ABA Federal Home Loan Bank Member Insights

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INSIGHT

Let's Be Clear About What the Federal Home Loan Banks Are All About (A Healthy Financial System Depends On It!)

As momentum builds for housing finance reform, the Federal Home Loan Banks have been viewed increasingly as having the real potential for being an important part of the solution. A major reason for their favorable status stems from how these 12 regional wholesale banks largely stayed out of trouble during the financial crisis and didn't require a government bailout. Equally important is the fact that their broad membership of financial institutions includes the nation's community banks, which many in Washington look to reward today for their prudent practices over the years in the mortgage market.

If you're an FHLB, or one of its 7,600 member-owners, all this should make you pretty happy--it's awfully satisfying to be viewed as being among the good guys.

Nevertheless, the FHLBs have a problem. As entities that have traditionally played a big - but largely behind-the-scenes - role in the nation's financial system, they're entering into the growing public debate over housing policy with a distinct disadvantage: Relatively few people understand them.

Now it's true that having kept their profile low has generally served them quite well. They've stuck to their assigned work and eschewed the limelight which, along with their financial track record, has helped them earn a lot of trust. But avoiding center stage has left them open to a big vulnerability. That is, it's easy for others to define them, or more accurately, incorrectly define them. See, for example, today's Bloomberg story. Most of the time it happens innocently. After all, the FHLBs aren't what you'd call a household name. Other times, it can be due to the demands of the definer's own agenda.

Either way, the problem creates a sizeable policy risk. If the misperceptions are left unchecked, decision-makers in Washington will make assumptions about the FHLBs that not only are inaccurate but could lead to the undoing of a uniquely structured charter. If that happened, the country would lose twice--once by forfeiting an important mechanism in housing finance, and again by undermining a structure that allows access by financial institutions to low-cost funding for liquidity and financial flexibility--which are benefits that are passed along to the borrowers' great benefit.

Let's step back and take a closer look at what comprises the correct view of these institutions.

As cooperatives, FHLBs are privately owned by their members, who are U.S. lenders of all sizes and many types. Each day they loan billions of dollars to these members through secured loans they call "advances". The members have access to this funding and liquidity so that they can put it to use for a broad range of their own customers' financial and credit needs.

Housing and homeownership have been central to the core purpose of the FHLBs since their founding in 1932. But it's misguided to interpret their sole purpose from the original and narrower charter as laid out by Congress at the very beginning of the Great Depression more than 80 years ago. Today their work goes well beyond housing.

Through legislation over the past two decades, Congress expanded its mandate for the FHLBs. Nearly a quarter of a century ago, Congress opened up membership in the FHLBs to all depository institutions. When it did so, Congress re-established the mission to be a mechanism for reliable access to efficient funding and liquidity--for housing and economic development. The latter includes the very large list of persistent and ever-changing needs that require capital and credit in order for American families and businesses to flourish.

This expansion by Congress has allowed the FHLBs and their members to support community lending in a greater variety of ways. The success of this bipartisan strategy came into sharp focus during the 2008 financial crisis when all other sources of liquidity virtually disappeared. The FHLBs were for a critical time the only source of liquidity for the entire banking system. Their ability to remain so reliable came from their very unique characteristics: a regional, scalable, self-capitalizing cooperative structure; broad participation by a diverse membership; and dependable access to deep and liquid global markets for FHLB debt.

It may sound like arcane stuff but it all is very meaningful to the membership of the FHLBs, which today consists of thrifts, commercial banks, credit unions, insurance companies, and community development financial institutions. At the end of the first quarter of 2013, they had 7,604 members, composed of 967 savings banks, 5,169 commercial banks, 1,185 credit unions, 268 insurance companies, and 15 community development financial institutions.

The composition of FHLB membership closely approximates the composition of the banking industry: 88 percent of members have less than $1 billion in assets compared with 91 percent of all banks and thrifts and 97 percent of all credit unions industrywide.

