MIT GCFP | GOLUB CENTER FOR FINANCE AND POLICY

Policy Lunch Series

FHLB Reform - Risk vs Return

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BOSTON UNIVERSITY

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MAIN RESPONSIBILITIES

1. Meet the needs of its membership
   a. 6,800 financial institutions including over 90 percent of FDIC insured banks
   b. Act as a low-cost, all-weather liquidity provider
2. Implement US Government Housing Policy

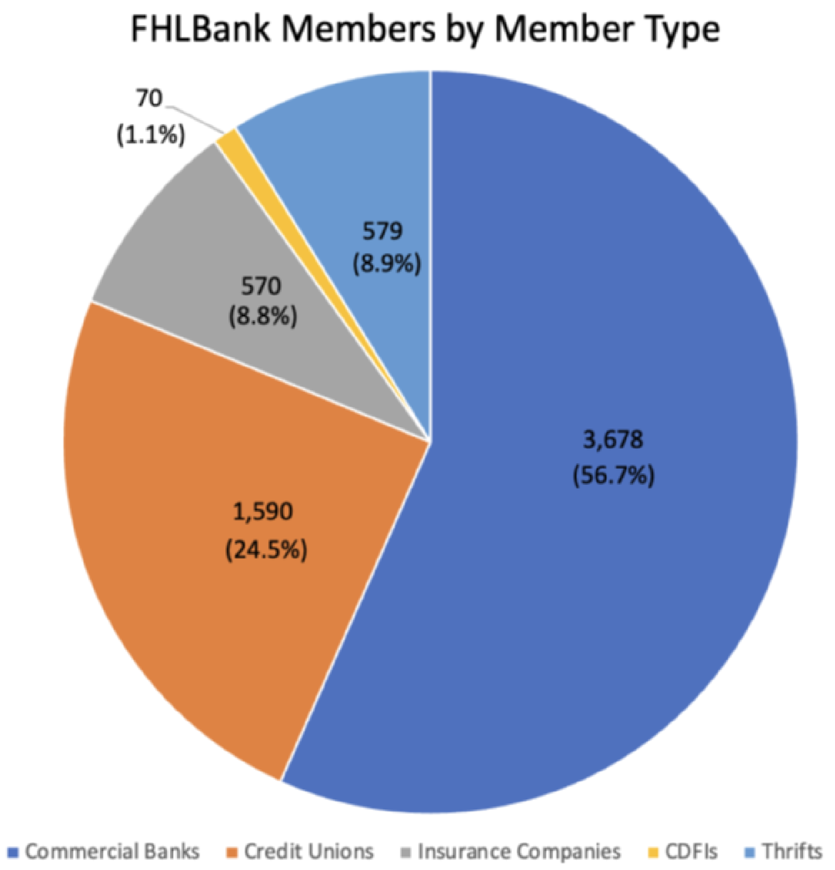
The FHLB system has been an important part of the US financial market plumbing since 1932.

This discussion will focus on market implications related to modifying and restricting the role of the FHLB system serving as a low-cost, all-weather, liquidity provider.

Reform should consider the possible unintended consequences related to modifying the FHLBs liquidity provider role.

