The Unraveling of the Federal Home Loan Banks

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The Federal Home Loan Bank system is a $1.3 trillion government-sponsored enterprise that operates primarily for the benefit of member financial institutions. Federal Home Loan Bank members enjoy generous dividends and ready access to fresh liquidity. The biggest beneficiaries are the biggest users of the system, including the largest banks and insurance companies in the country and banks facing financial distress. This essay explains the original aims of the Federal Home Loan Bank system, how the system fulfilled those aims quite successfully for decades following its creation in 1932 and how the system evolved to serve primarily private aims. By recovering the early design of the Federal Home Loan Bank system and the conditions that allowed the system to serve public aims, this essay provides a fresh blueprint for how it could and should be reformed.

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Introduction

> During the first half of this year, the Federal Home Loan Bank System issued $1.2 trillion in debt securities and supplanted the U.S. Treasury as the world's largest issuer of debt. That's quite a distinction, considering that most Americans have no awareness of the System.[1]

Richard Carnell
Assistant Secretary for Financial Institutions, Treasury Department
December 2, 1998

Although the Treasury Department long ago regained its position as the world's leading issuer of dollar-denominated debt, the Federal Home Loan Banks (FHLBanks) remain second.[2] That's no small feat in a world awash in public and private debt. And to this day, most Americans—and even many market participants, regulators and academics—have little appreciation of what the FHLBank system does, why it was created, how unmoored it has become from the aims that animated its founding and the myriad problems that result.

This Article strips back the veil of ignorance that has allowed the FHLBank system to use public backstops to serve largely private aims with minimal accountability for the last half century. Understanding the FHLBank system is no small feat.[3] No one did, or ever would, set out to create the FHLBank system that now exists. It is a creature designed for a bygone era that morphed to serve new aims and stakeholders rather than wither away as its original design became moot. Understanding its operations thus requires an understanding of how housing finance worked a century ago, how it has evolved, and myriad other changes in the structure of the financial system. Accentuating the challenge, many of the threats posed by the

1. Press Release, U.S. Dep't of the Treasury, Assistant Secretary of the Treasury (Financial Institutions) Richard S. Carnell Remarks Before the American Enterprise Institute (Dec. 12, 1998), https://home.treasury.gov/news/press-releases/rr2841 [https://perma.cc/K4L8-9HFB].

2. In May 2023, the total FHLBank debt outstanding reached $1.5 trillion. *See* Off. Fin., Monthly Issuance Data Archive: 2010-2023 – 'Outstandings', FHLBANKS, *available via* https://www.fhlb-of.com/ofweb_userWeb/pageBuilder/debt-statistics-61 [https://perma.cc/G4J9-8CX8]; *see also* Heather Perlberg, *A $1.5 Trillion Backstop for Homebuyers Props Up Banks Instead*, BLOOMBERG (June 4, 2023, 7:00 PM), https://www.bloomberg.com/news/features/2023-06-04/us-effort-to-help-homebuyers-get-affordable-loans-mainly-benefits-banks-instead [https://perma.cc/MJJ2-NJPU] (describing recent reliance on FHLBs by troubled banks and the size of the FHLB system's balance sheet).

3. Complementing the historical analysis undertaken here are two other recent pieces that raise overlapping concerns about the soundness, aims, and impact of the Federal Home Loan Bank (FHLBank) system. *See generally* Stefan Gissler, Borghan Narajabad & Daniel Tarullo, *Federal Home Loan Banks and Financial Stability*, 9 J. FIN. REGUL. 1 (2023) (exploring "past incidence and future potential for the [FHLBanks] to amplify financial stability risks" and proposing a "framework for regulatory reform . . . to contain these risks"); Stephen G. Cecchetti, Kermit L. Schoenholtz & Lawrence J. White, *The FHLB Role in the SVB and Related Debacles*, *in* SVB AND BEYOND: THE BANKING STRESS OF 2023, at 173 (Viral V. Acharya, Mathew P. Richardson, Kermit L. Schoenholtz & Bruce Tuckman eds., 2023), https://cepr.org/system/files/publication-files/188970-svb_and_beyond_the_banking_stress_of_2023.pdf [https://perma.cc/64NP-YBMQ] (detailing the "enabling role" FHLBanks played in "delaying the regulatory reckonings" of various recently troubled banks arguing that "[p]olicymakers should eliminate, or sharply reduce, the role of the 'lender-of-next-to-last-resort' played by the [FHLBanks]").

FHLBanks are probabilistic rather than concrete. And its omnipresence in the U.S. financial system means counterfactuals are often the only way to assess the benefits that may flow from significantly curtailing the system's scope.

Yet it is past time to confront these challenges head on. Recent events illustrate longstanding flaws in the system's design. As deposits and market-based funding started drying up for regional banks in 2022, the FHLBanks stepped in. The FHLBanks provided fresh liquidity—the lifeblood of banks—to Silicon Valley Bank, Signature Bank, First Republic Bank and Silvergate Bank, allowing each bank to limp along without undertaking the steps needed to address their fundamental weaknesses. By late spring 2023, all four had failed. Nonetheless, the FHLBanks made out whole while the Federal Deposit Insurance Fund (FDIC) suffered major losses and financial regulators had to invoke extraordinary authorities to contain the collateral damage stemming from two of the failures. The FHLBanks played similar roles helping soon-to-fail banks stay afloat in the savings and loan (S&L) crisis of the 1980s and again during the 2007-09 financial crisis. And, each time, the FHLBanks came out on top—not losing a penny even as the crises inflicted significant losses on the FDIC, taxpayers and the real economy.

The primary contribution of this Article is to provide a comprehensive account of how the FHLBank system was meant to work, to show how well it initially fulfilled those aspirations, and to explain how changes in housing finance and financial markets preclude it from ever again having the impact it once did on housing finance. Examining the path-dependent evolution of the FHLBanks—and the environment in which they operate—makes it plain that Congress never set to create the FHLBank system that now exists. Yet understanding the conditions that allowed the FHLBanks to work so well during their first few decades also provides a template that can be used to identify domains where that original design could still have a positive impact. The analysis here thus not only explains *why* reform is necessary, but it also provides new insight into *how* best to reform this government-sponsored behemoth.

Back in 1932, when President Herbert Hoover ushered the creation of the FHLBank system, mortgages were hard to get and ill-suited to the needs of the typical American family. This put home ownership out of reach for many. At that time, there was also a growing cadre of small, community-oriented financial institutions—thrifts, such as S&Ls—that specialized in making home loans. This combination enabled the original FHLBank model: use implicit government backing to raise cheap funds and then loan those funds to thrifts that could post "good" mortgages as collateral. Defining good mortgages by reference to both credit risk and how well a loan served consumer needs allowed the FHLBanks to facilitate the availability of home loans in ways that simultaneously promoted home ownership and wealth creation among the middle class. The FHLBank also served as a critical backbone of an ecosystem that enhanced the resilience of the small financial institutions focused on serving the needs of the communities around them. By looking closely at the historical moment in which the FHLBanks came into being and the first few decades of their operation, this Article shows that the FHLBanks did indeed work as intended.

Yet the analysis further reveals a multi-front undoing of this early, useful FHLBank system. Housing finance today bears little resemblance to housing finance circa 1932. This is in part a story of successful government policy. The rise of the Federal Housing Administration (FHA), Fannie Mae, Freddie Mac and Ginnie Mae and the many programs run by these agencies and government-sponsored enterprises (GSEs) mean it is far easier today for the typical American family to access a home loan with fixed monthly payments structured to facilitate wealth creation.[4] It is also a story of deregulation. The thrifts that were the primary vehicle through which the FHLBank system worked its magic are now a small fraction of FHLBank membership and look far different than the thrifts of yesteryear. The loosening of the restrictions imposed on commercial banks and thrifts have largely mitigated any differences between them, a trend accentuated by Congress's decision to grant commercial banks access to the FHLBank system. And it is also a story of financial innovation, which, in conjunction with the GSEs, has allowed nonbank mortgage companies to originate the majority of new home loans—without any access to or support from the FHLBank system.

The Article further shows that as the FHLBank system became unmoored from the structure that animated its creation, it evolved to serve increasingly private interests while still harnessing valuable public backstops and exemptions. Making matters worse, it became a "lender of next to last resort" to banks and thrifts. It is in this capacity that it has loaned so much money to SVB, Washington Mutual and so many other financial institutions on the verge of failure, and it is in this capacity that it continues to allow financial institutions to tap government-backed financing while avoiding the accountability that comes with going to the nation's designated lender of last resort, the Federal Reserve. And while the main contribution of this Article is to show why the FHLBank system should not be allowed to continue in its current form, the process of uncovering what has gone right and wrong in its history also illuminates the best path for reform.

There is an understandable instinct among many that want to reform the FHLBank system to focus on ways to have the system do more to promote housing finance. It is the Federal Home Loan Bank system after all, and policy challenges around housing certainly persist. As this Article shows, however, the massive changes in housing finance over the last century limit the ability of the FHLBank system to support housing, and the

4. *See infra* Section II.A.

small banks that once were the cornerstone of housing finance, in accordance with its original design. This helps explain why even those who want the FHLBanks to do more for housing often focus on reforms that would have been foreign to the original design of the system, such as increasing the amount of earnings that go to affordable housing programs.[5] While those types of reforms would be an improvement from the status quo, they would likely accentuate the flaw at the core of today's FHLBank system—its excessive focus on profitability and rent extraction.

Others troubled by the current FHLBank system would eliminate their charters, dismissing this type of public-private enterprise as a relic of a bygone era that does far more harm than good.[6] Much of the analysis here supports this critique, but that does not lead inexorably to the conclusion that eliminating the regime is the best path forward. For one thing, although first-principles reasoning does not distinguish between whether government support should be provided in the first place or the support currently provided should be removed, in practice, the distinction does and should bear weight. Although large banks borrow more from the FHLBanks in aggregate terms than small banks, small banks are more reliant on the FHLBank system to reduce their maturity mismatch, manage liquidity, and remain resilient in the face of shocks. There are good reasons to pause before stripping small banks of a risk-management tool on which they have relied for decades, particularly given the other challenges they face.

Just as importantly, the history provided here lays the groundwork for an alternative approach to reform: shrink and refocus the system in line with its original design, while mapping that design onto today's financial system. The FHLBanks were successful when they focused on helping small, community-oriented financial institutions extend the type of credit that they are uniquely well-suited to provide, and that may otherwise be under-provisioned. In 1932, that meant helping thrifts and home loans for middle-class families. Today, that may entail a wider array of small, community-oriented financial institutions, including community banks, thrifts, CDFIs and possibly even small regional banks. It may also include different types of lending, such as small-business loans or financing the atypical

5. *See, e.g.*, *FHLBank System at 100: Focusing on the Future*, FED. HOUS. FIN. AGENCY (Nov. 2023), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHLBank-System-at-100-Report.pdf [https://perma.cc/H8QU-AYZG] [hereinafter *FHFA Report*] (suggesting Congress should double the AHP from ten to twenty percent); Federal Home Loan Banks' Mission Implementation Act, H.R. 3323, 117th Cong. § 8(a)(1)(B)(i) (2021) (same); Letter from Maxine Waters, Ranking Member, Fin. Servs. Comm., House of Reps., to Sandra Thompson, Dir., Fed. Hous. Fin. Agency 5 (July 24, 2023), https://democrats-financialservices.house.gov/uploadedfiles/7.24_cmw_ltr_fhfa_re_fhlb_rev.pdf [https://perma.cc/B2H2-8E66] (suggesting that "FHLBanks should increase their contributions [to Affordable Housing Programs] to a minimum of 15%, and consider voluntary contributions that bring their total contributions to at least 25%").

6. Nicholas Thielman, *The Decline and Fall of the Federal Home Loan Banks,* BLOG: CATO AT LIBERTY (Jan. 2, 2024, 4:38 PM), https://www.cato.org/blog/decline-fall-federal-home-loan-banks [https://perma.cc/J9H8-233E].

dwellings that may be critical to addressing the housing shortage. Although a detailed reform proposal is beyond the scope of this Article, the approach flows straight from the history of the FHLBank system. Reforming the system so it once again primarily serves smaller financial institutions and the credit needs of the communities in which they operate could right-size and refocus the FHLBank system so it again serves largely public aims.

Bringing about any meaningful reform of the FHLBank system will not be easy. Much of the FHLBank system operates "off-balance-sheet," disguising the extent of taxpayer assistance that flows to the system. And there are a lot of stakeholders who benefit from the current arrangement. This helps explain why the FHLBank system has been allowed to persist in its current form for so long. Yet the time for reform may finally be nigh. The Federal Housing Finance Agency (FHFA), which oversees the FHLBanks, spent more than a year reevaluating the system's past, present and future, culminating in a report that details many of the ways the FHLBanks have deviated from their original mission and it provides an array of proposed reforms.[7] Although the reforms are more incremental than the vision proposed out here, the report is helping to spark a much-needed debate about just whether and in what form this system should persist. This Article provides the context needed to understand why significant reforms are warranted and the impact of various proposals now on the table.

This Article proceeds in four parts. It begins by explaining the origins and early operations of the FHLBank system. It explains not only why the FHLBank system was created, but it also explains the rise of S&Ls and other thrifts in the United States, and the pivotal role these small, community-oriented financial institutions played in the design of the FHLBank system. Part II explores how changes in housing finance and other developments undermined the ability of the FHLBank system to work as originally intended and how Congress exacerbated these challenges by coming to rely on the FHLBanks as a useful source of off-balance-sheet funding. Part III looks at the FHLBanks today. It examines the ways in practice and presentation, the FHLBanks consistently prioritize profits and member interests over public good. It further shows how their frequent support for weak banks is endemic to their design and it explains why the liquidity the FHLBanks provide to the banking system more broadly during periods of distress likely does more harm than good. Part IV explains the forward-looking policy implications of the lessons gleaned from the history, evolution and current operations of the FHLBank system. It lays out the tradeoffs in the four major routes that could lie ahead and argues that focusing on the design of the original FHLBank system provides the best blueprint for reform.

7. *See FHFA Report*, *supra* note 5.

I. The Rise of the FHLBanks

In December 1931, 3,600 people from across the country gathered together at a conference sponsored by the White House on housing.[8] President Hoover was concerned with the way the housing market was contributing to an acute contraction of economic activity and he was hopeful that restarting the housing market and promoting the building of new homes might help pave the way for the economy to recover. His administration had good reason for concern. Between 1925 and 1933, new housing starts fell by ninety percent and expenditures on residential construction fell by ninety-four percent.[9] Hoover and his administration were also justly concerned about the way challenges around housing were accentuating the economic pain of American families at a time of great economic distress. Foreclosures were rising, and half of all mortgages would be in default by 1934.[10] And the technocrat in Hoover recognized that there were meaningful deficiencies in housing finance that the government could help mitigate.

The conference brought together a wide array of stakeholders, including homebuilders, realtors, city planners, bankers and others, and included representatives from every state in the union.[11] The aim was in part to hear from these various groups, but also to garner support for an agenda that had been more than a year in the making.[12] In preparation for the conference, the Hoover administration had commissioned 31 separate committees—25 focused on factfinding and another six charged with making recommendations—to produce reports laying the groundwork for the discussions.[13]

A central focal point of the reports and deliberations was whether more could be done to facilitate housing finance. Even before the 1929 stock market crash, the mortgage market looked nothing like the mortgage market today.[14] Home mortgages were very hard to obtain, and availability varied significantly by region. The home loans that were available tended to have short durations, require sizeable down payments, and have balloon

8. Natasha Porfirenko & James Ryan, *Register of the President's Conference on Home Building and Home Ownership (1931: Washington, D.C.) Records*, ONLINE ARCHIVE OF CAL. (1998), https://oac.cdlib.org/findaid/ark:/13030/tf1w1001jf/entire_text [https://perma.cc/ATZ6-C3BD].

9. ADAM J. LEVITIN & SUSAN M. WACHTER, THE GREAT AMERICAN HOUSING BUBBLE: WHAT WENT WRONG AND HOW WE CAN PROTECT OURSELVES IN THE FUTURE 45 (2020).

10. *Id.* at 40.

11. Herbert Hoover, President, Statement Announcing the White House Conference on Home Building and Home Ownership (Sept. 15, 1931), https://www.presidency.ucsb.edu/documents/statement-announcing-the-white-house-conference-home-building-and-home-ownership [https://perma.cc/WF6X-WDCE].

12. *Id.*

13. Porfirenko & Ryan, *supra* note 8.

14. For an overview of housing finance around this time, see generally LEVITIN & WACHTER, *supra* note 9.

structures—in which monthly payments covered only interest, and the full principal amount of the loan was due at maturity.[15] Amortizing loans—in which monthly payments reduce principle alongside covering interest—were far harder to come by. A five-year, interest-only loan that required a fifty or sixty percent down payment was typical. In part because of this, many people also had to obtain a second-lien mortgage in order to buy a home. This shaped the nature of the housing stock available—smaller, simpler homes—and the range of people who could afford their own homes—a figure that never reached fifty percent and went down over the Great Depression.[16]

Hence, a central aim of President Hoover's main reform proposal, the creation of a new Federal Home Loan Bank system, was to increase the availability of home loans and to shift the terms of those loans to terms that better suited middle-class families.[17] Yet, consistent with other banking laws at the time, the Federal Home Loan Bank Act was also imbued with a host of policy judgments about the types of institutions that should be making home loans. In particular, it sought to buttress a burgeoning but recently weakened breed of small, community-oriented financial institutions known as thrifts.

The overarching idea at the core of the FHLBank system is that in an environment where access to capital and liquidity are constrained—for both financial institutions and the borrowers they serve—providing financial institutions access to government-sponsored sources of liquidity and financing can increase the capacity of those financial institutions to make loans. Further, by requiring financial institutions to post particular types of loans as collateral in order to access that government-backed financing, the government can influence the types of loans that financial institutions make. And by allowing only certain types of financial institutions access to this government-backed financing, the government can also enhance the viability and competitive advantage of some types of financial institutions over others. These abstract ideas came alive in the Federal Home Loan Bank Act in the form of congressionally established policies regarding the types of financial institutions that could join the FHLBank system and the types of collateral those institutions could post in order to get a loan—known as an advance—from a FHLBank.

Structurally, the FHLBank system was roughly modeled on the Federal Reserve system (which at the time, was more private than it is today). Like the Fed, the FHLBank system would consist of up to twelve regional banks under the oversight of a central body, the Federal Home Loan Bank Board (the FHLBank Board). Like the regional Federal Reserve Banks, the regional FHLBanks would be structured as member-owned

15. *Id.*
16. *Id.* at 17-19.
17. Porfirenko & Ryan, *supra* note 8.

cooperatives and would provide liquidity via "discounting"—that is, making loans against specified collateral.[18] And, like the Fed, the FHLBanks were structured as banks to banks.

Yet there were a number of important differences between the Fed and the FHLBank system. Only commercial banks, not thrifts, could join the Federal Reserve and only banks, not thrifts, could access the Fed's collateralized lending facility, known as the discount window. Discount window loans could only be extended for a few months, were meant to be used only as a last resort, and could be secured only by commercial credit, not home loans. By precluding thrifts from access to the Fed's discount window and further precluding them from accessing it indirectly via a bank through the collateral constraints, the contours of the Fed circa 1932 help explain the need for something akin to the FHLBank system. The FHLBank system differed from the Fed by serving a different type of financial institution—thrifts—and accepting a different type of collateral—mortgages. But the FHLBank was not just a Fed for thrifts and housing. It also sought to further different policy aims. The collateralized loans it extended could last years, not just months. As a result, FHLBank advances could be used by a financial institution to access much needed liquidity during periods of stress but they could also be used as a longer-term source of financing.

Exploring in more detail the membership and other policies of the FHLBank provides insight provides insight into how and why this system could help both thrifts and aspiring homeowners. And looking at significant differences in how the Fed and the FHLBank have evolved since 1932 provides useful insight into why we ought to be concerned about the operations of the FHLBank system today.[19]

A. FHLBanks: Membership and Collateral

The policy choices Congress made in setting up the FHLBank system can only be understood by reference to housing finance and the nature of the banking system circa 1932. The most significant and, until the Depression, rapidly growing source of home loans in the United States were savings and loans (S&Ls) and other building associations—both kinds of thrifts. The inspiration for these organizations came from abroad. Building societies first emerged in England in the late 1700s, and by 1850, England boasted more than 2,000 building societies that enabled working people to pool their resources and extend mortgages to members in turn.[20]

In 1831, two factory owners who had emigrated from the England put the same idea into action in the United States. They co-founded the Oxford

18. Hoover, *supra* note 11.

19. *See infra* Section III.A.

