



In Defense of the Federal Home Loan Banks

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BY JIM PARROTT AND MARK ZANDI

Congress had a remarkable run of housing policy during the Great Depression of the 1930s, creating the Federal Housing Administration, the Home Owners' Loan Corp., the Federal Savings and Loan Corp. (Fannie Mae), and the Federal Home Loan Bank system. This collection of government-backed institutions was created to broaden access to mortgages through the economic cycle in an effort to stabilize and eventually expand homeownership. In the years since, each of these institutions has generated its fair share of debate, with the notable exception of the FHLB system. Its regulator, the Federal Housing Finance Agency, has changed that recently in kicking off a review of the purpose and future of the system that has attracted an unprecedented amount of input from academics, policymakers and stakeholders.

Much of the discussion thus far has been critical of the system, driven largely by concern that the FHLB system's role is ill-defined and overly broad, affording its members significant economic benefit for which the taxpayer receives too little in return. We believe this is based on a misconception of the role of the FHLB system, which depends in large part on the breadth of its reach and the benefit it provides its members. In this brief, we clarify how this system works, how it benefits the mortgage market and the broader economy, and how it can be improved with some modest changes.

How the FHLB system works

The FHLB system is made up of 11 regional cooperatives designed to provide liquidity to their member institutions, which in turn provide liquidity to the residential mortgage market and by extension the broader financial system. The system was initially set up to support savings and loans and insurance companies, the main channels through which mortgages were provided at the time. But as the mortgage market changed with the collapse of the savings and loans and the rise of commercial banks and mortgage securitization, the FHLB system adapted, shifting its support to the new channels. Today its approximately 7,000 members include banks, credit unions, thrifts, insurance companies, and Community Development Financial Institutions.

To be eligible for membership in a FHLB, smaller depositories insured by the Federal Deposit Insurance Corp. must make or purchase mortgages or mortgage-backed securities and meet various risk management requirements; insurance companies and CDFIs must meet these core requirements and hold at least 5% of their assets in mortgages or mortgage-based securities; and larger depositories insured by the FDIC and credit unions insured by the National Credit Union

Administration must meet these core requirements and hold at least 10% of their assets in mortgages or mortgage-based securities.¹ Those eligible for membership become members by purchasing shares in the cooperative, giving them access to various forms of liquidity and any dividends on the cooperative's retained earnings.

Each cooperative raises capital by selling shares to its members and issuing debt into the capital markets. Investors in their debt pay close to the risk-free rate paid for U.S. Treasuries, allowing the FHLBs to provide liquidity for their members on terms better than they get elsewhere. The market-wide view that there is little risk in the FHLBs' debt is critical to the economic benefits they pass on to their members and driven largely by the way they collateralize their loans or advances, risk-sharing among the 11 FHLBs, and the support they receive from the U.S. government.

FHLB members are required to put up significant collateral against advances provided by its FHLB. The FHLB has a secured claim to this collateral, putting it ahead of unsecured creditors. It also has unique statutory protection from the exclusions, stays and other powers of the receiver in the insolvency proceedings of its depository members and some of its insurers. For those for which it does not have this statutory protection—some insurance companies and CDFIs—the FHLBs require more and higher-quality collateral to cover the incremental risk.² This aggressive approach to securing their advances significantly reduces the risk that the FHLBs suffer a loss on the primary source of liquidity they provide, in turn minimizing the risk that they default on their debt.

Further reducing their risk of default, the FHLBs are jointly and severally liable for the consolidated debt issued system-wide, with a line of credit from the Treasury of \$4 billion. Most important, they benefit from the market's assumption that the government would step in to support them should that line be exhausted. Taken together, these factors give global investors confidence that there is little to no risk in investing in the FHLBs' debt.

The FHLBs are also exempt from local, state and federal income taxes, though each is obligated to establish an affordable housing

1 Smaller depositories are those with less than \$1.417 billion in assets, and larger depositories have more than this in assets. While the 10% asset requirement is statutory, the 5% requirement is not and is applied somewhat differently by each FHLB.

2 The FHLBs require full collateralization of advances to members. Mortgage assets accepted as collateral backing advance borrowing are monitored for collateral adequacy and quality based on the type and value of the collateral. Assets accepted as collateral are discounted to reflect the risks inherent to the value of these assets, such as credit, market and liquidity risks. The amount of collateralization required may be adjusted as conditions change to assure the advance remains satisfactorily backed by collateral pledged over the life of the advance and as the value of the collateral changes.

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program to which it must contribute at least 10% of its annual net profits. These programs must be designed to provide financing for the purchase, construction or rehabilitation of owner-occupied housing for households below 80% area median income; or for the purchase, construction or rehabilitation of rental housing where at least 20% of the units are affordable and occupied by those with incomes no greater than 50% of area median income.

How members benefit from the FHLBs

The primary benefit members receive from the FHLBs is liquidity. The FHLBs provide this liquidity by purchasing members' residential mortgage loans and securities, investing in their residential housing projects, providing standby letters of credit to guarantee deposits made by municipalities, and most important, providing advances collateralized by their mortgage assets, U.S. Treasuries, and small-business, agriculture and community development loans.

In typical times, advances make up around two-thirds of the liquidity that FHLBs provide (see Chart 1). The funding ranges in maturity from overnight to 30 years, and since the FHLBs do not set any restrictions on the use of the advances, members use the liquidity for a full range of purposes. How and how aggressively a member uses them depends largely on its business model and market conditions that impact the cost of FHLB advances relative to other sources of liquidity, such as deposits and bank debt.

