Two Legal Issues Relevant to FHFA's Review of the FHLB System
by
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On August 31, 2022, the Federal Housing Finance Agency ("FHFA") announced that it would conduct a comprehensive review of the Federal Home Loan Bank System. This article addresses two legal issues relevant to the review: (1) FHFA's statutory authority to reduce the number of Federal Home Loan Banks ("FHLBanks"); and (2) the application of the FHLBank statutory "super lien."

FHFA's Authority to Reduce the Number of Federal Home Loan Banks

The Federal Home Loan Bank Act ("FHLB Act") establishes a maximum number of twelve Federal Home Loan Bank Districts and an expectation that there should be no fewer than eight Districts. There are nuances to a reduction of the number of FHLBanks to below eight, but the maximum number is fixed. The most recent example of a decline in Districts to eleven resulted from the 2015-2016 merger of the Seattle and Des Moines institutions into a Des Moines District Bank. That transaction was not driven by a desire to reduce the number of FHLBanks, but rather safety and soundness concerns. The Seattle Bank's membership had declined, its capital base eroded to an undercapitalized level, and the need for nearly six years of enhanced oversight led to a determination by consent order to undertake the merger.

The FHLB Act provides that the Director of FHFA may make "readjustments" to the Districts by altering which States are in a particular District, and that the Director may create new Districts, provided that there are no more than twelve.

The Act also provides that the Director may reduce the number of Districts to fewer than eight pursuant to a voluntary merger or the liquidation of a FHLBank under FHFA's conservatorship and receivership powers. In other words, reducing the number of Districts below eight appears not to be justifiable solely on efficiency or cost-savings grounds. Reducing the number or Districts below eight must be based upon a voluntary merger of FHLBanks or the existence of a very troubled FHLBank that requires prompt remedial action.

The FHLB Act also permits the FHFA Director to make a finding that "the efficient and economical accomplishment of the purposes of [the Act] will be aided" by action under promulgated regulations to liquidate or re-organize a FHLBank and another FHLBank may acquire its assets. This provision may be challenged by the affected FHLBank under legal process. The provision appears to require a finding tied to the safety and soundness of the FHLBank, not one based on a general authority to eliminate a District.

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In summary, the Director of FHFA has the statutory authority to reduce the number of Districts from the current eleven to eight, or even less. However, the reduction from twelve to eleven was based upon safety and soundness considerations, and any reduction below eight must be based upon a voluntary merger or a significant safety and soundness problem.

The Application of the FHLBanks' Statutory Super Lien

The fundamental purpose of the Federal Home Loan Bank System is housing finance. The FHLBanks carry out this purpose by making low-cost loans (advances) to member institutions. When the FHLB Act was adopted in 1932, membership was limited to mortgage lenders (*e.g.,* savings and loan associations, savings banks, and cooperative banks) and insurance companies. It was not until 1989 that Congress expanded membership to all federally insured depository institutions. In 2008, membership was again expanded by Congress to include Community Development Financial Institutions ("CDFIs"), and finally, in 2015, to include non-federally insured credit unions.

When expanding membership classes, Congress was aware that the FHLBanks were established to serve an important public policy goal, and that their safe and sound operation should not be jeopardized by including members that are not subject to appropriate State or Federal supervision. Thus, all members must be in the business of making home mortgage loans and are generally required to meet minimum home mortgage asset requirements. Moreover, advances must be fully secured by one or more specific types of collateral, including residential mortgage loans and residential mortgage-backed securities, but other collateral includes government securities, cash, other real estate related collateral, and, in some cases, secured small business, agriculture, or community development loans, or securities backed by such loans.

In most cases, members must use the proceeds of long-term advances (that is, advances with an original term to maturity of more than five years) to fund residential housing finance. However, the smaller FDIC-insured institution members are permitted to obtain long-term advances to fund small business and community development activities. Short-term advances are not so restricted.

When a member institution becomes a member of a FHLBank, it may sign an "advances and security" agreement that establishes a blanket lien covering all eligible collateral. The FHLBank may make advances up to a specified percentage of the value of the collateral. In 1987, at the height of the savings and loan crisis, Congress amended the FHLB Act to provide any security interest granted by a member to a FHLBank would have priority over the claims of any other unsecured party, including a conservator or receiver, such as the FDIC, in the case of an insured depository institution, or the NCUA, in the case of a federally insured credit union. This provision is commonly called a "super lien."

This super lien is often cited as one reason no FHLBank has ever had a credit loss on an advance, and it is viewed as a key factor in their AAA credit rating. This reduces their

cost of funds and the savings are passed on to members in the form of lower interest charges on advances. Some have argued that the super lien is less significant in light of amendments to the Uniform Commercial Code that make it easier for creditors to perfect security interests in mortgage-related assets.

The FDIC has argued the super lien makes it more expensive for it to resolve failed depository institutions since the FHLBank must be paid in full (including prepayment penalties) before it will release its over-collateralized interests. Concerns also have been raised that the super lien may reduce the incentives for the FHLBanks to carefully underwrite and monitor their advances and that the super lien insulates the FHLBanks from market discipline. Finally, since the FHLBanks typically are over-collateralized, the protection afforded by the super lien may make it more expensive for members to obtain private sources of funding. Uninsured funding encourages institutions to operate in a safe and sound manner (e.g., imposes market discipline).

While the super lien is applicable to all "members" of a Federal Home Loan Bank, some question if it can apply to insurance company members in light of the McCarran-Ferguson Act. That statute provides that State law generally governs the regulation of insurance and shall not be preempted by Federal law unless the Federal law expressly regulates the business of insurance. Thus, if there is a conflict between the super lien and State insurance law, it is unclear which statutory system would prevail.

In addition, CDFIs do not have a dedicated receiver, and in case of the failure of a CDFI, the FHLBank would have to seize and sell the collateral in order to recover on their loan, which adds time and uncertainty to the recovery process. As a result, the FHLBanks set higher collateral requirements for advances to CDFIs.

When Congress authorized non-federally insured credit unions to become members of a Federal Home Loan Bank in 2015, it expressly preempted State laws that would otherwise allow a conservator or receiver of a credit union from repudiating contracts relating to a FHLBank advance or a security interest held by a FHLBank in collateral supporting an advance. The 2015 amendment also specified that a FHLBank would have the same priority and rights as if the advance had been made to a federally insured credit union.

If the proposed review of the Federal Home Loan Bank System results in a recommendation to Congress to expand membership opportunities, it is essential that the recommendation consider both the public policy purposes of the FHLBanks and the need to ensure their continued safe operation. This should include careful consideration of whether to extend the FHLBanks' super lien to non-depository institutions, and if any modifications should be made, as was done in the case of non-federally insured credit unions. This should include a solicitation of public comments regarding the current super lien, whether it should continue in its current form, and whether and how it should apply to any new classes of members.