Be Careful What You Wish For

Some advocates contend that the Federal Home Loan Banks (FHLBanks) should not provide advances to large members and instead should restrict advances to small members. The same advocates argue that the nation's affordability challenges require more from the FHLBanks to support affordable housing.

These propositions indicate a lack of understanding of the mission, structure, and operation of the FHLBanks and are contradictory as limiting advances reduces the capacity of the FHLBanks to support members, support the U.S. financial system, and provide funding for affordable housing and community development programs.

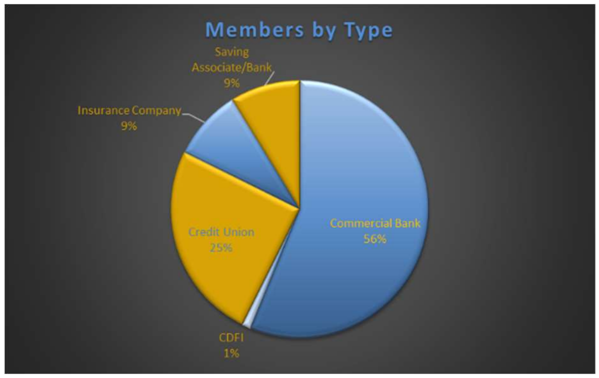
The mission of the FHLBanks, as established by Congress in the Federal Home Loan Bank Act of 1932 (and updates), is to provide reliable, stabilizing liquidity and grant funds to member institutions through all economic cycles, and to support housing and community development through their members.[1] The FHLBanks' liquidity mission is foundational to the stability of the U.S. financial system. The FHLBanks serve members ranging from several million dollars to several trillion dollars in assets that include commercial banks, credit unions, insurance companies, savings institutions, and community development financial institutions.[2] The availability of on-demand liquidity to the System's diverse membership of over 6,500 members, coupled with the fact that the 11 Home Loan Banks are privately-capitalized, regionally situated, independently operated, jointly and severally liable for the System's consolidated obligations, and have a 90+ year history of timely payments, are a source of strength not only for members, but also for the entire U.S. financial system and the U.S. economy.

Proposals to restrict membership or participation would change the System's risk profile, hinder the System's ability to meet members' liquidity needs safely, soundly, efficiently, and responsibly in all economic conditions, and would reduce credit availability in communities across the U.S. Further, disruption of the System's liquidity function would have negative repercussions for affordable housing and community development activities. Any proposal to change the System's structure or risk profile must be thoroughly evaluated and analyzed so the implications on members, the U.S. financial system, and the availability and affordability of financial products are fully understood.

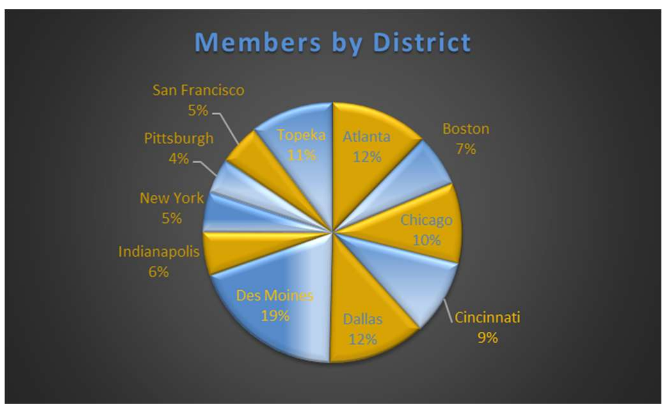
The FHLBank System's ability to access capital markets and deliver low-cost funding to members relies upon the System's 92-year track record, cooperative structure, and low risk profile. Changes that alter the FHLBank's risk profile, such as restricting the membership or activity of large members, would increase the System's cost of funds and ultimately increase borrowing costs for Americans. The FHLBank System's everyday market presence allows the FHLBanks to rapidly respond to liquidity

[1] https://fhlbanks.com/federal-home-loan-bank-act/
[2] https://www.fhfa.gov/DataTools/Downloads/Pages/Federal-Home-Loan-Bank-Member-Data.aspx

shocks and perform the liquidity first-responder role that has been paramount when liquidity is most needed to stabilize markets, including in the Great Financial Crisis in 2008-2009, at the start of the COVID-19 pandemic in 2020, and during the bank runs in March 2023. Restricting large member activity would limit liquidity and raise the cost of funds for smaller members and by extension increase costs for homeowners, small business borrowers, and farm families. Surely, this is not the desired outcome of those advocating for change, but that would be the outcome.



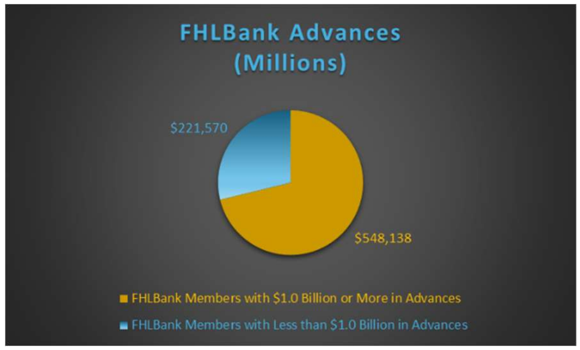
If Congress were to change FHLBank membership in a way that restricted participation by the largest, most regulated, most systemically important financial members, capital markets would rightly recognize the change as altering the System's risk profile. In addition to the altered FHLBank System risk profile and cost of funding that would arise from limiting participation of large financial institutions, a second, equally important impact would be the massive reduction in FHLBank liquidity operations.



