Does Lending By The FHLBs Impact The FDIC’s Deposit Insurance Fund?

AN INDEPENDENT ANALYSIS OF EMPIRCAL STUDIES AND A CASE STUDY ON SILICON VALLEY BANK

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FOREWARD

One cannot help but be troubled by the headline: “After [Silicon Valley Bank’s] Failure, Its Attempted Rescuer Charged $285 Million in Fees.”[1] According to the press, the Federal Home Loan Bank of San Francisco (“FHLBSF”) assessed a “penalty” related to the Federal Deposit Insurance Corporation’s (“FDIC’s”) prepayment of advances made to Silicon Valley Bank (“SVB”) during its final weeks of operation.[2] The implication, of course, is that the FHLBSF scored a windfall profit at the expense of the FDIC’s insurance fund and, indirectly, the expense of the insured depository institutions that pay into that fund.

In the wake of this criticism, as well as criticisms related to the Federal Home Loan Banks’ (“FHLBs’) “super lien” authority (described below) and the theoretical “moral hazard” generated through FHLB advances more generally, the FHLBSF asked Ludwig Advisors (or “us”) for its views on several questions related to the impact of lending by the FHLBs on the FDIC’s deposit insurance fund following a bank failure. Our review of available data and writings on the topic uncovered no evidence that FHLB advances have a material negative impact on the FDIC’s insurance fund.

The FHLBSF compensated Ludwig Advisors for our efforts. Our opinions represent our independent determinations, based on the information cited in this paper. We reviewed a draft of this note with representatives of the FHLBSF prior to its publication. Although they provided us with data related to these issues, explained some of the general operations of the FHLBs and offered their views on these questions, our conclusions remain our own.

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[1] Buhayar, N. (2024 March 12). Bloomberg. Retrieved October 11, 2024: https://www.bloomberg.com/news/articles/2024-03-12/after-svb-failed-fhlb-charged-285-million-in-fees-to-wind-down-financing.
[2] PYMNTS (2024 March 12). Retrieved October 11, 2024: https://www.pymnts.com/news/banking/2024/report-svb-collapse-triggered-record-285-million-penalty/.

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I. INTRODUCTION AND OVERVIEW

Since its establishment, the FHLB System has evolved both at the direction of Congress and due to market and economic changes. However, its core mission remains the same: serving as a reliable, stable source of liquidity to its member institutions.

In the 1930s, Congress created the FHLB System, a network of what are today 11 individual regional FHLBs supported by a central Office of Finance and Council of Federal Home Loan Banks. Congress empowered the FHLBs to make stable and reliable funds available to provide emergency liquidity to illiquid members who could not satisfy withdrawal requests from depositors, and provide the potential for existing home owners to refinance into longer term, fully amortizing loans (to be supported by FHLB advances) instead of the short term bullet loans that were prevalent before the Great Depression.[3] Today, after a series of legislative and regulatory changes, FHLB advances support a wider range of member activities beyond housing finance. That evolution began more than 40 years ago. In 1982, Congress expanded the power of thrifts, and the FHLB System's regulator reacted to that change by removing the prior restrictions on how FHLB advances could be used.[4] Congress enacted legislative changes in 1989 to broaden FHLB membership, and in 1999 to equalize treatment of all members and allow members that were not specialized lenders to fully access to FHLB advances.

This paper is focused on whether the FHLBs' lending policies disadvantage the FDIC as the receiver for failed insured depository institutions and, indirectly, the banking system as a whole. Specifically, commentators have suggested that: (i) the super lien provision provides the FHLBs with an unfair advantage over other creditors, and indirectly encourages imprudent lending; (ii) the prepayment fees assessed by the FHLBs benefit the FHLB System at the expense of the insurance fund; and (iii) the implicit government guarantee of the FHLB System's consolidated debt creates moral hazard by imposing insufficient market discipline on the FHLBs' lending practices.

This review uncovered no evidence to suggest that FHLB lending increases losses to the FDIC's insurance fund. Specifically:

- Whatever advantages the FHLBs might have enjoyed as a result of their statutorily granted lien priority have essentially been abrogated by changes made to the Uniform Commercial Code ("UCC") in 2001. An easier process for perfecting a security interest in mortgages that does not involve taking possession of a mortgage note is now available to most lenders, including the FHLBs, which in any case never had the authority to supersede a security interest already perfected by another lender.
- Prepayment fees allow the FHLBs to manage the interest rate risk they incur through issuance of public debt instruments to fund advances to members. These fees are mandated by statute. Furthermore, FDIC regulation limits the payment of such fees to the actual economic losses incurred by the FHLBs.

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[3] Creation of a System of Federal Home Loan Banks, Hearings before a Subcommittee on the Committee on Banking and Currency on H.R. 7620, United States House of Representatives, 72nd Cong., 1st Sess., Mar. 1932.
[4] 47 Fed. Reg. 56316 (Dec. 16, 1982) (final agency rule amending 12 CFR § 531).

