GSE Activity Report

Thursday, September 1, 2022

Centenarians Get a Face Lift

Summary

As seems always the case, FHFA Director Thompson is as good as her word to Congress earlier this summer, announcing yesterday a review of the extent to which the Home Loan Banks and their System meet the mission assigned to them and, regardless, if that mission still makes sense. Building on our initial assessment of FHFA's plans, we here turn to what the System, its allies, and reformers are likely to say and what FHFA and/or Congress will then do about it.

Impact

This FHLBs have come under increasing pressure since an *American Banker* op-ed harshly criticized their governance, media picked this up, and – the coup de grace – a massive study from former FRB Gov. Tarullo and Fed economists totally took the System to task on mission creep, risk and regulatory arbitrage, minimal compliance with affordable-housing requirements, and much, much more. The System pushed back hard, but all the controversy resurrected questions that fell from view only because Fannie and Freddie monopolized all the GSE-policy bandwidth since their conservatorship fourteen long years ago.

That hard experience now colors debate about the Home Loan Banks – once reason they have happily endured being ignored – as does the populist and progressive rhetoric that has moved far to the right and left since Home Loan Banks were last talked about in the halls of federal power. The main questions around which debate now will center include:

- **Mission**: The Tarullo et. al. paper argues that the System's mission of late mostly generates short-term bonds for government MMFs that fund all sorts of member non-mortgage activities, especially for insurance companies that have become among the biggest users of System advances. FHFA in 2014 tried to rein this in by demanding that all members demonstrate that advances went to mortgages and kicking out MREITs and captive res that have finagled their way into FHLB membership.

- **Membership**: The membership restrictions sort-of survived in final form; the mortgage-related restrictions dropped following vociferous protests from community banks and credit unions. These issues will surely be revisited along with a new, bigger one in the wake of nonbank dominance of mortgage finance – nonbank membership. We think this is possible given fears about nonbank liquidity squeezes, but this will take new law that will surely open the System to nonbanks only in concert with subjecting them to the CRA.

- **Systemic Risk**: One of the deadliest parts of the Tarullo paper that's among the many that also reflect the Federal Reserve's institutional view of the System addresses the extent to which some or all of the Banks could withstand the sharp liquidity squeeze sure to result if MMFs under stress stop borrowing and the System finds itself in the classic borrow-short/lend-long

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wringer.

- **Prudential Standards**: System capital and liquidity rules are artifacts of the 1990s and will surely get a rewrite once FHFA starts to think all this through with a little help from its friends at FSOC. As is always the case, new rules on these critical parameters mean new Home Loan Banks with redefined strategies even if nothing else materially changes. Yes, we know, FHFA didn't ask any questions about System rules, but rules are what FHFA does and, following comment, it may well start on issues where it stands the strongest chance of near-term success.

- **Products and Services**: As FHFA rather wryly notes, the Banks were created a century ago. FHFA doesn't say – doubtless because it goes without saying – that mortgage markets then and now are a tad different. This isn't exactly news to the System, which has long sought to worm its way around Fannie and Freddie opposition and craft a securitization future for itself. It came a bit close to this in the early 2000s with "Mortgage Partnership Finance" arrangements, but these ended very badly and thus debate stopped. Now, it starts anew. It would almost surely take Congress to authorize securitization and, given the hard experience also of the GSEs, we think this most unlikely without a strong showing of the extent to which an FHLB-spawned secondary market would support LMI, rural, or first-time homeowners and agreement to a lot of new rules to ensure that System securitization is sound securitization.

- **Affordable Housing**: This is prominently featured in FHFA's request and is sure to be a big point of discussion and debate. At the least, FHFA will redraw the Banks' obligations into its equitable-finance framework, likely demanding equitable-finance plans from each Bank if it decides it has statutory authority to do so as we expect it will. But, an even more interesting question is the extent to which FHFA uses a longstanding rule allowing Banks to hold certain alternative assets to expand into portfolio assets such as foreclosed mortgages or CRE properties and – for community banks – rural and small-business loans along with any others that promote community development.

Outlook

Of course, nothing much might happen – it's been the happy fate of the FHLBs so far to be largely left out of the housing-policy debate. But, any institution that runs at about $1 trillion in obligations backed by an implicit guarantee has a place in the halcyon of big-deal federal entities. Once talked about in the structured way FHFA proposes, it will be hard to put the System back in its comfortable bottle.

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