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The Honorable Sandra Thompson

Director Federal Housing Finance Agency

Constitution Center 400 7th Street, SW

Washington, D.C. 20219

*Delivered Electronically*

The Federal Housing Finance Agency’s “System at 100” review of the Federal Home Loan Bank (FHLB) System has raised a fundamental question: Is the Home Loan banks’ mission to boost liquidity or housing? The answer is “both.” My views are formed by more than 40 years of financial services industry experience in academia, the Federal Reserve System, private banking and, most recently, as an Independent Director and Risk Committee Chair of the FHLBank Cincinnati.

The System was created back in the 1930’s to support the housing sector at a time when its major members, thrift institutions, were largely involved only in making mortgage loans. Borrowing funds from the newly established FHLB’s obviously involved “raising liquidity” to fund mortgages.

In those days, there was no such thing as “asset-liability management” and no financial institutions were required (or chose) to write down a “liquidity management policy.” By the time commercial banks and credit unions were permitted to join the System in 1989, the management and Boards of Directors of depository institutions, with the encouragement of their respective regulatory agencies, all had a strong focus on asset-liability and liquidity management, guided by written, board-approved policies. These concepts and methods had to be developed and gradually enhanced over a period of time, all in the service of improving risk management.

Today, all depository institutions are required by their respective regulators to identify “contingent sources of liquidity” in their policies. These funds are expected to be available to address any shortfalls caused by what economists call “liquidity shocks.” The sources of liquidity shocks are unanticipated declines in deposits or unexpected increases in loan demand. One method to address these liquidity shortfalls is to borrow the needed funds in the capital markets. But over 9 out of every 10 depository institutions lacks access to the capital markets as a result of a so-called “market imperfection.” Because of large fixed costs associated with issuing securities, intermediaries in the capital markets will only underwrite securities in large amounts. The classic assumption in economic analysis of free, unfettered access to markets consequently does not hold for small financial institutions facing the capital markets. But through its “Office of Finance,” the FHLB’s can borrow in the capital markets in large sums. Having accessed the market, the FHLB’s, in turn, can lend these funds to member institutions in smaller amounts. By acting as a classic financial intermediary, the FHLB’s solve the market imperfection problem. Not surprisingly, almost all community-oriented institutions identify FHLB borrowings (“advances’) as a primary source of contingent liquidity in their policies. When the FHLB System was created over 90 years ago, the concept of “capital market imperfections” was as foreign to financial institution managers as asset-liability and liquidity management were.

Since a small number of very large financial institutions can access the capital markets, it might be argued they should not be permitted to be members of the FHLB System. But these institutions were not excluded in the enabling legislation. Today, they are large users of FHLB funding and hence underwrite a substantial portion of the infrastructure costs of operating the System. Excluding these large institutions would consequently force consolidation in the System and substantially shrink both its assets and its earnings. The drop in earnings would yield a concomitant decline in the System’s contribution to affordable housing.

Some have suggested that the FHFA should seek to require the FHLB’s to lend only to support housing-related lending. But tying FHLB advances to explicit funding of home finance will increase prospective liquidity risk in the banking system by short-circuiting access to advances for addressing liquidity shortfalls on the liability side of the balance sheet. Lenders would then be forced to decline requests for loans, including housing-related loans.

It would seem to be counterproductive for the FHFA to implement regulations or support legislation that could reduce funds available for affordable housing and increase potential liquidity risk in the financial system. Significant evolution and innovation are hallmarks of the financial system since the 1930’s, and we should not be surprised to see that the FHLB System has evolved along with it.

Sincerely,

Donald J. Mullineaux, Ph.D.

DuPont Endowed Chair in Banking and Financial Services Emeritus in the Gatton College of Business and Economics at the University of Kentucky

FHLB Cincinnati Independent Director, Risk Committee Chair