LinkedIn post, Ryan Donovan, the lead FHLBank spokesman and President of the Council of Federal Home Loan Banks noted “The Home Loan Bank system isn't broken and is functioning precisely as Congress has intended. Ultimately, FHFA’s review should build on the System’s strong foundation not tear it down. As the saying goes, "if you break it, you buy it."
- Protection of the FHLBanks’ financial interests was front and center on the first day of the listening sessions. One FHLBank member advocate stated that increasing affordable housing support comes from “funds that would otherwise be used for dividends.”
- Other FHLBank advocates have not so subtly threatened litigation; and predicted massive disruption in capital markets, irreparable harm to community banks and other calamities if the FHFA’s recommendations are adopted.

FHLBank Mission

The most significant FHFA recommendation deals with the FHLBanks’ mission. The FHFA report says:

- “The Bank Act does not explicitly describe the mission of the FHLBanks.”
- “FHFA plans to develop a clear mission statement for the FHLBank System that explicitly incorporates the following core objectives: (i) provide liquidity to members; and (ii) support housing and community development.”
- This “mission statement for the FHLBank System should explicitly reflect the purpose, intention, and overall objective of the System [and] should provide a basis for evaluating the FHLBanks’ ability to meet mission objectives in a safe and sound manner and serve as a reliable source of low-cost financing in support of housing and community development.”

A regulatory mission statement will ensure that FHLBanks give their full attention to housing and community development. The report lays out how this will work:

- “FHFA plans to issue a proposed rule that would clarify the mission of the FHLBanks and provide metrics and thresholds for measuring mission achievement.”
- “FHLBank members that demonstrate a meaningful commitment to the overall mission of the FHLBanks should receive the greatest benefit from the System,” including “discounted advance rates or differential dividends on capital stock.”
- FHFA also will consider how to incorporate mission achievement in the examination processes with a possible stand-alone mission examination rating.
- “FHFA expects each FHLBank to develop a Mission-Oriented Collateral (MOC) program that incentivizes the use of collateral” connected to the mission.

- "FHFA plans to amend its regulation to describe mission performance as a core responsibility of the board. This amendment will clarify each board's duty to take concrete steps to incorporate successful achievement of both safety and soundness and mission activity in executive incentive compensation goals."

Affordable Housing

The FHFA report makes a strong case for the Congress to revise law enacted in 1989 that requires FHLBanks to devote 10percent of net income to support affordable housing through their Affordable Housing Program (AHP). The report: "Given the challenges to housing affordability in markets across the country—rising rents and interest rates, high construction costs, increasing house prices, and limited housing supply, FHFA supports an increase in AHP contributions, as the FHLBanks have the financial capacity to make a larger AHP contribution without adversely affecting their safety and soundness."

The FHLBanks have said for some time they would be spending an additional one to five percent of net income in voluntary contributions but their actions have not yet met that commitment. The voluntary spending on affordable housing as reported in FHLBank financial statements was $4 million in 2021, $1 million in 2020, and $2 million in 2019. The FHFA has reported for the first time on the voluntary affordable housing spending at each FHLBank in 2022. Voluntary spending for the system in 2022 was a little over one percent of net income ($46.6 million). While FHLBank Pittsburgh came in just under five percent, no other FHLBank came close. The largest FHLBank (Des Moines with 13 states) spent nothing on voluntary programs in 2022, while FHLBank Topeka spent $20,000.

The FHLBanks repeatedly state they are the largest private sector source of affordable housing funds. For comparison, Fannie Mae and Freddie Mac contributed $1.06 trillion in funds to the National Housing Trust Fund and the Capital Magnet Fund in 2022 while FHLBanks contributed $350 million. While FHLBanks are privately capitalized, their statutory ties to the government resulted in the Office and Management and Budget treating AHP funds as government funds for purposes of the federal budget.

Another recent Council of FHLBank piece[5] says FHLBanks "expect to contribute nearly $1 billion toward affordable housing and community development this year." If the FHLBanks are basing this on 10 percent of net income (statutory) and 5 percent of net income (voluntary) this suggests 2023 FHLBank net income will be in the area of $7 billion (15 percent of $6.7 billion is 1$ billion).

If the FHLBs provided 20 percent or 30 percent of net income to the AHP, the impact on housing would be significant. Consider that HUD's HOME program (the largest federal affordable housing block grant program) is slated to receive $1.5 billion in FY 2024 appropriations legislation. A 20 percent affordable housing contribution from FHLBanks

[5] https://www.americanbanker.com/opinion/fhfa-must-be-transparent-about-its-plans-for-the-home-loan-banks

based on expected 2023 net income would be $1.4 billion and a 30 percent contribution would provide $2.1 billion.

Increasing the AHP assessment would bring the FHLBanks' financial obligation to the broader public back to levels they operated under from 1989-2011. During that period, the FHLBanks were required to pay 10 percent of net income for affordable housing and 20 percent of net income to pay a share of the taxpayers' debt service on S&L clean-up bonds (known as REFCORP). With the completion of the REFCORP obligation in 2011 through a process that offered no public notice or comment, the FHLBanks retained that 20 percent of net income. That change has resulted in the growth of retained earnings resulting from this income stream by over $7 billion. These retained earnings are an important component of FHLBank capital but also provide FHLBanks and their members a risk-free source of income (from investments of that capital) and a pot of money that can be used to support dividends for years to come.

The FHFA's groundbreaking work on FHLBanks represents a once-in-a-generation opportunity to refocus FHLBanks efforts supporting affordable housing and community development. The regulatory process going forward will be open to comment by all interested parties. The Coalition for Federal Home Loan Bank Reform, https://www.fhlbreform.org, is an independent, non-partisan source of information and analysis for those who want to participate.

Let's get engaged and get to work.