Introduction

Conference on Federal Home Loan Banks and State and Local Revenue Bonds

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The Federal Home Loan Banks were a 1932 innovation of the Hoover administration. As Mark Flannery and Scott Frame note in their paper, they were initially intended to provide long term mortgage funding that would enable savings and loan associations and other housing lenders to offer fixed rate long term mortgage loans. Incidentally, the availability of FHLB advances also enabled these institutions to liquidate their mortgage portfolios and thus have the funds available to honor withdrawal requests by the savers who were their depositors.

The Federal Home Loan Bank System and the market it serves are quite different today. Originally a funding vehicle for home mortgage lenders, it is now open to commercial bank membership, and the FHLBs are authorized to make advances for community development that benefit low and moderate income families. And as Larry White and Scott Frame point out in their paper, that means that the benefits they can confer are not necessarily available only—or even primarily—for home mortgage lending. Even if the charter of the Bank System were written very restrictively, the funding they provide to their members is fungible and can be—and undoubtedly is—used for ordinary commercial lending as well as mortgage lending.

Ronald Reagan once said that the closest mankind will ever come to immortality is a government agency, and the FHLBs are no exception. As the market has changed, the FHLBs—with the help of Congress—have made themselves relevant to a financial world that is no longer concerned about where the funds for mortgage lending will come from. From 1989, when the collapse of their main constituency—the S&Ls—began in earnest, to 2006, the FHLBs grew from $175 billion to over $1 trillion in assets, which is a fairly impressive example of making yourself relevant to the new world of finance.

The FHLBs are government sponsored enterprises (GSEs) in the sense that they are chartered by the government, perform a government mission, and enjoy various government-granted privileges such as exemption from federal, state and local taxes. The result of these connections to the government is to give them a privileged position in the capital markets, very much like Fannie Mae and Freddie Mac. Even though their securities are not explicitly backed by the federal government, participants in the capital markets do not believe that the government will ever allow them to fail. This enables them to obtain AAA ratings for their debt and favorable rates on their securities, which they pass along to the banks and S&Ls that are their members.

This conference is about a service that is different from funding their members' activities. It is about using their AAA rating, in effect, to guarantee the debt securities of state and local governments, and thus entitling those governments to receive more favorable interest rates on their securities than they would otherwise be able to attain.

The question we will deal with today is, quite simply, whether this is good policy. The standard justification for government action in the financial economy is the existence of a market failure—a conclusion that the free market alone cannot address a particular problem. The FHLBs were set up in the first place to rectify a market failure—the lack of long term funding for residential mortgages and the illiquid condition of the local savings institutions that were the source of much mortgage lending.

The Federal Housing Finance Board is the regulator of the FHLB System. Before it authorized the FHLBs to back state and local revenue bonds in 1998, it received a letter from the Treasury Department objecting to the pending action. The Treasury wrote: “The proposed rule would enable the FHLBanks to make more aggressive use of their federal subsidy and to take on risks with which they have little or no experience. Yet it would not respond to any demonstrated market failure, would not advance the System’s statutorily defined housing finance mission, and would rest on what we view as questionable legal authority.”

In the great tradition of the U.S. government, the FHFB ignored the Treasury and went right ahead with its plans. Yet the Treasury’s argument encapsulates the issue. Is there a market failure today? How does one determine whether there *is* a market failure? Is there a statutory limitation on what the FHLBs are permitted to do, or is this question to be decided solely by the FHFB?

The private companies that now operate in this field argue that they are fulfilling every legitimate need for state and local financing, and thus there is no market failure. Supporters of the FHLB position argue that the credit enhancement activity the Banks want to pursue is necessary if underserved communities are to be able to build the infrastructure and public facilities they need.

This raises two additional questions: what is an underserved community? And even if an underserved community represents a market failure, how can underserved communities be differentiated from every other state and local issuer that would like to receive the benefits of FHLB support?

The overriding issue, of course, is how far government sponsored enterprises should be allowed to intrude into the private financial markets. Because of their inherent advantages, they can easily dominate any market they enter. If market failure is not sufficiently clear, what standard should we use?

The FHLBs have not yet been able to make use of the FHFB’s enhancement of their authority. In order for them to do so, a change in tax law is required. In several recent Congresses, legislation has been introduced that will make the necessary change, and if at some point the legislation passes the FHFB’s action will probably be tested in court. But before that happens, we have an opportunity to look at this initiative as a matter of policy, and to consider whether it makes sense on that level.