20. David A. Price & John Walter, *Private Efforts for Affordable Mortgage Lending Before Fannie and Freddie*, 102 FED. RSRV. BANK RICHMOND ECON. Q. 321, 330 (2016).

Provident Building Association in Frankford, Pennsylvania. The model quickly spread through the northeast and then beyond. For these early thrifts, members would commit to making payments and in turn would become eligible, in time, to receive a mortgage (often allocated via auction).[21] As in England, industrialization facilitated the spread of S&Ls by creating a population of steady wage earners living in proximity to one another, and sometimes bound by working in the same factory.[22] State laws further facilitated the spread of thrifts, as every state adopted laws enabling the creation of thrifts and it was typically far easier to form a thrift than to form a bank.[23]

For decades, thrifts thrived and spread as a primary mechanism by which ordinary Americans could obtain a mortgage. By 1893, the United States boasted 5,600 building associations with 1.3 million members and over $470 million in assets.[24] And most of those 1.3 million members were laborers, including factory workers, houseworkers, mechanics and artisans.[25] The industry continued to grow in the decades that followed. By 1930, building associations had 12.3 million members—including roughly 10 million savers and 2 million borrowers, as the two became distinct if overlapping over time—and $8.8 billion in assets.[26]

Following the mold set in England, early building associations had limited pathways for expanding membership and would dissolve when they fulfilled their aim of enabling each of their members to buy homes.[27] Over time, however, this and other features evolved to create a more flexible organizational form. Vesting greater authority in managers allowed strangers to be members alongside one another, and for the organization to remain viable even as members came and went.[28] Yet it also created new sources of vulnerability. Core to the stability of early S&Ls was the fact

21. *Id.* at 328-30.

22. *Id.* at 329-31 ("As in Britain, the growth of building and loan associations in the United States was likely aided by the factory system and the swelling of a wage-earning class . . . .").

23. *See* David L. Mason, From Building and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1989, at 51-54 (2001) (Ph.D. dissertation, Ohio State University) (ProQuest); *see also* FED. HOME LOAN BANKS, THE FEDERAL HOME LOAN BANK SYSTEM 1932-1952, at 52-55 (1952) (describing the "deep[]-rooted history" of the FHLBank system, including early variation among the states in the "number of companies which were making home loans").

24. Price & Walter, *supra* note 20, at 333-34.

25. *Id.* at 334.

26. *Id.* at 337 ("In 1930, despite the financial crisis the preceding year, membership was up to 12.3 million and assets totaled $8.8 billion."); FED. HOME LOAN BANKS, *supra* note 23 (stating that in 1930 thrifts had $9 billion in assets and providing the breakdown of borrowers and savers). Other work suggests slightly different figures. Heather A. Haveman & Hayagreeva Rao, *Structuring a Theory of Moral Sentiments: Institutional and Organizational Coevolution in the Early Thrift Industry*, 102 AM. J. SOCIO. 1606, 1609 (1997) (noting that "thrifts controlled $7.4 billion in assets" by 1929 (citing RAYMOND W. GOLDSMITH, FINANCIAL INTERMEDIARIES IN THE AMERICAN ECONOMY SINCE 1900, at 73-75 (1958))).

27. Price & Walter, *supra* note 20, at 329; Haveman & Rao, *supra* note 26, at 1616.

28. Haveman & Rao, *supra* note 26, at 1636-44.

that most members were both borrowers and providers of funds, so they wanted the institution to remain stable. So long as this was true, seeking money back during a period of stress would be self-defeating. As the symmetry between the people behind the asset-side and liability-side of S&L balances waned, however, and members were increasingly allowed to get their money back. And although thrifts could not issue demand deposits for another century, members could demand their money back and often (though not always) with much less notice than the duration of the mortgages that those funds backed. A requirement of thirty or sixty days' notice for the return of funds, for example, was common.[29] As a result, thrifts became increasingly vulnerable to shifting economic conditions.

This vulnerability became manifest as the Depression set in. In the decade following the onset of the Depression, a third of all thrifts closed down, and even those that stayed open struggled.[30] The rapid contraction in the thrift industry both contributed to, and was accentuated by, a rapid decline in housing values. Alongside the virtual cessation of new home starts, existing single-family home prices declined roughly thirty percent between 1925 and 1933.[31] All of this helps to explain why the committees commissioned by President Hoover homed in on housing finance and thrift stability as key factors in helping to counter the challenges impeding the housing market generally.

Savings associations were the other type of thrift institution granted FHLBank membership. Savings associations had started a little earlier than S&Ls and building associations, and engaged in a wider array of financing activities, so a close nexus with housing cannot explain the decision to grant them FHLBank access. Like other thrifts, however, savings associations tended to be small, focused primarily on serving workers and often had a mutual ownership structure, affirming a focus on supporting financial institutions that served the needs of the middle-class and other laborers.[32]

Insurance companies were also allowed to become FHLBank members. Like mortgage companies and thrifts, insurance companies helped fill the vacuum left by the inability of commercial banks to engage in residential lending and hold mortgage assets. Mortgages and mortgage-backed securities also helped insurance companies diversify their holdings and the long-term nature of life insurance policies meant insurance companies were well suited to hold debt that took years to mature. By 1929, insurance companies held roughly sixteen percent of all outstanding mortgage debt.[33] Insurance companies were not inherently fragile like thrifts or banks, but they were viewed as providing a socially valuable service in extending

29. Price & Walter, *supra* note 20, at 388.
30. *Id.* at 339.
31. *Id.* at 339 n.97.
32. FED. HOME LOAN BANKS, *supra* note 23, at 53.
33. Price & Walter, *supra* note 20 at 339; *see also* LEVITIN & WACHTER, *supra* note 9.

insurance policies and they were better regulated than the other nonbank financial companies in the mortgage market at the time.

Shifting the focus from those granted membership to those denied FHLBank membership provides more insight into the value judgments at play. On this front, the exclusions were as significant as the inclusions. Two notable exclusions were the mortgage companies and mortgage trust companies of the day. These nonbank entities were among the financial companies that had emerged in response to the limitations on the ability of commercial banks to make home loans and the vacuum that was created in financing markets. They have been credited with creating the earliest mortgage-backed securities (MBS) in the United States.[34] In contrast to thrifts, however, they tended to attract capital from large investors—not workers—and they often were used to fund an array of real estate loans, not just residential mortgages.[35] And just like today's nonbank mortgage companies, they were not subject to the same type of prudential regulation governing most thrifts' insurance companies. So Congress made a decision to exclude them even though granting them membership may have been the better choice if the only aim was to promote housing finance.

The most significant limitation given the realities of the mortgage market at the time was the exclusion of individuals. Non-institutional lenders, such as individuals and families, made forty percent of all of the mortgages outstanding when the FHLBank system was first instituted. The decision to categorically exclude one of the biggest sources of housing finance is another reflection of the ways membership policy reflected Congress's efforts to use the FHLBanks to make choices about who *should* be mortgage lenders, rather than a reflection of from where money was currently flowing.

Commercial banks were also denied any ability to join the FHLBank system. One reason is the relatively modest role they played in housing finance. At the time, commercial banks generally focused on serving the needs of businesses instead. This is reflected in the fact that most commercial banks faced significant constraints on their ability to make home loans. It was not until 1983 that the rules limiting the ability of national banks to make home loans were relaxed completely.[36] Yet even state banks that enjoyed more flexibility to make home loans and may well have opted to increase that business if given access to the FHLBank system were denied membership. Among the bank-like organizations, the FHLBanks were for thrifts, not banks.

Alongside these categorical eligibility requirements, the Federal Home Loan Act provided additional checks on who could become FHLBank members. In order to mitigate risk, for example, the FHLBank

34. Price & Walter, *supra* note 20, at 325-28.
35. Haveman & Rao, *supra* note 26, at 1608 tbl.1.
36. LEVITIN & WACHTER, *supra* note 9.

Board was to deny membership to any financial institution if its financial condition was in peril, and good standing with a primary regulator was often required when an institution first became a FHLBank member.[37] Similarly, to ensure that advances were being used to promote the public interest, the FHLBank Board was to deny membership to any institution if "the character of its management" or its home-financing policies were inconsistent with making mortgages on sound terms that benefitted borrowers or were otherwise inconsistent with the purposes of the Act.[38] And, separately, membership was to be denied or revoked if an institution imposed a rate of interest, including all possible fees, that exceeded the relevant statutory cap or, in the absence of such a cap, eight percent.[39] Access to the FHLBanks was meant to be a carrot that encouraged thrifts to make home loans that also served the borrowers to whom they were made.

Institutions that met these layered criteria had the option, but no obligation, to join their regional FHLBank. To do so, they had to buy "stock" in the FHLBank, typically with the amount established based on the volume of home loans the institution held. To this day, the regional FHLBanks remain structured as cooperatives, although the types of stock they issue and how much members can and must acquire have changed over time. Most, though not all, FHLBank services are available exclusively to members. If a financial institution no longer wants to remain a member, it must sell its stock to a fellow FHLBank member or to the issuing FHLBank. FHLBank shares and the attendant rights cannot otherwise be transferred.

In exchange for becoming FHLBank members, financial institutions receive benefits, which have grown in variety and value over time. The primary benefit enjoyed by FHLBank members is access to additional liquidity and funding, and the primary way this is achieved is via secured loans, known as advances. Home loans, which otherwise were quite illiquid at the time, were the main form of collateral that FHLBank members could post to secure an advance.

From the beginning there was a modest tension in aim to promote residential lending that was not otherwise occurring—a move that inherently entailed taking some risk and encouraging members to do the same—and promoting the health of FHLBanks. Alongside membership, defining the eligible collateral and the amount that a FHLBank could advance to a member depending on the type of collateral posted was a key policy tool for balancing these aims.

37. Federal Home Loan Bank Act, ch. 522, § 4(a), 47 Stat. 725, 726 (1932) (current version at 12 U.S.C. § 1424(a) (2018)).

38. *Id.*

39. *Id.* at 727 (repealed 1989).

Initially, the FHLBanks could loan up to fifty percent of the face value of qualifying mortgages.[40] Qualifying mortgages had to be first-lien loans, secured by a home with a value of $20,000 or less, and had to be "long-term loans" in the view of the FHLBank Board (but could not have terms beyond fifteen years).[41] Mortgages with longer durations entailed greater risk, but also better met the needs of ordinary Americans. Although these durations may seem short by today's standards, they helped change thrifts' incentives and capacity to make slightly longer-term home loans. Similarly, the cap on the value of the home securing the mortgage ensured that the loans were going to borrowers buying modestly priced homes, not the wealthy.

Further reflecting the way advances were used to promote the provision of credit on terms favorable to borrowers, FHLBanks were authorized to extend advances of up to sixty percent of the amount of unpaid principle for amortizing loans with a duration of at least eight years.[42] Amortization helps borrowers build wealth and reduces the riskiness of a loan to the borrower. By agreeing to lend more to members who were posting amortizing, longer-term loans as collateral, the FHLBanks were using collateral terms to shape the types of mortgages available to better serve the needs of ordinary Americans.

The FHLBank membership and the thrift-mortgage nexus were strengthened by further congressional acts in the years that followed. In 1933, Congress passed the Home Owners' Loan Act (HOLA), authorizing the creation of federal thrifts.[43] To ensure that the new federal thrifts remained focused on serving local communities and functioned as community-based institutions, federally chartered thrifts could make loans only to borrowers within a 50-mile radius and federal thrifts were also required to have a mutual ownership structure akin to early state thrifts.[44] Just as national banks must be members of the Fed (whereas membership remains optional for state banks), national thrifts were required to join their regional FHLBank. Federally chartered thrifts were overseen by the FHLBank Board, which delegated much of that oversight authority to the regional FHLBanks, in a manner akin to the way the regional Federal Reserve Banks did—and often continue to—supervise Fed member banks in their districts. And in 1934, Congress passed the National Housing Act, which created the Federal Savings and Loan Insurance Corporation (FSLIC), also overseen by the FHLBank Board as a parallel to the FDIC but focused exclusively on insuring deposit-like liabilities of state and

40. *Id.* at 732 (1932) (current version at 12 U.S.C. § 1430(a)(2) (2018)).

41. *Id.* at 732 (1932) (current version at 12 U.S.C. § 1430(b) (2018)).

42. *Id.* at ch. 522, § 10(a)(1), 47 Stat. 725, 731-32 (1932) (current version at 12 U.S.C. § 1430(a)(1) (2018)).

43. Home Owners' Loan Act, 12 U.S.C. §§ 1461-70 (2018).

44. Fred E. Case, *Deregulation: Invitation to Disaster in the S&L Industry*, 59 FORDHAM L. REV. S93 (1991).

federal thrifts.[45] Other, more extensive government innovations to try to support housing finance soon followed, and continued to grow in scope in the subsequent decades.[46]

B. Early Success of the FHLBanks

Focusing in on the nature of the FHLBank system and the environment in which it originated provides helpful insight into the policies it sought to further and how it operated to achieve those ends. As a starting point, when the FHLBanks were created, thrifts were meaningfully different than banks. They made different types of loans—primarily mortgages—and lacked access to any other source of government-backed liquidity. In this environment, access to advances served multiple, important aims.

First, it had the potential to stabilize thrifts, individually and collectively. Thrifts did not issue demand deposits as commercial banks did, but as they evolved to allow members to come and go, they had been forced to devise ways to allow people to get their money out of a thrift. It was common for a thrift to allow members to demand their money back with thirty to sixty-days' notice. At the same time, the assets that thrifts were holding, namely mortgages, were increasing in duration, from five to often eight or more (and soon, many more years). The overall structure of thrifts was thus much like that of banks. Thus, like banks, thrifts engaged in meaningful liquidity and maturity transformation. This made them socially useful and it also worked most of the time, as deposits and deposit-like claims are often very stable sources of funding. But it also rendered them vulnerable to runs, as reflected in the "run" on the S&L run by Jimmy Stewart's character in *It's a Wonderful Life*.[47] By providing members a way to access fresh liquidity without selling off assets, FHLBanks could help deter such runs and limit the need for thrifts to resort to value-destroying "fire sales" of the mortgages they held.

That thrifts benefitted from having ready access to liquidity during periods of distress is not just hypothetical. In a 1952 report celebrating the first twenty years of the FHLBank system, the FHLBank Board emphasized that access to fresh liquidity from the FHLBank system was particularly valuable to thrifts when shocks caused rapid increases in withdrawals—as happened in the 1930s, after the bombing of Pearl Harbor and again during the early phases of the Korean War.[48] So long as thrifts were denied access to the Fed's discount window, it was critical that they had their own lender of last resort.

45. National Housing Act, 12 U.S.C. §§ 1701-50 (2018).
46. *See infra* Section II.A & II.B.
47. *See* IT'S A WONDERFUL LIFE (Paramount Pictures 1946).
48. FED. HOME LOAN BANKS, *supra* note 23, at 26, 61-63.

Yet in contrast to loans from the Fed's discount window, FHLBank advances were not just a last resort. They could have far longer durations and were extended on terms designed to make them attractive to thrifts as a stable source of financing. Although thrifts often increased their borrowing in response to shocks, they also used the FHLBank advances as a way to diversify their funding, enhancing resilience and stability. This was important because in an environment where liquidity and capital were constrained, providing additional financing to thrifts was an effective way to get more of the type of loans they produced: mortgages. And this environment also made it possible to use collateral policy to shape the types of mortgages they issued in ways that made them more borrower-friendly. In short, given the many frictions and constraints in financial markets at that time, greasing the wheels on the financing of certain types of loans could help satiate significant and unmet demand, enabling real impacts on people's lives and the health of the broader economy.

These features were interconnected and fed a virtuous cycle that helped thrifts to grow and lend. The 1952 report from the FHLBank Board emphasized how in helping members meet withdrawal demands, the FHLBanks also helped inspire public confidence in thrifts. This in turn increased the willingness of savers to put their money into a thrift, allowing the thrifts to grow and make even more home loans. Over time, the connection evolved, as having ready access to liquidity when needed also allowed thrifts to hold less cash and engage in more lending.

The 1952 report further highlights the importance of the way the FHLBank system enabled thrifts to access "the capital markets for supplementary funds."[49] Today, securitization provides a ready mechanism for money to flow from all sorts of nonbank lenders into housing finance via the capital markets, but securitization was far less common at the time. And thrifts were so small, they had no other way of accessing market-based financing. The FHLBanks filled this gap—tapping the capital markets to increase the funds available for home loans.

The primary way FHLBanks funded their loans and other activities was through the issuance of debt, commonly referred to as consolidated obligations because the FHLBanks were (and remain) jointly and severally liable for payment of this debt. Although this alone would have allowed the FHLBanks to access capital markets and raise funds on more favorable terms than available to individual thrifts, the consolidated obligations were particularly attractive to investors because the FHLBanks' status as a government-sponsored enterprise (GSE) created a widespread (and persistent) assumption that the government would backstop the debt if for any reason the FHLBanks could not repay it in full. The FHLBanks have never had to rely on this government backstop, but it became explicit for other housing GSEs, Fannie Mae and Freddie Mac, when the federal

49. *Id.* at 24.

government put them into a conservatorship and ensured all outstanding debts were fully covered back in 2008.[50]

Alongside increasing the amount of capital flowing to housing finance, the FHLBanks also played a valuable role helping to redistribute liquidity within the housing finance ecosystem. In addition to lending funds to members via advances, FHLBanks also accepted deposits from member institutions that had more liquidity than they could immediately put to good use—a real challenge at times given that thrifts could only make limited types of loans and in limited geographic areas. This liquidity could then be redistributed to other members of that FHLBank or could be redistributed to other parts of the country via a deposit in a sister FHLBank. As the 1952 report explains: "Through the device of inter-bank deposits a geographical equalizing of supply and demand of funds is possible over wide areas."[51]

In a world still awash in information asymmetries and other frictions, the FHLBanks could achieve more expansive and less expensive liquidity redistribution than possible via interthrift lending, with the attendant benefits of providing both savers and borrowers access to the distinct services they needed, even when there was a mismatch in the demand for these services in a geographic area. This is another way that the FHLBanks were well designed to cater to the distinct needs of small and community-oriented financial institutions.

There was some learning that occurred over time, and the original design of the FHLBank system was far from perfect. For example, the initial FHLBank Act authorized FHLBanks to make home loans directly should a potential borrower be unable to obtain credit elsewhere. The restrictions on such lending meant that it wasn't used and the authority was phased out. Similarly, policy makers realized that to encourage lending to more marginal borrowers, further government support was needed—which soon came through the creation of additional, distinct government programs. And changes in housing finance allowed for an evolution in collateral and other policies. In both 1935 and 1950, the statutory scheme was amended to accommodate learning and evolution, while still honoring the original design.

Overall, the FHLBank system worked as intended. It helped serve as a backbone of a system of housing finance that was both very much local—constituted of small organizations that focused on extending credit and facilitating savings for the individuals and families in the communities where they were based—and national—supported by a network of FHLBanks that could readily raise funds from capital markets, redistribute liquidity across the system and enhance the resilience of the entire ecosystem by

50. *See infra* Section II.C (describing the way this backstop shapes the rating and pricing of FHLBank debt).

51. FED. HOME LOAN BANKS, *supra* note 23, at 24.

providing extra liquidity during periods of stress and promoting public confidence in the soundness of thrifts.

