

July 14, 2024

Director Sandra L. Thompson
Federal Housing Finance Agency
Constitution Center
400 Seventh Street, SW
Washington, DC 20024
Re: Request for Information on Federal Home Loan Bank Mission

Dear Director Thompson:

Thank you for raising these important questions about the mission of the Federal Home Loan Bank (FHLBank) system.¹ Updating the Core Mission Activities (CMA) regulation for the FHLBank system is a critical step in the efforts to redirect the system to again serve primarily public aims. As a law professor who has spent years studying the FHLBanks and a former Congressional staffer who helped write the Housing and Economic Recovery Act (HERA) which created the Federal Housing Finance Agency (FHFA) to regulate the FHLBanks, we have been inspired by the important role the FHLBanks historically played in facilitating the flow of under-supplied credit and promoting the viability of the small financial institutions that are distinctly well positioned to provide that credit. We have been equally disheartened studying the FHLBanks' operations in recent decades. The FHLBanks today are more focused on maximizing profits and extracting economic rents than serving the public aims that could justify the significant public subsidies the FHLBanks enjoy.

The first question that the Request for Information (RFI) poses is fundamental, and our comments focus almost entirely on the question of how best to tether the main business of the FHLBanks—that is, liquidity provisioning via advances—with the housing and community development aims at the core of the FHLBank system. To preview our conclusion: The FHFA should cease assuming that all advances are core mission activities. General liquidity provision was an important and legitimate function of the FHLBank system during its early decades. At that time, most of FHLBank members were thrifts, thrifts were fundamentally different than banks, and thrifts lacked direct access to the Federal Reserve System (Fed) as a lender of last resort. Today, thrifts and banks are almost identical for economic, legal, and regulatory purposes, and most FHLBank members that engage in maturity transformation can (and should) borrow from the Fed's discount window if they face liquidity strains.

The evolution of the FHLBank system as a lender-of-second-to-last resort reduces accountability, undermines the efficacy and functioning of the Fed's discount window, and allows the FHLBanks to exploit their government backstop without furthering public aims. It also allows troubled institutions to continue the same behaviors that led to their problems, exacerbating the eventual negative consequences and increasing risk to the financial system. For these reasons, the CMA should clarify that general liquidity support is outside the mission of the FHLBanks. That means, among other things, that not all advances should be seen as core mission activities.

¹ The views expressed in this letter are the authors' own and do not necessarily reflect the views of the Brookings Institution or others affiliated with the Brookings Institution.

As we further explain, advances still play a critical role in promoting access to the mortgages families need to buy homes and the credit small business need to survive, and they can otherwise promote community development aims. More creative use of advances to promote those aims should be actively encouraged. Imposing excessively stringent requirements on financial institution members to show that particular advances are furthering such aims could impede the use of advances even in circumstances when they are likely to serve such aims.

The FHFA should use the CMA to lay out a balanced approach, encouraging broad and creative uses of advances when likely to promote credit creation while making clear that not all advances further such aims. This may entail using proxies when appropriate to increase the probability that advances are being used to further a legitimate aim. For example, it may be appropriate to assume that any advances to sufficiently small financial institutions or advances secured by relatively illiquid collateral promote the aims of the FHLBank system. Establishing a reasonable nexus between the provision of advances and the housing and community development aims are the only way to justify the myriad public subsidies the FHLBank System enjoys. The FHFA could also encourage FHLBanks to reward members via dividends, advance terms, or other mechanisms when those members find creative ways to promote the type of lending the FHLBank Act, as amended, implicitly seeks to support.² Focusing the mission of the FHLBank System on promoting the provision of credit to the households and businesses that need it and primarily supporting smaller financial institutions is the best way to revive the original mission and design of the FHLBank System.

Liquidity Provisioning: The Fed and the FHLBanks

Silicon Valley Bank (SVB), Signature, and First Republic all borrowed heavily from their local FHLBank before going under in the spring of 2023. SVB, for example, went from having almost no loans outstanding at the end of 2021 to being the biggest single borrower from the FHLBank of San Francisco at the end of 2022. By that time, it had \$15 billion in loans outstanding, 17 percent of FHLBank of San Francisco's total outstanding advances.³ The second biggest borrower from the FHLBank of San Francisco at the end of 2022 was First Republic Bank, with \$14 billion, constituting 16 percent of the FHLBank's outstanding advances.⁴ This is not a new pattern. Washington Mutual, IndyMac, Countrywide and other banks that failed or merged to avert failure during the 2007-2009 financial crisis took the same course.⁵ And going back to the savings and loan (S&L) crisis, S&Ls that ended up in resolution were far more likely to have borrowed, and typically borrowed far more, from the FHLBanks than their healthy peers.⁶ In each of these instances, troubled financial institutions that probably ought to have been closed were able

² For a discussion of the way the current dividend policies reflect the wrong set of incentives, see Steven Kelly, Susan McLaughlin, and Andrew Metrick, "FHLB Dividends: Low-Hanging Fruit for Reconfiguring FHLB Lending," *Program on Financial Stability at the Yale School of Management*, January 18, 2024, <https://som.yale.edu/story/2024/fhlb-dividends-low-hanging-fruit-reconfiguring-fhlb-lending>.

³ Federal Home Loan Bank of San Francisco, *Form 10-K for the Period Ending December 31, 2022*, filed March 10, 2023, <https://www.sec.gov/ix?doc=/Archives/edgar/data/0001316944/000131694423000047/fhlbsf-20221231.htm>.

