GSE Activity Report

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The Dark Magic of GSE Maturity Transformation

Summary

A new paper from the Milken Institute researches a question we have long asked: how much funding do the largest banks get from Home Loan Banks and who takes the risk? In just a few years, FHLBs have taken a large piece of the maturity-transformation business once core to banks. Nice work since they got it, but they've also now gotten a lot of new risk for which their prudential structure in our view is ill-designed.

Impact

This paper validates market assumptions, including ours, that the 2015 regulatory rewrite for MMFs reduced MMF funding for large banks and led many of them straight to a Federal Home Loan Bank near them or any of their offices. Further, the paper finds that the $1 trillion or so shift from prime to "govie" funds meant not only less market appetite for bank-issued commercial paper, but also more demand for System COs, reducing borrowing rates for the System and allowing it to charge less for advances. And, as market demand grew, Banks changed their funding structures to offer more short-term, floating-rate notes to mimic lost MMF-funding opportunities.

Reflecting the impact on these changes for the largest banks, the paper finds that most of the demand for FHLB funding over the past five years has been fueled by banks with assets over $250 billion, which quadrupled System borrowings. That the LCR kicked in over this time period and most dramatically affected banks over this size threshold is, unsurprisingly, also found to play an important role sparking advance demand. The GSIB risk-based capital surcharge adds a penalty for the biggest banks deemed to rely on too much short-term wholesale funds, perhaps offsetting the LCR's impact to some degree for advances, but this is not addressed in the paper and does not appear to be a significant factor given the sharp shift to the Banks in recent years.

The SEC's MMF rules were forced on it by the Fed through the Obama Treasury Department. Although the shift in overall short-term, wholesale funding across the financing system has had an array of unintended effects beyond those described above for the FHLBs, the rules did achieve perhaps their most important goal: banks with assets over $250 billion are the safer for them. As this Milken paper observes, however, the Home Loan Banks are not safer for these rules.

In essence, FHLBs now conduct maturity transformation, taking on one-quarter or so of all U.S. bank

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non-deposit liabilities. As with the shift of Fannie and Freddie into non-core products for profit – and then for risk – so too with the FHLBs as their inter-connectedness grows with the growing dependence of very large banks on taxpayer-backed funding that takes interest-rate and duration risk without any of the capital, resolution, or other prudential safeguards applied to private-sector U.S. banks. Yes, we know – the FHFA has rules about some of these things, as well as repeated injunctions to the Banks not to do as much short-term, floating finance as they did and mostly still do. Little of this regulatory framework – largely unchanged since the 2008 crisis – is in our view up to snuff given the significant transformation of the System confirmed by this study.

Outlook

The Home Loan Banks preserve their political clout by counting on all the community banks that enjoy System membership. In the past, these small-bank and thrift members enjoyed the lion's share of advances, but this as noted changed dramatically starting in about 2012. The Milken paper notes that in 2012, advances were just 0.8% of the largest bank's liabilities, while all other banks held 3.8% of liabilities in advances. In the first quarter of 2017, large banks advances were 2.7% of their liabilities, even as other banks upped their 2012 total by only twenty basis points to 4%. Given that big banks borrow a lot more and that the size of their advances is generally a lot larger than smaller banks, the shift in System advance distribution speaks to a structural change not only in the purpose of the Home Loan Banks, but also the risk they present via the inter-connectedness channel.

In remarks earlier this year, FRB Vice Chairman Fischer pointed to these changes as a cause of concern about FHLB risk. He neglected to mention, as does this paper, that the Banks have a prior lien ahead of the FDIC. That is, even if the largest bank in the country falters and fails to repay its advances, a Home Loan Bank left unpaid by the bank cleans out the failed banks coffers ahead of the FDIC or any other creditor. It was for this reason that the San Francisco Home Loan Bank suffered nary a scratch when IndyMac failed, and the System similarly sailed through the S&L crisis of the 1980s ahead of the storm that befell U.S. taxpayers.

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