The FHLBanks continued to operate in accord with its original design through the mid-1960s. According to the 1963 Annual Report from the FHLBank Board: "The members of the [FHL]Bank System are predominantly locally owned and managed mutual institutions, serving the thrift and home-financing needs of the communities in which they are based."[52] The average FHLBank member in 1963 had assets of just $22 million, that's less than $220 million today after adjusting for inflation.[53] These were *small* financial institutions. Moreover, virtually all of the members were thrifts that focused on housing—4,960 of the 5,001 FHLBank members at the end of 1963 were S&Ls. And, the great majority of FHLBanks were structured as mutuals, accountable to their members (as opposed to stock corporations, which were accountable to shareholders).[54] The remaining FHLBank members were all savings associations; there were no insurance company members despite their earlier and subsequent membership in the FHLBank system. Collateralized lending continued to constitute the primary activity of the FHLBanks and that collateral continued to consist primarily of residential mortgages, with modest amounts of Treasuries and agency MBS also used as collateral.[55]

Yet, the market structure and other dynamics that allowed the FHLBanks to serve as an important backbone supporting small financial institutions and a particular type of credit were on the verge of change. For one thing, thrifts were growing in importance relative to both savings banks and commercial banks. In 1955, S&Ls held 9% of the total assets in the financial system—modestly more than the 7% they held in 1933. By 1965, that figure reached 14%, and it kept growing from there, even as the overall financial sector was also growing as a result of the increasing role of pension funds, mutual funds and other nonbank financial companies.[56]

In sum, the FHLBank system worked well and in accordance with its original design for more than three decades after its founding. Yet its ability to function in accord with design was contingent on the environment in which it was operating. As the next section makes clear, for a whole host of reasons, those conditions are no longer present and cannot be readily recreated—at least with respect to housing.

52. FED. HOME LOAN BANK BD., REPORT OF THE FEDERAL HOME LOAN BANK BOARD FOR THE YEAR ENDED 1963, at 10 (1963).

53. US INFLATION CALCULATOR, https://www.usinflationcalculator.com (last visited Aug. 17, 2023).

54. FED. HOME LOAN BANK BD., *supra* note 52, at 11.

55. *Id.* at 14.

56. JAMES R. BARTH, THE GREAT SAVINGS AND LOAN DEBACLE 18 tbl.2-1 (1991).

II. The Unmooring of the FHLBank System

Having built up how the FHLBank system functioned, and why it was so useful, during the early decades of its operations, this Part shows how much has changed over the last fifty years. In general, credit constraints have eased relative to a century ago, but there are also more specific developments at play. This Part addresses (1) a proliferation of other government programs to support housing finance, reducing the marginal additional gains that the FHLBanks can confer; (2) further changes in housing finance that create a mismatch between the entities that actually originate and hold mortgages and FHLBanks' current membership; and (3) changes in the FHLBank system largely driven by congressional efforts to exploit its off-balance-sheet status. Exploring each in turn, and the overlaps among them, helps explain how and why the FHLBanks have become so unmoored from their original purpose, setting the stage for them to evolve in ways that disproportionately benefit members and introduce troubling distortions in the banking system.

A. The Government's Role in Housing Finance

The advent of the FHLBank system was significant because it marked the first time the federal government recognized it could and should play a meaningful role helping to facilitate the issuance of home loans in order to expand access to home ownership. Yet the creation of the FHLBank system was a modest step relative to what followed. First, immediately following the creation of the FHLBank system, Congress took a number of steps to address the acute challenges posed by the Depression. Alongside authorizing the creation of federal thrifts and creating an insurance fund for thrifts, Congress authorized the FHLBank Board to create a new Home Owners' Loan Corporation (HOLC) which could refinance troubled mortgages—forcing a haircut and then restructuring the loans into fifteen-year, amortizing loans. In time, the government came to appreciate the benefits of guaranteeing the principal on HOLC securities, allowing them to trade at par, and creating a model whereby the government could standardize the terms of mortgages in ways that benefited borrowers and promoted the creation of a secondary market for mortgage debt—so long as the government absorbed some or all of the credit risk. To stimulate the issuance of new mortgages and new construction, the 1934 National Housing Act created the Federal Housing Agency, which among other things could provide partial insurance of mortgages meeting certain characteristics, including a low, fixed rate of interest and a fully amortizing structure.[57]

The ways that providing a limited government backstop could facilitate the issuance of mortgages and other lessons from these interventions

57. LEVITIN & WACHTER, *supra* note 9, at 45-50.

helped to spur and inform the creation of the Federal National Mortgage Association in 1938. From its inception, and increasingly over time, the Federal National Mortgage Association—which has since split into Fannie Mae and Ginnie Mae—transformed the mortgage market. Fannie Mae has and continues to play a central role guaranteeing mortgage credit risk and creating a secondary market for conventional home loans. Ginnie Mae plays a similar function for mortgages insured by the FHA, the Veteran's Administration or certain other public programs. They were joined in 1970 by the Federal Home Loan Mortgage Corporation, now Freddie Mac, which was created at the same time Congress authorized Fannie Mae to expand its business to non-government loans.

The evolution of Fannie Mae and the creation of Freddie Mac were meant to aid the housing market and housing finance at a time when the private market for mortgages was contracting as a significant rise in interest rates reduced the value of the long-term, fixed interest loans held by S&Ls, rendering many functionally insolvent.[58] At the time, both were needed as Fannie Mae initially focused on securitizing mortgages issued by banks whereas Freddie Mac was specifically designed to create a secondary market for mortgages originated by thrifts, reflecting how distinct these two ecosystems remained at the time.[59]

The impact of Fannie Mae, Freddie Mac and Ginnie Mae on housing finance is hard to overstate. For each of the preceding three years (2020-22), well over seventy percent of all new home loans that were originated end up in a securitization vehicle sponsored by Fannie, Freddie or Ginnie, commonly known as agency MBS. By the end of 2022, agency MBS accounted for two thirds of the total mortgage debt outstanding.[60]

In order for a mortgage to qualify for inclusion in one of those securitization structures, it must satisfy a range of criteria, including requirements relating to the value of the home securing the mortgage, the loan-to-value ratio, the income and employment status of the borrower, term, amortization structure and other features. Although these criteria vary depending on the program, the ubiquity of these standards means banks often now use them even when they are issuing a mortgage that they intend to hold in their own portfolio. Hence, it is now these other government and government sponsored entities (Fannie, Freddie and Ginnie), not the FHLBanks, that are shaping mortgage credit terms and availability.These

58. *Id.* at 72-76.

59. *Id.* at 72.

60. Laurie Goodman, Janneke Ratcliffe, Michael Neal, Jung Hyun Choi, Linna Zhu, John Walsh, Daniel Pang, Amalie Zinn, Katie Visalli, Aniket Mehrotra, Matthew Pruitt, Alison Rincon, DeQuendre Neeley-Bertrand, Todd Hill & Anna Barcus, *Housing Finance: At a Glance Monthly Chartbook, July 2023*, at 6, URB. INST. HOUS. FIN. POL'Y CTR. (2023), https://www.urban.org/sites/default/files/2023-10/Housing_Finance_At_A_Glance_Monthly_Chartbook_July_2023.pdf [https://perma.cc/72MC-LKSQ].

entities also play a more direct and far greater role than the FHLBanks do in facilitating the flow of funds from the capital markets to housing finance.

As a result of these developments and further reforms, the types of mortgages available and the overall level of mortgage availability look starkly different today than they did in 1932. The median American family now has ready access to a thirty-year, amortizing mortgage. This both makes it far easier for the typical American family with limited wealth to acquire a home and it allows a family to use that acquisition and associated mortgage as a structured savings vehicle. This is why Adam Levitin and Susan Wachter make the thirty-year, amortizing mortgage the "hero" of their historical account of the evolution of housing finance in the United States.[61]

This does not mean that today's housing market is without challenges. Just the opposite—affordable housing is a pressing concern and racial inequities in housing wealth continue to be a significant contributor to the racial wealth gap. (Historically, many of the federal programs, including features of the FHLBanks, contributed to racial disparities.) However, access to financing on reasonable terms—relative to income, home value and prevailing interest rates—is no longer the primary obstacle standing in the way of a typical middle-class family and the dream of home ownership. Instead, the primary obstacles today are limited supply, high prices and a higher interest environment.[62] Analyses by the Urban Institute show that the number and proportion of affordable homes available for sale has been declining steadily since 2015.[63] In Spring 2023, households earning a median income could afford only one-fifth of all of the homes for sale.[64]

The FHLBank system does play a role in addressing this affordable housing challenge, primarily by fulfilling a requirement that at least ten

61. *See generally* LEVITIN & WACHTER, *supra* note 9.

62. Jung Hyun Choi & Amalie Zinn, *Eighty Percent of Homes on the Market Aren't Affordable for Households Earning Median Income or Less*, URB. INST. (Dec. 7, 2022), https://www.urban.org/urban-wire/eighty-percent-homes-market-arent-affordable-households-earning-median-incomes-or-less [https://perma.cc/T8QG-N3VU].As discussed further below, there is one single-authored, unpublished paper suggesting that even against this backdrop, access to a FHLBank continues to contribute to somewhat lower mortgage rates and increased mortgage availability, but the magnitude is far smaller in today's environment, the mechanism far less direct and there are alternative possible explanations for the finding. *See* Dayin Zhang, Government-Sponsored Wholesale Funding and the Industrial Organization of Bank Lending (Oct. 2, 2020) (unpublished manuscript), https://drive.google.com/file/d/17Q68-6IrnFYM108TsnLkoaedncIT_9_G/view [https://perma.cc/B2F8-U5PK].

63. Choi & Zinn, *supra* note 62; *see also* Jared Bernstein, Jeffery Zhang, Ryan Cummings & Matthew Maury, *Alleviating Supply Constraints in the Housing Market*, WHITE HOUSE COUNCIL OF ECON. ADVISORS: BLOG (Sept. 1, 2021), https://www.whitehouse.gov/cea/written-materials/2021/09/01/alleviating-supply-constraints-in-the-housing-market [https://perma.cc/2QG5-AEY4] (describing the "perennial problem" of "underlying supply constraints in the housing market" and "outlin[ing] the [Biden] Administration's . . . proposals . . . to address the supply shortage and reduce price pressures in the housing market").

64. Choi & Zinn, *supra* note 62.

percent of the net earnings go to affordable housing programs.[65] Nonetheless, this is merely one manifestation of the challenge, examined further below, of Congress using the FHLBanks as a source of revenue that doesn't actually show up in the federal budget, rather than utilizing the unique design of the FHLBank system to promote policy goals.[66] Moreover, the impact of these contributions once again pales in comparison to the role of the other GSEs. As housing expert Michael Stegman has pointed out, "since the AHP's inception in 1990, the FHLBanks have funded far fewer low-income homes and apartments than Fannie Mae and Freddie Mac funded in 2021 alone."[67] The FHLBanks do, at times, play a meaningful role helping smaller financial institutions create mortgages that can qualify for these other government programs, and any additional money for affordable housing is helpful given the magnitude of the challenge. And there are still domains in housing finance that remain plagued by meaningful frictions. For example, the types of innovative housing needed to address today's supply and affordability challenges can remain difficult to finance, but the FHLBanks do little to focus their energies on these domains.

Looking at the bigger picture, the advent of myriad, more direct and expansive government programs designed to shape the terms and availability of mortgages massively reduce the marginal impact that the FHLBanks can have in shaping housing finance. And the distinct design of the FHLBank system—that seeks to use collateralized loans to encourage particular types of lending and to support the viability of small institutions—is ill suited to address many of today's housing challenges.

B. Housing Finance

The creation of Fannie Mae, Ginnie Mae, the FHA and other government programs didn't just diminish the relative role of the FHLBanks in housing finance, they also paved the way for shifts in the types of financial institutions suited to originate and hold mortgages. More generally, the mix of financial institutions engaged in these activities has been transformed over the last fifty years.

For one thing, today's thrifts engage in lending and activities far beyond home loans and they also play a much smaller role in the origination of home loans. Each of these trends took hold over time. Deregulation started modestly, for example, with shifts such as allowing thrifts to issue

65. 12 U.S.C. § 1430(j) (2018); *see infra* Section II.C (describing the addition of this requirement).

66. *See infra* Section II.C.

67. Michael Stegman, *How the FHFA Can Increase Federal Home Loan Bank Affordable Housing Investments* 2, URB. INST. (Mar. 2023), https://www.urban.org/sites/default/files/2023-03/How%20the%20FHFA%20Can%20Increase%20Federal%20Home%20Loan%20Bank%20Affordable%20Housing%20Investments.pdf [https://perma.cc/NS8W-G8MH].

mortgagees further afield from their headquarters.[68] But it was the inflation shock of the 1970s, coupled with a shifting approach to regulation generally (toward a greater reliance on market-based mechanisms), that brought about the lasting transformations.

When inflation and interest rates spiked, thrifts were particularly hard hit. Mortgages tend to have longer durations than other types of loans, and longer duration credit instruments go down in value more as interest rates go up. As a result, even many thrifts that had made loans only to creditworthy borrowers wound up balance sheet insolvent (that is, the actual, market-based value of their assets did not exceed their liabilities). Higher interest rates also made it harder for banks and thrifts to retain deposits. At the time, banks and thrifts faced strict limits on the interest they could pay on deposits—with the cap for some types of deposits set at zero. As a result, as interest rates went up, depositors increasingly withdrew their money and moved it into alternative types of accounts on which they could earn interest. Congress responded to these developments not by closing the weak thrifts, but by trying to help thrifts (and, to a lesser extent, banks) earn their way back to health.

First, Congress adopted the Depository Institutions Deregulation and Monetary Control Act of 1980, giving banks and thrifts far more freedom to offer higher rates of interest on deposits, allowing thrifts to offer demand deposits just like banks, giving thrifts and banks that were not members of the Federal Reserve direct access to the Federal Reserve's discount window, and more than doubling the deposit insurance cap.[69] When that wasn't sufficient to resolve the problem of unhealthy thrifts, Congress went even further. In 1982, lawmakers passed the Garn–St. Germain Depository Institutions Act, phasing out all interest rate caps, expanding the authority of thrifts to invest in commercial loans and other assets and relaxing an array of rules around real estate lending.

There was some principled basis for making these changes. Many of the reforms followed recommendations that had come from the Hunt Commission, named after its chairman Reed Oliver Hunt, CEO of a paper and pulp company. President Nixon had created the commission in 1970 to explore how banks and thrifts could remain competitive in a changing financial landscape.[70] Yet the massive decline in the health of thrifts between the issuance of the report and Congress's adoption of the reforms set the

68. Barth, *supra* note 56, at 21.

69. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C.).

70. Roland I. Robinson, *The Hunt Commission Report: A Search for Politically Feasible Solutions to the Problems of Financial Structure*, 27 J. of Fin. 765 (1972); Paul S. Anderson & Robert W. Eisenmenger, *Impact of the Proposed New Financial Structure on Mortgage Markets*, *in* POLICIES FOR A MORE COMPETITIVE FINANCIAL SYSTEM: A REVIEW OF THE REPORT OF THE PRESIDENT'S COMMISSION ON FINANCIAL STRUCTURE AND REGULATION 149 (1972).

stage for disaster, allowing weaknesses in the S&L sector to grow and spread. The ramifications were many.

Of particular relevance here is the way deregulation mitigated the differences between banks and thrifts. Banks could and increasingly did start to extend and hold home loans; and thrifts expanded their operations beyond housing finance. Between 1978 and 1986, mortgages plummeted from being more than 85% of S&Ls' assets to just over 50% of their assets.[71] Many S&Ls also converted from mutual ownership structures to being controlled by stockholders, reflecting and facilitating a shift away from serving members and their communities toward generating profits. By 1986, stock-controlled S&Ls controlled 64% of the industry's assets.[72] Meanwhile, the ability of both thrifts and banks to use demand deposits to fund their activities and to offer an array of insured deposit products, further undermined the distinctness of thrifts in serving the masses. And a separate justification for thrifts to have access to FHLBank advances—that they lacked access to the Fed's discount window—also disappeared, as thrifts and commercial banks had equivalent statutory access to Fed liquidity by 1980.

As discussed further below, for reasons that were far from principled, Congress responded by allowing all commercial banks to become members of the FHLBanks, initially with a requirement that—at the time they first become members—at least ten percent of their assets be mortgages. Once a bank—or thrift or insurance company—becomes a member, there was not then nor has there ever been any ongoing requirement or check on how much of their business continues to be home loans. As a result, even as industries, such as insurance, have evolved to play an ever-smaller role in housing finance, they continue to enjoy FHLBank membership.

Subsequent developments further blurred the line between thrifts and banks. In cleaning up the S&L crisis, Congress eliminated the separate insurance fund for thrifts, meaning that they are now insured by the FDIC alongside banks. The deregulation was so great that by the early 2000s, many banking organizations could legally operate as either a bank or a thrift, potentially contributing to a competition for laxity among federal banking regulators and the weak oversight the preceded the 2008 financial crisis.[73] Congress put an end to much of this gamesmanship in the Dodd-Frank Act by requiring that federal thrifts to be regulated and supervised by the OCC—like banks—and requiring thrift holding companies to be

71. Alane Moysich, *The Savings and Loan Crisis and Its Relationship to Banking*, FED. DEPOSIT INS. CORP., *in* 1 HISTORY OF THE EIGHTIES – LESSONS FOR THE FUTURE: AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S, at 167, 179 fig.4.1 (1997), https://www.fdic.gov/bank/historical/history/167_188.pdf [https://perma.cc/9BEM-QWGS].

72. *Id.* at 179.

73. KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 9 (2011).

overseen by the Fed—like bank holding companies.[74] As a result, what had been two genuinely distinct systems of financial intermediation, serving different types of clients and providing different types of credit, are today functionally one system.

Thrifts continue to play a somewhat greater role in providing home financing, but they are declining in relative importance as FHLBank members. As of the end of 2022, just 8.7% of all FHLBank members were thrifts. More than 57% of current FHLBank members are commercial banks, and credit unions—an increasingly amorphous type of bank equivalent—constitute over 24%.[75]

Accentuating the mismatch between the FHLBank system and housing finance is the shift of mortgage origination to companies that are neither banks or thrifts. Nonbank finance company now originate the majority of all new mortgages.[76] Moreover, most of these companies are large, national entities that bear little resemblance to the community-oriented thrifts of yesteryear.

According to a Bankrate analysis of the most prolific mortgage originators in 2022, four out of the top five were nonbank originators. The top two—Rocket Mortgage (formerly Quicken Loans) and United Shore Financial (now United Wholesale Mortgage)—dominated the landscape, issuing nearly 813,000 mortgages with an aggregate value of $255 billion between them.[77] That's less than Rocket alone in the boom year of 2021—when Rocket originated 1.2 million loans worth $340 billion—but it's far more than the only bank in the top five—Wells Fargo, which issued 143,000 loans worth $79 billion in 2022. And Wells Fargo subsequently announced that it intends to roll back even further on its mortgage business.

Moreover, banks are often less willing than nonbanks to make loans to less creditworthy borrowers. Data compiled by the Urban Institute shows that of all of the loans packaged into agency MBS, the median borrower FICO score for loans originated by banks was 27 points higher (at 760) than the median borrower FICO score for loans originated by nonbanks (733).[78] Because these nonbanks lack depositors and are reliant on

74. Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 5, 7, 12, 15, 22, 26, 28, 31, and 42 U.S.C. (2018)).

75. Off. of the Inspector Gen., *An Overview of the Federal Home Loan Bank System*, FED. HOUS. FIN. AGENCY (Mar. 31, 2023), https://www.fhfaoig.gov/sites/default/files/WPR-2023-002.pdf [https://perma.cc/FM4R-34XN].

76. JIM PARROTT & MARK ZANDI, IN DEFENSE OF THE FEDERAL HOME LOAN BANKS 8 ch.6, URB. INST. (Apr. 2023), https://www.urban.org/sites/default/files/2023-04/In%20Defense%20of%20the%20Federal%20Home%20Loan%20Banks_0.pdf [https://perma.cc/P346-KH9T].

77. Jeff Ostrowski, *The 10 Largest Mortgage Lenders in the U.S.*, BANKRATE (Apr. 3, 2023), https://www.bankrate.com/mortgages/largest-mortgage-lenders [https://perma.cc/B6P2-EGBT].

78. Laurie Goodman, Janneke Ratcliffe, Michael Neal, Jung Hyun Choi, Linna Zhu, John Walsh, Caitlin Young, Daniel Pang, Amalie Zinn, Katie Visalli, Aniket Mehrotra, Matthew

market-based sources of funding, they are probably more fragile and more in need of an outside source of liquidity should distress set in than either banks or thrifts. Nonetheless, these nonbanks are not eligible to join the FHLBank system. As a result, the originators of the majority of new home loans, which also play an outsized role in making loans to less creditworthy borrowers, operate completely outside the FHLBank system.

