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Financial Myths in the Marketplace

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Executive Summary

A series of myths motivate ill-advised policymaking in junk fee regulation, credit card regulation, and in proposed reforms to the Federal Home Loan Bank. These counterproductive rules and regulations threaten to reduce consumer transparency, undermine consumer choice of goods and services, and ultimately inflate prices. The following three sections examine these myths in detail, explain why they are flawed, and then show how government intervention creates more problems than it solves.

The Myth of Pro-consumer Junk Fee Regulation

The Biden administration has prioritized cracking down on so-called *junk fees*, which are roughly defined as unexpected or hidden fees a company charges a consumer for a service.[1] The administration believes these fees distort the true cost of goods and services and create an unfair marketplace for consumers. Through the eyes of the Biden administration, these junk fees increase consumer prices.

The administration argues the solution to the junk fee problem is for regulatory agencies to intervene and stop these unfair practices.[2] They err in thinking these regulations are pro-consumer and lead to greater transparency. This policy view is based more on myth than fact. Importantly, the administration has not settled on a concrete "junk fee" definition that it applies consistently.[3] And to the extent that it tries to enforce this moving target, the administration has categorized as junk many pro-consumer business practices that are not junk at all. In fact, many mislabeled junk fees serve a valuable market function—increasing transparency and discouraging risky behavior.[4]

For example, credit card late fees are routinely misclassified as junk fees. When consumers take on credit card debt, they agree to pay that debt back on time or at least the minimum payment. When they do not, a fee is imposed to cover the costs incurred by the credit issuer and to encourage future timely payments. Credit card issuers lose an average of $38 per late fee.[5] The Biden administration has suggested implementing a cap of $8 on late fees, preventing creditors from even paying back the expense of dealing with missed payments.[6]

Consumers not only agree to these charges when using credit, but also benefit from their imposition. In fact, one study on the subject found that late fees lower tardiness on subsequent

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[1] Beth Braverman and Erica Sandberg, "What Is a Junk Fee and How Does It Affect You?" U.S. News & World Report, updated April 25, 2024, https://money.usnews.com/money/personal-finance/spending/articles/what-are-junk-fees-and-how-do-they-affect-you.

[2] "Biden-Harris Administration Announces Broad New Actions to Protect Consumers From Billions in Junk Fees," The White House, October 11, 2023, https://www.whitehouse.gov/briefing-room/statements-releases/2023/10/11/biden-harris-administration-announces-broad-new-actions-to-protect-consumers-from-billions-in-junk-fees/.

[3] Jeffrey Westling, "Web of Junk Fee Rules Causing More Confusion Than the Fees," American Action Forum, July 31, 2024, https://www.americanactionforum.org/insight/web-of-junk-fee-rules-causing-more-confusion-than-the-fees/.

[4] Ryan Bourne and Sophia Bagley, "The Incoherence of the White House's Anti- "Junk Fees" Agenda," Cato Institute, March 11, 2024, https://www.cato.org/blog/incoherence-white-houses-anti-junk-fees-agenda.

[5] "Letter to CFPB on Credit Card Late Fees and Late Payments ANPR," American Bankers Association, August 1, 2022, https://www.aba.com/advocacy/policy-analysis/ltr-cfpb-credit-card-late-fees-anpr.

[6] "Readout of White House State Legislative Convening on Combatting Junk Fees," The White House, March 8, 2023, https://www.whitehouse.gov/briefing-room/statements-releases/2023/03/08/readout-of-white-house-state-legislative-convening-on-combatting-junk-fees/.

payments by 19 percent—incentivizing consumers from accruing debt or additional fees.[7] The further the late fee was from the due date, the less effective it became.

A poll by North Star Opinion Research on consumer sentiment found that most respondents believed a decrease in late fees would increase tardiness,[8] which conforms with the facts.[9] The public seems to have a better understanding of this intuitive insight into human nature than many policymakers.

In reality, junk fees—credit card late fees or any other kind—imposed on a product or service are often just a combination of several surcharges that will not necessarily be taken off the total price even if these fees were eliminated. When a customer makes a purchase, different factors can work to increase the price incrementally, and these can be itemized for the user to catalog. Removing these itemized fees would not reduce the price but, ironically, hide the charges from the user.

For example, when a customer gets their cell phone bill, that bill rarely lists only one price.[10] Instead, consumers receive a bill that lists itemized charges that collectively make up the final price. Some of these charges, such as administrative fees, reflect standard operating costs.[11] Others, such as equipment and installation fees, may reflect the labor provided by the wireless company. Most of the time, the name of each charge closely describes the service provided, making it easier for customers to understand the purpose of each.

