Director Sandra Thompson
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Submitted via Web site submission

September 19, 2022

Dear Director Thompson:

I am writing today to share my views on the announced review of the Federal Home Loan Bank System and a selection of the recent criticisms of that system. I also offer some suggestions for how the system can be improved/reviewed in the future. My views presented here are mine alone.

By way of background, I am an elected Illinois Member Director of the Federal Home Loan Bank of Chicago ("FHLBC"). I sought this position because I had come to think highly of that bank and what it does for my community and my employer. This view has only been enhanced as I have come to know those who work at the FHLBC and experienced directly more of what the Bank does. I am also Chairman & CEO of Devon Bank, a roughly $500 mil. 77 year old community bank headquartered on the north side of Chicago. My first managerial task at Devon Bank was to "fix" a "broken" mortgage department about 15 years ago. As part of this process, Devon Bank became a Seller/Servicer to both Fannie Mae and Freddie Mac and joined the FHLBC. Devon Bank's mortgage department is now a very large portion of its business, and we now offer mortgages in 36 states, focused on first-time home buyers and religion-based financing. (Most of our mortgage customers have few or no other home financing options that they would find acceptable— they are otherwise the "under-banked.") I have also created two residential/commercial mortgage investment conduits, helped Fannie Mae create a uniform religion-sensitive mortgage product, helped Freddie Mac create a specialized mortgage program, and helped create a "new markets" mortgage program for the Minnesota Housing Finance Agency. I have given presentations on aspects of mortgage finance at events sponsored by the U.S. Treasury; the International Monetary Fund; Harvard, DePaul, and Northwestern law schools; and given related presentations in Canada, Turkey, the United Arab Emirates, and the U.S. embassies of Malaysia, and the Kingdom of Bahrain. I will shortly be a re-appointed board member of the Community Bankers' Association of Illinois.

I learned the value of the FHLBC very clearly in the Great Recession. Devon Bank had a $13 million "Fed Funds" line with one of the "too big to fail" banks that was cut off with ten days notice. This posed a challenge for Devon Bank, and could have been a serious problem. The FHLBC monitored our collateral position carefully, and became more conservative with our borrowing capacity, but stood ready to meet our liquidity needs when other financial institutions did not. This was important and memorable.

It is useful here to talk about 'back-up' liquidity and 'primary' liquidity. The criticisms leveled against the FHLB System of late have talked about the substantial drop in the level

of advances outstanding as a result of pandemic cash inflows to member financial institutions ("FI"s) being evidence of the irrelevance of the FHLB System. Since that time, advance levels have about doubled. This ability to extend a large amount of credit on a rapid basis due to unforeseen circumstances is the definition of back-up liquidity. As anyone who looks at FHLB advance levels over time will see, there was a spike at the beginning of the pandemic shut down, followed by a plunge as stimulus money came in, and now we are seeing a resurgence towards more "normal" levels as depositors' stimulus money gets used in the normal course. This is an example of the system working as it was intended. Sometimes you need the liquidity, sometimes you don't, and that state can flip quickly, and FIs are graded by their regulators in their ability to manage the amplitude, direction, and speed of those flips. When Devon Bank's Fed Funds line was cancelled, we did not need the liquidity at the moment. But we might have at any moment, and our bank examiners were watching. We needed the FHLBC to be standing by.

Primary liquidity is the ability to handle the more daily fluctuations in an FI's balance sheet. People make deposits and they send out money. Hopefully these amounts in and out are relatively closely balanced. Not always. At my relatively small bank, the bank size can change by a few million dollars up or down daily. And then along comes loan funding. Devon Bank's average mortgage size is a bit above $260,000. We know roughly when a mortgage is going to close. We send the money to a title company, we get back a mortgage a few days later. A few days later still, the mortgage likely gets sold to Freddie Mac (in most cases for us) and a few more days later we get our money back from selling the mortgage. But in our busiest mortgage months, we may fund ten times the amount of mortgages that we fund in our slowest months, and the total funded in any month may amount to 10% of Devon Bank's balance sheet. And in a Texas freeze that shuts down a GSE processing center as happened last year, it could be much more. These fluctuations are more than our normal liquid cash reserves.