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- The Federal government mitigates moral hazard concerns in the banking industry overall through, primarily, regulating banks. Prudential regulators are empowered to evaluate whether a bank is appropriately using its funding and to direct FHLBs to cease making advances. The Federal Housing Finance Agency ("FHFA") is empowered to do the same through its supervisory authority over the FHLB System.

Consequently, we see no rationale for the FDIC or the FHFA to encourage new limitations on FHLB lending, or for the banking supervisory community to discourage FHLB members from utilizing this relatively inexpensive and reliable liquidity source as a component of a sound liquidity plan. To do so would only serve to frustrate Congressional goals in creating the FHLBs.

In reaching this conclusion, we are not suggesting that the operations of the FHLBs cannot be improved. The FHFA, which regulates the FHLB System, is constantly seeking to ensure that the FHLBs operate in a prudent manner.[5] A review of the internal operations of the FHLBs, however, is beyond the remit of this note.

This paper is structured as follows. Section II sets the context for the paper through reviewing how the FHLBs currently function. Section III reviews the three most common criticisms of FHLB lending and its impact on the FDIC's insurance fund. Section IV further supports these counterarguments through a case study on SVB.

[5] FHFA Office of Inspector General (2024 August 19). FHFA Could Enhance Its Supervision of the Federal Home Loan Banks by Incorporating Lessons Learned from the Spring 2023 Bank Failures. Evaluation Report EVL-2024-003. https://www.fhfaoig.gov/sites/default/files/EVL-2024-003.pdf.

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II. ROLE OF FHLBS

This section establishes context for this paper's conclusions. First, we review the structure of the current FHLB System. We then describe some of the FHLBs' current operations, focusing on the ways in which the FHLBs support their members.

A. FHLB SYSTEM STRUCTURE

Established by Congress in 1932 through the Federal Home Loan Bank Act, the FHLB System comprises 11 regional FHLBs, the Office of Finance, and the Council of Federal Home Loan Banks.[6] Today, each FHLB is a cooperative, owned and capitalized by its member institutions who voluntarily join by purchasing stock in the FHLB. Each is governed by a board of directors. A financial institution can apply for FHLB membership if it, among other requirements, makes long-term home mortgage loans and has a home financing policy that is consistent with sound and economical home financing.[7] Additionally, insured depository institutions (other than community financial institutions) must have at least 10 percent of their total assets in residential mortgage loans.[8]

Through their roles as liquidity providers, the FHLBs extend low-cost secured loans (or "advances") to their members. To fund these advances, FHLBs issue consolidated debt in the public markets, generally at almost a half-point (0.4 percent) below market rates, likely due to the perception that their obligations are backed by the Federal government.[9] The FHLBs pass on these lower rates to its members through lower interest rates on advances. The Office of Finance, a core component of the FHLB System, issues debt on behalf of all the FHLBs. The FHLBs are jointly and severally liable for the debts that any FHLB issues.

Although advances are the FHLBs' largest offering (and the subject of this paper), the FHLBs also offer other services and products to provide funding to members, including: the Acquired Member Asset programs, through which the FHLBs purchase certain residential mortgage loans from members; and issuing standby letters of credit to members, which guarantee payments to be made by a member to another third-party entity under certain conditions.

In addition, due to changes enacted through the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), the Federal Home Loan Bank Act requires that FHLBs establish programs to support affordable housing, including contributing 10 percent of their prior year's net earnings to an Affordable Housing Program that provides grants or subsidized advances to finance

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[6] The FHLB System originally comprised 12 regional FHLBs. In 2015, FHLBs of Des Moines and Seattle merged, resulting in the current network of 11 FHLBs. *Source*: FHFA Office of Inspector General (2016 March 16). Merger of the Federal Home Loan Banks of Des Moines and Seattle. White Paper WPR-2016-002. https://www.fhfaoig.gov/Content/Files/WPR-2016-002.pdf.
[7] The following types of financial institutions may apply for FHLB membership: any building and loan association, savings and loan association, cooperative bank, homestead association, insurance company, savings bank, community development financial institution, or insured depository institution.
[8] 12 CFR § 1263.6
[9] Congressional Budget Office (March 2024). The Role of Federal Home Loan Banks in the Financial System. https://www.cbo.gov/publication/60064.

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homeownership or rentals for low- or moderate-income households; and offering a Community Investment Program, which provides lower-cost advances to finance housing and economic development projects.[10]

B. ROLE AS LIQUIDITY PROVIDER

The FHLBs remain loyal to the core mission established in the 1930s. However, Congress has explicitly authorized the modern FHLB System to support its members by providing liquidity for activities unrelated to home financing. Notably, the FHLBs' primary business is offering to their approximately 6,500 members—many of whom are smaller regional or community banks—low-cost, stable, and reliable funding in the form of advances. The Federal Reserve Bank of Philadelphia recognized that FHLB advances have the same purpose as core deposits: serving as a stable source of funds, even during periods of economic stress.[11]

