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GROWTH AND MISSION EXPANSION IN FEDERAL HOME LOAN BANKS

Strong public administration—effective bureaucracy—lacks legitimacy in U.S. political culture. Despite episodic gushes of reverence for fire fighters and soldiers, people in the United States have been wary of administrative capacity since the beginning of the Republic and remain so. It may be that this is because, as Alexis de Tocqueville observed, democracy preceded bureaucracy in the United States, in contrast to the progression in Europe in which state bureaucracies were well established before democratic regimes.¹ It is also the case that U.S. politicians stoke popular apprehension regularly, whether blatantly, by blaming social and economic difficulties on bureaucrats, or obliquely, by calling for a new kind of public management. Even as increasingly complex social and economic relationships generate more complicated public problems, neither citizens nor political elites are likely to place a high priority on maintaining a public bureaucracy with adequate resources to sustain routine capability and muster creative expertise.

Growth in an agency's budget or purview is viewed cynically. Certainly, expansion should be met with critical scrutiny. Ostensible public servants, for themselves or in league with private interests, may act at the expense of the public's interest rather than in its service. However, an agency of the government may be changing because the problem it attends to is mutating in an environment in flux or because the legislature has directed it to address some different, related problem. How would we know? Empirical investigation of individual cases is in order, especially if there is a lot of money or power measured in some other metric at stake. Political scientists should not rely on deduction, based on a theory, to conclude that an instance of growth or mission expansion is or is not appropriate. This is not to dismiss the usefulness of theory. Theory shapes empirical inquiry by directing attention to relevant questions. Current political science offers two competing

paradigms—public choice and behavioral choice—that raise questions to consider in studying a case of bureaucratic growth.

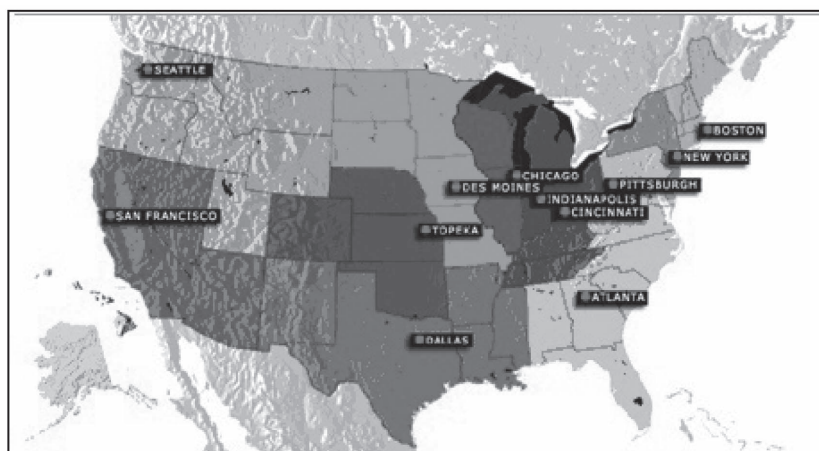
This book presents a case study of growth and mission expansion in the Federal Home Loan Bank System. Federal Home Loan Banks (FHLBanks or Banks) are arcane institutions. Even public administration scholars and practitioners, who know well that public policy is implemented in the twenty-first century by a heterogeneous cast of organizational characters, are probably not familiar with them. Despite this obscurity, FHLBanks warrant attention for their own sake as well as for the general lessons their transformation holds for the study of public administration. The case is compelling in itself because FHLBanks channel a noticeable share of society's resources to particular substantive policy purposes: they make a difference in what gets done in the world. For the study of public administration, the transformation of the Federal Home Loan Bank System offers a perspective on the question, a central one in the discipline, of why the mission of a public instrumentality changes. We will argue that FHLBanks' mission expanded because they comprised existing centers of administrative capacity, and the public has problems to which Congress directed their attention.

