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"Super Lien" Doesn't Mean Super Risk: Money Market Intermediation, Security Interests, Federal Home Loan Bank Lien Protections and Systemic Risk

Jonathan A. Scott

Reginald T. O'Shields

"SUPER LIEN" DOESN'T MEAN SUPER RISK: MONEY MARKET INTERMEDIATION, SECURITY INTERESTS, FEDERAL HOME LOAN BANK LIEN PROTECTIONS AND SYSTEMIC RISK

JONATHAN A. SCOTT*

REGINALD T. O'SHIELDS

I. INTRODUCTION

Several recent articles from staff at the Board of Governors of the Federal Reserve System[1] and the Office of Financial Research[2] highlight the linkage between the Federal Home Loan Bank ("FHLBank") System providing collateralized loans to its member banks and the FHLBank System's role in money market intermediation after the implementation of Securities Exchange Commission ("SEC") money market reforms and Basel liquidity rules in the aftermath of the 2008 financial crisis. One commentator has called the FHLBank System the "beating heart of the funding network that underpins the U.S. financial system."[3] The FHLBanks have become increasingly important providers of debt securities to money market funds that invest primarily in government and affiliated securities, including the FHLBanks.[4] The FHLBanks are also important providers of secured advances to their members, including large members

*Jonathan A. Scott is a Professor of Finance at Temple University and currently serves as Chairman of the Board of the Office of Finance of the Federal Home Loan Banks. Reginald T. O'Shields is Senior Vice President and General Counsel of the Federal Home Loan Bank of Atlanta. Any opinions expressed herein are solely those of the author and contributor, and do not express the opinions or viewpoints of the FHLBanks, the FHLBank Office of Finance, their officers or directors, or the FHLBank System.

1. *See* S. Gissler & B. Narajabad, *The Increased Role of the Federal Home Loan Bank System in Funding Markets, Part 1: Background*, FEDS NOTES (Oct. 18, 2017), https://www.federalreserve.gov/econres/notes/feds-notes/the-increased-role-of-the-federal-home-loan-bank-system-in-funding-markets-part-1-background-20171018.htm [hereinafter FEDS NOTES].

2. K. Anadu & V. Baklanova, *The Intersection of U.S. Money Market Mutual Fund Reforms, Bank Liquidity Requirements, and the Federal Home Loan Bank System* (Office of Fin. Research, Working Paper No. 17-05, Oct. 31, 2017).

3. Louie Woodall, Soaring Fed Home Loan Bank Borrowings Spark Systemic Risk Fears, RISK MAGAZINE 1, 2 (Jan. 10, 2018).

4. *Id.*

that have become subject to more stringent liquidity requirements after the financial crisis.[5] Finally, the FHLBanks are increasingly important participants in the federal funds market.[6]

This growth in lending to and by the FHLBanks during the phase-in of money market reform has been attributed in part to the FHLBanks' statutory lien on collateral pledged to them by their borrowers, which some have referred to as a "super lien" due to its unique statutory protections. The real estate collateral pledged to the FHLBanks has been provided by "subsidiaries of large insurance and bank holding companies to small savings banks and credit unions that might not otherwise have ready access to funding from investors who cannot secure such protection."[7]

The FHLBanks' statutory lien was originally established by the Competitive Equality Banking Act of 1987 ("CEBA"),[8] and is thus often referred to as the "CEBA lien." Its goal was to improve the standing of the FHLBanks as secured creditors by giving them priority in receivership over lien creditors such as the Federal Deposit Insurance Corporation ("FDIC") acting as receiver or conservator. This in turn would allow the FHLBanks to lend more securely and ensure an adequate flow of liquidity to the member banks and, through those banks, to businesses, homeowners, and other consumers. Past reference in the literature to the lien argued that it created disincentives for underwriting and pricing risk.[9] While not specifically stated in the most recent references to the statutory lien, the implication is that without the lien protections afforded to the FHLBanks, the increased money market intermediation by the FHLBanks would not have occurred.

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5. *Id.*

6. Ben Craig & Sara Millington, FED. RES. BANK OF CLEVELAND, THE FEDERAL FUNDS MARKET SINCE THE FINANCIAL CRISIS (2017), https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2017-economic-commentaries/ec-201707-the-federal-funds-market-since-the-financial-crisis.aspx (last visited Feb. 9, 2019) (discussing the federal funds market as the overnight lending market among banks in central bank reserves).