This has been vividly illustrated during the large swings in financial markets and the economy caused by the pandemic. When the pandemic first roiled markets, depositories immediately turned to FHLB advances, which jumped by \$160 billion in the first quarter of 2020 (see Chart 2). As policymakers stepped in and provided massive monetary and fiscal support, deposits soared and demand for advances fell as quickly as they had risen. As the pandemic receded, consumer

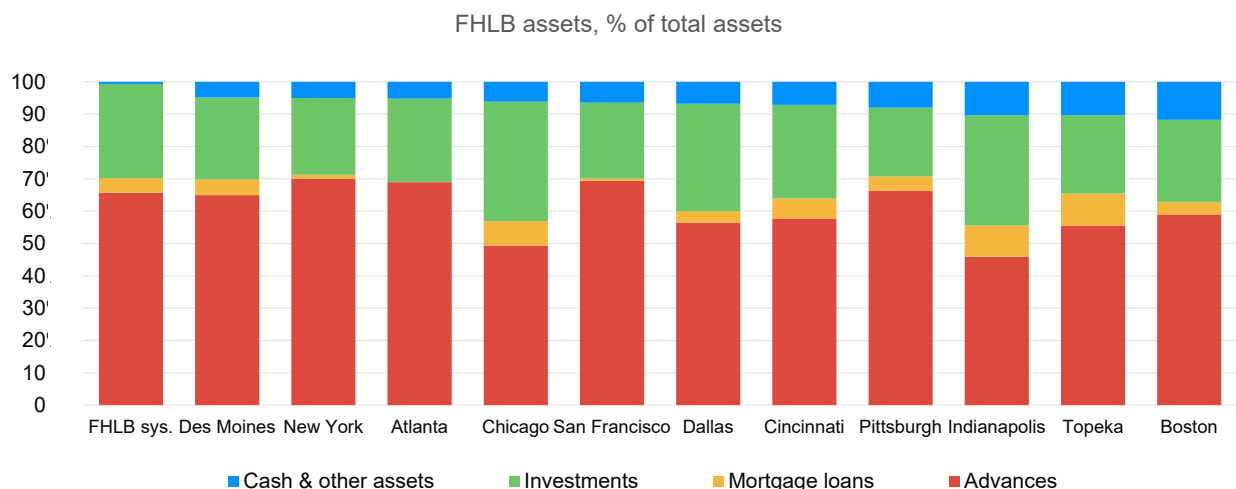
spending revived and deposits declined, sending advances back up again. They then remained high as consumers used their savings to supplement their incomes in the face of the higher prices for goods and services coming out of the pandemic.

While the pandemic has shown how sensitive FHLB advances are to market dynamics, the recent banking crisis has shown how critical they are to their members. As depositories saw a dramatic outflow of deposits in March, many turned to advances as a liquidity lifeline. The lending facility created by the Federal Reserve offered better terms, but many depositories were not yet comfortable with the newly established processes or the stigma some associated with use of the facility or the Fed window to imply. FHLB advances offered a more familiar and easily accessible cushion to handle the stress of fleeing deposits, tiding members over until the deposit flows abated or they grew more comfortable with the liquidity offered by the Fed.

The FHLB system played a similar role in the runup to the global financial crisis. When the house price bubble burst in 2007 and liquidity strains spread through the financial markets, the FHLBs were an early lifeline for its members, which increased their advances by about one-third. It was not until the next year that the Federal Reserve was able to step in with various credit facilities, and even then, many market participants were wary of the signals that tapping the Fed might send to the market. As in the recent banking crisis, while the Fed's dramatic moves were ultimately critical to the stability of the markets, the earlier, more accommodating presence of the FHLBs bought its members time and ultimately lessened the burden on the Fed.

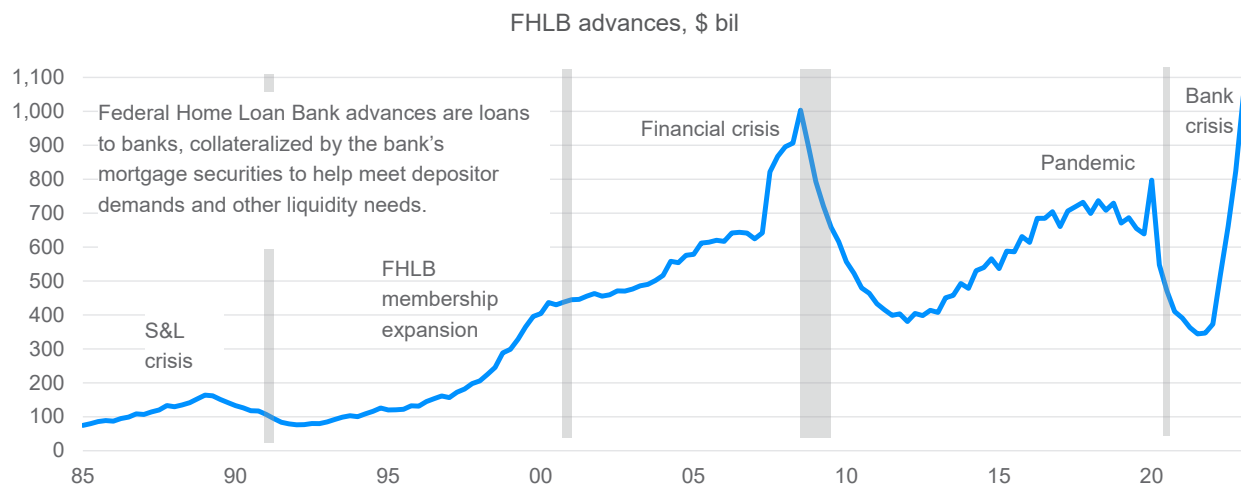
In addition to liquidity, members of the FHLBs benefit from a taxable dividend, which each member receives on its ownership interest when its FHLB turns a profit. The profitability of each FHLB is driven largely by the net interest margin on its advances; as it makes more