Proposals that seek to ban junk fees would likely instead incentivize companies to bundle these prices together into a singular upfront price, which risks obscuring the true cost of each charge, and undermines transparency. Under such a scenario, the true cost of each charge would not disappear—as operational and regulatory costs do not cease to exist. Instead, consumers would simply no longer be able to see why they are charged a certain price. Furthermore, it is hypocritical for the government to shame businesses for a practice they often use themselves—and it is often these government fees that nickel and dime consumers and taxpayers for services many do not desire.

For example, taxpayers must contend with a laundry list of government fees ranging from state and local sales taxes to infrastructure maintenance fees. Some of those taxes and fees, including the Federal Universal Service Fund Fee[12] and 911 Service Fee, may not even be directly related to the service provided at all but instead serve as a method of revenue generation for various government subsidy programs and emergency services.[13] According to the Tax Foundation, at

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[7] Peter Fishman and Devin G. Pope, "Punishment-Induced Deterrence: Evidence from the Video-Rental Market," eScholarship, May 26, 2006, https://escholarship.org/content/qt17r2v5jb/qt17r2v5jb_noSplash_0a52c2cadcbbdd8871c7d389d0153f82.pdf.

[8] "Credit Card Fee Survey," North Start Opinion Research, March 16, 2023, https://www.northstaropinion.com/credit-card-fee-survey.

[9] Peter Fishman and Devin G. Pope, "Punishment-Induced Deterrence: Evidence from the Video-Rental Market," eScholarship, May 26, 2006, https://escholarship.org/content/qt17r2v5jb/qt17r2v5jb_noSplash_0a52c2cadcbbdd8871c7d389d0153f82.pdf.

[10] Megan Leonhardt, "8 Sneaky Charges Hiding in Your Cell Phone Bill," Money, June 13, 2016, https://money.com/fees-taxes-charges-cell-phone-bill/.

[11] "Introducing Your New AT&T Bill," AT&T, accessed November 7, 2024, https://www.att.com/scmsassets/images/support/smb/pdf/SampleBillGuide-SmallBiz.pdf.

[12] Keith Laake, "What's the Universal Service Fund on my Phone Bill?" Cost Control Associates, accessed November 7, 2024, https://costcontrolassociates.com/blog/whats-line-item-phone-bill/.

[13] "911 Emergency Service Fee," CenturyLink, accessed November 7, 2024, https://www.centurylink.com/home/help/account/billing/taxes-fees-and-surcharges-on-your-bill/911-emergency-service-fee-explained.html.

the end of 2023, these government-mandated taxes and fees made up nearly 25 percent of a customer's bill on taxable voice services such as landline and wireless telephone service.[14]

The reality is that junk fees are ill-defined and mean many different things to many people, including to those in the government.[15] Many of the itemized fees that a customer sees at check-out reflect a specific good or service that is provided. Even when fees take the form of a penalty, like credit card late fees, they serve a valuable market function that critics risk obscuring.

The Myth of the "Successful" Durbin Amendment

Some financial myths have played an instrumental role in pushing lawmakers to pass bad laws and regulations. Chief among them is the myth that the Durbin Amendment[16] has helped stabilize the debit card market, benefited small businesses, and lowered consumer prices.[17] So influential and pervasive is this myth that it has inspired copycat legislation, notably the Credit Card Competition Act (CCCA).[18] The CCCA threatens to apply similar Durbin-style regulations to credit card processing networks, which primarily differ from debit card processing networks in that funds to pay for a transaction come from a line of credit as opposed to directly from the customer's bank account.[19]

Unfortunately, the CCCA would produce significant unintended consequences for the very consumers and businesses that supporters claim it would help. To understand why, it is first necessary to go back in time to the adoption of the Durbin Amendment and the subsequent fallout for the debit card market that transpired.

In the aftermath of the 2007–2009 Great Recession, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which overhauled the nation's financial system by introducing a wide range of new regulations.[20] Added at the last minute to this piece of legislation was an important amendment called the Durbin Amendment, named after Sen. Dick Durbin (D-Illinois), which imposed burdensome new regulations on the debit-card market. Specifically, the Durbin Amendment established[21] new limits on debit-card interchange fees —

