INDUSTRY PERSPECTIVES

The Role of the Implied Guarantee Subsidy in FHLB Membership

Beautiful Politics but Ugly Policy

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The Role of the Implied Guarantee Subsidy in FHLB Membership: Beautiful Politics but Ugly Policy

A Political Economy Essay

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Introduction

The Federal Housing Finance Agency (FHFA), the regulator of Freddie Mac, Fannie Mae and the eleven Federal Home Loan Banks (FHLBs), put out a request for input (RFI) in February of this year concerning what type of companies are eligible to be members of the FHLB system, thereby gaining access to its "low-cost… advances."[1]

The FHLB system consists of eleven regional banks that are cooperatives owned by their members, which their congressional charters currently specify can include commercial banks, thrifts, credit unions, insurance companies and certain other organizations. The FHL banks borrow in the capital markets, with government support (as explained below), and lend the funds – called "advances" – to their member-owners, secured by certain types of loans or securities (also as specified in the charters) and with extra margin to provide credit protection. Because of the government support to their borrowings, the advances are low cost compared to the regular market rate funding available to the member-owners. The original focus of the FHLB system, established as the Great Depression got into full swing and as implied by its name, was on mortgage lending and mortgage-centric financial institutions that were not eligible to be members of the Federal Reserve system (i.e., it excluded commercial banks, which were eligible); such institutions were in great distress at that time. Since then, as described in more detail below, the system has undergone material mission creep.

As the late-June deadline for the RFI neared, articles appeared in the mortgage industry press to report on the views of various interest groups. "Industry trade groups have once again come out in favor of expanding the membership base of the Federal Home Loan Bank system," summarized one such article.[2] It made specific reference to the American Bankers Association (ABA) and the Mortgage Bankers Association (MBA), large and well-established industry associations that naturally represent the interests of their many members – which for the ABA includes the FHLBs themselves, and which for the MBA includes independent mortgage banks (IMBs) – and others who would benefit from becoming members. It also referenced the Urban Institute's support of expanding membership to, in particular, IMBs.

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[1] See FHFA, "Federal Home Loan Bank Membership: Request for Input," February 2020, https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/RFI-on-FHLBank-Membership.pdf.
[2] "Industry Groups in Favor of Allowing New FHLB Entrants," *Inside Mortgage Finance*, June 25, 2020, https://www.insidemortgagefinance.com/articles/218432-expanded-membership-for-fhlbs.

A lot of the comments – including in the RFI document itself – focused on whether it was legitimate or good policy for some mortgage-specialized real estate investment trusts[3] (known as mREITS), which by themselves would not be eligible to be members, to effectively become eligible through the usage of a "conduit" – in this case, a specially-created insurance subsidiary, as insurance companies are eligible to be members.[4] They also focused on the mechanics needed to ensure that any new class of member would be strong enough to not hurt the financial strength of the FHLBs, which is a necessary consideration due to their cooperative structure.

The benefit of FHLB membership is almost always cited by the system's supporters to be access to funding in stressed markets. However, as will be further described below, the reality is much more complex. Membership allows all members to access funds not just in stressed periods, but on an everyday, long-term basis. Given the government support to their borrowings, FHLB advances are cheaper than members could get elsewhere, so that borrowings available on that everyday, long-term basis become a source of subsidy to those borrowing members. And the subsidy has grown over time, to the point where it is now quite large and very politically attractive, as explained below.

Thus, at its core, the real story of FHLB membership expansion is a scramble to get in on one of the largest and most politically attractive subsidies from the taxpayer available to the mortgage industry today: under-market-rate funding to routinely carry mortgage (and some other) assets, which is worth billions of dollars per year… and the amount is growing fast right now. For example, when commercial banks won the right to become members back in 1989, that win represented a major long-term lobbying accomplishment on their part with the payback of subsidized funding costs ever since.

This was a classic unintended consequence: the FHLBs' mission had crept over decades from mainly providing stressed funding for small thrifts to providing subsidized routine funding heavily to large banks. Everyone in the mortgage industry knows about it, but amazingly, in all the submitted comments on the issue of expanding FHLB membership, no one just comes out and says it plainly and clearly (although a very few get close to doing so). It seems to be like a taboo subject, something that one is not supposed to talk about in polite company.[5]

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[3] A REIT is a particular type of leveraged real estate-related investment fund that, because it distributes a high percentage of its profits to its shareholders as dividends, qualifies for certain tax advantages. It has several characteristics more commonly found in hedge funds.

[4] Such subsidiaries, known as "captive insurers," would be used mainly or totally to borrow from the FHLB system to fund the mortgage assets of their mREIT parents. They are not substantively in the actual insurance business.

[5] Interestingly, even the FHFA's RFI document, which in some detail explains the background behind what it calls the "low-cost advances" that the FHLBs make to their members, never just plainly says that this is a case of the implied guarantee. Policy transparency would have been improved if they had done so.

The FHLB subsidy stems from the implied guarantee of its debts by the US government, as more fully explained below. Historically, this implied guaranty subsidy is best known in the context of Freddie Mac and Fannie Mae using it, and arguably abusing it. In fact, prior to their entering conservatorship in 2008, the implied guarantee subsidy was the source of the majority of GSE profits! As a subsidy, it was politically highly attractive because it was so well hidden: it appears on no government budget line and it does not appear on any list of "tax expenditures";[6] it does not require annual congressional approval; in fact, the two government-sponsored enterprises (GSEs) even denied in their public pronouncements that it existed. As a result of all this history, when the two companies entered conservatorship, a key feature of the rescue was the massive forced reduction in the inappropriate use of the subsidy (also discussed further below).

Yet, that very same implied guarantee subsidy is alive and well – and growing – at the FHLBs today. It is the source of virtually all their profits, they officially deny it exists (while privately admitting that it does), it appears on no budget line or list of tax expenditures, it has no obvious limit as to how large it can get, and it does not require congressional reapproval every year. Subsidies don't get much more politically attractive than that – one could even argue that it is possibly the most politically beautiful subsidy ever invented. Naturally, once such an attractive subsidy is created, everyone wants to get their piece of the pie. After all, who would not want a subsidy that is so well hidden and yet so profitable and that can go on year after year, growing without limit. So, for decades, there has been lobbying to get legislative changes, influencing to get favorable regulations, and the cutting of deals to get in on the FHLB subsidy gravy train – it's all part of how Washington works in such a situation. And it has indeed worked quite well for the FHLBs and their members, with a steady expansion (i.e., mission creep) over decades of membership criteria and of what assets can be funded by the subsidized money. Only the taxpayer is the poorer.

