Insight

What Are the Federal Home Loan Banks Even For?

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Executive Summary

- The Federal Home Loan Banks (FHLBs) are a network of private banks whose debts are presumed to be guaranteed by the federal government; in exchange for this and many other regulatory privileges, the FHLBs are required to contribute 10 percent of annual earnings to affordable housing programs.
- The United States faces a significant housing supply shortfall and congressional Democrats and the Biden Administration are seeking to expand the role of the FHLBs in the provision of affordable housing; while the goal is admirable, the FHLBs are an enormous, thinly capitalized, ostensibly privately owned financial entity making loans in the systemically risky real estate sector with losses guaranteed by the government and met by the taxpayer.
- Congress and the administration must take steps to minimize the market distortion and moral hazard of the FHLBs, not expand it.

Introduction

The role the Federal Home Loan Banks (FHLBs) play in both the housing and finance sectors has come under increased scrutiny in Washington since it was revealed in 2023 that the network of banks issued?$30 billion in loans to Silicon Valley Bank, Silvergate, and Signature Bank shortly before each collapsed – a decision seemingly at odds with the FHLBs' mandate to provide banks liquidity specifically to support housing finance and community investment.

Following recent calls by congressional Democrats for the FHLBs to better support affordable housing, Deputy Secretary of the Treasury Wally Adeyemo on August 6 met with FHLB leadership and published a letter encouraging them to deploy more of their resources to this end. This raises a number of policy questions, the most fundamental of which being: What role should the FHLBs actually play in the creation of affordable housing?

The Adeyemo Letter

On July 31 Deputy Secretary Adeyemo met with President Timothy Barrett of the Federal Home Loan Bank of Boston, leadership of the other 10 FHLBs, and the director of the Federal Housing Finance Agency (FHFA), and subsequently clarified the contents of this meeting in a letter to the chair of FHLB of Boston. After first noting that lowering the costs of housing is a priority for the Biden Administration, and that the key to this problem is improving the country's dwindling housing supply, Deputy Secretary Adeyemo points out that last year the FHLBs collectively paid out $3.4 billion in dividends and held over $20 billion in unrestricted retained earnings, but allocated just $792 million to programs supporting affordable housing programs.

Adeyemo requested both that the FHLBs commit to spending at least 20 percent of net income on affordable housing going forward and that a portion of the FHLBs' capital be used to create "a pool of capital that can lower the cost of new housing production across the country." (The deputy secretary provides no further detail

as to how this might be put into practice.) Were the FHLBs to fail in either of these regards, Adeyemo notes that "we" (whoever that is) "will need to work with Congress to ensure the FHLBs are taking steps that are consistent with their mandate." The letter gives the FHLBs 15 days to respond to these "proposals."

Policy Implications

What are the FHLBs and what is their mandate?

The FHLBs are a network of 11 regional banks across the United States that are privately capitalized and do not receive government funding but are overseen by the FHFA. They have a public purpose mandate, founded by the government during the Great Depression to provide banks with low-cost funds that could be used to finance mortgages. Often called the lender of next to last resort, the FHLBs are the only entities paid out ahead of the Federal Deposit Insurance Corporation (FDIC) in bank resolution – and are effectively taxpayer subsidized.?In other words, the FHLBs are an enormous, thinly capitalized, ostensibly privately owned financial entity making loans in the real estate sector, historically the economy's most systemically risky area.

In addition, the FHLBS receive significant preferential treatment, most notably total exemption from all corporate federal, state, and local taxation. The capital invested in FHLBs gets preferential treatment under the Basel capital regime. In March 2024 the Congressional Budget Office released a report detailing the $7.3 billion in public subsidies the FHLBs will receive in 2024. To earn this treatment, all the FHLBs must do is contribute 10 percent of annual earnings to affordable-housing programs (in May 2023, the FHLBs volunteered to commit 15 percent, a goal they have never achieved).

