Federal Home Loan Bank Reform

Improving an Underappreciated Resource for Housing Finance

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August 2024

The Federal Housing Finance Agency (FHFA) asked recently for input on the Federal Home Loan Banks' (FHLBs') mission, membership, and affordability requirements.[1] In this brief, we offer our thoughts on these issues, weaving them into two questions: what is the appropriate mission of the FHLBs, and how should their membership and housing affordability requirements be changed to better support that mission?

What the FHLBs' Mission Should Be

The mission of the FHLBs should be to provide funding for affordable housing and community development, as well as liquidity to the institutions that support the mortgage market. The first of these is a straightforward statutory obligation, so we begin with an explanation of the banks' less appreciated liquidity function and later turn to how their membership and affordability requirements should be changed to better support this mission.

Why the FHLBs' Liquidity Support Is Important to Housing Finance

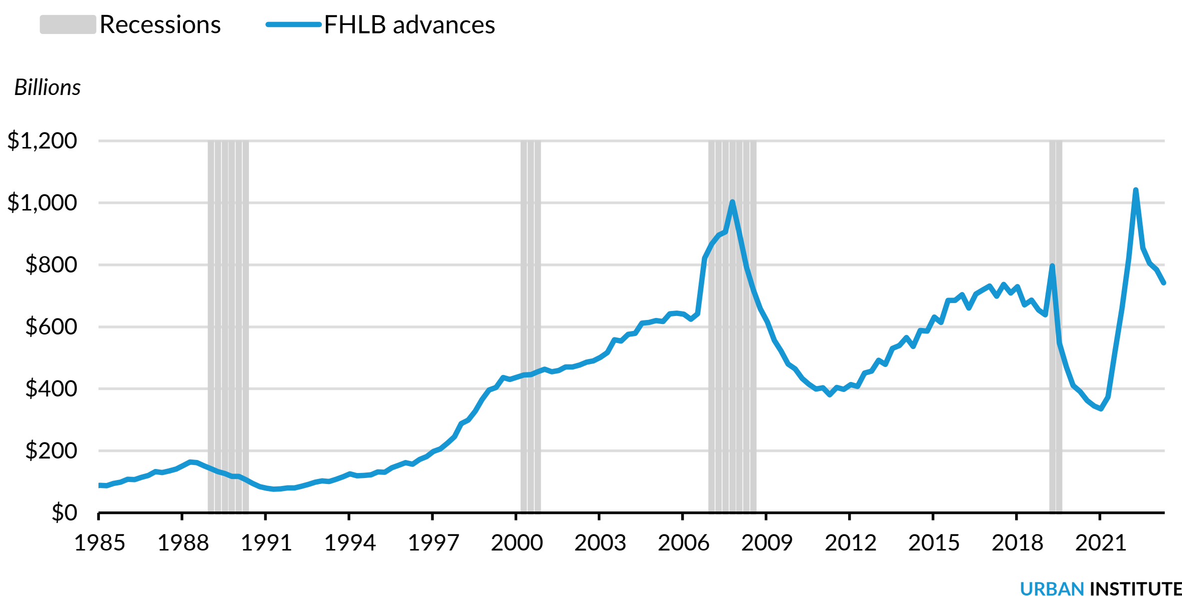
The FHLBs provide their members a consistent source of low-cost funding at a predictable interest rate through the economic cycle. This function is critical to the mortgage market during times of stress, when funding would otherwise become prohibitively expensive, a cost that would flow through to the market in the form of tighter and more expensive access to mortgage credit.

Figure 1 shows the variability in FHLB lending to its members. Note the spikes during the financial crisis (2007–08) and during the Silicon Valley Bank failure (2023) and, to a lesser extent, during the pandemic.

FIGURE 1

Advances Are an Important Source of Liquidity

FHLB advances



Source: Board of Governors of the Federal Reserve System, data from Federal Reserve Economic Data.
Note: FHLB = Federal Home Loan Bank.