Chart 1: FHLB Advances Make Up the Bulk of the System's Assets



Sources: FHLB Office of Finance, Moody's Analytics

Chart 2: FHLBs Are the Financial System’s Liquidity First Responder



Sources: FHFA, Moody’s Analytics

loans, profits increase and so too do the members’ dividends. In 2020, for instance, the FHLBs paid out almost \$1.6 billion in dividends, and in 2021 that fell by well more than one-third to \$1 billion (see Chart 3).

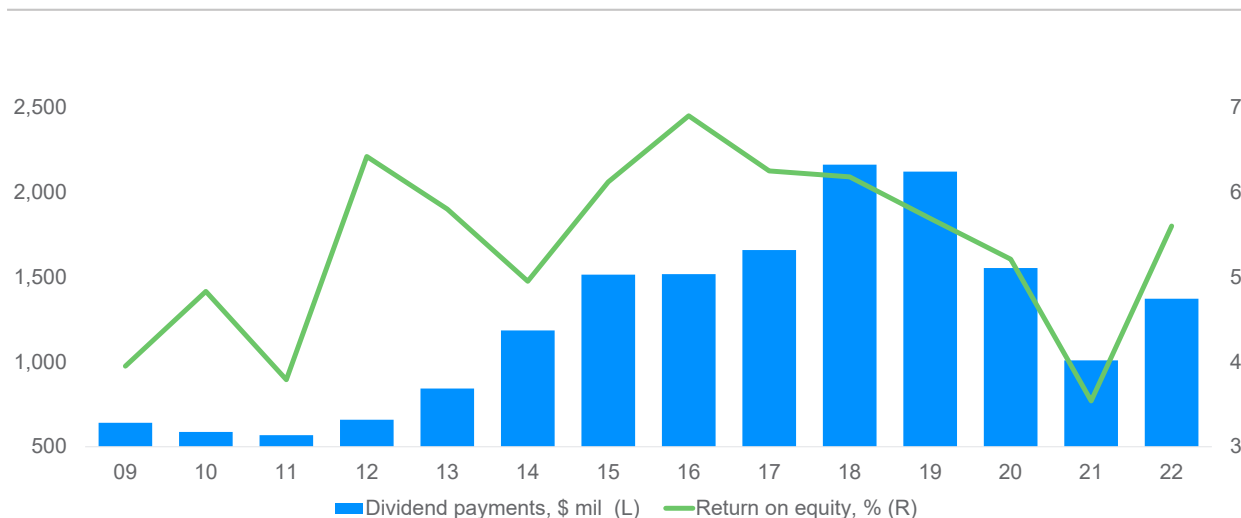
How the economy benefits from the FHLBs

Of course, the FHLBs were not established by Congress to benefit their members. They were established to support liquidity in the mortgage market and by extension the broader financial system, particularly for smaller institutions with limited funding sources and particularly in times of stress. The FHLBs support the mortgage market by reducing mortgage rates and their volatility through the economic

cycle. By lowering the cost of capital for institutions that make or invest in mortgages, the FHLBs lower the cost of the mortgages these institutions then provide to homebuyers. According to a recent University of Wisconsin study that examined the impact of bank mergers and FHLB membership on mortgage rates, FHLB membership reduces mortgage rates by 18 basis points and increases mortgage lending by more than 16%.

The study also found the impact on mortgage rates and lending to be greater for smaller community banks. The FHLB system helps level the playing field among lenders, providing access to liquidity on equal terms to all members irrespective of size. This allows smaller lenders such

Chart 3: Reasonable Return on FHLB Membership



Sources: FHLB Office of Finance, Moody’s Analytics

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as credit unions and community banks to maintain some parity with larger ones with access to sources of funding on terms that often benefit larger institutions.

The FHLB system also supports the availability of affordable housing. Each FHLB is required by statute to create an Affordable Housing Program designed to support affordable homeownership and rental housing and funded by no less than 10% of the FHLB's net profits. In 2022, the FHLBs together contributed \$355 million to support affordable homeownership and rental housing through AHP.

However, the most important benefit the FHLBs provide the economy is the stabilizing role they play for their members through the economic cycle. As has been made particularly clear over the last several years, the FHLBs provide a durable and consistent source of liquidity, without which the cost of funding for many lenders would become prohibitively expensive during times of stress, severely restricting the availability of all credit and potentially the viability of these institutions. This would be particularly hard on smaller institutions, which have fewer sources for liquidity available. Indeed, without the FHLB system it is likely the banking system would be substantially more concentrated, as smaller institutions would not have the ability to navigate periods of stress and the loss of liquidity.