⁴ Federal Home Loan Bank of San Francisco, *Form 10-K for the Period Ending December 31, 2022*.

⁵ Kathryn Judge, "Three Discount Windows," *Cornell Law Review* 99 (2014): 795; Adam B. Ashcraft, Morten L. Bech, and W. Scott Frame, "The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?," *Journal of Money, Credit and Banking* 42 (2010): 551; Stephan G. Cecchetti et al., "The FHLB Role in the SVB and Related Debacles," in *SVB and Beyond: The Banking Stress of 2023*, ed. Viral V. Acharya et al. (New York: NYU Stern Business School, 2023), 189, <https://drive.google.com/file/d/1M067WV7Ilogb0Jtrsl33ggpbHIAvJlR6/view>.

⁶ Lisa K. Ashley et al., "Access to FHLBank Advances and the Performance of Thrift Institutions," *Federal Reserve Bank of Chicago Economic Perspectives* 22 (1998): 33, 40, 41 tbl. 6.

to limp along longer than they should have thanks to fresh liquidity support from the FHLBanks. This is why the FHLBanks are often known as the “lender of next-to-last resort.”

Yet in contrast to the Fed, the FHLBanks are ill-suited to serve as a lender of last resort. They lack the right incentives, capacity, and accountability mechanisms. Making matters worse, their role makes it harder for the Fed to know in a timely way just how much stress there is in the banking system. The country would be better off if the Fed, and only the Fed, served as the lender of last resort.

To be sure, the FHLBanks historically played an important role to providing liquidity. When Herbert Hoover signed the bill creating the FHLBank System, he directly analogized it to the Federal Reserve System.⁷ Although the Fed under-performed during the Great Depression, the Depression made clear that financial institutions that use shorter-term liabilities to fund longer-term assets were inherently fragile. By having a central bank or Federal Home Loan bank-to-bank stand ready and willing to make loans to financial institutions during periods of general financial distress, the government can play a critical role in helping to promote the resilience of individual financial institutions and the health of the broader financial system they constitute. And back in 1932, when the FHLBanks were created, savings and loan institutions, building associations, and other types of thrifts lacked any direct access to the Fed’s discount window.⁸ Adding to the challenges in housing finance, the Fed at that point in time, did not accept mortgages as collateral.⁹ Against this background, it made good sense for general liquidity support to be among the roles played by the FHLBank system.

These background conditions that helped justify having the FHLBanks provide general liquidity to member financial institutions no longer hold, however. FHLBank membership has expanded significantly to encompass banks alongside thrifts and insurance companies. The FHLBank members that engage in meaningful maturity transformation—banks and thrifts—all have access to the Fed’s discount window.¹⁰ And the collateral that a member financial institution can use to obtain fresh liquidity from the FHLBank System can now also be used by that financial institution to obtain fresh liquidity from the Fed, an institution that is far better situated to serve as the nation’s lender of last resort.

Wrong Incentives

One reason the FHLBanks keep loaning money to troubled banks is that in every instance, the FHLBanks that made those loans were repaid in full. SVB’s failure, for example, cost the Deposit Insurance Fund more than \$16 billion.¹¹ That amount will have to be replenished by imposing a special assessment on healthy banks that were more prudent in their risk management.

⁷ Herbert Hoover, “Statement Announcing the White House Conference on Home Building and Home Ownership,” (speech, online by Gerhard Peters and John T. Woolley, The American Presidency Project, September 15, 1931), <https://www.presidency.ucsb.edu/node/207591>.

⁸ David Torregrosa, Remy Mitchell, and Sebastien Gay, *The Role of Federal Home Loan Banks in the Financial System* (Washington D.C., Congressional Budget Office, March 2024), <https://www.cbo.gov/publication/60064>.

⁹ Clay J. Anderson, *Evolution of the Role and Functioning of the Discount Mechanism* (Philadelphia: Federal Reserve Bank of Philadelphia, November 1966): 22, https://fraser.stlouisfed.org/files/docs/historical/federal%20reserve%20history/discountmech/evolrole_ander.pdf.

¹⁰ Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C.).

¹¹ Chie Hogenmiller et al., *Material Loss Review of Silicon Valley Bank* (Office of Inspector General for the Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau, September 25, 2023), <https://oig.federalreserve.gov/reports/board-material-loss-review-silicon-valley-bank-sep2023.htm>.

Nonetheless, the FHLBank of San Francisco which loaned \$30 billion to SVB in the fifteen months prior to its failure got paid back in full.¹² It even earned an extra \$285 million as a result of prepayment penalties it imposed when the loans it had made to SVB were paid back early, adding costs to the Deposit Insurance Fund.¹³

More generally, the FHLBanks internalize none of the costs that a bank failure imposes on the Deposit Insurance Fund, other banks, and, often, the economy more generally. They always get repaid in full. This is primarily because the FHLBanks demand excess collateral and often blanket liens when making loans, buttressed by a statutory “super-lien.”¹⁴ These features ensure FHLBanks are paid in full before depositors—including the FDIC’s Deposit Insurance Fund that protects insured depositors—see a dime. As a result, they lack incentive to ensure they only provide fresh liquidity to solvent banks—a core tenet that has guided central banks in their roles as lenders of last resort since 1873.¹⁵ The FHFA thoughtfully recognized this challenge in its [System at 100 Report](#), but so long as the FHLBanks are shielded from losses, there is little reason to think that this problem can easily be mitigated. This is particularly the case given that, in contrast to the Fed, the FHLBanks have no internal supervisory capacity.