The FHLB conducts a credit assessment of an institution when it applies to become a member. Based on the assessment, the FHLB sets a cap on the member's financing availability. A typical cap will range from 20 percent to 60 percent of a member's total assets.[12] The FHFA defines the types of assets that members can pledge as collateral for advances (described below) and per regulatory guidance, the FHLB sets a cap on borrowing based on a member's creditworthiness and collateral pledged to the FHLB, subject to any financing limits.[13] However, it does not place restrictions on the use of advances beyond a statutory provision mandating that *long-term* advances "be made for the purpose of providing funds to any member for residential housing finance" (in addition to the requirement that to become a member, insured depository institutions must hold 10 percent of their assets in residential mortgages at the time of application).[14]

1. Collateralization

Under the Federal Home Loan Bank Act, the FHLBs are required to obtain and maintain collateral to *fully* secure advances.[15] At the time of originating or renewing an advance, a member must pledge eligible collateral as defined by the Federal Home Loan Bank Act and FHFA regulations. In the early history of the FHLB System, eligible collateral for advances was limited to home mortgage loans. As the FHLB System has evolved, Congress has permitted FHLBs to accept a wider range of eligible collateral, such as multifamily first and second lien loans, agency mortgage-backed securities, private label mortgage-backed securities, other real-estate related collateral, debt obligations or securities issued by the U.S. government, and cash and deposits held at the FHLB. Single-family

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[11] Disalvo, J. and Johnston, R. (2017). Banking Trends: The Rise in Loan-to-Deposit Ratios: Is 80 the New 60? Economic Insights, Federal Reserve Bank of Philadelphia. https://ideas.repec.org/a/fip/fedpei/00021.html.
[11] Disalvo, J. and Johnston, R. (2017). Banking Trends: The Rise in Loan-to-Deposit Ratios: Is 80 the New 60? Economic Insights, Federal Reserve Bank of Philadelphia. https://ideas.repec.org/a/fip/fedpei/00021.html.
[12] FHLBanks Office of Finance (2024 March 22). Federal Home Loan Bank System Lending and Collateral Q&A. https://www.fhlb-of.com/ofweb_userWeb/resources/lendingqanda.pdf.
[13] Ibid.
[14] 12 U.S.C. § 1430(a)(2). The Federal Home Loan Bank Act also has a provision stating that community financial institutions can use long-term advances for loans to small businesses, small farms, small agri-businesses, and community development activities.
[15] 12 U.S.C. § 1430(a)(1)

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residential first lien loans represent approximately 49 percent of all eligible collateral pledged across the FHLBs.[16]

Each FHLB assigns a haircut to all collateral pledged by its members. The FHLB bases this haircut on the type and volatility of the underlying asset and the cost associated with selling or liquidating the asset, in addition to its assessment of the borrower's financial condition.[17] Although haircuts vary by asset and borrower, FHLBs set haircuts generally at market rates. For example, the haircut for single-family mortgages averages 28 percent (from a range of 12 percent to 55 percent), while for commercial real estate loans, the average haircut is 34 percent (from a range of 19 percent to 50 percent).[18]

The haircut on the collateral is used to determine, in part, how much of an advance an FHLB will make to a member. For example, if an FHLB assigns a 25 percent haircut to a member pledge of $1 million in mortgage loans, the member would be eligible for up to $750,000 in advances from the FHLB, subject to the credit limit assigned to the member.

The practical effect of this haircut is that FHLB advances are typically "over-collateralized" in that the value of the pledged collateral exceeds the value of the advance borrowed by a member. The FHLBs' policy to over-collateralize advances is similar in substance to normal asset-based lending practices in private markets. Commercial lenders, who hold assets as collateral, typically set an advance rate at far less than 100 percent of the value of the underlying asset collateral.

2. Authority

Unlike the Federal banking supervisors, such as the FDIC and the Board of Governors of the Federal Reserve System ("Federal Reserve"), the FHLBs do not have supervisory authority over their members.[19] They do not have the authority to compel responses to information requests from a member on its financial condition or management strength. Consequently, the FHLBs rely on information from a member's prudential regulators or public sources for insight into a member's safety and soundness (in addition to information disclosed by members to the FHLBs).

FHFA regulation permits FHLBs to make new advances or to renew outstanding advances to members with positive tangible capital, even if the member is capital deficient. However, these regulations also provide that the FHLB cannot advance new or renewed funds to an institution if a member's Federal regulator notifies the FHLB in writing that a member's use of FHLB advances is prohibited. FHFA regulations further prohibit FHLBs from lending to members with negative tangible

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[16] FHFA Division of Federal Home Loan Bank Regulation (December 2023). Report on Collateral Pledged to Federal Home Loan Banks. https://www.fhfa.gov/sites/default/files/2024-01/2023-Annual-Collateral-Report-to-Congress.pdf.

[17] FHLBanks Office of Finance (2024 March 22). Federal Home Loan Bank System Lending and Collateral Q&A. https://www.fhlb-of.com/ofweb_userWeb/resources/lendingqanda.pdf.

[18] Congressional Budget Office (March 2024). The Role of Federal Home Loan Banks in the Financial System. https://www.cbo.gov/publication/60064.

[19] Although the Federal Home Loan Bank Board (the predecessor to the Federal Housing Finance Board and the FHFA) was originally primary regulators of thrifts, FIRREA created the Office of Thrift Supervision to supervise thrifts.