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[14] Scott Mackey and Adam Hoffer, "Excise Taxes and Fees on Wireless Services Drop Slightly in 2023," Tax Foundation, November 2023, https://taxfoundation.org/wp-content/uploads/2023/11/Excise-Taxes-and-Fees-on-Wireless-Services-Drop-Slightly-in-2023.pdf.
[15] Trey Price, "Junk Fees are Ill-Defined and the New Rule Will Hurt the Gig Economy," The Economic Standard, March 15, 2024, https://theeconomicstandard.com/junk-fees-are-ill-defined-and-the-new-rule-will-hurt-the-gig-economy/.
[16] Will Hoverson, "Durbin Amendment: How are Federal Reserve regulations affecting payment processing fees?" Checkout.com, June 10, 2024, https://www.checkout.com/blog/revisiting-the-durbin-amendment#:~:text=The%20Durbin%20Amendment%20directs%20the,with%20respect%20to%20the%20transaction.%E2%80%9D.
[17] Dick Durbin, "Myths and Realities about Swipe Fee Reform," accessed November 7, 2024, https://www.durbin.senate.gov/imo/media/doc/Myths%20and%20Realities%20about%20Swipe%20Fee%20Reform.pdf.
[18] "S.1838 – 118th Congress (2023-2024): Credit Card Competition Act of 2023," Congress.gov, June 7, 2024, https://www.congress.gov/bill/118th-congress/senate-bill/1838/text.
[19] Greg Depersio, "Debit Card vs. Credit Card: What's the Difference?" Investopedia, updated October 24, 2024, https://www.investopedia.com/ask/answers/050415/what-are-differences-between-debit-cards-and-credit-cards.asp.
[20] "H.R.4173 – 111th Congress (2009-2010): Dodd-Frank Wall Street Reform and Consumer Protection Act," Congress.gov, December 2, 2009, https://www.congress.gov/bill/111th-congress/house-bill/4173/text.
[21] Julia Kagan, "Durbin Amendment: What It Is, How It Works, Impact," Investopedia, updated April 11, 2024, https://www.investopedia.com/terms/d/durbin-amendment.asp.

also known as swipe fees — and added requirements for all card-issuing banks with $10 billion or more in assets to offer merchants at least two choices of unaffiliated payment card networks.[22]

Durbin believed[23] the amendment was needed to crack down on the anti-competitive business practices of the supposed Visa and Mastercard card duopoly and restore healthy market competition to provide relief to consumers and small businesses.[24] Specifically, he believed that merchants should have access to more than one payment processing network and that swipe fees imposed a "hidden tax on consumers and merchants."[25]

The Amendment succeeded in lowering debit card interchange fees from roughly $0.44 per transaction to around $0.24—but consumers received almost none of the savings.[26] Instead, retailers pocketed the money and continued to charge consumers the same prices as before.[27] One study by the Federal Reserve Bank of Richmond found that after the amendment's passage, 77.2 percent of merchants left their prices unchanged, while 21.6 percent decided to raise them.[28] Importantly, just 1.2 percent of merchants lowered their interchange fees.[29]

In practice, the Durbin Amendment forced covered banks to make up lost revenue by raising user fees,[30] like ATM fees, increasing minimum balance requirements, and scaling back user services like free checking accounts, which research suggests contributed to an increase in the unbanked population.[31] Perhaps the biggest blow to consumers came in the virtual elimination

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[22] "What are interchange fees and how are they calculated," BigCommerce Essentials, accessed November 7, 2024, https://www.bigcommerce.com/glossary/interchange-fees/.
[23] Dick Durbin, "Durbin Sends letter to Wall Street Reform Conferees On Interchange Amendment," May 25, 2010, https://www.durbin.senate.gov/newsroom/press-releases/durbin-sends-letter-to-wall-street-reform-conferees-on-interchange-amendment.
[24] Peter Westberg, "Visa and Mastercard: The Global Payment Duopoly," Quartr, March 1, 2024, https://quartr.com/insights/company-research/visa-and-mastercard-the-global-payment-duopoly.
[25] Ronald Bird, "The Durbin Amendment: A Short Regulatory History," Cato Institute, Spring 2024, https://www.cato.org/regulation/spring-2024/durbin-amendment-short-regulatory-history.
[26] David S. Evans, Howard H. Chang, and Steven Joyce, *The Impact of the U.S. Debit Card Interchange Fee Caps on Consumer Welfare: An Event Study Analysis*, The University of Chicago Law School, Working Paper No. 658 (2nd Series), October 2013, https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1651&context=law_and_economics.
[27] Todd J. Zywicki, Geoffrey A, Manne, and Julian Morris, "Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses," International Center for Law & Economics, April 25, 2017, https://laweconcenter.org/images/articles/icle-durbin_update_2017_final.pdf.
[28] Zhu Wang, Scarlett Schwartz, and Neil Mitchell, *The Impact of the Durbin Amendment on Merchants: A Survey Study*, Federal Reserve Bank of Richmond, Economic Quarterly, Volume 100, No. 3, pp. 183-208, Third Quarter 2014, https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2014/q3/pdf/wang.pdf.
[29] Ibid.
[30] Marl D. Manuszak and Krzysztof Wozniak, "The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation," Washington: Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2017-074, July 2017, https://www.federalreserve.gov/econres/feds/files/2017074pap.pdf.
[31] Todd J. Zywicki, Geoffrey A Manne, and Julian Morris, *Price Controls on Payment Card Interchange Fees: The U.S. Experience*, George Mason Law & Economics Research Paper, No. 14-18, last revised January 14, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446080

