Community Bankers Association of Illinois®

One Mission. Community Banks.®

October 18, 2022

The Honorable Sandra L. Thompson
Director
Federal Housing Finance Agency
Constitution Center
400 7th Street, SW
Washington, D.C. 20024

Regarding: FHLBank System at 100: Focusing on the Future

Dear Director Thompson:

The Community Bankers Association of Illinois ("CBAI"), which proudly represents nearly 300 Illinois community banks, appreciates the opportunity to provide our observations and recommendations regarding the Federal Housing Finance Agency's ("FHFA" or "Agency") comprehensive review titled – ***FHLBank System at 100: Focusing on the Future***. CBAI agrees with the Agency's statement that "The FHLBanks have been a critical source of liquidity for their members for the past 90 years, especially during times of market stress, such as the Great Recession and the outset of the COVID-19 pandemic. The FHLBanks also support low-income housing and community development directly by offering a variety of programs to their members, including the Affordable Housing Program, the Community Investment Program, and the Community Investment Cash Advance Program." CBAI acknowledges the Director's statement that "As the Federal Home Loan Banks approach their centennial, FHFA will

CBAI is dedicated to exclusively representing the interests of Illinois community banks and thrifts through effective advocacy, outstanding education, and high-quality products. CBAI's members hold more than $80 billion in assets, operate 860 locations statewide, and lend to consumers, small businesses, and agriculture. For more information, please visit www.cbai.com.

conduct a comprehensive review to ensure they remain positioned to meet the needs of today and tomorrow."

Background

The overwhelming majority of CBAI's nearly 300 community bank members are also members of the Federal Home Loan Bank of Chicago ("FHLB-Chicago," "FHLB-C," or "Chicago Bank"). As an aside, my experience with the FHLB-Chicago spans decades, earlier as a career-long community banker and now as an advocate for Illinois community banks. I am perhaps uniquely situated in having seen the many benefits the FHLBanks provide their members from several different perspectives.

Structure

The FHLB System ("System") was formed by Congress in 1932 to support housing and economic development. The FHLBanks are designed to work cooperatively with and not compete against their members, including community banks. Unfortunately, other government agencies compete directly against community banks (i.e., the Farm Credit System) having long since abandoned its narrowly focused mission. Other more recent examples of our government (i.e., the public sector) competing directly with private-sector community banks include the Small Business Administration directly lending to small businesses, the United States Postal Service delivering postal banking, and various state or municipality-owned banks. Each of these competitive incursions undermines our private-sector-focused capitalist economic system. **CBAI believes the FHLB System and Banks should serve as a model for how a government agency should work cooperatively with and not compete against the private sector and community banks. We urge the FHFA to not change this cooperative structure.**

Individual FHLBanks, in different regional districts, are informed by their member directors, officers, and shareholder members about the types of products and services that would help them best serve their customers and communities. This information is shared among the regions/districts (i.e., cross pollination) and ensures that multiple expertise and experience is brought to bear on complex and pernicious issues. **CBAI is concerned that the benefits of a regional structure consisting of many district FHLBanks will be lost by any centralization of ownership and management. Calls for consolidation of the System ignore the many benefits of decentralization which must not be sacrificed for the sake of "operational**

efficiency."

Advances

The FHLBanks provide advances (e.g., liabilities that are similar to deposits) to members which are funded by the System using government agency securities. In fact, the FHLB System is the second largest issuer of government securities – overshadowed only by the United States Treasury. Advances to members support lending and are used for asset-liability management purposes – which assist the lending function. Advances are important in helping community banks *match fund* their loans, including those for housing and community development, rather than risk an interest rate mismatch between the lending income stream and the payment of the offsetting liability.

Advances are particularly important for community banks because, with their traditional banking model, they have fewer sources of alternative funding for liquidity purposes than the larger banks. One of our community bank members described his experience with the Chicago Bank by stating, "When it comes to alternative funding, the FHLB provides an excellent menu of choices and always provides an ideal solution for my Bank."

The collateral backing advances are primarily high-quality securities, including those generated by the government sponsored entities ("GSEs") – many of which support housing, but also has more recently included different types of loans. The FHLBanks flexibility to consider and approve other types of collateral is helpful to members looking to take full advantage of advances to support their customers and communities. With the safety and security of the individual FHLBanks and System in mind, collateral is given different weights (i.e., collateral advance rates) to ensure that in the unlikely event of the need to liquidate collateral, no loss will be suffered.