Not only have origination practices changed in ways that strain the rationales undergirding FHLBank membership policies, but so have patterns of who actually holds mortgage debt. As a preliminary matter, that the majority of mortgages end up packaged into an agency MBS has transformed the landscape, making it far, far easier for a wide array of institutions—including the Fed—to hold and trade large amounts of mortgage debt, while assuming relatively little credit risk. Today, insurance companies, which continue to enjoy FHLBank membership, play a far smaller role holding mortgage-related debt than other financial institutions, such as mortgage REITs (real estate investment trusts), which hold a lot of mortgage-backed debt and remain unable to become FHLBank members. Nonetheless, insurance companies remain active FHLBank members while REITs cannot join.

Alongside changes in FHLBank membership, changes in collateral policy—and the proliferation of securities backed by mortgages—further weakened the relationship between the FHLBank design and its ability to promote housing policy. Today, the instruments that the FHLBanks can accept as collateral include not only residential first-lien mortgages, but also some second-lien mortgages, first- and second-lien commercial real estate loans, land loans, agency MBS, nonagency MBS, private-label commercial MBS and, from some members: small business loans/securities, small farm loans/securities, small agribusiness loans/securities and community development loans/securities.[79] At the end of 2022, commercial real estate loans constituted more than a fifth of all eligible collateral at play in the FHLBank system even though promoting commercial real estate has never been a stated aim of the FHLBank system.

In short, even those who defend the FHLBank system have acknowledged the significant mismatch between housing finance as it operates in the United States today and FHLBank membership and collateral

Pruitt, Alison Rincon, DeQuendre Neeley-Bertrand, Todd Hill & Anna Barcus, *Housing Finance: At a Glance Monthly Chartbook, June 2023*, at 17, URB. INST. HOUS. FIN. POL'Y CTR. (2023), https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-june-2023 [https://perma.cc/X767-T6Q2]. Much of this difference was driven by the fact that nonbanks are much more inclined than banks to issue loans suited for Ginnie Mae, which tends to service the least creditworthy borrowers. *Id*.

79. DIV. OF BANK REGUL., FED. HOUS. FIN. AGENCY, REPORT ON COLLATERAL PLEDGED TO FEDERAL HOME LOAN BANKS (Dec. 15, 2022), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2022-Annual-Collateral-Report-to-Congress.pdf [https://perma.cc/6YK5-2AR7].

policies.[80] The differences between banks and thrifts that had animated the creation of the FHLBank system have faded to the point of irrelevance. The transformation of so many mortgages into agency MBS not only shows how much the government is otherwise doing to support housing finance, but also ensures a steady flow of capital to housing finance without any help from the FHLBank system. That thrifts now have ready access to the Fed should they need a lender-of-last resort obviates acute liquidity constraints as a rationale for the FHLBank system. That so many entities outside the FHLBank system are so central to housing finance today is a sign of how robust housing finance can be even without any support from the FHLBank system, casting further doubt on the utility of this system in promoting housing finance.

C. The Off-Balance-Sheet Temptation

The proliferation of other government programs to support housing finance and the evolution of housing finance in ways that further reduce the capacity of the FHLBank system to promote housing finance in the manner it was designed to do raises the question of why the FHLBanks still exist. There is no single answer to this quandary, but much of the answer lies in the way the FHLBanks operate largely outside the federal budget, allowing them to generate seemingly free revenue that Congress can then put to useful purposes. This was a feature that Congress found particularly useful when it finally got serious about addressing the S&L crisis.

Recall, Congress and regulators initially took the approach of deny and delay in responding to the way a rapid rise in interest rates had left many S&Ls and other thrifts underwater. The deregulation that ensued proved counterproductive. For example, more than doubling deposit insurance limit (from $40,000 per holder and account type to $100,000), removing the cap on the interest that could be paid on insured deposits and allowing thrifts to issue more types of deposits did make it easier for thrifts (and banks) to retain deposits. But those deposits now came at a very high cost, reducing profitability.

The bigger challenge was that insolvent thrifts now had both the incentive and capacity to take outsized risks in hopes that they might gamble their way back to health—as insured depositors could enjoy a very high rate of return, providing fresh liquidity to a weak thrift without any concern that they might lose money as a result. The size of risks that thrifts could take was further accentuated by Congress's decision to relax the rules regarding the assets thrifts could hold and the activities in which they could engage. The combination of reforms, in short, allowed thrifts to grow rapidly, often by offering exceptionally high rates on insured deposits, and

80. PARROTT & ZANDI, *supra* note 76.

then use that fresh liquidly to make big investments in commercial real estate and other risky ventures that would pay off—or not—in a big way.

As usually happens when weak financial institutions try to gamble their way back to health, most of the troubled thrifts ended up just digging bigger holes, as liabilities increased in magnitude at a faster rate than assets. The FHLBank Board had neither the will nor the funds to clean up the mess. By the late 1980s, FSLIC, the separate insurance fund for thrifts simply didn't have enough money to actually resolve all of the failed thrifts still in operation.

This put the government in a difficult position. Weak thrifts were hurting banks and the economy generally, and needed to be closed. But closing those thrifts in an orderly fashion and paying off all insured depositors was going to be costly for the government. And Congress had committed itself to a series of deficit reduction targets a few years earlier, creating little wiggle room in the budget for unplanned expenditures—no matter how necessary or long-term beneficial.[81]

Rather than be honest about missing its target or make painful cuts elsewhere, Congress came up with an ingenious "solution." The rules governing Congress's budget, like accounting rules generally, are far from perfect. They aspire to capture economic reality, but they also entail assumptions and judgement calls that enable gamesmanship around the margins.[82] A classic accounting game, used by private industry and governments alike, is to find ways to undertake activities that generate money or other benefits "off-balance sheet."[83] This is often accomplished by a slight of hand wherein a supposedly remote entity engages in an activity that inures to the benefit of the government or company, and often is able to do so by issuing debt implicitly backstopped by the unofficial parent organization.

Leading up to the 2008 financial crisis, for example, many banks created sheet special purpose vehicles (SPVs) that issued sought-after short-term debt and other claims backed by asset-backed securities.[84] Because the amount of interest paid on the debt, short-term and otherwise, was less than the interest generated by the asset-backed securities held as assets, these entities generated profits for the sponsoring bank. At the same time, because the sponsoring bank had no legal obligation to the creditors of the

81. The Balanced Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 99-177, 99 Stat. 1037; *see also* Kenneth Ryder, *A Guide to FIRREA's Off-Budget Financing*, 2 STAN. L. & POL'Y REV. 82, 82 (1990).

82. For other examples of these imperfections, see, for example, Natasha Sarin & Lawrence H. Summers, *Understanding the Revenue Potential of Tax Compliance Investment* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27571, 2020); and Scott Levy, Note, *Spending Money to Make Money: CBO Scoring of Secondary Effects*, 127 YALE L.J. 788 (2018).

83. The discussions here of accounting rules, for both private and public entities, is simplified while seeking to capture the essence of the transactions at play.

84. *E.g.*, Basel Comm. on Banking Supervision, Report on Special Purpose Entities, BANK FOR INT'L SETTLEMENTS (Sept. 2009), https://www.bis.org/publ/joint23.pdf [https://perma.cc/M4JM-34EL]; Viral V. Acharya, Philipp Schnabl & Gustavo Suarez, *Securitization Without Risk Transfer*, 107 J. FIN. ECON. 515 (2013).

SPV, accounting rules did not require the bank to include any of the vehicle's assets or liabilities on its balance sheet.

In reality, these schemes were profitable because everyone assumed banks would step in if needed. And in 2007, banks had to make good on that implicit promise. As investors questioned the value of asset-backed securities, the holders of the short-term debt opted to take their money back rather than roll it over, causing a liquidity crunch at many SPVs. As selling the assets in the distressed environment would have produced losses that would have been passed along to the creditors (many of whom had a relationship to the sponsoring bank), many sponsoring banks assumed full responsibility for both the assets and liabilities of these entities, revealing the gimmicky nature of the accounting treatment and suggesting that they should have been consolidated all along. Limiting the ability of banks to again engage in such gamesmanship was among the earliest and least controversial of the reforms that followed.

The U.S. government has a similar relationship to the GSEs, Fannie Mae, Freddie Mac and the FHLBanks. The U.S. government can use these GSEs to further government aims, and it gets to treat some of the earnings as effectively revenue. Moreover, the market has long priced GSE debt in a way that assumes the government would step in if needed—a perception that was confirmed when the government stepped in to protect all of the creditors of Fannie Mae and Freddie Mac in 2008—and some government regulations even treat GSE debt as effectively government debt.[85] Moody's Investor Service, for example, gives the debt issued by the FHLBanks a rating of Aaa even though its ratings of most of the FHLBanks is far lower, a1.[86] The reason: Moody's "assumption of a very high likelihood of support from the US Government."[87] This allows the FHLBanks to raise funds far more cheaply, and far more shielded from market discipline, than if market participants actually viewed the FHLBanks as private or otherwise independent of the government. Even other government agencies, such as the Securities and Exchange Commission, the Fed and other banking regulators often treat FHLBank as akin to debt of federal government for regulatory purposes.

Nonetheless, because the government does not have a formal, legal obligation to creditors of the FHLBanks, the accounting rules governing the U.S. government let the government pretend that it won't actually protect GSE creditors, allowing the FHLBanks to remain "off-balance

85. *See infra* Section III.A.2 (describing how GSE debt is treated as government debt under securities laws).

86. PARROTT & ZANDI, *supra* note 76, at 4.

87. *Id.* (quoting Moody's). Notably, even the stand-alone rating is likely higher than it would be if the FHLBanks were not GSEs, as that status gives them other benefits that further enhance their profitability.

sheet."[88] The gap between the economic reality of the relationship between the GSEs and the government and accounting rules explains much of the mischief that surrounds the FHLBank system.

Congress took full advantage of this accounting gimmick in cleaning up the S&Ls.[89] Rather than have the government foot the full bill, the government raised much of the funding needed by the issuance of new bonds, and it made the FHLBanks primarily responsible for paying off those bonds.[90] Logistically, this was accomplished via the creation of a shell company, RefCorp, that issued the bonds and served as the vehicle via which FHLBanks would pay off from their net earnings.[91] This was a controversial move. The Comptroller General was among the many who expressed concern. He saw the move as an effort to "avoid the discipline required by constrained budget resources" and a "serious threat to the integrity of the government's budget."[92] Nonetheless, Congress went ahead.

Moreover, having decided to depend on FHLBank profits as a source of free money, Congress realized it needed to create a FHLBank system capable of generating the profits needed to pay off the RefCorp bonds. It did this primarily by expanding the pool of financial institutions that could join the FHLBank system. Congress allowed any commercial bank or credit union that—at the time it became member—had at least ten percent of its assets in residential real estate loans join the FHLBank system. As a result, the total members in the FHLBank System increased from 3,200 in 1989 to more than 8,000 in 2005, even as the total number of banks and thrifts declined during the period.[93] Over the same time, total FHLBank system assets grew from approximately $175 billion to $1 trillion. The far

88. Even the Congressional Budget Office seems to acknowledge the tensions inherent in this treatment. *See, e.g.*, *Financial Commitments of Federal Credit and Insurance Programs, 2012 to 2021*, at 2 n.3, CONG. BUDGET OFF., (Mar. 2023), https://www.cbo.gov/system/files/2023-03/58614-Federal-Financial-Portfolio.pdf [https://perma.cc/U54Z-PNSD] (explaining that since Fannie and Freddie were put into conservatorship, their assets and liabilities are consolidated as part of the U.S. budget but "the debt of other GSEs . . . [,] including the Federal Home Loan Banks . . . [,] are not included in this analysis because they are treated as private companies whose financial activities do not affect the federal budget" despite "an implicit federal guarantee").

89. For an overview of the choice Congress faced, see *The Budgetary Treatment of the Proposed Resolution Funding Corporation (REFCORP): Statement Before the Task Force on Urgent Fiscal Issues, H. Comm. on Budget*, 101st Cong. (May 19, 1989) (statement of Charles A. Bowsher, Comptroller Gen. of the U.S.), https://www.gao.gov/assets/t-afmd-89-8.pdf [https://perma.cc/75N8-9Y6E].

90. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183.

91. The discussions here of accounting rules, for both private and public entities, is simplified while seeking to capture the essence of the transactions at play.

92. Bowsher, *supra* note 89, at 1-2.

93. Off. of the Inspector Gen., *A Brief History of the Housing Government-Sponsored Enterprises*, FED. HOUS. FIN. AGENCY, https://www.fhfaoig.gov/Content/Files/History%20of%20the%20Government%20Sponsored%20Enterprises.pdf [https://perma.cc/QE47-EU9S] [hereinafter *A Brief History*].

larger FHLBank was, as intended, able to pay off the RefCorp bonds, which were retired fully on July 15, 2011.[94]

This would have been a natural point in time to re-evaluate the FHLBank system, yet there was no built-in mechanism to trigger such a review. And while budgetary pressures eased for a while during the early 2000s, by 2011, the American public (and hence their elected officials) were again quite concerned about the size of the U.S. deficit, as they are again today.[95] As a result, largely off-balance-sheet mechanisms that can produce revenue that can be deployed for useful purposes remain attractive. And Congress in 1989 decided to use the FHLBanks' profits to do more than just pay off the RefCorp bonds.

Even Congress could not ignore that the revised structure of the FHLBank system—with both banks and thrifts as members, a wider array of assets that could be pledged as collateral, and changes in housing finance that had eliminated many of the frictions that the FHLBanks had been allowed to solve—was not well tethered to its original aims. In deciding to allow the system to grow when shrinking it likely would have been the more prudent course, Congress found a new way to use the FHLBanks support affordable housing—effectively via a new tax on the FHLBanks. Alongside having to pay off the RefCorp bonds, the FHLBanks were now obliged to contribute ten percent of their net earnings to affordable housing programs.[96] The ten percent figure was phased in over time, but has remained fixed at that level since 1995.

In short, the 1980s were a period of significant transformation in the banking industry generally and for thrifts in particular. The preconditions required for the FHLBanks to work as originally designed, using membership and collateral policies to support small thrifts and housing finance, faded into history. In deciding to allow commercial banks of all sizes to become FHLBank members, particularly when coupled other changes in bank policy that allowed banks to grow massively in scale and scope, Congress largely abandoned its previous commitment to using the FHLBank system primarily to enhance the viability of small, community-oriented financial institutions. It justified this decision by surmising, correctly, that allowing large commercial banks access to the FHLBank system could

94. Press Release, Fed. Hous. Fin. Agency, FHFA Announces Completion of RefCorp Obligation and Approves FHLB Plans to Build Capital (Aug. 5, 2011), https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=11822&context=ypfs-documents [https://perma.cc/RDG5-ETZ3].

95. Lydia Saad, *Americans' Worries About Economy, Budget Top Other Issues*, GALLUP NEWS (Mar. 21, 2011), https://news.gallup.com/poll/146708/americans-worries-economy-budget-top-issues.aspx [https://perma.cc/X2NQ-N6ML]; Alan Rappeport & Jim Tankersley, *U.S. Deficit, Pegged at $1.7 Trillion, Effectively Doubled in 2023*, N.Y. TIMES (Oct. 20, 2023), https://www.nytimes.com/2023/10/20/business/treasury-report-shows-1-7-trillion-deficit.html [https://perma.cc/VRV5-QBB7].

96. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 721, 103 Stat. 183, 423-26 (modifying 12 U.S.C. §§ 1430(i), (j) (2018)).

make the system far more profitable without increasing its risk profile. In exchange, Congress tasked the FHLBanks with new financial responsibilities—allowing Congress to both clean up the failed S&Ls and do more to support affordable housing without having to take responsibility for any of the associated costs.

III. The FHLBank System Today

That the FHLBank system has grown and morphed over time in response to changes, both internal and external, does not necessarily mean it should be eliminated. The unmooring of the FHLBanks means their original raison d'être does not suffice to justify their scale or scope. But dynamism is part of life, and finance in particular, so the real question is just what the FHLBanks do now.

In tackling this question, this Part provides the third leg in the stool supporting the need for significant FHLBank reform. It provides a snapshot of who the current system serves and the distortions it introduces. Alongside the early successful days and the gradual unmooring of the system charted in Parts I and II, it provides the foundation needed to understand why reforms are needed and the general form those reforms should take.

A. Public Support for Increasingly Private Gain

Public-private partnerships of various forms are ubiquitous today and for good reason. As reflected in the original FHLBank system, harnessing the relative strengths of private and public actors into an integrated ecosystem can achieve aims not readily available to either set of actors alone. Nonetheless, a constant risk with such public-private ecosystems is that the private actors involved find ways to tilt the scales, increasing the private gains and undermining the balance on which the enterprise was built. The evolution of the FHLBank is a case study in these dynamics and this shift is among the reasons that the system merits reform.

1. FHLBank system v. Federal Reserve system

From the beginning, the FHLBanks embodied a distinct public-private undertaking, one roughly modeled on the Fed. Given the early and explicit parallels, understanding the very different ways the two systems have evolved provides a useful starting point for assessing today's FHLBank system.

At its founding, the Federal Reserve system was used as a rough model for the FHLBank system and, at an abstract level, the two system retain many similarities. Each has eleven or twelve regional banks that carry out much of the system's operations, the regional banks are structured as cooperatives in which "member" financial institutions own stock, that stock entitles member financial institutions to vote on a majority of directors of the board of the on the regional bank and the right to receive dividends, and each system has a centralized, DC-based, public agency that oversees and shapes many aspects of the system's policy making.[97] And both are subject to ongoing oversight by Congress and Congress can change the rules governing their activities. Looking more closely at the governance and operations of each system, however, reveals that the Fed has become far more public-minded over time while the orientation of the FHLBanks has become increasingly private.

The heart of today's Federal Reserve system is a seven-member board of governors. Each of these governors is presidentially nominated and Senate confirmed. The same process is used for appointing the chair of the Fed and various vice chairs, each of whom has distinct and important policy-making roles. For example, the Federal Reserve Vice Chair for Supervision sets the agenda for regulatory policy. And the Federal Reserve board alone has authority to make most policy decisions; the Reserve banks then play a central role in carrying out those policies, through supervisory and other activities.

Monetary policy, which may be the most important policy decisions the Federal Reserve makes, is set by the Federal Open Market Committee (FOMC). So long as all of the governorships are filled, Federal Reserve governors hold 7 of the 12 voting seats on the FOMC, so the balance of power sits with presidentially appointed actors. "Member banks" still sit on the boards of the regional Fed bank, but these bank directors hold only one-third of the seats and cannot participate in choosing leadership of the regional bank.[98] And the dividend rate that members banks earn on the Federal Reserve "stock" they are required to hold is set by statute.[99] If the Fed earns any extra, that money goes to the Treasury Department, not member banks.

The Federal Reserve has also adopted a range of practices, some mandated by Congress and others implemented on its own volition, to increase transparency and accountability. All minutes and transcripts of FOMC meetings are eventually released to the public. The Fed submits regular reports to Congress, the Fed chair and other officials regularly testify both the House and Senate and the Fed Chair and other Fed officials also hold

97. The statutory scheme governing the Federal Reserve Banks has been amended a number of times, including the addition of a requirement that all directors of the regional banks be approved by the Board.

98. *About the FOMC*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Mar. 20, 2024), https://www.federalreserve.gov/monetarypolicy/fomc.htm [https://perma.cc/9MRE-CPRC]; *Overview: Federal Reserve System Board of Directors*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Jan. 5, 2024), https://www.federalreserve.gov/aboutthefed/directors/about.htm [https://perma.cc/ZS7W-TZ6C].

99. BD. OF GOVERNORS OF THE FED. RSRV. SYS., FINANCIAL ACCOUNTING MANUAL FOR FEDERAL RESERVE BANKS app. 173 (2023).

regular press conferences, providing critical opportunities for public engagement.[100] The Fed must get the approval of government actors, such as the Treasury, for any lender-of-last-resort activities beyond short-term, discount window loans to banks, including any longer term loans of the type the FHLBanks can make as a matter of course.[101] And the Fed must also comply with a host of disclosure requirements, both in the short and long-term, when making such loans.[102]

Ultimately, the proof is in the pudding. In 2022 and 2023, the Federal Reserve made a series of policy decisions that ensured the Fed would operate at a significant loss. It made this mix of decisions, relating to the size and composition of its balance sheet interacting with its policies on short-term interest rates, because it was prioritizing the Fed's dual mandate of promoting employment while controlling inflation (not to mention looking out for the stability of the financial system). Its congressionally given aims, not its own bottom line, rightfully drives its decisions. This was true not just for Federal Reserve Governors, but also the presidents of the regional Reserve Banks.