of debit card reward programs, forcing them to shift their payment habits from debit cards to cash and prepaid credit cards.[32]

Even with such a negative policy legacy, the myth of the Durbin Amendment's success continues to the present day, with those in Congress seeking similar regulations applied to the credit card market.[33] In 2022, Senator Durbin introduced the Credit Card Competition Act (CCCA),[34] sometimes referred to as "Durbin 2.0."[35] The act was designed to meddle in the credit card market in a similar way to how the Durbin Amendment meddled in the debit market. While this particular bill failed, as did a later attempt to include it as an amendment to the 2022 National Defense Authorization Act, another bill of the same name was introduced again last year.[36]

The CCCA of 2023,[37] like the 2022 version, is designed to enhance credit card competition by requiring credit card issuers with assets over $100 billion to provide merchants with at least two credit card networks to choose from when processing credit card transactions.[38] It would also, among other things, require that at least one of these networks not be operated by Visa or Mastercard. Supporters believe such requirements would reduce credit card interchange fees if more cost-effective networks are available.[39]

Unfortunately, the CCCA is deeply flawed and largely premised on the same myths as the first Durbin Amendment. Specifically, the CCCA wrongly assumes that Visa and Mastercard operate a vast credit card duopoly, which they use to impose their will on consumers and small businesses by fixing rates at unreasonable levels.

Visa and Mastercard do not have a duopoly.[40] A close look at credit card networks in the U.S. by purchase volume reveals that while Visa controls about 61 percent of the market, Mastercard controls 26 percent, and American Express controls 11 percent.[41] Discover also represents a

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[32] Geoffrey A. Manne and Kristian Stout, "Impact of the Durbin Amendment's Cap on Interchange Fees," International Center for Law & Economics, May 2021, https://laweconcenter.org/wp-content/uploads/2021/05/tldr-interchange-fees.pdf.
[33] "Doomed to Fail: The Consequences of the Original Durbin Amendment," Electronic Payments Coalition, July 5, 2023, https://electronicpaymentscoalition.org/resources/doomed-to-fail-the-consequencesof-the-original-durbin-amendment/.
[34] "S.4674 – 117th Congress (2021-2022): Credit Card Competition Act of 2022," Congress.gov, July 28, 2022, https://www.congress.gov/bill/117th-congress/senate-bill/4674.
[35] Kristen E. Larson, "Senator Durbin attempts to revive Durbin 2.0 with Senate Judiciary Committee hearing in April and solicits testimony from Visa, Mastercard, United Airlines and American Airlines CEOs," Consumer Finance Monitor, February 14, 2024, https://www.consumerfinancemonitor.com/2024/02/14/senator-durbin-attempts-to-revive-durbin-2-0-with-senate-judiciary-committee-hearing-in-april-and-solicits-testimony-from-visa-mastercard-united-airlines-and-american-airlines-ceos/.
[36] Lynne Marek, "Durbin credit card amendment hit speed bump," October 12, 2022, Payments Dive, https://www.paymentsdive.com/news/credit-card-payments-competition-bill-durbin-congress-defense-spending-bill/633904/.
[37] "S.1838 – 118th Congress (2023-2024): Credit Card Competition Act of 2023," Congress.gov, June 7, 2024, https://www.congress.gov/bill/118th-congress/senate-bill/1838/text.
[38] Dick Durbin, "Short Summary of the Credit Card Competition Act of 2023," 2023, https://www.durbin.senate.gov/imo/media/doc/The%20Credit%20Card%20Competition%20Act%20of%202023%20-%20one-pager.pdf.
[39] Sara Rathner, "What to Expect if the Credit Card Competition Act Passes," NerdWallet, updated April 25, 2024, https://www.nerdwallet.com/article/credit-cards/what-to-expect-if-the-credit-card-competition-act-passes.
[40] Norbert Michel, "Durbin Remains Persistent – and Misguided," Cato Institute, June 13, 2023, https://www.cato.org/commentary/durbin-remains-persistent-misguided.
[41] Christy Rodriguez, "U.S. Credit Card Market Share by Network & Issuer – 2024 Facts & Statistics," July 13, 2024, Upgraded Points, https://upgradedpoints.com/credit-cards/us-credit-card-market-share-by-network-issuer/#source.