So where do we get the money when we need it? Deposits are a great source of funding. But they don't come quickly, and they don't always come when you need them. Also, in times of crisis, a stressed FI may be prohibited from paying more to encourage more deposits faster as may be needed for the FI to bring in the deposits it needs. Also, with FDIC insurance limits, an FI may need to bring in more than one account for each mortgage it is going to fund, even if it has customers willing and able to deposit up to the insurance limit (an infrequent occurrence). (An exception may be brokered deposits—which draw increased regulatory scrutiny and are thus not as broadly functional a tool.) Deposits are great for providing a "base layer" of funding, but they are a terrible source of providing for back-up liquidity or managing the day-to-day fluctuations in liquidity.

Of course, an FI can bring in more deposits than it needs, and use the excess deposits to buy bonds, and then sell the bonds if it needs the liquidity, but this is also a bad strategy in most cases. Bond trading has transaction costs, could generate losses, and telegraphs to examiners that maybe an FI doesn't know how to manage its liquidity properly with "safer" sources and thus it should be criticized. I know of no banker that would engage in this as a strategy absent exigent circumstances.

The critics of the FHLB System have stated that FIs needing liquidity could go to the Federal Reserve Discount Window. I would trust that former officers of that system would know that there is a widely-held belief amongst FIs, and their examiners, and at least some

former Federal Reserve employees, that FIs are strongly discouraged from using the Federal Reserve Discount Window as a source of normal-course liquidity. At a dictionary definition level, the "Investopedia" definition of "lender of last resort" uses the Federal Reserve as the one named example. Simply put, absent a special program such as the PPP Loan Fund, there is an assumption that if you are borrowing from the Fed frequently there must be something wrong with you causing that need. Services that review banks also look for this in Call Report data, so borrowing over a quarter-end is something banks, in my experience, are loathe to do.

The critics also say that the FHLB liquidity function can, and should, be provided by "private pools of capital" as a lender of first resort instead of the FHLBs. Private pools of capital like the one that cut off Devon Bank? Or private pools of capital like Devon's former Fed Funds line providers that went out of business during the great financial crisis when having back-up liquidity was most needed? These private pools of capital are often competitors to smaller FIs, have their own liquidity concerns, and don't want to reserve their capital to make available credit lines when their own capital may be strained. They cannot be relied on when their help may be most needed. Of course, these private pools of capital, in the form of national and regional banks, frequently manage their own liquidity, you guessed it, through THEIR usage of the FHLB System. Without the FHLB System operating as it does, these private pools of capital may not be available.

In my experience, the FHLB System has proven itself to be the safest and most reliable way for banks such as my employer to manage their liquidity needs. It is important to point out that our borrowings from the FHLBC are primarily to manage our home financing business and/or are secured by mortgage collateral. Even though the advances are being made to a "commercial bank," those advances are the "but for" source of our ability to handle a decent sized mortgage business.

Critics might argue that Devon Bank is the exception, rather than the rule, as a large percentage of mortgage customers are going to alternative lenders for mortgages and not to banks. Of course, these alternative lenders also need liquidity to manage the same issues that FIs need to manage. Where do the alternative lenders go for liquidity? While I cannot speak for all, I know Devon Bank has provided liquidity for a few such mortgage lenders, and our liquidity comes from the FHLBC. Thus, the FHLBC is also the "but for" cause of the liquidity, one step removed, for these alternative mortgage lenders as well. Devon Bank is effectively "de-risking" this lending for the FHLB as Devon Bank has the capital capacity to maintain the collateral needed to manage the needed liquidity, unlike these alternative lenders, and is inserted in an earlier loss position in front of the FHLBC.