11 FHLBs Stretch from Boston to SF

To join, members buy equity stock and receive an annual dividend of 6%

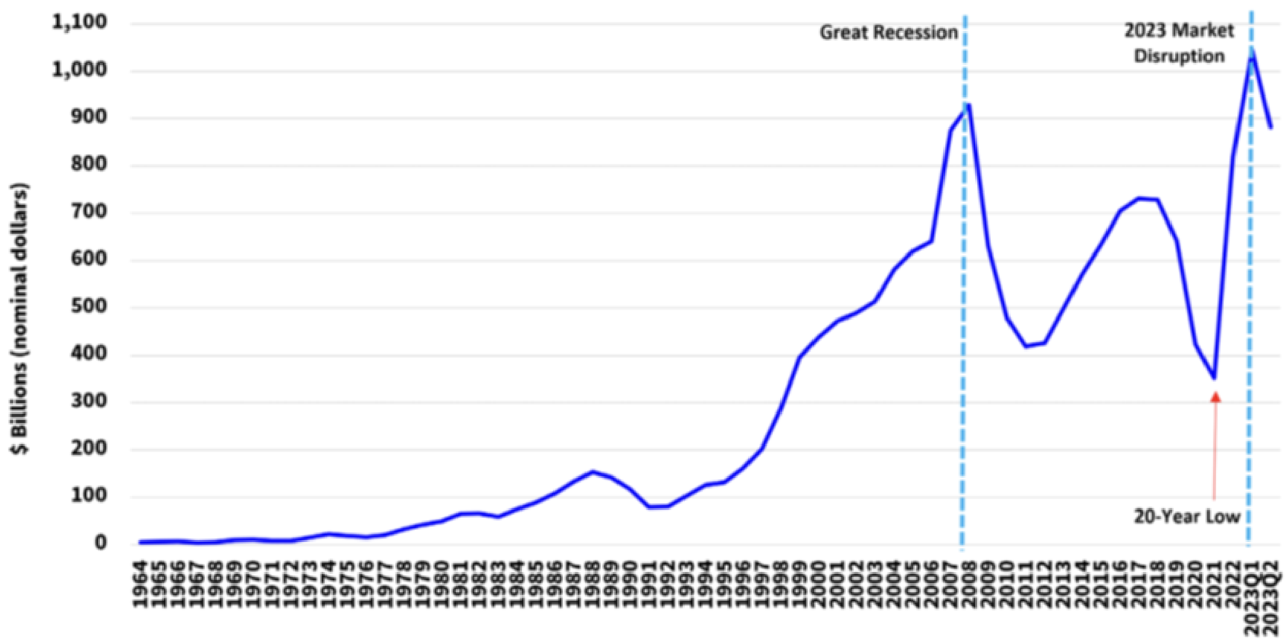


FHLBs: All-weather liquidity provider role acts as an important market shock absorber

FHLB advances (loans) provide a stable, low-cost funding source w/maturities short to longer term (5 years+)

<u>2023 Banking Crisis</u>:
Liquidity demand hit
Significant levels!

FIGURE 10: FHLBANK ADVANCES OUTSTANDING SINCE 1964 (BOOK VALUE)



Source: Based on FHLBank data, as of June 30, 2023

Fed: In assuming more of the liquidity shock absorber role

Important Questions:

1. **Would the Fed want to assume this liquidity provider shock absorber role?**
2. **When would FHLB members be handed off to the Fed?**
3. **What financial measures would trigger this handoff?**
4. **How would this process be initiated?**
5. **How would the handoff be done to reduce the risk of negative stigma?**
6. **Would the Fed be able to provide liquidity at the same speed and duration as the FHLBs?**
7. **Would the cost of liquidity be higher and borrowing limits lowered for members deemed financially weak?**

FHLB System Is not a Lender of Last Resort

- **By Definition: a lender of last resort is who a bank turns to when they urgently need funds and you've exhausted all other options**

- **Traditionally this role is assumed by the Fed via the discount window operations**

- **Compared to the FHLB system, borrowing duration is short-term and credit requirements are different**

FHLB System – All-weather Liquidity provider

- **FHLB system, by design, has provided liquidity during market calm and market stress periods**
- **Members who receive advances and amounts are intentionally <u>not</u> immediately disclosed … this reporting time delay, makes hedge funds and other short seller unhappy but reduces market instability**
- **Unlike the Fed, the FHLBs is not set up to examine their membership for Safety & Soundness or provide bank examiner assessments e.g., CAMELS ratings**

Fed Handoff Risk – Meeting Member liquidity Needs

Challenges:

1. **If a FHLB member bank's financial health declines, when and how should a hand-off to the Fed and access to the discount window occur?**