THE FEDERAL HOME LOAN BANK SYSTEM

What are Federal Home Loan Banks, and what do they do? Congress chartered the twelve Banks of the Federal Home Loan Bank System in 1932, in the Federal Home Loan Bank Act, to channel money into home ownership. As a congressionally chartered financial institution designed to direct capital flows toward a public policy purpose, the FHLBank System is a government-sponsored enterprise (GSE). The term GSE did not exist, as far as we can tell, when FHLBanks were established. The system was classified as a GSE retrospectively, after Congress had chartered additional financial intermediaries to pursue public policy priorities. These include Fannie Mae and Freddie Mac in home ownership, Sallie Mae in higher education, and Farmer Mac in agricultural policy.²

Federal Reserve Banks, however, did exist in 1932, and Congress looked to the Federal Reserve Act for a model in structuring the Federal Home Loan Bank System.³ As in the Federal Reserve System, there are twelve Federal Home Loan Banks. Each serves as a lender for financial institutions in a geographic district. Figure 1.1 shows the twelve FHLBank districts and the cities in which FHLBanks are located. Some of the Banks have moved from one city to another over time; in 2010, there were FHLBanks in Boston, New York, Pittsburgh, Atlanta, Cincinnati, Indianapolis, Chicago, Des Moines, Dallas, Topeka, San Francisco, and Seattle.

Originally, the kinds of financial institutions that were eligible to join a Federal Home Loan Bank were savings and loan associations, mutual savings banks, and insurance companies. In 1989, Congress opened FHLBanks to



Source: <http://www.fhlbanks.com/> <accessed April 30, 2008>

Figure 1.1. FHLBank districts.

commercial banks and credit unions as well. Historically, S&Ls with federal charters were required to join an FHLBank, while membership was optional for state-chartered S&Ls, mutual savings banks, and insurance companies. In 1999, Congress made membership voluntary for all eligible institutions. In order to join a Federal Home Loan Bank, an institution buys stock in the Bank serving the district where its headquarters are located. There is no market for the stock, which reverts to the FHLBank if a member withdraws. Federal Home Loan Banks are thus member-owned cooperatives.

A central motivation for joining a Federal Home Loan Bank is to have access to funds for liquidity and lending. Wholesale loans from a Federal Home Loan Bank are termed “advances.” The purposes for which advances may be lent are restricted statutorily—originally, to housing finance, but more recently commercial loans, farm and agribusiness loans, and community facilities have become eligible under certain conditions. While these statutory restrictions on using advances exist, it is no secret that money is fungible, and tracking dollars from an FHLBank is not feasible. The effective constraint arises through collateral requirements, which are also statutory. Advances must be collateralized with the types of loans for which advances may be used, or with government and agency securities. Advances have a wide variety of structures intended to meet borrowing institutions’ needs and range in term from one day to thirty years.

To raise money for making advances to their members, Federal Home Loan Banks sell notes and bonds termed “consolidated obligations” in U.S. and international capital markets. Consolidated obligations are the joint and several liability of all twelve FHLBanks, though no FHLBank has ever

been called upon to make good on proceeds received by another FHLBank.⁴ Consolidated obligations are not guaranteed by the U.S. government, but because the Federal Home Loan Bank System is chartered by the government, markets perceive an implicit federal guarantee of their debt. Given joint and several liability and the perception of an implicit guarantee, markets treat consolidated obligations as almost as safe as Treasury securities.

With total assets of \$1.3 trillion at the end of 2007, the Federal Home Loan Bank System is a very large financial institution, about the size of J. P. Morgan Chase and Bank of America, the two largest commercial banks in the United States in mid-2008.⁵ Table 1.1 summarizes Federal Home Loan Banks' combined balance sheet at the end of 2007, based on the system's combined financial report. On the asset side, advances constitute 68.7 percent of the total. Other statutorily permitted investments—federal funds, certificates of deposits, commercial paper and mortgage-backed securities—add up to 23.4 percent. Federal Home Loan Banks acquire mortgages from members to hold in portfolio, accounting for 7.2 percent of their assets. The .7 percent labeled as “other assets” includes such items as loans to other FHLBanks and equipment.