This is a story that needs to be told in the interest of that long-suffering taxpayer.

A Very Short History of the FHLB System

In the early days of the Great Depression, housing – at that time, the largest sector of the economy – came under great stress for many reasons, one of which was the drying up of mortgage credit availability. Back then, mortgages were very parsimonious in comparison to today (e.g., maturities were

[6] "Tax expenditures" is a phrase meaning the economic loss of revenue to the US government from some deduction, credit or other special interest feature in the tax code. There are lists of "tax expenditures" to give transparency more equivalent to what on-budget expenditures would receive.

mostly only up to ten years versus today's thirty, loans were available only up to about 50% or 60% of a home's value versus today's 80% and more). They also were mostly not made by commercial banks but by a wide array of community financial institutions (and certain insurance companies), which came under great distress as their sources of funding dried up in the Depression's early days.

As a result, the Hoover administration and Congress developed the Federal Home Loan Bank Act, passed in July 1932, to supposedly provide a quasi-central bank for its members, which consisted of various types of mortgage lenders not then eligible to be Federal Reserve members. Among other things, the act was designed to improve the funding of those home lending institutions – specifically excluding the Fed-eligible commercial banks[7] – by creating something analogous to the discount window at the Federal Reserve. It did so by establishing twelve regional Federal Home Loan Banks[8] that were to act as industry cooperatives among eligible lenders to provide funding against mainly mortgages during stressed markets, which was only possible with government support of the debt issued by the FHLBs.[9] It was one of many efforts in the Depression to provide stressed-market liquidity to lending institutions. Given how stressed markets were during all the years of the Great Depression, the FHLBs developed a business model in which they carried advances to their members at all times, not just during peaks of particular stress.

With the pandemic-related stressed markets that occurred just weeks after the RFI was issued, the importance of such access to liquidity was certainly reaffirmed. However, pressure to expand the membership goes back decades and has persisted in markets undergoing little if any stress; the largest such expansion occurred in 1989 when commercial banks became eligible.[10] As such banks already had access to funds in stressed times via the Federal Reserve's discount window, it should have become apparent to observers that more was going on than just worries about liquidity in tough times.

The original design of the FHLBs really had two overlapping purposes, not just one, as revealed when one digs into the details of how they worked. As stated above, one purpose was to provide benefits to a whole array of smaller, community-based, mortgage-centric financial institutions – what we would now tend to call "thrifts," a politically sympathetic group – that played a key role in housing

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[7] The act listed "any building and loan association, savings and loan association, cooperative bank, homestead association, insurance company or savings bank."
[8] Interestingly, by conventional definition, the FHLBs are actually not banks but specialty finance companies.
[9] An interesting observation is that the Hoover administration looked for the industry to help solve its own problems; this approach contrasts with that of the Roosevelt New Deal, whereby "an alphabet soup" of government agencies were created to solve problems – something very new in the history of the federal government at that time.
[10] Federally insured credit unions also became eligible at that time.

finance; the goal was to help them not just to survive the liquidity stresses of the Great Depression, but also to be strong enough to fight against the collapse of homeownership and homebuilding, which at that time was the biggest sector of the US economy. Given how stressed those years were, the distinction between providing funds just in unusual and temporary (i.e., "stressed") circumstances (which the Fed's discount window was designed to do) and providing funds on an everyday basis, outstanding more permanently, was inadequately established.[11] The FHLBs really could do both. The second purpose, reflected by the nature of how their advances were structured, was to support (via providing funding at low cost) the ownership of mortgage assets by many types of financial institutions, ranging from large insurance companies (not so politically sympathetic) to local thrifts (and, as stated previously, excluding commercial banks).

This multiplicity of roles and lack of clarity about the FHLBs' exact purpose – which was clearly more than just providing stressed-market liquidity – would come back and enable significant mission creep in the decades that followed.

Fast-forwarding to today, the FHLBs are now comprised of eleven banks (after two merged) operating as regional industry cooperatives. They are required to cross-guarantee each other to create, in reality, a single government-supported borrower when it comes to investors buying their debt; in some ways, then, they are a single balance sheet with a complex (and high-cost) legal and operational structure to allow the separate banks and their boards to manage pieces of that balance sheet.[12] They also benefit from advantages given to them by Congress, most prominently (1) an exemption from federal and state income taxes, which functions as another back-door subsidy to the companies, and (2) a line of credit from the US Treasury to purchase up to $4 billion of their debt.

That line of credit is a key component by which the government plays a budget game: put in place all the bells and whistles to make the marketplace believe that the FHLBs will never be permitted to default – such as that line of credit, as well as the federal charters and statements by elected and administration officials over time – but officially deny that any guarantee of their debt exists so that the cost of providing it never shows up in the federal budget.[13] This is called the "implied guarantee," and it

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[11] The Federal Reserve, as part of its efforts to help fight the pandemic-induced economic downturn, has relaxed discount window rules to make borrowing less a "stress" situation and more a routine one because this whole period of time, like the Great Depression, is regarded as being stressed. Supposedly, this relaxation of the rules will end as the downturn subsides.

[12] The FHLBs' Office of Finance runs the collective funding operations of each of the individual FHLBs in recognition of their being, via the cross-guarantee, economically just a single borrowing organization.

[13] The list of special features to show "strong US government support" is long, and includes, beyond the line of credit, such things as: created by Congress, a public mission, interest on their debt exempt from state and local

has proven quite effective over many decades. The two large GSEs, Freddie Mac and Fannie Mae, also historically were beneficiaries of such an implied guarantee, but this advantage was lost in the Financial Crisis and replaced by a formal support agreement. Nevertheless, the FHLBs and other organizations still benefit from the implied guarantee, for which they pay nothing.