In the first quarter of 2024, the Combined Financial Report for the Federal Home Loan Bank System showed that 71% of FHLBank advances outstanding were attributable to 126 members with $1 billion or more in advances.[3] However, **while large members draw the largest advances in dollars, the vast majority of advances (over 96%) are to small members**. Logically, small banks and credit unions with $1 billion or less in assets do not have the need or collateral to support billion-dollar advances. So, unsurprisingly, small dollar value advances are taken by small members and large dollar value advances are taken by large members. Interest income on advances is the System's primary

[3] https://www.fhlb-of.com/ofweb_userWeb/resources/2024Q1CFR.pdf

source of income, so any restriction on participation or membership by large members would directly reduce the income available to support operations and programs benefiting small members.



In addition to taking the overwhelming majority of advances, **smaller members tend to take larger advances-as-a-percentage-of-assets**, so a small dollar value advance to a small member can be hugely impactful, while a large dollar value advance to a larger member may be just a drop in the bucket. If a $1 million advance to a small credit union allows the credit union to originate a small business, affordable housing development, or community organization loan that would not otherwise be originated, that is impactful for that credit union and for that community even though it was "small" relative to the size of the FHLBank System.

In addition to the interest income the FHLBanks generate on advances to large members, regular use by large members allows the FHLBank System to maintain the market presence that is foundational for market liquidity. Constant market presence and low risk profile allow the System to raise low-cost funds for the benefit of members, large and small and, by extension, for the benefit of borrowers. The System is composed of members of all sizes and any restrictions on participation of large members would have negative externalities that harm the remaining small members by reducing system diversity, reducing the System's consistent market presence, and weakening the System's risk profile, all of which would result in a weakened ability to raise low-cost funding in capital markets.

Finally, advocates for reducing large member participation in the FHLBank System also often want the FHLBanks to increase funding for their Affordable Housing Programs (AHP). As previously discussed, 71% of advances are attributable to large members and FHLBank income is primary interest income on advances.[4] Therefore, reducing the activity of the largest FHLBank members will necessarily reduce the income available to fund operations and AHP initiatives. If the objective of

[4] https://www.fhlb-of.com/ofweb_userWeb/resources/2024Q1CFR.pdf

proposed changes to the FHLBank System are to increase affordable housing and community development funding, restricting FHLBank membership or activity would be counterproductive.

The Federal Home Loan Bank System's 2023 Combined Financial Report showed that the record liquidity provided in 2023 generated record income and record AHP assessments, funding that is available now in 2024. **Across the 11 FHLBanks, the System expects to provide approximately $1 billion in AHP and voluntary program funding for affordable housing and community development in 2024!**

As of the first quarter of 2024, FHLBank System income and AHP assessments were even higher than in the first quarter of 2023, thus, under the status quo, the Federal Home Loan Banks' AHP programs are on track for another strong year in 2025, assuming nothing disrupts the current trajectory. As shown in the figures above, smaller members are responsible for the majority of advances, but larger members are responsible for the majority of advance dollars and resultant FHLBank System interest income.

The chart below shows the FHLBanks' cumulative AHP contributions from 1990 through 2023 totaling more than $8.3 billion. The chart also depicts a counterfactual in which large members are excluded from the FHLBank System[5]. In the counterfactual, the largest 3.5% of members are removed. Under the counterfactual 71% of advances, 71% of income, and 71% of AHP assessments disappear. **Even if AHP assessments had been doubled or tripled starting in 1990, cumulative funding available for affordable housing and community development under the counterfactual would be $1 billion to $3.5 billion less than under the current FHLBank status quo.** Thus, it is critical to 1) have clearly defined objectives, and 2) perform rigorous quantitative analysis before embarking on any changes to the System. Policymakers must make certain that changes to foundational elements of our system of housing finance are, in fact, pareto improving, achieve the desired results, and do not have unintended consequences.

Congress very thoughtfully created and has adapted an FHLBank System over 92-years with a symbiotic structure whereby 1) large members generate the majority of System income and lower the System's risk profile, which enables the System to raise low-cost funding in capital markets for the benefit of all FHLBank members, 2) the System "levels the playing field" through provision of low-cost funding to small, niche community lenders that would otherwise struggle to compete with national lenders and serve the unique needs of underserved communities across the country, and 3) the System contributes a percentage of earnings to support affordable housing and economic development programs – currently 10% for AHP + an additional 5% committed in 2023 on a go-forward basis for voluntary housing and community development programs across each of the 11 FHLBank districts.

The FHLBank System is a remarkable example of a win-win-win: members receive cost-effective liquidity, borrowers receive lower cost borrowing and a wider range of credit products through FHLBank members, and taxpayers receive a stronger, more resilient financial system and increased affordable housing and community development funding without any Congressionally appropriated

[5] The counterfactual assumes large members (defined here as members with advances > $1 billion in Q1'24) account for the same percent of the member population over time. In Q1'24, 71% of members had advances of $1 billion or more, thus, the counterfactual assumes these members are excluded and there is a 71% reduction in AHP assessments each year, all else equal. Realistically, one could expect FHLBank income (and AHP assessments) fall even further as overhead expenses would remain fixed, since membership only declines by 3.5% and the dollar value of advances (and associated income) fall by 71%, but the system needs to maintain capacity to serve the remaining 96.5% of members.

funds. Proposals to eliminate large members from the FHLBank System would jeopardize this balance and imperil the win-win-win that Congress created and Americans enjoy today.