The FHLB system is more accommodating and responsive to liquidity needs than the Federal Reserve, and thus better able to handle all but the most severe liquidity demands of its members. It is also a more stable and reliable source of liquidity than private financial institutions such as warehouse lenders and thus is better able to provide its members the certainty needed for consistent and durable liquidity. It effectively operates as an at-the-ready liquidity buffer, stabilizing members' cost of capital, and thus the availability of mortgage credit, through the economic cycle.

This stabilizing role has been critical several times in recent memory alone, as alternative sources of capital fled the system, and the Fed was yet to step in as the lender of last resort. Without the FHLBs, these downturns in the economic cycle would have been significantly more painful, with greater swings in the cost and availability of credit, exacting greater damage on the economy.

Taxpayer subsidy to the FHLBs

The benefits the FHLB system provides do come at a cost to taxpayers, since the FHLBs themselves enjoy public benefits for which they do not pay. This includes exemption from federal, state and local taxes and SEC registration. But the most valuable subsidy is that provided by the implied federal government guarantee of the FHLBs' debt. As with Fannie Mae and Freddie Mac prior to their conservatorship, investors believe that the FHLBs are too critical to the mortgage market and financial system for the government to allow them to fail. And as with Fannie and Freddie, this belief underpins the Aaa rating on which their low cost of capital—and thus their entire business model—depends.

This is borne out in the FHLBs' standalone ratings, which indicate an institution's credit risk absent government support. Each of the

FHLBs has a standalone rating of a1, with the exception of the New York FHLB, which has a rating of aa3 because of the strength of its advance business and its more modest mortgage portfolio.

As stated in a recent Moody's Investors Service review of the FHLB's rating:

The Federal Home Loan Bank System's (FHLBank System) Aaa long-term senior unsecured debt rating and Prime-1 short-term issuer rating reflect the combination of the FHLBank System's a1 baseline credit assessment (BCA) and our assumption of a very high likelihood of support from the US Government (Aaa stable) due to the FHLBank system's special role as a provider of liquidity to the US banking system. As such, the assigned ratings incorporate the benefits to creditors from the FHLBank Systems' status as a government-sponsored enterprise (GSE). The rating outlook is stable.³

We estimate the value of the U.S. government's implicit guarantee of the FHLBs' debt based on the yield advantage they receive on their debt. This is determined by comparing their yields with the higher yields on comparable issues from other systemically important private financial institutions.⁴ This yield difference is then multiplied by the amount of new debt issued in the year and by the amount of new debt estimated to remain outstanding in future years. Those future annual reductions in borrowing cost represent subsidies secured in the year but expected to be realized in the future. Finally, current and future annual subsidies are capitalized at a discount rate equal to the FHLB's borrowing cost, producing the year's total taxpayer subsidy.

The amount of taxpayer subsidy to the FHLBs fluctuates with market conditions. It rises in times of stress, when there is stronger demand for advances and investors in their debt would demand a premium absent the implied guarantee. And it falls as the stress recedes, when the demand for advances declines along with the difference the implied guarantee makes to investors. For example, in 2021, when banks were awash in deposits and FHLB advances were at historic lows, the government subsidy was an estimated \$1.9 billion. That is less than we estimate the subsidy to be for the first quarter of 2023 alone, given the surge in advances and value of the perceived guarantee due to the banking crisis. The size of the subsidy thus handily tracks the value the FHLBs provide the mortgage market, which also rises in times of stress and falls in times of relative calm.

The total taxpayer subsidy provided to the FHLBs in 2022 is estimated to be \$5.5 billion. This includes the \$4.7 billion value of the U.S. government's implicit guarantee of the FHLBs' debt and \$800 billion in tax and SEC registration exemptions. We view this to be a conservative estimate.

Criticisms of the FHLBs

In the months since the FHFA invited comment on the FHLBs, the system has received a considerable amount of criticism. The

³ See "Federal Home Loan Banks, Credit Opinion," Moody's Investors Service, January 2023.

⁴ To estimate the taxpayer subsidy, we used a similar approach to that used by the Congressional Budget Office in "Federal Subsidies and the Housing GSEs," Lucas and Phaup, 2001.

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criticisms tend to fall into two somewhat contrary camps, with some arguing that the FHLBs have the potential to distort and destabilize the financial system rather than support it, and others that it does not do enough to help the mortgage and housing markets.

Criticism that the FHLBs distort the financial system

Critics contend that the FHLBs distort the financial system by crowding out deposits and depressing deposit rates, relying too heavily on money market funds for their funding, and potentially disrupting the federal funds market. Each of these criticisms is overstated if not misplaced.

Banks use FHLB advances in lieu of deposits to fund their lending activities, but as advances account for only less than 5% of total bank liabilities, whatever impact they might have on deposits would be modest. And the rise and fall of advances tends to follow—rather than lead—the rise and fall of deposits (see Chart 4). This suggests that in their use of advances FHLB members are reacting to swings in deposits, not causing them. This is, of course, precisely what happened during the most recent banking crisis as depositories used advances to manage the severe disruption caused by a run on their deposits.

The FHLBs have long relied on money market funds for funding, but this increased with the SEC reforms to the money funds in 2016 that pushed the money funds to invest more in government-backed securities, including FHLB debt. The money funds demand has been particularly focused on short-term FHLB debt because of their continuous risk of investor withdrawals. Critics contend that the FHLBs' reliance on this funding source makes it overly vulnerable to its retreat.