The contrast to the FHLBank system is stark. As a threshold matter, the governance was and remains oriented to serving the interests of member banks. The majority of the board of directors of each FHLBank consists of individuals who work full-time at a member financial institution.[103] And even the "independent directors," that constitute a minority of the board (including at least two with some demonstrated history of public service) are elected by the FHLBank members.[104] Thus, the FHLBank board and leadership are beholden first and foremost to member financial institutions. Federal Reserve member banks also elect two-thirds of the directors of the regional Reserve Bank boards, but Dodd-Frank precludes directors who represent financial institutions from voting on the leadership of the Reserve Bank.

During the decades when most member financial institutions were thrifts, which themselves had mutual ownership structures and were often quite community focused, the impact of FHLBank member representation on the board and their role in governance may have been consistent with the public-regarding aims of the FHLBanks. Yet as the door was opened to banks, and many thrifts converted to shareholder ownership, the impact

100. *E.g.*, Federal Reserve Act § 2B, 12 U.S.C. § 225b (calling for semiannual reports and testimony on supervision and press conferences after each FOMC meeting).

101. 12 U.S.C. § 343(3) (2018).

102. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, 12 U.S.C. § 248(s)Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 5, 7, 12, 15, 22, 26, 28, 31, and 42 U.S.C.).

103. Federal Home Loan Bank Act § 7, 12 U.S.C. § 1427(a)(2)(A) (2018).

104. *Id.* at §§ 1427(a)(2)(B), 1427(a)(3)(B)(ii).

of this high degree of accountability to member banks has produced a far more profit-oriented FHLBank system.[105]

2. Private Benefits and Orientation

The private orientation of today's FHLBanks comes through in the compensation schemes that the FHLBank boards set for their management teams, and again the Fed serves as a useful reference point. Fed governors, as public employees, earn roughly$200,000 per year. John Williams, the President of the New York Fed and the most highly compensated of all regional Fed presidents, earned $513,400 in 2021.[106] That may seem like a lot of money, but it is far less than what the FHLBank of New York paid to each of its top five officers. The President and CEO of the FHLBank of New York, for example, enjoyed a total annual compensation between $2.3 million and $3.4 million for the last three years (2021 to 2023).[107] The President of the Dallas Fed earned $440,700 in 2020.[108] In that same year, the President of the FHLBank of Dallas took home over $2.1 million.[109] In 2022, the CEO of the Indianapolis FHLBank was the most well compensated FHLBank head, raking in annual compensation valued at $3.7 million.[110] In 2023, her compensation exceeded $4.3 million.[111]

One reason FHLBank presidents earn so much more is that the FHLBank boards—or, more often, the expensive outside consultants they hire—routinely use purely private banks as the appropriate reference point in setting executive compensation, even though running a comparably sized commercial bank is a far more complex and demanding undertaking.[112] According to Donald Layton, who ran Freddie Mac for eight years

105. Notably, the way votes are allocated among members does give smaller members more influence relative to their stake. 12 U.S.C. § 1427. In practice, this does little to mitigate the focus on profitability or the way loans to the largest members can increase that profitability. *Id.*

106. Michael S. Derby, *Derby's Take: It's a Full House When It Comes to Regional Fed Chiefs*, WALL ST. J. (Aug. 23, 2022), https://www.wsj.com/articles/derbys-take-its-a-full-house-when-it-comes-to-regional-fed-chiefs-11661247000 [https://perma.cc/KJ2U-554A].

107. Fed. Home Loan Bank of N.Y., Annual Report (Form 10-K) 194 (Mar. 21, 2024).

108. Derby, *supra* note 106.

109. Fed. Home Loan Bank of Dall., Annual Report (Form 10-K) 104 (Mar. 22, 2023). In 2023, the President and CEO of the FHLBank of Dallas earned just shy of $2.3 million. Fed. Home Loan Bank of Dall., Annual Report (Form 10-K) 103 (Mar. 21, 2024).

110. Perlberg, *supra* note 2.

111. Fed. Home Loan Bank of Ind., Annual Report (Form 10-K) 171 (Mar. 12, 2024).

112. *FHFA Report*, *supra* note 5, at 67 (explaining that "[t]he FHLBanks' standard practice in setting the salaries of FHLBank executives is to compare executive salaries for similar positions at similarly sized commercial banks,' why this is not appropriative given that "FHLBanks are not comparable to commercial banks in many regards," and that this approach has been "a key driver of the high levels of executive compensation at the FHLBanks"); Donald Layton, *The GSE Public-Private Hybrid Model Flunks Again: This Time It's the Federal Home Loan Bank System (Part 2)* NYU FURMAN CENTER BLOG: THE STOOP, (Mar. 11, 2024) https://furmancenter.org/thestoop/entry/the-gse-public-private-hybrid-model-flunks-again-this-time-its-the-federal-home-loan-bank-system-part-2 [https://perma.cc/7TDW-FK45hfa] (noting that "[m]ost of the 11 FHLB CEOs make $2 million or more annually, with one of them earning over $3 million," a "salary scale is dramatically out of line with that of the CEOs of other private-public hybrids").

while it operated under the government conservatorship, excessive compensation is one of a number of indicia that the "FHLB System has much in common with [Fannie Mae and Freddie Mac] in terms of how they have exploited their GSE status to emphasize maximizing profits."[113]

Dividends are a concrete example of how FHLBank members benefit when the profitability and size of the FHLBank system goes up. Although the FHLBanks could pay more to affordable housing programs and do more to support public aims when profits go up—particularly after the RefCorp bonds were paid in full—the biggest beneficiaries of FHLBank profitability today are its members—who benefit from reliable and increasingly sizeable dividends. In 2021, for example, the FHLBanks paid out more than $1 billion in dividends to their member banks while contributing just $350 million to affordable housing programs.[114] The tendency to pay exceptionally high dividends continued even after the FHFA came out with its report suggesting the FHLBanks should be more focused on serving public aims. The Federal Home Loan Bank of New York, for example, announced a 9.5% dividend for the third quarter of 2023, the first dividend it issued following the report.[115]

Aggregating these various ways that the FHLBank system enriches its stakeholders, and comparing that to the benefits that flow to affordable housing, makes the real beneficiaries of the current regime plain. According to an analysis by Bloomberg, "[f]rom 2012 through 2022, the home-loan banks spent more than $22 billion compensating their staff and paying dividends — six times more than their contributions to the housing programs."[116]

That the FHLBanks see themselves as serving members more than the public also comes through in the ways that individual FHLBanks and the Council of FHLBanks discuss the FHLBank system. For example, in July 2023, someone interested in the FHLBanks that went to their collective website, FHLBanks.com (a website run by the Council of FHLBanks) would come across this explanation on the homepage:

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113. Layton, *supra* note 112.

114. Dennis C. Shea & Owen Minott, *Federal Home Loan Banks Should Do More than the Minimum for Affordable Housing*, THE HILL (Mar. 31, 2023, 3:30 PM ET), https://thehill.com/opinion/finance/3928017-federal-home-loan-banks-should-do-more-than-the-minimum-for-affordable-housing [https://perma.cc/9TEC-AGUX]. The effective rate of return on dividends is actually far greater, as many FHLBanks loan members much of the funding required to purchase their shares.

115. *President's Report: The FHLBNY Declares a 9.50% Dividend for the Third Quarter of 2023*, FED. HOME LOAN BANK N.Y. (Nov. 15, 2023), https://www.fhlbny.com/news/presidents-report/2023/pr111523 [https://perma.cc/3D7A-DVAK].

116. Noah Buhayar, Heather Perlberg & Austin Weinstein, *A $1.3 Trillion Home-Loan System Gone Astray Is Fighting an Overhaul*, BLOOMBERG (Dec. 20, 2023, 3:31 PM EST), https://www.bloomberg.com/news/articles/2023-12-20/federal-home-loan-banks-why-lobbyists-are-fighting-housing-lending-reform?sref=0SF97H1m [https://perma.cc/MVL2-SWPJ].

> The FHLBanks are 11 regionally based, wholesale suppliers of lendable funds to financial institutions of all sizes and many types . . . . The FHL-Banks are cooperatively *owned* by member financial institutions in all 50 states and U.S. territories.[117]

Nothing in the business model suggests a public purpose or government sponsorship. Scroll further down, and this further explanation was provided: "By harnessing the collective power of their members, the FHL-Banks bring the efficiencies and cost savings to every city, town and county in the nation. It is a model that works."[118] That it is a model that works because the FHLBanks are government-sponsored entities is nowhere acknowledged; instead, such descriptions make it sounds as though it is the efficiencies of the system, rather than implicit government backing that enabled cheap funding, that are at its heart.

Clicking through to obtain additional information does eventually reveal that the FHLBanks are GSEs, but even then, that information is included in dry, paragraph form while emphasized in much larger print is the assertion: "Each FHLBank is operated independently and *receives no taxpayer assistance*."[119] The website also describes the Affordable Housing Program as "one of the largest sources of *private sector grants* for housing and community development in the country."[120] Such claims are revealing about how the FHLBanks see themselves and to whom they hold themselves accountable. They are also pervasive.[121]

This profit incentive has at times gotten FHLBanks into trouble. According to the FHFA, in 2009, half of the FHLBanks faced financial difficulties as a result of losses on private mortgage-backed securities they had bought in the years leading up to the financial crisis.[122] For the FHLBank of Seattle, these financial difficulties coupled with the failure of its biggest client (Washington Mutual) provided debilitating. The FHLBank system came through unscathed, but only after the FHLBank of Seattle was

117. *The Federal Home Loan Banks,* FHLBANKS, https://fhlbanks.com (emphasis added).

118. *Id.*

119. *Acquired Member Assets*, FHLBANKS, https://fhlbanks.com/ama [https://perma.cc/3GZ6-KX3Q] (emphasis added).

120. *Affordable Housing and Community Development*, FHLBANKS, https://fhlbanks.com/affordable-housing-2020-awards [https://perma.cc/R54U-CSXN] (emphasis added).

121. *E.g.*, Jack Farley, *The Banking System's Guardian Angel You've Never Heard Of | Michael Ericson & Dan Siciliano on Federal Home Loan Banks*, FORWARD GUIDANCE WITH JACK FARLEY (Aug. 18, 2023), https://blockworks.co/podcast/forwardguidance/ab1f2ab6-3c82-11ee-91a2-578fa3321978 [https://perma.cc/PR8U-FGQ4] (capturing Michael Ericson, President of the Chicago Federal Home Loan Bank, and Dan Siciliano, chair of the Council of FHLBs and independent director of the San Francisco FHLB, repeatedly describing the FHLBanks as private, repeatedly asserting that they are subject to market discipline and, in response to the interview host's point about the implicit government backstop, suggesting that there is indeed a free lunch to be had and that bond markets—not the government—is the source of the subsidy the FHL-Banks enjoy).

122. *A Brief History*, *supra* note 93, at 6.

merged into the FHLBank of Des Moines,[123] in a transaction akin to the way the weak banks were merged into stronger ones throughout the 2008 financial crisis.[124] More recently, and potentially more troubling, as money market mutual fund reforms increased demand for short-term "government debt," and thanks to rules that allow FHLBank debt to qualify as government debt for relevant purposes, the FHLBanks started funding their operations using a lot more short-term debt, making FHLBanks more vulnerable to funding shocks and increasing the possibility (even if still slim) of systemic ramifications.[125]

Also telling is the way the FHLBanks have responded when asked to take on public responsibilities. Under the Federal Home Loan Act, as amended, to remain eligible for long-term advances, FHLBanks must satisfy FHFA-promulgated standards for community investment or service.[126] The standards include consideration of factors such as the member's performance under the Community Reinvestment Act and its record of lending to first-time homebuyers. In 2011, the FHFA proposed putting the onus on FHLBanks—rather than the FHFA—to ensure their members remain in compliance with the standards.[127] Rather than seeing this as a natural outgrowth of their duties, the FHLBanks fought back. They submitted a joint letter to the FHFA arguing that monitoring compliance was a regulatory function—which, in their view, was not their responsibility. As is typical for rulemaking in this area, virtually all of the comment letters (the mechanism through which the FHFA solicits feedback) came from the FHLBanks or members or supporters. So, four years later, the FHFA backed down and issued a final rule that didn't shift any of this burden to the FHLBanks.[128] Again, this is precisely what one would expect if the FHLBanks are focused on serving the interests of their members, but not what one would expect if their aim was instead to promote the public policies Congress has prescribed for them.

The tendency for the FHLBanks to fight back when asked to use more of the subsidy they enjoy to further public aims continues to this day. In response to the FHFA Report suggesting that the FHLBanks should be more mission focused and proposing modest reforms towards that aim, the FHLBanks marshalled their resources to defend the status quo. To get a better understanding of how the FHLBanks were mounting their defense,

123. OFF. OF THE INSPECTOR GEN., FED. HOUS. FIN. AGENCY MERGER OF THE FEDERAL HOME LOAN BANKS OF DES MOINES AND SEATTLE: FHFA'S ROLE AND APPROACH FOR OVERSEEING THE CONTINUING FHL BANK (Mar. 16, 2016).

124. Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009).

125. For more on the additional maturity transformation now undertaken by the FHLBank system and associated risks, see Gissler, Narajabad & Tarullo, *supra* note 3.

126. Federal Home Loan Bank Act § 10(g)(1), 12 U.S.C. § 1430(g)(1).

127. Federal Home Loan Bank Community Support Program–Administrative Amendments, 80 Fed. Reg. 30336, 30342 (May 28, 2015) (codified at 12 C.F.R. pt. 1290).

128. *Id.*

reporters at Bloomberg undertook an investigation in which they examined an array of public records and interviewed "more than two dozen people familiar with their efforts."[129] Bloomberg found that as the FHFA was preparing its report, "the FHLBs and their supporters swarmed public events and submitted scores of comments . . . . Behind the scenes, they were also lobbying lawmakers and regulators . . . ."[130] As the report was finalized, the trade group representing the FHLBanks "hired a top lobbying firm and ramped up its spending on political influence by nearly 40%."[131] And at least eight of the individual FHLBanks have hired their own outside lobbyists.[132] The tremendous profitability enabled by the current structure of the FHLBank system also means a lot of money that can be used on lobbying efforts that entrench that system.

The FHLBanks are also subject to far fewer of the accountability and transparency obligations than the Fed. The FHLBanks are subject to some minimal disclosure requirements. They must submit securities filings, including annual and quarterly reports; the FHFA submits an annual report to Congress that includes a discussion of its oversight of the FHLBanks; and there is a separate annual congressional report on the collateral policies and practices of the FHLBanks. But even these materials provide the public very little information about just who the FHLBanks are loaning money to and on what terms. Instead, all of the deliberations and most of the operations of the FHLBanks—where real policy decisions are made—remain shrouded from the public, just as they are with private companies. This is in stark contrast to the extensive disclosure obligations imposed on or otherwise undertaken by the Fed. Although public disclosure of the details can be delayed for up to two years, the Fed must disclose detailed information about all of the loans it makes when fulfilling its role as lender of last resort.[133]

3. Governance, Public Subsidies and Other Support

The FHLBanks may claim that they are largely private organizations but a closer look at their design reveals a very different picture. This is evident, for example, in their governance, that is, the allocation of economic and control rights. For private corporations, so long as the shareholders, board of directors and management agree, they have incredible discretion to make changes. They can dissolve the company and pay out the funds received to shareholders. They can radically change the nature

129. Buhayar, Perlberg & Weinstein, *supra* note 116.

130. *Id.*

131. *Id.*

132. *Id.*

133. *Discount Window Lending*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Mar. 29, 2024) https://www.federalreserve.gov/regreform/discount-window.htm [https://perma.cc/V973-MCJU] (providing quarterly reports of lending activity).

of the business, from a maker of shoes into a biotech or a floral company. They can sell the corporation to any type of buyer, from a private equity investor to an individual to another firm. They can also alter their governance rules, issue new types of stock, change the rules regarding which shareholders get to vote or how much those votes are worth or give some shareholders different rights with respect to dividends or upon liquidation. Subject to fiduciary obligations, any of these are options for a private corporation.

Not one of these options exists for the FHLBanks, no matter how much bank members, directors or management might collectively want to pursue them. The federal government has prescribed the business model. The FHLBanks use discretion in implementation, but they cannot start making shoes or selling flowers even if everyone internal to the system so agreed. No FHLBank can dissolve and distribute the proceeds to its members. No FHLBank can sell itself off to a private equity firm, no matter how high the price offered. No FHLBank can change the rules regarding how its board of directors are elected. Every single one of these decisions, and more, have been resolved by Congress.

This does mean that the FHLBanks are purely public either. Instead, the FHLBanks, like many organizations, are public-private hybrids. They sit in on the spectrum that exists between government agencies, on one hand, and private organizations on the other. The FHLBank Act, as amended, sets out the terms of this partnership. That Congress can, and very often has, amended the terms of the FHLBank Act is a sign of Congress's and the public's continued stake in the enterprise. It is true that the FHLBank members manifest their stake in this partnership by buying stock in their FHLBank, but the same is true—to this day—of the Federal Reserve banks. In each instance, the rights that accompany the stock are a small subset of the rights belonging to any shareholder of a truly private corporation or a member of a privately formed and constituted cooperative. To be sure, on the public-private spectrum, the FHLBanks today are more private than the Federal Reserve Banks, but they both still sit on the continuum.

As a further point of reference, the governance of the FHLBanks suggests that they are further from the private end of that spectrum than Fannie Mae and Freddie Mac before they were placed in conservatorship. Until then, the stock of Fannie and Freddie was freely traded on the New York Stock Exchange. It could be bought or sold by absolutely anyone, at any price. In this sense, Fannie and Freddie shareholders had a financial claim that looked a lot like the residual claim held by purely private shareholders. By contrast, Congress determines how much stock FHLBank members can and must buy. Congress sets the terms pursuant to which the FHLBank members buy that stock and Congress dictates when it can and must be sold. That only FHLBank members can own FHLBank stock, that they must buy and sell it at par, and that the members cannot change these rules—in contrast to say, a private cooperative—all affirm that the FHLBanks sit far more to the public side of the public-private spectrum than their public statements and operations suggest.

In exchange for tasking the FHLBanks with important public aims, Congress also provided them a host of benefits that no private company enjoys. The most significant, but by no means only, is the implicit public backstop on its debt, allowing it to raise funds far more cheaply than it otherwise could. The classification of those securities as government debt for many regulatory purposes, and the ability of the Fed to buy and sell FHLBank debt as part of its open-market operations, further increases demand and lowers funding costs. There are also a range of regulatory and tax exemptions from which the FHLBanks benefit. For example, the earnings of the FHLBanks are exempt from local, state and federal income tax, and the interest paid on FHLBank debt is exempt from state income tax.[134] The FHLBank system also has a $4 billion line of credit with the Treasury Department and can use Federal Reserve Banks as fiscal agents.[135]

The FHLBanks also enjoy statutory protections that significantly reduce the risks associated with their lending activities, enhancing the effective value of the asset side of their balance sheets. For insured depositary institutions, such as thrifts and banks, any loans from a FHLBank are paid off in full before any depositor or the Federal Deposit Insurance Corporation (in its capacity as insurer) gets a cent.[136] This helps explain why the FHLBanks can accurately brag that they have never lost any money on an advance (despite often lending large amounts to banks that fail).

At various times, the Congressional Budget Office has attempted to place a value on the public subsidy enjoyed by the FHLBanks and other GSEs.[137] Although inherently coarse, such efforts are helpful at dispelling claims that the system does not enjoy benefits as a GSE. For the fiscal year 2024, the CBO expects the "the net government subsidy to the FHLB system will amount to $6.9 billion (with a plausible range of about $5.3 billion to $8.5 billion)."[138] Net means that this is the amount of the subsidy after deducing the required payments to affordable home programs. This subsidy comes in two forms. First, just shy of $1 billion (an estimated $0.9 billion for 2024) arises from the various regulatory and tax exemptions the FHLBanks enjoy. The remainder comes from the implicit government backstop. In the CBO's assessment, "FHLBs would receive an S&P rating in the range of A to BBB+, or four to six notches below AA+" without the

134. 12 U.S.C. § 1433.