The ability of a commercial bank to become a member of multiple FHLBanks is another problem that creates incentives between the FHLBanks to compete with each other in a race to laxity on advances. The FHLB system was designed in an era where multi-state banking was not allowable, hence multi-district FHLB membership was not realistic. The removal of inter-state restrictions in the 1990s coupled with massive consolidation has led to an era when almost all of the largest and many of the larger banks are or have the potential to be members of multiple FHLBanks. This creates the potential for banks to arbitrage other FHLBanks against each other in competing for advance business. Even if banks choose to functionally concentrate advances in one FHLBank, the threat of switching can cause misaligned incentives, particularly if that bank is one of the larger borrowers from the FHLB.

The solution is to require single district membership for all banks. This was included in the Treasury Department’s Housing Finance Reform proposal of 2011.¹⁶ It was good policy then, and it is good policy today. FHFA could consider imposing this through regulation as part of ensuring the safety and soundness of the FHLB system.

A related reason that the FHLBanks lack the right set of incentives is that their leaders are not as accountable as the leaders of the Federal Reserve System. Although both systems were

¹² Noah Buhayar, “After SVB’s Failure, Its Attempted Rescuer Charged \$285 Million in Fees,” *Bloomberg.com*, March 12, 2024, <https://www.bloomberg.com/news/articles/2024-03-12/after-svb-failed-fhlb-charged-285-million-in-fees-to-wind-down-financing>.

¹³ Noah Buhayar, “After SVB’s Failure, Its Attempted Rescuer Charged \$285 Million in Fees.”

¹⁴ David Torregrosa, Remy Mitchell, and Sebastien Gay, *The Role of Federal Home Loan Banks in the Financial System*.

¹⁵ This is the year that British public intellectual Walter Bagehot published his book, *Lombard Street: A Description of the Money Market*, explaining why the Bank of England should be willing to serve as a lender of last resort and the principles that should guide those interventions. The principles that have come to be known as Bagehot’s dictum remain highly influential. Whether they are actually followed has been a matter of more debate. See generally, Thomas L. Hogan, Linh Le, and Alexander William Salter, “Ben Bernanke and Bagehot’s Rules,” *Journal of Money, Credit and Banking* 47, no. 2/3 (2015): 333–48; Walter Bagehot, *Lombard Street: A Description of the Money Market* (London: Henry S. King & Co., 1873).

¹⁶ Department of the Treasury and Department of Housing and Urban Development, *Reforming America’s Housing Finance Market: A Report to Congress* (Washington D.C.: U.S. Dept. of the Treasury, 2011), 14, Retrieved from the Digital Public Library of America, http://catalog.gpo.gov/F/?func=direct&doc_number=000794397&format=999.

public-private hybrids when first created in the early 1900s, each has undergone a number of subsequent reforms, rendering the Federal Reserve far more public and the FHLBanks far, far more private.¹⁷ This comes through in their respective approaches to providing liquidity. Although the FHLBanks have been more than happy to make loans to deeply troubled banks, they adjust the terms on which they will extend loans in order to minimize their credit risk. This means, among other things, that when the value of particular types of assets are more volatile or going down because of uncertainty about their value, the FHLBanks can demand bigger haircuts to loan against that collateral. This is just what they should do if they are trying to reduce their credit risk but the opposite of what a good lender of last resort would do, as higher haircuts tend to exacerbate liquidity strains. Their tendency to look out for their own bottom lines more than the public good is also reflected in their willingness to demand blanket liens against all of a bank’s assets, despite the fact such liens can impede a bank’s ability to borrow from the discount window.¹⁸

FHLBank leadership is incentivized to make profit both for their members and as a result of their personal compensation.¹⁹ FHLBank Presidents earned an average of \$2.9 million in annual compensation, with the highest making \$4.4 million, in 2023.²⁰ This compensation is multiples higher than Federal Reserve Bank Presidents, who themselves earn far more than the Chair or Governors of the Federal Reserve System.²¹ This disparity is particularly striking given that the Federal Reserve system was a model when the FHLBank system was first created; it, too, continues to operate as a cooperative, with private member financial institutions, albeit with residual profits going to the Treasury Department; and the Federal Reserve Banks have larger work forces and engage in a wider variety of activities than individual FHLBanks. Focusing just on cities that have both a Federal Reserve Bank and a FHLBank, Table 1 captures the mismatch between compensation and operations (with the latter reduced to the size of the workforce).

Table 1: FHLBank and Federal Reserve Bank President Compensation and Operations

Bank	President compensation (\$ (2022) ²²	# of employees (2022) ²³	# of branches excluding	Operating expenses/non-interest expense	Assets
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¹⁷ Kathryn Judge, “The Unraveling of the Federal Home Loan Bank System,” *Yale Journal on Regulation* 41 (Forthcoming 2024).

¹⁸ When the Fed is making a loan via the discount window or via an emergency liquidity facility, the Federal Reserve Bank making the loan can only do so if secured to its satisfaction. E.g., 12 CFR 201.3.

¹⁹ Kathryn Judge, “The Unraveling of the Federal Home Loan Bank System.”

²⁰ Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2023* (issued Mar 22, 2024), S-14, https://www.fhlb-of.com/ofweb_userWeb/resources/2023Q4CFR.pdf.

