Garrett A. Hartzog
Oconomowoc, WI 53066
gar_h@yahoo.com
https://www.linkedin.com/in/garretthartzog/

Federal Housing Finance Agency
Office of the Director
Constitution Center
400 7th Street, SW
Washington, D.C. 20219

Re: FHLBank System at 100: Focusing on the Future

By electronic submission to: https://www.fhfa.gov/AboutUs/Contact/Pages/Request-for-Information-Form.aspx

Dear Director Thompson:

Thank you for the opportunity to provide written input to help inform the Federal Housing Finance Agency's (FHFA) comprehensive review of the Federal Home Loan Bank (FHLBank) system. My input reflects my own personal views, informed by my experience in the housing finance system inclusive of my own time at the FHFA, and does not represent the views of any company or other organization. I approach this topic both as someone who has been a customer of a variety of different types of financial institutions (e.g., large depositories, community banks, credit unions, and non-depository mortgage lenders) but also as someone who recognizes that the FHLBanks have untapped potential that should be unlocked for the benefit of the housing finance ecosystem.

My comments will focus on two main areas:

1) FHLBank membership
2) Credit Risk Transfer (CRT)

I suspect you will receive an ample supply of commentary regarding the topic of FHLBank membership, but I feel that my letter would be incomplete without addressing it. Likewise, you will hopefully receive substantial comments regarding the topic of affordable housing. Beyond encouraging careful consideration of that topic, my only additional thought is that given the cyclical nature of housing markets, we should be careful about when assistance is provided, and what form that takes. Helping those who are least able to afford homeownership needs to be done with a consideration as to whether these efforts will thrust more borrowers into an overheated market, potentially setting these new homeowners up for a difficult financial situation with respect to a home that could soon depreciate. Regardless of what occurs with the

FHLBanks affordable housing programs, I would encourage the FHFA to review the outcomes of these programs in a critical manner on a regular basis, and make public the findings.

One topic you may not receive as much input on is the potential for the FHLBanks to offer new products. While there are frequent exciting developments occurring with regards to Fannie Mae and Freddie Mac (collectively, the Enterprises), there is not as much attention paid to the FHLBanks, which is unfortunate. My commentary on new product offerings will focus on CRT. Although the FHLBanks have been engaging in forms of CRT via Mortgage Partnership Finance (MPF) and Mortgage Purchase Program (MPP), there is the potential for new and innovative CRT programs, some of which would be in collaboration with the Enterprises.

<u>Federal Home Loan Bank Membership</u>

The topic of FHLBank membership will likely be the topic that receives the highest level of input. Based on my attendance at the first listening session, it is clear that this is a topic capable of generating strong emotions, both from the existing membership base and from those who wish to become members.

The Federal Home Loan Banks are a critical source of liquidity, and thus provide competitive advantages for their membership.

During the financial crisis, I heard the FHLBanks described as “the lender of first resort”. This is not only marketing speak, but also reality. The funding advantage of the FHLBanks, combined with their cooperative structure, results in access to liquidity through all cycles, and at a cost that is better than what is available outside of the FHLBank system.

Having access to low-cost funds provides a competitive advantage over institutions that don’t have the same access. To be fair, perhaps the additional regulatory and capital burdens that FHLBank members face offsets this advantage compared to non-depository lenders. Even if this were the case, the role of the FHLBanks was never intended to be a financial offset to prudent regulation.

Thinking back to the start of the pandemic, liquidity became problematic for Real Estate Investment Trusts (REITs) that focused on mortgages, as well as for other non-depository lenders. The Coronavirus Aid, Relief, and Economic Security (CARES) Act provided much needed assistance to homeowners and renters, but when combined with the contractual obligations that many mortgage servicers had, it made things extremely difficult for these lenders from a liquidity perspective. Ironically, this was a period of huge origination volume and gain on sale margins. To invoke Charles Dickens, it truly was the best of times and the worst of times.

This sector of the mortgage market begged for some sort of liquidity assistance, and former Director Calabria correctly observed that the Enterprises are not equipped to engage in such a practice.

Had these institutions been FHLBank members, they would have been able to access liquidity, and at very little risk to the FHLBank system by virtue of the FHLBank's focus on ensuring that advances are properly collateralized.

The statutory language of the Federal Home Loan Bank Act as amended clearly would not permit direct membership by most non-bank lenders.

Having reviewed the text of the Federal Home Loan Bank Act, it's clear that there's no direct route for a non-depository to become a member of the FHLBank without new legislation. While this direct route does not exist, an indirect route exists via the use of captive insurance companies, although this route is currently blocked by the FHFA's rulemaking on FHLBank membership. Therefore, it is indeed possible to open the door to non-depository lenders, as the FHFA has the discretion to engage in further rulemaking.