small, but fast-growing, share of this purchase volume, which may soon rival that of Visa and Mastercard if Capital One succeeds in acquiring Discover.[42]

Another way to view Visa and MasterCard's control of the credit card market is to examine their market share by number of cardholders.[43] When viewed in this light, 52 percent of Americans own a Visa credit card, 43 percent own a Master Card, 19 percent own a Discover card, and 17 percent own an American Express card.[44] These numbers hardly provide evidence of healthy market competition.

There are also many emerging challenges to Visa and Mastercard's market power. Fintech companies like PayPal and Venmo perform many similar market functions to credit cards but bypass traditional payment networks entirely by allowing consumers to make payments directly.[45] And "buy now, pay later" companies like Klarna similarly allow consumers to transact with those legacy financial intermediaries, but with a positive financial twist: consumers can avoid transaction fees by dividing their purchase payments into monthly installments.[46] New services such as these provide consumers with alternative avenues for making purchases and suggest that the market is becoming more competitive, not less.

Even if Durbin's notion of a credit card duopoly was accepted at face value, that does not mean the existence of a duopoly is itself problematic. As noted by scholars at the Cato Institute, from a legal standpoint, all that matters is what companies do with their market power, and there is no evidence that Visa and Mastercard are currently wielding their power to harm consumers.[47] Interchange fees for basic credit cards have remained largely unchanged at 1.5 to 3.5 percent per transaction.[48] Even so, there is no evidence that the CCCA would meaningfully cause interchange fees to decline since the legislation does not explicitly include a fee cap.[49] But even if these fees did decrease, there is no reason to think this would translate to consumer cost savings since history has shown that merchants are unlikely to lower prices.

Just like they did with the original Durbin Amendment, retailers would likely once again pocket the savings while card-issuing banks are forced to cut costs by scaling back services and eliminating programs. That would be a devastating development for the more than 83 percent of U.S. adults who report owning a credit card.[50] According to the International Center for Law & Economics, 86 percent of these credit card owners have active rewards cards, generating a

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[42] "Capital One to Acquire Discover," Capital One, February 20, 2024, https://investor.capitalone.com/news-releases/news-release-details/capital-one-acquire-discover.
[43] Jack Caporal, "Credit and Debit Card Market Share by Network and Issuer," The Motley Fool, updated October 18, 2024, https://www.fool.com/the-ascent/research/credit-debit-card-market-share-network-issuer/.
[44] Ibid.
[45] Joe Light, "Visa and Mastercard Are Under Attack. They Will Do Just Fine," Barron's, August 16, 2023, https://www.barrons.com/articles/visa-mastercard-are-under-attack-they-will-do-just-fine-7d2e67ce.
[46] "Disrupting The $8T Payment Card Business: The Outlook On 'Buy Now, Pay Later,'" CB Insights, March 2, 2021, https://www.cbinsights.com/research/report/buy-now-pay-later-outlook/.
[47] Norbert Michel, "It's Time to Break the Myth of the Credit Card Market Duopoly," Cato Institute, September 6, 2022, https://www.cato.org/blog/its-time-break-myth-credit-card-market-duopoly.
[48] Billie Anne Grigg and Witney Vandiver, "How Much Are Credit Card Processing Fees?" NerdWallet, last updated September 20, 2024, https://www.nerdwallet.com/article/small-business/credit-card-processing-fees#:~:text=The%20answer%20varies%20widely%20by%20provider%20and%20pricing,general%2C%20they%27re%201.5%25%20to%203.5%25%20of%20the%20transaction.
[49] Ted Rossman, "Credit Card Competition Act would harm consumers," Bankrate, July 21, 2023, https://www.bankrate.com/credit-cards/news/credit-card-competition-act-would-harm-consumers/.
[50] Adam McCann, "Number of Credit Cards and Credit Card Holders," WalletHub, August 6, 2024, https://wallethub.com/edu/cc/number-of-credit-cards/25532.

whopping $75 billion in consumer rewards every year.[51] The CCCA would put these rewards at risk and go against what most small business decision-makers say they want – the same, or less, government regulation in payment processing.[52]

The Many Myths of the Federal Home Loan Bank

The Federal Home Loan Bank (FHLB) is a series of nine regional government-sponsored[53] banks tasked with providing member financial institutions access to liquidity and supporting housing and community development.[54] Created to support homeownership during the Great Depression, today the FHLB system plays a critical role in supplying the market with steady mortgage funding and serves as a link between lenders and investors.[55] Despite performing this role remarkably well, critics of the FHLB have proposed a series of misguided regulatory proposals that are based more on myth than fact.[56]

American Consumer Institute (ACI) research explains that three myths inform criticism around the FHLB: 1) the FHLB doesn't support small-to-medium-sized banks; 2) the FHLB costs taxpayer money; and 3) the FHLB has fallen short of its mission to support housing and community development.[57] Taken together, these three myths motivate premature and misguided policy reforms that risk undermining a healthy financial marketplace.