As explained in the Introduction, that implied guarantee – especially as it is free – acts as a major subsidy to the FHLBs since they can "raise funds in the capital markets at interest rates only slightly higher than those on comparable Treasury instruments."[14] Those subsidized funds are used mainly by members to routinely carry mortgage assets; stressed-market funding is also available when needed, but this has proven secondary in terms of the dollars employed. (This is, of course, quite different from how the Federal Reserve handles its discount window, which is usually only supposed to be used in stress situations and is generally priced at market or above.) While how much lower (due to the implied guarantee) the cost of funding the FHLBs is varies over time and requires some estimation to calculate, the difference is clearly significant.[15]

The mission creep of the FHLBs stems from special interests (including the FHLB management teams) lobbying to exploit the two objectives buried in the DNA of the FHLBs' charters. The addition of commercial banks – including the largest – as members in 1989 marked a very major revision to the public policy concept of an FHLB's function, as it was clearly not about access to stressed-market funding, which such banks already had, or more generally helping smaller thrifts have access to funding on a routine basis, which such banks also already had. It was about the FHLBs being a channel to supposedly "help housing" by having an additional category of owner of home loans, the commercial banks, get access to the subsidized funding available on a long-term basis (as well as during stress periods), in the hope that somehow this would make mortgage rates lower for borrowers or credit more available. This extension of membership to commercial banks then became the basis for any type of financial institution that owns mortgage assets – whether loans or securities – to argue that it too should be a member. This argument in fact is the one used by supporters of allowing mREITS to join via captive insurer conduits. And why stop there: IMBs want to be members even though they provide no permanent financing of mortgages, securities firms could argue they should be members as well to be

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income tax, debt issuance subject to Treasury approval, and more. See http://www.fhlb-of.com/ofweb_userWeb/pageBuilder/credit-ratings-31.

[14] FHFA, "Federal Home Loan Bank Membership: Request for Input," 4.

[15] With the implied guarantee, the FHLBs are rated the same as the US government – AAA and AA+ – by the two major ratings agencies. Those agencies also report that without the implied support, the FHLB system by itself would get a significantly lower rating. In the case of S&P's rating, as explained in its publicly-available listing of its ratings (see www.standardandpoors.com), this means it would go from AA+ to BBB+, a six-notch drop.

able to more easily carry mortgage asset trading inventories, and so on. As a result, there has been a steady and sometimes successful press through the political system to expand who can be a member of the FHLBs in order to get a piece of that everyday funding subsidy.

More specifics on the FHLBs and how they operate will be discussed below.

Lessons from the Two GSEs

The implied guarantee subsidy was a background topic of interest to a limited number of people until it more broadly burst onto the Washington radar screen starting in the early 2000s. This happened, however, in connection with the two large GSEs of Freddie Mac and Fannie Mae, rather than the FHLBs, and due mainly to Alan Greenspan, then the long-serving and very respected chairman of the Federal Reserve, giving speeches in which he criticized the balance sheets of the two companies as representing a source of risk to the financial system. He also more specifically pointed to the discretionary investment portfolios of the two companies, which then added up to about $1.5 trillion.[16] Over time he was joined by the Bush administration in pushing for several reforms of the GSEs, including limits on the investment portfolios that would decline over time. The declining limits were both to reduce systemic risk and also to eliminate a subsidy going to the two companies that was not warranted (explained further below).

The implied guarantee definitely existed in the minds of the marketplace when it came to the two GSEs, as their debt instruments (both secured and unsecured) carried interest rates just a small amount above that required on Treasury securities. Investors looked both to the nature of the GSEs' congressional charters, which stipulated that a portion of the two companies' board members were appointed by the president,[17] that they had a line of credit from the Treasury, that the role the companies played in the housing finance markets was so crucial (i.e., large and core to the markets' operation), and also to a long history of statements by elected officials: voilà, there was an assumption of a guarantee of debt investors by the government. This assumption held despite a statement stamped on the debt of the two companies that it was *not* guaranteed. In the end, the investors were correct in

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[16] See, for example, "Greenspan Urges Better Regulation of Fannie Mae and Freddie Mac," *New York Times*, April 6, 2005, https://www.nytimes.com/2005/04/06/business/greenspan-urges-better-regulation-of-fannie-mae-and-freddie-mac.html, and Greg Robb, "Greenspan Urges Fannie, Freddie Portfolio Limits," *MarketWatch*, April 6, 2005, https://www.marketwatch.com/story/greenspan-renews-push-for-fannie-freddie-oversight. Also interestingly, this $1.5 trillion was larger than the Federal Reserve's balance sheet pre-Financial Crisis, which was under $1 trillion at the time.

[17] The administration voluntarily stopped making such appointments during the Greenspan-led push to restrain the GSEs, in order to remove one of the supports from the implied guarantee. It was too late however, as was revealed when the companies entered conservatorship.

their assumption – for when the two companies became destabilized in 2008, they were indeed rescued by the government and holders of their debt protected from any default (while equity owners of the companies were not protected).

Advantaged by this implied guarantee, historically the two companies were able to issue mortgage-backed securities (MBS) at very low rates, and this worked *directly* to reduce the cost of mortgage credit to primary market lenders; the assumption was that there was enough competition among primary market lenders (there being over a thousand of them) to lead to this benefit being largely passed on to homeowners.[18] As a result, this specific usage of the implied guarantee was not unduly criticized – one could even easily argue it was working just as intended.

However, at some point in the 1990s and increasingly into the 2000s, it seems the two GSEs discovered and then began exploiting what can only be called a loophole in their design. They began to issue, in growing size, unsecured debt at near-Treasury rates (well under what large financial institutions, not benefitting from the implied guarantee, would pay) and used the proceeds to invest in mortgage-related assets. They mainly bought their own MBS – thus taking back onto themselves all the interest rate risk that was intended to be "passed through" to MBS investors – and they earned a good spread on it because of the cheap funding cost. In addition, they bought significant amounts of private label securitization (PLS) bonds (i.e., mortgage securitization bonds that had no government support of any kind) for extra return.

