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Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
TEL (312) 915-7075
FAX (312) 915-8508

Statement No. 144

For information contact:

Paul M. Horvitz
(713) 784-5086

Statement of the Shadow Financial Regulatory Committee

on

Expanded Powers for Federal Home Loan Banks

May 4, 1998

Legislation has been proposed in both Houses of Congress that would broaden eligibility for membership in the Federal Home Loan Bank System (FHLB) and expand the lending authority of the Federal Home Loan Banks. The bill introduced by Senator Hagel (S.1423) would make all commercial banks with total assets up to \$500 million eligible for Home Loan Bank membership without reference to their investment in mortgage lending, which is required under present law. The FHL Banks were originally created to support financing of home ownership, and now lend to members only on the basis of residential mortgages as collateral. The Hagel proposal would expand eligible collateral to include secured loans for small business, agriculture, rural development or low-income community development.

This initiative is similar to a bill introduced in the House in 1996 by Representative Baker that would convert the Federal Home Loan Banks to "Enterprise Resource Banks." The Shadow Financial Regulatory Committee criticized that proposal in May 1996 (Statement No. 133).

If legislation like that proposed by Baker and Hagel is enacted, the FHLBs would become general purpose lenders to depository institutions. It appears that the major category of loans that could not serve as collateral for FHLB advances would be loans by large banks to large, suburban business firms.

The operation of the FHLBs represents a subsidy to member institutions since the FHLBs, because of their status as Government Sponsored Enterprises (GSEs), are able to borrow (and hence relend) at rates just slightly above Treasury rates. This reflects the market belief that the U.S. government would not allow a default by a GSE. This means, as the Committee has pointed out often, that the GSEs represent a risk to the taxpayer. The Committee's concern on that score

would be alleviated if the FHLBs were privatized, as described in Statement No. 134.

The FHLBs pose an additional risk to the federal deposit insurance system because of the collateralized nature of their lending. In case of a bank or thrift failure, the FHLBs take the collateral (typically the best assets of the banks), leaving the FDIC to cover insured deposits with the remaining, depreciated assets.

At the time the Committee last discussed this issue, some analysts believed that the survival of the FHLB system was questionable absent an expansion of allowable activities. That is not the case today. The FHLBs are now profitable and expanding their lending within current constraints. There is no financial need for any expansion of their role.

The Committee has repeatedly opposed efforts to expand the role of GSEs. Reminiscent of the plant in the Little Shop of Horrors, the GSEs' appetite for growth is insatiable, and represents a threat to both competing private institutions and the taxpayer. Growth of this dangerous plant has been fertilized by its supporters in Congress, and watered by a flow of lobbying effort and campaign contributions from those who hope to benefit from this growth. The Committee believes that what is required is an application of weed killer.