7. FEDS NOTES, *supra* note 1.

8. Competitive Equality Banking Act of 1987, Pub. L. No. 100-86 (1987), 12 U.S.C. § 226 (2012).

9. *See, e.g.*, R.N. Collender & J.A. Frizell, *Small Commercial Banks and the Federal Home Loan Bank System*, 25 INT'L REGIONAL SCI. REV. 279, 280 (2002) (stating that, due to the existence of this special lien priority, FDIC officials remain concerned that it can enable or encourage risk taking by FHLBank members); *see, e.g.*, R.L. Bennett, M.D. Vaughn & T. J. Yeager, *Should the FDIC Worry about the FHLB? The Impact of Federal Home Loan Bank Advances on the Banks Insurance Fund* 12 (Federal Reserve Bank of Richmond, Working Paper 05-05, July 2005) (arguing that it is rational for the FHLBanks to ignore failure risk when pricing advances because of the statutory lien protection).

References to the FHLBanks' statutory lien as a contributor to the growth in money market intermediation, or the lack of losses on loans to members, known as advances, vastly overstates its importance. The role of post-financial crisis regulation of bank liquidity and money market funds, the FHLBanks' cooperative structure and system of comprehensive safety and soundness regulation, amendments to the Uniform Commercial Code ("UCC") that provided new methods of establishing priority in the event of debtor insolvency, and FHLBank secured lending practices with real estate collateral are far more important than the CEBA lien in explaining the expansion. The CEBA lien was enacted because of unique circumstances during the thrift crisis of the 1980s and the ambiguity in perfecting security interests with multiple creditors without possession. In this article we explain that the secured lending practices of the FHLBanks and the revisions of the UCC in 2001 result in the CEBA lien having value only in a few narrow instances where the borrower defaults. As such, it cannot be considered a meaningful catalyst in recent growth in money market intermediation.

II. THE ORIGINS OF THE CEBA LIEN

Section 10 of the Federal Home Loan Bank Act was amended by CEBA in 1987 to improve the standing of the FHLBanks as secured creditors by giving them priority in receivership over other parties and lien creditors such as the FDIC acting as receiver or conservator. The law establishing the CEBA lien reads:

> Notwithstanding any other provision of law, any security interest granted to a Federal Home Loan Bank by any member of any Federal Home Loan Bank or any affiliate of any such member shall be entitled to priority over the claims and rights of any party (including any receiver, conservator, trustee, or similar party having rights of a lien creditor) *other than* claims and rights that: (1) would be entitled to priority under otherwise applicable law; and (2) are held by actual bona fide purchasers for value or by actual secured parties that are secured by actual perfected security interests.[10]

10. Federal Home Loan Bank Act § 10(e), 12 U.S.C. § 1430(e) (2012) (emphasis and punctuation added).

This provision was included in the legislation because, at the time, the Federal Savings and Loan Insurance Corporation ("FSLIC") was experiencing significant financial difficulties as a result of savings and loan associations failing at a record rate.[11] FSLIC struggled to conserve cash resources and offered FSLIC guarantees to the FHLBanks as collateral in place of, or in addition to, first mortgages or mortgage-backed securities provided as collateral by savings and loans in return for advances from FHLBanks. The CEBA lien was intended to provide comfort to the FHLBanks and encourage them to continue lending to insolvent thrifts at that time.

To understand how the CEBA lien would encourage lending to insolvent thrifts, a quick review of the FHLBank lending process is necessary. Upon joining a Federal Home Loan Bank, a member must sign an "advances and security agreement" that establishes a security interest in the member's assets for any asset by the FHLBank to the member. Each FHLBank has specific policies defining eligible collateral and its valuation as security for extensions of credit. All FHLBanks perfect their security interests in the collateral under the UCC.