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capital, unless a member's Federal regulator requests in writing that the FHLB make such an advance.[20]

3. *Relation to the Discount Window*

We do not review the operations of the Federal Reserve's Discount Window as part of this paper. However, we address two attributes that highlight the differences between the Discount Window advances and FHLB advances.

First, FHLB advances and Discount Window loans generally serve different purposes. The FHLB and the Federal Reserve's Discount Window were established with distinct roles and with funding structures that support these roles.[21] The FHLBs support home financing and are liquidity providers to their members regardless of market conditions. As described above, the Office of Finance issues consolidated debt in capital markets to fund advances on behalf of a specific FHLB. The Office of Finance issues debt daily, and by acting as fiscal agent for the FHLBs, the consolidated obligations have lower rates than might be possibly obtained by individual FHLBs. The debt carries high ratings (Moody's Aaa/P-1).[22] In contrast, the Discount Window's principal function is serving as the "lender of last resort."[23] When a bank borrows from the Discount Window, the Federal Reserve credits its Reserve Bank account, making funds available almost instantaneously (after collateral is posted).

In practice, the Discount Window and FHLBs can complement one another. During market turmoil, the FHLBs work with the Federal Reserve to support Discount Window operations by enabling members to re-pledge excess FHLB collateral to the Federal Reserve to support access to the Discount Window. This can take the form of collateral administration agreements or intercreditor agreements that enable the FHLBs to subordinate their interest in the collateral to the Federal Reserve.[24]

Second, members may seek FHLB advances *instead of* the Federal Reserve's Discount Window, even during times of market stress. Some have even gone so far to argue that the FHLBs, in their capacity as liquidity providers, subsume the role of the "lender of next-to-last resort."[25] This preference for FHLB advances may be due to the FHLBs' ability to provide longer-term advances and multiple advance types that can be more tailored to meet a member's day-to-day funding needs or target a member's specific asset liability management needs; the stigma associated with

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[20] 12 CFR § 1266.4

[21] Federal Home Loan Banks (1952), The Federal Home Loan Bank System 1932-1952. https://fraser.stlouisfed.org/title/federal-home-loan-bank-system-1932-1952-9257.

[22] FHLBanks Office of Finance. About Debt Securities. Retrieved October 11, 2024: https://www.fhlb-of.com/ofweb_userWeb/pageBuilder/debt-securities-21.

[23] Congressional Research Service (2024 May 8). Federal Reserve's Discount Window: Policy Issues. IF12655. https://crsreports.congress.gov/product/pdf/IF/IF12655.

[24] U.S. GAO (2024 March 8). Federal Home Loan Banks: Actions Related to the Spring 2023 Bank Failures. GAO-24-106957 Q&A Report to the Committee on Financial Services, House of Representatives. https://www.gao.gov/products/gao-24-106957.

[25] Ashcraft, A., Bech, M., and Frame, W.S. (November 2008). The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?, Federal Reserve Bank of New York Staff Report no. 357. https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr357.pdf.

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accessing the Discount Window, which may exacerbate investor or depositor fears; the Discount Window's operational limitations; or the Discount Window's history of providing short-term funding only. Together, these challenges may risk aggravating the condition of distressed institutions by limiting access to funding when they need it the most. They also illustrate why it is critical that the Federal banking supervisors communicate with the FHLBs about institutions undergoing severe stress and when further advances to the institutions would be inappropriate (even if collateral is available).

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III. CRITICISMS OF THE FHLBS' LENDING PROGRAM

This section discusses three common criticisms of FHLB advances and their negative impact on the FDIC insurance fund:

(i) FHLBs enjoy a "super lien" position that protects them from credit losses at the FDIC's expense;

(ii) The FHLBs charge excessive prepayment fees to its members, which the insurance fund pays when a bank fails; and

(iii) The implicit government guarantee of FHLBs' consolidated debt creates a moral hazard since it affects market discipline of buyers of that debt, incenting the FHLBs to over-extend credit to institutions engaged in excessive risk-taking.

We analyze each of these arguments below. Based on our analysis, we cannot find any evidence that the FHLBs impose an undue burden upon the deposit insurance fund.

A. SUPER LIEN

CRITICISM OF THE FHLB SYSTEM
A common criticism relates to the FHLBs' "super lien" position. Congress created the so called "super lien" through the Competitive Equality Banking Act of 1987 ("CEBA"). CEBA states that "any security interest granted to a Federal Home Loan Bank by any member...shall be entitled to priority over the claims of any party other than parties which have obtained a perfected security interest."[26] A 2024 report from the Congressional Budget Office argued that, in the event a bank failed and the value of the FHLB's collateral decreased below the total amount due to the FHLB, the super lien, coupled with the overcollateralization of advances, would still protect the FHLB from losses. These losses instead would be borne by other creditors—including the FDIC and, therefore, uninsured depositors.[27] This argument, or versions of it, appear frequently in criticisms of the FHLB System by the FDIC, think tanks, and others.[28]

