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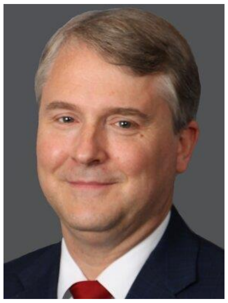
4 Key Types Of Coming FHLBank Reforms To Watch

By **Andrew Olmem, Jeff Taft and Daniel Pearson** (December 11, 2023, 10:58 AM EST)



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Although the Federal Housing Finance gency's recent review of the Federal Home Loan Bank system has received relatively little press attention, the FHFA's proposed reforms, if adopted, could significantly alter the structure and operation of the FHLB system, and potentially materially change the requirements of being a Federal Home Loan Bank member.

On Nov. 7, the FHFA released its much-anticipated report, "FHLBank System at 100: Focusing on the Future."[1] The report contains the results of the FHFA's yearlong comprehensive review of the FLHB System and a series of proposed regulatory and legislative reforms. This article provides an overview of the report and its legislative and regulatory recommendations.

Background

Over the past year, the FHFA has conducted a comprehensive review of the FHLB system that included several public listening sessions, roundtables with thought leaders, and solicitations for written comments. In anticipation of the FHLB system's upcoming centenary, the FHFA undertook the review to assess what changes may be needed to enable the FHLB system to complete its mission in the years ahead.

In the report, the FHFA states that its

> vision for the future is to have an effectively governed [FHLB] System that efficiently provides stable and reliable funding to creditworthy members and delivers innovative products and services to support the housing and community development needs of the communities its members serve, all in a safe and sound manner.

To realize this vision, the FHFA proposes reforms to four categories:

1. The mission of the FHLB system;

2. Stable and reliable source of liquidity;

3. Housing and community development; and

4. The FHLB system's operational efficiency, structure and governance.

The FHFA also indicates that it intends to implement other reforms through the supervisory process or other administrative means, such as the issuance of guidance. The FHFA's key recommendations are discussed in more detail below.

FHFA Recommendations

1. The Mission of the FHLB System

In the report, the FHFA notes that no specific institutional mission for the FHLB system was provided when the FHLB system was established in 1932. The FHFA contends that a more explicit mission statement is warranted, and states that it intends to develop a statement that expressly incorporates the objectives of:

1. Providing liquidity to members; and

2. Supporting housing and community development.

Once the FHLB system's mission is clarified, the FHFA wants to further incentivize mission compliance by expanding the scope of examinations to which FHLBanks are subject and rewarding institutions that demonstrate commitment to the mission objectives.

Finally, the FHFA plans to broaden the FHLBanks' reporting obligations to include a more detailed discussion of their district needs and how well they are meeting them.

2. Stable and Reliable Liquidity

Recognizing that the FHLB system was established to provide liquidity to members and support the housing market, the FHFA states its intent to enhance the FHLBanks' ability to meet this core objective.

In the report, the FHFA describes its plans to ensure that FHLBank funding remains low-cost even in times of high demand. It also plans to improve banks' ability to manage intraday liquidity to meet member needs, including by restricting debt issuance by a single FHLBank and increasing limits on FHLBanks' unsecured extensions of credit using deposits held in interest-bearing deposit accounts to equal the limit on overnight fed funds sales.

However, the FHFA states that it wants to make sure that member commercial banks and thrifts do not turn to the FHLBanks, rather than the Federal Reserve, as lenders of last resort during times of financial distress. Legal and operational limitations constrain the ability of the FHLBanks to play this role. The FHFA says it intends to work with the Federal Reserve Board and federal banking regulators to facilitate the use of the discount window for institutions in weakened conditions, rather than relying on the FHLBanks.

In addition, the FHFA will work with its large depository members to ensure that they have agreements in place to borrow from the discount window. The FHFA will also negotiate with the Federal Reserve Banks to facilitate the movement of collateral from FHLBanks to Federal Reserve Banks to support discount window lending.

In the report, the FHFA also describes its plans to require the FHLBanks to engage in more intensive risk management of their members to mitigate the safety and soundness risks that can arise from a member's poor financial performance. To that end, the FHFA seeks to enhance its oversight of each FHLBank's credit risk evaluation of its members, tighten limits on a member's ability to access advances without sufficient capital, and reassess prepayment penalties that can exacerbate the costs of member failure.

The FHFA also intends to increase its scrutiny of FHLBanks' own capital management practices by reviewing each FHLBank's retained earnings policies, and by imposing annual stress testing assessment and disclosure requirements.

Finally, the FHFA outlines its plan to require FHLBanks to incorporate climate resiliency efforts into their core business and housing programs to account for higher insurance costs and risk to collateral stemming from climate change.

3. Housing and Community Development

A recurring theme throughout the report is strengthening the FHLB system's role as a facilitator of affordable housing and community development. The FHFA states that it wants to take additional steps to ensure that collateral securing FHLBank advances furthers this objective. To do so, the FHFA intends to find ways to bring more non-depository community development financial institutions, or CDFIs, into FHLBank programs.

The FHFA also wants the FHLBanks to establish mission-oriented collateral programs, and seeks to support this initiative by allowing all CDFI and credit union members to pledge Community Financial Institution, or CFI, collateral to secure FHLBank advances, a benefit currently only available to Federal Deposit Insurance Corp.-insured depository institutions.

