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US Rates Watch

FHFA's bark on FHLBs louder than its bite

07 November 2023

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FHFA recommendations less severe than expected

The actual Federal Housing Finance Agency (FHFA) recommendations for the (Federal Home Loan Bank) FHLB system are much smaller in scope than prior press reports had indicated. FHFA would like to ensure Federal Deposit Insurance Corporation (FDIC_-insured banks are prepared to use the Fed's discount window during severe market stress events when liquidity needs spike, not the FHLB system. We expect limited near-term impact on advance activity but could see lower fed funds and a higher effective federal funds rate (EFFR) rate over time.

Centennial review relatively benign

The FHFA, which regulates the FHLB system and Fannie Mae and Freddie Mac, released a report today on recommendations to improve the FHLB system. Earlier press reports caused market participants to brace for a large reduction in the FHLB platform, but it appears that the actual recommendations are much smaller in scope than press reports had indicated. In our view, the main impact of the recommendation would be a reduction in fed fund trading volumes, which is already a very small market and will likely have minimal add-on impacts within the fixed income or bank funding business. While the full FHFA report is 116 pages, the fact sheet, which covers all the recommendations, is only 1.5 pages.

Focus is on the Fed's discount window

In our view, the main recommendation of the report is to make sure that FDIC-insured banks are prepared to use the Fed's discount window during severe market stress events when liquidity needs spike, as in March 2023. The FHLB system was not designed to fund banks on the verge of failure or those that are in immediate need of funding to prevent insolvency. Banks (along with credit unions) already received a similar message in an interagency policy statement last month in which the Fed and FDIC told banks to monitor their ability to tap the discount window and use it when needed. FHFA has joined the Fed and other regulators to strongly encourage banks – which are the bulk of FHLB membership – to rely on Fed funding in crisis periods rather than FHLB funding. This should have minimal impact on FHLB business during normal times but should limit FHLB balance sheet expansion in crisis periods. In addition, FHFA will ask FHLB to increase real-time credit evaluation of its members, especially during stress periods. FHLBs might also be subject to stress tests to strengthen capital management. And there will likely be stricter limits on single borrowers that seek large liquidity injections from FHLB. Again, this would appear to only be relevant in acute stress episodes.

… More detail on page 2…

Government program funding and system efficiency

FHFA will also ask Congress to increase FHLB's annual contribution to affordable housing programs. We would not expect Congress to address this issue quickly, if at all.

FHFA will also examine the idea of consolidation of the 11-bank FHLB system. Each district lends to members in geographical areas, similar to the arrangement of the Federal Reserve district banks. FHLB district banks vary in size from 280 to 1260 members, and FHFA may look at some potential mergers. Membership eligibility was a big concern based on the earlier press reports, but we do not see any major changes.

In order to qualify for FHLB membership (which allows a bank to borrow from FHLB), a bank must hold at least 10% of its assets in residential mortgage loans or equivalent mission assets. The FHFA guidance would require that banks meet this threshold on an ongoing basis. We do not expect this to be significantly restrictive for existing member banks, as the largest borrowers are typically above this threshold.

Potential impact to fed funds market: lower volumes

FHFA will seek to expand the FHLB's access to commercial bank deposits for their internal liquidity management as opposed to predominantly relying on the fed funds market in which they normally lend their daily cash holdings. This will likely reduce total fed funds (FF) volumes, which are already typically below $100bn per day.

A reduction of fed funds volumes would also decline if advance activity were to decline – especially in stress periods. We suspect limited near-term impact in FF volumes but over time reduced FF activity risks, placing upward pressure on the EFFR rate. Lower FF lending activity may assist in pushing the Fed to shift its policy target away from EFFR toward SOFR over time. Details are below.

Lower advances: Any reduction in FHLB advance activity – which is not likely during normal times – would likely result in lower FF volumes. In the past, higher FHLB volumes have occurred with higher FF volumes, though a surge in March FHLB advances saw FF volumes decline (Exhibit 1). If the FHFA report results in lower advance activity, we see risks of lower FF volumes as well.

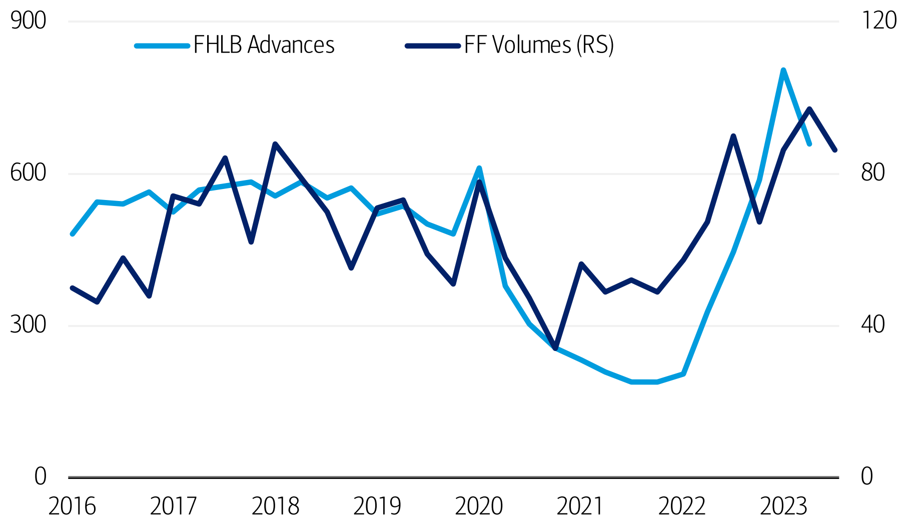
District consolidation: The FHLB Act suggests a district count of "not less than eight nor more than twelve." FHLB consolidation could risk a reduction of fed funds lending volumes, which are a key source of each regional bank's liquidity management. Fewer banks would likely mean less liquidity management need and lower FF volumes.

Interest-bearing bank deposits: Greater use of interest-bearing deposits (IBDs) at commercial banks could substitute for FHLB FF lending activity. FHLBs have used IBDs for years, but we are skeptical that these are available as true liquidity vehicles (commercial banks likely want to see sticky deposit levels in these accounts to count them as stable deposits). If FHLBs were to shift their IBD activity to a true liquidity source, that might reduce the need for FF lending. The FHLBs would likely need to ensure that IBD levels are in line with money market levels to have them potentially cannibalize FF lending activity.

Overall, the FHLB report suggests potentially lower FF volumes in the future and higher EFFR sets. We expect that any changes in FHLB FF lending activity are likely quarters into the future. We suspect that there will be limited near-term changes in FF lending activity but could see upward pressure on future EFFR settings if FF volumes decline. Any material decline in FF volumes could push the Fed to shift its policy target away from EFFR (90% of EFFR lending is from FHLBs) and toward SOFR.

Exhibit 1: FHLB advance activity and FF volumes ($bn)

FF volumes have historically risen as FHLB advance activity increases



Source: Bloomberg

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