135. 12 U.S.C. § 1431, 1435.

136. 12 U.S.C. § 1430 (2018).

137. *The Role of Federal Home Loan Banks in the Financial System*, CONG. BUDGET OFF., (Mar. 2024), https://www.cbo.gov/publication/60064 [https://perma.cc/7L86-K4ZY] [hereinafter CBO 2024]; DEBORAH LUCAS & MARVIN PHAUP, CONG. BUDGET OFFICE, FEDERAL SUBSIDIES AND THE HOUSING GSES (2001).

138. CBO 2024, *supra* note 137.

implicit backstop, a difference that translates into a much lower cost of funding.[139]

2024 is not an outlier, but rather typical of the large and persistent subsidies the FHLBanks enjoy. Back in 1999-2000, the CBO estimated the benefit of the implied government backstop to be $13.6 - $15.6 billion and it further estimated that the tax and regulatory benefits bestowed on the FHLBanks were worth an estimated $1.2 billion in 2000.[140]

Independent assessments have been similarly large. Roughly following the methodology used by the CBO, Mark Zandi and Jim Parrott—in a paper defending the FHLBanks—also sought to quantify the taxpayer subsidy to the FHLBank system in recent years. The most significant effective subsidy is in the funding cost advantage the FHLBank system enjoys as a result of the implied government backstop. By comparing the yields on FHLBank debt with the yields on otherwise comparable private debt (of large, systemically significant financial institutions), Zandi and Parrott estimate that the value of the implied government backstop resulted in a $4.7 billion subsidy to the FHLBanks in 2022, a year when the system was relatively small. They further estimate that the FHLBank system saves $800 million from tax and SEC exemptions, bringing the total estimated taxpayer subsidy to $5.5 billion for 2022.[141] In their view, this is likely a "conservative" estimate—that is, the actual subsidy is probably bigger, not smaller—and acknowledge that the value of the implied government backstop and other mechanisms of value transfer can vary significantly depending on market conditions and other factors.

One reason such efforts to quantify the benefits typically understate their true magnitude is that the value FHLBank members derive from that membership can vary significantly depending on broader financial conditions. This is particularly true with respect to advances. Even when money is flowing freely in private markets, the FHLBanks often remain competitive as a source of funding because of their access to cheap capital. But the ability to tap the FHLBanks for additional liquidity becomes far more valuable during periods of distress, a factor not event included in Parrott and Zandi's analysis.[142]

Another challenge in trying to assess the costs and benefits of the FHLBank's operations is that the probabilistic nature of many of the "costs" reduce their salience and create genuine uncertainty about whether and how they will actually have to be paid. This a classic challenge with off-balance sheet activities, and one reason they so often create bad incentives. From Congress's perspective, most of the subsidies that flows to the FHLBanks feel free while the benefits seem concrete. This comes through and

139. *Id.* at Appendix A.
140. *Id.*
141. PARROTT & ZANDI, *supra* note 76.
142. *See infra* Section III.A.3.

is reinforced by the assumptions used by Congressional Budget Office (CBO)—which treat the implicit backstop of the FHLBank system as costless to the U.S. government while treating the affordable home loan program commitments as a source of revenue. Who doesn't want something for nothing? Even if the bulk of the benefits flow to private actors—as they do—so long as there is some public benefit, why not take it? Buttressing this view, FHLBank insiders often play down the subsidy of the implied government backstop by emphasizing that so long as the FHLBanks remain healthy, the subsidy doesn't actually cost the taxpayers anything.

The challenge with this line of reasoning is that even if the probability of FHLBank default is quite low, and there are reasons to believe it is, there are reasons to expect that the cost would be far higher and the consequences more far reaching than any of these estimates suggest. As reflected in the discussion of other off-balance sheet shenanigans, they often cease to work at the worse possible times. Banks made plenty of money off of SPVs in the early 2000s, accentuating their profitability at a time when they were already doing well. When the crisis first hit in August 2007, however, and banks faced a far more challenging environment, the SPVs not only ceased to yield profits—they were the source of unanticipated losses as banks consolidated all the distressed asset-backed commercial paper and debt funding it onto their balance sheets. Just when they needed more capital, they found themselves with less. This ultimately harmed not only the sponsoring banks, but was among the many factors contributing to the financial weaknesses that inflicted such painful blows on the real economy starting in 2008.

The dynamics surrounding the demise of Fannie and Freddie, which is probably more comparable, was even more dire. When the government bailed out Fannie Mae and Freddie Mac in Septembers 2008, the intervention was not only costly fiscally, but it also accelerated and magnified the brewing financial crisis.[143] When supposedly "safe" assets can no longer be treated as safe, financial dysfunction and the need for widespread government support often follows. The FHLBanks pose just such a risk.

Moreover, it is not just solvency issues that get financial institutions in trouble. More often, the challenge is a lack of liquidity. This risk goes up the more dependent a financial institution is on short-term funding. And the FHLBanks have significantly increased their reliance on short-term funding in recent years, taking on some of the maturity transformation that once occurred in banks.[144] The FHLBanks remain unlikely to fail anytime soon. But that probability is not zero, and the consequences could be devasting. The FHLBanks could also become a source of systemic risk, even shy of failing, should a lack of liquidity cause them to curtail advances significantly, particularly if that happens when banks do not have time to

143. *See supra* Section II.C.

144. Gissler, Narajabad & Tarullo, *supra* note 3.

develop other plans. This is why the next subpart turns to look directly at the role of the FHLBanks as liquidity providers.

Putting these pieces together, it is clear that the FHLBanks are a public-private enterprise, one established by the government which continues to enjoy many government-conferred benefits. Yet the FHLBanks often purport that they are "private," and the biggest beneficiaries of the system are the FHLBank members who get to reap the dividends and other benefits of membership. The analysis here is simplified. The FHLBank system is so extensive at this point that this is necessary for the sake of analysis. There are benefits, costs and other interesting features not examined herein. For example, many FHLBanks work with smaller members to increase their capacity to produce mortgages that are suitable for resale, including helping them qualify for inclusion in other housing finance programs.[145] Nonetheless, the broad picture remains, and suggests some type of rebalancing may be warranted.

B. Distortions: Liquidity Without Accountability

Another, possibly more important reason to reform the FHLBanks is that their operations can introduce meaningful and troubling distortions in the banking and financial industry. One of the most striking features of the FHLBank system is the role it has come to play as a "lender of second to last resort"—providing liquidity to both individual banks and the banking system when that liquidity is otherwise scarce. It is known as the lender of "second" to last resort because it is where banks often go when they need liquidity but want to avoid turning to the nation's designated lender of last resort, the Federal Reserve.

Recall, no one ever set out to create this overlapping regime. Originally, the FHLBanks were meant to serve as a lender of last resort only for thrifts, which at the time had no access to the Fed's discount window. The overlap emerged as thrifts gained access to the Fed and banks gained access to the FHLBank system, gutting the line that had separated the regimes. For a variety of reasons, borrowing from the Fed's discount window has long been "stigmatized." Wanting to avoid the stigma or any hint of desperation, banks often shy away from borrowing from the Fed even if they could really use the support.[146] Because FHLBank advances are used by banks in good times and bad, they don't have this stigma. It also helps that the FHLBanks can provide longer term loans than the Fed can provide

145. *See, e.g.*, Press Release, Fed. Home Loan Bank of Chi., Federal Home Loan Bank of Chicago and Ginnie Mae Reach $3 Billion Milestone in MPF® Government MBS (June 29, 2022), https://www.fhlbc.com/news/details/2022/06/29/fhlbank-chicago-and-ginnie-mae-reach-3-billion-milestone-in-mpf-government-mbs [https://perma.cc/BB5D-JDP2].

146. *See, e.g.*, Olivier Armantier, Eric Ghysels, Asani Sarkar & Jeffrey Shrader, *Discount Window Stigma During the 2007-2008 Financial Crisis* 5 (Fed. Rsrv. Bank of N.Y. Staff Report No. 483, 2015), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr483.pdf [https://perma.cc/YL77-4GUZ].

via its discount window. As a result, when banks need more liquidity and are having a hard time accessing that liquidity in the market, they consistently go to their FHLBank before and often in lieu of going to the Fed.

After SVB and Signature bank failed, many depositors got scared and started pulling money from regional banks. The FHLBank system helped regional banks make up this shortfall, raising $304 billion in fresh funds in order to satisfy a spike in member demands for advances.[147] That figure was nearly twice the amount that the Federal Reserve lent during the same period, even though the Fed used its emergency authorities to create a special lending facility with very favorable terms.[148] This additional lending helped banks but it also benefitted FHLBanks, whose profits for the first six months of 2023 were three times what they had been during the same period in 2022.[149] At first glance, this may seem really useful. After all, more liquidity is generally a good thing during periods of stress. Yet the FHLBanks have not only provided valuable liquidity to the banking system during periods of stress, they have consistently provided that liquidity to the weakest financial institutions, often allowing them to delay a necessary reckoning and increasing the ultimate costs of their failures. Just as importantly, having two lenders of last resorts undermines accountability, and there are reasons to expect that the Fed would and could provide far more liquidity and in better designed ways without the FHLBank system.

Looking back at the 2007-2009 financial crisis and other periods of banking turmoil serves as a starting point for understanding the role the FHLBanks currently play in providing liquidity, and to whom that liquidity support flows.

1. The 2007-2009 Financial Crisis

Then-Federal Reserve economist Adam Ashcraft and co-authors document how FHLBank advances exploded during the first year of the 2007-2009 financial crises. Total advances grew from less than $650 billion in July 2007 to more than $1 billion by August 2008—just before the failure of Lehman Brothers.[150] The Fed also responded quickly to the liquidity

147. Austin Weinstein & Max Reyes, *FHLB Issues $304 Billion in a Week as Banks Boost Liquidity*, BLOOMBERG (Mar. 20, 2023), https://www.bloomberg.com/news/articles/2023-03-20/fhlb-issues-304-billion-in-one-week-as-banks-bolster-liquidity [https://perma.cc/EWQ6-RY8M].

148. Press Release, Bd. Of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Announces It Will Make Available Additional Funding to Eligible Depository Institutions to Help Assure Banks Have the Ability to Meet the Needs of All Their Depositors (Mar. 12, 2023), https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm [https://perma.cc/5VUN-BRM6].

149. Press Release, Fed. Home Loan Banks Office of Fin., Office of Finance Announces Second Quarter 2023 Combined Operating Highlights for the Federal Home Loan Banks (July 28, 2023), https://www.fhlb-of.com/ofweb_userWeb/resources/2023Q2FHLBCombinedOperatingHighlights.pdf [https://perma.cc/YV7R-2HNS].

150. Adam B. Ashcraft, Morten L. Bech & W. Scott Frame, *The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?*, 42 J. MONEY, CREDIT & BANKING 551 (2010).

shock that first hit in August 2007, and it encouraged banks to borrow from the discount window. But in contrast to the FHLBanks, the Fed had few takers.[151] Starting in December 2007 and throughout the following year, the Fed found creative new ways to provide additional liquidity to banks and nonbanks outside its traditional discount window lending. Nonetheless, it was not until March 2008—after the failure of Bear Stearns—that the Fed overtook the FHLBanks as the largest government-sponsored provider of emergency liquidity.

Whether the additional liquidity that the FHLBank system provided during the early stages of the crisis was net beneficial is hard to know. The rise in FHLBank advances did ease liquidity strains early in the crisis, facilitating market functioning and credit creation during this period. But looking ahead, that easing may have been far from optimal. A core challenge throughout the 2008 crisis was the Fed's slowness in appreciating and responding to the magnitude of the challenge it was facing, as reflected in its relative ill-preparedness when Lehman failed despite the crisis have already been underway for more than a year.[152]

Although speculative, it is possible that had more banks been forced to go to the Fed earlier and in greater amounts, the Fed would have found ways to overcome the stigma—as other central banks did during this period of time. Just as importantly, because there is no ambiguity with respect to how much banks need liquidity when they turn to the Fed, had the Fed been forced to confront directly the full magnitude of bank demand for government-backed liquidity, Fed officials may have come to appreciate the magnitude of the challenge earlier and more forcefully than they did, creating at least a chance that officials would have accepted offers of more authority or taken additional steps that could have helped reduce the fallout to come.[153]

Other ramifications of this bifurcated system are less speculative and just as concerning. The Fed's actions throughout the 2008 financial crisis and more recent periods of turmoil demonstrate its clear commitment to using its lender-of-last-resort authority to ease financial dysfunction. Whether it is making the right call each time it intervenes is a matter of debate, but its willingness and ability to respond aggressively during periods of stress is not.[154] As we just saw, the Fed is focused primarily on promoting public aims, not profit. As a result, the Fed is willing to take risks and incur losses—subject to statutory constraints—when doing so is the best course of action for addressing market dysfunction and otherwise

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151. Armantier, Ghysels, Sarkar & Shrader, *supra* note 146, at 3-4.

152. Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM. L. REV. 843 (2016).

153. *Id.*

154. JEANNA SMIALEK, LIMITLESS: THE FEDERAL RESERVE TAKES ON A NEW AGE OF CRISIS (2023).

promoting the public interest. This orientation is key to making the Fed a good lender of last resort.

The same cannot be said of the FHLBanks. They may provide a lot of liquidity, historically, but they do so on terms that ensure it also benefits their bottom line. For example, while the Fed typically reduces haircuts on collateral to encourage more borrowing and facilitate more liquidity entering the financial system during periods of stress, the FHLBanks often increase haircuts—reducing the credit risk exposure of the FHLBank at the expense of the systemic liquidity that would be optimal. This importance of public-private entities prioritizing public interest over private risk (while by no means ignoring the latter) in the provision of liquidity during periods of stress is what motivated Walter Bagehot's landmark work laying out the case for having a lender of last resort.[155] Additionally, as Ashcraft and coauthors show, the FHLBanks are dependent on market functioning, whereas the Fed is not. This can limit the ability of the FHLBanks to provide fresh liquidity during periods of extreme stress—precisely when it is most needed. And of course, consistent with the bifurcation in the evolution of the Fed and the FHLBanks, the Fed's lender-of-last-resort activities are subject to meaningful disclosure obligations and other mechanisms for ensuring accountability, none of which are imposed on the FHLBanks.

Yet the greatest challenge with the FHLBank lending during this time was not just that it allowed banks to bypass the Fed; it is that a disproportionate share of the fresh funds went to the most troubled banks. For example, the five financial institutions that most ramped up their advances from the FHLBank system during the latter half of 2007 were Washington Mutual, Bank of America, Countrywide, Merrill Lynch and Wachovia, in that order.[156] Of these five, only Bank of America remained standing (having acquired two of the others on this list) by the end of 2008. Washington Mutual was the largest bank failure when it failed in 2008. At the time, the FHLBank of San Francisco was its biggest creditor—having advanced WaMu almost $59 billion.[157] The FHLBank of San Francisco had also advanced significant funds to IndyMac, that until recently was the costliest failure for the FDIC and other depositors. While the FHLBank was made whole when IndyMac failed,[158] uninsured depositors incurred $2.6 billion in losses and the Deposit Insurance Fund took a $12.4 billion hit, at a time

155. WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (1873).

156. Ashcraft, Bech & Frame, *supra* note 150, at 560 tbl.3.

157. *OTS Fact Sheet on Washington Mutual Bank*, OFF. OF THRIFT SUPERVISION (Sept. 25, 2008), https://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-09-25%20OTS%20Fact%20Sheet%20on%20Washington%20Mutual%20Bank.pdf [https://perma.cc/Y5YY-LX3L].

158. Peter Coy, *Federal Home Loan Bank System Faces Risk*, NBC NEWS (Nov. 7, 2008, 3:45 PM EST), https://www.nbcnews.com/id/wbna27597675 [https://perma.cc/5W4B-N7LF].

when it was already depleted.[159] Although the super-lien may make it easier for the FHLBanks to pay little heed to the health of financial institutions in making advances, it is the secured lending that typically plays a more central role in ensuring the FHLBanks are protected while other creditors suffer. This is consistent with the literature on how secured lending can impose costs on lenders. More generally, throughout 2007 and 2008, troubled banks regularly relied on FHLBank advances to bypass having to confront the market discipline they would endure if seeking outside funding, or the regulatory inquiries that might accompany borrowing from the Fed. There is little benefit to providing banks this type of third option when they are facing distress.

2. Other Bank Crises

Similar dynamics have been on display in the recent regional bank turmoil. As a starting point, it is striking that the majority of the biggest borrowers from the FHLBank system at the end of 2022 were regional banks—edging out the larger financial institutions such as J.P. Morgan and MetLife that had been among the biggest borrowers in previous years. This suggests that regional banks were facing strains long before March 2023, but it wasn't necessarily apparent to the Fed in the way it would have been had those banks been forced to go to the discount window when a declining depositor base and other shifts prompted them to increase their reliance on government-backed liquidity.

A more granular look suggests even more reasons for concern. At the end of 2021, Silicon Valley Bank did not have any advances outstanding from the FHLBank of San Francisco. By the end of 2022, SVB was the single biggest borrower from the FHLBank of San Francisco, with advances totaling $15 billion—seventeen percent of FHLBank of San Francisco's outstanding advances.[160] The second biggest borrower from the FHLBank of San Francisco at the end of 2022: First Republic Bank, with $14 billion, constituting sixteen percent of the FHLBank's advances. Within months, both banks would fail. And yet again: the FHLBanks were made whole despite lending that enabled these weak banks to hobble along, while the FDIC's Deposit Insurance Fund suffered record-setting losses, displacing IndyMac's first-place position. The FDIC estimates that it will cost the Deposit Insurance Fund $20 billion to cover the losses

159. Eleanor Laise & Katie Marriner, *Don't Worry Too Much About Losing Your Bank Cash. Bank-Failure Data Don't Support Panic over Uninsured Deposits*, MARKETWATCH (Apr. 22, 2023, 12:20 PM ET), https://www.marketwatch.com/story/dont-worry-too-much-about-losing-your-bank-cash-bank-failure-data-dont-support-panic-over-uninsured-deposits-219fc64 [https://perma.cc/DPS4-2W7Y].

160. Fed. Home Loan Bank of S.F., Annual Report (Form 10-K) (Mar. 10, 2023).

associated with SVB's failure—more than any other failure in bank history.[161] First Republic is not far behind, with the FDIC expecting to lose roughly $13 billion in connection with its failure.[162]

The other two regional banks that failed in the spring of 2023—Signature and Silvergate—also relied heavily on FHLBank advances to stay afloat as they started to face difficulties. Both banks have also gotten attention because each were also major providers of financial services to crypto firms, and the collapse of many cryptocurrencies contributed to the debilitating withdrawals and lack of trust at each institution. Signature was the fourth biggest borrower from the FHLBank of New York at year-end 2022, with $11 billion in outstanding advances at its demise. Silvergate was a much smaller regional bank than any of the others and yet it still had borrowed more than $4 billion from the FHLBank of San Francisco in late 2022, before winding down its operations.[163]

Counterfactuals are always hard to run, but there is a good possibility that these banks would have been forced to go to the Fed for liquidity far earlier than they did if they had not been able to rely on such massive advances from their FHLBank. And such borrowing—even in a world in which there was more discount window lending—would likely have compelled the Fed to look more closely at why these institutions (and, quite likely, other regional banks) were being forced to tap government-backed liquidity. How the resolution of these institutions would have played out under such a scenario is hard to know, but it's unlikely it could have been worse and it may well have been far smoother, with potentially much smaller losses to the FDIC.

Not only did these failures result in record-breaking losses to the FDIC, but they were also on the verge of so threatening the health of the broader financial system that regulators felt compelled to invoke exceptional emergency powers. With respect to both SVB and Signature, regulators invoked the "systemic risk exception" to the obligation otherwise imposed on the FDIC to resolve failed banks in the manner that imposes the least cost on the Deposit Insurance Fund. The systemic risk exception is designed to be used only in extraordinary circumstances. It can be invoked only with approval by a super-majority of the Board of Governors of the Federal Reserve, a super-majority of the FDIC Board and the Treasury Secretary, in consultation with the President. The long-term

161. Press Release, Fed. Deposit Ins. Corp., First-Citizens Bank & Trust Company, Raleigh, NC, to Assume All Deposits and Loans of Silicon Valley Bridge Bank, N.A., From the FDIC (Mar. 26, 2023), https://www.fdic.gov/news/press-releases/2023/pr23023.html [https://perma.cc/E97A-LLDB].