Consolidated obligations dominate the liability side of the balance sheet, accounting for 92.5 percent of FHLBanks' total liabilities and capital. Deposits—from members, other FHLBanks, other U.S. government instrumentalities, and institutions for which the FHLBank provides correspondent services—account for 1.7 percent of liabilities and capital. The small pool of “other liabilities” includes two special assessments levied by Congress in

Table 1.1. FHLBank System balance sheet highlights, year end 2007

| | \$ in billions | % of total assets |
|--|----------------|-------------------|
| Advances | 875 | 68.7% |
| Investments | 299 | 23.4% |
| Mortgage loans held for portfolio, net | 92 | 7.2% |
| Other assets | 9 | .7% |
| Total Assets | 1,274 | 100% |
| | \$ in billions | % of liabilities |
| Total consolidated obligations, net | 1,179 | 92.5% |
| Deposits | 22 | 1.7% |
| Other liabilities | 19 | 1.6% |
| Total capital | 54 | 4.2% |
| Total liabilities and capital | 1,274 | 100% |

Source: *Federal Home Loan Banks 2007 Combined Financial Report*.

1989 in the statute that laid out procedures for resolving the crisis in the savings and loan industry: FHLBanks are required to contribute to debt service on bonds issued by the Resolution Trust Corporation⁶ and to fund affordable housing programs in their districts. This leaves FHLBanks with capital at 4.2 percent of their total assets.

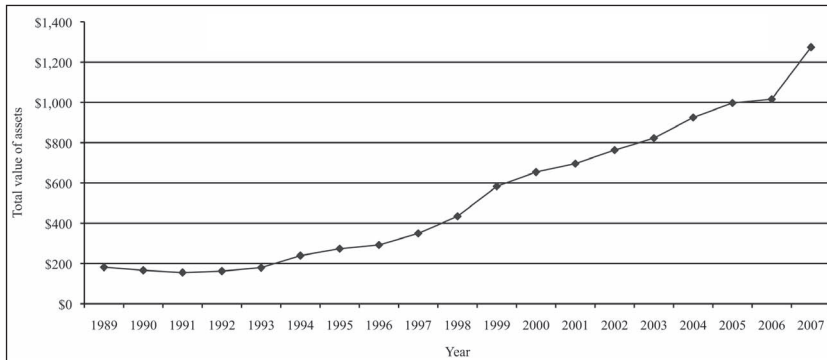
GROWTH IN THE FEDERAL HOME LOAN BANK SYSTEM

The system's considerable size results from growth that began in the 1990s and became controversial by the end of the decade. In the run-up to passage of comprehensive financial services legislation in 1999 (the Gramm-Leach-Bliley Act) high-visibility policy makers raised alarms over this growth and questioned whether the Federal Home Loan Bank System was overstepping its public purpose or even served a public need at all anymore. Treasury secretary Robert Rubin highlighted that "during the first quarter of 1998 alone, the System . . . replaced the Treasury as the world's largest issuer of debt" and argued that "most of the System's investments . . . do nothing to support residential mortgage lending or otherwise advance the System's public purpose."⁷ House Financial Services Committee chair Jim Leach charged that "today the [Federal Home Loan] banks represent a system in search of a rationalization for existence. . . . It is the history of government-sponsored enterprises that when left too long to their own devices, they have a tendency to stretch their powers and transform their functions."⁸ A *Business Week* columnist concluded that the system "keeps growing, with little social purpose."⁹

These charges comprise a serious indictment of a public instrumentality. It has overstepped its purpose. Society no longer needs it. Yet it is growing willy nilly, presumably making money for somebody at the public's expense. Legitimacy is at stake. If the charges are accurate, the system should be reined in, terminated, or privatized.

There is no question that the FHLBank System grew in the 1990s. Figure 1.2 (next page) graphs the level of its assets. After declining from 1989 to 1991, systemwide assets began to grow—moderately through mid-decade and accelerating at the end. By 1999, when Gramm-Leach-Bliley passed, assets had increased to \$583 billion, 376 percent of the 1991 low point. Growth has continued since then, with total assets reaching more than \$800 billion by 2003, passing the \$1 trillion mark by the end of 2006, and spiking to \$1.3 trillion in 2007.