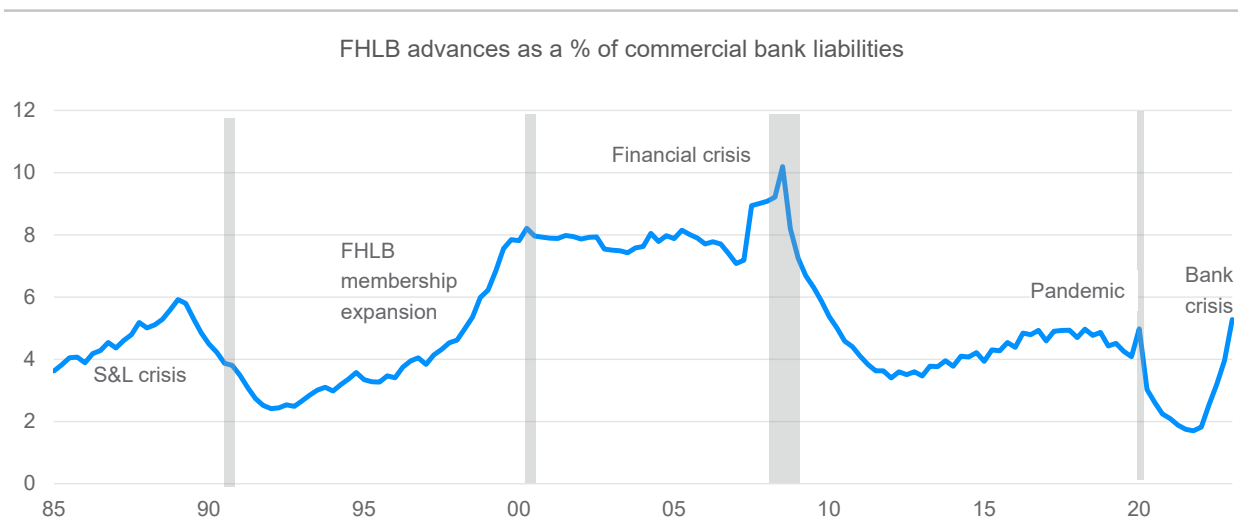
But this concern overstates the risks. Money funds have become an increasingly stable source of funding since the financial crisis, given

their ability to engage in profitable reverse repo operations with the Federal Reserve as the Fed pays interest on reserves. Moreover, FHLBs enjoy strong demand for their debt from a wide range of other fixed-income investors, including investment advisors and bond fund managers, state and local governments, insurance companies, pension funds, banks, central banks, and nonfinancial corporations. This diverse mix of sources allows the system to source funding continuously across the entire fixed-income market, under nearly all market conditions.

The FHLBs have become the largest lender in the federal funds market, the market for bank reserves that determines the federal funds rate the Federal Reserve uses to manage monetary policy. FHLBs are active in the funds market, which provides them with the flexibility to manage the rollover risk on their own short-term liabilities and meet demand for advances. While there is no debate that in normal times the FHLBs' participation in the funds market helps stabilize the funds rate, there is concern that in stressed environments the FHLBs may exit the market and amplify the volatility in rates.

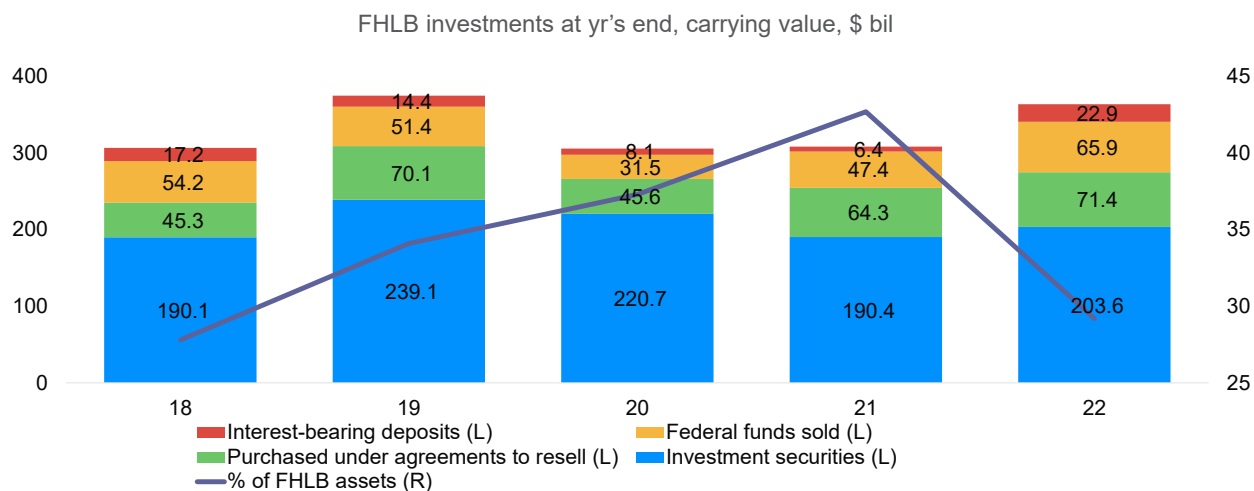
However, there is little evidence of this, since investments in fed funds have been stable even through times of stress (see Chart 5). During recent severe liquidity events, the Federal Reserve has reacted quickly with massive injections of liquidity into the market. The ample amounts of liquidity available to financial institutions (including those that borrow in the fed funds market) results in lower needs for funding, and likewise, lower borrowing costs. This environment of ample liquidity and lower borrowing costs typically leads the FHLBs to deploy less excess liquidity in the fed funds market, as the cost does not justify the exposure to unsecured investments. The impact of the FHLBs on the federal funds market thus