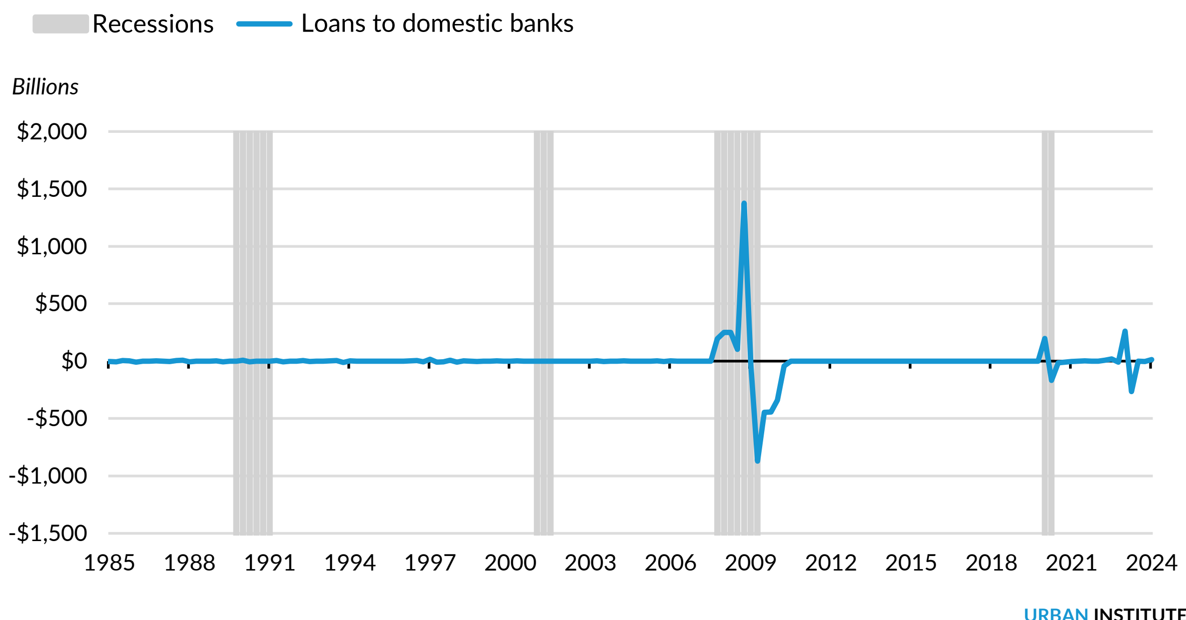
This funding has reduced bank defaults, averting the contraction in mortgage credit that follows when mortgage lenders shut down (Moore et al. 2023). Although the impact on the mortgage market is difficult to quantify, it is likely significant, as bank defaults tend to create runs on other banks with similar characteristics, sending waves of stress through the sector that translate into higher costs of capital, tighter lending, and more financial instability. A recent paper from the Federal Reserve Bank of New York shows that during the March 2023 banking crisis, 22 banks experienced runs on their deposits. The FHLBs provide a critical cushion against these runs, as the banks that survived them did so by borrowing new funds and raising deposit rates, not by selling liquid assets (Cipriani, Eisenbach, and Kovner 2024). Almost all the banks that experienced a run relied on the FHLB system.

The Federal Reserve's discount window is another critical source of support in times of stress, but it is meant to be available only as a last resort. Figure 2 shows the pattern of discount window use is more concentrated than is use of the FHLBs' advances, operating more like an on-off switch in moments of significant stress. Absent the FHLBs, use of the discount window would likely be still more dramatic, with banks even more desperate for quick access to large sums of liquidity to stave off stress.

FIGURE 2

Lending by the Federal Reserve's Discount Window Is Concentrated

Loans to domestic banks through discount window, transactions



Source: Board of Governors of the Federal Reserve System, data from Federal Reserve Economic Data.