Why did growth alarm policy makers? Much of the explanation lies with the nature of the system's chief funding mechanism. As noted above, to raise money for loans to member financial institutions and other assets, Federal Home Loan Banks issue debt securities called "consolidated obligations." Because the Federal Home Loan Bank System is a GSE, the market views these securities much as it views U.S. Treasury debt. This is problematic,



Sources: FHLBank Combined Financial Reports 1993, 1994, 1996, 1997, 1998, 1999, 2000, 2005, 2007.

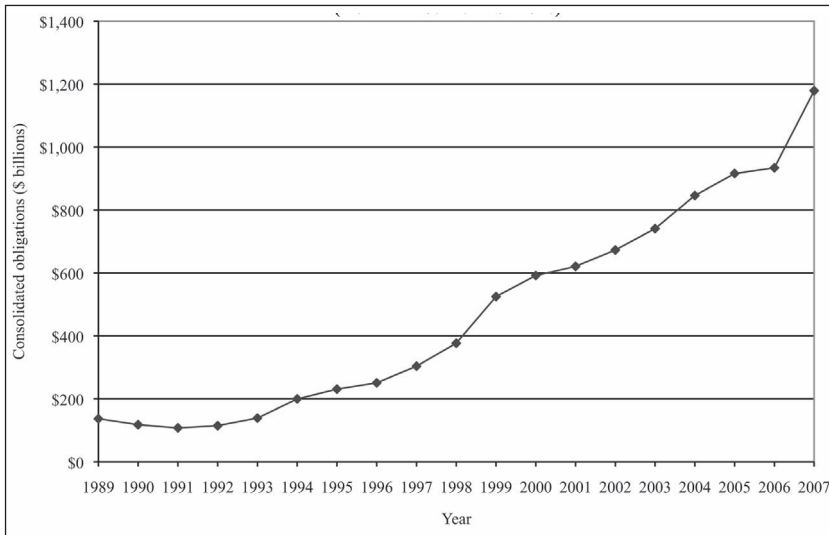
Figure 1.2. FHLBank system assets, 1989–2007.

from the viewpoint of a Treasury Secretary, because FHLBank System debt competes with Treasury issuances and could drive up their cost.

A second problem with this funding mechanism arises from the perspective of policy makers concerned with the federal budget. Though Federal Home Loan Banks are not funded through the appropriations process, their debt nevertheless presents a potential liability for taxpayers. Consolidated obligations are treated much like U.S. government securities in policy and law, so the market perceives a government guarantee even though this debt is explicitly *not* guaranteed by the U.S. government. Congress was acutely sensitized to contingent liability for financial institutions in the course of resolving the S&L crisis of the late 1980s. We share this concern, and this is the issue that caught our attention in the first place, drawing us into this study.

Figure 1.3 shows the level of consolidated obligations issued annually from 1989 through 2007. Not surprisingly, the trend is similar to that of system assets. Issuances fell from \$137 billion in 1989, when the S&L crisis was statutorily resolved, to a low of \$108 billion in 1991. The graph then turns upward, reaching \$525 billion—486 percent of the 1991 low—by the end of the decade. The upward trend continues in the 2000s, with issuances increasing each year to cross the trillion dollar mark in 2007.

These indicators—total assets and consolidated obligations—substantiate critics' observation that the system had grown noticeably by the late 1990s, and illustrate further that it continues to grow. But what shall we make of the charges that this growth does not serve a public purpose? The specter of an agency run amok with the taxpayers' credit card, evoked by system critics, is alarming. But is it the case that expansion is wanton? Growth



Sources: FHLBank Combined Financial Reports 1993, 1994, 1996, 1997, 1998, 1999, 2000, 2005, 2007.

Figure 1.3. FHLBank consolidated obligations, 1989–2007.

does not necessarily indicate loss or perversion of public purpose. Were the FHLBanks serving public purposes as they grew throughout the 1990s?