The safety and soundness of the Federal Home Loan Banks is not derived from a narrow membership base, but rather through sound policy regarding the structure of its advances and the collateral it accepts.

Many of the arguments against expanding membership in the FHLBank system argue that non-depositories could create significant risk for the FHLBanks. While the argument sounds logical because of differences in regulatory oversight, cost of capital, and a non-diversified business model, it ignores the "secret sauce" of the FHLBanks.

If we look back to the creation of the FHLBanks, it was to provide a source of liquidity for Savings and Loan (S&L) associations, as they were not eligible to become members of the Federal Reserve system. These days, S&Ls are best remembered for the S&L crisis, during which approximately one in three S&Ls failed. Despite the catastrophic level of S&L failures, the FHLBank system not only remained intact but was able to fund the Resolution Funding Corp (REFCORP) which in turn funded the Resolution Trust Corporation (RTC) where you previously served.

Given that the FHLBanks were able to structure their advances and other activities in such a way to survive the fallout of the S&L crisis, it seems entirely feasible that they would also be able to implement prudent policies to facilitate providing liquidity to non-depository lenders in a safe and sound manner.

The Federal Housing Finance Agency's rule on Federal Home Loan Bank membership should be revised to permit captive insurers, which would create a level playing field and also set the stage for equitable Credit Risk Transfer opportunities.

While preventing membership by captive insurers was good policy the last time the FHFA engaged in rulemaking around FHLBank membership, the COVID-19 Pandemic has demonstrated that the housing finance ecosystem is lacking when it comes to the ability to address sudden spikes in the demand for liquidity. To be clear, this was not an environment in which credit performance was an issue, and it was not an environment in which earnings were an issue – the

CARES Act prevented a potential wave of mortgage defaults, and the Federal Reserve created significant monetary stimulus that resulted in substantial profits for the mortgage industry. The real issue was a sudden need for liquidity by institutions that were sound credit risks, and the FHLBanks would have been well positioned to meet this need.

Revisiting the rules on FHLBank membership to reopen eligibility for captive insurers would create an avenue by which non-depositories can once again become members, and level the playing field when it comes to sources of liquidity.

Furthermore, although my comments that follow regarding CRT can be considered separately from my comments on membership, allowing non-depositories to join the FHLBank system in conjunction with innovations in CRT would create more opportunities to strengthen the market for CRT and efficiently deploy private capital to improve safety and soundness, and potentially lower the cost of homeownership.

The Federal Home Loan Banks are well positioned to expand Credit Risk Transfer in an equitable fashion

The Federal Home Loan Banks have a history of engaging in Credit Risk Transfer via their Mortgage Partnership Finance and Mortgage Purchase Programs.

Although the Enterprises receive the bulk of the attention given to CRT, it is important to remember that the FHLBanks acquire mortgages from members, and transfer a portion of the risk back in exchange for an ongoing risk premium via the MPF and MPP programs. This arrangement creates skin in the game for the members, while also providing them with an additional source of revenue, and is a form of Lender Risk Sharing (LRS).

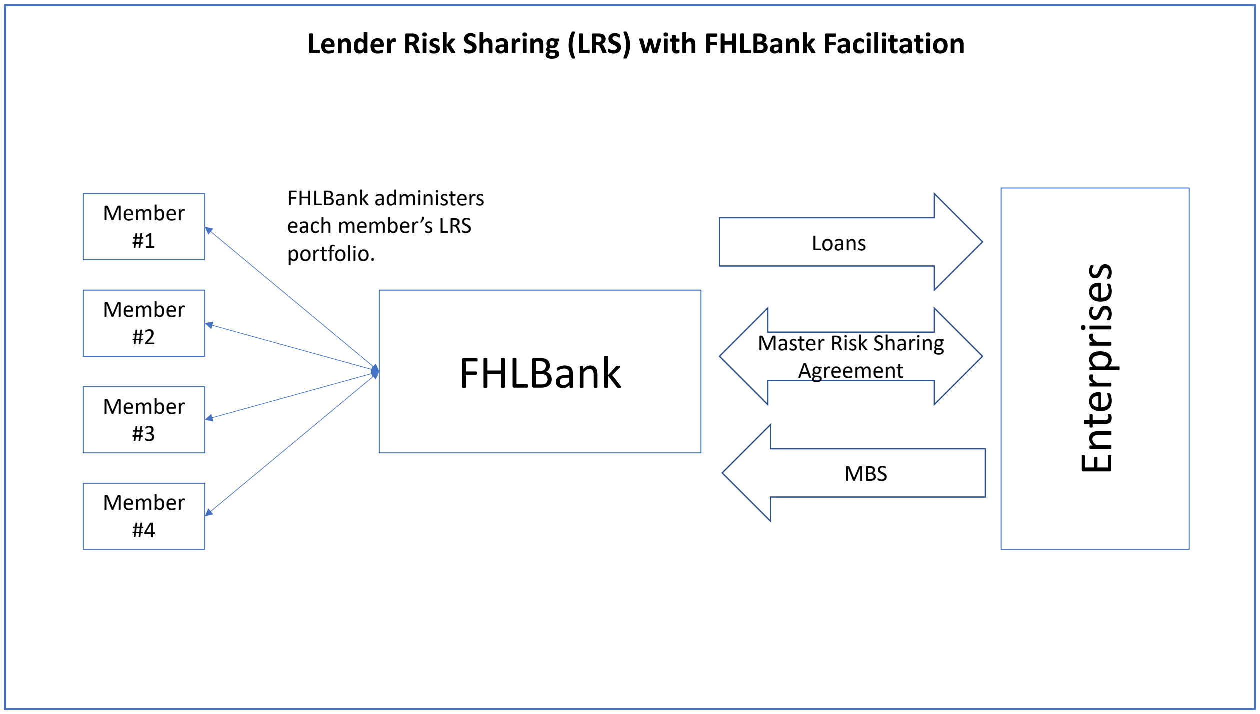
As the FHLBanks already have the infrastructure to administer the MPF and MPP programs, allowing them to engage in new forms of CRT could be viewed as an extension of their existing practices.

