How the FHFA Can Increase Federal Home Loan Bank Affordable Housing Investments

Michael Stegman

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The Federal Housing Finance Agency (FHFA) has initiated a sweeping review of Federal Home Loan Banks (FHLBanks) as the system enters its 10th decade,[1] focusing on, among other issues, how the system can return to its historical mission of providing liquidity to financial institutions across the country to expand mortgage lending in a changing marketplace, and finding sensible ways to strengthen the "FHLBanks' role in promoting affordable, sustainable, equitable, and resilient housing and community investment," the subject of this brief.[2]

The Role of the Federal Home Loan Bank System

Created in 1932, long before the widespread adoption of the long-term fully amortizable fixed-rate mortgage and a securitization-based secondary market, the national network of 11 FHLBanks (originally 12) was created as a for-profit, cooperatively owned system with a mission to increase liquidity and mortgage lending for its now 6,700 financial institution members who were once the dominant providers of mortgage finance to American households.[3] Thanks to government sponsorship such as that received by its younger government-sponsored enterprise (GSE) siblings, Fannie Mae and Freddie Mac, the FHLBank system features an implied federal guarantee of its debt, enabling it to borrow at near-government rates. This federal guarantee enables the FHLBanks to supply below-market-rate loans (i.e., advances) to their respective members while earning a spread. To secure the advances, member institutions must pledge collateral to the FHLBanks, which decide how much to advance by discounting (haircutting) that collateral based on how safe or risky they perceive the collateral to be.

Most FHLBank advances constitute an arbitrage of credit flows in the capital markets, generating system-wide net profits of $1.8 billion in 2021, more than half of which (57 percent) was returned to the members in the form of dividends (FHLBank, n.d.-a).[4] Given that this profit is based on an implied government subsidy of more than $6 billion a year according to one estimate,[5] it is fair to ask whether taxpayers are receiving sufficient returns on their investment in the form of affordable housing and community development.

Putting the FHLBanks' Affordable Housing Activities in Perspective

In recognition of this subsidy, the FHLBanks are required by law to allocate 10 percent of their respective net earnings to support a member-based affordable housing program (AHP), including a mandated competitive rental component and a smaller voluntary, noncompetitive homeownership grant.[6]

Through their respective AHPs, the FHLBanks in 2021 collectively awarded $352.4 million that is expected to support an estimated 32,771 affordable homes, including 19,785 low-income rental units and 12,986 homeowner units (DHMG 2022). In the AHPs' more than 30-year history (1990 to 2021), the FHLBanks have allocated $7 billion to support 756,000 affordable units in more than 18,700 rental projects (DHMG 2022). Notably, competitively awarded AHP rental housing grants typically fund only a very small share of total development costs, ranging in 2021 from a low of 2.7 percent by the Atlanta FHLBank to a high of 10.6 percent in Pittsburgh AHP awards, which raises the question of the overall impact of AHPs in expanding the supply of affordable rental housing (DHMG 2022). From 1995 through 2021, the FHLBanks' homeownership set-aside programs provided approximately $1.5 billion in funding, supporting more than 251,000 low- and moderate-income households, almost 84 percent (211,999) of whom were first-time homebuyers, whose average grant over the period totaled $5,992.

These AHP data exclude any affordable homes funded by member institutions who participate in either of the two FHLBank system's secondary market initiatives: the Mortgage Purchase Program (MPP) and the Mortgage Partnership Finance Program (MPF®). Mortgages the FHLBanks buy under the MPP are held on the balance sheet, with the seller retaining credit risk and the FHLBank holding liquidity, interest rate, and prepayment risks. At year-end 2021, the FHLBanks collectively held $55.5 billion in MPP loans in portfolio, representing 8 percent of their combined total assets (FHLBank, n.d.-a). Created in 1997 by the Chicago FHLBank, the MPF provides a secondary market outlet for approved members who are predominantly small banks or thrifts and credit unions with assets of less than $400 million, who face challenges dealing directly with Fannie Mae or Freddie Mac (FDIC 2017). Today, 9 of the 11 FHLBs purchase conventional and government loans from their participating financial institutions through the MPF.

