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The Evolving Role of the Federal Home Loan Banks in Mortgage Markets

by Daniel K. Maloney and James B. Thomson

The 1929–33 contraction had far reaching effects in many directions, no least on monetary institutions and academic and popular thinking about the role of monetary factors in the economy. A number of special monetary institutions were established in the course of the contraction, notably the Reconstruction Finance Corporation and the Federal Home Loan Banks, …

—Friedman and Schwartz (1963)

Created by 1932 legislation, the Federal Home Loan Bank System is part of the federal infrastructure for promoting home ownership in the United States. For much of its history, the System's 12 Federal Home Loan Banks (FHLBs) have fulfilled their mission by providing liquidity to the housing finance industry, primarily the nation's savings and loans and savings banks. More recently, they have assisted commercial banks as well. The FHLBs increase the liquidity of mortgage markets by making advances (loans) to member institutions, which use the advances to make new mortgage loans. Advances are secured against the members' mortgage-related assets.

The 1980s thrift debacle resulted in legislation that completely overhauled the federal regulatory system for savings and loans and the Federal Home Loan Bank System. The System underwent major restructuring, but the fundamental mission of the FHLBs remained housing finance.

While the mission of the FHLBs has not changed, their activities have expanded in a number of important ways. Over the past decade, the FHLBs substantially increased the size of their investment portfolios, including their holdings of mortgage-backed securities. In 1999, the FHLBs' lending authority was extended by the Gramm-Leach-Bliley Act to include the loans secured by small business and agricultural credits of community depository institutions (currently defined as depository institutions with $538 million or less in total assets). To date, lending activity under this new authority has been trivial—only $8.4 billion of advances (1.72 percent of total advances) secured by small business and agricultural loans were outstanding on December 31, 2002.

From the perspective of its traditional housing finance mandate, the FHLB System undertook a major new initiative in 1997: the direct holding of mortgage loans. Through purchases of mortgage loans from FHLB System member institutions, the FHLBs join the ranks of the two other government-sponsored enterprises that have a mission to promote home ownership—the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation—in promoting the secondary market for mortgages. The evolution of FHLB mortgage activities took another important turn recently as the FHLB of Chicago recently received permission to operate a new program in which mortgage assets purchased from FHLB members are securitized.

The public commitment to support home ownership remains strong, and expanding the FHLBs' housing-related asset powers is consistent with that objective. But as with other government-sponsored enterprises, the FHLBs' public charters convey upon them special treatment not afforded privately chartered firms, providing them with competitive advantages in the marketplace—not the least of which is the perceived implicit government backing of their liabilities. Therefore, the continuing evolution of FHLB activities merits periodic review.

The Federal Home Loan Banks are part of a system created by the federal government to promote home ownership. This *Commentary* looks at new initiatives undertaken by these government-sponsored enterprises to expand their role in financial markets and the attendant implications for their balance sheets.

Providing Liquidity to Mortgage Lenders

The FHLBs were established as a liquidity facility for the housing finance industry. Initially, they operated as deposit-replacement facilities, making advances to thrifts and other FHLB member institutions. Thrifts would use FHLB advances to insulate their mortgage lending activities from shifts in loan demand and deposit flows. Through time, these housing lenders began to use FHLB advances as a routine source of funding for their mortgage assets.

For the better part of six decades, membership in the FHLBs was limited to institutions specializing in housing finance—largely savings associations. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 opened up membership in the FHLBs to commercial banks. Starting from zero at the beginning of 1990, commercial bank membership has grown to 5,886 institutions (73 percent of all FHLB members) as of December 31, 2002.

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Providing liquidity through secured lending remains the FHLBs' most important activity. More than 64 percent of the FHLBs' total assets ($764 billion) consisted of outstanding advances ($490 billion) as of December 31, 2002. While the current ratio of advances to assets is substantially below the high mark set in 1980 (90 percent), it is considerably above the historical low of less than 49 percent recorded in 1995. Moreover, on average, advances accounted for nearly two-thirds of FHLB assets over the past five years. And despite the widening of the pool of eligible collateral for community financial institutions under the 1999 Gramm-Leach-Bliley Act, over 98 percent of advances are still secured by housing-related assets.

