COMMUNITY HOME LENDERS OF AMERICA

October 31, 2022

FHFA Request for Information
The Future of the Federal Home Loan Banks

The Community Home Lenders of America (CHLA) writes to submit comments and recommendations in response to FHFA's Request for Information regarding the future of the Federal Home Loan Bank system.

These comments are offered during a period of changing mortgage origination and refinance marketplace over the last ten years. As large banks have moved sharply away from mortgages, independent mortgage bankers (IMBs) and community banks have moved to fill the gap. At the same time, community lenders have been shown to originate—safely—a higher proportion of mortgages to families both more diverse and less wealthy than the industry average overall.

The CHLA joins other observers asking that IMBs have full access to FHLB system; otherwise, the FHLBs become marginalized over time from much of the mortgage market that most Americans use. If the FHLBs remain truly "home loan" organizations, they cannot become even more divorced from the industry that brings the most mortgage money to Main, Maple, and Elm Streets of America.

The lower cost of funds from FHLB advances would directly facilitate more first-time buyers qualifying for home loans at IMBs, which in turn would allow these families to escape rents that have recently outpaced incomes, trapping these families in untenable financial situations that bleed wealth rather than building it.

At the same, CHLA recognizes that this change will take time, and possibly involve detailed planning over joint liability and counterparty concerns; this broad change may in fact draw in the US Congress as well. For this reason, we also urge you to also consider a narrower policy change in the short term that takes advantage of existing FHLB customers and processes.

We recommend that the FHFA direct the FHLBs to create a dedicated new advance program, channeled through warehouse banks, to create more liquidity for IMBs, particularly to meet originator pipeline-hedge margin calls, as well as servicer advance needs in Congressionally-mandated forbearance situations, such as spring 2020.

BACKGROUND

The early phase of the COVID pandemic brought a dramatic surge in Federal Reserve purchase activity, including an acceleration of MBS purchases in a very short period of time, the scale and speed of which we had never witnessed in mortgage markets**.** This resulted in a sharp and rapid decrease in mortgage rates, which in turn created a major deterioration in the value of the routine pipeline hedges utilized by many lenders in the industry. The result was lenders began experiencing margin calls on their hedge positions that threatened to deplete cash on their books.

This was exacerbated for IMB mortgage servicers that were required to meet increased demands for servicing advances, particularly with the Congressionally-mandated forbearance option.

In a more normalized market of interest rate changes over time, these fluctuations do not bring accelerated rates of margin calls. Lenders are able to properly time the settlement of both their loan sales and hedge positions to match cash flow and liquidity needs, retiring the hedges once the related mortgage loans are closed and sold—generally in 30-60 days. However, since the hedge positions deteriorated at such a rapid pace, the dealers who held these hedge positions demanded the cash losses, via margin call, prior to the lender closing both their hedge positions and the underlying mortgage loans.

To be clear, this was not an issue of undercapitalized lenders short on cash. Nor did these stresses have anything to do with how well lenders had managed their underwriting, their balance sheets, or their businesses. It was an industry-wide crisis resulting from the notional values of mortgages written by lenders and the rapid erosion in the valuation of the corresponding hedge position from the result of unforeseen change in federal monetary & economic policy that came with no notice and no time to react. The sharp and novel Federal Reserve action presented an externality that no lender could have modeled nor foreseen. It was an unprecedented Fed action.

This next point is key. The irony here is that the lender's corresponding pipeline of mortgages was **increasing in value at the same rate as the deterioration of the pipeline hedge**. It was solely the timing difference of when cash needed to be sent out, relative to when the same cash amount was received back into the company. It was not a valuation difference.

PROPOSAL

Thus, it makes sense for the FHFA to contemplate, and direct the creation of, a new FHLB program that would authorize current members of the system—depositories engaging in warehouse lending to IMBs—to make short-term advances to cover this sort of event during periods of market turbulence Advances could mature in 120-180 days and be paid off by the IMBs, similar in concept to Fed Funds lent to stabilize the short term needs of banks. The underlying mortgages could be used as collateral if required.

While the situation brought on by the pandemic resulted in a decrease in rates that precipitated these margin calls, any rapid change in rates, up or down, could have similar effects. At the pace of interest rate increases today, it's possible there could be a precipitous drop, similar to 2020, if a large global event should spook the markets. A dedicated advance system that recognizes short-term dislocations from Federal Reserve actions—or unexpected global events--makes sense.

The existing warehouse banks, already members, would simply be able to identify this dedicated advance program and draw on it on behalf of their existing customer IMBs.

FHFA, in conjunction with the FHLBs, would of course need to create parameters to ensure this special advance did not fund individual lenders that encountered problems of their own making; the key is to restrict this program to short-term economic situations affecting most or all lenders, stemming from an uncontrollable external cause.

WHY ALTERNATIVE SOLUTIONS HERE FALL SHORT

Some might ask: don't IMBs have the ability already to contact their warehouse banks and access liquidity for this exact situation? The answer is they do in theory, but the practical world is such that a Spring 2020 event results in squeezes all along the plumbing; some warehouse banks became more conservative and had to prioritize their own deployments of liquidity. This solution—a dedicated advance program—would ameliorate this concern.

Some might say the solution here is simply increase capital levels or liquidity requirements for lenders using pipeline hedging. They might say that with two rapid rate changes in 3 years' time, the IMB models are vulnerable and need to change.

The answer is that higher capital or liquidity requirements for unicorn external events--that will naturally resolve quickly--are an inefficient solution; they are inefficient precisely because they are a blunt instrument with blunt-instrument costs. Higher capital and liquidity requirements by their very nature will reduce both lending levels and the universe of community lenders available to American families looking for safe mortgage products. Generally, capital and liquidity requirements are suitable to protect investors, consumers, and markets from more common risk events, or to protect the market against inefficient or frankly flawed lenders.

We don't want to raise capital or liquidity requirements for rare, external events—affecting solid, well-managed lenders--unless we agree that consolidation of the lender market is good public policy. This idea protects community lenders and their customers seeking safe mortgages, while also not introducing new risk or complexity to the FHLB system and its members.

CHARTER AND RISK CONSIDERATIONS

As an interim step along the way to an eventual goal of full membership eligibility for IMBs, CHLA's proposal has a number of benefits in terms of limiting risk and addressing charter concerns:

1. **Avoids directly expanding direct membership eligibility for IMBs - by channeling the advances through warehouse banks, which are already eligible for FHLB advances.**

2. **Channels the advances through banks in their capacity as lenders to IMBs, thus bringing to the process the expertise and judgment of these banks to the advance process.**

3. **Provides a liquidity backstop for periods like spring of 2020, when advance requirements of servicers escalated, thus reducing market and systemic risk**

4. **Facilitates FHLB advances backed by collateral with asset values (servicing advances), when used to help non-bank servicers meet advance demands.**

In closing, we note that 75 state and national bank trade groups recently wrote to ask FHFA Director Thompson to waive financial requirements, in order to allow banks to continue accessing low-cost funding from the FHLB system, even if a bank reports having negative tangible capital.

The principle behind this request is that federal agencies and programs like the FHLBs have a public purpose in facilitating affordable homeownership - and in more stressful economic periods, it is appropriate to provide flexibility and enhanced liquidity to promote this purpose, and there are ways to accomplish this in a safe and sound manner.

We believe the same principle should apply to non-banks as well as banks - and to our proposal.

Thank you for consideration of these comments and recommendations.

Sincerely Yours,

COMMUNITY HOME LENDERS OF AMERICA