The FHLBs are particularly important to smaller institutions, which have limited alternatives. There is a modest Federal Reserve program available to institutions with less than $500 million in assets, but it is intended to fill seasonal needs and leaves the many smaller institutions that hold assets just above that limit no backup liquidity other than the FHLBs. The FHLB system thus levels the playing field by allowing smaller institutions to continue to lend through the cycle on the same terms as larger institutions, which they would otherwise be unable to do. Not surprisingly, research shows the impact of the FHLB system on mortgage rates and lending to be greater for smaller community banks.[2]

How Membership Requirements Should Be Tailored to Support the FHLB Mission

For the FHLBs' support of their members' liquidity needs to translate effectively into support for the housing finance system, the FHLBs' membership needs to be closely tied to housing finance. But their membership requirements are not adequately calibrated to that role today, allowing the FHLBs to support some members with a minimal ongoing role in the housing finance system and failing altogether to support many institutions increasingly critical to housing finance.

There are two ways that membership can create a strong nexus between the liquidity the FHLBs provide and the housing finance system it is intended to support: (1) aligning the kinds of institutions

that can be members with those the mortgage market depends on and (2) ensuring that each institution that becomes a member has an ongoing commitment to supporting housing finance. The FHLBs' membership requirements can be improved on both counts.

Updating Membership to Align with Today's Mortgage Market

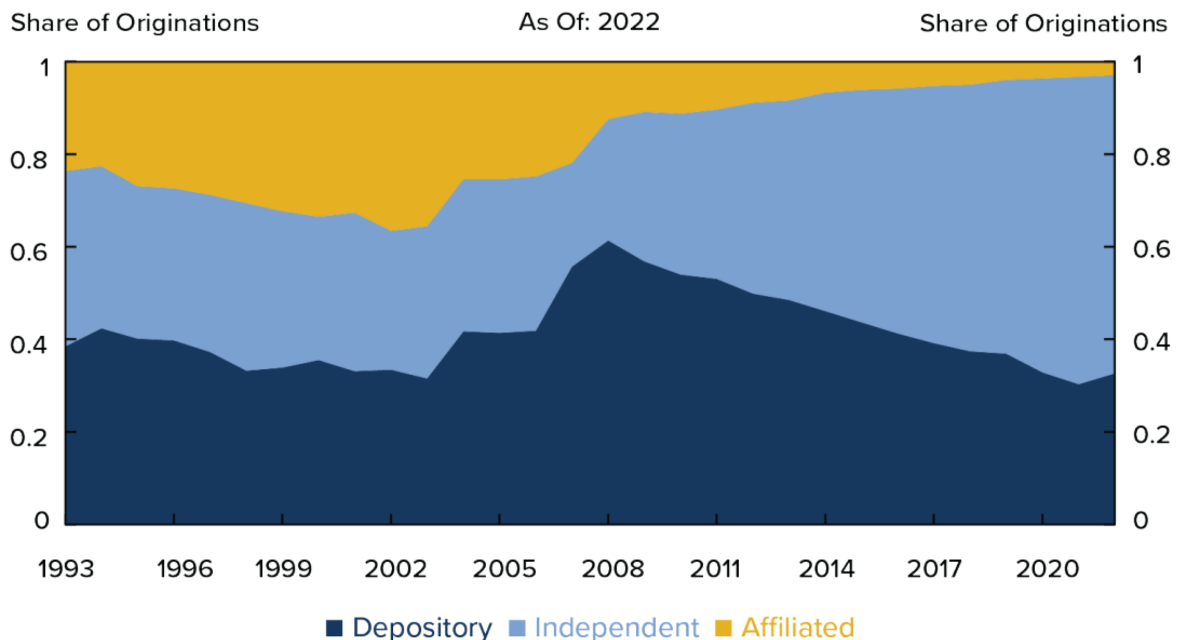
When the FHLB system was founded in 1932, it served federal savings and loan associations and insurance companies, the predominant sources of mortgage liquidity at the time. Over time, the system expanded its membership to reflect a changing mortgage market, adding federally insured commercial banks and credit unions in 1989, community development financial institutions (CDFIs) in 2007, and non–federally insured credit unions in 2015.