The shift away from advances is reflected largely in the FHLBs' investment portfolio. From 1990 through the end of of 2002, FHLB investments increased from $72 billion to $206 billion (over 27 percent of total assets). These investments—which consist largely of holdings of mortgage-backed securities, securities of the U.S. Treasury and official agencies, federal funds sold, and interest-bearing deposits in banks—increase the flexibility with which the FHLBs can manage their balance sheets. For instance, the FHLBs can use their investment accounts to accommodate unforeseen changes in demand for advances by making offsetting changes in their investments—increasing investments when demand for advances is falling and decreasing investments when demand for advances is rising. Investments appear to be attractive assets to hold in portfolio for their own sake as well, for their magnitude has grown enormously since 1990. Certainly, the $96 billion of mortgage-backed securities (nearly 47 percent of total investments) held by the FHLBs on December 31, 2002, provide a means of supplying credit to the housing industry other than the more traditional advances.

■ Direct Holdings of Mortgages

On January 9, 1997, the FHLB of Chicago received approval from the Federal Housing Finance Board to operate a pilot program for a new initiative, the Mortgage Partnership Finance Program, which allowed the Chicago bank to engage in a new activity, directly purchasing mortgages from FHLB members. Two years later, all 12 FHLBs were granted the right to establish mortgage-asset programs similar to Chicago's. In June 2000, the Finance Board removed a $9 billion cap on the Chicago pilot and made mortgage-asset programs permanent for those FHLBs that decided to offer them. By the end of 2000, 11 of the 12 FHLBs held mortgages purchased under one of two such programs: the program pioneered by the FHLB of Chicago or a program established in 2000 by the FHLBs of Seattle, Indianapolis, and Cincinnati called the Mortgage Purchase Program. Seattle, Indianapolis, and Cincinnati offer their program to their members, and all other FHLBs offer Chicago's program to theirs. The FHLB of Atlanta plans to offer the Mortgage Purchase Program to its members in 2003. Currently, all 12 FHLBs are holding mortgage assets on their balance sheets.

Both mortgage-asset programs offer FHLB System member institutions a new method for funding fixed-rate conventional, FHA, and VA mortgages. Under the programs, member institutions may sell mortgage loans to an FHLB as an alternative to retaining these assets on the balance sheet or selling the loans in the secondary market to Fannie Mae or Freddie Mac. By selling mortgages to an FHLB, the member institution avoids paying guarantee fees to Fannie or Freddie. Under Chicago's Mortgage Partnership Finance Program, members receive credit enhancement fees from the FHLB. This fee compensates the member institution for sharing some of the credit risk after the loan is purchased by the FHLB. Under the Mortgage Purchase Program, the equivalent of the Fannie or Freddie guarantee fee is deducted from the purchase amount and deposited into a lender's reserve account. A separate account is established for each pool of loans bought from a member. Members receive payments from the FHLB out of their reserve account based on the performance of the underlying loans. While the structure of the loss-sharing arrangement under each of the two mortgage-asset programs is somewhat different, both programs offer members a higher return on sales of mortgage loans in exchange for retaining some of the credit risk. In addition to a portion of the credit risk, the FHLBs fully assume the interest-rate risk and prepayment risk of the mortgages they purchase.

FHLB mortgage assets have grown considerably since the two mortgage-asset programs received final approval in 2000. Over the past 12 months, total mortgage assets have more than doubled, rising from $27.6 billion on December 30, 2001, to $60.1 billion at the end of 2002. Mortgage assets increased from 3.62 percent to 7.93 percent of total assets, accounting for 49 percent of total FHLB asset growth over the same period. Mortgage loans held under the Mortgage Partnership Finance Program were $42.3 billion as of December 31, 2002, and $18.3 billion under the Mortgage Purchase Program.