Members may provide the mortgage loans held on their books as assets as collateral for the loan. Depending upon its specific credit underwriting criteria, the FHLBank may not require immediate delivery of the notes representing the mortgage loan collateral. Alternatively, the FHLBank may require segregation of mortgage loan collateral at the member's site, which assists the FHLBanks in monitoring the location of the pledged notes and ensuring that the collateral is not delivered to another party. The FHLBank may also require additional data and reporting on the loan collateral. Table 1 reproduces a table from the 2017 Combined Financial Report that shows the range of collateral lending values by pledging method.[12] However, at any time an FHLBank may, in its judgment, require the member to physically deliver mortgage loan collateral, including the pledged notes, so that possession is established—a critical issue in determining the priority of claims in a receivership.

11. *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION—CURRENT FINANCIAL CONDITION AND OUTLOOK (1988), https://www.gao.gov/assets/110/102136.pdf (last visited Feb. 9, 2019).

12. 2017 Combined Fin. Report, Office of Fin. of the Fed. Home Loan Banks 1, 95 (Mar. 23, 2018), http://www.fhlb-of.com/ofweb_userWeb/resources/2017Q4CFR.pdf.

At the time of the adoption of the CEBA lien, the only method to perfect a security interest in instruments (e.g., mortgage notes) under the UCC was through possession;[13] no provision existed in the UCC to establish a perfected security interest in instruments by filing a financing statement. If multiple creditors had a security interest in the same mortgage notes and none of these creditors had taken possession of the notes, the priority of the claims was determined by the order in which the security interest was attached.[14]

The CEBA lien gave the FHLBanks' security interest—even without possession of the notes—priority over an unperfected security interest of other creditors *only if no other secured creditor had possession of collateral*. However, if another secured creditor with a valid security interest had possession, the CEBA lien would have been of no value because the UCC established perfection, and thus priority, of a perfected security interest, through possession of collateral. Where the CEBA lien did have value was in the context of a member insolvency and subsequent receivership, in which the FHLBanks would have been unperfected under the prior version of the UCC. The legislative intent behind the CEBA lien presumably was motivated to avoid this result, and to encourage the FHLBanks to continue lending to their members during difficult circumstances so that adequate liquidity was maintained in the home financing market.

III. THE CEBA LIEN TODAY

The revision of the UCC in July 2001 created the ability to perfect a security interest in instruments by filing a financing statement in addition to perfecting[15] by obtaining possession of the collateral.[16] If there are multiple creditors that file financing statements against the same collateral *and* no creditor has possession, the UCC now provides for a "first

13. *See* U.C.C. § 9-312(a) cmt. n.2 (noting that the change in the most recent version of the UCC to permit perfection by filing a financing statement "is likely to be particularly useful in transactions involving a large number of notes that a debtor uses as collateral but continues to collect from the makers," which is exactly the situation between the FHLBanks and their members).

14. *See* U.C.C. §§ 9-322(a)(3), 9-203(b) (stating that attachment occurs when a security agreement is authenticated, the FHLBank has given value, and the member has rights in the collateral). There was potential for confusion because security agreements are usually dated but typically do not include the exact time of execution since they are not filed with a public body, but are bilateral documents between lenders and borrowers. like financing statements.

15. U.C.C. § 9-312(a).

16. U.C.C. § 9-313(a).

to file" priority[17] in the event of bankruptcy or receivership. In the event no secured creditor has possession of the collateral, and the FHLBank has not filed its financing statement first, the CEBA lien, as provided since its enactment, would not grant the FHLBank priority over the earlier "actual security interest" perfected under the UCC.[18] The CEBA lien now just fills in the gap for a situation where: (1) no secured creditor, including the FHLBank, has possession of collateral; and (2) no other secured creditor, including the FHLBank, has filed a valid financing statement at the time of the receivership.[19] In this limited case, the FHLBanks have priority over other secured creditors, as well as receivers, conservators, or other lien creditors, which, given the credit policies and practices of the FHLBanks in addition to their highly regulated nature, is likely to be a rare event.

The FHLBanks could be satisfied with the security interest established by the advances agreement, and not be concerned at all with credit underwriting in only one case: if they had the perfect foresight that no other secured creditor would have a valid perfected security interest in a member's assets in the event of a receivership. Without this perfect foresight, the FHLBanks have credit risk even with the CEBA lien in place. If the FHLBanks have not taken delivery of collateral and some other secured creditor has possession, or if the FHLBanks have not filed an earlier financing statement, the CEBA lien does not put them ahead of other perfected secured creditors. The CEBA lien thus offers very limited additional protection for the FHLBanks beyond that provided for all secured creditors under the UCC since 2001.