Taking note of the above exclusion, 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 (DHMG 2022). In 2021, Fannie Mae and Freddie Mac together funded 360,000 single-family affordable purchase mortgage loans, of which 62 percent were to first-time homebuyers (FHFA 2022a). On the multifamily side, the GSEs acquired loans on approximately 750,000 low-income rental units in 2021, including approximately 170,000 that were affordable to very low–income households. In addition to these direct mortgage acquisitions, the GSEs generated more than $1.1 billion in additional low-income housing resources in 2021 through a statutory affordable housing assessment. In the seven years it has been levied (2016 through 2022), this assessment has yielded more than $4.3 billion in affordable housing resources that by law are channeled to the US Department of Housing and Urban Development's Housing Trust Fund and the US Treasury's Capital Magnet Fund (FHFA 2022b).

The Value Proposition for Taxpayers and Recommendations for Action

AHP funding ($352 million in 2021) may be weighed against the value of the FHLBanks' implied government guarantee (about $6 billion in 2021) and other benefits such as exemption from local, state, and federal income taxes or its emergency credit line from the US Treasury. Or the funding could be measured relative to the dividends returned to member financial institutions who are shareholders in their respective FHLBank cooperatives, which totaled more than $1 billion in 2021.[7] However the funding is weighed, a good case can be made that the value proposition for taxpayers is not compelling. This is why the Biden administration's failed Build Back Better Act would have increased required AHP funding to 15 percent of net profits instead of the current 10 percent,[8] while another bipartisan measure awaiting consideration in the current Congress would double AHP funding to 20 percent if passed.[9]

Should an FHLBank measure be taken up this session, lawmakers should consider putting the FHLBanks on equal footing with Fannie Mae and Freddie Mac affordable housing funding by replacing the 10 percent profits tax with an annual assessment of 15 to 20 basis points on the rolling 12-quarter average of the outstanding balance of FHLBank advances. Moving to a three-year moving average would reduce year-to-year volatility, and making affordable housing funding part of the FHLBank business model rather than funding AHPs as a tax on profits would reinforce the importance of affordable housing to the FHLBank mission.

It has been 34 years since Congress last legislated significant changes to the FHLBank system (via the Financial Institutions Reform, Recovery, and Enforcement Act[10]), and it has been a decade since legislators took up, but failed to enact, comprehensive GSE reform that notably would have maintained the FHLBank system status quo if it had been enacted, despite glaring weaknesses that were revealed during the financial crisis (CRS 2014). Given this history and a dim likelihood that Congress will seriously consider any FHLBank legislation in the current session, the logical question is whether the FHFA can use its various administrative authorities—supervisory, regulatory, and guidance—to significantly increase the system's funding of affordable housing and community development investments?[11] This brief argues that it can and lays out three broad areas for administrative action.

1. Increase FHLBank Support for Smaller Community Banks and Other Mission Lenders Who Play an Outsize Role in Financing Affordable Housing and Community Development in Underserved Markets

Starting in 1989, Congress has designated a special class of mission lenders eligible for FHLBank membership called community financial institutions (CFIs), originally defined as community banks with assets of less than $500 million (adjusted annually for inflation, the CFI asset limit is currently $1.4 billion).[12] CFIs were later expanded to include federally insured community development financial institutions (CDFIs), minority-owned depositories, CDFI loan funds and venture capital funds, and state-chartered credit unions without federal insurance.[13]

What makes FHLBank membership critical to CFIs is that they are not on equal footing with big banks, facing higher costs in the capital debt markets while having less access to the secondary mortgage market. So when it comes to addressing the unique needs of rural and financially vulnerable communities, an emphasis of the ongoing review of the FHLBank system,[14] the FHFA should do more to support the nearly 3,000 CFIs in smaller rural counties where more affordable credit is desperately needed, and the FHFA should dig into why 4 of the 11 FHLBanks in 2021 failed to issue an advance to a single CFI (DBR 2022).[15] Bolstering the role of CDFIs should also be a high priority. Just 68 of the nation's nearly 1,400 certified CDFIs are members of an FHLBank, which should raise a regulatory red flag (FHFA 2022b). That in the CDFI-rich five-state Boston FHLBank district just 4 of 47 certified CDFI loan funds have become members is another sign that something is amiss.[16]

