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INSIGHT

Lenders of Next-to-Last and Last Resort: In Competition?

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A solvent bank may seek a cash advance from the *lender of last resort*, meaning a district Federal Reserve bank's discount window, when it needs immediate liquidity. However, there is a certain stigma associated with such borrowing, so banks often prefer to borrow from a *lender of next-to-last resort*, a district Federal Home Loan Bank (FHLB), although this option is less immediate. Recently, the Federal Reserve announced another option for banks to obtain cash advances, the Bank Term Funding Program (BTFP), which may potentially divert revenues away from the FHLB system.

Background

The Federal Home Loan Bank Act of 1932 (P.L. 72-304; 47 Stat. 128) created the Federal Home Loan Bank system, consisting of 11 regional institutions and the system's Office of Finance, that collectively constitute one government-sponsored enterprise. The FHLBs are federally chartered cooperative financial institutions, meaning that each FHLB is privately owned and capitalized by its members. Four types of financial institutions may become FHLB members: (1) federally insured depository institutions (i.e., banks and credit unions), (2) insurance companies, (3) community development financial institutions, and (4) non-federally insured credit unions that meet certain criteria.

The FHLBs, sometimes referred to as lenders of next-to-last resort, make cash loans to member lending institutions in their regional districts. Members may obtain FHLB cash advances if they hold assets that can be used as collateral for the loans. Eligible assets include government-backed securities, such as U.S. Treasuries, and mortgage-backed securities (MBS) issued by Ginnie Mae, Fannie Mae, and Freddie Mac. By obtaining liquidity from an FHLB, a bank can avoid the stigma associated with going to the lender-of-last resort—a Federal Reserve bank's discount window. When solvent banks go to the discount window, rather than borrow cash from other private financial institutions or the FHLBs, they may not have ample amounts of *liquid assets*, which are easily convertible to cash, such as government-backed securities. Given that the Federal Reserve discourages excessive use of the discount window for cash advances, banks typically go to the FHLBs first for liquidity.

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Recent Developments

Following the Federal Reserve's recent interest rate increases, the market value of existing government-backed securities declined. Specifically, the yields on existing securities already held in bank portfolios were relatively low compared to new issuances with higher interest rates. In addition, the use of government-backed securities to obtain FHLB cash advances did not preclude bank insolvencies during March 2023.

- In response to a sudden outflow of deposits from its digital asset customers, Silvergate Bank turned to its lender of next-to-last resort, the FHLB of San Francisco, to obtain $4.3 billion of cash advances. Silvergate pledged government-backed securities as collateral. The news that Silvergate experienced losses on loans held in portfolio—despite those losses stemming from sales of government-backed securities—triggered more concerns that arguably contributed to its decision to voluntarily liquidate and wind down operations.
- The FHLB of San Francisco reported providing $13.5 billion in cash advances to Silicon Valley Bank (SVB). Following a $1.8 billion loss on a sale of $21 billion of available-for-sale securities consisting predominantly of fixed-income government-backed securities, SVB announced a plan to issue common equity along with other strategies to improve its liquidity position. SVB's depositors and venture capital customers, however, used social media to express concerns and still moved their deposits out of the bank. Bank regulators closed SVB on March 10, 2023.
- The FHLB of New York provided cash advances to Signature Bank, which reportedly pledged $23.5 billion of highly liquid government agency securities as collateral. The bank regulators closed Signature Bank two days after SVB's failure to reduce contagion risk—that is, the risk of adverse news about one financial institution spreading and adversely affecting other institutions with some similarities in business models, although they may not have any obvious business relationships.

The typical practice of using high-quality liquid assets to obtain cash did not avert these insolvencies. Although FHLB borrowing lacks the stigma associated with the discount window and is considered a routine practice for obtaining liquidity, some stakeholders arguably formed unfavorable perceptions that still led to panic runs by some depositors.

On March 12, 2023, the Federal Reserve announced the BTFP. In contrast to a Federal Reserve Bank's discount window, which charges above-market rates for loans, eligible depositories will receive cash loans based upon above-market values (e.g., the initial par values) of their government-backed securities used as collateral. The FHLBs, however, must still offer cash loans based upon current market as opposed to initial par values of eligible collateral. (Unlike the Federal Reserve, the FHLBs must issue debt to raise the funds that they in turn lend to member financial institutions.) The FHLB of Dallas subsequently disclosed to investors (on its updated 10-K form for the fiscal year ended December 31, 2022) that the Federal Reserve's BTFP could reduce the demand for its advances over the term of the program. Stated differently, the BTFP could potentially become a more attractive liquidity source, possibly causing declines in the FHLB system's earnings and, consequently, the amount of funding collected for the FHLB districts' affordable housing programs. For this reason, the BTFP's purpose to mitigate market panic may inadvertently bring about competition between the Federal Reserve and the FHLBs.

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