The FHLBanks have demonstrated considerable experience in different economic and financial climates to prove that they will continue to successfully manage the risks associated with collateralized advances to members. **CBAI believes no significant policy changes regarding advances are needed and that any evolutionary refinements should be left to the collective knowledge, experience and expertise of the Banks, their boards, senior management, and their member owners**.

During the previous financial crisis, providing liquidity in the form of collateralized advances to its members was truly a lifeline. At that time, bank regulators were paying particular attention to community banks' primary and secondary sources of liquidity, which, as an industry, community banks have fewer sources to access liquidity than larger banks. Unfortunately, for many community banks, the stability of their traditional deposits was being threatened because these small banks were considered too-small-to-save versus too-big-to-fail ("TBTF"), and they were not granted the complete government support and protections as commercial money market accounts. The result was a very real possibility that in a *flight to safety*, community banks would suffer existential liquidity problems.

Most community banks had come to rely on one alternate source of liquidity almost without question, namely Fed Funds lines with their correspondent banks, but these were being examined, re-evaluated, curtailed, or altogether terminated - with scant notice and time to react. One of our community bank members reported that his bank's Fed Funds line, in the low eight-figure range, was terminated by a TBTF bank with 10-days' notice.

Bright and shining stars during these dark times were advances from FHLBanks, including the FHLB-Chicago, to their local community banks. System-wide advances increased over 56% from a pre-crisis $640.7 billion at the end of 2006 to over $1 trillion in 2008. The FHLB-C's performance was also impressive, increasing almost 46% from $26.2 billion at the end of 2006 to $38.1 billion at the end of 2008. As the economic and financial crisis eased, advances returned to normal levels. Without the availability and timely delivery of these advances there would have been many more completely unnecessary failures of community banks which would have devastated their customers and communities.

Well into the COVID-19 pandemic quite the opposite situation occurred. The U.S. Government's response to the pandemic was to infuse trillions of dollars into the economy to prevent a seizing of the markets, financial system, and economy. These government programs (i.e., Economic Impact Payments (EIPs) and Paycheck Protection Program (PPP)) were deposited into bank accounts causing community bank deposits to balloon in size. One of our community bank members, with under $300 million in assets, reported that his bank's deposits increased over $40 million dollars while the number of accounts increased by a net of only 15.

As logic would dictate, in the face of all this liquidity, System advances declined over 56% from a high of $806.9 billion in March of 2020 to low of $350.0 billion in September of 2021. The

Chicago Bank experienced a 16% decline from $55.0 billion to $46.0 billion in the same period. Criticism has been leveled at the System that this significant decrease in advances is proof of the waning relevancy of the FHLBanks. That position is completely inaccurate. These ebbs and flows in advances are precisely what should and did happen in response to changing economic and financial conditions and member needs.

Our community bankers are truly thankful that the FHLB-Chicago was there to not only support them, but also the stability of the financial system, and the broader economy for consumers. **CBAI urges the FHFA to not impede the ability of the FHLB System and FHLBanks to quickly respond to rapidly changing economic and financial conditions and be able to meet their members' liquidity needs.**

Membership of the FHLBanks has evolved over the years, beginning with thrift institutions, but membership was later expanded to include commercial banks, credit unions, Community Development Financial Institutions ("CDFIs"), and insurance companies. Congress has traditionally taken the lead in expanding membership and have done so several times. During this evolution of membership, the important nexus that has always been maintained is housing finance and community development – which is the mission and purpose of the FHLBanks. Unfortunately, there has been a recent misstep with eligibility for membership.

For many years, captive insurance companies ("Captives") were included in FHLBank membership. Then in 2016, a proposal was approved by the FHFA which unilaterally required Captives to terminate their membership in FHLBanks. CBAI strongly opposed this move in comment letters to the FHFA, stating that certainty of membership is of paramount importance to all FHLB members. Membership decisions have historically been expansive - not restrictive, and if the FHFA could terminate a class of members through rulemaking (versus Congressional action) <u>any</u> FHLB member, in fact, <u>all</u> members are threatened - and <u>no</u> member is safe. **CBAI believes this misguided policy to terminate the membership of Captives undermines the stability and reliability of FHLBank membership and must be avoided. Even at this late date, CBAI urges the FHFA to reconsider that misguided policy decision and permit Captives to be eligible for FHLB membership.**

While CBAI approves of a reasonably expansive philosophy with respect to FHLBank membership, that position comes with several indispensable caveats. To qualify for membership, there must be a nexus to housing finance. Non-mortgage consumer or commercial lenders, technology, commercial, consumer, communications companies, or fintechs should not qualify for FHLB membership because they lack a housing finance nexus.