Although there are likely many contributing factors for these disappointing numbers, a big one has to do with the widespread practice of overcollateralizing CFI borrowings in part to sustain the FHLBank system's boast of never having incurred a dollar of credit loss on a single advance in its 90-year history (FHLB 2019). Each FHLBank establishes its own policies regarding how much it will discount members' collateral values to account for various contingencies, but overall, haircuts generally increase with the perceived risks of the collateral type (DBR 2022). Haircuts on CFI collateral far exceed those on most other asset types because no FHLBank wants to be the first one to have an advance go bad.

In 2021, across all FHLBanks, the weighted average effective haircut on CFI collateral was 43.8 percent—meaning a CDFI, for example, would have to post $178 in collateral for every $100 in advances—which is much greater than the haircuts applied to private-label mortgage-backed securities of 24.9 percent and even larger than the haircuts applied to home equity lines of credit and second-lien collateral (DBR 2022). Given their modest asset holdings, limitations on eligible collateral, and outsize haircuts, many CFIs cannot leverage the benefits of FHLBank membership to serve their communities.

Below are four actions for the FHFA to consider:

- Reduce haircuts on collateral advances posted by highly ranked community banks that are within the CFI asset threshold based upon the Independent Community Bankers of America top lender scoring system[17] or other appropriate metric.

- Reduce haircuts on collateral-securing advances for CFIs, backstopping potential losses with creation of either a FHLBank-by-FHLBank or system-wide first-loss reserve fund that would be capitalized by earnings on FHLBanks' retained earnings that totaled more than $23 billion at the end of 2021.[18]
- Expand CDFI partnerships by building on the commitments made by major companies and foundations to invest in Black CDFIs in response to renewed racial justice concerns, and the FHFA and the FHLBank system should allow banks and other approved third parties to post collateral on behalf of designated CFIs to enable these mission lenders to significantly expand their affordable housing and community development funding.[19]
- Building on its recent decision to reduce Fannie Mae and Freddie Mac guarantee fees for certain borrowers and affordable mortgage products, while raising fees on other nonmission loans to compensate for the lost revenue, the FHFA should explore the feasibility of developing an internal cross-subsidy system for FHLBanks to support greater mission funding that would involve lower markups and spreads on advances to CFIs, while offsetting those discounts with marginally greater markups on advances for non-mission-critical funding.[20]

2. Boost Affordable Housing and Community Economic Development Financing by Ratcheting Up Two Underused Project-Based Investment Programs

In addition to AHPs, the Federal Home Loan Bank Act created two more vehicles for supporting mission-driven investments by FHLBanks: a noncompetitive, mandated Community Investment Program (CIP)[21] and a voluntary Community Investment Cash Advance Program (CICA).[22] Via discounted advances or grants, bank members use these resources to develop targeted housing and community economic development projects to benefit low- and moderate-income households and their communities. Via discounted advances, FHLBanks directed $1.7 billion in CIP affordable housing resources to help 8,000 households and directed funds to help build infrastructure and create and preserve jobs to strengthen local neighborhood economies in 2021 (DHMG 2022). Total FHLBank CICA funding in 2021 added an additional $1 billion in low-cost advances and grant support to targeted economic development.

So far, so good. But total CIP and CICA investments amounting to less than 1 percent of total advances ($351 billion) in 2021 is at best disappointing (FHLBank, n.d.-b). Two FHLBanks did not even participate in CIP that year, despite a statutory requirement. Moreover, less than 3 percent of the more than 6,500 FHLBank members participate in either of the programs—whether through lack of interest, insufficient program knowledge, or unwieldy or overly restrictive requirements, we do not know (DHMG 2022). What we do know is these data points should serve as a clarion call to the FHFA to use its supervisory, guidance, and regulatory authorities to expand participation and use of these important programs.