To see how misaligned these eligibility categories have become with the mortgage market, it helps to look at some numbers. Figure 3 shows the share of the overall single-family mortgage market originated by independent mortgage bankers (IMBs), which are not eligible for FHLB membership. As of 2022, IMBs originated 64 percent of all mortgages, up from around 25 percent in 2008. And the IMB origination share of agency securitizations is 83 percent, up from around 30 percent in 2013.

FIGURE 3

Independent Mortgage Bankers Are Responsible for Most Mortgage Lending

Loan origination, by type of originator



Source: Financial Stability Oversight Council (FSOC), *Report on Nonbank Mortgage Servicing 2024* (Washington, DC: US Department of the Treasury, FSOC, 2024), figure 4.

Notes: Depositories include credit unions. Independent refers to nonbank mortgage companies. Affiliated refers to nonbank mortgage companies affiliated with a depository institution.

If we look at the share of mortgages that IMBs service, we see a similar pattern. The share of the single-family agency mortgage market nonbanks serviced increased from 35 percent in 2013 to 65 percent at the end of 2023.

The secondary market shows a more modest misalignment between the categories of FHLB membership and the kinds of investors driving the mortgage market. Table 1 shows that the top holders of mortgage-backed securities (MBS)—commercial banks and insurance companies—are members, but real estate investment trusts (REITs), another significant source of secondary market liquidity, are not.

TABLE 1

Mortgage-Related Security Holdings, by Investor Type, in the First Quarter of 2024

Billions of dollars

Investor type	Total	Agency	Non-agency
US depository institutions	**3,138.85**	**3,061.40**	**77.44**
Commercial banks	2,267.49	2,217.07	50.42
Savings institutions	257.42	246.94	10.48
BHC trading accounts	430.89	421.34	9.55
Credit unions	183.06	176.06	7.00
Other investor types			
Federal Reserve System	2,380.24	2,380.24	0.00
Foreign investors	1,479.87	1,268.21	211.66
Mutual and money market funds	1,189.29	1,172.79	16.50
Public and private pension funds	204.24	199.54	4.70
Life insurance companies	200.28	123.28	77.00
Mortgage REITs	173.42	168.46	4.96
Securities brokers and dealers	165.99	158.99	7.00
Property and casualty insurers	146.99	128.99	18.00
State and local governments	136.05	134.00	2.05
Fannie Mae and Freddie Mac	51.38	50.42	0.96
FHLBs	40.48	39.14	1.35

Source: *Inside MBA & ABS*, June 14, 2024, issue.

Notes: FHLB = Federal Home Loan Bank; MBS = mortgage-backed securities; REIT = real estate investment trust. Total MBS outstanding is remaining principal balance, while mortgage-related securities holdings are variously reported as fair-value and amortized cost. Sources include the Federal Financial Institutions Examination Council, the Federal Reserve System, the FHLBs, Fannie Mae, and Freddie Mac. Foreign investor holdings are based on US Treasury data. Estimates from REITs, mutual funds, money market funds, pension funds, life insurers, state and local governments, and property and casualty insurers are based on Federal Reserve disclosures of total agency debt and MBS holdings.

The most meaningful change policymakers could make to align the FHLB system with the mortgage market we have today would be to expand membership to IMBs and, to a lesser degree, REITs. That alone would vastly increase the degree to which the liquidity support that the FHLBs provide their members translates into support for the housing finance system. Both business models are central to today's mortgage market, and both are vulnerable to liquidity risk in times of stress. This liquidity risk stems in large part from both entities being essentially monoline mortgage entities, with IMBs originating and servicing mortgages and REITs holding at least 75 percent of their assets in

mortgage-related investments. The mortgage market would benefit enormously from providing them access to a stable liquidity source through the cycle.

This is easier said than done. The FHLBs' ability to provide their members access to stable, low-cost capital depends on their ability to issue debt at a near risk-free rate. And they can do that only because of the significant risk-mitigation measures they have in place around membership and collateral, some of which would be difficult to apply to IMBs and REITs.