Consequently, the absence of credit losses on advances by FHLBanks is more likely the result of incentives for the FHLBanks to engage in prudent underwriting to identify credit difficulties and potential situations where delivery of mortgage notes must be accelerated to protect their rights as secured lenders under the UCC.[20] This prudent

17. U.C.C. § 9-322(a)(1).

18. The statute differentiates between actual secured parties and lien creditors, such as receivers, conservators and trustees. Actual secured parties would be those parties that have lent money or given value to the debtor/borrower.

19. *See* U.C.C. § 9-501(a) (amended 2010) (requiring that U.C.C financing statements must be filed in the appropriate office in a specific state, must be correctly completed, and renewed on a periodic basis to be valid.).

20. An example of a legal structure in which the FHLBanks clearly must engage in prudent underwriting is lending to insurance companies where the CEBA lien may not apply due to the McCarran-Ferguson Act and the concept of reverse preemption of Federal law with respect to the regulation of the business of insurance. A number of states, including North

underwriting includes extensive and regularly updated credit underwriting, regular collateral analysis and pricing, and periodic collateral verification reviews, including on-site visits.[21] This is not to say that the CEBA lien has no value to the FHLBanks. Rather, we are suggesting that an FHLBank board of directors would not be meeting its duty of care—specifically sound and informed judgment—if it permitted FHLBank management to rely solely on the CEBA lien to enforce its rights as a secured creditor. The CEBA lien—like all secured lending—may be thought to increase the cost of resolution for member banks in receivership, yet covered bonds or any other non-deposit secured borrowings pose a similar problem as a result of the protections afforded to all valid perfected security interests under U.S. law. On the other hand, secured lending is generally less expensive to the borrowing financial institution, and thus facilitates the flow of credit to consumers, businesses, and homeowners.

The recent development of covered bonds provides an illustration of how the priority of secured creditor rights under the UCC is more than just of theoretical interest to the FHLBanks.[22] Covered bonds provide investors a secured claim against specified assets pledged by the borrower similar to the secured lien held by the FHLBanks. In this context, if an FHLBank were to lend to the same institution that issued the covered bonds, lending limits would need to be adjusted by the FHLBanks to ensure sufficient collateral is in place to preserve claims against the assets of the borrower in the event of the borrower's receivership. Should a covered bond issuer be placed in receivership, there can clearly be more than one party with a security interest in the failed bank's collateral, including an FHLBank. The CEBA lien would not resolve this conflict in

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Carolina, have adopted provisions protecting FHLBank liens from the avoidance powers of the receiver for an insurance company. NC Gen. Stat. § 58-30-147 (2016). The FHLBanks as cooperative government sponsored enterprises also have a general duty to protect the investment of their members through prudent underwriting.

21. OFFICE OF FIN. FED. HOME LOAN BANKS, FED. HOME LOAN BANKS COMBINED FIN. REPORT (2017), http://www.fhlb-of.com/specialinterest/financialframe2.html (last visited Feb. 9, 2019) (describing the underwriting processes used by the Federal Home Loan Banks).

22. CBs are popular in Europe and the Commonwealth countries but have not yet gained much traction in the United States. In Canada the pool of bonds is ring-fenced and considered bankruptcy remote. Covered bonds have thrived in markets with specific legislation that addresses the complex legal structure of a covered bond claim. *See Covered Bonds as a Source of Funding for Bank's Mortgage Portfolios*, Royal Bank of Canada, Financial System Review 40 (June 2018), https://www.bankofcanada.ca/wp-content/uploads/2018/06/fsr-june18-ahnert.pdf. Whether or not the U.S. Congress takes on the task of implementing the necessary legislative changes to encourage this market as part of GSE reform remains a matter of speculation. *See Covered Bonds in the United States – Latest News,* US Covered Bonds, www.us-covered-bonds.com (last visited Feb. 9, 2019).

favor of the FHLBank if the holder of the covered bond filed a prior, valid UCC financing statement, or had obtained possession of the collateral.