They did this discretionary investing in such great size that by 2004 and 2005, when Greenspan was pushing for limitations, it amounted to about $1.5 trillion.[19] That means the GSEs owned – not just guaranteed, but owned outright – at least about one of every five dollars of single-family first mortgages in America.[20] They also helped fuel during the bubble years the buildup of the PLS market, the source of many bad practices, by owning (along with the FHLBs, financed with the same implied guaranty cheap funding) about one of every six dollars outstanding.[21]

When I arrived at Freddie Mac in 2012 as CEO, I asked for analysis of all its historic investing activity. It turned out, as much as the staff could estimate it, that virtually all the profit earned by the

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[18] Most GSE-guaranteed loans start out being made by primary market lenders who directly access the MBS markets, to which the GSEs' guarantee fee is added. Lenders thus fairly directly got the advantage of the MBS rate's being low due to the implied guarantee.
[19] I recall this was commonly talked about in the markets as being like a giant internal hedge fund at the GSEs.
[20] There was no obvious benefit to homeowners from this investing activity. Of course, the GSEs justified it with classic lobbying phrases to claim there was such a benefit (e.g., "it helped prime the pump for MBS"), but in reality, it was simply immaterial.
[21] The GSE positions were concentrated in the best-rated tranche of the PLS securitizations. However, this concentration proved to still generate large losses in the Financial Crisis.

company was due to the cheap funding of the discretionary investments; zero was earned by producing actual investment returns beyond that. As that cheap funding profit was so high, accounting for the majority of GSE profits, it generated a tremendous amount of stockholder wealth and executive compensation… until it all collapsed in 2008.[22]

So, Greenspan was spot on in his concern. The implied guarantee led to bad behavior by the two GSEs as they sought to generate profits from it by expanding their balance sheets with discretionary investing to never-before-seen sizes. Unfortunately, his push to get a limitation on this discretionary investing via legislation failed – the lobbying of the GSEs and their allies was just too powerful. But with the government rescue of the two companies via conservatorship in September 2008, the implied guarantee chickens came home to roost:[23] the rescue agreement required the two companies to wind down the size of their investment portfolios in an orderly fashion over ten years (so as not to cause market distress) by about two-thirds, very much as Greenspan had originally proposed.[24]

Beautiful Politics…

It is no surprise to any adult in America that a lot of what goes on in Washington is about subsidies, as one of the most basic fundamentals of political activity can be easily summarized: "cash to me is good" (along with its partner, "cash away from me is bad"). It's generally very hard to get a subsidy though, leading to interesting creativity about how to make it easier.

For an interest group trying to get some subsidy, fighting each year to get an allocation of the federal budget, among all the other priorities of government, is really difficult. Channeling the subsidy into an entitlement makes it a bit easier – once the entitlement is in the budget, its supporters just have to defend against it being removed, as it annually renews otherwise. Getting the subsidy through special treatment in the tax code is perhaps even easier – it's less obvious that money is being spent since it is

[22] Interestingly, some of the members of the housing finance policy community who were justifiably very critical of this abuse of the implied guarantee by the two GSEs to build up such risk-taking investment portfolios were totally comfortable with the FHLBs doing the exact same thing, despite losses on their activities (discussed below). This includes senior officials at the FHFA when I arrived at Freddie Mac in 2012. It's a great example of the frustrating inconsistency one finds in government and politics.
[23] This is how the chickens came home to roost in a tactical fashion. One can argue they also came home to roost in a strategic fashion by generating enough losses to ensure that the GSEs fell into conservatorship.
[24] The portfolios are now even smaller, having dropped by about 75%; the remaining 25% is needed to currently support the underlying guarantee business rather than being discretionary in nature.

hidden as less revenue being collected by the IRS, and it mostly keeps going year after year, just like an entitlement.[25]

I am aware, however, of no subsidy that is as politically advantageous as the implied guarantee subsidy. It appears on no line of the Federal budget, neither as an annual expenditure nor as entitlement spending. It appears in no list of tax expenditures. Interestingly, many of those involved will even deny that such a thing exists.[26] I was once asked by a knowledgeable person, who admits it exists, if the subsidy were, however, a sort of victimless crime: while the GSEs and FLHBs benefitted from the subsidy, it was not apparent who lost out on the other side. In fact, the loss shows up in Treasury debt costing more than it otherwise would, as the bonds that carry the implied guarantee compete for investors in government-quality debt. (Of course, no one can demonstrate that loss in concrete terms, as it would require a controlled experiment to scientifically prove, and no one is about to interrupt the national economy to run such an experiment.)[27]

The FHLBs, similarly to the pre-2008 GSEs, do not admit the existence of the implied guarantee of their debt by the US government. They attribute their low cost of funding to their "combined size and strength."[28] A video from their website talks about how investors like the relationship the FHLBs have with the federal government, in that they have congressional charters and a public purpose. But that's it. However, reality intrudes via the public documents of how the ratings agencies come up with their ratings. Standard & Poor's, for example, rates them as BBB+ on their own (i.e., before considering government support). It then increases this to AA+ because of that government support, which is the same rating it gives to the US government. That's the power of the implied guarantee – FHLBs with BBB+ financials get rated AA+, six notches higher! The result is much lower funding cost, discussed more below, for which they pay zero to the government.

And that subsidy, because it is tied to how much funding the FHLBs require, grows in proportion to that funding amount… without any limit! That's a feature that almost no subsidy of any other type

[25] This reduced transparency, which makes it politically easier to convince elected member of Congress to vote in favor of a particular subsidy proposal, has been rendered somewhat less effective as the Treasury is now required to compile and publish a list of "tax expenditures."

[26] I once attended a meeting, along with the CEO of my bank, with Franklin Raines, then the CEO of Fannie Mae. When the topic of the implied guarantee was first mentioned, he slammed his hand down on the table and denied it existed. "Show me where it says we are guaranteed. Our debt specifically says there is no such guarantee. We get the rates on our debt that we do because we're a great company." Yet, it totally existed, and the rating agencies stated at that time in writing that they gave Fannie Mae a AAA rating specifically because of it.

[27] One can argue the cost to the government of providing the implied guarantee also showed up via the instability of the GSEs, leading to their being taken over by the government.

[28] Per "FHLBanks: The Basics," https://fhlbanks.com/wp-content/uploads/2020/01/FHLBanks.TheBasics.pdf.

gets, and it makes the implied guarantee subsidy a winner by any political measure: not just hidden, unaccounted for and deniable, but also unlimited in size. In politics, that's pure beauty – a lobbyist's dream.

The latest figure for the FHLBs' debt issued with this implied guarantee was $1.1 trillion as of March 30, and it was growing fast in the pandemic as more firms borrowed as debt markets were roiled. Pretty soon it will be getting near the $1.5 trillion level at which Federal Reserve Chairman Greenspan began to speak out about the systemic risk and thus the need for reform of the GSEs nearly twenty years ago.

