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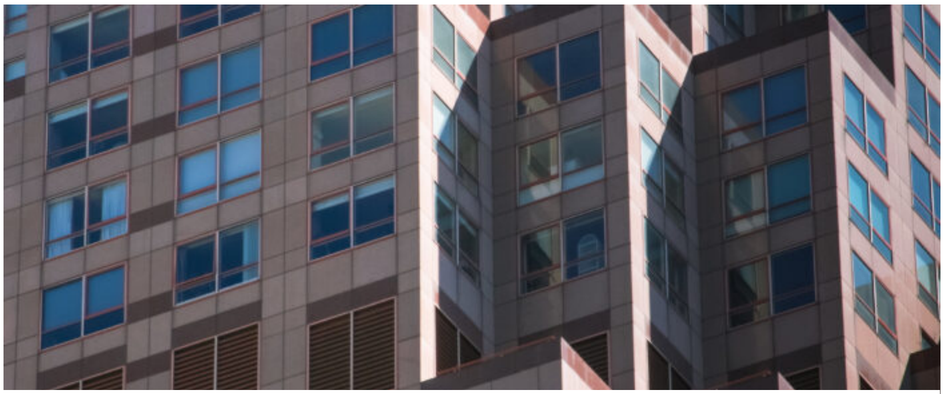

The Federal Home Loan Bank of San Francisco's headquarters building. Photo by sagesolar.

Myths and facts about the Federal Home Loan Bank System

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ABA Viewpoint

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A recent book on the failure of Silicon Valley Bank devotes a chapter to the role of the Federal Home Loan Bank of San Francisco, which provided advances to SVB before it failed. The San Francisco FHLB did not face losses, but it was nonetheless subject to criticism for possibly prolonging SVB's life and, in the authors' view, increasing the cost of failure. The authors — Stephen G. Cecchetti, Kermit L. Schoenholtz and Lawrence J. White — also draw a number of conclusions that reflect a misunderstanding of fundamental components of FHLB system operations. We examine three of these conclusions in this staff analysis. The authors' primary claim is that the high prioritization of FHLB claims in bankruptcies disincentivize the FHLBs and their regulator from consistently monitoring credit quality, in the most extreme case allowing for insolvent firms to continue to operate and possibly increasing the eventual cost of failure. This line of reasoning, however, ignores the private-sector monitoring from equity and debt holders who should have *stronger* interests in assessing solvency of FHLB borrowers than institutions that do not have FHLB advances.

Fact: Most banks that borrow from the FHLBs are generally in good financial condition and see FHLB advances as an integral part of normal financing. ABA analysis of Call Reports estimates that about a quarter of all banks have constant or increasing outstanding advances on a quarter over quarter basis, illustrating the routine use of the FHLBs by many banks. And, in odd contrast to the argument that banks turn to the FHLBs out of desperation, the thrust of regulations in recent years has been to encourage more bank usage of FHLB advances. More recently, the first figure in the NYU FHLB chapter (page 193) shows a significant increase in advances from 2021 to 2023, but it ignores the unprecedented fiscal response after the pandemic led to a record surge in deposits, suppressing banks' demand for advances. It should also be noted during the time period of declining advances, critics of the FHLB System described this decline as a sign that the system had become irrelevant and outdated, rather than acknowledging the massive impact fiscal stimulus had on rising deposits.

Prior to the implementation of Dodd-Frank regulations, banks could turn to other banks to meet short-term funding needs and inter-bank lending was an integral part of monetary policy implementation – the inter-bank lending market allowed banks to reallocate scarce reserves to stay in compliance with reserve requirements, motivating the Fed to use the inter-bank cost of funds as its policy target. Regulatory costs imposed since the financial crisis such as the Liquidity Coverage Ratio and stress testing now discourage inter-bank lending. Regulatory restrictions have also reduced the funding available from money market mutual funds that, in the past, would have been a direct source of liquidity for larger banks.

Myth: FHLB loans allow insolvent banks like SVB to continue operating making problems worse and more expensive to resolve.

Fact: The FHLBs lend against high quality collateral, reducing the risk that a failing institution imposes costs on member banks. The requirement to collateralize loans ensures that borrowing by any one bank is limited by their unencumbered assets. This collateralization created difficulties for SVB — reportedly, it was unable to redirect collateral from the FHLB to the Fed's discount window effectively — but ensured that the San Francisco FHLB was fully protected. While the incident indicates that the FHLBs and the Fed need a more efficient process for reallocating collateral, it is also an illustration of the robustness of FHLB risk management.

The authors argue that FHLB loans allowed recently failed banks to operate longer than they would have in the absence of the FHLBs. These banks failed, however, due to runs rather than clear insolvency. The ability of those banks to provide unencumbered collateral for FHLB loans strongly suggests that insolvency was not a foregone conclusion. In addition, lending to banks in need of funding is the FHLBs' core business. The authors are, in effect, arguing that FHLBs take on the role of regulators, overseeing overall institutional health rather than focusing on their role as lenders concerned about avoiding credit losses.

If the FHLBs were not to provide funding during periods of stress, banks may be forced to seek prohibitively expensive alternative sources; costs would be disproportionately greater for smaller community banks. The absence of FHLB funding could also turn liquidity concerns into solvency problems for some banks, increasing bank failures at times of stress. Limiting bank failures during periods of financial stress not only protects the dynamism of the banking sector (through fewer mergers and liquidations), but also reduces payouts from the Deposit Insurance Fund.

notes. Today, the FHLBs perfect their security interest, like any other creditor, to receive the collateral that was pledged at the time when an advance was made — that is, they simply receive the collateral that was originally promised to them if an advance were to go unpaid. Second, it is banks, their customers and their shareholders — not taxpayers — that pay into and maintain the DIF. If those banks and their stakeholders see the FHLBs as a source to increase bank financial stability, and therefore stability of the DIF, they should be allowed to use them.

Conclusion

With the Federal Housing Finance Agency expected to release a report on its comprehensive review of the Federal Home Loan Banks in September 2023, the assertions raised by the authors will likely gain further attention. As demonstrated here, those assertions do not hold up to scrutiny and should not be used by the FHFA or other policymakers as a basis for regulatory or legislative changes. ABA will work to ensure that any recommended changes to the long-standing relationship between banks and the FHLBs are based on facts, not myths. Watch for further updates and other resources from ABA in response to proposals or reports set forth by the FHFA.

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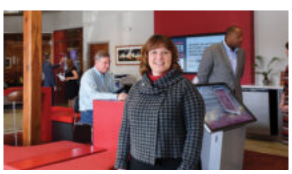

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