Liquidity: The FHLBanks' Foundational Mission

The foundational public purpose of the FHLBank System is its liquidity mission. This central aspect was reaffirmed by Congress when it passed the Housing and Economic Recovery Act of 2008 (HERA). Since its founding in 1932, the funding provided by the FHLBank System has always supported housing finance, either by members holding residential mortgage loans on their balance sheet, or by members holding mortgage-backed securities (MBS) they have invested in. As wholesale lenders, the FHLBanks exists to serve members by providing market access to reliable, on-demand funds for housing, community economic development, and operating cash flow (liquidity).

FHLBank liquidity is vitally important. It assures that financial institutions have funds to lend for homeownership and rental housing, as well as for small businesses, agriculture enterprises, and other purposes necessary for strong communities in all credit environments. The liquidity provided by FHLBanks supports the national economy and helps lenders meet their business needs and provide access to credit for their customers in normal and stressed market conditions.

Liquidity Defined

Liquidity refers to the efficiency or ease with which an asset can be converted into cash without affecting its market price. Cash, of course, is the most liquid asset available to financial institutions. The more liquid an asset is, the easier it is to turn it back into cash. The FHLBanks help their members take a relatively illiquid asset, like a mortgage, and convert it into cash that can be used for future lending or balance sheet management. Without FHLBank access, mortgages must be funded with deposits, or the mortgage originator must wait for another home loan to be paid off to free up additional cash. Mortgages can be pledged, and advances can be made on the same day, whereas other funding sources that require the sale of assets or other loan payoffs take longer and are subject to market value fluctuation.

To obtain on-demand liquidity, FHLBank members pledge collateral assets to their FHLBank and receive an advance (loan) against the current value of the collateral. FHLBank advances are not directly tied to any particular home mortgage loans or any other type of collateral, which facilitates dynamic, flexible financing and the free substitution of collateral.

Source of FHLBank Liquidity

The FHLBank System is funded entirely by private capital. Members purchase stock as a condition of membership and those funds help provide capital for each FHLBank. Additionally, the FHLBank System funds itself by issuing bonds in the capital markets. The Office of Finance serves as the capital market agent, issuing and servicing all debt securities for the FHLBanks. The debt instruments issued by the FHLBank System are known as consolidated obligations and include consolidated bonds and consolidated discount notes.

Buyers of debt securities issued by the FHLBanks represent the entire spectrum of domestic and international fixed-income investors, including commercial banks, central banks, money market funds, investment managers, major corporations, pension funds, government agencies and individuals. Consolidated obligations are backed only by the financial resources of the FHLBanks and are the primary source of funds for the FHLBanks, in addition to deposits, other borrowings, and capital stock issued to members. The FHLBanks primarily use these funds to provide advances to members.

Supporting the Mortgage Market

In addition to holding whole mortgages on their balance sheet, insured depositories also hold significant amounts of MBS and must have cost-effective, reliable term funding to do so. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 imposed higher risked-based capital requirements for holdings of residential mortgages (50% requirement compared to 20% for MBS), making it more attractive for insured depositories to hold MBS rather than whole mortgages. FHLBank advances allow depositories to hold more MBS on their balance sheets, which helps mortgage costs low (i.e., fewer buyers of MBS would increase MBS pricing and ultimately increase costs for mortgage borrowers).

Support for the holding of mortgage assets by members is a core part of the FHLBank System's mission. FHLBank members hold approximately 64 percent of the mortgage market. As of year-end 2022, total mortgages outstanding amounted to $16.9 trillion – 73 percent of which were comprised of MBS or 1-4 family whole loans.

The economic benefit of borrowing funds from the FHLBanks at more favorable rates is passed on to consumers across the country. An August 2020 University of Wisconsin study, authored by Dayin Zhang, highlights that FHLBank activity generates an estimated $130 billion in mortgage lending each year (a 16% annual increase), while also saving consumers $13 billion annually in mortgage interest payments (18 basis points on a home mortgage rate).