²¹ Board of Governors of the Federal Reserve System, *109th Annual Report of the Board of Governors of the Federal Reserve System – Statistical Tables*, (2022), Table G.12. <https://www.federalreserve.gov/publications/2022-ar-statistical-tables.htm>; “Who Are the Members of the Federal Reserve Board, and How Are They Selected?,” FAQs, Board of Governors of the Federal Reserve System, last modified April 3, 2019, https://www.federalreserve.gov/faqs/about_12591.htm.

²² Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2022* (issued March 24, 2023), S-14, https://www.fhlb-of.com/ofweb_userWeb/resources/2022Q4CFR.pdf; Board of Governors of the Federal Reserve System, *109th Annual Report*, Table G.12.

²³ Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2022*, 26; Board of Governors of the Federal Reserve System, *109th Annual Report*, Table G.12.

			HQ (2024) ²⁴	(\$ thousands) (2022) ²⁵	(\$ millions) (2022) ²⁶
FHLBank Atlanta	\$2,003,932	319	0	\$138,000	\$151,622
Fed Bank Atlanta	\$443,100	1,814	5	\$500,162	\$603,124
FHLBank Boston	\$2,009,612	188	0	\$91,000	\$62,898
Fed Bank Boston	\$462,365	1,273	0	\$408,332	\$222,488
FHLBank Chicago	\$1,634,547	495	0	\$244,000	\$126,853
Fed Bank Chicago	\$477,900	1,679	1	\$482,900	\$578,801
FHLBank Dallas	\$1,790,916	201	0	\$102,000	\$114,349
Fed Bank Dallas	\$440,600	1,303	3	\$266,322	\$431,596
FHLBank New York	\$2,321,427	327	0	\$200,000	\$157,391
Fed Bank New York	\$528,800	2,971	0	\$2,000,955	\$4,429,847
FHLBank San Francisco	\$2,408,408	297	0	\$162,000	\$121,056
Fed Bank San Francisco	\$512,300	1,913	4	\$496,984	\$889,653

The FHFA has the authority to prohibit compensation that is not reasonable and comparable with similar businesses.²⁷ Given their public purpose and historical analogy against Federal Reserve Regional Banks, the Federal Reserve Regional Bank seems like the right starting point for assessing the proper comparable levels for FHLBank executives.²⁸ With respect to design, as this letter otherwise clarifies, the aggregate value of advances should not support a larger salary. Instead, compensation should be set by reference to how much advances and other activities actually promote the values set forth in the CMA. If a FHLBank opts to expand other types of operations to promote housing and community development financing, such as expanding the Mortgage Partnership Finance Program or developing other programs specifically to promote community development financing, for example, that could be a reasonable basis for a relatively higher salary. After all, the statute points to compensation reasonable and comparable to “similar

²⁴ Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2022*, 41; “Federal Reserve Banks,” About the Fed, Board of Governors of the Federal Reserve System, Accessed June 28, 2024, <https://www.federalreserve.gov/aboutthefed/federal-reserve-system.htm>.

²⁵ Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2022*, F-82-F-83; Board of Governors of the Federal Reserve System, *109th Annual Report*, Table G.9.

²⁶ Federal Home Loan Banks, *Combined Financial Report for the Year Ended December 31, 2022*, F-78-F-79; Board of Governors of the Federal Reserve System, *109th Annual Report*, Table G.8A.

²⁷ Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. §4518 (2008).

²⁸ For a further explanation of why many of the private banks that the FHLBanks now use as reference points are not comparable, see Donald H. Layton, “The GSE Public-Private Hybrid Model Flunks Again: This Time It’s the Federal Home Loan Bank System (Part 2),” *The Stoop NYU Furman Center Blog* (blog), March 11, 2024, <https://furmancenter.org/thestoop/entry/the-gse-public-private-hybrid-model-flunks-again-this-time-its-the-federal-home-loan-bank-system-part-2>.

businesses” and “involving similar duties and responsibilities.”²⁹ These could include community development organizations and housing finance organizations such as LISC and Enterprise.

Limited Accountability

There is far from adequate public accountability with respect to the FHLBanks’ lending decisions. There is no affirmative obligation to publicly disclose borrowers or terms, even with a delay. FHLBank officials also face less ex post accountability than Fed officials when they make decisions that contribute to bad outcomes. For example, despite the massive lending by the FHLBank of San Francisco to SVB and First Republic and the many congressional hearings that followed those failures, the FHLBank officials involved were never forced to testify. This stands in stark contrast to the numerous hearings on bank examination that followed those events.

To booster accountability, FHFA could convene public fora where FHLBank leadership and public stakeholders discuss FHLBank actions. FHFA can build on its successful FHLB reform process, [FHLBank System at 100: Focusing on The Future](#), by formalizing a set of semi-annual hearings on the FHLB System and on particular banks.

Another concern is how the FHLBanks have employed paid lobbyists to gain influence in Congress. In 2023, FHLBanks and their organizations spent \$3.37 million on registered lobbyists.³⁰ The nearest historical precedent to FHLBanks, Federal Reserve Banks, are government chartered but privately owned cooperatives that do not employ private lobbyists. Thus, one has to ask, why do the FHLBs? Presumably the purpose of these expenditures is to increase the FHLBanks direct access to Congress to maximize their profits and limit public scrutiny of their actions.