The Federal Housing Finance Agency could successfully revive the Enterprises' Lender Risk Sharing transactions via the Federal Home Loan Bank system, creating a program that is both equitable and scalable.

When former Director Calabria looked that the Enterprises' LRS programs, he found that the pricing granted was inconsistent with the notion that the Enterprises should be creating a level playing field for G-Fees, as opposed to rewarding high volume customers. Shortly thereafter, the FHFA announced the end of the LRS programs.

Bringing back LRS transactions would benefit the Enterprises by restoring a form of front-end risk transfer, giving them yet another way to manage risk. In order to prevent the abuses of the past, LRS could be modified to include the FHLBanks in the middle of the transaction. The Enterprises would thus be prevented by picking winners in terms of how it prices this form of CRT, and the administration of the LRS would be handled by the FHLBanks – institutions that have already demonstrated an ability to administer CRT programs with lenders of all sizes, as illustrated by MPF and MPP. In order to facilitate this approach, the FHLBanks could introduce new variants of MPF and MPP that provide for expanded risk sharing options combined with delivery of loans to the Enterprises for securitization.

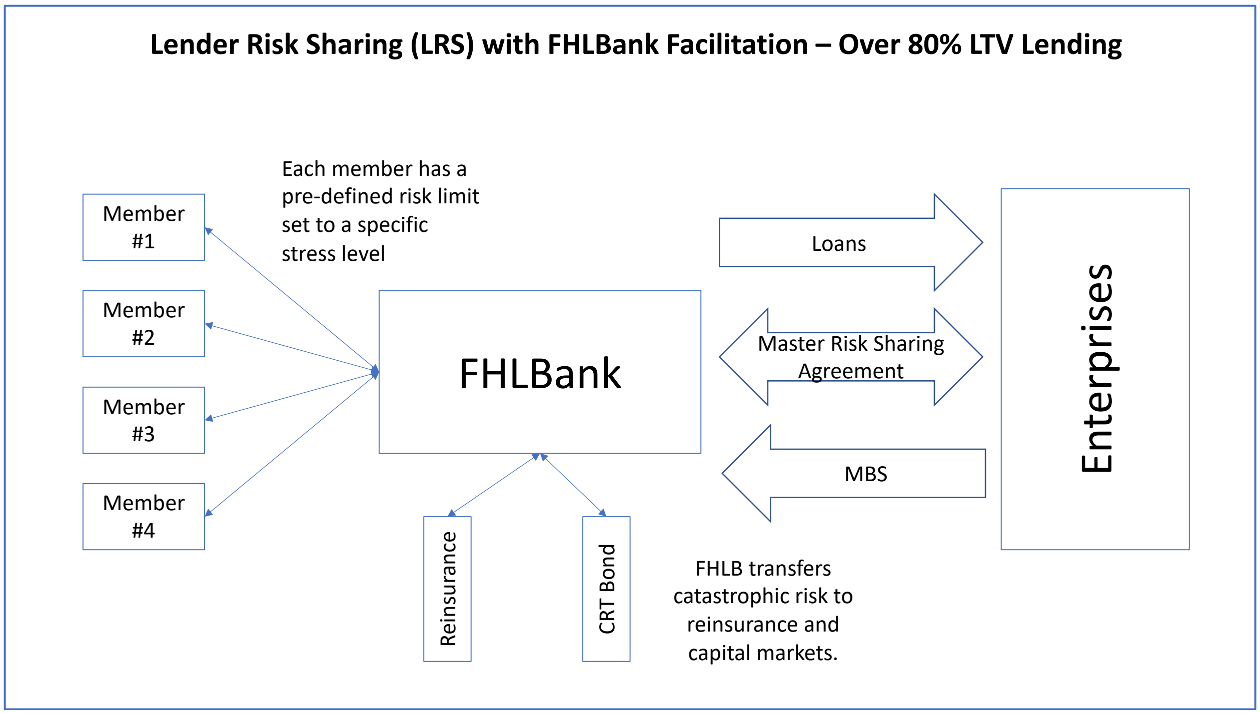
Such a program could function as illustrated in this diagram:



By having a single master agreement between an FHLBank and each Enterprise, there is no discretion on the part of the Enterprises as to how the risk transfer is priced for each lender, and from the perspective of the Enterprise, the amount of overhead is the same whether there is a single lender participating or a thousand different lenders. Meanwhile, the FHLBank can leverage its expertise in administering MPF and MPP agreements.

Another application of this approach that would provide a benefit for members as well as homeowners would be to allow the FHLBanks to engage in LRS as outlined above, but for the specific purpose of fulfilling the Enterprises' charter requirements regarding over 80% LTV lending. By doing so, a virtuous cycle is established whereby quality loans that perform well will be capital accretive, and subsidize the cost of assuming risk on the portion of the loan that is over 80% LTV. In addition, such a program could be administered at a reduced cost when compared to the costs of traditional mortgage insurance executions in which twenty to thirty cents (if not more) of every premium dollar are consumed by operating expenses. This is similar to the rationale for the IMAGIN program offered by Freddie Mac, which sought to provide a less expensive execution for borrowers by eliminating marketing and other costs via the use of protected cells and a panel of reinsurers.

These lender exposures do not necessarily need to be wholly retained by the members. The FHLBanks could also work directly with a panel of reinsurers to take on a portion of this risk, or perhaps even issue their own insurance-linked notes (ILNs) similar to what the mortgage insurance companies are currently doing, as illustrated below:



Lender Risk Sharing (LRS) with FHLBank Facilitation – Over 80% LTV Lending

The Federal Home Loan Banks should also be allowed to directly participate in the Enterprises' Credit Risk Transfer programs via member syndicates.

In addition to retaining their own risk, given the profile of many of the FHLBank members, there would be benefits to allowing them to engage in CRT on diversified pools of mortgages guaranteed by the Enterprises. Since the FHLBanks have many members with relatively localized footprints, there is a portion of the membership that has fairly high correlation risk. Normally we think of correlation in terms of being heavily concentrated in one product, but given the nature of cross-selling at the local level, it's possible to have a diversity of products whose performance is highly correlated because the customers have common exposures to local employers and other factors that are localized. By allowing FHLBank members to acquire CRT risk from the Enterprises, they experience a diversification benefit that would normally be unavailable to them.

The ability to add diversified risk to the balance sheets of community banks solves the public policy puzzle of having responsive local financial institutions, while reducing the inherent volatility that these institutions face. Such an approach effectively allows the members of the FHLBank system to enter into a co-op for credit risk. The CRT in question could be based off the overall Enterprise book of business, as current CRT operates, or it could be based on a segregated portfolio of FHLBank member mortgage production.

The rationale for the FHLBanks being a part of this equation is that they would be afforded a high counterparty rating, and thus maximize the capital benefit for the Enterprises under the Enterprise Regulatory Capital Framework (ERCF), and they are equipped to participate at scale. Most member institutions simply aren't large enough to consider directly participating in taking on Enterprise CRT risk, but with the FHLBanks involved, it becomes possible for smaller institutions to collectively participate in a significant manner.

The logistics would in principal follow what occurs today, but with the FHLBanks entering into agreements directly with the Enterprises. The size of these agreements would be based upon the appetite of their membership, with a potential for the FHLBanks adding their own layer of reinsurance or capital market coverage for catastrophic loss.

Conclusion

It's important to remember throughout all of this that although the FHLBanks have been around for 90 years, they have not operated in a static environment. They have seen changes in their regulatory structure, the composition of their membership, and even the creation and disposition of Freddie Mac. As they approach their 100th anniversary, it's important to not only preserve what works, but to support innovation to make sure that they can continue to support homeownership in a manner that is relevant and ultimately beneficial for the next generation of homeowners.

Thank you once again for the opportunity to provide commentary, and I am happy to engage in further dialogue regarding the ideas that I have raised.

Sincerely,

Garrett A. Hartzog