An Equalizer for Community Lenders

Furthermore, access to FHLBank liquidity serves as an equalizer for small, community-based lenders that do not have ready access to other low-cost, nationally available funding sources. Under existing laws and regulations, all FHLBank members, regardless of size, have access to advances on equal terms based on criteria such as member credit quality and collateral. This equality in pricing helps all members, from the largest to the smallest, serve all communities, including rural and underserved areas.

Lending to large members, primarily commercial banks and insurance companies, is also foundational to the FHLBanks' liquidity mission. Large financial institutions are among the FHLBank System's most active borrowers, reflective of their size and market shares. This helps the FHLBank System maintain daily presence in the debt market and enables the System to issue debt at lower yields, which results in better pricing for all FHLBank members. Limiting or restricting the participation of large financial institutions would result in an increase in the cost of FHLBank liquidity, which would directly harm smaller financial institution members that rely on their FHLBank for access to the capital markets. In a June 2023 study, the head of U.S. rates strategy at TD Securities stated that if large member access was restricted:

> "For banks, the impact of limiting FHLB advances would force them to look elsewhere for funding such as CP/CF [commercial paper/cashflow loans], which would sharply increase the cost of funding."

The FHLBanks as a whole draw strength from a diverse membership and serve as risk buffers for members and for the broader financial system.

Liquidity in Times of Market Stress

When Congress created the FHLBanks, it well understood that in stressful economic times, liquidity pressure and bank runs will occur. In 1987, with the Savings and Loan crisis imminent, Congress granted to the FHLBanks special collateral protections to help ensure their mission of providing liquidity could continue without the risk of credit losses, assuming that an FHLBank was lending on sufficient collateral. During periods of financial stress, the FHLBanks are often first responders, as members quickly turn to them for additional liquidity to help them weather the storm and provide financial regulators time to develop any additional programs that may be necessary.

When demand for FHLBank advances increases, it may be symptomatic of a systemic market condition placing pressure on the financial services industry and some institutions may fail. However, FHLBank lending to troubled institutions requires primary regulator approval and is subject to FHLBank underwriting to moderate receivership losses that may otherwise be incurred by the FDIC, the NCUA, or the state insurance regulator, as applicable. Lending to troubled members is done in coordination with the Federal Reserve Bank and the leverage and collateral used in FHLBank lending uses private capital, rather than direct government support as is the case with Federal Reserve Bank lending. Utilization of this private capital matter is a core strength of the nation's central banking system and alleviates some pressure on the Federal Reserve in times of crisis.

FHLBank advances do not cause, enable, or delay bank failures, and may provide additional time to avoid rushed fire sale liquidation and for an orderly wind down by a primary regulator. FHLBank advances may also prevent other members from failing during disrupted market conditions. During the first quarter of March 2023, 5.7 percent of new advances were provided to banks that ultimately failed. This is unfortunate, but it is quite possible other banks would have failed without the coordinated support of the FHLBanks, the Federal Reserve, and the U.S. Treasury.

A July 2023 ratings report by S&P on the FHLBank System noted that:

> "The recent banking turmoil highlighted the FHLB System's importance to the U.S. banking sector. When many member banks experienced significant deposit outflows, the FHLBs provided liquidity by extending advances to members. Advances grew to $1.05 trillion as of March 31, 2023, from $827 billion at year-end 2022. We expect outstanding advances to decline as market liquidity normalizes; however, advances will remain elevated for the remainder of 2023 as the Federal Reserve keeps monetary policy tight to fight high inflation. The FHLB System's role during the COVID-19 pandemic in 2020 and the U.S. mortgage crisis of 2008 further illustrates its importance to the U.S. banking sector in times of uncertainty and economic dislocation"

Due to the unique funding and risk allocation structure of the FHLBanks, the FHLBank System has a 90-plus year history as being first responders to allay consumer fears that their bank, large or small, will not be able to honor massive deposit withdrawals. When market stresses occur, FHLBanks engage in confidential dialogue with primary regulators to mitigate the risk of failure and achieve a least cost resolution. These "in the field," real time decisions may be second guessed after the fact, but the FHLBanks' role in providing liquidity and financial stability for the nation's financial institutions is their paramount mission.