IV. THE CEBA LIEN AND TAXPAYER RISK

The FDIC and other statutory lien creditors, such as state insurance receivers and bankruptcy trustees, may have continuing concerns about the CEBA lien's potential to increase their exposure in the event of a member's receivership.[23] As such, it is worth contrasting FHLBank advances with the treatment of a repurchase agreement (another instance of secured borrowing) in the event of receivership. The repurchase agreement is treated essentially like a secured financing by the FDIC, and the value of the claim of the buyer/secured party will be based on the difference between the collateral value and the amount borrowed.[24] If the collateral value exceeds the loan value, the FDIC would give value to the full amount borrowed and repay the borrowing from the sales proceeds of the collateral, or repay the buyer/secured party for returning the assets.[25] And if the collateral value is less than the amount borrowed, the FDIC would only repay the value of the collateral, leaving the buyer/secured party with a general unsecured claim for this deficiency.[26] The only difference between the repo and advances treatment in receivership is the situation where the collateral value is less than the amount borrowed. In this case, the Federal Deposit Insurance Act ("FDI Act") provides that the rights of the receiver to disallow or determine a claim to be undersecured does not apply to extensions of credit by an FHLBank, or a Federal Reserve bank, or security interests granted as a result of these extensions of credit.[27] FDIC regulations issued pursuant to the FDI Act further provide that if the receiver is in possession of any collateral pledged to an FHLBank, the receiver shall, upon request of the Bank, promptly deliver the collateral to the Bank or its designee.[28]

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23. *See e.g.*, D. Stojanovic, et al., *Is Federal Home Loan Bank Funding Risky Business for the FDIC?*, FED. RES. BANK OF ST. LOUIS REGIONAL ECONOMIST (Oct. 2000); *see generally* D. Stojanovic et al., *Do Federal Home Loan Bank Membership and Advances Increase Bank Risk-Taking?*, 32 J. BANKING & FIN. 680 (May 2008); *see also* R. Bennet et al., Should the FDIC Worry About the FHLB? (Fed. Res. Bank of Richmond, Working Paper No. 2005-10, July 2005).
24. 12 U.S.C. §§ 1821(e)(8)(D)(i), 1821(e)(8)(D)(v), 1821(e)(8)(E)(ii) (2012).
25. § 1821(d)(5)(D)(ii) (2018).
26. *Id*.
27. § 1821(d)(5)(D)(iii) (2018).
28. 12 C.F.R. § 360.2(b) (2018).

The FHLBanks indeed have better protection than an unsecured and other secured creditors in many circumstances—assuming no other valid secured creditor had possession of the collateral or filed a valid, prior financing statement. In practice, a financially weak counterparty is unlikely to obtain repo funding, but in the event it could, the collateral haircuts would be larger than a more creditworthy borrower and the term of the credit much shorter. Similarly for the FHLBanks, weaker financial members would be subject to larger haircuts and term restrictions as well in order to provide additional protection to the FHLBank.[29] These protections also support the public liquidity mission of the FHLBanks to be consistent providers of liquidity to the financial system, consistent with safe and sound operations.[30]

Another difference between the repo and advances treatment in receivership is the issue of prepayment fees. Federal regulations and the FHLBanks' advances and security agreements stipulate that prepayment fees are required for early retirement of advances (unless callable) under most circumstances.[31] These fees are asymmetric and make the FHLBanks economically neutral when current advances rates have fallen relative to the rate on the current, higher rate advance outstanding. Under FDIC regulations, this fee would have to be paid by the FDIC as part of the repayment of the advance to obtain clear title to the collateral securing the advance.[32] This cost to the FDIC may not be required for a repo of a similar maturity, but it is not related to the CEBA lien.

V. THE CEBA LIEN AND SYSTEMIC RISK

The primary question the literature addresses around the CEBA lien is whether it contributes to excessive risk exposure either through individual large bank lending or collective lending across all members. The literature makes a number of references to the CEBA lien, frequently referred to as the "super" lien, as an explanation for the

29. OFFICE OF FIN. FED. HOME LOAN BANKS, *supra* note 21.

30. 12 U.S.C. § 4513(f) (2012); 12 C.F.R. §1265.2 (2018).

31. Exceptions exist where an advance contains a prepayment option, is for a maturity or pricing term of six months or less, or is otherwise designed to make the FHLBank financially indifferent to the early repayment. *See* 12 C.F.R. § 1266.6(b) (2018) (requiring an FHLBank must charge a prepayment fee which makes the FHLBank financially indifferent to repayment).