Potential members must also purchase stock in a similar amount as community banks. Potential members must secure their advances with the same high-quality assets as other members and must be subject to the same collateral advance rates and "haircuts". Importantly, members must be as highly regulated and examined by bank prudential (or equivalent) regulators and they must be subject to the same enforcement actions and liability for a failure to comply with laws, rules, and regulations as community banks. These and other rigorous requirements must be complied with. **CBAI believes that while it is possible for others to qualify for membership in FHLBanks it will require the potential member to make a significant commitment and they must not have any advantage over existing members or pose threats to the stability of the System.**

Products and Services

The FHLBanks provide a variety of products and services to their members. Advances have been designed to meet members need for loan funding and for asset/liability management purposes. The FHLB-C for example, offers fixed rate, adjustable-rate, and hybrid advances. Members can obtain letters of credit ("L/Cs") for public unit deposits, performance guarantees, and bond credit enhancements. One of our member community bankers reported, "When it comes to obtaining, maintaining, and/or increasing funds from our municipal customers, obtaining a letter of credit from the FHLB remains a popular and trusted option for collateralization." Another member said that his bank uses L/Cs in their relationship with their local school districts and their county-owned hospital.

In addition, the popular Mortgage Partnership Finance ("MPF") program offers several different ways to participate. The MPF program is a particularly valuable program because it allows banks to originate residential mortgages in their communities and then participate those opportunities to the FHLBs. This cooperative partnership in residential mortgage finance allows community banks to replenish their lendable funds to make new residential mortgages to their customers in their communities

Community Investment

The FHLBanks contribute 10% percent of their income to affordable housing and community development. The amounts contributed, in their entirety, have been significant enough to qualify the System as the largest single contributor to affordable housing in the nation. The System-wide and full-range of community investment products include the Affordable Housing Program ("AHP") which - since 1990, has made nearly $7 billion in grants assisting nearly one million households, the Down Payment Plus ("DPP") programs which - since 1995, have awarded $250 million in grants to almost 50,000 homeowners, Community Advances (i.e., Community Development, Housing and Small Business) which – since 1989, have made available over $13 billion in discounted advances, and the Community First (voluntary programs) which - since 2014, have included the Community First Fund, Capacity Building Grants, Disaster Relief Grants, COVID-19 Program, Community First Award, and new for 2022 - Diverse Developer Initiatives, Accelerator Small Businesses, and Housing Counseling. These products have been designed to serve members' customers and communities and have been developed through a close collaboration between the FHLBank boards of directors, senior management, and the member owners. **CBAI urges the FHFA to not disturb this close collaboration which has resulted in an impressive array of community investment products.**

Great care must be taken to balance the amount the FHLBanks allocate to these worthwhile community investment products to not upset the delicate equilibrium between the other constituencies within the FHLBanks, which would jeopardize an already highly successful record of performance across many economic cycles and financial conditions. The income derived from the carefully run operations of the FHLBanks must not only include the requirement to contribute to the various community investment initiatives, but also fulfill the need for the FHLBanks to retain earnings to grow and maintain the necessary sound financial condition and results of operations to be able to continue to serve its members. In addition, FHLBanks' earnings must also provide a reasonable *return on investment* to its member owners. **CBAI believes that an appropriate equilibrium has been achieved.**

<u>Emerging Issues Regarding Advances</u>

A recent issue has emerged that is threatening community bank members' access to FHLB advances. The problem is being caused by the prolonged low interest rate environment which has driven members' investment portfolios to historic low yields, followed by rapid and unprecedented increases in market interest rates to staunch inflation (which was caused by the COVID-19 pandemic, supply chain issues, increased oil prices, and disruptions in the labor market). As a result, most banks have large unrealized losses in their investment portfolios. For some, this has decreased their Net Tangible Equity below an FHFA benchmark, which then requires the FHLBanks to prohibit extending new advances or renewing maturing advances (for more than 30 days) without the approval of the member bank's prudential regulator.