Continued strong mortgage growth has implications for the capital adequacy of the FHLBs. Asset growth exceeded FHLB capital growth in eight of the last 10 years, including 2002, and as a consequence, the FHLBs' capital-to-asset ratio declined from 6.92 percent in 1991 to 4.76 percent as of December 31, 2002. Moreover, the shift in asset composition from low-risk advances to mortgages and mortgage-backed securities has implications for capital adequacy because the FHLBs are subject to risk-based capital requirements. Even with the loss-sharing agreements in place, FHLB mortgage holdings are riskier than advances and hence, under risk-based capital requirements, incur a higher capital charge (require more capital to be held against them) than advances. In other words, asset growth driven by the mortgage-asset programs requires higher growth in FHLB capital than balance-sheet growth driven by advances.

Due primarily to differences in the number of member institutions participating in FHLB mortgage-asset programs, the growth in FHLB mortgage assets has been uneven across the 12 FHLBs. The FHLB of Chicago alone holds just under $26.2 billion in mortgages, which accounts for 43 percent of the FHLB System's mortgage assets (and it represents over 40 percent of the Chicago bank's assets). The top five FHLB mortgage holders, accounting for 32 percent of FHLB System assets, collectively own 85 percent of System mortgage holdings. For some of these FHLBs, continued growth in their mortgage-asset programs may be constrained by capital requirements, resulting in the need to raise capital from members or to find alternatives to funding additional mortgages purchased on their balance sheets.[1]

One such alternative to funding mortgage purchases on the balance sheet is the FHLB of Chicago's recently approved Shared Funding Program, which allows Mortgage Partnership Finance Program loans to be securitized.[2] The Shared Funding Program will increase the flexibility the FHLB of Chicago has in funding new Mortgage Partnership Finance Program loans by turning relatively illiquid mortgage loans into more highly liquid instruments (mortgage-backed securities) that can then be booked to the FHLB of Chicago's balance sheet or sold. While the specifics of the new program are still being worked out, initial reports indicate that the sales of the program's mortgage-backed securities will be limited to FHLBs and to FHLB System member institutions. This does not, however, appear to be an overly binding constraint given that 5,886 banks, 1,390 savings associations, 660 credit unions, and 75 insurance companies are members of the FHLB System. Overall, the commercial bank and savings association members of the FHLB System hold a total of $4.8 trillion of assets, which is close to 50 percent of total bank and thrift industry assets.[3]

Conclusion

There is no question that the FHLBs are undergoing change. Such evolution is natural and necessary given the continued and often dramatic changes in financial markets—and particularly in the housing finance markets the FHLBs were created to support. Increased holdings of mortgage-backed securities and direct holdings of mortgages through the two new FHLBs mortgage-asset programs represent new methods for fulfilling the FHLBs' original housing-related mission. These mortgage-asset programs also appear to be important drivers of FHLB asset growth. In addition, part of the FHLB System's mission is to promote access to housing for all Americans. The FHLB mortgage-asset programs indirectly support this goal by providing member financial institutions liquidity to accommodate further residential mortgage loan originations. Finally, to the extent that the FHLB mortgage-asset programs displace or reallocate loan sales that would have normally been purchased by Fannie Mae or Freddie Mac, the Mortgage Partnership Finance Program, Mortgage Purchase Program, and the Shared Funding Program increase the competitiveness of the secondary mortgage market—further lowering the cost of housing finance to homeowners.

Footnotes

1. Interestingly, the most aggressive purchaser of mortgages, the FHLB of Chicago, has bucked the declining capital trend for the FHLBs as a group. The FHLB of Chicago's 97 percent capital growth has exceeded its 83 percent asset growth since the end of 2000—its capital-to-asset ratio has risen from 4.81 percent to 5.16 percent over the same period.

2. Information on the Shared Funding Program can be found at <http://www.fhfb.gov/Hal2000/docs/Approvals/2002_pdfs/2002-APP-07.pdf>.

3. Commercial bank members of the FHLB System hold around $3.8 trillion in assets or 43 percent of total U.S. banking assets. Close to 100 percent of savings associations, both in terms of number of institutions and share of industry assets (over $1.0 trillion) belong to the FHLB System.

Recommended Readings

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