162. *Id.*

163. Kate Berry & John Heltman, *Silvergate Has 'Fully Repaid' Home Loan Bank Advances*, AM. BANKER (Mar. 2, 2023, 8:34 PM EST), https://www.americanbanker.com/news/silvergate-has-fully-repaid-home-loan-advances [https://perma.cc/G763-ZS5F].

ramifications of the use of this exceptional authority will likely be felt for years, along a range of different axes.

Rewind to the S&L crisis of the 1980s and similar patterns emerge yet again. Recall, the interest rate increases of the 1970s inflicted significant losses on thrifts by causing the value of fixed-rate, long-term mortgages—the primary asset they held—to fall in value, even if borrowers still paid off the loans in full. The deregulation of the 1980s gave thrifts the authority to make riskier loans in domains such as commercial real estate, but weakened thrifts still needed access to sufficient liquidity to stay afloat. They got this in part by offering high rates on insured deposits; but weak S&Ls also got much of the liquidity they needed to keep operating by borrowing from the FHLBanks.

A study published by the Federal Reserve Bank of Chicago found that both at a national level and in the half-dozen states most affected by the S&L crisis, failed thrifts were more likely to borrow and borrowed proportionately more from FHLBanks than healthy thrifts.[164] Focusing in on the 205 thrifts that regulators closed in 1988, they found that "76[%] borrowed from their FHLBank three years before closure" with some financing as much as "72[%] of their total assets with FHLBank loans."[165] By contrast, just 40% of solvent thrifts had any advances outstanding from the FHLBanks at the end of that year.

As these examples make plain, the FHLBanks don't just step up to provide liquidity to healthy banks during times of stress, they consistently provide the most money to troubled institutions. The FHLBanks often brag that they have never lost a penny on an advance. But when viewed alongside the laundry list of failed banks that relied on FHLBanks after they were already in a weakened state, it is clear that this should be a matter of shame, not pride—a mark they consistently look out for their own financial health, while disregarding the impact on the broader financial system or the taxpayers that foot the bill when the FDIC runs out of funds. The underlying challenge is that the FHLBanks have neither the means nor incentive to police the financial health of the banks to whom they loan money because they have so many other tools for ensuring they get paid even when banks fail, and even when they fail at the worse times or in spectacular fashion.

3. Why the Fed Should Be *the* Lender of Last Resort

There is little debate about the merits of the FHLBank system helping troubled banks limp along, the outsized role the FHLBanks have consistently played in helping troubled banks, and the costs imposed on the FDIC

164. Lisa K. Ashley, Elijah Brewer III & Nancy E. Vincent, *Access to FHLBank Advances and the Performance of Thrift Institutions*, 22 ECON. PERSPS. 33, 40, 41 tbl.6 (1998).

165. *Id.* at 33.

(and sometimes other depositors) as a result. Few have tried to defend such lending. But the normative implications of the role the FHLBanks play as "lender of second to last resort" for the banking system more generally is more contested.

Some see the role the FHLBanks continue to play in providing liquidity during periods of stress as desirable.[166] Under this view, the capacity of the FHLBank system to step in and provide fresh liquidity when a shock hits is socially valuable for the same reason that having a lender-of-last resort is helpful. In the face of a shock, financial institutions often face demands for liquidity—clients withdraw money and drawdown on lines of credit—and may rationally hoard liquidity, dynamics that can and have contributed to significant market dysfunction. A lender of last resort that stands ready and willing to provide additional liquidity—through collateralized lending—can indeed help short circuit these adverse consequences. So maybe having the FHLBanks provide additional liquidity is still useful, even if most FHLBanks members can also go to the Fed.

In earlier work, I was somewhat sympathetic to this argument.[167] More liquidity during periods of stress can be incredibly useful. With further reflection and more information, however, I have come firmly to the view that these additional liquidity injections—even if sometimes helpful—do far more harm than good. The primary reason is that there are a lot of benefits from having one, and only one, lender of last resort, and the Fed alone has evolved to play this role well.

As a starting point, it is far from easy to separate serving as a lender of last resort to the system generally and providing outsized support to the most troubled institutions, which naturally will want to borrow the most. The Fed has supervisory expertise and a view of the bigger picture in a way that makes it far better suited to navigate the difficult judgment calls that inevitably arise in deciding just how much to loan to a bank that may be facing a mere liquidity crunch but which may also be struggling to remain solvent. The super-lien enjoyed by the FHLBanks accentuates their weaknesses in this regard, but the problem would persist even if that particular flaw were corrected.

Second, forcing banks to go to the Fed when they need emergency liquidity provides the Fed valuable information about the health of individual banks and the banking system more generally. Having a lender of second to last resort that is also a provider of financing during normal periods muddies the water and reduces the quality of the information conveyed by banks' reliance on government-backed liquidity. Third, the Fed has much better incentives and a better track record than the FHLBanks in putting the health of the financial above its bottom line. For example, the FHLBanks have at times increased haircuts on collateral during

166. PARROTT & ZANDI, *supra* note 76; Ashcraft, Bech & Frame, *supra* note 150.

167. Kathryn Judge, *Three Discount Windows*, 99 CORNELL L. REV. 795 (2014).

periods of stress—the right thing to do if the aim is to minimize the credit risk to which the FHLBanks are exposed but the wrong thing to do if the aim is (as it should be) to minimize the spread of dysfunction. By contrast, during periods of broader stress, the Fed often modifies the terms of its lender-of-last-resort lending in ways that encourage borrowing and promote the healthy functioning of the financial system.[168]

Another reason, albeit different in nature, is that Congress has thoughtfully constructed an array of transparency and other accountability mechanisms around the Fed's lender of last resort activity. These decisions reflect the importance of accountability when the government is intervening in ways that can bestow significant benefits, even if also socially beneficial.[169] And while no one might be paying attention to the actions of the FHLBanks most of the time, should they end up propping up banks even more culpable than those they have propped up in the past, concerns about crony capitalism and the credibility of the government might well come to bear in ways that detrimentally impact financial regulation more generally.

Finally, it is far from fair to assume that the amount of lending that the Fed currently undertakes through its discount window and other facilities would remain static should the FHLBanks reduce the role they play in this regard. Other central banks are more able and willing than the Fed, and many can provide longer term loans. While the Fed may not be eager to expand its role in this regard, serving as the lender of last resort was the original rationale for the Fed's existence and remains a central function. The Fed has expanded its liquidity provisioning in the past when circumstances warranted and there is little reason to suspect it would not do so again.

This analysis is not exhaustive, nor should this issue alone drive the reform of the FHLBanks. Moreover, as a practical matter, any form of the FHLBanks that allows them to continue to make collateralized loans—the heart of what they do—will likely entail having them play some role providing additional liquidity during periods of stress. The issue here is scale and scope. The FHLBanks consistently outdo the Fed in providing liquidity to banks during periods of distress during the early phase of crises, which is precisely when the Fed might most benefit from having better information about just how dire things really are for banks. Significantly shrinking the FHLBank system and making it more focused on achieving specified public aims, rather than maximizing profits, could go a long way in alleviating these challenges.

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168. Eric Milstein & David Wessel, *What Did the Fed Do in Response to the Covid-19 Crisis?*, BROOKINGS (Dec 17, 2021), https://www.brookings.edu/articles/fed-response-to-covid19 [https://perma.cc/YU72-65ZQ] (noting that during the Covid crisis, "[t]he Fed lowered the rate that it charges banks for loans from its discount window by 2 percentage points, from 2.25% to 0.25%").

169. These mechanisms have long existed and have been refined over time, most recently as part of the Dodd-Frank Act.

C. Advances

Given that advances to members have always been the primary business of the FHLBanks, and that advances to thrifts, collateralized by home loans, were central to its early operations, looking at who is receiving advances today and what they are posting as collateral provides another useful way of gauging to whom the benefits of today's FHLBank system flow and where the original design of the system may still be having some impact.

1. To Whom Do the FHLBanks Lend

We can begin to answer these questions by looking at who is borrowing money from the FHLBanks in recent years. As a threshold matter, the publicly available information on this question is useful but incomplete. Most FHLBanks provide only limited information about who they are loaning to and in what amounts. Many of the FHLBanks provide annual, and sometimes quarterly data, on their top five or ten borrowers in the reports they file with the SEC. The two annual reports that the FHFA provides to Congress also provide some aggregate data about who is borrowing from the FHLBanks, the types of collateral they are posting and who the biggest borrowers are, but the amount of transparency pales in comparison to what is now demanded of the Federal Reserve and banks that borrow from its discount window or emergency lending facilities.[170]

Looking at the annual reports to Congress over the last decade reveals a FHLBank system that provides a lot of loans to very large financial institutions. At the end of 2017, for example, "the largest borrowers at the holding company level were J.P. Morgan Chase, Wells Fargo, Citigroup, and Bank of America., which together represented $175 billion or 24.0% of total FHLBank advances."[171] In 2019, the biggest borrowers were Wells Fargo (again), J.P. Morgan Chase (again), Citigroup (again), and BB&T.[172] All very big financial institutions, whose collective borrowing represented 16% of all advances extended that year. The same trend held in 2021, when the five largest borrowers were New York Community Bancorp Inc., MetLife, J.P. Morgan Chase, Midland Financial Co., and TIAA," which collectively "represented $60.1 billion or 17.2% of aggregate advances.

In 2022, the makeup of the five largest borrowers shifted a bit, foreboding the troubles to come for large regional banks. By the end of the

170. *E.g.*, OFF. OF THE DIR., FED. HOUS. FIN. AGENCY, 2022 REPORT TO CONGRESS (2023); DIV. OF BANK REGUL., FED. HOUS. FIN. AGENCY, REPORT ON COLLATERAL PLEDGED TO FEDERAL HOME LOAN BANKS (2022).

171. OFF. OF THE DIR., FED. HOUS. FIN. AGENCY, 2018 REPORT TO CONGRESS 14 (2019).

172. OFF. OF THE DIR., FED. HOUS. FIN. AGENCY, REPORT TO CONGRESS 2019, at 36 (2020).

year, Wells Fargo remained in the top five, but the other four—PNC Financial Services Group Inc., Truist Financial Corporation (formerly BB&T Corporation), New York Community Bancorp, Inc., and U.S. Bancorp—were all large regional banks.[173] This again illustrates how the FHLBank system operates at the forefront of potential weaknesses in the banking system, in addition to showing the outsized role of the largest borrowers, as the top five had loans totaling $139.4 billion, seventeen percent of the aggregate advances.

Zooming in on New York, one of the biggest FHLBanks, provides some more color. At the end of 2022, outstanding advances to the three biggest borrowers constituted forty-three percent of the total advances; and the top ten constituted seventy-six percent.[174] Citibank came in number one. Five of the top ten were insurance companies. Signature Bank came in fourth with respect to the par value of advances outstanding, and second if looking at the profits generated from those advances.

There is no single take-away from these figures. They are consistent with the notion that the FHLBank system is more focused on profitability and rent extraction than public impact. This type of lending yields significant private gains for FHLBanks and their members. In lending so much to large institutions, the FHLBanks engage in far more borrowing and lending than they would if making fewer large loans. This increases the rents extracted via the implicit government backstop, increases profits and increases the dividends paid.

Each FHLBank sets its own dividend policy, but most have been quite generous in recent years. Continuing with the FHLBank of New York example, every quarter for the preceding five years (between Q2 of 2018 and Q1 of 2023), the FHLBank paid out dividends. The dividend rate varied, but was never below 4.25% despite the low interest rate prevailing for much of this time. And in recent quarters, the dividend rate exceeded 7%.[175] This money went disproportionately to the shareholders, as the top six as of the end of 2022 held more than 58% of its outstanding stock, and three of those six are insurance companies, but all members enjoyed higher risk-adjusted returns than they could have earned on just about any other investment.[176] And dividends have continued to increase across the FHLBank system in 2023. Despite the failures of SVB and First Republic, the FHLBank of San Francisco paid a quarterly dividend in excess of 8% for the third quarter of 2023.[177] In aggregate, the FHLBanks paid out $1.3

173. *Id.*

174. Fed. Home Loan Bank of N.Y., Annual Report (Form 10-K) (Mar. 17, 2023).

175. *Investor Relations*, FED. HOME LOAN BANK N.Y., https://www.fhlbny.com/about-us/investor-relations [https://perma.cc/JL6G-7RRR] (last visited Aug. 21, 2023).

176. Fed. Home Loan Bank of N.Y., Annual Report (Form 10-K) 174 (Mar. 17, 2023).

177. Press Release, Fed. Home Loan Bank of S.F., Bank Announces Third Quarter 2023 Operating Results (Oct. 26, 2023), https://www.fhlbsf.com/about/newsroom/bank-announces-

billion in dividends each year from 2020 to 2022; they further paid out $1.5 billion in just the first half of 2023.[178] These totals dwarf the amounts paid into affordable housing programs.[179]

Yet the public rationale for allowing the FHLBanks to make so many large advances to large banks and to significantly increase lending to regional banks is far from clear. Most very large banks and insurance can access market-based sources for financing through more direct means. When they cannot, there may be a very good reason they should not have access to fresh funding without some type of market-based or public-benefit check. As Dan Tarullo and co-authors point out, "beyond providing an additional emergency liquidity backstop, FHLBs allowed credit unions… to increase their assets beyond what their stable deposit funding would have permitted, adding to the fragility of the financial system."[180] The same can be said with respect to borrowing by other types of FHLBank members. More generally, although making large loans to large and very large financial institutions is consistent with Congress's implicit decision in 1989 to expand the FHLBanks in ways that would generate the profits needed to pay off the RefCorp bonds, it is entirely foreign to the original design of the FHLBanks. And the rationale for allowing such profits subsequent to the full repayment of the RefCorp bonds is far from clear.

Small banks do still use FHLBank advances as well, and they are likely to be more reliant on such advances as they are less able to access capital market funding in other ways. According to the Independent Community Bankers of America (ICBA), which advocates on policy matters that impact the country's community banks, "over ninety-five percent of ICBA members belong to their regional FHLB."[181] The ICBA's depiction of the role the FHLBanks currently play is remarkably well aligned with the original model. As the ICBA explains: "Community banks provide local knowledge and local contacts with home builders, small businesses, economic development officials, and community leaders. The FHLBs in turn provide the necessary liquidity needed to complete many local projects."[182] This depiction does not justify or explain the current scope of the FHLBank system, but it does suggest that looking past the biggest shareholders and borrowers can reveal domains where there continue to be significant frictions of the kind the FHLBanks may be well positioned to help address.

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third-quarter-2023-operating-results?title_ns=%22third%20quarter%22 [https://perma.cc/Q4BJ-DQPY].

178. *FHFA Report*, *supra* note 5, at 49.

179. *Id.*

180. Gissler, Narajabad & Tarullo, *supra* note 3, at 17.

181. Letter from Ron Haynie, Senior Vice President, Hous. Fin. Pol'y, to Sandra Thompson, Dir., Fed. Hous. Fin. Agency (Mar. 31, 2023), https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/comments-on-fhlbank-system-at-100-review.pdf [https://perma.cc/69CL-6YRL].

182. *Id.*

2. Collateral: Allowed, Used and Not Used

Alongside understanding the range of financial institutions that borrow from the FHLBanks, looking at the types of collateral they post sheds further light on the actual impact of today's FHLBank system. According to annual reports made to Congress on the types of collateral posted in the FHLBank system, single-family housing remains the most common type of collateral used for advances. At year-end 2021, single-family (one to four units), first-lien loans constituted forty-eight percent of the collateral posted and multi-family was another nine percent. Whether advances backed by home loans still advance housing related aims is a more difficult question given the increased liquidity of such loans and the breadth of other activities that member institutions undertake.

On the one hand, one (as yet, unpublished) paper by Dayin Zhang suggests that the FHLBank system continues to have a favorable impact on mortgage availability and terms.[183] The paper looked at instances where a bank acquired multiple smaller banks, some of which were FHLBanks members and some of which were not. It then looked at the impact of the acquisition on mortgage availability and terms in the area served by the acquired bank. It found that the positive impact on mortgage availability increased and terms was greater when the target bank was not previously a FHLBank member than when it was, leading the author to conclude that FHLBank membership (as opposed to improvements in management) played a causal role in any improvements in mortgage availability and terms. The paper further found that the impact was greatest for smaller banks, consistent with the notion that smaller banks have fewer alternatives readily available to them. Given the many benefits of FHLBank membership for small banks, the assumption that small banks that were not FHLBank members are as well managed as otherwise similar banks that are FHLBanks members may be a questionable assumption and non-banks play a much bigger role in the mortgage space today than during the period examined (1994–2016). Nonetheless, the piece does raise interesting questions about the financial constraints that may continue to inhibit lending by banks and other financial intermediaries and the way GSE provision of collateralized loans to alleviate such constraints may enhance the terms and availability of credit.

On the other hand, there are a lot of reasons to suspect that the relationship between the collateral posted and actual lending is far more attenuated today than it was in 1932. This is particularly true with respect to traditional, residential loans that have become far more liquid and are now deeply integrated into an ecosystem with deep secondary markets, in significant part because of the government programs outlined above. Examples of financial institutions posting acceptable housing collateral only to

183. Zhang, *supra* note 62.

use the fresh liquidity to fund activity well beyond the scope of what the FHLBanks have ever been designed to support are rampant.

Tarullo and co-authors, for example, highlight the way a credit union used FHLBank liquidity to grow rapidly, with much of that growth occurring outside of its mortgage business.[184] Bloomberg has had a series of articles showing how sophisticated "financiers [are] tapping into the nation's 11 Federal Home Loan Banks" to access liquidity for a wide range of purposes.[185] Although they must post the required collateral, MBS and Treasuries are so liquid and pervasively used, this often has not proved to be much of constraint on the ability of some of these financiers to use FHLBank funding while "operat[ing] more like hedge funds."[186] According to an analysis by Bloomberg, at the end of 2022, "42% of the more than 6,400 banks, credit unions and insurers that could borrow from the [FHLBank] system hadn't reported making a single mortgage in the past five years."[187] Before recent reforms, Marsh, which holds itself out as the "the world's leading insurance broker and risk advisor,"[188] worked with REIT clients to create captive insurance companies "for the purpose of accessing funding with the Federal Home Loan Bank system."[189] As Marsh explained: "Clients have formed FHLB captives that not only help insure the risks of the mortgage originator or REIT parent, but also help the company gain access to low-cost funding through the FHLB, allowing them to increase leverage and improve liquidity at attractive rates."[190] Although this particular loophole has been largely closed, this is illustrative of the ways that in accepting collateral that is already very liquid and that is widely used by private and government actors for liquidity management purposes, the FHLBanks have positioned themselves to be more generic liquidity providers that facilitators in the issuance of scarce credit.

Commercial real estate (CRE) loans are the second most common type of collateral pledged with the FHLBank system. CRE constituted more than twenty-one percent of pledged collateral at year-end 2021, and

184. Gissler, Narajabad & Tarullo, *supra* note 3, at 16-17.

185. Noah Buhayar, Heather Perlberg & Tom Schoenberg, *How a Vegas Whale, and Many More, Tap Billions Meant for US Housing*, BLOOMBERG (Oct. 20, 2023, 7:15 AM EDT), https://www.bloomberg.com/news/articles/2023-10-20/savvy-financiers-tap-billions-meant-for-mortgages-from-1-4-trillion-fhlb-system [https://perma.cc/5V5F-2WRC].

186. *Id.*

187. *Id.* The reasons for not reporting lending to the government vary, but it commonly reflects the fact that "many members lend so little to homebuyers that they are not subject to the reporting requirements of the Home Mortgage Disclosure Act." *Id.*

188. *About Marsh*, MARSH, https://www.marsh.com/pr/en/about/about-marsh.html [https://perma.cc/RS4M-EPLQ].

189. *Using Captives to Access Federal Home Loan Banking System Funding*, MARSH, https://www.marsh.com/pr/en/services/captive-insurance/insights/using-captives-to-access-federal-home-loan-banking-system-funding.html [https://perma.cc/ZP6F-B2SX].