The causes and reaction to this situation are unprecedented and not an indication of an economic or financial crisis that is threatening the existence of community banks. This situation is caused by the FHFA following Generally Accepted Accounting Principles ("GAAP") while the banking regulators are following an appropriately more nuanced approach to these snap-shot *mark-to-market* valuations of bank investment portfolios. The regulator's approach eliminates purely *paper losses* or gains by following established regulatory accounting principles ("RAP"). The existence of GAAP/RAP differences should not suggest that one approach is right and the other wrong, rather, the banking regulators are taking the more realistic approach, that absent other indicators of stress or problems, they can reasonably discount the importance of unrealized or *paper losses.*

Unfortunately, a more reasonable and nuanced approach is not the current position of the FHFA and that is causing completely avoidable and unnecessary liquidity issues for community banks. **CBAI recommends this problem be solved as follows.**

- **The FHFA should issue an interim final rule ("IFR") which suspends the capital requirement and allows the FHLBanks to continue to offer new and renew existing advances.**
    - **The FHFA's IFR should include a request for comments from the various constituents to recommend ways to avoid this potentially harmful situation in the future.**
        - **The simplest solution is for the FHFA to align its capital rules with those used by the banking regulators.**
- **Although not within the purview of the FHFA, the prudential banking regulators should provide waiver letters at the request of the banks they are responsible for regulating which will permit the FHLBanks to continue to offer new and renew existing advances.**

Feedback Requested in the Proposal

Using the information above as support, CBAI briefly responds to the FHFA's request for feedback in the following six areas.

1. The FHLBanks' general mission and purpose in a changing marketplace;

The FHLBanks are closely following their mission and purpose. The boards of the FHLBanks, senior management, and the diverse group of members provide sufficient guidance to adjust their strategies and tactics as circumstances dictate. **CBAI urges the FHFA to not interfere with the FHLBanks in their continuing to follow their mission and purpose in changing times.**

2. FHLBank organization, operational efficiency, and effectiveness;

The current cooperative structure and regional nature of the FHLBanks are beneficial to their effective and efficient operations. **CBAI believes a consolidation of the FHLBanks under the guise of "operational efficiency" would be misguided and harmful, and would impede the FHLBanks in their efforts to follow the mission and purpose.**

3. FHLBanks' role in promoting affordable, sustainable, equitable, and resilient housing and community investment;

The FHLBanks accomplishments in promoting affordable, sustainable, equitable, and resilient housing and community investment are unquestioned. Their accomplishments should be recognized, valued, and nurtured. These accomplishments have been the result of an assiduous focus by the FHLBanks on their mission and purpose**. CBAI urges the FHFA to not upset the delicate equilibrium that has permitted these accomplishments or future accomplishments will be jeopardized.**

4. Addressing the unique needs of rural and financially vulnerable communities;

CBAI's members which serve rural and agricultural communities report that the FHLBanks have been particularly helpful in assisting them in meeting the needs of rural communities, many of which are financially vulnerable, by designing appropriate products and services. **CBAI urges the FHFA to not interference with the FHLBanks continuing to address the needs of rural and financially vulnerable communities.**

5. Member products, services, and collateral requirements;

The FHLBanks have evolved and continue to design products and services (including flexible collateral requirements) to meet the needs of their members in their efforts to serve their customers and communities. This evolution has taken place and has been very successful because of the regional structure and collaborative nature of the FHLBanks**. CBAI strongly advises against the consolidation of the FHLBanks, which we believe would harm the evolutionary development of products and services to meet the needs of its members and their communities**.

6. Membership eligibility and requirements.

Membership in the FHLBanks comes with requirements and responsibility. The FHFA should not unilaterally exclude classes of members for membership. The trend in membership has been expansive with one unfortunate exception (i.e., Captives). **CBAI urges that any future reasonable expansion of membership must not give new members benefits (or provided exceptions) not shared by all the members, and the safety and soundness of the FHLBanks and the System must be carefully guarded.**

<u>Conclusion</u>

CBAI recommends that after this Comprehensive Review has been completed, the FHFA should not disrupt the cooperative structure, regional nature, special functions, and the unique purposes of the FHLBanks. Also, the Agency should not impose any additional membership requirements that would undermine the certainty of continued membership and there should be no additional distribution requirements that would reduce the capital which supports their important products and services and provides a reasonable return on a member’s investment. In addition, the FHFA should issue an IFR which suspends the capital requirement and allows the FHLBanks to continue to offer new and renew existing advances to alleviate the potential liquidity problems caused by the Net Tangible Capital requirements.

Thank you for the opportunity to provide our observations and recommendations. We look forward to a continued dialogue with the FHFA as the FHLB System heads towards its 100th anniversary – and beyond. If you have any questions or require any additional information, please contact me at davids@cbai.com or (847) 909-8341.

Sincerely,

/s/

David G. Schroeder
Senior Vice President
Federal Governmental Relations