At the time of the CEBA's passage, the only way to perfect an interest in mortgages pledged as collateral was to take physical possession of mortgage notes. Without physical possession of these notes, the FHLBs would be secured lenders without a perfected security interest and would

[26] S.790 - 100th Congress (1987-1988): Competitive Equality Banking Act of 1987. (1987 April 1). https://www.congress.gov/bill/100th-congress/senate-bill/790.
[27] Congressional Budget Office (March 2024) The Role of Federal Home Loan Banks in the Financial System. https://www.cbo.gov/publication/60064.
[28] See also: Congressional Research Service (2024 May 8). Federal Reserve's Discount Window: Policy Issues. IF12655. https://crsreports.congress.gov/product/pdf/IF/IF12655; *and* Ashcraft, A., Bech, M., and Frame, W.S. (November 2008). The Federal Home Loan Bank System: The Lender of Next-to-Last Resort?. Federal Reserve Bank of New York Staff Report no. 357. https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr357.pdf.

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compete with other secured lenders with unperfected security interests for available assets in the event of a bank failure. Congress addressed this situation by providing the FHLB with a statutorily perfected lien on pledged collateral. This amendment clarified any ambiguity by granting a FHLB priority over other secured creditors *only if* the collateral did not have a prior perfected interest.[29] At the time, other lenders were at a relative disadvantage, as they would still need to obtain physical possession of notes to perfect their interests.

However, with changes to the UCC in 2001, FHLBs *and* any other lenders are now able to perfect their interests through UCC financing statement filings (in addition to physical possession of notes). With this change, if multiple secured creditors filed a claim on the same collateral and none have possession, the creditor who was "first to file" has priority in a receivership. Thus, the lien priority "advantage" afforded to the FHLBs through the CEBA is mostly a moot point in almost all cases, unless, for example, there are state-specific nuances to mortgage loan security interests or the rare scenario in which no secured creditor (including the FHLB) has perfected its security interest through possession or filing at the time of receivership.[30] In practice, that means the FHLBs are like any other secured lender with perfected interests in collateral and do not create any extraordinary costs to the FDIC insurance fund in the case of a bank failure.[31]

For example, with respect to collateralization requirements, a FHLB advance is similar to the Federal Reserve's Discount Window loans. The Federal Reserve evaluates and assigns a haircut—or advance rate—to collateral pledged by a member institution requesting the loan.[32] The Federal Reserve requires a perfected security interest in all collateral pledged to secure Discount Window loans. Thus, in the event of a bank failure, these secured loans are repaid in a similar manner to FHLB advances. Moreover, if the Federal Reserve has perfected its security interest in collateral before other secured creditors (including the FHLB), it has the priority claim over that collateral pursuant to the UCC.

Furthermore, in the repayment waterfall, lenders with perfected security interests in the assets of the failed bank have priority when claiming the assets pledged to them. However, this waterfall does not mandate that the creditors with perfected security interests, such as FHLBs, must be repaid as soon as a bank is put into receivership. Rather, in an orderly liquidation, the receiver (the FDIC) has several options for resolving a failed bank, such as holding onto the advances or including the liabilities as part of a sale to another bank.[33] If the FDIC decides to preemptively pay off the FHLB advances, as well as other secured loans, to access the pledged collateral, that decision is presumably a choice made to achieve the FDIC's least cost resolution objective—and

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[29] Scott, J. and O'Shields, R. (2019 March 1). "Super Lien" Doesn't Mean Super Risk: Money Market Intermediation, Security Interests, Federal Home Loan Bank Lien Protections and Systemic Risk. 23 N.C. Banking Inst. 11. https://scholarship.law.unc.edu/cgi/viewcontent.cgi?article=1474&context=ncbi.
[30] Ibid.
[31] This section of the paper focuses on the "super lien" provision established by the CEBA. It does not explore other potential sources of advantages to the FHLBs and secured creditors under different statutes.
[32] Federal Reserve. Borrowing. Retrieved October 11, 2024: https://www.frbdiscountwindow.org/Pages/General-Information/Borrowing. See also 12 CFR § 201.3.
[33] In the event that the value of collateral used to secure advances is declining at a rapid pace and before the FDIC and FHLB agree on a plan for the payment of outstanding advances, FDIC regulation acknowledges that the FHLB has the authority under applicable laws to sell collateral to satisfy the FHLB's claim. 12 CFR § 360.2(c)

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implies that paying off the FHLB advances represents the lowest cost to the FDIC relative to other options.[34]

B. PREPAYMENT FEES

CRITICISM OF THE FHLB SYSTEM

Following the failures of three banks between March and May 2023, there has been a good deal of controversy surrounding FHLB prepayment fees. Critics argue that these fees increase costs to the FDIC, which usually must pay off advances and fees, including prepayment fees, to take collateral that has been pledged by a failed bank to an FHLB. For example, when the FDIC prepaid FHLBSF advances in the wake of SVB's failure, Bloomberg characterized the $285 million prepayment fee charged to SVB as "unusually large."[35] In an opinion piece, IndyMac's then-CEO said he was "stunned" by the $340 million fee that the FDIC, as IndyMac's receiver, would have had to pay if it ended up prepaying the bank's FHLBSF advances following the bank's collapse in 2008.[36]

Prepayment fees do not represent windfall profits for the FHLBs. Instead, these fees are a tool that the FHLBs utilize to manage their own exposures and mirror the costs that the FHLBs incur from early payment of the bonds used to fund advances.

