# Reimagining the Federal Home Loan Bank System

## By Clifford Rossi

As its currently constructed, the volatile U.S. housing finance system is dominated by a pair of government-sponsored enterprises (GSEs) and is vulnerable to systemic risk. The problem, in short, is that there is simply no competition for Freddie Mac and Fannie Mae – the only GSEs that can serve as mortgage credit guarantors.

But is there a solution to this dilemma? Yes! If the Federal Home Loan Bank System (FHLB) was reinvented, and if the banks in the FHLB (FHLBanks) were granted the power to act as guarantors, systemic risk would be reduced, competition would increase and the housing finance market would become more stable.

Now is actually the perfect time to weigh such a reinvention, since the Federal Housing Finance Agency (FHFA), the FHLB's regulator, recently said it's considering the possibility of reforming the system.

Before we delve further into the "how" and "why" of a restructuring of the FHLB, let's quickly review the organization's history and current purpose.

**FHLBanks: Mission Impossible**

Chartered in 1932 during the height of the Great Depression, the FHLB has been a relatively low-profile player in the U.S. housing finance system for the last 90 years. It's goal was – and largely remains – to provide liquidity to the mortgage market.

The FHLB is currently comprised of 11 individual institutions (include commercial banks, credit unions and insurance companies) that act essentially as a kind of group lenders' bank. Technically, because of their federal charter and an implied government guarantee, the FHLBanks are considered GSEs. However, unlike their much larger GSE cousins, Freddie Mac and Fannie Mae, they do not have the authority to securitize mortgages.

Rather, the FHLBanks provide their 6,500 members (including banks, credit unions, insurers and community development financial institutions) with funding via advances - or secure loans largely collateralized by residential mortgages. The special status of the FHLBanks as GSEs, combined with their joint and several liability for their collective debt, gives these lenders the ability to offer relatively low-cost financing to members.

Over time, however, the small lender, community-based and affordable housing focus of the FHLBanks has morphed into something else. Indeed, today, direct allocation of advances to support mortgage lending has shrunk, thanks in part to a disproportionate share of FHLBank advances now going to the larger depositories.

The direct role of the FHLBanks in supporting housing finance is now overshadowed by Fannie Mae and Freddie Mac, exacerbated in part by the dominance of nonbank financial institutions (NFIs) in the origination and servicing business.

To increase their market presence, the FHLBanks must think of ways to expand their membership base. An expansion of members to include nonbanks would seem like a logical move for the FHLBanks. However, that would immediately expose them to significant risk, since, unlike traditional banks, nonbank mortgage lenders are not regulated at the federal level for safety and soundness.

The FHLBanks also attempted to boost their market relevance with the 1997 rollout of the Mortgage Partnership Finance (MPF) program. The MFP enabled FHLBanks to enter into risk-sharing arrangements with lenders directly, and the hope was that this would aid them in their efforts to compete against the big GSEs on credit risk. However, given the continuing dominance by the Freddie Mac and Fannie Mae, it's clear that the MFP has never realized its full potential.

What could the future of the U.S. housing finance market look like, with FHLB and the FHFA now in search of a long-term viable mission for the FHLBanks?

**Reimagining FHLBanks**

GSE reform has been batted about for years with no movement from Congress that pragmatically would be required to achieve a comprehensive restructuring and post-conservatorship outcome. As a result, the duopolistic, economically-inefficient model for the mortgage secondary market continues today.

Moreover, the issue with systemic risk to U.S. taxpayers from exposure to two exceptionally large credit guarantors has not been addressed.

Various proposals for a more competitive mortgage secondary market surfaced several years ago, including one from the Mortgage Bankers Association that recommended a multiple guarantor approach. While the MBA did not directly specify what firms could be good candidates as mortgage credit guarantors competing with Fannie Mae and Freddie Mac, FHLBanks would be well positioned, with some restructuring, for such a role.

This isn't as far-fetched an idea as it sounds at first glance: as some readers may recall, the FHFA in 2008 was directed by Congress to consider the possibility of allowing the FHLBanks to securitize mortgage loans.

Having four or five guarantors in the mix would reduce systemic risk to the housing finance system by diversifying across more guarantors, enhancing competition. It would, moreover, amplify the ability of FHLBanks to promote community-oriented mortgage lending and affordable housing opportunities.

FHLBanks are mortgage specialists with deep experience managing these risks in all types of markets. Their ability to launch and proliferate the MPF program underscores their expertise at pricing and structuring viable credit risk-sharing arrangements. What's more, thanks to the implementation of the Common Securitization Platform (CSP) for Fannie Mae and Freddie Mac, FHLBanks now have a clearer path to enter into direct securitization, with fewer operational hurdles.

**The Three "Rs"**

The roadmap to transition the FHLBanks to a true guarantor/securitizer role would need to take on a three-pronged approach: restructure, recapitalize, and revitalize.

Restructuring would entail consolidating the 11 FHLBanks into two to three larger entities to achieve scale. Challenges would include addressing charter issues and establishing a full, explicit guarantee -- for both the current GSEs and the new ones.

Recapitalizing the FHLBanks would be critical, given their relative high degree of leverage today. As part of this process, issues relating to their joint and several liability debt-issuance activities would need to be examined.

Revitalization would include upgrading operational and systems capabilities and improving risk management processes and controls. This final step is vital for an effective transition.

**Parting Thoughts**

The FHLBanks have provided liquidity to the U.S. mortgage market for roughly 90 years. But their mission has waxed and waned over time, and we're now at a point where their impact in community-based mortgage lending has diminished.

The current fragmented U.S. housing finance system would never have been designed as it stands today. Long-term restructuring of the FHLBank system, while not an easy path forward, provides the best solution for reducing systemic risk and promoting a more competitive mortgage secondary market.

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