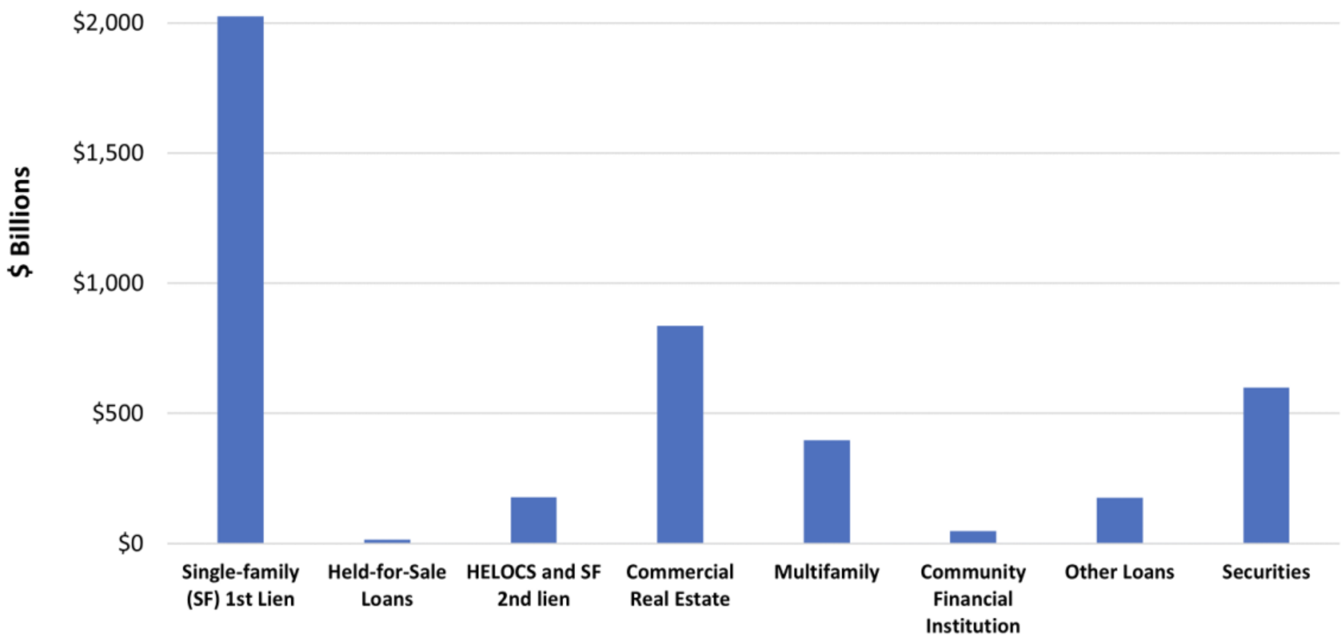
2. **Should non-banks such as insurance companies have access to the discount window?**

3. **Going forward, based on Reform Recommendations, what would be the market implications on availability and speed of liquidity in times of market uncertainty?**

4. **How can financially weak member bank be protected against destabilizing market forces and profiteering?**

FHLB Advances: Risk is reduced by requiring excess collateral

FIGURE 2-B: COLLATERAL TYPES PLEDGED BY FHLBANK MEMBERS



Source: Based on FHLBank data, as of June 30, 2023

High credit ratings increase the availability and materially lowers the cost of funding