Prior to Fannie Mae and Freddie Mac being placed into conservatorship by FHFA, both organizations employed a large team of lobbyists. Reports of the effectiveness of the Government-Sponsored Enterprise (GSE) lobbying organization indicate it was one reason why Congress was slow to enact stronger regulation of the GSEs and created pressure to keep their regulator from taking tougher action. For example, “when Congressman Paul Ryan (R-WI) sought to increase regulation of the GSEs, Fannie Mae sent lobbyists to harass him in his Wisconsin congressional district, going so far as to call his constituents and accuse him of seeking to increase mortgage rates, generating 6,000 angry responses to his office.”³¹ This was one reason Congress created FHFA and specifically changed FHFA’s funding system from discretionary Congressional appropriations to direct mandatory funding from their regulated agencies (e.g., taken “off annual appropriations”).³²

²⁹ Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C §4518 (a) (2008).

³⁰ “Council of Federal Home Loan Banks Profile: Summary,” Organizations Summary, OpenSecrets, 2024, <https://www.opensecrets.org/orgs/council-of-federal-home-loan-banks/summary?contribcycle=2024&id=D000049792&lobcycle=2024&outspendcycle=2022&topnumcycle=2024&toprecycle=2024>;

“Federal Home Loan Bank Profile: Summary,” Organizations Summary, OpenSecrets, 2024, Accessed June 28, 2024, <https://www.opensecrets.org/orgs/federal-home-loan-bank/summary?contribcycle=2024&id=D000025773&lobcycle=2024&outspendcycle=2022&topnumcycle=2024&toprecycle=2024>.

³¹ U.S. House of Representatives Committee on Oversight and Government Reform, *The Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008* (May 2010), 15, <https://oversight.house.gov/report/the-role-of-government-affordable-housing-policy-in-creating-the-global-financial-crisis-of-2008/>.

³² Earlier versions of the Senate Bill 190 had clear intent of removing the FHFA from the appropriations process, see Mark Jickling, *Government-Sponsored Enterprises (GSEs): Reform Legislation in the 109th Congress* (Congressional Research Service, Jan 2007), 14,

One of the first actions FHFA took after placing each GSE into conservatorship was to eliminate their external lobbying contracts.

FHFA should explore the conflicts created by FHLB lobbying efforts. This could begin with a clear, public articulation by the FHLBanks on the purpose of their lobbying efforts as a way to ensure that any lobbying they are undertaking is consistent with the CMA. It may also include a consideration by FHFA of its authority to impose limits on FHLBank lobbying, including constraints on the hiring of external lobbyists. Such consideration should recognize that the FHLBanks have rights under the First Amendment and those rights must be respected. However, as government-chartered enterprises using public subsidies to supposedly serve a public purpose, the appropriateness of lobbying activities and the hiring of paid external lobbyists deserves greater scrutiny. This is particularly important given that the consequences of these lobbying campaigns can include reduced public accountability.

Improving Lender of Last Report

Another factor rendering the FHLBanks ill-suited to serve as lenders of last resort is that there is no assurance FHLBanks will have sufficient access to liquidity during periods of stress, when banks most need a reliable source of liquidity. The Fed does not face any liquidity constraint. It can create as many new liquid assets as needed to quell periods of stress. This raises accountability concerns, as just noted, but it also ensures that the Fed has the capacity to rise to the occasion no matter how much liquidity may be needed.

In contrast, the FHLBanks have to raise money in the capital markets in order to then loan it on to banks. Most of the time, this works.³³ (Just like, most of the time, banks are stable.) The FHLBanks enjoy an implicit government backstop. As with the other government-sponsored enterprises, Fannie Mae and Freddie Mac before they were put into receivership in 2008, this backstop enables the FHLBanks can issue debt more readily and more cheaply, so they have often been able to borrow a lot and re-lend it quickly even during periods of stress.³⁴ But this constraint has at times proved to be a challenge.³⁵ Moreover, the FHLBanks have become more reliant on short-term sources of funding in recent years, increasing their possible fragility and the risk (even if small) that they will not be able to borrow as much as banks might need in the event of real distress.³⁶

A further challenge of having two lenders of last resort, one of which also makes loans for other reasons, is that it muddies the information that a well-designed lender of last resort regime

https://www.evercrsreport.com/files/20070116_RL32795_664677ceb6692d385159a713209737be8a465f89.pdf; Secretary John W. Snow also stressed the budgetary independence of GSE regulatory reform, see *Testimony of Secretary John W. Snow Before the U.S. Senate Committee on Banking, Housing and Urban Affairs Proposals for Housing GSE Reform*, 109th Congress (April 2005), <https://home.treasury.gov/news/press-releases/js2362>.

³³ Steven Kelly, Susan McLaughlin, and Andrew Metrick, “FHLB Dividends: Low-Hanging Fruit for Reconfiguring FHLB Lending,” *Program on Financial Stability at the Yale School of Management*, January 18, 2024, <https://som.yale.edu/story/2024/fhlb-dividends-low-hanging-fruit-reconfiguring-fhlb-lending>.

³⁴ Jim Parrott and Mark Zandi, *In Defense of the Federal Home Loan Banks* (April 10, 2023), <https://www.urban.org/research/publication/defense-federal-home-loan-banks>.

³⁵ Ashcraft et al., “The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?.”

