Rebuttal and Reality: Unpacking the Yale Program on Financial Stability Critique of the Federal Home Loan Bank System

January 2024

The Yale School of Management's Program on Financial Stability (PFS) recently published a paper, the latest in a series of articles regarding the Fed's role as an emergency backstop for financial institutions, that unjustly took aim at the Federal Home Loan Bank System and the valuable, Congressionally-mandated role it plays as a liquidity provider to its members.

The PFS paper's central point can be best summarized as supporting the Fed as the primary, if not sole, source of liquidity for financial institutions, particularly during times of financial uncertainty. It claims that liquidity provided by the FHLBanks creates an incentive for members to rely on this liquidity to an extent that is more than "optimal from a financial stability perspective." Yet this claim is not substantiated. On the contrary, FHLBank liquidity has proven time and again to be a critical component of financial stability, particularly during times of market stress. In fact, FHFA's recent report on the FHLBank System, which the PFS paper refers to repeatedly, stated that the FHLBank System "has been a reliable source of liquidity for its members, especially during times of market stress" and that "public perception of its viability adds to the confidence in the overall financial system."

The FHLBanks recognize that their members see them as a reliable source of liquidity ***in addition to*** their core deposits, brokered deposits, the repo market, and borrowings from the Fed. Otherwise stated, the FHLBanks are just one of several options that financial institutions can turn to for their liquidity needs and the FHLBanks are fully supportive of ensuring that market participants continue to have a multitude of options in this regard. It is difficult to see how systemic financial stability would be improved by having fewer liquidity sources available and attempting to force financial institutions to rely primarily on the Fed.

Furthermore, the PFS paper notes critically that the services the FHLBanks provide are attractive to FHLBank members. But this is the whole purpose of the FHLBank System and what Congress intended in creating the System. The authors of the PFS paper seem to want the Federal Reserve to provide the liquidity currently provided by the FHLBank System, but that's not what Congress envisioned nor is it wise policy. The next time there is stress in the financial system do we really want to find out what happens if the FHLBanks' can't support their members? Is it prudent to depend solely on the Federal Reserve? Every agency (including the Federal Reserve) naturally wants more authority and responsibility, but Congress has wisely recognized the importance of establishing a separate system to provide liquidity for the housing market, given its critical importance to American households and the U.S. economy.

The FHLBanks fully support the Federal Reserve serving as the lender of last resort. FHLBanks are taking, and have taken, steps to ensure their members are properly positioned to borrow from the Federal Reserve, if necessary, as the PFS paper recommends. Further, FHLBanks are in regular contact with bank regulators to make sure troubled banks do not improperly utilize FHLBank liquidity. The paper's suggestion that the FHLBanks are or want to supplant the Federal Reserve as the lender of last resort is simply wrong.

Since establishment nearly a century ago, the FHLBank System has played a critical role in the U.S. financial system by ensuring the availability of liquidity for mortgage lending and community investment. Proposed changes to foundational structures, whether at the Federal Reserve or the Federal Home Loan Banks, must be thoroughly and transparently vetted with all relevant stakeholders to ensure continued stability and reliability.