The FHLBs have statutory protection from the Federal Deposit Insurance Corporation's (FDIC's) priority over a depository's assets in insolvency, securing the FHLBs' interest in the collateral these institutions put up against their advances. And FHLBs rely heavily on the oversight of their members provided by their primary prudential regulators, a function they do not have the resources to provide for their thousands of members. Neither of these risk mitigants would apply neatly to IMBs or REITs, as neither has a federal prudential regulator or a statutory arrangement that could put the FHLBs first in the line of creditors during insolvency.

These challenges can be overcome, however. To better collateralize their advances, the FHLBs could require that the collateral the IMBs and REITs put up be placed into a bankruptcy remote trust. Or they could require IMBs and REITs to put up more collateral against their advances, as they already require of CDFIs, over which they also lack priority-lien status. Congress could also create statutory protections for the FHLBs over the assets of REITs and IMBs, as states are considering doing for the FHLBs' interest in the assets of member insurance companies.[3] And to address the lack of a single federal prudential regulator, policymakers could require that IMBs or REITs submit to prudential oversight by the FHFA to become an FHLB member. In short, the FHLB system can adapt to safely accommodate these entities.

The larger problem for the IMBs is that they may have a difficult time meeting whatever collateral requirements are put in place. Mortgage servicing rights compose a sizeable share of assets for most IMBs, but they are not among the forms of collateral allowed under the relevant statute. Congress could expand the forms of acceptable collateral, but mortgage servicing rights are illiquid and volatile, so the FHLBs would need to apply a meaningful haircut to cover their risk as collateral. Ginnie Mae mortgage servicing rights are especially illiquid, with only Ginnie Mae–approved issuers eligible to own them and those that acquire them assuming considerable liabilities, including obligations to advance principal and interest payments on higher-risk loans backed by the Federal Housing Administration, the US Department of Agriculture, and the US Department of Veterans Affairs, as well as liabilities arising from prior servicers' errors. Thus, the IMBs most in need of liquidity support—those with large Ginnie Mae books—would likely find the least support from the FHLBs.

Strengthening the FHLBs' Ongoing Membership Requirements

The FHLBs' ongoing membership requirements could also be improved to strengthen the nexus between FHLB liquidity and housing finance. Currently, an institution eligible for membership must meet a mortgage asset test. CDFIs, insurance companies, and smaller FDIC-insured depositories must

make or purchase some mortgages or MBS. Larger FDIC-insured depositories and all National Credit Union Administration–insured credit unions must hold at least 10 percent of their assets in mortgages or MBS. And then each FHLB can set additional requirements above these minimum thresholds. For example, the Des Moines FHLB requires an insurance company to hold at least 5 percent of its total assets in residential home loans, residential MBS, or other mortgage-related assets to be eligible for membership.[4]

In these tests, all eligible mortgage assets receive the same weight, even though mortgages originated by member institutions have a greater impact on expanding the supply of available mortgage credit than MBS acquired in the secondary market. To entice institutions to have a greater impact on mortgage credit availability, consideration could be given to weighting the assets, with loans originated or held counting more than MBS in determining compliance with membership requirements.

The bigger shortcoming in these asset tests is the absence of any comparable ongoing requirement. Once an institution meets its initial asset test for membership, it can unwind much of its mortgage-related positions without losing membership. The FHFA has proposed to address this flaw by extending the 10 percent mortgage asset requirement for admission to an annual requirement for some institutions. This is a wise move, ensuring that the support the FHLBs provide to their members is more likely to translate into ongoing support of the housing finance system.

The new ongoing asset test should not be applied to insurance companies, however, as it would reduce rather than increase the FHLB system's support of housing finance.

Insurance company mortgage loan exposure totaled $627 billion in 2020, about 8 percent of their total assets under management, with life insurance companies holding 96 percent of the total and property and casualty companies holding most of the rest (Johnson and Carelus 2021). The overwhelming share of mortgage exposure is held by large companies with total assets under management of $10 billion or more, and the bulk of the exposure is in multifamily housing, where they are one of the sector's most critical investors.

If the FHFA were to impose a 10 percent ongoing residential mortgage test for insurance companies, many current FHLB members would not pass. And of those that would not pass, many would abandon the FHLBs rather than increase their housing finance positions.