³⁶ For an explanation of why the FHLBanks have taken on this maturity mismatch and broader implications, see Stefan Gissler, Borghan Narajabad, and Daniel K. Tarullo, “Federal Home Loan Banks and Financial Stability,” *Journal of Financial Regulation* 9, no. 1 (April 3, 2023): 1–29. <https://doi.org/10.1093/jfr/fjad002>.

generates.³⁷ One reason that banks like going to the FHLBanks and that FHLBank advances are not stigmatized in a manner akin to the discount window is that banks get advances from their local FHLBank for all kinds of reasons. Sometimes it is because they are facing a liquidity shortfall. Other times, the regional FHLBank may offer a more attractive rate on medium-term financing than other possible sources. Yet other times, a bank may be seeking to diversify its funding sources. Sometimes FHLBank borrowing may even hide distress at the bank, as was the case recently with Heartland Tri-State Bank. Heartland's executive had lost millions of the bank's money in a crypto scam.³⁸ Yet disclosure of this fact was delayed, as Heartland managed to borrow a substantial share of the bank's asset base in under 60 days, despite the bank not having borrowed from an FHLBank in years.³⁹ A bank's decision to obtain an advance from a FHLBank is an inherently noisy signal. It may indicate that a bank, or the banking system generally, is facing liquidity strains, but it may also be attributable to other factors.

There are fewer reasons that a bank, or banks in general, seek financing from a true lender of last resort, such as the discount window. When there is a broad increase in bank borrowing from the discount window, for example, it usually indicates that there is something amiss causing liquidity shortfalls in the system. This provides the Fed useful information. It alerts the Fed that there may be a growing threat to that stability and that it may want to figure out that underlying cause, if it has not already.

To be sure, given banks' reluctance to use the discount window, there are benefits at times to the ways banks have used FHLBanks advances as a source of liquidity during times of stress. During periods of stress, banks, the banking system, and financial system more generally benefit from additional liquidity, regardless of its source. These benefits are a reminder why both the FHLBank system and discount window should be fixed in tandem, even if the policies to do so are held by different agencies. Just as fixing the FHLBank system is key to enhancing the utility of the discount window, ensuring the discount window is viable and well-functioning is key to minimizing the challenges that could otherwise arise from introducing needed reforms to the FHLBank system.

The good news is that the Fed and other bank regulators are taking meaningful steps to try to enhance the usability of the discount window and to reduce the associated stigma, and there are indicia that these efforts will become more robust in the months and years ahead.⁴⁰ These developments should further reduce the social value of having the FHLBanks play a role in general liquidity provision and make efforts to clarify the mission of the FHLBanks all the more timely.

The CMA should clarify that general provision of liquidity to all members is outside the mission of the FHLBanks. Managing liquidity is often a challenge for any financial institution. Providing liquidity and a more stable source of funding to financial institution members is a key way that the FHLBanks help promote housing and community development. Moreover, overly

³⁷ *E.g.*, Kathryn Judge, "The First Year: The Role of a Modern Lender of Last Resort," *Columbia Law Review* 116 (2016): 843, https://scholarship.law.columbia.edu/faculty_scholarship/106.

³⁸ Claire Williams, "Failed Kansas Bank Rapidly Borrowed \$21 Million from FHLB System," *American Banker*, February 12, 2024, <https://www.americanbanker.com/news/failed-kansas-bank-rapidly-borrowed-21-million-from-fhlb-system>.

³⁹ Claire Williams, "Failed Kansas Bank Rapidly Borrowed \$21 Million from FHLB System."

⁴⁰ *E.g.* Jeanna Smialek and Rob Copeland, "Bank Runs Spooked Regulators. Now a Clampdown Is Coming.," *The New York Times*, March 5, 2024, <https://www.nytimes.com/2024/03/05/business/economy/silicon-valley-bank-federal-reserve.html>.

rigid or demanding requirements that put the onus on financial institutions to show that advances are being used for housing and community development aims could excessively constrain the use of advances. The solution to this quandary is to devise workable proxies for when advances are likely to meaningfully serve housing or community development aims. Some initial thoughts on how this might be done follow.

Advances that Support Housing and Community Development

FHLBank members are a diverse group and their reasons for using advances vary. Many of the biggest borrowers from the FHLBanks have myriad other ways of accessing liquidity and funding so long as they remain healthy. The same is not true for many of the smaller financial institutions. Similarly, there are significant differences in the liquidity of the various types of assets that the FHLBanks accept as collateral. Mortgage-backed securities (MBS), particularly agency MBS, for example, are far more liquid than loans to small businesses or mortgages secured by atypical properties, even though more innovative forms of housing development may be just what is needed to address today's affordability crisis.⁴¹ Mapping the types of institutions and the types of assets where frictions are most likely to arise can provide a guide for those domains where the FHLBanks can have the greatest positive impact in encouraging lending. And it is by encouraging lending that would otherwise not happen that the FHLBanks can most effectively promote housing and community development. This was the original design of the FHLBanks, and it should again be restored as central to their mission.

Looking back to the early decades of the FHLBanks provides insight into how they can serve aims that remain relevant. In contrast to the Fed, the FHLBank system was not designed to serve merely as a lender of last resort that enhances the stability of financial institution members in the face of economic shocks. They were designed to promote the extension of a particular type of credit—home loans—and to encourage financial institution members to make those loans on terms that served the needs of working families.⁴² Congress set them up to accomplish these aims through membership and collateral policies. Individuals, for example, were not allowed to join the FHLBank system even though they were among the major issuers of mortgages at the time. Neither were state banks, even though many made home loans. Instead, the focus was on institutions that specialized in serving working Americans and promoting housing (various forms of thrifts) and, to a lesser extent, supporting a secondary market for mortgages at a time the government did not otherwise promote the creation of such a market (hence the inclusion of insurance companies).