Such criticism disregards the key role that prepayment fees play in enabling the FHLBs to provide long-term advances to their members, and to manage their interest rate risk exposure. These fees are so important that FHFA regulation *requires* FHLBs to charge a prepayment fee "which makes the [FHLB] financially indifferent to the borrower's decision to repay the advance prior to its maturity date."[37] Prepayment fees are calculated using a specified formula, generally equal to either the present value of the daily lost cash flow to the FHLB for short-term advances, or to the FHLB's cost of unwinding the hedged transaction, along with amounts for the cost of funds and administration, for longer-term advances.[38] The prepayment fee methodology is generally specified in each advance transaction confirmation so the member, its regulator, and the FDIC are aware that the advance may incur fees at the time of prepayment.

Prepayment fees are essential in enabling longer-term advances by aiding FHLBs to manage their interest rate risk. In absence of these fees, FHLBs would have to forego interest payments and, upon prepayment, potentially be compelled to reinvest funds at lower interest rates depending on market conditions; this introduces uncertainty into the FHLBs' cash flows, impairing their ability to

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[34] U.S. GAO (2024 March 8). Federal Home Loan Banks: Actions Related to the Spring 2023 Bank Failures. GAO-24-106957 Q&A Report to the Committee on Financial Services, House of Representatives. https://www.gao.gov/products/gao-24-106957.

[35] Buhayar, N. (2024 March 12). Bloomberg. Retrieved October 11, 2024: https://www.bloomberg.com/news/articles/2024-03-12/after-svb-failed-fhlb-charged-285-million-in-fees-to-wind-down-financing.

[36] Bovenzi, J. (2023 March 17). American Banker. Retrieved October 11, 2024: https://www.americanbanker.com/opinion/heads-the-federal-home-loan-banks-win-tails-the-fdic-loses.

[37] 12 CFR § 1266.6

[38] FHLBank Atlanta. Credit Products. https://corp.fhlbatl.com/files/documents/credit-products-brochure.pdf.

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raise debt in the private markets or increasing the price of such debt. In turn, the FHLBs would have to either reduce the amount and/or tenor of the liquidity available to their members or increase the price of advances, weakening their ability to further their mission to support housing finance.

Additionally, the argument that prepayment fees increase costs to the FDIC is misleading because FDIC regulations both limit the amount of prepayment fees and permit payment of these fees only if they do not disadvantage the FDIC. FDIC regulations establish limits on prepayment fees to "the present value of the loss attributable to the difference between the contract rate of the secured borrowing and the reinvestment rate then available to the Bank" and permit claims for prepayment fees only if the advance is secured by sufficient collateral that any principal, unpaid interest, and prepayment fees can be fully covered by the proceeds from their sale.[39]

Although prepayment fees are required by FHFA regulations, and limited by FDIC regulations upon a bank's insolvency, the FHLBs also offer balance sheet management tools to provide flexibility to members in a changing rate environment. One of those tools is known as the "Symmetrical Prepayment Advance" feature, which adds symmetry to certain advances with maturities of one year or longer. If a member opts into this feature while originating an advance and interest rates subsequently rise, a member can receive a credit that allows it to prepay an advance at an amount below the outstanding par value.[40]

Some critics have highlighted that the FHLBs may select to waive prepayment fees, suggesting that these should have been waived during the spring 2023 bank failures.[41] It should be noted that FHFA regulation stipulates that prepayment fees may be waived only if prepayment does not result in economic loss to the FHLB, and that the decision to waive fees must be applied consistently across all members.[42] To waive prepayment fees, even in times of crisis, would set a negative precedent, introducing subjective decision making and weakening this important risk control.

[39] 12 CFR § 360.2(e)
[40] FHLBank Dallas (August 2018). Symmetrical Prepayment Advance. https://www.fhlb.com/getmedia/4264492b-082e-4887-9004-fbb8750cec5a/WP-002-Symmetrical-Prepayment-08152018.pdf.
[41] Buhayar, N. (2024 March 12). Bloomberg. Retrieved October 11, 2024: https://www.bloomberg.com/news/articles/2024-03-12/after-svb-failed-fhlb-charged-285-million-in-fees-to-wind-down-financing.
[42] 12 CFR § 1266.6(b)(3),(4)

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C. MORAL HAZARD

CRITICISM OF THE FHLB SYSTEM

Moral hazard arises when one party has an incentive to take excessive risks because it does not bear the costs of those risks. In the context of this paper, the presence of moral hazard stems primarily from the implicit government guarantee of FHLB-issued debt in addition to the FHLBs' other public privileges (e.g., their tax-exempt status, or their explicit line of credit with the U.S. Treasury). For these reasons, FHLBs' creditors impose insufficient market discipline on the FHLBs' lending practices, distorting incentives such that in pursuit of higher returns, FHLBs might imprudently over-extend credit to banks in ways that may increase the likelihood of financial distress.[43]