<u>The FHLB doesn't support small-to-medium-sized banks</u>

Despite concerns that the FHLB is a wayward financial institution that increasingly provides financial products and services to large banks that do not need them, the FHLB continues to primarily serve small-to-medium-sized banks and credit unions.[58] The FHLB supports small-to-medium-sized financial institutions by providing access to low-cost liquidity, in the form of fully secure advances, that these institutions may struggle to obtain any other way since they tend to lack the same money and resources as large financial institutions.[59]

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[51] "ICLE on CCCA's Impact on Reward Cards," International Center for Law & Economics, March 22, 2024, https://laweconcenter.org/icle-on-cccas-impact-on-reward-cards/.
[52] "National Small Business Week 2024 Electronic Payments Survey," Small Business Payments Alliance, accessed November 7, 2024, https://smallbusinesspaymentsalliance.com/national-small-business-week-2024-electronic-payments-survey/.
[53] Troy Segal, "Government-Sponsored Enterprise (GSE): Definition and Examples," Investopedia, updated August 19, 2024, https://www.investopedia.com/terms/g/gse.asp.
[54] "The Federal Home Loan Banks" FHLBanks, accessed November 7, 2024, https://fhlbanks.com/.
[55] David Torregrosa and Mitchell Remy, "The Role of the Federal Home Loan Banks in the Financial System," Congressional Budget Office, March 2024, https://www.cbo.gov/publication/60064.
[56] "FHLBank System at 100: Focusing on the Future," Federal Housing Finance Agency, November 7, 2023, https://www.fhfa.gov/sites/default/files/2024-01/FHLBank-System-at-100-Report.pdf.
[57] Nate Scherer and Issac Schick, "Federal Home Loan Bank, Tax-Free: Liquidity to Support Housing," American Consumer Institute, August 13, 2024, https://www.theamericanconsumer.org/wp-content/uploads/2024/08/Federal-Home-Loan-Bank-Tax-Free.pdf.
[58] Noah Buhayar, Heather Perlberg, and Austin Weinstein, "A $1.3 Trillion Banking System Gone Astray is Fighting Overhaul (1)," Bloomberg Law, December 20, 2023, https://news.bloomberglaw.com/banking-law/a-1-3-trillion-home-loan-system-gone-astray-is-fighting-reform.
[59] "Affordable Mortgage Lending Guide," Federal Deposit Insurance Corporation, updated October 29, 2021, https://www.fdic.gov/resources/bankers/affordable-mortgage-lending-center/guide/part-3-docs/advances.pdf.

As ACI noted, small banks ($1 billion to $10 billion) and midsized banks ($10 billion to $250 billion in assets) are the first and second most consistent users of FHLB liquidity.[60] This point is often lost on critics because they tend to look at 10-Q and 10-K Securities and Exchange Commission reports, which only provide data on the top 10 borrowers, in terms of dollars.

Small-to-medium-sized financial institutions rely on this liquidity for everything from standard business operations to surviving periods of market instability where extra emergency financing is required, such as during the recent Silicon Valley Bank collapse.[61] However, there is no evidence that FHLB advances increase risk or contribute to market instability. On the contrary, a recent Urban Institute study found that the FHLB consistently serves as a "source of stability to the financial system, not instability" and helps reduce failure rates for financial institutions.[62] This is consistent with other research which has found that FHLB risk management practices are particularly beneficial for small banks.[63]

FHLB products and services, specifically low-cost advances, meet a legitimate need in the market and should be celebrated, not criticized, especially when that criticism is largely based on myths about the FHLB's lack of support for small and medium-sized financial institutions.

The FHLB costs taxpayers' money

Another myth about the FHLB is that it is a drag on taxpayers. This myth usually takes two forms.

First, critics allege[64] that the FHLB's potential use of the Deposit Insurance Fund (DIF)—a fund for deposit insurance—in the event of a bank failure poses a danger to taxpayers since it is taxpayers who would be asked to foot the bill.[65] They note that the FHLB possesses what is known as a super lien, which affords it first claim to "assets pledged as collateral for advances when the Federal Deposit Insurance Company becomes the receiver of an FHLBank member."[66] In other words, if the sale of bank assets does not produce enough liquidity, the FHLB can always tap the DIF to make up the difference.