3. Raise the Threshold on FHLBank Members' Community Support Program Requirements as a Condition for Maintaining Access to Long-Term Advances

When Congress amended the Federal Home Loan Bank Act in 1989 to allow commercial banks to join the FHLB system,[23] it also required FHLBanks and their members to create separate but complementary community support programs.[24] Going forward, each bank would have to create and maintain multifaceted programs to support members' affordable housing finance activities and established standards of community investment and services that each of the now more than 6,000 FHLBank members would have to meet to maintain their access to long-term bank advances. Congress directed that individual community support programs as promulgated by a rulemaking must account for factors *such as* (emphasis added) members' performance under the Community Reinvestment Act, financial institutions subject to Community Reinvestment Act, and members' records of lending to first-time homebuyers.[25]

But the FHFA's community support regulation seems to have turned into little more than a pro forma exercise rather than a way of holding members' feet to the fire. As currently written, the FHFA's online community support template merely requires members to report the number and dollar amount of mortgage loans made to first-time homebuyers in the preceding two years, without setting minimum levels of adequacy or expectations. The remainder of the template is a check-the-box laundry list of related activities and services for members to indicate all that apply, while leaving room to specify other homeownership supports that are not prelisted (FHFA 2012).

Below are two specific actions the FHFA can take:

- The importance of strengthening the community support regulation cannot be overstated since it is the only statutory provision that empowers the FHFA to condition members' continued access to long-term advances on meeting minimum levels of required mortgage activity. The FHFA should consider setting minimum thresholds for mortgage lending by bank members and broaden community support requirements to include a new affordable rental housing finance component. This should be permissible under the statutory language creating the community support program, which prefaces the factors that the FHFA's implementing rule must account for with the phrase "such as."
- When Congress tied members' continued access to long-term advances in 1989, it did not define what constituted a long-term advance, though the FHFA set that threshold at greater than one year. Because of members' increasing reliance on short-term advances—41.5 percent of total advances across the 11 FHLBanks had a duration of one year or less in 2021—the FHFA should consider lowering the threshold for what constitutes a long-term advance from one year or longer to, say, 180 days or more to strengthen the nexus between liquidity and mortgage finance (FHLBank, n.d.-b).

Conclusion

The original intent of the FHLBank system was to provide liquidity to expand home financing for financial institutions that held the mortgages they originated on their balance sheets. Since then, the mortgage market has evolved so that the secondary markets provide the primary source of mortgage liquidity for big FHLBank members. But there remain unmet needs. By deepening support for the broad range of CFI mission lenders, such as exploring additional ways these institutions can more efficiently access the secondary market through refinements to the MPP and the MPF, the FHFA can take important steps to recenter the FHLBank system around its original intent to expand affordable mortgage credit to American households and underserved markets.

Notes

1 "FHLBank System at 100: Focusing on the Future," Federal Housing Finance Agency, last updated March 14, 2023, https://www.fhfa.gov/PolicyProgramsResearch/Programs/Pages/FHLBank-Focusing-on-the-Future.aspx.

2 Federal Housing Finance Agency, "FHFA Announces Comprehensive Review of the Federal Home Loan Bank System," news release, August 31, 2022, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Comprehensive-Review-of-the-FHLBank-System.aspx.

3 See the website for the Federal Home Loan Banks at https://fhlbanks.com/.

4 See also US Department of the Treasury, "'Federal Home Loan Banks' Assistant Secretary of the Treasury (Financial Institutions) Richard S. Carnell House Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises," press release, September 24, 1998, https://home.treasury.gov/news/press-releases/rr2705.

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6 "Housing Mission," Federal Home Loan Banks, accessed March 15, 2023, https://fhlbanks.com/housing-mission/.