Other critics also have pointed to structural features of the FHLB System that could present moral hazard. In a 2005 paper, the FDIC argued that the FHLBs face no credit risk—because overcollateralization of advances and their "super-lien" position—and therefore do not price the risk of bank failure in their advances. As a result, a moral hazard arises because members draw from the FHLBs at inexpensive rates that are not appropriately risk adjusted and shift the downsides to the FDIC which would absorb the costs if the bank failed.[44] In a similar vein, Ashley, Brewer, and Vincent (1998) found that during the savings and loans crisis in the 1980s, insolvent thrifts borrowed from the FHLBs more than the rest of the industry because the FHLB offered below-market rates on its advances. These distressed thrifts then used advances to "gamble" on riskier assets knowing that the deposit insurer at the time would be liable for losses.[45]

We have already demonstrated that the so-called super lien, following changes in the UCC, offers the FHLBs little practical or legal advantage over other secured lenders, so is not a source of moral hazard risk. The subsidy of an implicit guarantee, along with other public privileges, theoretically could create moral hazard. However, there are mechanisms in place to mitigate moral hazard—particularly excessive lending to failing or riskier members—in practice.

First, the prudential regulators are better positioned to address any hypothetical moral hazard than the FHLBs. The FHLBs do not have supervisory authority over members; such authority was

[43] Gissler, S., Narajabad, B., and Tarullo, D. (2022 June 13). Federal Home Loan Banks and Financial Stability. Harvard Public Law Working Paper No. 22-20. https://ssrn.com/abstract=41356855; Ashley, L., Brewer III, E., and Vincent, N. (June 1998). Access to FHLBank advances and the performance of thrift institutions. Federal Reserve Bank of Chicago Economic Perspectives, Vol. 22, 2nd, No. 2. https://www.chicagofed.org/publications/economic-perspectives/1998/2qepart3; *and* Flannery, M. and Frame, S. (2006). The Federal Home Loan Bank System: The "Other" Housing GSE. https://www.atlantafed.org/-/media/documents/research/publications/economic-review/2006/vol91no3_flannery-frame.pdf.

[44] FDIC (July 2005). Should the FDIC Worry about the FHLB?. FDIC Center for Financial Research Working Paper No. 2005-10. https://archive.fdic.gov/view/fdic/12039/fdic_12039_DS1.pdf.

[45] Ashley, L., Brewer III, E., and Vincent, N. (June 1998). Access to FHLBank advances and the performance of thrift institutions. Federal Reserve Bank of Chicago Economic Perspectives, Vol. 22, 2nd, No. 2. https://www.chicagofed.org/publications/economic-perspectives/1998/2qepart3.

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removed from the banks by FIRREA in 1989. Rather, supervisory authority rests with the prudential regulators: the States, the Federal Reserve, the Office of the Comptroller of the Currency, and the FDIC. Depending on the charter type, the appropriate regulator is empowered to assess a bank's liquidity position, funding plan, management strength, and new business lines. The regulator is positioned to evaluate whether the bank is appropriately using its funding, including that from the FHLBs. At any point a regulator could tell a bank to stop drawing funds from the FHLB—or an FHLB to stop advancing funds to a member—and the FHLB would be legally required to cease lending.

Second, when it is obvious from public reports that a bank is in distress—as it was in the case of SVB—the FHLBs themselves move to limit draws, communicate and coordinate with regulators, and assess new requests and credit limits.[46] Moreover, under FHFA regulations, FHLBs can only extend advances to members with positive tangible capital, serving as a control to limit new or renewed advances to distressed members. Also, the Federal government has mitigated any potential moral hazard by regulating the FHLB System itself through the FHFA, which has the authority to define regulations governing the FHLBs' risk management practices, examine the FHLBs, and set capital standards.[47]

Third, there is no evidence or incentives for a member to use FHLB advances to acquire risky assets. Even with lower-cost funding from a FHLB, a member still has strong incentives to make prudent lending decisions so that it can pay dividends to shareholders. Furthermore, advances are not necessarily associated with higher levels of risk-taking but rather serve as a stable source of non-deposit funding. Davidson and Simpson (2016) present a nuanced view of this relationship between advances and "bank" risk (i.e., credit, interest rate, liquidity, and leverage risks). The authors found that in a normal economic environment, advances do not encourage increased risk-taking for banks with normal default probabilities; rather, advances are associated with lower interest rate risk. However, when bank probabilities of default are high, the evidence suggests that advances are associated with higher levels of risk.[48] Finally, FHLB funding makes up such a *small* percentage of overall bank funding in the vast majority of cases that even if a bank was using FHLB advances to acquire risky assets, the practical impact of the theoretical moral hazard is minimal. The chart below illustrates the relatively small contribution FHLB advances make towards a bank's overall funding structure (note: the Y-axis reflects FHLB advances as a percentage of total assets, and the X-axis represents years, starting with 2001 and ending with 2023).[49] Even for the heaviest "users" of FHLB advances (banks with $10 to $250 billion in assets), advances peaked at around 11 percent of total assets during the 2008 crisis and leveled out to less than 6 percent of total assets before the 2023 bank failures.[50]