Critics err when they assume that the DIF is taxpayer-funded when it is not. Instead, the DIF is funded through the premiums of Federal Deposit Insurance Company bank members. FHLB advances are always matched with the collateral from borrowing banks, providing an additional layer of protection. In other words, when advances are paid back, they are equal in value to the security of the loan, thereby negating the risk involved with offering the advances.

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[60] Damien Moore, Jim Parrott, Martin Wurm, and Mark M. Zandi, "The Federal Home Loan Banks Support Systemic Stability," Urban Institute, November 3, 2023, https://www.urban.org/research/publication/federal-home-loan-banks-support-systemic-stability.
[61] "Silicon Valley Banks insolvency explained," Wealth Management, March 2023, https://www.ig.ca/en/insights/silicon-valley-banks-insolvency-explained.
[62] Damien Moore, Jim Parrott, Martin Wurm, and Mark M. Zandi, "The Federal Home Loan Banks Support Systemic Stability," Urban Institute, November 3, 2023, https://www.urban.org/research/publication/federal-home-loan-banks-support-systemic-stability.
[63] Travis Davison and W. Gary Simpson, "Federal Home Loan Bank Advances and Bank Risk," *Journal of Economics and Finance,* Forthcoming, July 25, 2014, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2471836.
[64] Viral V. Acharya, et al., "SVB and Beyond: The Banking Stress of 2023," NYU Stern Business School, July 3, 2023, https://drive.google.com/file/d/1M067WVIlogb0Jtrsl33ggpbHIAtVjlR6/view.
[65] "Deposit Insurance Fund," Federal Deposit Insurance Corporation, last updated March 14, 2024, https://www.fdic.gov/resources/deposit-insurance/deposit-insurance-fund/.
[66] "An Overview of the Federal Home Loan Bank System," Federal Housing Finance Agency Office of Inspector General, March 31, 2023, https://www.fhfaoig.gov/sites/default/files/WPR-2023-002.pdf.

A second concern FHLB critics raise deals with a supposed "implied guarantee" on the FHLB's debt. This "implied guarantee" refers to the belief that the federal government backs FHLB's debt and will come to its rescue in the event of a financial crisis.[67] However, as its name suggests, this guarantee is implied and not in any way official. There is no guarantee that the federal government would intervene in the event of bank insolvency. In fact, this guarantee has never even been tested in the FHLB's 92-year history.

The reality is that the FHLB does not impose an unnecessary burden on taxpayers, even if critics like to pretend that it does. It does provide the market with plenty of benefits such as easy access to low-interest liquidity and support for affordable housing and community development programs.

<u>The FHLB has fallen short of its mission to support housing and community development</u>

Third, critics allege that the FHLB has strayed from its mission to support housing and community development.[68] This myth is based on a fundamental misunderstanding of the role Congress has asked the FHLB to play in the financial and housing markets.

While it is true that the FHLB has evolved over the years to provide more services to more types of financial institutions, it has only done so to meet underlying shifts in mortgage lending, technology, and product and financial service offerings. As the Federal Housing Finance Agency (FHFA)—the FHLB's chief regulator—has itself noted, the FHLB has "undergone significant changes over nine decades" that reflect related shifts in "technology and structured products, land use and development, demographics, legal and regulatory frameworks, and consumer preferences.[69]

Importantly, these changes have only occurred at the direction of Congress—and these added responsibilities have not come at the expense of mission achievement. Since passing the Federal Home Loan Bank Act (Bank Act) in 1932, Congress has periodically updated the Bank Act to reflect market changes, usually facilitated by the emergence of new types of financial institutions.[70] For instance, in 1989 Congress expanded FHLB membership to include federally insured depository institutions like commercial banks and credit unions.[71] Importantly, Congress specified that membership was contingent upon the institution's support of affordable housing and community development programs. For example, non-community financial depository institutions must have at least 10 percent of their assets in residential mortgage loans or equivalent mission-oriented assets.