32. *See* 12 C.F.R. § 360.2(e) (2018) (allowing a claim for an FHLBank's prepayment fee if it is pursuant to a written contract, the amount of the prepayment fee does not exceed the present value of the FHLBank's loss, and the prepayment fee is fully secured).

FHLBanks avoidance of any credit losses associated with advances. It is argued that the super lien creates disincentives for underwriting and pricing risk, which permits a member bank to grow by substituting advances for insured deposits. Thus, borrowing members can grow without any market discipline thus increasing the risk to the FDIC.[33] For the reasons stated above, the relatively narrow scope of additional protection afforded by the CEBA lien is not sufficient to incentivize the FHLBanks to make imprudent or excessive loans to a single borrower.

A recent set of articles by Gissler and Narabajad addressed potential systemic risk created by the FHLBanks as a consequence of SEC-mandated money market reform and new liquidity ratios mandated by the banking regulators consistent with the Basel III accords.[34] The argument is that the FHLBanks have become the new intermediary between commercial banks and money market funds. Instead of commercial banks (or bank holding companies) issuing certificates of deposit or commercial paper directly to prime money market funds, which due to negative regulatory treatment have shrunk in size, the (perhaps unintended) consequence of SEC and Basel III changes resulted in increased demand by government funds for eligible securities issued by the U.S. government and affiliated entities. Aside from Treasury discount notes, securities issued by Government Sponsored Enterprises were the next largest source for fund assets.[35]

Among the GSEs, the FHLBank System had been the largest issuer of discount notes and were the likely source of new paper that were

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33. *See* D. Stojanovic et al., *Do Federal Home Loan Bank Membership and Advances Increase Risk Taking*, 32 J. BANKING & FIN. 680, 684 (2008).

34. On July 23, 2014, the United States Securities and Exchange Commission adopted structural and operational reforms to address risks of investor runs on money market funds. These reforms included requiring a floating net asset value (NAV), liquidity fees and redemption gates for institutional prime money market funds, and were phased in over a two-year period beginning in 2014. Funds investing 99.5 percent or more of their assets in cash and government securities, including those issued by the FHLBanks, are exempt from these rules. FEDS NOTES, *supra* note 1; *see also* Press Release, Sec. and Exchange Comm'n, SEC Adopts Money Market Fund Reform Rules (July 23, 2014), www.sec.gov/news/press-release/2014-143.

35. The Investment Company Institute (ICI) reports that as of September 30, 2018, Agency securities comprised $610 billion and repurchase agreements backed by Agency securities comprised $323 billion out of $2,187 billion in total government money market fund assets. Total U.S. government security holdings were $735 billion of Treasury debt and $515 billion of repurchase agreements secured by Treasury debt. *See* Investment Company Institute, MONEY MARKET FUND PORTFOLIO, https://www.ici.org/research/stats/mmfsummary (last visited Feb. 9, 2019).

qualified investments for these funds.[36] However, the FHLBanks would only be issuing new discount notes to support demand for advances. Based on the construction of the liquidity coverage ratio and net stable funding ratios, the globally systemically important bank (G-SIB) members began borrowing from the FHLBanks to meet the minimum requirements for both ratios.[37] Consequently, the shift of approximately $400 billion from prime funds to government funds reflected the desire by investors to avoid the new risks associated with prime funds and a G-SIB strategy to shift borrowing to the FHLBanks to efficiently address the new liquidity requirements and to make up for the loss of funding from the prime funds.

The systemic risk arises from two sources: the concentration of lending to G-SIBs as a result of this new intermediation in the money markets and the potential inability of the FHLBanks to rollover the debt issued to support the G-SIB borrowing.[38] An argument is made that the CEBA lien has led to more growth than would otherwise occur and increases systemic risk because it "bails out" poor underwriting, leading to lack of concern about the borrower's ability to repay.[39] A G-SIB in distress may have a material financial impact on the FHLBanks because of the G-SIB's multiple memberships. If the FHLBanks are perceived to have financial difficulties, it could spill over into the money markets, especially if investors are worried about the implicit government backstop. Additionally, this loss of investor confidence could destabilize the FHLBank System causing it to lose access to money markets or find its access impaired.[40] In this situation, the System would be forced to use contingent liquidity or not rollover advances to G-SIBs, creating further stress on money markets as they seek other sources of short-term funding. A related aspect to this scenario, but independent of G-SIB distress, is that

36. Discount notes are securities issued with a maturity of 365/366 days or less that are generally sold at issuance for less than their stated principal amount at maturity, but may be sold at par or at a premium, and are paid only on their maturity dates at 100% of their principal amounts. FHLBANKS, *Supplement to Information Memorandum* 1, 8 (Mar. 19, 2012), http://www.fhlb-of.com/ofweb_userWeb/pageBuilder/information-memorandum-112.

37. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the FDIC adopted a final rule in September 2014 that implemented enhanced quantitative liquidity requirements consistent with the standards established by the Basel Committee on Banking Supervision. *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*, BASEL COMM. ON BANKING SUPERVISION (Jan. 2013), http://www.bis.org/publ/bcbs238.htm.

38. FEDS NOTES, *supra* note 1; *see also* Anadu & Baklanova, *supra* note 2.

39. FEDS NOTES, *supra* note 1.

40. *Id*.

some exogenous shock impairs the ability of the FHLBanks to rollover their short-term debt, causing a liquidity crisis to spread through the money markets as the FHLBanks either adjust their investment portfolio or do not roll over advances causing their member banks to search elsewhere for funding.

While the worst case scenarios outlined above are possible, neither is very probable.[41] It is true that FHLBank advances have grown significantly in recent years, from approximately $500 billion at the end of 2013, to over $700 billion at the end of 2017. It is also true that the FHLBank consolidated debt is now a favorite of money market investors. However, neither of these trends is attributable to the CEBA lien.[42] This increase in the size of the FHLBanks' combined balance sheet is due to a number of factors, including an improving economy, a stabilizing financial sector, and post-financial crisis legislation and regulation encouraging member banks to hold more liquidity. This increase in investor demand has not been driven by a desire to exploit loopholes in the law that allow FHLBanks to lend to their members imprudently and excessively. The narrow constraints of the CEBA lien provide no protection to an FHLBank making an imprudent advance. Moreover, lending to large institutions is closely monitored and the scenarios described above assume a static management response, which would not be the case. All lenders, including the FHLBanks, would monitor potentially troubled credits and certainly reduce the maturities as risk indicators signaled future problems. As such, concerns about rollover risk based on the maturity intermediation today is not necessarily what a balance sheet would look like moving into a crisis.

The FHLBanks do benefit from a number of structural and legal advantages that support their ability to act as reliable providers of liquidity during crises, as they did during the lead-up to the 2008 financial crisis.[43] The FHLBanks operate as cooperatives which require capital contributions from their members in order to borrow and participate in their

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41. Anadu & Baklanova, *supra* note 2.

42. OFFICE OF FIN. OF THE FED. HOME LOAN BANKS, 2017 COMBINED FINANCIAL REPORT, 1, 95 (Mar. 23, 2018), http://www.fhlb-of.com/ofweb_userWeb/resources/2017Q4CFR.pdf.

43. Adam B. Ashcraft et al., *The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?*, FED. HOME LOAN BANK OF NEW YORK, No. 357 (Nov. 2008), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr357.pdf (last visited Feb. 9, 2019).

services.[44] All advances from an FHLBank must be secured.[45] The Secretary of the Treasury is authorized to purchase obligations of the FHLBanks up to $4 billion.[46] This authority was made unlimited during the recent financial crisis as a sign of support for the FHLBanks and as a market stability mechanism, but that authority was not utilized.[47] All of these factors along with the FHLBanks' history of prudent underwriting—much more than the CEBA lien—have encouraged investors to purchase FHLBank debt in large volumes.

VI. CONCLUSION

The FHLBanks occupy an increasingly significant role in the nation's financial system. This role has been enhanced as the result of regulatory changes after the 2008 financial crisis such as increased liquidity requirements and money market fund reforms. As a result, commentators have raised concerns over the incentives, such as the CEBA lien, that may exist for the FHLBanks to lend excessively, which could negatively impact financial markets due to the important role of the FHLBanks in funding markets. These concerns seem misplaced due to the limited nature of the CEBA lien. After changes in the UCC in the early 2000s, the CEBA lien has limited applicability and offers little additional protection to the FHLBanks beyond that available to any secured lender.