FEDERAL HOME BANK LEADERS' VIEWS OF THEIR PUBLIC PURPOSE

As one kind of evidence in an empirical foundation for answering that question, we wanted to know what officials in the field, in the FHLBanks, thought they were doing as they grew their institutions. How did they see their organizations' purpose in the political economy? How did they view their mission? In the first of four sets of elite interviews conducted for this study, we asked them. In 2000 we interviewed nineteen FHLBank executive managers and board members in three Federal Home Loan Banks.¹⁰

A caveat is in order: The term *mission* has two meanings in literature with which public administration scholars and practitioners are likely to be familiar. In the sociologically influenced approach to organization theory and the study of bureaucracy, 'mission' means the purpose that gives an organization its cohesiveness and its actions meaning: it is an expression of values. Mission evolves in response to external pressures and internal social forces as organizational leadership tries to maintain an institution's integrity while ensuring its survival.¹¹

A second meaning of ‘mission’ is reflected in the scholarly and practical literature of public management.¹² Here mission is a management tool—a device by which a principal directs the behavior of an agent. In conducting interviews for this study, we learned to avoid the term because it was often negatively associated with this second meaning, viewed as a directive from the outside, from Congress or the regulator. Mission in this second sense—as a mandate—was sometimes perceived as a threat to mission in the first sense—the unifying value that permits the organization to survive and thrive. Thus we asked managers and board members for their views of the “purpose” of their FHLBank, what they thought their FHLBank “should be doing.”

We found that while the range of congressional mandates, which we identify in following chapters, is acknowledged and accommodated in each FHLBank (with varying degrees of enthusiasm), three distinguishable central emphases regarding the purpose of the Federal Home Loan Banks had emerged among the system’s leadership by 2000: to support housing finance, to facilitate housing and community development, and to support the viability of community financial institutions. Table 1.2 shows our interpretation of each interviewee’s view of his or her FHLBank’s purpose. For some interviewees,

Table 1.2. Interviewees’ view of mission

| Interviewee Code | Mission Emphasis | | |
|------------------|------------------|----------------------|-----------------------|
| | Housing Finance | Support Com’ty Banks | Housing & Com’ty Dev. |
| 1 | * | | |
| 2 | * | ** | |
| 3 | * | ** | |
| 4 | | * | |
| 5 | * | ** | |
| 6 | * | | |
| 7 | | * | |
| 8 | * | | |
| 9 | * | | |
| 10 | | * | |
| 11 | * | | |
| 12 | | | * |
| 13 | * | | ** |
| 14 | | | * |
| 15 | ** | | * |
| 16 | * | | |
| 17 | * | | |
| 18 | | * | ** |
| 19 | | * | ** |

*Central emphasis

**Secondary emphasis

a secondary emphasis is indicated as well; these are cases in which two of the three missions were expressed and the second was viewed not just as a means to the first but as an important end in itself.

For some Federal Home Loan Bank leaders, the central purpose of the system today, as when it was established in 1932, is to support housing finance—that is, to make home ownership broadly accessible and affordable through the structure of the financial system. One FHLBank executive was emphatic in the view that “we are to operate for narrow purposes. . . . The overwhelmingly most important and historically *only* purpose was housing finance. . . . The essence of the Home Loan Bank is a way to create bond-based financing for home mortgages . . . and the Home Loan Bank, as envisioned in 1932 and as still existing today, does that by lending money to the [member] institutions to finance their mortgages.”

An FHLBank board member also captured this housing finance purpose, along with Congress’s intent to achieve it systemically, in arguing that the FHLBank mechanism “is a way for the government to keep housing generally affordable. I look at our general government policy as wanting . . . reasonably priced food, and reasonably priced and available housing. And I see the Federal Home Loan Bank System as being one of the tools that it uses to make that—and keep that—happening.”

The second view of Federal Home Loan Banks’ purpose that emerged in our interviews is what we have termed the “housing and community development mission.” Housing finance still figures in, but the housing and community development mission is both more expansive and differently focused. The emphasis is on activities intended to improve the quality of people’s lives in communities or neighborhoods where there are social and economic challenges. Attention is directed to project-specific, subsidized, low-cost development of rental as well as owner-occupied housing; business development that promises jobs for economically disadvantaged people; and initiatives that contribute to catalyzing, developing, and maintaining the organizational infrastructure necessary for community development. One executive manager explained that “[our Bank’s] purpose is really to positively impact and affect the lives of people living in our district . . . in terms of providing them with a home to live in, a job and a safe and growing community to live in. That’s the end game of what we’re trying to achieve ultimately when you really come down to it. Now, we do that . . . through intermediaries and partners and various institutions including commercial banks and nonprofit organizations and whatever.”