Chart 4: FHLB Advances Are a Small Share of Bank Liabilities



Sources: Federal Reserve, FHLB Office of Finance, Moody's Analytics

Chart 5: FHLB Investments Have Been Stable



Sources: FHLB Office of Finance, Moody's Analytics

declines in these moments of stress, making the market less vulnerable to their sudden exit.⁵

Criticism that the FHLBs destabilize the financial system⁶

Critics also argue that the FHLBs can be a source of systemic instability in a crisis. Most recently, they have claimed that the FHLBs' funding of Silvergate and Silicon Valley Bank shows that the FHLBs' lack of oversight and restrictions on the use of their advances accelerates rather than mitigates risk in a time of stress. While this concern is not surprising as policymakers work to understand the causes of these failures, it too is misplaced here.

The FHLBs do not have regulatory or supervisory authority over their members. They rely on the safety and soundness regulators of their members to provide the necessary oversight. This is as it should be, as the FHLBs are not nearly as well positioned as these regulators to monitor the safety and soundness of thousands of members of different sizes and business models. They focus instead on the risk posed by the liquidity they provide, which they manage primarily through aggressive collateralization.

Nor should the FHLBs limit how their advances are used. To provide critical liquidity to the institutions on which the mortgage market depends, they must provide it on terms flexible enough to allow their members to address their wide range of liquidity needs. Indeed, given the dynamic nature of these needs and the fungibility of liquidity generally, prescribing what members can do with the funds would likely be unworkable, undermining the mission of the FHLBs to quickly provide liquidity to members, particularly in times of stress.

More broadly, critics worry about the FHLBs' reliance on cheap short-term funds to provide longer-term advances at higher rates. While all banks engage in some form of this so-called maturity transformation, the size of the FHLBs has given rise to concern that theirs may pose a particular risk to the system in a time of stress. Again, the concern appears overblown.

The FHFA has issued guidance to the FHLBs in an Advisory Bulletin on liquidity management intended to ensure that the FHLBs will be able to provide their members with liquidity even without access to capital markets for an extended period. As part of this liquidity management regime, the FHFA limits the FHLBs' maturity gap, which is the difference between cash flows generated by their assets and those required to be used to service their liabilities as a percentage of total assets. This largely ensures that the FHLBs are not taking on an unsustainable level of maturity transformation, making it unlikely that their maturity transformation would result in an intensification of liquidity strains in the broader financial market.

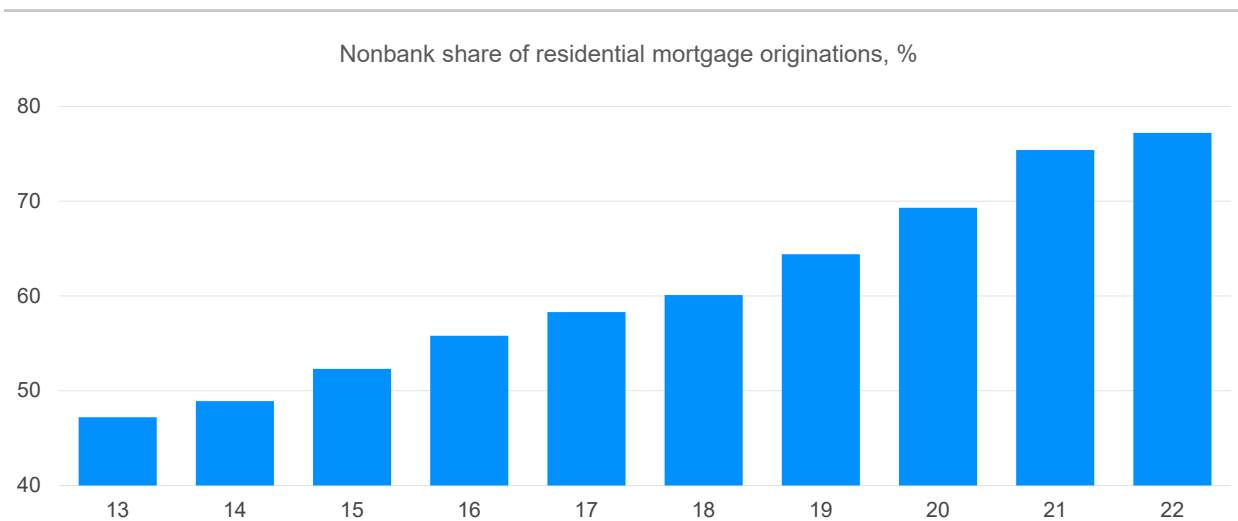
There are benefits to this modest level of maturity transformation, including lower marginal funding costs for members, which helps smaller, community-based institutions compete with larger providers and ultimately reduces borrowing costs for consumers. And it allows the FHLBs to use their debt issuance to source low-cost funding to support the broad investment needs of their diverse investor base. So long as it remains in check within a robust liquidity management and oversight regime, the FHLBs' maturity transformation supports rather than undermines the FHLBs' stabilizing role by strengthening its capacity to provide funding through the cycle.⁷

⁵ It is also worth noting here that the funds market is much diminished since the financial crisis, suggesting that the Fed should switch its policy rate to another, such as the Secured Overnight Financing Rate, or SOFR.