Collateral

The effort to shape credit in ways that helped promote mortgage availability and structure mortgage finance in a way to help homeowners was even more evident in the collateral policies used at the time. Back in 1932 when the FHLBanks were founded, the typical home loan had a duration of roughly five years, and it had a balloon structure pursuant to which borrowers often paid only interest during the life of the loan and had to repay the principal in full at the time the loan matured.⁴³ When a borrower could not get a new loan to pay back the principal, foreclosure

⁴¹ Noah Buhayar, Heather Perlberg, and Tom Schoenberg, "A Vegas Whale and Wall Street Tap Billions Meant for US Housing," *Bloomberglaw.com*, Oct. 20, 2023, <https://news.bloomberglaw.com/banking-law/a-vegas-whale-and-wall-street-tap-billions-meant-for-us-housing>.

⁴² Federal Home Loan Bank Act, ch. 522, § 4(a), 47 Stat. 725, 726 (1932) (current version at 12 U.S.C. § 1424(a)); Kathryn Judge, "The Unraveling of the Federal Home Loan Bank System."

⁴³ Adam J. Levitin and Susan M. Wachter, *The Great American Housing Bubble* (Harvard University Press, 2020).

often resulted. Congress recognized that longer duration loans and amortization—that is, a loan structure pursuant to which principal and interest are paid off over time—were more likely to serve the needs of the typical American family.⁴⁴ FHLBanks’ collateral policy reflected this. Even though longer-term loans generally entail more risk, the FHLBanks provided *smaller* haircuts on home loans that were at least eight years and amortizing than on other home loans.⁴⁵ Risk of default mattered, but whether the loan being used as collateral actually benefited the borrower mattered as well.

These types of concerns appear to be largely absent in how FHLBanks today set collateral policy. Reflecting just how far removed the advances business has become from the housing and community development missions of the FHLBanks, the haircuts seem to be determined based almost entirely on the credit risk an asset poses to the FHLBanks with little regard to whether the collateral in question is the type of asset that member institutions should be encouraged to create.⁴⁶

In order to better tether FHLBanks advances to the aims of promoting housing finance and community development today, the FHLBanks should return to their approach of being *less* risk averse when it comes to advances that are likely to promote housing and community development aims. This would mean imposing smaller, or at least not much bigger, haircuts on small business loans, agricultural loans, and other types of community development collateral, even if that means assuming some credit risk. It may also mean moving away from the use of blanket loans, at least in some circumstances. And, when collateral represents particularly useful types of credit creation, it could entail specifically making the loan non-recourse to further encourage such lending. These are not issues that should be resolved in the CMA, but they are the types of possibilities that should be left open and encouraged by the CMA. That the FHLBanks have not lost any money on advances should not be a point of pride among FHLBanks; it is a sign of their tendency to prioritize profitability over the important role they could play in promoting healthy extensions of credit.

Small business, agriculture, and other forms of community development credit, just like home loans back in 1932, involve meaningful risk and significant information asymmetries. They are costly loans for banks to make, even when they provide meaningful benefits for the borrower, the economy, and society. The same is true today of many loans backing housing developments that are innovative and help to meet today’s affordability crisis but that do not fit neatly into any of the categories established by the other GSEs. For the FHLBanks to make a positive social impact via their extension of advances, many of those advances should be facilitating the extension of credit where it might not otherwise reach. These forms of collateral should be favored and encouraged.

Another area where FHLBanks could do more is to promote the 5-49 unit housing market. By dint of history, single family mortgages can support one to four units and have a robust secondary market heavily supported by the GSEs.⁴⁷ Large multi-family buildings that have more

⁴⁴ Natasha Porfirenko and James Ryan, “Archival Description of President’s Conference on Home Building and Home Ownership,” Online Archive of California, 1998, https://oac.cdlib.org/findaid/ark:/13030/tf1w1001jf/entire_text/.

⁴⁵ Federal Home Loan Bank Act, ch. 522, §10(a)(1), 47 Stat. 725, 731-32 (1932) (current version at 12 U.S.C. § 1430(a)(1)).

⁴⁶ Kathryn Judge, “The Unraveling of the Federal Home Loan Bank System,” 36-37.

⁴⁷ N. Eric Weiss and Sean M. Hoskins, *The Conforming Loan Limit* (Congressional Research Service, August 2, 2013), <https://crsreports.congress.gov/product/details?prodcode=RS22172>; Federal Housing Finance Agency, “FHFA

than 50 housing units have a private market that allows for risk diversification and attracts significant investment capital.⁴⁸ Stuck in the middle are projects that create between five and 49 units of housing. In this space second financing is difficult for a variety of reasons, including the fixed costs of project due diligence and risk syndication against the size of the project.⁴⁹ However, housing of exactly this size is often what is allowable by local zoning and desirable among small and large urban areas.⁵⁰

The FHLB system is uniquely poised to take advantage of this. FHLBs ability to customize terms of credit and acceptance for collateral matches well with the unique size and terms of these projects. FHLB's depth of membership among smaller financial institutions matches well the banks that engage in commercial real estate of projects of this size.⁵¹ FHLBs prioritized position should financial institutions face trouble further insulates them from potential losses on these projects. The FHFA should consider how to incentivize FHLB work in the 5 to 49 unit space. This exemplifies the potential of the FHLBanks to play a meaningful, positive role in facilitating credit creation and real economic activity if its mission is revitalized in an appropriate way.