A conviction that the central purpose of their FHLBank is to support the viability of community financial institutions is the third view that we encountered. Some leaders in the Federal Home Loan Bank System are convinced that smaller, locally owned and managed banks and S&Ls are crucial to economic health and clearly threatened as the banking industry consolidates. One manager elaborated on this sense of the mission:

A lot of it boils down to what does this country . . . really want? Does it want a local presence, with local citizens, providing opportunities in the local community—I think far greater than the bigger institutions can? People will not all do business over the Internet. People would like to sit across the table from a human being and discuss their personal financial situation. And . . . in my opinion, there aren't enough big financial institutions with all of the talent that's needed to really give the same level of customer service that you have today with thousands of community-based organizations. I think the community organizations are truly committed to the hometown America which I don't think has gone out of vogue in this country. Without [the FHLBank]—if you think about this: here's a \$50 million institution in a small town, able to access funding at rates comparable to the largest institutions in this country and effectively compete for consumer lending, mortgage lending, support of their local community. And I think that's been important to this country for years. And that's why I think you'll see a growing importance of the Federal Home Loan Bank System.

A board member, likewise, centered the support of community financial institutions as FHLBanks' purpose, maintaining that "what the issue is now is that . . . we need a counter-point to the mega-mergers problem. We need to still be able to have a mechanism for smaller banks . . . to be able to have liquidity . . . , as a substitute for a deposit base."

We thus found three distinguishable views of their institution's mission among executive managers and board members at the individual FHLBanks: support housing finance; facilitate housing and community development; and maintain the viability of small, community-based financial institutions. In each FHLBank we visited, one of these views was dominant, though all three were acknowledged to some extent.

That leaders in the Federal Home Loan Banks have a clear sense of their public purposes provides some justification for the growth and mission expansion that have occurred. But legitimacy for democratic public administration requires not only that administrative officials view themselves as pursuing public goods but also that this pursuit is authorized in the broader public policy process. Where did each of these three missions come from? Why and how did the mission of the Federal Home Loan Banks expand?

OVERVIEW

We address these questions in the following chapters. Chapter 2 is about the social science methodology and political science theories upon which we relied. People reading this book for description and history of Federal Home Loan Banks may want to skip over chapter 2 and can do so with-

out losing the story. For students and scholars of public policy and public administration, we describe the “grounded research” approach to studying social phenomena. Grounded researchers begin with questions rather than hypotheses and permit themselves to ask additional questions, reinterpret their data, and gather more data as the study unfolds. They talk about “data in the head,” which includes disciplinary theories, as well as data from the field. We also describe two competing theoretical paradigms in political science that we used to shape this study—public choice, rooted in economics, and behavioral choice, rooted in cognitive and social psychology—and review their applications to public administration and public policy. We go on to describe our data from the field, gathered through several rounds of elite interviews, from current and historical documents, and from websites.

In each of chapters 3, 4, and 5, we tell a story of one of the three missions we found among FHLBank leaders—housing finance, housing and community development, and maintaining small banks. We describe the mission and ask why and how it originated and took hold.

In chapter 6, we draw on these three analytical narratives to argue that mission originated and expanded in the FHLBanks because *public problems* were identified in the policy process, and Congress deployed *administrative capacity* to address them. We ultimately view the expansion that has occurred as legitimate but caution that given changes in the environment and internal structure of FHLBanks since the mid-1990s, the same behavioral mechanism that is important in explaining their legitimate growth—the direction of experts’ attention—could undermine their public focus. Accordingly, chapter 7 suggests consideration of three reforms.

Finally, we include an afterword. As the manuscript for this book was under review during 2008, the extent of the damage done to housing finance and the broader economy by practices in subprime mortgage lending and securitization of such mortgages was becoming apparent. The afterword asks what, if any, relationship Federal Home Loan Banks had to these practices.