I would also like to touch on the issue of public support for and knowledge of the Federal Home Loan Bank System. Although I cannot speak for the other FHLBs, the Chicago FHLB, as a member-owned cooperative, prefers to have its members, who are the ones originating loans, be the face in the communities they serve. As such, it is only natural that most people would not know of the work done behind the scenes by the FHLBs, just as they don't know much of other wholesale providers to the various retail providers that the end-user customers do business with on a daily basis in a multitude of industries. "The people" are not the FHLBs' customers; the FHLBs' FI members are the FHLBs' customers. In my experience, the FHLBC does a very good job of reaching out to its current and prospective customers— the local FIs. It is not a contradiction to say that the FHLBs may

be invaluable to their communities, and also be anonymous—to the broader public. In this, there is a criticism to be found if you wish to find one. The FHLB System could do a better job of telling its story. The empirical data of how well the System is fulfilling its public mission is hard to find, as the relevant data is not widely collected or dispersed, and some relevant entities have no incentive to share such data. For instance, the affordable housing contributions are clear and measurable from public data, but how much the FHLBC does to support Devon Bank's fundamental business of "banking the under-banked" is not readily ascertainable from public data, and I have little interest in telling our competitors how much of what kind of business we are doing.

It is one thing to denigrate the FHLB System by stating that the amount it contributes to statutory affordable housing programs is "paltry". However, there are two problems with this critique. First, at least some of the FHLBs spend more than the statutory minimums. But second, even the statutory programs make the Federal Home Loan Bank system, over the long term, I believe, the largest private funder of affordable housing in the country (over the short-term, MacKenzie Scott MAY be funding more, but that data is also not readily available).

But where does this funding come from that goes into the FHLBs' affordable housing? The FHLBs are privately-owned cooperatives. They earn money. That money belongs to their shareholders. The critics point out that the FHLBs are not subject to federal, state and local income taxes, and the value of this freedom from taxation doesn't come close to equaling the sums paid out for affordable housing. Well, guess what? Most mortgage investment companies, perhaps the most analogous businesses, aren't taxed this way either. Most mortgage REITS are not going to pay any income tax— they are going to pass on the bulk of their income to their shareholders, and their shareholders are going to be the ones that pay income taxes on the income earned in the form of dividends. FHLB dividends paid to members are certainly subject to income tax. Partnerships, REITs, royalty trusts, business development companies, and other forms of "pass through" investments that are not taxed at the corporate level are well represented in the U.S. tax code.

But at the FHLBs, dividends are paid only after subtracting out the money that is set aside for the FHLBs' affordable housing programs. So, is this requirement to set aside a portion of a private company's lawful earnings an illegal taking? Although it may be tempting to say "yes," we have a different term for a law requiring you to set aside a portion of your income for a societal purpose— a tax. The requirement to give up income comes from a different statute than the income tax provisions of the Internal Revenue Code. This is a tax that even mortgage REITs do not have to pay, making the FHLBs MORE heavily taxed than similarly-situated companies. It is disingenuous to say that the FHLBs themselves are not taxed, even more disingenuous to say FHLB earnings are not taxed, and Congress, not the FHFA, is free to decide how much it believes is fair to require the FHLBs to devote of their owners' money to affordable housing. But just calling the current 10% set aside "paltry" doesn't diminish that the System still funds more affordable housing than any other private entity in the U.S. over the long term.

The critics of the FHLB System discuss the Federal Home Loan Banks' dividends. What the critics do not say is that these dividends are tied to the shares owned, and the shares owned are largely tied to the usage of the Banks' products. Thus those dividends are

payments to owners for supporting the cooperative (thereby generating more affordable housing dollars) and effectively act as a discount on the use of those products paid specifically to those that help support the individual FHLBs the most. Those dividends, for instance, lower the net effective costs of borrowing from an FHLB— in the case of my employer, secured by mortgage collateral and often used to manage our mortgage business in line with the FHLBC's statutory purpose.