Typically, the use of advances is fairly consistent across the various asset sizes, though smaller institutions are currently funding a larger portion of their balance sheets with advances than larger institutions. Many of these smaller institutions have limited or no direct access to the capital markets other than through their FHLB.

In addition to depository institutions, more than 250 insurance companies are now members of an FHLB. Insurance companies are a significant part of the System, representing almost 13 percent of outstanding advances.

All these members use advances for all sorts of reasons: nto fund new originations and existing portfolios of mortgages, to purchase mortgage-backed securities, and to manage the substantial interest rate risk associated with holding mortgages in portfolio. Some members layer in term advances alongside their deposits, altering the duration profile of their liabilities to better match their assets and mitigate risk. Other members use shorter-term, on-demand liquidity to offset unexpected deposit runoff or to take advantage of an opportunity to quickly add assets.

Advances enable members to effectively manage their balance sheets and lower the cost of extending credit to American consumers and businesses for many purposes. The FHLBs provide member-owners--again, of all sizes--with competitively priced funds in all economic conditions so that those members can provide credit and financial services in their communities.

Where does all this leave us when it comes to the restructuring of the housing finance system? It brings us back to the fact that the FHLBs remain a vital provider, through their members, of funding for housing and homeownership in America. Their member-owners remain significant players in housing finance, notwithstanding the continuing pace of greater concentration being observed in both mortgage originations and servicing.

The core strength of community financial institutions is their deep knowledge of local markets and their personal relationship with customers. In the case of housing and homeownership, community financial institutions in smaller communities and in rural markets are often the sole source of mortgage credit as larger institutions focus on more populated areas.

While not having the dominant share of mortgage originations, community financial institutions originate a significant amount of mortgage loans. During the first quarter of 2013, $435 billion of mortgages were originated. Community banks and thrifts with less than $10 billion in total assets originated $55 billion of residential mortgage loans during the first quarter of 2013.

The housing policy debate will take time--and a fair amount of wrangling. But it’s safe to say that there already is bipartisan agreement that the goal is to achieve a sustainable housing finance system for the future that does not expose the taxpayer to unnecessary risk.

The FHLBs have a critical role to play in serving their members in the housing finance system of the future. The FHLBs have demonstrated their role as a safe and reliable provider of liquidity throughout the recent financial crisis, and their regional, self-capitalizing, cooperative structure will enable them to serve their members' needs in a safe and sound manner. These unique characteristics should be maintained--for the benefits of local housing needs and consumer and business credit demands of many kinds.

The fact that many policymakers may be looking to the FHLBs as contributors to the challenges of creating a new housing finance system speaks to these institutions' long history as prudent players which have worked successfully to balance taxpayer risks with public benefits. They have fulfilled their role for more than eight decades without any credit losses or taxpayer dollars.

Moreover, their role as suppliers of wholesale funding goes straight to the importance of maintaining a role for institutions of all sizes in the housing finance system of the future. It is of almost incalculable importance to maintain the FHLBs' overarching responsibility to their members to be reliable sources of liquidity. A strong economy requires a robust financial system comprised of lenders of all sizes and types making credit available to consumers and businesses. Every day, thousands of U.S. lenders--from the largest to the smallest and doing business in every community--rely on a Federal Home Loan Bank as a source of funds for financing housing, jobs and economic growth. That purpose must continue even as--and especially because--policymakers now look to these institutions as problem-solvers in housing finance reform.

In the future, the FHLBs will continue to play the role they have played so successfully for over 80 years. They may also be allowed or encouraged to expand that role in new ways. While that presents exciting opportunities, those opportunities must be balanced with caution that nothing is done to destabilize, or harm the FHLBs and their core mission.

That's why defining the FHLBs inaccurately--either intentionally or inadvertently--does a disservice to policymakers, as well as to the nation's lending institutions and the communities they serve.

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