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FHLBs—Mission and Possible Improvements

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Based on long experience and extensive study of various systems of housing finance and of financial systems generally, I respectfully offer the following thoughts on the mission of and possible improvements in the Federal Home Loan Banks (FHLBs).

Mission

I think the mission of the FHLBs is to support, in key words of the Federal Home Loan Bank Act, “sound and economical home finance,” by linking sound home finance nationwide to the bond market. FHLBs’ principal activities should always be clearly tied to this mission, which should benefit tens of millions of mortgage borrowers throughout the country.

FHLB member institutions should be those which provide sound and economical home finance. As markets evolve over time, which types of institutions are eligible membership should adapt to appropriately reflect this evolution. For example, as commercial banks, originally excluded from FHLB membership, largely supplanted savings and loans in home finance, they were logically made eligible for FHLB membership by the Financial Institutions Reform, Recovery and Enforcement Act of 1989.

In my view, the FHLBs should take minimum credit risk, and all the credit risk of the mortgages they link to the bond market should be borne in the first place by the FHLB member financial institutions. This is true of both FHLB advances, in which all the underlying assets stay on the books of the member, and for the fundamental concept of the FHLB Mortgage Partnership Finance program, in which the mortgage loan moves, but a permanent credit risk “skin in the game” stays for the life of the loan with the member institution, where it belongs. Note that this is the opposite of selling loans to Fannie Mae and Freddie Mac, in which the lending institution divests the credit risk of its own customer that results from its own credit decision.

Since the mission of the FHLBs is sound and economical home finance, their subsidizing affordable housing projects is secondary. In an economic perspective, these programs may be seen as a tax on the FHLBs, and in a political perspective, a tactic which allows members of Congress the convenience of creating subsidies without having to approve or appropriate the expenditures.

FHLBs without doubt have important benefits from their government sponsorship. These benefits should primarily go to supporting sound and economical home finance provided by member institutions throughout the country. To assert that all or most of these benefits must go to subsidizing affordable housing is obviously disproportionate.

In the “mission” discussions, we can usefully distinguish between two groups of FHLB beneficiaries. First are those who have also have skin in the game through having put their own money at risk by capitalizing, funding or financially backing FHLB operations. They are the stockholder-members, the bondholders, and the U.S. Treasury. Second are those who only receive subsidies from the FHLBs.

Suggested Improvements

1. The FHLBs should be given the formal power to issue mortgage-backed securities, provided these securities are always designed so that serious credit risk skin in the game remains with the member institutions. This would give the FHLBs a very important additional method to carry out their mission and would be a long-overdue catching up with financial market evolution.

2. The Federal Home Loan Bank Act should be amended specifically to authorize the FHLBs to form a joint subsidiary to carry out functions best provided on a combined, national basis. The participating FHLBs should own 100% of this joint subsidiary. This addition to the FHLB Act is needed because of the requirements of the Government Corporations Control Act of 1945, when the U.S. Treasury still owned some FHLB stock. It has not owned any for 70 years, but the 1945 statutory requirement is still there.

3. The prohibition of captive insurance companies from being FHLB members should be promptly withdrawn. In my view, this was not only a mistake, but inconsistent with the FHLB Act, which has provided from July 1932 to today that “insurance companies” in general, with no distinctions among them, are eligible for FHLB membership. I believe to change that required Congressional action, which was not taken. Any insurance company, including a captive insurance company, which provides sound and economical home finance should be eligible for FHLB membership.

I hope these ideas will be helpful for the ongoing success of the FHLBs.

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