As to the size of the dividends themselves, which the critics refer to as the FHLBs' "generous dividends," in comparison to mortgage REITs (using FTSE/NAREIT data for home financing mortgage REITs, at August month-end), the average home mortgage REIT dividend yield was 13.06%, nearly twice the dividend yield of the highest-paying FHLB in the System at 6.75%, and nearly three-times the average yield of 4.87%. Or, using a simpler comparison, the FHLBC's activity stock dividend rate is 5.75% and its membership stock yield is 2.375% both at September 15, while the Freddie Mac average 30 year mortgage rate is 6.02% for the same period. Dollar-for-dollar, just retaining originated mortgages would appear to be a higher-yielding investment for FIs than investing in FHLBC stock. It would appear that FHLB members are finding value in their memberships beyond just "generous dividends."

Another aspect of public support for the FHLB System cited by the critics is the "taxpayer support" that makes the FHLB consolidated obligation bonds tradeable due to the "implicit backing" of the "long-suffering taxpayers." My first question is, how can taxpayers be long-suffering from providing a subsidy that they have never had to pay to a system the critics argue the taxpayers do not know exists? My second question is how can these subsidized, but not actually subsidized, institutions be systemically much too dangerous as evidenced by "a more than passing familiarity with losses," yet be much too conservative in that they have never suffered a loss on an advance? My third question is, how can we be this close to the Great Recession and still be discussing "implicit guarantees" of bonds by taxpayers? Did major bond investors, of the type that buy FHLB consolidated obligation bonds, not learn anything during the meltdown of the global credit markets? Due to the nature of these consolidated obligation bonds, the entire FHLB System, with its diversity of management and owners and approaches described as "inefficient" by the critics, would have to risk total failure for the question of a guarantee to come into play.

So where can improvements be found? One question that I hear asked is whether there are too many Federal Home Loan Banks. My answer is "maybe." Each of the FHLBs operates somewhat differently, as do state governments, providing a "laboratory" for best practices. While they do serve local communities, and, as a community banker, I believe that local touch-point is of fundamental importance, I cannot answer the question as to how big a geography is too big. Each state has a different set of needs and housing markets and population densities, and each FHLB has a different level of engagement and responsiveness and differing programs—I do not believe this is an easy question to answer. While I do not know the answer, I do believe this is an area that merits further study.

Like the critics, I also believe that the system has untapped potential. I believe, as a cooperative, the FHLBs should be able to create more products and services that tap into this cooperative nature. For instance, creating pooled mortgage investment products,

where the investment risks are shared directly by FHLB members choosing to participate, could be attractive to both members, the greater FHLB System, and could enhance the mortgage market. I also believe, with the right inputs and supports, it should be feasible to advance the ability to fund solar and geothermal systems for homes across the country—which would be very difficult to do without the right inputs and supports due to the state-by-state regulation of real estate liens. I also, however, believe that this would be difficult to do within the existing FHLB System due to the regulatory and systemic constraints that are not welcoming to anything that might look like innovation. I would hope that the output of the FHFA's systemic review will be more of a "yes, if" orientation than the current "no, not really" orientation. As the entire financial industry is learning, the need to innovate faster is of fundamental importance. This is not a comment on safety and soundness, but rather one about making decisions faster to avoid being an obstacle that gets routed around. Reducing the supervisory load on a product development cycle to months rather than years would be a noteworthy accomplishment.

Finally, I believe there should be opportunities to expand FHLB membership beyond banks, credit unions, CDFIs, and select insurance companies. A more diversified membership structure allows for more stable balance sheets. As can be seen from the relative stability of the Chicago FHLB during the ups and downs of the pandemic compared to some of the other FHLBs, the composition of membership, when members in different industry segments are driven by different forces, makes a difference. That does not mean that membership should be opened widely without thought. It should be opened carefully based on where there are efficiencies in doing so, and where new member types serve to remove over-all risk per member and not increase it. Fundamental to this is the ability to collateralize advances. Posting sufficient collateral, or proving use of advances, that tie to the System's mission I believe would provide a governor on what entities fit well within the FHLB business model and statutory purpose.

Thank you for your attention, and I am available to discuss any of these issues further with the FHFA staff should there be any interest in doing so.

Sincerely,

/s/ David Loundy, Esq.

℅ Devon Bank
6445 N. Western Ave.
Chicago, IL 60645

David@DevonBank.com
773-465-2500