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9 Federal Home Loan Banks' Mission Implementation Act, H.R. 3323, 117th Cong. (2021).

10 Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-78, 103 Stat. 183 (1989).

11 "Forum on the Future of the Federal Home Loan Bank System," Brookings Institution, February 10, 2023, https://www.brookings.edu/events/forum-on-the-future-of-the-federal-home-loan-bank-system/.

12 Dusan Stojanovic, Mark D. Vaughan, and Timothy J. Yeager, "Is Federal Home Loan Bank Funding a Risky Business for the FDIC?" *Regional Economist* (blog), Federal Reserve Bank of St. Louis, October 1, 2000, https://www.stlouisfed.org/publications/regional-economist/october-2000/is-federal-home-loan-bank-funding-a-risky-business-for-the-fdic; and Notice of Annual Adjustment of the Cap on Average Total Assets That Defines Community Financial Institutions, 87 Fed. Reg. 80184 (December 29, 2022).

[13] Federal Home Loan Bank Membership for Community Development Financial Institutions, 74 Fed. Reg. 22848 (May 15, 2009).

[14] Federal Housing Finance Agency, "FHFA Announces Comprehensive Review."

[15] See also "Community Banks: Number by State and Asset Size," Banking Strategist, accessed March 15, 2023, https://www.bankingstrategist.com/community-banks-number-by-state-and-asset-size.

[16] "Total Number of Certified CDFIs as of March 14, 2022," Community Development Financial Institution Fund, accessed March 15, 2023, https://view.officeapps.live.com/op/view.aspx?src=https%3A%2F%2Fwww.cdfifund.gov%2Fsites%2Fcdfi%2Ffiles%2F2022-03%2FCDFI_Cert_List%252003_14_2022_Final.xlsx&wdOrigin=BROWSELINK.

[17] See Ed Avis, "Who Made ICBA's 2020 Top Lenders List?" Independent Banker, July 1, 2020, https://independentbanker.org/2020/07/who-made-icbas-2020-top-lenders-list/. Using Federal Deposit Insurance Corporation data for 2019, Independent Community Bankers of America calculates a lender score out of 100 for each community bank. The score combines the average of the bank's percentile rank for lending concentration and for loan growth over the past year in each lending category. It then adjusts each score for loan charge-offs in each category at certain percentile thresholds.

[18] Cortez Masto, letter to Sandra L. Thompson.

[19] Aallyah Wright, "These Alternative Banks Could Be the Key to Shrinking the Racial Wealth Gap," Capital B, March 6, 2023, https://capitalbnews.org/financial-literacy-cdfi-explain/.

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[22] Community Investment Cash Advance Programs, 12 U.S.C. 1430 (2013).

[23] Federal Home Loan Bank Community Support Program—Administrative Amendments, 80 Fed. Reg. 30336 (May 28, 2015), 30342.

[24] Amendments to Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-78, 103 Stat. 183 (1989).

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About the Author

Michael Stegman is a nonresident fellow at the Urban Institute, a visiting professor at Duke University's Sanford School of Public Policy, and distinguished professor emeritus and founding chair of the department of public policy at the University of North Carolina at Chapel Hill. Previously, he was senior policy adviser for housing in the Obama White House at the National Economic Council, after serving three years as counselor to the secretary of the Treasury for housing finance policy. As a top housing policy adviser, he coordinated administration policies on housing finance reform, access to credit, and other housing issues. Previously, he served as assistant secretary for policy development and research at the US Department of Housing and Urban Development (HUD) in the Clinton administration and was deputy assistant secretary for research at HUD under former president Jimmy Carter. Stegman serves on the advisory board of Home Partners of America and has previously held nonresident fellow positions at the Milken Institute, the Joint Center for Housing Studies of Harvard University, the Center for Household Financial Stability at the St. Louis Federal Reserve Bank, the Center for Community Capital at the University of North Carolina at Chapel Hill, and the Bipartisan Policy Center. Stegman has a BA in political science from Brooklyn College and an MCP and PhD in city planning from the University of Pennsylvania.

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