CFI collateral includes small business loans, small farm loans, small agribusiness loans, community development loans and certain related securities. The FHFA takes the view that permitting CDFI and credit union members, which would qualify as CFIs were their deposits FDIC insured, to pledge CFI collateral would help these institutions support the FHLB system's housing and community development goals.

In the report, the FHFA states its intent to study whether FHLBank advances should be more strictly tied to uses of funds that advance FHLB system mission objectives. The FHFA notes its interest in potentially broadening the definition of "long-term advance," which would require a greater proportion of FHLBank advances to be tied to FHLB system mission objectives.

The FHFA also calls for increasing the minimum statutory funding — both on a voluntary basis and through congressional action — for the Affordable Housing Program from the current 10% of each FHLBank's yearly net earnings, and expanding the use of Community Investment Programs and Community Investment Cash Advance programs by members.

The FHFA also intends to expand access to affordable housing programs — potentially by "updating [Affordable Housing Program] regulatory provisions for revolving loan funds, assessing options for [area median income (AMI)] flexibility in high-cost areas, increasing per-household homeownership set-aside grants in high-cost areas, and revising certain project compliance and monitoring requirements to increase programmatic efficiency."

The FHFA also seeks to enhance the scope of the Targeted Community Lending Plan.

Finally, the FHFA states that it wants to look at ways to increase support for pilot programs to address district needs, increase multifamily housing support and support for first-time homebuyers, enhance requirements for member financing in their own communities, and expand the FHLBanks' mortgage loan purchasing activities in minority census tracts.

4. FHLB System Efficiency, Structure and Governance

The FHFA proposes a series of reforms to the operations of the FHLB system. The FHFA states that FHLB system membership requirements should be "strengthen[ed] and harmonize[d]," such as by requiring members to demonstrate an ongoing commitment to mission objectives and by taking a more stringent approach to members' compliance with membership requirements.

Probably most importantly, the FHFA intends to require members to have at least 10% of their assets in residential mortgage loans or equivalent mission assets on an ongoing basis, rather than only at the time of application.

The FHFA also discusses potential changes to FHLBank membership requirements, including the possibility of extending membership to additional entity types, as long as they are subject to existing membership requirements, such as nonbank mortgage companies and mortgage real estate investment trusts. The FHFA acknowledges that stakeholders have increasingly asked for the inclusion of these institutions within the FHLB system, but states that this reform would require a statutory change.

If Congress were to amend the membership eligibility requirements, the FHFA recommends that any newly eligible entities be subject to the generally applicable membership requirements to ensure safety and soundness and mission orientation, including "(1) inspection and regulation, (2) community support or service requirements, and (3) the requirement that 10% of their assets be in residential mortgage loans or an equivalent mission asset or activity requirement."

The FHFA will also issue guidance aimed at achieving parity between members that have access to multiple FHLBanks and those with access only to one FHLBank.

The FHFA also states that it plans to review the number of FHLBanks and the distribution of members among them, observing that members are unevenly distributed among the 11 existing FHLBanks, which are themselves unevenly distributed across the U.S. states. While the FHFA raises the possibility of reorganizing districts and consolidating FHLBanks, it acknowledges that the number of FHLBanks is required by statute to be between eight and 12.

Finally, the FHFA discusses whether there is a need to change expectations with respect to FHLBank board size, composition and executive compensation. The FHFA notes that the statutory "grandfather provision" can result in imbalances in representation between states. The FHFA contends that board composition could benefit from increased diversity of experience, skills and technical subject matter expertise.

The FHFA will also recommend that Congress pass legislation to grant the FHFA more authority over the setting of FHLBank executive compensation. Further, the FHFA will seek to clarify each FHLBank board's duty to more closely tie executive compensation to FHLB system mission objectives.

Going Forward

The report signals the start of a significant effort by the FHFA to reform the FHLB system. For most FHLBank members, the most consequential reforms are likely to be any changes to the requirements for obtaining FHLBank advances and FHLBank membership requirements.

In addition, the proposed changes in FHLBank lending to distressed banks, if adopted, could limit FHLBank members' access to FHLBank advances when they are most in need. To the extent that the Federal Reserve's discount window lending does not provide a perfect substitute for the loss of access to FHLBank advances, members could find themselves with less access to liquidity during times of financial distress.

Conversely, new limits on FHLBank advances to distressed banks could finally cause a revival in the use of the discount window, which banks have been reluctant to borrow from due to a perceived stigma associated with its use.

Although the most consequential reforms will require statutory changes that are unlikely to pass during the remainder of the current term of Congress, the FHFA could be well positioned to secure legislation in the next Congress depending on the results of the 2024 elections. In the near term, the FHFA is now expected to issue rulemakings to implement the proposals that do not require statutory changes. Accordingly, FHLBank members should be prepared for a series of rulemakings by the FHFA over the course of the next year.

Because the FHFA expressly states its intent to also adopt certain reforms through the supervisory process, FHLBanks should expect more stringent supervisory actions from the FHFA. The report is just the beginning of what is likely to be a long reform process of the FHLB system.

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[1] https://www.fhfa.gov/PolicyProgramsResearch/Programs/Pages/FHLBank-Focusing-on-the-Future.aspx.