Given the quasi-private nature of the FHLBs, federal oversight is light-touch and, typically to meet affordable housing goals, the network has benefitted from multiple expansions loosening the regulatory reins and allowing the FHLBs to enter into even riskier new lines of business. Any risks borne by the FHLBs are implicitly if not explicitly held by the taxpayer – as, for example, when during the financial crisis the Treasury was authorized to purchase unlimited amounts of FHLB debt.

How badly are the FHLBs failing to meet their mandate?

Interestingly, and perhaps frustratingly for the administration and Senate Democrats, the FHLBs aren't failing to meet their mandate. As noted in Deputy Secretary Adeyemo's letter, the FHLBs collectively paid out $3.4 billion in dividends last year and held over $20 billion in unrestricted retained earnings, but allocated "just" $792 million to programs supporting affordable housing programs (Senator Warren notes that the FHLBs' ratio of dividends to affordable housing programs is 8.5 to 1, but confusingly cites a much lower affordable housing program figure of $395 million). The 2023 consolidated income statement for the FHLBs' boasts a combined net income of $6.7 billion. Deputy Secretary Adeyemo's affordable housing program figure of $792 million represents 12 percent of net income – short of the 15 percent voluntary goal but in excess of the 10 percent regulatory requirement.

Despite this success, the small percentage of the total loan portfolio allocated to affordable housing goals raises the question of how the remainder is distributed. Of particular note, after the collapse of Silicon Valley Bank, it emerged that the FHLB network had made $30 billion in loans to SVB, Silvergate, and Signature Bank shortly before each collapsed. This is not even the first time – in the 2007–2008 financial crisis, the FHLB network made significant advances to Washington Mutual, Countrywide, and Wachovia – all of which collapsed. Aside from raising questions regarding the meticulousness of due diligence performed by the FHLBs' loan origination teams, it is fundamentally difficult to square these loans with the network's purpose of boosting the country's mortgage market. More practically, while $792 million meets Congress' current requirements for

the FHLBs, the total amount is a drop in the bucket compared to the country's housing supply needs and is insultingly small by comparison to the FHLBs' willingness to offer $30 billion to Silicon Valley Bank.

What purpose do we want the FHLBs to serve?

The FHLB network shares remarkable similarities to the government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac prior to the financial crises. The GSEs also enjoyed remarkable privileges: a line of credit at the Treasury, exemptions from securities registration requirements, microscopic capital backstops, the ability to have their debt held in unlimited amounts by banks, the highly risky and hugely profitable monoline housing-based hedge funds, and more. Where the GSEs went, so too might the FHLBs: implicit taxpayer backing became an explicit drain on the Treasury, and the GSEs became (and remain)?wards of the state.

The many regulatory benefits enjoyed by the FHLBs allow the banks to borrow at near-Treasury rates, as well as lend out to member organizations at below-market rates. The system, in addition to leading to a severe market distortion, also creates significant moral hazard. The FHLBs' "super lien" status requires them to be paid out even before the FDIC in the event of borrower default; the semi-private nature of the FHLB network ensures that all we know about their operations can be found in their quarterly filings.

Deputy Secretary Adeyemo's implied threat to "work with" Congress to penalize the FHLBs is curious on a number of fronts. While it is easy (and pleasurable) to imagine some of the FHLBs privileges being revoked, most notably the extension tax exemptions enjoyed, it is difficult to imagine any Congress, let alone this one, banding together to do so. It is also in line with this administration's approach to ignore the potential costs of the rules and regulations it promulgates – and if the housing market is as weak as the Biden Administration notes, is expanding the role of an organization totally insensitive to risk and backed by the taxpayer the most sensible approach?

Conclusions

We have been down this road before. Quasi-governmental and thinly capitalized housing finance titans engaging in mission creep to make ever-more risky forays into products and services both in and out of explicit congressional approval rarely ends well. At the end of the day, the American taxpayer will foot the bill. While increasing the supply of affordable housing is a laudable policy goal, the FHLB network is simply not the appropriate vehicle to meet these aims, and policymakers should not be calling for an expansion in the FHLBs' role in any way. Instead they should revoke the network's charters entirely.