190. *Id.*

the figure has been around twenty percent for some time.[191] As CRE loans are much less liquid than traditional home loans, the FHLBanks may have more of an impact on actual lending here. But whether that impact is desirable is another question. The bigger haircuts that the FHLBanks demand on CRE collateral protect the FHLBanks from losses but don't address the other consequences that may flow from promoting CRE lending. Notably, CRE has always been risky lending, and is connected with banking crises across jurisdictions.[192]

At the other end of the spectrum from single-family residential and CRE loans are the types of collateral that FHLBanks are allowed to accept but that are not used that often in practice. Most striking in this regard is the dearth of "community financial institution collateral." A little background here is helpful. In the Gramm-Leach-Bliley Act of 1999, Congress continued the general trend of deregulation, with respect to the FHLBank system and banking generally, but it did so—in part—in a manner that was mindful of how much the FHLBank had veered from its original design and focus. Consistent with the traditional function of the FHLBank system to support small, community-focused financial institutions and to facilitate the issuance of credit that served local communities that might be otherwise under-supplied, Congress authorized the FHLBank to accept some additional types of collateral from "community financial institutions" (CFIs)—FDIC-insured banks and thrifts with assets below $1 billion, adjusted for inflation (currently, $1.239 billion).[193] As a result, CFIs can use small business loans, small agricultural loans, including farm and agribusiness loans, community developments, and other types of related instruments as collateral for advances from the FHLBank system.

In 2008, as part of the Housing and Economic Recovery Act of 2008, Congress took the focus on small financial institutions and community lending one step further and authorized community development financial institutions (CDFI) certified by the Treasury Department to also join the FHLBank, even though such institutions are not subject to prudential oversight by a banking regulator. These institutions too can post the wider array of collateral that supports community development beyond housing finance.

191. *See* DIV. OF BANK REGUL., FED. HOUS. FIN. AGENCY, REPORT ON COLLATERAL PLEDGED TO FEDERAL HOME LOAN BANKS 6 tbl.1 (Nov. 8, 2018), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Collateral-Pledged-Report_Nov2018.pdf [https://perma.cc/GYW5-2Y47] (showing that commercial real estate was nineteen percent of pledged collateral at year-end 2017).

192. Richard J. Herring & Susan M. Wachter, *Real Estate Booms and Banking Busts: An International Perspective* (Wharton Sch., Univ. Pa., Fin. Insts. Ctr. Working Paper No. 99-27, 1999), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2546407 [https://perma.cc/Q8QE-W3QM].

193. Notice of Annual Adjustment of the Cap on Average Total Assets That Defines Community Financial Institutions, 86 Fed. Reg. 6650 (Jan. 22, 2021).

Much like the mortgage market of a century ago, credit in many of these domains appears to remain constrained and smaller financial institutions play a distinct and important role in facilitating the flow of credit of the types that now qualify. For example, a recent staff report from the New York Fed found a positive correlation between the extent of growing inequality in a state and declines in small business employment.[194] They posit that this connection arises because less wealthy households have proportionately more of their wealth in bank deposits, enabling local banks to extend credit to local small businesses. As household wealth goes up, relatively more savings flow to capital markets and less goes into local banks. This limits the ability of local banks to make loans. Their finding that small business employment goes down suggests that both small banks and small businesses face real constraints, and that limited access to credit can meaningfully diminish the ability of small businesses to grow in ways that would support employment and other aspects of the local economy.

Other evidence tells a similar story. According to the Federal Reserve's 2023 small business credit survey, 94% of the small businesses surveyed experienced some type of financial challenge in the preceding year, with the majority having difficulty paying operating and navigating uneven cash flows—challenges that credit lines and other ready access to credit can help address.[195] Forty percent of the firms surveyed did in fact seek a loan or credit line, usually to pay operating expenses or to expand.[196] Of those, only 53% were fully approved, another 26% were partially approved and 21% were denied any new credit.[197] Not measured is how many didn't seek credit, even if fresh cash would have been quite useful, because they did not anticipate being approved.

Evidence also supports the important role that small banks have long played, and continue to play, in small business lending.[198] In 2021, for example, community banks held just 13% of the banking system's assets and

194. Sebastian Doerr, Thomas Drechsel & Donggyu Lee, *Income Inequality and Job Creation*, FED. RSRV. BANK N.Y. (Aug. 2023), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr1021.pdf [https://perma.cc/RVH9-KA9W].

195. Emily Wavering Corcoran, Jordan Manes, Lucas Misera & Ann Marie Wiersch, *2023 Report on Employer Firms: Findings from the 2022 Small Business Credit Survey* 7, FED. RSRV. BANKS (Mar. 2023), https://www.fedsmallbusiness.org/-/media/project/smallbizcredit-tenant/fedsmallbusinesssite/fedsmallbusiness/files/2023/2023_sbcs-employer-firms.pdf [https://perma.cc/Y52V-TSZA].

196. *Id.* at 13.

197. *Id.* at 17.

198. *See generally, e.g.*, Robert Cull, Lance E. Davis, Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Historical Financing of Small- and Medium-Size Enterprises*, 30 J. BANKING & FIN. 3017 (2006) (finding that a "variety of local financial institutions emerged" in North America "during the 19th and early 20th centuries" "to supply the needs of [small- and medium-enterprises]" and, in so doing, that "they helped to mobilize significant new resources for economic development"). Banks generally have played an important role in small business lending. *See* Mitchell A. Petersen & Raghuran G. Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data*, 49 J. FIN. 3, 5, 7-10 (1994) ("Small firm borrowing is heavily concentrated among a few lenders, with banks being the predominant source.").

17% of its loans, yet they also held 40% of outstanding small business loans.[199] This is a smaller figure than it used to be, but it reflects the persistent and positive relationship between small banks and local, small business lending. The Fed's small business credit survey further found that small businesses report having a much better experience when they borrow from a small bank than when they seek financing from a large bank or a nonbank, such as a fintech lender.[200]

This is just a small slice of the evidence one would want to compile to establish that market failures akin to those that plagued housing finance in 1932 persist, even if in less stark form, in other domains such as small business lending. And that like housing finance, small, community-oriented financial institutions may be uniquely well situated to increase the supply of otherwise under-provisioned credit. Further evidence of the important role that small businesses play in the economy could also help to establish the broader economic gains that such a scheme might enable. And it would also be important to explore the distributional impact of providing further support for small banks to engage in small business lending, as one reason for the historical limitations on banking branching was to ensure the broad provision of credit. There are also other domains where credit may be similarly constrained, including in the housing space beyond single-family homes.

The point here is modest: Even though federal interventions into the mortgage market have smoothed away many of the frictions that once impeded the ability of middle-class families to access an amortizing, long-term mortgage, such frictions likely remain larger than is socially optimal in other domains. And at least some of those domains, like housing finance circa 1932, might be ones that could be uniquely well suited to smaller banks that can harness local knowledge and relationships in the process of originating and subsequently managing a loan. If this is true, there are still ways that a much smaller FHLBank might be able to thrive using the template established in 1932, even if mapped onto new domains.

At the same time, experience shows that *allowing* the FHLBanks to be active in these domains and to play a meaningful role in community economic development is not sufficient. The FHLBanks could do much more along these lines right now, but it is not the most profitable business for them, so most do don't do much of it. CFI collateral represented 1.5 and 1.7% of all pledged collateral in 2020 and 2021, respectively, roughly where it was back in 2017, suggesting little fluctuation and low overall levels.

199. *Community Banks Continue to Play a Pivotal Role for Small Businesses*, FED. RSRV. BANK OF KAN. CITY: COMM. BANKING BULL. (Oct. 14, 2021), https://www.kansascityfed.org/banking/community-banking-bulletin/highlight-community-banks-continue-to-play-a-pivotal-role-for-small-businesses [https://perma.cc/2SCZ-GJK6].

200. Wavering Corcoran et al., *supra* note 195, at 21.

Putting the pieces together, so long as the FHLBanks remain focused first and foremost on profitability and maximizing the rents they can extract for the benefit members, their operations will most likely continue in the form they now take—disproportionately lending more to large banks and accepting real estate loans (which are often either standardized or large) to serve as the primary form of collateral. Lending to smaller institutions against riskier collateral entails more risk or more effort, in the form of actually doing more diligence into the health of the financial institution and the value of the collateral. There may be social benefits to such a course, but the current FHLBanks are not going to get there on their own.

IV. Looking Ahead

The primary aim of this Article is to explain why and how the FHLBanks have veered from their original design in ways that merit attention and reform. Laying out the optimal reforms to adopt is beyond the scope of this Article. Nonetheless, this history does shed helpful light on some of the tradeoffs at play in the approaches to reform currently under discussion. It also opens up and provides some support for a route to reform that thus far has received little attention.

To oversimplify, there are four possible paths for the FHLBank system. At one extreme, the FHLBanks could be allowed to persist in their current form. They are a massive organization and the services they provide to banks likely do have some positive spillover effects on bank lending and other activities. They also play a particularly notable role providing more liquidity to the banking sector during periods of distress, which, once a crisis hits, can help banks avoid fire sales.

Yet, as the analysis here shows, these benefits are likely dwarfed by the drawbacks. Liquidity provision during times of stress is socially useful, but the Fed is far better positioned to provide it than the FHLBanks. The Fed has better information, better resources, better incentives and is more accountable when it comes to the inevitable tradeoffs at play in such lending. Outside of periods of stress, the current FHLBank system facilitates rent seeking by the FHLBanks and their executives and members. That the costs to taxpayers are probabilistic and abstract does not justify the disproportionately private allocation of the gains.

These dynamics do suggest that any reforms should likely be implemented gradually, and should perhaps be accompanied by other reforms. For example, to compensate for what should be a significant reduction in the capacity of the FHLBanks to serve as the lender-of-next-to-last resort, it may be prudent to expand the authority and otherwise seek to reduce around the Fed's lender-of-last-resort facilities. But as the analysis thus far has hopefully made clear, some type of reform is warranted.

At the other extreme, given how far the FHLBank system has veered from its original design, another option is to eliminate the system entirely. This approach would helpfully address the distortions and unfairness the current system engenders. Roll back the clock to 1989, and this may well have been the optimal path for Congress to have pursued. But timing here matters, as to the other alternatives.

With respect to timing, banks generally and small banks in particular have come to rely on the FHLBanks not only as a source of additional liquidity during periods of stress, but as a liquidity and risk management tool in good times as well. Although the largest banks can easily seek capital market financing directly, the same is not true of small banks. And smaller financial institutions are facing significant competitive pressures as a result of digitalization, the continued growth of nonbank alternatives and other developments. The right policy at the wrong time can be the wrong policy, and taking away a long-provided tool of support just when banks most need it could have far-reaching and undesirable collateral consequences, such as accelerating the disappearance of community banks and small regional banks and other community-oriented financial institutions. Thus, before pursuing such a path, it is worth at least considering the alternative options available.

In between these two extremes are myriad proposals to meaningfully reform the FHLBank system. For the sake of simplicity, these can be put into two broad buckets. The first prioritizes housing finance, given that was the aim that the FHLBanks were originally meant to serve.[201] Prioritizing housing finance would likely entail a range of reforms to the FHLBank system. As Mark Zandi and Jim Parrott, principled defenders of the current regime contend, if one really wants to promote housing finance given how the market works today, nonbank lenders such as Quicken and nonbank holders of mortgages, such as REITs should likely be eligible to become FHLBank members as well. The most common reform proposed in this regard is to increase the proportion of the FHLBanks' earnings that must go to affordable housing projects.

There are some advantages to such reforms relative to the status quo. Housing affordability remains a real challenge and many of the inequities in housing were accentuated by actions by the FHLBanks and other federal policies. But there are also significant drawbacks and limitations to this approach. Such efforts to do more for housing will do little to address the core drawbacks inherent in the current FHLBank system. Rent seeking and distortions around liquidity provisioning would likely continue and could even grow. If more money goes to affordable housing, for example, the FHLBanks will have even more basis for lobbying for yet further expansions in their operations. Similarly, allowing nonbanks access to the FHLBank system could also undermine the relative competitiveness of

201. *E.g.*, Shea & Minot, *supra* note 114.

banks and create new risks to the stability of the FHLBank system. Even if nonbank lenders may benefit from having more government-backed liquidity, the FHLBanks are ill-suited to such a public-regarding duty.

The final approach to reforming the system would be to explore ways to revive its original design while mapping that design onto the realities of today's banking and financial system. This would mean homing in domains where the original nexus—small, community-oriented financial institutions PLUS socially valuable credit that may be under-provisioned or extended on terms that are not adequately favorable to the borrower. Where these two come together, collateralized lending of the type the FHLBanks were designed to undertake can have the greatest positive impact—promoting access to credit where it is needed, modestly tweaking the terms of that credit to better suit the needs of borrowers and enhancing the resilience of smaller financial institutions—while reducing opportunities for excessive rent extraction.

To be sure, there are value judgments at play in prioritizing particular types of financial institutions and particular types of credit. This Article has only scratched the surface of the type of information that would need to be compiled to map out exactly what form this type of path should take. But there are a lot of reasons to think such an approach could be fruitful and timely. On both the left and the right, there is increasing attention being paid to the role of government policies in directly and indirectly shaping the types of companies that thrive, and those that cannot survive. Although the focus is often on the drawbacks of excessive concentration and the systemic threats posed by too-big-to-fail financial institutions, there is a related movement afoot to ensure the ongoing viability of small businesses and community banks.

The aim of promoting smaller, more community-focused financial institutions has been central to the U.S. bank regulatory policy for most of its history, with the recent shift away from that focus being more the aberration than the rule.[202] Although there are very good reasons not to revert to a world of only unit banking, providing community-focused financial institutions modest support for engaging in lending that benefits local communities could go a long way in ensuring their viability alongside the global, systemically important banks that now dominate the banking landscape.

Importantly, this type of arrangement, in which a public or quasi-public bank serves as a bank to small, community-oriented banks in ways that enhance their viability and capacity to make socially useful loans, has worked in settings beyond the early decades of the Federal Home Loan Banks. Perhaps the most vibrant example today is the Bank of North Dakota. The Bank of North Dakota is a state-owned bank founded in 1919, a

202. *See, e.g.*, Saule T. Omarova & Graham S. Steele, *Banking and Antitrust*, 133 YALE L.J. 1162 (2024).

time such banks were relatively common.[203] The initial impetus was to help provide wheat farmers in the state access steady financing on reasonable terms by making them less vulnerable to the fluctuating demands of out-of-state bankers. Adopted in conjunction with the creation of a state-controlled grain elevator, the Bank of North Dakota was part of the intra-state infrastructure that state policy makers used to partially shield citizens from the full impact of the Great Depression that soon followed.

Today, the Bank of North Dakota's core mission is to "promote agriculture, commerce and industry in North Dakota," primarily by working with community banks in the state to promote lending that serves these aims. At the end of 2022, more than seventy percent of the bank's $5.4 billion loan portfolio consisted of business or agricultural loans.[204] Usually, a community bank in the state underwrites a qualifying loan and the Bank of North Dakota either "participates" by taking over a share of the loan or buys it outright. This seems to enable the banks to make more loans in ways that, earning over $190 million.

There are also indications that the operations of the Bank of North Dakota have meaningfully enhanced the resilience of small banks in the state and their capacity to make small business and agricultural loans. According to 2014 analysis by the Institute for Local Self Reliance, North Dakota has more small community banks per capita than any other state and those banks extend more small business loans per capital than in any other state.[205] There are also signs that this network of small banks has continued to serve as a valuable infrastructure for providing additional support during periods of stress. For example, in an analysis of the allocation of the first stage of loans issued pursuant to the Paycheck Protection Program, designed to help small businesses and their employees withstand the economic shock associated with Covid, the researchers are the New York Fed found that nearly sixty percent of small businesses in North Dakota had received a PPP loan—a higher proportion than in any other state.[206] There are meaningful differences between the Bank of North Dakota model and the early FHLBanks, and much that may be unique to North Dakota apart from having a state bank. The point here is that it there are models beyond

203. For a history of the Bank of North Dakota, from its origins to today, which has been summarized in a number of sources, see generally *History of BND*, BANK N.D., https://bnd.nd.gov/history-of-bnd [https://perma.cc/7KRT-8YMV]; Yolanda K. Kodrzycki & Tal Elmatad, *The Bank of North Dakota: A Model for Massachusetts and Other States?* (Fed. Rsrv. Bank Bos., New England Pub. Pol'y Ctr., Research Report No. 11-2, 2011); and Stacy Mitchell, *Public Banks: Bank of North Dakota*, INST. FOR LOC. SELF-RELIANCE, https://ilsr.org/rule/bank-of-north-dakota-2 [https://perma.cc/7BXR-DCEM].

204. *See Game Changer: Annual Report 2022*, at 19, BANK N.D. (2023), https://bnd.nd.gov/pdf/2022_bnd_annual_report.pdf [https://perma.cc/KW8F-5NFK].

205. Mitchell, *supra* note 203.

206. Haoyang Liu & Desi Volker, *Where Have the Paycheck Protection Loans Gone So Far?,* FED. RSRV. BANK N.Y.: LIBERTY ST. ECON., (May 6, 2020), https://libertystreeteconomics.newyorkfed.org/2020/05/where-have-the-paycheck-protection-loans-gone-so-far [https://perma.cc/HK2D-JH47].

the early days of the FHLBank system that could also serve as useful templates for evaluating the benefits and challenges of restructuring this GSE so that it could better support the vibrancy of small, community-oriented banks and particular types of credit creation.

This Article lays the groundwork needed to see how the FHLBank system could be harnessed to enhance the resilience of smaller banks and to help spur small banks to remain focused on serving the businesses, farmers and others in the communities where they operate. Significantly, Congress has already laid much of the groundwork needed for the FHLBank system to shift in this direction, although further work would be needed to align the statutory scheme with such a vision.

The biggest challenge lies in shifting the focus of the FHLBanks so they actually use their authorities in ways that promote the public aims they are uniquely well suited to promote rather than focusing on their own profitability and the rents they can pass along to members. It is beyond the scope of this Article to create such a road map, and it may take a variety of forms. But the contours are clear. The public-private nature of the FHLBank system should be made clear and should be reflected in its governance and operations. The governance of the FHLBanks should evolve so that its leaders are held more accountable for promoting public aims more and are less accountable in ways that accentuate a focus on profitability. There should also be additional mechanisms for promoting transparency and public engagement with the FHLBanks, starting with more public information about just who is borrowing from the FHLBanks, in what volumes and on what terms. There should be limits on the shareholdings and advances to preclude—or at least limit—the skew toward the largest FHLBank members embedded in the current regime. There should similarly be limits on how quickly any individual financial institution can increase its reliance on the FHLBanks relative to peers, reducing the capacity for troubled banks to lean on the system for support. And, there should be mechanisms by which the FHFA routinely assesses how changes in the nature of banking and financial markets more generally alter the appropriate scope and focus of the FHLBank system.

More significant changes may also be warranted, and might again be usefully informed by the history laid out here. For example, as useful as the original FHLBank system was, the federal government quickly learned that it could have far more impact—even when working in the context of a carefully calibrated public-private ecosystem—by shifting some credit risk from lending institutions to the government. Some FHLBanks have developed innovative programs for credit enhancement, but far more could be done to use the profits the FHLBanks generate to support risk-sharing arrangements when doing so would help promote the clarified aims of the system.

There are risks with this type of approach, but in conjunction with restructuring and refocusing the FHLBank system, it is the type of intervention that could have a meaningful impact on marginal credit creation where it matters. It would also likely lead to a much smaller FHLBank system than would efforts to focus on housing as housing, reducing significantly the distortions and conferral of unjustified private benefits.

Conclusion

The FHLBank system has been in place for almost a century. Yet the FHLBank system that exists today would be foreign to its creators. The core contribution of this Article is to show why meaningful reform of the FHLBanks is overdue, and the many, even if subtle, costs that flow from allowing the status quo to persist. Yet it further shows that if the aim is to promote public aims while minimizing the private benefits and distortions, the original model of the FHLBank system is a great place to start. Mapping that design onto the very different landscape that exists today shows that it is still possible to use this public-private hybrid to support smaller banking organizations and to promote lending that benefits the lender, borrower and the community where both reside and yet may not occur without some additional grease.