⁶ The most serious criticisms of this kind were made in "Federal Home Loan Banks and Financial Stability," Gissler, Narajabad, and Tarullo, *Journal of Financial Regulation*, March 2023.

⁷ Of course, the FHLBs' members can potentially engage in irresponsible asset/liability management practices, whether they borrow through the FHLBs or through other wholesale funding channels. Their risk of maturity transformation is mitigated in the case of FHLB lending because of its fully collateralized lending model, surveillance of members and their collateral quality, FHLBs' balance sheet liquidity, strength of its debt franchise, and status as a government-sponsored enterprise that provides the broad support of a deep investor base.

Chart 6: Mortgage Market Is Quickly Evolving



Sources: FHLB Office of Finance, Moody's Analytics

It is important to keep in mind that the FHLBs are designed to be a bulwark against instability through the cycle. Their explicit and implicit support from the government reduces the pressure that the system faces in times of stress, keeping the cost of their debt low and stable. And the legal protections they enjoy during a member's insolvency proceedings and the mutualization of their liabilities across the system reduce further still the strain on any single FHLB in even the most severe economic conditions.

These considerable protections against market stress allow the FHLBs to function as something of a liquidity first responder. They are well positioned to provide immediate support to their members when they come under stress, giving the Federal Reserve and other policymakers more time and market feedback to assess market conditions and devise the appropriate policy response. The Federal Reserve is ultimately the lender of last resort, and under extraordinary circumstances will need to step in and backstop the financial system, but the FHLBs provide critical support in these and other significant but less systemic periods, and by so doing ensure the crises are fewer and less severe.

The FHLBs could do more to support the mortgage and housing markets

Arguments that the FHLBs could do more to support the mortgage and housing markets have more merit. In turning to these arguments, though, it is important to keep in mind a key constraint on just how much support the system can provide. The central benefits the FHLBs provide to the housing finance system—stabilizing liquidity and increasing resources for affordable housing—are sensitive to how much business members do with their FHLBs. The liquidity the FHLB system provides depends in significant part on the considerable volume of debt it issues regularly. This issuance is driven by the volume of business done by FHLB members. And the resources the FHLB system generates for affordable housing are taken from the profits of each of

the FHLBs, which again depends on the volume of business done with its members. To maximize the policy benefits the system provides, policymakers must be careful not to push the system so hard as to undermine its value to members.

With that in mind, there are three ways the FHLB system could be expanded usefully: expand its membership, expand its support of CDFIs, and expand its support for affordable housing.⁸

Expanding FHLB membership

When the FHLBs were established nearly a century ago, supporting the mortgage market meant supporting the lending of savings and loans and insurance companies. This changed with the collapse of the S&Ls and the rise of banks and securitization as sources of mortgage credit. The FHLBs adjusted their membership accordingly.

The market has since shifted again, with the rise of nonbank originators in the primary market and real estate investment trusts in the secondary market. Today, nonbanks make up more than three-fourths of new originations and REITs more than one-tenth of MBS purchases (see Chart 6).⁹ For the FHLBs to continue to support the mortgage market in the way they were intended to, they must again adapt to accommodate the evolution of the market.

To remain effective as they adapt, however, the FHLBs must be careful not to compromise the foundation on which their support of the mar-

⁸ Lawmakers are already focused on ways to reform the FHLB system. U.S. Senator Catherine Cortez Masto (D-Nev.) recently introduced legislation to require the FHLBs to increase their investments in affordable housing, community development, and small-business lending. Cortez Masto's [Federal Home Loan Banks' Mission Implementation Act](#) directs the FHLBs to do more to meet the affordable housing and community economic development needs of the communities they serve. Companion legislation has also been introduced in the House of Representatives by Congressman Ritchie Torres (D-N.Y.-15).

⁹ According to the National Association of Real Estate Investment Trusts, as of December 2021, REITs held 11.3% of the outstanding balance of agency mortgage-backed securities issued or guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae.

ket rests, namely their low cost of capital. If the system were to adapt in a way that meaningfully increases its risk, investors would demand a higher return on its debt, compromising the ability of the FHLBs to provide stable access to low-cost liquidity through the cycle. The FHLB system should thus expand its membership to accommodate the critical players in the mortgage market only on terms consistent with the risk assumed under current membership requirements.

The FHLBs' membership requirements help them control risk with three tools: capital, collateral and oversight. Applying the first to new categories of members is straightforward, at least in theory, as any new categories of member should be required to hold the same level and quality of capital as current members relative to their respective risks. In practice, this may be more complicated given different accounting and regulatory conventions. The other two tools undoubtedly also would be complicated to implement but doable.

The FHLBs already deploy a range of approaches to collateralizing their advances, so they should be able to develop one that works for new kinds of members that do not have statutory protection during insolvency proceedings. For instance, they could increase the amount and quality of collateral required as they do for insurance companies and CDFIs, require that collateral be placed into a bankruptcy remote trust to approximate the statutory protections they have for depositories, or some combination of the two.