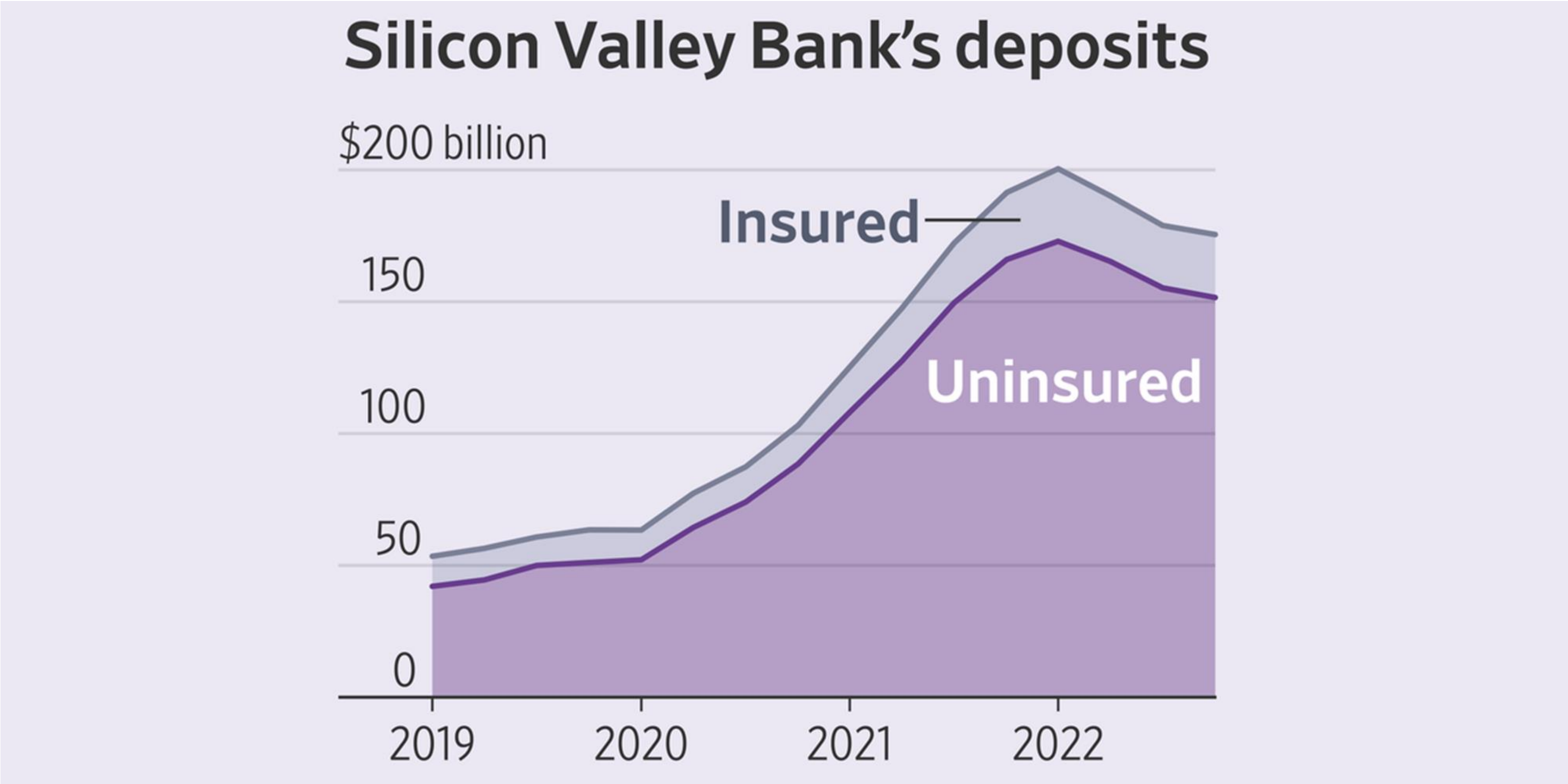
- **S&P has assigned all 11 FHLBs a bond rating of AA+, stable (Dec 6, 2023)**
- **The Office of Finance can raise funds at lower cost and pass on savings to members (big and smaller) based on this high credit rating**
- **Ratings are enhanced because of collateral approach applied & GSE status (halo effect)**

Access to Low-cost Liquidity

- **Small credit unions and thrifts have access to the same low rate as larger banks**
- **However, some argue the big member banks e.g., JPM should <u>not</u> enjoy such benefits**
- **Policymakers <u>need</u> to also ensure that Reform including changes in collateral requirements and greater lending to riskier borrowers such as CDFIs don’t negatively impact FHLBs AA+, stable bond rating**

SVB Collapse: Many built-in Control Points Failed!

