Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Recent revelations about the Federal Home Loan Bank System have made it still more imperative to address whether at least $1 trillion of implicitly-guaranteed federal debt should be authorized to feather the FHLBs' pockets instead of furthering public welfare. As we detailed in a recent client report, flat-out mission contradictions are clear in the case of a crypto-heavy bank's use of FHLB funding as a lifeline which it surely obtained because the System can lend with impunity because it has a prior lien ahead of even the FDIC. However, this case isn't the only current mission conundrum. The other is little-noticed but at least as problematic: the extent to which Home Loan Banks lend not to support homes, but instead to give foreign banks in the U.S. a tidy revenue source via a nifty interest-rate arbitrage play that disadvantages U.S. banks and may even threaten financial stability and monetary-policy transmission.

But first to the question of whether the FHLB System is required to do better. It would seem totally obvious that Home Loan Banks issue debt through the System's Office of Finance thanks to taxpayer benefits. However, in connection with a discussion of the prior lien, an FHLB spokeswoman said the System operates without any resort to taxpayers. Leaving aside the fact that the Banks don't pay taxes and couldn't raise hundreds of billions at near-Treasury spreads if they weren't cushioned in the taxpayers' bosom, the law says these entities are agencies of the U.S. Government and regulates them as such. That this law is woefully out of date is one thing; that it exists is irrefutable.

The Banks do not, though, just rely on indefensible assertions that none is backed by the taxpayer. They also point to what they describe as a "never-lost-a-nickel" record. Here too, assertions strain credulity.

To polish is pristine image, the System notes it emerged unscathed from the S&L crisis of the 1980s that cost taxpayers at least $250 billion. Miraculous given the debacle, but unmentioned in this self-exoneration is the prior lien when S&Ls failed, allowing it to move ahead of the federal deposit insurance system each time one of the thrifts it buoyed went bust.

In the 2008 great financial crisis, this happened all over again, most spectacularly at Indy Mac. This was a high-risk subprime mortgage lender operating in the sheep's clothing of a regulated thrift funded principally by brokered deposits and the Home Loan Bank System. When even brokered depositors got the willies, the System kicked in more billions and then promptly took them out ahead of the FDIC when Indy Mac blew up.

And it's not just taxpayers and the FDIC that gets hurt. Although insurance companies now never make mortgages or any other form of housing loan, anachronisms of the 1932 FHLB chartering law allow them still to fund themselves at the FHLB window. When they do and can't pay it back, the FHLB has, I'm told, stepped in ahead of resolution guarantee funds and other creditors, exacerbating losses to these funds and putting policyholders at risk.

The same prior-lien precedence problem is happening all over again now in the crypto crisis. Silvergate got $4.3 billion from the same FHLB that floated Indy Mac – San Francisco – even though the very troubled bank shuttered the only mortgage activity it had which never accounted for anywhere near as much as the huge System advance. As the bank itself acknowledges, the advance was an emergency liquidity line akin to those supposed to come only from the Fed and then only to solvent banks.

If Congress wants taxpayers to back banks that aren't eligible for discount-window advances or are afraid that asking for one would spook markets, then it should say so. Until it does, the Federal Home Loan Banks shouldn't use their prior lien to operate a discount window proving only the power of moral hazard at government entities that should either know better or be told so.

However, the Banks aren't just backstopping crypto banks with no credible right for to mission-compliant FHLB funds. To bolster their profits, Home Loan Banks also play a high-risk role in the financial market.

We noted this in 2017, but a new post from the Federal Reserve Bank of New York brings the story through the end of 2020. As it shows and an important recent paper also demonstrates, its government-backed status gives the System a unique role in the U.S. dollar-funding market. Although Home Loan Banks cannot place reserves at the central bank, they have other Fed-provided benefits. As a result, Home Loan banks are able to raise funds at the fed-funds rate and then lend them to banks at a slight spread above that rate, with the borrower then placing these funds into their central-bank deposits. This arbitrage between the federal-funds rate and that the Fed pays in interest on reserves (IOR) isn't possible for U.S. banks because they are required to hold a high leverage ratio for these reserve assets as well as pay FDIC premiums against them. In sharp contrast, foreign-bank branches and agencies come under the leverage ratios of their parent companies and are not insured depositories subject to FDIC premium charged against their central-bank deposits. As a result, in an era of ample reserves, playing this spread – tiny though it is – is lucrative for both foreign-bank branches and the Home Loan Banks.

As a recent paper from a former Fed governor and current Fed staff demonstrates, the FHLB arbitrage gains also comes at the expense of effective monetary policy. The Fed has enough problems figuring this out without also battling the profit incentives of a nominally federal entity.

The System's regulator, the Federal Housing Finance Agency, has rightly launched a wide-ranging review of the Home Loan Bank System. The "listening sessions" it hosted allowed Home Loan Banks across the country to mobilize supporters and they can and should be heard. Largely missing at these sessions, though, were analytics about Bank non-mission exposures and threats to financial stability and macroeconomic growth. These gaps should be quickly remedied so FHFA brings the Banks to heel and then deploys their advantages to the greater good of residential-housing finance facing yet another crisis for lower-income homebuyers and the smaller banks that depend on the System to achieve their housing-market goals and thus also the System's mission.