Likewise, prudential oversight for new members would be critical but appears manageable. The FHLBs' current members are each overseen by a prudential regulator. This is vital, because the FHLBs do not have the authority or expertise to track the financial health of thousands of members. To expand membership to key players in the mortgage market that have no such prudential regulator—notably Independent Mortgage Banks and REITs—the FHLBs could require them to submit to the prudential oversight of FHFA as a condition of membership. This would require the FHFA to expand its resources to handle the role, but it seems well positioned to do so given its current responsibilities managing the risks posed by the counterparties of Fannie Mae and Freddie Mac.

It is, of course, easier to suggest that the FHLBs should accommodate their risk management regime to new kinds of institutions than to show how to do it. And the effort may well require steps that exceed the authority of the FHLBs and their regulator, the FHFA, as did the last major update to the system when Congress expanded membership to include commercial banks, credit unions and CDFIs. But if the FHLB system is to continue to play the critical role in housing finance that it has played over the last century, it must find a way to adapt along with the evolving mortgage market.

Expand support for CDFIs

Another way the FHLBs have struggled to keep up with the evolving economy is in their support of their member CDFIs. Though CDFIs are well positioned to help the FHLBs provide capital to lower-income, underserved communities, the FHLBs have had a difficult time providing them with the support they need to increase their impact in a meaningful way.

This is partly because the FHLBs lack a clear community development strategy. In the absence of clear goals, a plan for meeting those goals, and some metrics to assess success, the FHLBs and stakeholders alike have struggled with how to align the resources of the FHLBs with the needs of the CDFIs. The FHLBs also struggle with managing the lending risks posed by the complex loan structures involved and the absence of the insolvency protections they have with other members.

To address these issues, the FHFA should work with the FHLBs to develop a clear community development strategy, complete with discernible goals and ways to assess progress. Then one or two of the FHLBs should be tasked with developing products and programs consistent with that strategy that are available to CDFIs throughout the FHLB system. By bringing all the FHLBs' community development efforts into a common policy and funding framework, it will be easier to align the considerable resources of the FHLBs with the considerable mission opportunities offered by the CDFIs, and to promote the partnerships and collaboration needed to maximize the flow of capital to the communities that need it.

Expand support for affordable housing

Policymakers should also take steps to strengthen the FHLBs' support for affordable housing. The FHLBs should be required to contribute as much as 25% of their earnings to affordable housing, more than doubling their current effort to bring it in line with the combined marginal federal, state and local tax rates paid by other private financial institutions. In effect, the FHLBs would then be paying taxes with the proceeds earmarked to support affordable housing. This would not affect their after-tax profitability enough to impede the critical liquidity support they provide the market.

To make this funding more effective, the Affordable Housing Program requirements should be streamlined. The statutory requirements for AHP are relatively simple—each FHLB must set up its own AHP that supports defined groups of homeowners and renters—but the regulations that have been developed over the three decades since these statutory requirements were created have made the umbrella program unnecessarily complex for both the FHLBs and those they partner with on affordability efforts. Policymakers should reassess the multiple layers of restrictions and requirements that have built up in the AHP over the years with an eye to making it easier for AHP participants to develop, implement and modify AHP efforts.

Last, policymakers should allow FHLBs more flexibility in deploying contributions above 10% of earnings. A decade ago, too many homes for sale created a downward spiral in prices and a devastating rise in negative equity, forcing many from their homes in a way that put homeownership out of reach for years to come; yet today it is too few homes creating a rise in house prices that again has put homeownership out of reach for many. What is needed to support affordable housing has changed dramatically with policymakers struggling to adjust their approach to keep up with the changing landscape. And there is as much variation of need from one region to another as there is through the economic cycle. For example, while Pittsburgh and Cleveland need help renovating their limited affordable housing stock, Seattle and San Francisco need help building theirs.

Yet the AHP is designed for a relatively small number of specific, scalable national programs focusing primarily on two kinds of support: demand-side help for prospective homeowners and supply-side help for renters. There will always be a need for these two kinds of support, but we require a broader range of tools to address the broader range of need and the capacity to develop new tools as the needs change. The FHLBs should not only be allowed but encouraged to experiment with a broader range of programs to increase affordability, from construction loans for entry-level homes, to funding for demolition to address blight, to relief for those struggling to pay their rent or mortgage. To accommodate this dynamic adjustment to the AHP, the FHFA would need to develop an oversight regime that approves the proposed efforts, sets measurable objectives, and then holds the FHLBs accountable for the results.

Increasing, streamlining and expanding the support the FHLBs provide for affordable housing in this way would make them a much more effective force in addressing the wide range of deep housing needs facing the nation.

Conclusion

The last several years of market disruption, from the dramatic swings brought about by the pandemic to the stress created by the recent run on our nation's banks, have made it clear how important durable sources of liquidity are to the stability of our financial system. Warehouse lenders, capital markets, and the Federal Reserve provide much of what is needed, but not all. Relying entirely on warehouse lenders and capital markets would leave the system vulnerable to dramatic swings in market confidence. And while the Fed stands ready to step in during periods of crisis, it takes time to do so with the force, breadth and nuance often needed. The FHLBs help fill the gap between these two sources of funding with access to low-cost liquidity through the cycle for institutions operating in the mortgage market. This helps stabilize the cost and availability of mortgage credit and with it the housing market and broader economy. If anything, the FHLB system should be expanded to provide that support more broadly and effectively in an ever-changing mortgage market and financial system.

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