This is because insurance companies are more important to the FHLB system than the FHLB system is to insurance companies. More than 570 insurance companies are FHLB members, increasing more than fivefold in the past two decades.[5] These insurance company members punch above their weight, accounting for 16 percent of all advances but only 5 percent of its members.[6] The typical insurance company advance is much larger than other member advances,[7] and they provide a steady demand for advances that is generally unaffected by turmoil in the banking system. Moreover, just 12 percent of all insurance companies were FHLB members,[8] leaving lots of room for additional growth.

Yet FHLB advances remain a small share of insurance companies' total liabilities. In 2016, advances composed less than 2 percent of liabilities for life insurance companies and 0.33 percent of liabilities for property and casualty companies.[9]

Increasing the cost to insurance companies of using the FHLBs' model is more likely to push out those already in the system than to get them to increase their mortgage holdings, meaningfully reducing the level and stability of the FHLBs' revenues and, with it, their ability to support housing finance.

How the FHLBs' Affordability Efforts Should Be Improved

The FHLBs also support housing finance through a few funding channels for affordable housing and community development.

Each FHLB is required by statute to operate an Affordable Housing Program (AHP), into which it contributes at least 10 percent of its prior year's earnings. The FHLBs are required to include in their AHP a competitive, predominantly rental property funding program in which a member submits an application to the FHLB that is evaluated against other member applications. The FHLBs are also allowed (though not required) to include in their AHP a program in which their members fund various forms of assistance for those looking to buy or maintain a home.

Each FHLB is also required by law to supplement an AHP with a Community Investment Program (CIP), which provides low-cost advances to finance targeted affordable housing and economic development programs, and a Community Investment Cash Advance (CICA) program, which provides low-cost advances for targeted economic development.

Between 1990 and 2023, the FHLBs awarded $8 billion in AHP subsidies (FHFA 2024). And in 2022, they provided $3.5 billion in advances through CIP and $1.4 billion in advances through CICA (DHMG 2023).

In addition to these direct funding efforts, the FHLBs support community development through advances to their member CDFIs, which provide affordable financial services in distressed communities.

Each of these efforts could be improved.

The AHP is too narrow a channel of support for affordable housing, helping address only a few of the many affordability challenges the FHLBs are well positioned to help tackle. This is partly because of the narrow scope of the two eligible categories of AHPs and partly because of the prohibitive patchwork of inflexible rules FHLBs and their counterparties must meet in implementing AHPs. And the program as a whole is underfunded, requiring only a fraction of what the FHLBs can provide.

The CIP and CICA programs have done little to supplement the AHP's direct funding efforts, with investments that amounted to less than one half of 1 percent of total advances ($819 billion) in 2022. Two FHLBs did not even participate in CIP, despite it being a statutory FHLB requirement, and only 175 of the 6,500 FHLB members obtained a CIC or CICA loan (DHMG 2023).

The FHLBs' support of CDFIs has also fallen short of its potential. CDFIs are perhaps better positioned than any other institutions to help the FHLBs support the communities that would most benefit, but FHLBs have struggled to take advantage of their membership. Often uneasy about the more complicated risks and opportunities CDFIs create, the FHLBs have tended to offer advance terms that many CDFIs do not find practical or economical. Only about 70 of the 600 nondepository CDFIs have opted to join the system, and far fewer tend to have outstanding advances at any given time (FHFA, n.d.).

The most impactful step to improve the FHLBs' support for affordable housing and community development would be to increase the affordable obligation of the FHLBs to at least 20 percent of their annual earnings but give them more flexibility in allocating the funds above the current 10 percent level. This would allow the FHLBs to expand their reach to address a wider range of needs in their communities, with programs that are easier to implement and expand.

A second useful change would be to provide the FHLBs more AHP credit for moves that leverage AHP funds to attract other funding, thus increasing the reach and impact of each AHP dollar spent. We offer a few examples to illustrate what we have in mind.

