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Viewpoint: Liquidity Aid via the Home Loan Banks

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The debt markets are in turmoil. Mortgage availability, especially for large loans, is tight. This has become a significant factor in the dramatic slowdown in home sales and the nationwide decline in home values.

Some fear that the entire economy will suffer as orders for furniture, appliances, and other household goods diminish and consumers become more reluctant to make discretionary purchases.

These problems were triggered by concerns about the credit quality of subprime mortgages. The credit markets became reluctant to purchase mortgage-backed securities and, eventually, other debt issued by companies that could have subprime exposure. The market's reaction transformed a subprime mortgage problem into a liquidity crisis affecting a wide range of assets, including higher-quality mortgages.

Through my experience as counsel to the Council of Federal Home Loan Banks, I came to understand that liquidity is crucial for mortgage finance.

Most home loans are for 15 or 30 years, sometimes longer. Lenders must provide the entire amount of the loan at the time of closing but are repaid only a bit at a time over the course of the loan. Obviously, the ability to make loans will diminish quickly if there is no way to replenish the coffers sooner. Mortgage lenders needs to raise additional funds quickly, and at a low cost, to continue making home loans and earn a profit.

There are several ways to accomplish this goal. One method is securitization. The lender sells the mortgage to a third party, who creates a trust to hold that mortgage and thousands of others in a pool that supports bonds or other debt, the so-called mortgage-backed securities. The monthly mortgage payments are received by the trust, which pays the bondholders according to the terms of their notes.

The bondholders thus provide funds to the lender, allowing it to make additional mortgages to consumers.

The main reason for the current liquidity crunch is that investors have become reluctant to purchase mortgage-backed securities.

However, there is another source of liquidity that can play a critical role in restoring the smooth functioning of our mortgage markets without exposing the government to additional risk. That source is the Federal Home Loan Bank System.

The system was created in 1932 as a response to the crisis in mortgage finance during the Great Depression. Over 1,700 thrifts had failed, and the need for liquidity in the mortgage market was acute. The legislation established 12 Federal Home Loan banks in districts throughout the United States for the purpose of providing funds primarily to savings and loan associations. The funds were provided to lenders through loans, or "advances," secured by mortgages.

In 1989 commercial banks and credit unions that engage in a significant mortgage lending became eligible for membership in the Home Loan banks. More recently, in 1999 the banks were authorized to make advances to "community lenders" collateralized by small-business and agricultural loans. All members of the Home Loan banks are highly regulated financial institutions.

Each Home Loan bank is a privately owned cooperative responsible for system debt. The stock of each bank is not publicly traded, but instead is held exclusively by member institutions. Members elect a majority of each bank's directors, and its regulator, the Federal Housing Finance Board, appoints a minority.

A portion of the profits earned from a Home Loan bank's activities is returned to members in the form of dividends. The earnings also are used to support affordable housing through grants and subsidized loans, as well as to pay off some of the government debt that was issued to resolve the savings and loan failures in the late 1980s.

The Home Loan Bank System's affordable housing programs are responsible for nearly $3 billion of grants to create almost 600,000 housing units for low-income families, and over $47 billion of at-cost loans to finance another 575,000 units and thousands of economic development projects.

The banks are funded through the issuance of consolidated debt that is backed by all 12 banks. These debt instruments are an extremely efficient way to raise funds, and they have remained in demand even during the current liquidity crisis. They give the banks a very competitive source of funds for mortgages and community development.

Unlike Fannie Mae and Freddie Mac, the Home Loan banks accept mortgages of any size as collateral for their advances. The system also has an enviable record of safe lending. Since it was authorized in 1932, there has not been a single credit-related loss on a Home Loan bank advance.

Today, the Home Loan Bank System consists of over 8,100 member institutions, up from only 3,200 in 1989, when commercial banks and credit unions became eligible. In that same period total assets have increased from $175 billion to over $1 trillion.

While many of the Home Loan banks have expanded their activities to include not only advances, but also purchasing mortgages and mortgage-backed securities as investments, the primary emphasis of the system remains making advances to mortgage lenders, and these advances far exceed any other asset in the system.

When depository institutions and other lenders fund their loans through Home Loan bank advances, they obtain funds at a very low cost. The advances provide additional funds that can be used for new loans, and the low cost to the lender can be passed on to the borrower through lower-cost mortgages. The Home Loan banks also provide technical expertise and other financial instruments to assist their members in managing their interest rate risk and lending programs in general.

Unlike government insurance programs, advances accomplish these goals with little risk to the taxpayer, since the advances are fully secured and have never experienced a loss.

In sound economic times, the Home Loan banks help their members serve their community's credit needs, and in times of financial turmoil the banks offer a model for providing liquidity and restoring financial health.

In this time of financial stress in the mortgage markets, it is especially important that Congress, the Bush administration, and the financial services industry remember the important function the Federal Home Loan banks serve in increasing mortgage liquidity. The Federal Home Loan Bank System not only the "lender of last resort," as originally contemplated by Congress, but in fact the lender of best resort.

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