…but Ugly Policy

It is almost impossible to objectively declare if a particular subsidy is good or not. It is tied up in too much self-interest ("a good subsidy is one that directs cash to me; a bad subsidy is one where cash goes to someone else") and politics. But there is a very valid notion in Washington of how to assess whether a subsidy is *legitimate* through focusing on the process by which it came about, and whether that process is consistent with good and honest government. In this line of thinking, a legitimate subsidy is one that came about via a process with three key features:

- *Transparency.* The citizenry can know that the subsidy exists, how large it is, to whom the money goes and what its purpose is.
- *Non-corrupt and democratic approval.* The subsidy's approval was done in an above-board manner by a representative government exercising its non-corrupted judgment that the subsidy is warranted. This means no hidden subsidies couched in obscure language, no subsidies stuck into bills in the dead of night that no one notices prior to a vote in Congress, no votes overly influenced by campaign contributions, and so on.
- *Works as advertised and intended.* This means that the subsidy actually does what it was supposed to do: it went to the people advertised to be the beneficiaries rather than others or middlemen, it is actually delivering the benefits that were intended and promised, and generally it is working properly and effectively. Without such after-legislation information reporting requirements, an informed citizenry can't adequately exercise its judgment at the ballot box.

One can reasonably assume a subsidy that in practice generally meets the above criteria is legitimate, a result of a free country running its affairs to take the rough edges off life, which is a core function it is supposed to perform.

But as should be totally and completely obvious, the implied guarantee subsidy flunks just about every test of qualifying as a legitimate subsidy. It is not only hidden, it is even denied. The originally stated objective of a quasi-central bank to provide stressed-market liquidity to non-bank (and thus non-Fed member) mortgage lenders has morphed over time to be mostly about subsidized funding to routinely carry mortgage assets, and even to include the largest commercial banks and (for a while, and maybe again) mREITS, which are akin to hedge funds! The amount of the subsidy is totally obscure – in fact, virtually unknown – and it grows without limit. Whom it benefits is very unclear, although there is strong evidence that while originally aimed at smaller mortgage-centric financial firms it has in fact become too much a mechanism for the very biggest banks – which hardly need the help – to subsidize their earnings; it is unclear how much the average homeowner benefits, but it is very little, if at all.

This is not good and honest government, not even close. Hence, while politically beautiful, the implied subsidy – in terms of policy, rather than politics – is truly ugly.

Cui Bono - Who Benefits?

In examining any subsidy, it is obvious that one should "follow the money" and see who benefits from the taxpayer support. This is a very ancient doctrine, known as *cui bono* (Latin for "to whom is it a benefit?"), used in legal proceedings over two thousand years ago in ancient Rome. In following this doctrine, I will roughly estimate the subsidy's amount and then identify some of its major recipients.

Subsidy Amount

There is no way to concretely and accurately calculate how much the subsidy is worth without running some sort of controlled experiment – which is fine in a laboratory, but not possible in the real economy. Instead, I will roughly estimate it, with full admission as to its roughness, in two steps.

Step 1: What would the $1.1 trillion of debt now[29] enjoying the implied guarantee cost if it was not treated as "almost US Treasuries" but instead as being rated, as per S&P, BBB+? This "spread" was recently over 100 basis points, an elevated level due to pandemic-related market distortions. Historically, this spread can vary tremendously: higher in stress periods, lower in calm ones; higher when rates are high, lower when rates are low; and with the volatility that

[29] As per the March 31 financial statement of the combined FHLB system: http://www.fhlb-of.com/ofweb_userWeb/resources/2020Q1CFR.pdf.

derives from trading markets always being dynamic. Examining historical data, I roughly estimate 75 basis points as a reasonable average to use.

Step 2: The assumption that the FHLBs, absent the implied guarantee, would just issue unsecured debt of $1.1 trillion at a BBB+ rating, costing that average 75 basis points more, is not reasonable. Not only would the market likely not be large enough to absorb that amount, it would be too costly compared to alternative methods of funding whereby certain assets of the FHLB system could be used as collateral to obtain funds more cheaply. Assuming such alternative funding methods would be used to significant degree, I therefore will cut the 75 basis points extra cost down to 50 basis points (i.e., 0.5 percent). This is, again, admittedly very rough, but I believe it to be adequate, and maybe even conservative, for this type of policy analysis.[30]

So, the value of the subsidy is calculable as 0.5 percent on $1.1 trillion, or about $5.5 billion per annum at today's size of the FHLB balance sheet.[31]

Subsidy Beneficiaries

It is almost an iron law of politics that an attractive subsidy, such as that produced by the FHLBs' implied guarantee, will attract more groups trying to get in on the action – and that over time some will be successful. This process is aided by elected officials also liking the ability to deliver funding to some favored interest group, but without fighting for an on-budget appropriation; instead, it all happens behind the scenes by sharing in the implied guarantee subsidy. This hidden subsidy creates grateful recipients but leaves taxpayers none the wiser. Against this background, here is my list of beneficiaries in a logical order.

The FHLBs themselves: The FHLB organization takes money to operate – salaries for staff, premises costs, technology expenses, and so on. In 2019, those expenses were $1.4 billion. Clocking in at about one quarter of the entire value of the subsidy, these expenses act as a large tax of sorts before the intended beneficiaries see any benefits.[32] This tax rate is ameliorated

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[30] I note that the conclusions of this article are not particularly sensitive to the exact estimate of the funding benefit. Even if it was significantly higher or lower, the policy conclusions would be the same.

[31] Because of the pandemic, there is general talk about the FHLB balance sheet growing fast right now. The expectation is that the next publicly reported number, as of June 30 (but not yet published), will be at least $1.2 trillion.

[32] Based upon my understanding of the simple, monoline nature of the FHLB business, and informed by my having worked in large financial institutions for my entire forty-plus year career (and being CEO of two of them), this $1.4

somewhat as the FHLBs also deliver upon their stressed-market liquidity role when it is cyclically needed, a benefit which the subsidy calculation does not capture.

Member-borrowers, larger ones in particular: Because the FHLBs are structured as cooperatives (i.e. one has to be a member to be eligible to borrow), the members and the borrowers of the FHLBs' "low-cost advances" are one and the same. They should be the prime beneficiaries of the remaining approximately $4 billion of implied guarantee subsidy that is available after the FHLBs' own operating costs. But interestingly, as noted above, the original 1932 act creating the FHLBs limited membership, as described above, to an assortment of mostly community financial institutions, which are a politically sympathetic group that arguably needed and still maybe do need the help to stay healthy. To this day, the FHLB marketing materials emphasize this historic small town and "local lender" image of their organization as if were still true.