Unstable deposit base was allowed to grow exponentially

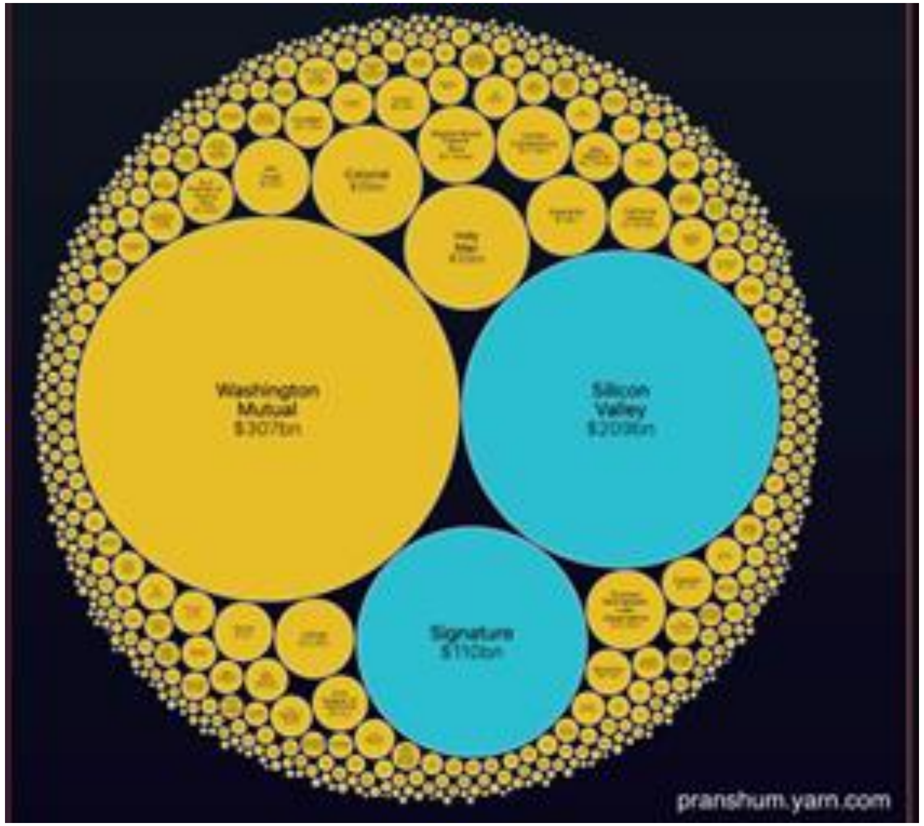


Control points: The SVB Collapse Should have been Prevented?

Capital Markets - Three lines of Defense

1. **<u>First Line</u> - Bank management, boards, external accounting & internal risk management**
2. **<u>Second Line</u> – Wall Street analysts, rating agencies & investors**
3. **<u>Third line</u> - Regulators at the Federal (Fed, FDIC) & State bank examiner level ... Yet all three lines of defense failed!**

FHLBs were <u>never</u> set up to be the safety & soundness examiner overseeing its 6,800 members



Myth – FHLB SF Caused the failure of 3 banks

FHLB SF provided significant liquidity to 3 of the 4 banks that failed in 2023*

1. **Silvergate - $40 billion +**
2. **SVB - $60 billion**
3. **First Republic Bank - $30 billion**

But did advances cause these three banks to fail?

If True: Then shouldn't reform focus on SF and not the other 10 FHLBs?

*** These three banks received just under 10 percent of total advances provided in the FHLB system. All advances were paid back in full.**

Myth – FHLB SF Caused the failure of 3 banks

<u>Facts</u>: Silvergate, SVB and First Republic Bank failed due to

1) **Poor asset-liability risk management practices**
2) **Overreliance on non-FDIC deposits**
3) **Concentrated customer risk**
4) **Large bets placed on interest rates**
5) **Depositor Runs**

The benefit <u>not</u> focused on:

During the March 2023 financial crisis, the FHLB system <u>quietly</u> provided valuable liquidity to 100s and possibly 1,000s of strong member banks, working with the FDIC and Fed to calm markets and help them weather the financial storm

FHLB Reform – Summary

1. **For any organization, it is healthy to evaluate how to improve its efficiency in meeting stated goals, serving customers and adjusting to changing capital markets.**
2. **Measuring ability to meet a clearly defined mission and providing incentives are also important.**
3. **In moving forward, it is critical <u>not</u> to underestimate the important behind-the-scenes all-weather shock absorber liquidity provider role played by the FHLBs in good and stressed markets.**

FHLB Reform – Summary

4. **Fed handoff risk including when and how financially weak FHLB members will have access to the discount window also needs to be carefully examined. Paramount is the need to minimize negative stigma and market disruption.**

5. **Reform should consider the myriad of unintended consequences related to modifying the FHLBs liquidity provider role.**