The FHLBanks are strictly regulated for safety and soundness by the Federal Housing Finance Agency ("FHFA"), and are required to conduct their secured lending in conformity with the UCC.[48] They are regularly examined on their credit and collateral practices. In addition, the CEBA lien may reduce systemic risk in that it, and accompanying regulations from the FDIC and other regulators, may signal public support for the FHLBanks' mission in a way that assures markets of the unique role of the FHLBanks in the financial system, thus reducing the risk of a freeze in liquidity to the FHLBanks and assuring an adequate flow of credit to member financial institutions. The recent financial crisis supports this

44. 12 U.S.C. § 1426(c) (2012).

45. § 1430(a)(1).

46. § 1431(i).

47. § 1431(l).

48. FED. HOUS. FIN. AGENCY, ADVISORY BULLETIN: COLLATERALIZATION OF ADVANCES AND OTHER CREDIT PRODUCTS PERFECTION AND CONTROL OF COLLATERAL (2013), https://www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/Pages/AB-2013-10-COLLATERALIZATION-OF-ADVANCES-AND-OTHER-CREDIT-PRODUCTS;-PERFECTION-AND-CONTROL-OF-COLLATERAL.aspx (last visited Feb. 9, 2019).

analysis in that the FHLBanks remained a consistent source of liquidity for the financial system, particularly during the early stages of the crisis.[49] Many states have recently enacted provisions similar to the CEBA lien in their state insurance codes so that their insurance companies will have reliable access to FHLBank liquidity.[50] Far more important to the safety and soundness of the FHLBanks, and by extension, the larger financial system, than the CEBA lien, is strong prudential management and supervision of the FHLBanks, including credit and collateral risk management, liquidity, and capital requirements. The FHLBanks benefit from strong oversight by the FHFA in these areas, which has been enhanced in recent years. The FHLBanks also benefit from a legal and regulatory structure that supports their resiliency during times of stress, including access to public support and an established source of capital support through their member institutions. These are the tools that should be relied upon to reduce systemic risk, not the removal of the CEBA lien.

49. 12 U.S.C. § 1430(a)(1) (2012).
50. NC Gen. Stat. § 58-30-147 (2016).

TABLE 1: COLLATERAL VALUES FOR FHLBANK LENDING (2017 COMBINED FINANCIAL REPORT

Table 45 - Effective Lending Values by Type of Collateral for all Borrowers at December 31, 2017

Collateral Type	Effective Lending Values Applied to Collateral	Average Effective Lending Value
Blanket Lien		
Single-family mortgage loans(1)	39%-94%	78%
Multifamily mortgage loans	25%-78%	71%
Other U.S. government-guaranteed loans	77%-92%	84%
Home equity loans and lines of credit	4%-83%	60%
Community Financial Institutions (CFI) collateral	13%-87%	56%
Commercial real estate loans	11%-87%	69%
Other loan collateral	32%-82%	48%
Listing		
Single-family mortgage loans(1)	1%-96%	82%
Multifamily mortgage loans	27%-89%	78%
Other U.S. government-guaranteed loans	91%	91%
Home equity loans and lines of credit	2%-92%	67%
CFI collateral	25%-73%	71%
Commercial real estate loans	32%-89%	72%
Other loan collateral	39%-96%	80%
Delivery		
Cash, U.S. government, and U.S. Treasury securities	79%-100%	93%
State and local government securities	8%-98%	89%
Municipal debt	54%-94%	76%
U.S. agency securities	75%-98%	95%
U.S. agency MBS and collateralized mortgage obligations (CMOs)	71%-98%	95%
Private-label MBS and CMOs	50%-96%	86%
CFI securities	93%-100%	96%
Commercial MBS	50%-97%	86%
Equity securities	67%-88%	84%
Other securities	51%-97%	87%
Single-family mortgage loans(1)	17%-93%	81%
Multifamily mortgage loans	50%-83%	73%
Home equity loans and lines of credit	9%-87%	67%
CFI collateral	30%-65%	53%
Commercial real estate loans	22%-87%	69%
Other loan collateral	10%-77%	76%
Student loan securities	95%-97%	95%

(1) Includes Federal Housing Administration and Department of Veterans Affairs loans.