However, it is most assuredly not still true. In 1989, Congress succumbed to lobbying pressure and added commercial banks as eligible members, with no restriction on their size. This was a major (very major!) example of mission creep that occurs over long periods of time. Today, the very largest commercial bank members plus a small number of other very large financial institutions – even though few in number compared to the large list of small members – account for a disproportionate share of the advances from the FHLBs and thus receive a similarly disproportionately large share of the implied guarantee subsidy. Specifically, at the end of 2019, the ten largest borrowers accounted for 30% of all advances, with Wells Fargo (the nation's largest bank mortgage lender) and JPMorgan Chase (the nation's largest bank) together accounting for just under 10% of total advances all by themselves (and it was 15% the prior year).

Embarrassingly, individual FHL banks can sometimes ridiculously concentrate their advances to the country's largest banks: 23% of all advances by the New York bank go to Citigroup, 62% of Pittsburgh's advances go to just three large banks (PNC, Ally and JPMorgan Chase), 29% of Cincinnati's go to US Bank, and 32% of Des Moines' go to Wells Fargo.[33] It was even worse the prior year, with JPMorgan Chase taking 43% of Cincinnati's advances and Wells Fargo an astounding 47% of Des Moines'!

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billion definitely seems to be quite high. The Congressionally-designed structure of eleven (originally twelve) regional banks, each with its own executive team and board, definitely contributes to this high cost, a reflection of political considerations outweighing economic efficiency.

[33] All figures as of December 31, 2019. See http://www.fhlb-of.com/ofweb_userWeb/resources/2019Q4CFR.pdf, starting on page 48.

On top of that, the spirit of the regional structure of the FHLBs is that an institution is a member of just one such bank; in reality, that understanding has apparently been kicked aside as JPMorgan Chase is a member of five different FHLBs, and three other top-ten listers are each a member of three different regional FHLBs![34]

So, the benefits of the remaining approximately $4 billion of implied guarantee subsidy go disproportionately to the very largest of the FHLB system's members, almost all of them being commercial banks. To repeat, the commercial banks – already members of the Federal Reserve with access to its discount window – do not need stressed-market liquidity sourcing from the FHLB system; they are members overwhelmingly to gain access to the subsidized funding.[35]

Beneficiaries go bipartisan via the affordable housing program: When commercial banks were pushing to be granted access to the FHLB system via legislation in 1989, the usual congressional horse-trading occurred. If banks – perceived as a Republican interest group – were going to get a benefit via access to the implied guaranty subsidy, then the Democrats in Congress wanted one of their interest groups to get a benefit as well. Thus was born the requirement in that same legislation for the FHLBs to contribute 10% of their net income to affordable housing programs. Such programs are administered through the individual banks in their local regions. In 2019, this contribution amounted to $362 million; in the last three years, it added up to over $1.1 billion, a not inconsiderable sum that does not have to compete for appropriations with other annual federal budget expenditures. As a proportion of the implied guarantee subsidy, it represents annually roughly 5% to 10% of it in the last several years.[36] This direct contribution to affordable housing is of course more mission creep, even if presumably more socially beneficial than many other FHLB activities.

[34] Ibid. The lobbyist-style argument for this phenomenon is that historic mergers have left these very large banks with multiple memberships. When mergers occur, lots of overlaps get cleaned up, so this looks more like gaming the system than some unfortunate side effect of a merger that can't be fixed. The downside of these multiple memberships is that the largest banks can play off the individual FHLBs against each other to extract the best credit and pricing terms.

[35] Unlike FHLB advances, discount window borrowings (leaving out some extraordinary stress periods) are priced at or above market rates, and are designed to be eliminated as fast as possible by the borrower, as there historically was definitely a stigma to borrowing from the window. I note that, in the pandemic, the Fed has suspended its usual notions, and made the discount window more generally available without the stigma and at low rates.

[36] Such affordable housing potential beneficiaries have a mixed reputation in housing circles: some are reputed to be very effective while others seem to be mainly politically well connected. Hopefully, the FHLBs are giving this share of the implied guaranty subsidy to the former rather than the latter.

Late-comers: Over time the political stars lined up to allow other types of institutions, attracted by both the stressed-market liquidity and of course the cheapness of the subsidized funding, to become members of the FHLB system. Non-depository Community Development Financial Institutions (meaning those that were not structured as banks) were added by Congress in 2008; their inclusion, however, is very much consistent with the spirit of the original 1932 Act. In 2015, credit unions that were not federally insured were similarly made eligible by Congress (federally insured ones had been added in 1989 along with commercial banks).

As already mentioned, earlier this past decade mREITS had gained access via setting up special-purpose insurance company subsidiaries (insurance companies being an original category of eligible member) to channel the cheap borrowings to themselves to earn more on their leveraged investments. This clear mission creep was then eliminated by the FHFA in 2016, but is apparently being reconsidered under the leadership of a new director.[37]

The borrowing homeowner: As described above, the FHLBs' executives and staff themselves benefit from the implied guaranty subsidy, as do the member-borrowers (especially the very largest), and even affordable housing groups benefit via the 10% requirement described above. But what about actual homeowning families with a mortgage – do they benefit from this hidden but lucrative and large subsidy? Lobbying materials I have seen over the years advocating for expanded FHLB membership argue they do – but the mechanism is very vague. The argument talks about the subsidy helping to make it cheaper for lenders and investors (even large ones) to carry mortgages and mortgage securities (both newly made and existing ones), which then hopefully translates in some fashion into lower rates for borrowers. However, based upon my knowledge of the markets and how large financial institutions work, the benefit would be a very small portion of the related subsidy, if anything measurable at all.[38] And that means expanded membership would be ineffective in delivering any material benefits to homeowners: simply put, all or almost all of the available subsidy ends up in the hands of the middlemen, not the ultimate borrower. Whereas the original 1932 legislation defined that subsidy as good public policy when the middleman was a community-based thrift-type institution, it is a different story

[37] If the mREITS are allowed again to use captive insurance companies, a tremendous loophole will open up, as virtually any firm of any type could do the same thing to get access to the cheap funding.