This example illustrates a larger pattern of Congressional adjustments to the Bank Act, where despite directing the FHLB to expand the number of services it provides to new institutions, Congress made sure that FHLB's overarching focus remains on housing finance. In the Housing and Economic Recovery Act of 2008, Congress makes this clear when it states that one of the

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[67] David Torregrosa and Mitchell Remy, "The Role of the Federal Home Loan Banks in the Financial System," Congressional Budget Office, March 2024, https://www.cbo.gov/publication/60064.
[68] Elizabeth Warren, "Warren Pushes to Reform Federal Home Loan Bank System to Address Affordable Housing Crisis," United States Senate, June 7, 2024, https://www.warren.senate.gov/newsroom/press-releases/warren-pushes-to-reform-federal-home-loan-bank-system-to-address-affordable-housing-crisis.
[69] "FHLBank System at 100: Focusing on the Future," Federal Housing Finance Agency, November 7, 2023, https://www.fhfa.gov/sites/default/files/2024-01/FHLBank-System-at-100-Report.pdf.
[70] H.R. 12280 – 72nd Congress (1931-1933): Federal Home Loan Bank Act," Federal Reserve Bank of St. Louis, July 22, 1932, https://fraser.stlouisfed.org/title/federal-home-loan-bank-act-5998?page=3.
[71] Pub. L. No. 101–73, § 704, 103 Stat. 415-416, codified at 12 U.S.C. 1424(a).

primary components of the FHLB mission is to support "affordable housing and community development."[72]

At no point has the FHLB ever abandoned this mission. In fact, by most accounts, the FHLB has increased rather than decreased the level of housing assistance it provides. Today the FHLB supports programs like the Affordable Housing Program (AHP), Community Investment Programs, and Community Investment Cash Advance programs. Since 1990 alone, the FHLB has contributed over $7.6 billion to the AHF, supporting over one million American households.[73] The FHLB also recently committed voluntarily to increase its annual AHP contribution from 10 percent of net profits to 15 percent.[74]

The FHLB also continues to assist the housing market by providing quick and easy access to liquidity services. According to a 2021 University of Wisconsin study, the FHLB "boosts annual mortgage lending in the U.S. by $130 billion," and can save Americans $13 billion annually on mortgage interest payments.[75]

The fact is that the FHLB can and does continue to meet its congressionally mandated housing and community finance obligations.

<u>Regulations built on myth are a recipe for disaster</u>

Each of these categories of FHLB criticism has contributed to pressure on the FHFA to crack down on the institution by proposing a wide range of new regulations. Unfortunately, these regulations—discussed in the FHFA's recent *FHL Bank System at 100: Focusing on the Future* report—risk undermining the important role the FHLB already plays in the financial market.[76]

While some of the regulations under consideration are fairly limited and center around enhancing public transparency, others are rather major and could "significantly alter the structure and operation of the FHLB System."[77] Those more drastic reforms would make it more difficult for member institutions to obtain quick access to liquidity as they have done in the past.

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[72] H.R. 3221 – 110th Congress (2007-2008): Housing and Economic Recovery Act of 2008, July 30, 2008, https://www.congress.gov/110/plaws/publ289/PLAW-110publ289.pdf.
[73] "Affordable Housing and Community Development," FHLBanks, accessed November 7, 2024, https://fhlbanks.com/affordable-housing-draft/.
[74] Peter E. Garuccio, "Federal Home Loan Banks Anticipate $1 Billion in Affordable Housing and Community Development Initiatives in 2024," Council of FHLBanks, May 7, 2024, https://fhlbanks.com/wp-content/uploads/2024/05/AHP-1-BN-Press-Release-05-07-24.pdf.
[75] Dayin Zhang, "Federal Home Loan Bank May Save Borrowers Money, Level the Playing Field for Small Banks," Wisconsin School of Business, February 4, 2021, https://business.wisc.edu/news/federal-home-loan-bank-may-save-borrowers-money-level-the-playing-field-for-small-banks/.
[76] "FHLBank System at 100: Focusing on the Future," Federal Housing Finance Agency, November 7, 2023, https://www.fhfa.gov/sites/default/files/2024-01/FHLBank-System-at-100-Report.pdf.
[77] Andrew Olmem, Jeffrey P. Taft, and Daniel B. Pearson, "FHFA Proposes Regulatory and Legislative Reforms for FHLB System," Mayor Brown, November 14, 2023, https://www.mayerbrown.com/en/insights/publications/2023/11/fhfa-proposes-substantial-regulatory-and-legislative-reforms-for-fhlb-system.

Conclusion

Financial myths permeate the marketplace of ideas and have real-life consequences for millions of American consumers and businesses. Myths surrounding junk fees, the Durbin Amendment, and the FHLB have inspired lawmakers and regulatory agencies alike to propose a wide range of misguided rules that will do nothing to help the consumers and businesses they were designed to defend—and even threaten to make the problems worse. Instead of relying on myths about program efficacy, policymakers should correct these faulty assumptions and resist misplaced impulses that will do more harm than good.