- Mission-oriented advances, either to fund CDFIs or to finance affordable housing and economic development projects, should be given credit toward the AHP requirement. Because these are advances, they should be credited as the differential between the market interest rate and the interest rate offered on the loans. The FHLB should receive credit for as long as the loan is outstanding.[10]
- FHLBs should also receive AHP credit for reducing haircuts on collateral-securing advances for CDFIs. They could backstop potential losses with an FHLB-by-FHLB or system-wide first-loss reserve fund capitalized by earnings on FHLBs' retained earnings. These earnings totaled more than $28 billion at the end of 2023 (Office of Finance 2024).
- The FHLBs should finance parts of the capital structure of affordable multifamily projects at a below-market "impact investing" interest rate, receiving AHP credit for the differential between the market interest rate and the rate at which they have provided the capital. If the investment is written down, the write-off should count toward the AHP goal.
- Finally, FHLBs should get more AHP credit for providing first-in capital of sufficient scale to attract other funding sources than they do for other development investments. Today, AHP rental housing funds typically fund a small share of total development costs, ranging from 2.2 percent by the San Francisco FHLB to 40 percent in Topeka AHP awards in 2022, with more than half of AHPs funding less than 5 percent of total development costs (DHMG 2023). AHP

funding is thus more often used to fill small funding gaps in a project rather than catalyze development that would not have happened absent the FHLBs' investment.

Increasing the size, flexibility, and leverage of the FHLBs' AHP obligations would dramatically increase the impact the FHLBs have on affordable housing and community development, bringing it in line with their considerable potential.

Providing AHP credit for minimizing advance haircuts for CDFIs as we have suggested would improve the FHLBs' support of these institutions, but it alone would not do enough. What is needed is an increase in the expertise and attention that the FHLBs dedicate to CDFIs. It is not practical to expect *all* FHLBs to develop the expertise, given the modest number of CDFI members in each, so the FHFA should dedicate a single FHLB to the task.[11] That FHLB could work with the national CDFI community to deepen its expertise and industry relationships, allowing it to improve existing FHLB products and develop new ones that better fit the CDFI community's unique needs. The dedicated FHLB could handle CDFI relationships and funding nationwide.

This model of dedicating a single FHLB to a complicated and somewhat unique challenge could be replicated for other efforts. Another promising candidate would be for small multifamily lending. It is often hard to find financing for smaller properties, especially those with 5 to 20 units, which include a disproportionate amount of naturally occurring affordable housing (HFPC 2020). Loan sizes are typically smaller, and in many cases, the lender is evaluating the financials of both the borrower and the property, making the evaluation overly costly for the return. A single FHLB focused on this challenge could offer several types of products to be used nationwide to increase financing in this space.

The model could also work well for construction lending. Banks have historically been the largest lenders for financing for land acquisition, development, and construction. This lending is capital intensive, however, and with higher capital requirements, increased regulatory scrutiny, and market disruption likely on the horizon, commercial banks have been pulling back from this market. An FHLB focused on this could step in with products available nationwide, as we have suggested for CFDIs and multifamily housing.

For this idea to work, the FHLBs that take some ownership of an issue for the rest of the system would need to be compensated for their role. We would suggest, at least initially, that some of these activities allow for full credit to both the referring FHLB and the FHLB handling the referral. After the programs are better established, a determination can be made whether this is too generous and, if so, how the FHLB referring the relationship or project and the one handling it should share the credit.

Lastly, the FHFA should expand the FHLBs' mission lending system-wide by better utilizing a few legacy programs.

The FHFA should direct the FHLBs to boost dividends for members that get outstanding ratings on their Community Support Programs (CSP). Congress created the CSP in 1989 when it first allowed commercial banks to join the system, requiring a passing grade for members to maintain continued

access to long-term advances. Since its inception, the FHFA and its predecessor have given this critical requirement only cursory attention, even though the CSP provides a direct connection between an FHLB and its thousands of members. The FHFA should take advantage of the program to reward FHLBs that are particularly effective in supporting affordability and community development.