[38] Also, any such benefit to homeowners is not well-targeted. Where other mortgage activities of the government almost always have size limits on the mortgages that can be supported - to target the benefit at the working and middle class, not wealthy homeowners - this subsidy has no such limitation. It could, in effect, be "welfare for the rich" by subsidizing very large mortgages (known as "jumbos" in the industry).

now that mission creep has resulted in the middlemen being often giant banks and sometimes highly leveraged investment vehicles.

Subsidy Expansion

It is worth mentioning that, beyond just expanding eligible membership, there have been other attempts, some more successful than others, to increase the pool of funds subject to the implied guarantee subsidy. Two are worth describing.

Investment portfolio: Similar to what is described above for the two GSEs, the FHLBs began to take advantage of their cheap funding to build up risk-taking investment portfolios as major profit centers in their own right, rather than just as adjuncts to help manage the liquidity of the underlying business of making advances to their members. While the FHLBs today legitimately talk about the conservativeness of their program of making advances to members, and how they have never had a credit loss, their investment portfolio experience is quite different. The FHFA's Office of Inspector General, for example, wrote a report in 2012 citing just four "troubled" FHL banks (specifically, Chicago, Boston, Seattle and Pittsburgh) where the losses on such investments in 2009 and 2010 alone added up to $2 billion.[39] The FHFA since has taken control of what investments are eligible for consideration, appropriately keeping the list to highly liquid and very-low-credit-risk assets to avoid a repeat of such large losses.

Beyond home loans: There has been a steady push over the decades for the FHLBs to make advances for purposes other than carrying home loan (i.e., mortgage) assets. This push has grown to include loans for which the collateral (which is always required for advances) includes: loans for small business, small farms, small agribusiness and community development, as well as government and agency securities.[40] I do not believe these categories are consuming a large percentage of the total advances of the FHLBs, but it clearly is another case of mission creep to deliver a hidden subsidy to groups that enjoy political favor. In fact, during my time as CEO of Freddie Mac, I saw some fairly aggressive lobbying by the leadership of certain FHLBs to continue that mission creep. It was not particularly successful during that time, but the history of the FHLBs shows that all it takes is the right set of political circumstances for Congress to be swayed by such lobbying.

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[39] See FHFA Office of Inspector General, "FHFA's Oversight of Troubled Federal Home Loan Banks," January 11, 2012, https://www.fhfaoig.gov/sites/default/files/Troubled%20Banks%20EVL-2012-001.pdf.

[40] See: https://fhlbanks.com/mission/.

Sauce for the Goose…

The failure of the effort led by Chairman Greenspan, along with the Bush administration, to get legislation passed to cap the two GSEs' ability to utilize implied-guarantee funding to continually grow their discretionary investment portfolios, showed how powerful the lobbying machine of the two companies was. That lobbying machine suddenly evaporated, however, when they were placed in conservatorship in September 2008 and were required, as one stipulation of their rescue, to no longer engage in such activities – not just no campaign contributions, but no initiating meetings with elected officials and so on. This change then released fresh thinking on the subject of the implied guarantee when, after the immediate crisis was over, attention in Washington turned to rebuilding the housing finance system on a sounder and better basis.

Interestingly, there was then unanimity across almost all the political spectrum that the implied guarantee was a bad idea, that it was inconsistent with good and honest government and too prone to enabling undesirable activities. Instead, a consensus quickly developed that, as government support was required for the GSEs' secondary mortgage market (i.e., guarantee) activities, the implied guarantee should be replaced by an admitted full guarantee by the US government, just like the one Ginnie Mae could place on loans guaranteed by FHA and VA. The consensus held that, furthermore, the guarantee should be explicitly paid for so the taxpayer was properly compensated for the risk being taken!

In the almost decade since this consensus emerged, it has never changed and remains a basic component of almost every proposal for legislation to reform the two GSEs in some fashion. In the case of the administrative reform currently being pursued by the government, since such a full guarantee cannot be instituted without legislation, the objective is to get as close as possible to it.[41]

The question, then, is why not pursue this same reform path for the FHLBs? The implied guarantee applied to their balance sheets is similarly a bad idea – and it absolutely enables all sorts of hidden subsidies that do not necessarily benefit the public. If this reform were to be done via legislation, the FHLBs should get charged the same fee that the GSEs would get charged;[42] if no legislation is likely, it would behoove Treasury and the FHFA to try to make the government's support more formal (even if

[41] This administrative reform would entail the current support agreement (known as the Preferred Stock Purchase Agreement, or PSPA) continuing, with an explicit fee charged for the support it gives to the two companies.
[42] If the two GSEs and the FHLBs both have robust capital requirements, then the residual risk to the taxpayers on their support should be approximately the same, so it seems reasonable for the fee to be the same for both types of organizations.

not a full guarantee), just as the two GSEs have now – with a fee paid by the FHLBs to Treasury to compensate the taxpayer for that support.[43]

But in an echo of the Greenspan episode, with the lobbying of the FHLBs and all the organizations that benefit from the implied guarantee, Congress seemingly just won't face the issue. In 2014, the Treasury developed language for a section of a housing finance reform bill, then being developed in the Senate, to additionally address some FHLB reforms, which it accurately saw were sorely needed. The draft language would have eliminated some of the more egregious practices – by, for example, prohibiting larger members from taking advances for more than 5% of the consolidated amount of advances across all the eleven FHL banks; by stipulating that credit requirements across the eleven banks would be standardized to eliminate venue shopping, where members in multiple FHL banks play each bank off against the others to get more lax credit or pricing terms; and by limiting the investment portfolios to low-risk, high-quality assets (like US Treasury securities). As one ex-Treasury official told me about this effort, there was basically no interest in the proposal across the political spectrum in Congress. Both Republicans and Democrats had important constituencies getting revenue from the implied guarantee, and neither wanted to rock the boat and jeopardize that. It is a classic tale of the swampiness of Washington. Until there is some major scandal or failure in the FHLBs, the implied guarantee on FHLB debt is unfortunately highly likely to remain with us for some time to come.

