Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Although a new paper by former FRB Gov. Tarullo and Fed staffers on the FHLB stirred considerable consternation across the Federal Home Loan Bank System, it's a crushing and persuasive critique of a giant GSE that has long preferred to go unnoticed. That's not unreasonable since the System has evolved from an essential small-bank funding source for mortgages into a taxpayer-subsidized capital-markets investment option. When public wealth is not allocated for public welfare, resources are misallocated and market integrity is compromised. But, unless the Home Loan Banks blow themselves up, they are here to stay. Thus, the policy challenge is not how to abolish them, but how best to redirect an established funding channel back to servicing the public good. Traditional single-family mortgages don't need the Banks anymore, but much else does.

The paper's criteria for considering taxpayer subsidies are a very helpful guide for moving forward and thus worth quoting at length:

> There is, of course, nothing inherently wrong with government subsidies. But subsidies should meet two conditions if they are to be sound public policy. First, they must be shown to becorrectives for identified market failures or instruments of targeted redistribution policies. Second, there must be governance mechanisms to ensure that the subsidies are used to achievethe ends specified by the legislature or regulator, and not for other purposes.

I suspect the authors would agree with a third point: if a credible, forward-looking case for the subsidy cannot be made by virtue of demonstrable public benefits that could not otherwise be equitably delivered at reasonable cost, then the subsidy should be redirected or terminated.

How do these tests work for the FHLBs? The purpose of the Home Loan Banks' subsidy -- more bank mortgage balance sheet lending -- is a vestige of the bygone era when there was no securitization via Fannie, Freddie, Ginnie, and other government agencies. As the paper details, banks large and small now hold few mortgages on portfolio and virtually all of these are jumbo loans rightly and expressly otherwise ineligible for direct public subsidy. Secondly, FHLB governance either of its own making or as directed by FHFA is light-touch at best and exploitative of a massive taxpayer subsidy at worst.

This paper is also ground-breaking by for the first time uncovering the inter-dependence of Federal Home Loan Banks and MMFs. MMFs are now the dominant investor in System debt, with the paper making clear how this has altered FHLB-debt maturity structure into shorter tenors, increased System interest-rate risk, hiked System funding for the biggest banks, and encouraged yield-chasing across the range of depository institutions and life-insurance companies.

Indeed, another vestige of days gone by is that insurance companies are even allowed to be Home Loan Bank members. When the System began in 1932, insurance companies made mortgages; now, they don't, meaning that System funding is simply a lower-cost alternative to private-sector or truly-sovereign debt. This isn't a picky point – as the paper shows, insurers now account for one-third of System advances, with MetLife now its largest borrower.

The paper is also prescient in its analysis of other aspects of FHLB activities with no demonstrable return for their subsidy value – for example, the Banks provided $150 billion in standby letters of credit largely funding member purchases of municipal debt. Given the tax subsidies already backing this sector, it's not at all clear why yet another subsidy is warranted. If it is, it should at least be recognized and reconciled with the System's over-arching statutory purpose: mortgage finance.

The dominant role of the System in the overnight federal-funds market also warrants careful scrutiny, especially in the wake of the 2019 repo crisis in which Home Loan Banks played a significant, problematic role. The FHLBs swept in when big banks stood back because of their own capital requirements which, as this paper makes clear, are no barrier to risk for Home Loan Banks still untouched by the capital rewrites that redefined big banks and the other GSEs after the great financial crisis.

On Wednesday, the House Financial services Committee will hear from FHFA Director Thompson. According to the committee majority-staff memo, FHLBs are on the agenda. A good place to start with hard questioning about why the FHFA has confined itself only to Fannie and Freddie when it comes to capital resilience, conflict-of-interest governance, and mission compliance. Congress should also point out that much could be done to address unmet mortgage-market needs in areas such as funding for small-dollar mortgages, equitable refis, and loan modifications.

Further, the relationship banking which community and mid-sized banks do very well is essential to start-up lending to small businesses and small farms – why not let the Banks into this arena under appropriate mission and safety-and-soundness buffers? What else might we do with a $1 trillion or so in funding backed by the taxpayer's implicit guarantee?

A lot is the clear answer, but this must be one accompanied by answers also to how best to make the FHLB System sound, strong, and a deserving beneficiary of taxpayer largesse. Reform will come hard to this insular GSE, but making it clear that the System must either change or dissolve could concentrate its mind on the future mission it could serve well and soon.