The FHFA should also improve the FHLBs' Mortgage Partnership Finance Program and the Mortgage Purchase Program. These programs allow members to originate and hold 30-year fixed-rate mortgages that meet their local communities' unique needs while transferring the interest rate risk to their FHLB. The FHLBs were forced to shrink the programs in the early 2000s because they could not transfer or effectively hedge this risk in the secondary market. The FHFA should give them the authority to issue MBS to manage this risk on behalf of their members, giving them another way to support liquidity in underserved markets in their communities.

Conclusion

The FHLBs are an indispensable source of support for the housing finance system. They provide critical funding for affordable housing and community development efforts across the country. And they provide critical liquidity to many of the institutions on which the housing finance system depends, without which we would see more instability among lenders, more defaults, and more volatility in the price and level of their lending, including their mortgage lending.

But their support for the housing finance system should be improved in four important ways:

- Realigning the FHLBs' membership requirements with today's mortgage market by extending membership to IMBs and REITs and ensuring that those eligible for membership cannot wind down their support for housing finance once admitted.
- Increasing the support the FHLBs provide for affordable housing and community development by increasing the size, flexibility, and leverage of the FHLBs' affordability commitments.
- Improving the FHLBs' overall effectiveness by dedicating individual FHLBs to take on particularly complex housing finance challenges on behalf of the broader FHLB system.
- Deepening the reach of the FHLBs in their communities by retooling their legacy programs: the CSP, the Mortgage Partnership Finance Program, and the Mortgage Purchase Program.

Making these changes would better align their membership and affordability requirements with their mission, vastly increasing their support of the nation's housing finance system.

Notes

[1] Federal Housing Finance Agency, "FHFA Requests Input on FHLBank System Mission," news release, May 16, 2024, https://www.fhfa.gov/news/news-release/fhfa-requests-input-on-fhlbank-system-mission.

[2] Dayin Zhang, "Government Sponsored Wholesale Funding and the Industrial Organization of Bank Lending" (master's thesis, University of Wisconsin–Madison, 2020), https://drive.google.com/file/d/17Q68-6IrnFYM108TsnLkoaedncIT_9_G/view.

[3] William Rabb, "Few Insurers Offer Input on Future of the Federal Home Loan Bank System," Insurance Journal, October 24, 2022, https://www.insurancejournal.com/news/southeast/2022/10/24/689524.htm.

[4] "Insurance Companies: Required Agreements and Forms," Federal Home Loan Bank of Des Moines, accessed August 1, 2024, https://www.fhlbdm.com/member-support/membership/new/insurance-companies/.

[5] "Insurance Companies: Your Key to Reliable Liquidity," Federal Home Loan Bank of New York, accessed August 1, 2024, https://www.fhlbny.com/become-a-member/about-membership/insurance/.

[6] Coley Lynch, "Federal Home Loan Bank Program," New England Asset Management blog, February 7, 2017, https://www.neamgroup.com/insights/federal-home-loan-bank-program.

[7] According to AM Best, "Life insurers use their FHLB membership mostly for spread/yield enhancement, while property/casualty and health insurers use it more for liquidity and short-term working capital/operations." See AM Best, "Best's Special Report: Insurer Membership in Federal Home Loan Bank Grows as L/A Companies Capitalize on Investment Spreads," news release, October 31, 2023, https://news.ambest.com/newscontent.aspx?refnum=253678&altsrc=23.

[8] AM Best, "Best's Special Report."

[9] Lynch, "Federal Home Loan Bank Program."

[10] The Chicago FHLB's Community First Fund makes direct, low-interest loans to CDFIs and has been highly successful. See Joe Neri, "Federal Home Loan Banks Can Act Now to Better Support Community Development," *Urban Wire* (blog), Urban Institute, July 10, 2024, https://www.urban.org/urban-wire/federal-home-loan-banks-can-act-now-better-support-community-development.

[11] In the FHFA (n.d.) report on the FHLBs at 100, having one FHLB develop expertise in a complicated and unique product was referred to as a Center of Excellence.

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Acknowledgments

This brief was supported by the Housing Finance Innovation Forum, a group of organizations and individuals that support high-quality independent research that informs evidence-based policy development. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at urban.org/fundingprinciples.

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