Recommendations

The FHFA cannot really address the issue of FHLB membership without facing two core conundrums of the FHLBs: (1) their design to deliver as a quasi-central bank stressed-market liquidity is inextricably intertwined with that liquidity also being available for everyday (i.e., non-stressed) usage *on a subsidized basis*; and (2) the FHLBs were designed to help thrift-type institutions broadly, but mission creep has led to a situation in which they now provide a hidden subsidy to many large financial firms that own mortgage-related assets. To sort this all out, I would recommend the FHFA's policy be reasonably expansive in terms of making unsubsidized stressed-market liquidity available to financial firms that are not members of the Federal Reserve, but be highly stingy when it comes to subsidized funding, making it

[43] Interestingly, the government has never said what it might want that fee to be for the GSEs. There have been proposals by policy specialists outside the government that range anywhere from 6 to 20 basis points per annum, the most common being 10 basis points. However, there are no adequate statistics upon which to base the calculation of such a fee; instead, it will be determined on a judgmental policy basis.

available only to smaller thrifts, if not eliminating it altogether. Based upon this general concept, here are some particulars to recommend to the FHFA:

Do whatever is possible as a regulator (i.e., within existing legislation) to reduce the subsidy of the implied guarantee. (1) Consider safety-and-soundness-based concentration limits to reduce the exposure of individual FHL banks to the largest financial institutions in America; for example, each individual bank should have no more than 10% of its advances to any one borrower.[44] (2) Similarly look to use regulation, if FHFA legal counsel deems it is allowed under existing legislation, to eliminate the ability of any one consolidated financial institution to be a member of more than one FHLB at a time, as is consistent with the original spirit of the act of 1932.[45] (3) More speculatively, explore – jointly with Treasury – replacing via administrative action the implied guarantee with a legal support agreement, akin to what exists now with the GSEs' PSPA, and charging for that support so the taxpayer gets some return on the risk.

Additionally, the FHFA should explicitly acknowledge the "implied guarantee," which it danced around in the RFI itself. The FHFA should state clearly and prominently, in the interest of good and honest government, that the implied guarantee, and the resulting subsidy, is a fact of life today, countering the FHLBs' false denial of its existence.

Be stingy in allowing access to FHLBs until the large implied guarantee subsidy is substantially reduced. Absent the material reduction of that subsidy (which likely takes legislation, despite the suggestions above to reduce it administratively), be stingy in allowing more access to the FHLB system. Have the courage to face down the lobbying by all the current and potential members to keep the hidden subsidy going and growing. (1) Totally eliminate conduits as a way for ineligible members to become eligible. (2) Do not be creative in defining ineligible members so that they can somehow be redefined as eligible. (3) Given the mission creep listed above, put out a policy statement that any such expansion of categories of collateral against which advances will be made will be few and far between and that there is an expectation individual FHLBs will engage in such non-home lending activities very sparingly, such that they all together never account for more than 10% of each bank's book of advances.

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[44] In their lobbying activities, the FHLBs focus on each bank being stand-alone for certain issues and on the combined interconnected system (with its cross-guarantee by each bank of all the others) on other issues, picking and choosing to their advantage. In this case, my recommendation is based upon looking at each bank individually, as this perspective is in the interest of good public policy.

[45] If this reform is not possible without legislation, a limit on the percentage of total system-wide advances to any one member (including all its consolidated affiliates) could serve as a good proxy. I would choose something like 2.5% as the limit (i.e., about $25 billion at today's size of the FHLB system).

Recommend to Congress that it sever and reduce, if not eliminate, the implied guarantee subsidy while continuing to make available to FHLB members unsubsidized everyday and stressed-market liquidity.[46] The FHFA makes recommendations to Congress for legislation with some frequency. This is where they should do so as well. State clearly that the original intent of the FHLB system, and its true and valid public purpose, is to provide stressed-market liquidity to support home lending and maybe a few other activities, and that the FHLBs can act expansively in accord with this purpose, but that the subsidy should either be eliminated or kept to a very targeted population of truly small, community-based, mostly-home-lending institutions.[47]

These recommendations are quite different from those submitted to the FHFA by the interested industry associations or mortgage industry firms. Reviewing the submitted comments, beyond various (and important) technical issues, the economic interest of the implied guarantee subsidy is overwhelmingly on display: those who don't have access to the subsidy want to get in on it (e.g., IMBs, mREITS), while those who have it already (e.g., small banks) mostly don't want anyone new getting it so that a competitive advantage can be maintained. In fact, the news article quoted at the beginning of this paper – "Industry trade groups have once again come out in favor of expanding the membership base of the Federal Home Loan Bank system" – is akin to reporting that the average teenager would like a raise in allowance! Is anyone surprised? Trade groups' wanting more subsidy for their members is as certain as the sun rising in the east.

This RFI has created an unusual and valuable public policy communications opportunity for the FHFA to make several clear, declarative statements for good and honest government, pushing against the long and deep history of rent-seeking in housing finance, in this case via the FHLBs' implied guarantee subsidy.[48] Let's hope it does so on behalf of the long-suffering taxpayer.

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[46] It is really impractical for the FHLBs to be available only in stressed-market scenarios, as they would have too little revenue to sustain themselves in normal times (whereas a central bank like the Federal Reserve has other activities that sustain it). So, eliminating the subsidy so that advances in everyday as well as stressed markets carry market rates is really the most one could hope for in such a situation.

[47] The original and still-used philosophy for the role of central banks in distressed markets, first proclaimed by Walter Bagehot in England almost 150 years ago (in *Lombard Street: A Description of the Money Market* (1873), colloquially known as the bible of central banking), is to help restore liquidity by making emergency loans secured by good collateral and at a penalty ("very high") rate of interest. The FHLB system's program of making advances to its members, in terms of its stressed-market liquidity role, reflects this philosophy, except that its interest rate is today less-than-market (due to the implied guarantee subsidy) rather than very high.

[48] If the FHFA actually takes a strongly "anti-implied guarantee subsidy" position, it will have to marshal its lobbying resources to counter the predictable onslaught by all the current and wannabe receivers of that subsidy to get Congress, maybe through one of those clauses added in the dead of night to must-pass legislation, to embed the subsidy even more fully into law. (Given the size of the subsidy - i.e. billions of dollars per annum - large lobbying

expenditures will be easy to justify by those wanting to keep it going on its hidden and deniable basis.) I should note that this is exactly what I was warned - by a government official - in a similar situation related to hidden subsidies elsewhere in the housing finance system. This is revealing how Congress is so much a part of the problem, rather than a part of the solution, in many situations.