Federal Home Loan Banks

Article

By Shadow Financial Regulatory Committee

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Although most of the commentary about the recently enacted Gramm-Leach-Bliley Act has focused on its elimination of some competitive barriers in the financial services field, in the long run the new powers granted to the Federal Home Loan Banks (FHLBs) may be among the most significant elements of the legislation.

The FHLBs are government sponsored enterprises (GSEs) that were originally created for the purpose of subsidizing and providing liquidity assistance to the S&L industry, which was in turn to provide financing for housing. Because they are perceived to have the implicit backing of the United States government, the FHLBs can borrow in the financial markets at highly favorable rates, and their loans to S&Ls were part of the government's long-standing policy to encourage greater home ownership.

With the maturity of the housing finance system in the United States, it has become clear that this form of government support for residential finance is not necessary. Under these circumstances, the FHLBs should have been abolished, but Congress has been unwilling or unable to do so. Instead, over the last few years, the FHLBs have been allowed to extend their lending activities to commercial banks that were heavily engaged in housing finance.

In the Gramm-Leach-Bliley Act, Congress has taken a major step to further expand the scope of the FHLBs' activities–authorizing them for the first time to make loans to "community financial institutions" (defined in the Act as banks and credit unions with assets of $500 million or less) that are collateralized by loans to small business and agriculture. Previously, FHLB loans could only be collateralized by housing loans.

The removal of that restriction makes additional FHLB subsidies available to small banks, and perhaps ultimately to large sectors of small business and agriculture. Thus, far from reining in the growth of the GSEs, Congress has actually expanded their potential role in the economy.

The Shadow Financial Regulatory Committee has frequently noted that the growth of the GSEs is a troubling phenomenon. Not only do the GSEs distort the allocation of credit by funneling financing to politically favored sectors of the economy, but once they have entered an area of financial activity the GSEs' implicit government backing allows them to drive out private sector competitors and achieve dominance in their markets. In addition, because they can provide financing at subsidized rates, the GSEs are able to muster substantial political support from the favored groups, which over time insulates them from Congressional oversight and could make them invulnerable to Congressional control.

Fannie Mae and Freddie Mac are leading examples of this phenomenon. These two GSEs have doubled in size every five years since 1970. At the end of 1998, they had assumed the risk–either through direct ownership or guarantees–of almost $1.8 trillion in residential mortgages, or 38 percent of the residential mortgage market. According to a recent forecast by its Chairman, Fannie Mae alone will have 28 percent of the residential mortgage market in five years. If we assume that Freddie will continue to grow at the same pace, almost 50 percent of all residential mortgages in the United States will be on the books of these two GSEs by 2003.

Another indication of the unchecked growth of the GSEs is the growth of their borrowings in the financial markets. In 1998, the three major GSEs–Fannie, Freddie and the FHLBs–borrowed more than the Treasury Department itself. The FHLBs were the largest borrowers, with a total of $2.5 trillion, followed by Freddie Mac with $2.1 trillion, and Fannie Mae with $843 billion.

Not only are the FHLBs large, they are growing rapidly. Last year, FHLB loans to the member banks increased by almost 27 percent, from $288 billion to $365 billion. By expanding the scope of FHLB lending to include small business and agricultural loans, Congress is increasing the subsidy that small banks receive from making these loans. This is bad enough, but Congress appears to have intended its action to benefit small business. If it has this effect, and leads to the development of powerful small business constituency in support of continued FHLB growth, Congress will in the end have created a GSE that is as powerful and dominant in small business lending as Fannie Mae and Freddie Mac have become in housing finance.

The Committee believes this is a dangerous trend. There is no “shortage” of small business and agricultural finance, but there is always a constituency for maintaining or increasing government subsidies. As the competitive advantages of borrowing from the FHLBs become more apparent, that financing could increasingly become a staple of small business and agricultural lending. Efforts to cut it back or control it–like efforts to restrict the growth of Fannie Mae and Freddie Mac–will be met with protests from small banks as well as the affected groups.

The Committee urges Congress to revisit this issue promptly and repeal the provisions of the Gramm-Leach-Bliley Act before it loses the ability to control the FHLBs. In the process, Congress should check the growth of all the GSEs, given the implications of this growth for competitive private financial markets.