Smaller Financial Institutions

Another lesson from the early decades of the FHLBank system that remains relevant is the ability to use advances to enhance the health and resilience of smaller financial institutions that do not have ready access to other sources of financing. In providing advances to savings & loans, building associations, and other types of thrifts, the FHLBanks enhanced the resilience of institutions that otherwise faced significant challenges.⁵² Community oriented financial institutions, from thrifts in the first half of the 20th century to minority depository institutions, community development financial institutions, and other community banks today, often operate differently than the largest banks. They can rely more heavily on relationships, not just databases, and have an important and different impact on the well-being of the larger community they serve. This is among the reasons that smaller banks continue to play an outsized role in domains such as small business lending.⁵³

Historically, federal law and many state banking laws contributed to the proliferation and sustainability of smaller financial institutions. This regime was one of the key ways that banking

Announces Conforming Loan Limit Values for 2024,” November 28, 2023, <https://www.fhfa.gov/news/news-release/fhfa-announces-conforming-loan-limit-values-for-2024>.

⁴⁸ See Chapter 6: Multifamily, *U.S. Real Estate Market Outlook 2022* (CBRE, December 8, 2021), <https://www.cbre.com/insights/books/us-real-estate-market-outlook-2022>.

⁴⁹ John G. Markowski, “Surprise! Most Affordable Rentals Are in Small Buildings,” In *Small Multifamily Rental Property Financing* (Office of the Comptroller of the Currency, 2015), 7-12, <https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-investments/pub-cdi-may-2015.pdf>.

⁵⁰ John G. Markowski, “Surprise! Most Affordable Rentals Are in Small Buildings.”

⁵¹ John G. Markowski, “Surprise! Most Affordable Rentals Are in Small Buildings.”

⁵² David L. Mason, “From Building and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1955” (PhD dissertation, Ohio State University, 2001) (ProQuest); Federal Home Loan Banks, “The Federal Home Loan Bank System, 1932-1952” (1952); Letter from Ron Haynie, Senior Vice President, Housing Finance Policy, to Sandra Thompson, Director, Federal Housing Finance Agency (Mar. 31, 2023), https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/comments-on-fhlbank-system-at-100-review.pdf?sfvrsn=bfef1317_0.

⁵³ Letter from Ron Haynie, Senior Vice President, Housing Finance Policy, to Sandra Thompson, Director, Federal Housing Finance Agency.

sought to limit excessive concentrations of power and to promote broad flourishing.⁵⁴ Since removing those restrictions, the number of community banks and other types of smaller financial institutions has declined precipitously despite the critical role they continue to play facilitating the flow of credit where it might not otherwise extend.⁵⁵

Smaller financial institutions have fewer outside funding options, so ready access to advances is more likely to have a positive and meaningful impact on their lending activity than it would for a large bank. Providing ready advances to small and possibly some mid-sized financial institutions may thus provide another rough but usable proxy for when advances are more likely to promote housing and community development aims.⁵⁶

The nature of the financial institution member could also be considered in conjunction with the balance sheet and activities of a specific member to determine whether there is a broader set of financial institutions that should continue to enjoy relatively unrestricted access to advances. For example, regional banks that hold a sufficient proportion of assets that meaningfully support housing or community development commitments, for example, should perhaps be given more ready access to advances than a firm such as SVB that does not originate much mortgage lending. The concern here is not the interest rate risk that brought SVB down but the fact that those investments did nothing to promote mortgage origination or home ownership.

As the RFI recognizes, “the objective of supporting housing and community development ... should be central to the FHLBanks’ day-to-day business with members and housing associates.”⁵⁷ The structure of the banking system has undergone significant changes over the last half century in ways that have and will shape which households and firms have access to credit through good times and bad. By helping to restore the original design of the FHLBank system, while mapping onto a very different financial system, the FHFA can promote greater access to affordable housing for homebuyers and homebuilders and otherwise promote healthy credit creation. FHFA can accomplish this while also reducing risks to the banking system, increasing financial stability, and reducing taxpayer exposure.

Thank you again for raising these important questions and for providing us an opportunity to address them.

Best regards,

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⁵⁴ Kathryn Judge, “Brandeisian Banking,” *The Yale Law Journal Forum* 133 (April 2024): 916.

https://scholarship.law.columbia.edu/faculty_scholarship/4440; Saule T. Omarova and Graham S. Steele, “Banking and Antitrust,” *Yale Law Journal* 133 (2024): 1162; Michael S. Barr, Howell E. Jackson, and Margaret E. Tahyar, *Financial Regulation: Law And Policy* (3d ed., Foundation Press, 2021), 36-41, 746-47.

⁵⁵ Mr. Justice Brandeis, “Competition and Smallness: A Dilemma Re-Examined,” *Yale Law Journal* 66 (1956): 69; Matt Hanauer, Brent Lytle, Chris Summers, and Stephanie Ziadeh, “Community Banks’ Ongoing Role in the U.S. Economy,” *Federal Reserve Bank of Kansas City Economic Review* (Second Quarter 2021): 37-81.

⁵⁶ See, e.g., Allen N. Berger and Gregory F. Udell, “Relationship Lending and Lines of Credit in Small Firm Finance,” *The Journal of Business* 68 (1995): 351; Mitchell A. Petersen and Raghuram G. Rajan, “The Benefits of Lending Relationships: Evidence from Small Business Data,” *The Journal of Finance* 49 (1994): 3.

⁵⁷ Federal Housing Finance Agency, *Request For Input: Federal Home Loan Bank Core Mission Activities And Mission Achievement* (2024), 7, <https://www.fhfa.gov/sites/default/files/2024-05/FHLBank-Mission-RFI-2024.pdf>.

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