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Assessing the Impact: FHFA Request for Input on Federal Home Loan Bank Membership

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OUR VIEW	On February 24, FHFA published for comment a Request for Input on Federal Home Loan Bank (FHLB) membership. We view this as the first step in expanding FHLB membership to include greater numbers of non-bank mortgage lenders and mortgage REITs, albeit indirectly through captive insurance subsidiaries. This would reduce a relative competitive advantage that banks and thrifts have enjoyed over non-banks in the residential mortgage lending area.
WHAT YOU SHOULD KNOW ***"NONBANKS ARE IMPORTANT PROVIDERS OF MORTGAGE CREDIT AND MORTGAGE SERVICING. IT IS UNCLEAR WHETHER SUBSTITUTES WOULD BE AVAILABLE IF THE LARGEST NONBANKS EXPERIENCED STRESS OR WIDESPREAD FAILURE DURING A MARKET DOWNTURN."*** **-- 2019 FSOC ANNUAL REPORT**	Membership in the FHLB system provides institutions with a form of low-cost funding, namely advances from a FHLB of which they are a member. Membership is restricted by certain statutory provisions and by FHFA regulations interpreting those provisions. While FHFA cannot change the statute, and Congress is unlikely to amend the statute in the near term, FHFA can revise its regulations to reflect a broader interpretation of the statutory membership criteria. Treasury Secretary Mnuchin has already called on both Congress and FHFA to broaden the membership of the FHLBs. The September 2019 Treasury Housing Reform Plan called on Congress to "consider permitting additional classes of mortgage lenders to become FHLB members." It further called on FHFA to "revisit its rule excluding captive insurance companies from FHLB membership…" "While there might be unique counterparty or other safety and soundness risks posed by advances to mortgage lenders that are not subject to comprehensive prudential regulation those risks potentially could be managed…" -- in plain English, non-bank mortgage lenders play a larger role in today's housing finance system and should become eligible to receive FHLB advances. At the same time, the Federal Systemic Oversight Council (FSOC) has identified a concern in the mortgage markets: the 2019 FSOC Annual Report notes that nonbanks have significantly increased their market share in mortgage originations and servicing since the financial crisis, particularly to low-income and riskier borrowers. FSOC noted their debt-to-equity ratio "raises questions about nonbanks' ability to perform during a downturn in the housing or mortgage markets." The ability to access FHLB advances would provide a stable source of liquidity for non-banks.
WHAT'S NEXT	FHFA is seeking public comment within 120 days on the Request for Input on FHLB Membership: https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/RFI-on-FHLBank-Membership.pdf FHFA is asking specifically whether there are "classes or types of institution not currently eligible for FHLB membership under FHFA's current regulation whose eligibility would simultaneously further both" the FHLB System's ability to provide liquidity for housing

	finance safely and soundly and the requirement that FHLB members have a nexus to housing finance and community development. FHFA is also asking for input on the "use of conduit arrangements by ineligible entities" and "if FHFA were to permit conduit arrangements, should it limit such arrangements to members whose parent company is actively and substantially engaged in activities that are consistent with the housing finance and community development mission of the FHLBs" – in plain English, FHFA is heeding Secretary Mnuchin's call to consider whether to overturn its 2016 regulation that barred captive insurance subsidiaries from FHLB membership. See "Background" below. FHFA will be the key decisionmaker on this issue. Banks, thrifts and those concerned by expansion of the government-sponsored enterprises' (GSEs') role supporting housing finance will engage allies in Congress to question FHFA Director Calabria about the ramifications of expanding FHLB membership. Notwithstanding this "oversight," Congress is highly unlikely to limit FHFA's authority in this area. Following review of the comments received in response to this Request for Input, nothing prohibits FHFA from undertaking a revision of its 2016 regulation. While Director Calabria generally supports reducing the Federal government's role in the residential mortgage market, he will consider whether allowing non-banks to access FHLB liquidity would address FSOC's concern about systemic risks in the event of a housing market downturn.
BACKGROUND ***"…MOST NONBANKS DO NOT HAVE A STABLE FUNDING BASE, AND INSTEAD RELY HEAVILY ON SHORT-TERM FUNDING FOR BOTH OBLIGATIONS AND SERVICING ADVANCES." --* 2019 FSOC ANNUAL REPORT**	As GSE, the FHLBs issue debt at favorable interest rates – only slightly higher than U.S. Treasury securities. FHLB members can take advantage of this lower-cost funding and provide home buyers with lower cost home mortgage loans. All FHLB advances to members must be secured by specified collateral, including residential mortgage loans and Treasury securities. Congress has limited FHLB membership to banks, thrifts, credit unions, insurance companies and Community Development Financial Institutions. Any such institution must make "long-term home mortgage loans." In addition, under the statutory "qualified thrift lender" test, a bank, thrift or credit union must have at least 10 percent of its total assets in "residential mortgage loans" to be eligible for membership. By regulation, FHFA has required insurance companies to have "mortgage-related assets" that "reflect a commitment to housing finance," although has not applied a 10 percent of total assets test. Prior to 2016, certain Real Estate Investment Trusts (REITs) and other investment funds that were not eligible for direct FHLB membership established indirect membership: they established captive insurance subsidiaries that became FHLB members. The captive insurance subsidiaries took FHLB advances to fund their parents' operations; the parent entities often provided the collateral for the advances. Under the tenure of former FHFA Director Watt, the agency in 2016 adopted a rule that barred most captive insurers and limited-purpose insurers from FHLB membership. The agency did so by requiring FHLB insurance company members to have as their "primary business…the underwriting of insurance for nonaffiliated persons or entities." The agency has also rejected attempts to establish indirect FHLB membership through for-profit CDFI's and through special purpose banks.