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[46] U.S. GAO (2024 March 8). Federal Home Loan Banks: Actions Related to the Spring 2023 Bank Failures. GAO-24-106957 Q&A Report to the Committee on Financial Services, House of Representatives. https://www.gao.gov/products/gao-24-106957.
[47] Public Law No. 110-289 (July 30, 2008), Sec. 1101-1118
[48] Davidson, T. and Simpson, G. (January 2016). Federal Home Loan Bank advances and bank risk. Journal of Economics and Finance. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2471836.
[49] Note that the X-axis reflects the years, starting with 2001 and ending with 2023. Moore, D., Parrott, J., Wurm, M., and Zandi, M. (2023 November 3). The Federal Home Loan Banks Support Systemic Stability. Urban Institute. https://www.urban.org/research/publication/federal-home-loan-banks-support-systemic-stability.
[50] The financial crises of 2008 led to the failure of a significant number of thrifts, which historically had a higher concentration of mortgage assets and therefore used a higher percentage of FHLB advances as their funding base. Because of these failures, borrowing overall from FHLBs decreased beginning in 2009.

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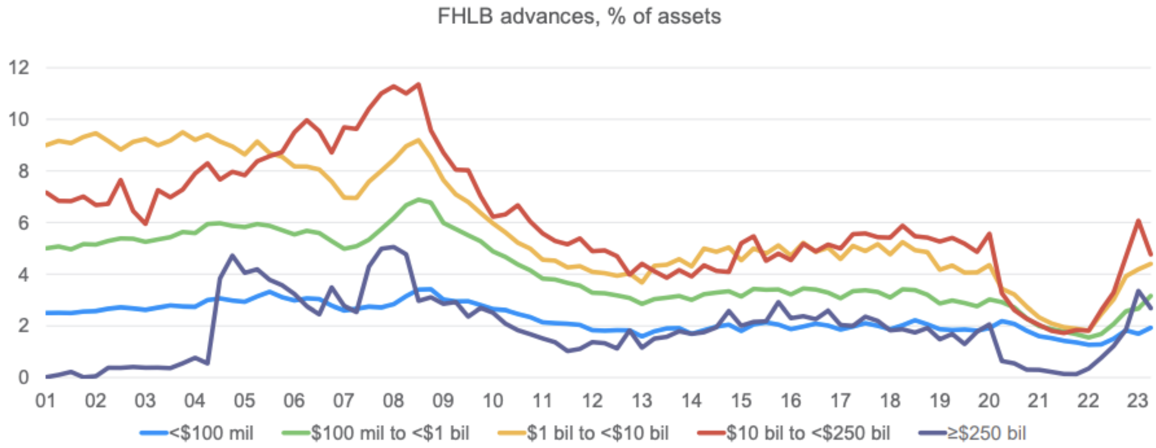

Sources: FDIC, Moody's Analytics

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IV. SVB CASE STUDY

Critics have raised many of the issues noted above in the context of the failure of SVB. Consequently, we thought it might be helpful to examine each of these three issues in the context of the FDIC's interactions with SVB.

This section starts with a factual recap of the events leading up to SVB's failure and SVB's borrowing from the FHLBSF. It then reviews the alternative sources of funding that SVB might have accessed immediately prior to its takeover by the FDIC. Finally, this section analyzes the three primary criticisms of the FHLBs—"super-lien," prepayment fees, and moral hazard—discussed above in the context of SVB's failure.

A. BACKGROUND

1. SVB from 2021 until Failure on March 10, 2023

SVB's failure is significant not only for its size (it was one of the largest bank failures in U.S. history), but also for the speed at which the bank failed, and for the succession of bank failures and market turmoil that followed.

SVB had approximately $210 billion in assets on its balance sheet when it failed on March 10, 2023. Given its size and importance in banking many technology and related companies in the United States, particularly in its Northern California base, the Federal government invoked a systemic risk exception for SVB, guaranteeing deposits in their entirety without regard to the FDIC's insurance limits.[51]

SVB was the first of three failures that occurred in close succession that spring. Following SVB were Signature Bank on March 12, for which the government also invoked a systemic risk exception, and First Republic Bank on May 1. A period of uncertainty followed these failures. Between February 7 and May 12, the S&P Regional Banks Select Security Index fell from 2034.91 to 1138.81.[52]

Broadly speaking, most bank failures result from deep-rooted credit issues that eventually impair the solvency of the bank. SVB differs in that its failure was not caused by major credit issues. Rather, the bank suffered from liquidity issues related to its capital investments. The bank made large investments in longer-dated securities at low interest rates, which lost market value as interest rates increased over the course of 2022 and into 2023. As investors became aware of the unrealized losses on SVB's balance sheet, customer sentiment about the bank changed. Depositors began to withdraw funds, and a run on the bank began. Although the bank run began slowly, it accelerated at an extraordinary speed. To meet withdrawal demand, the bank sold substantially all its available-for-sale securities, crystalizing a $1.8 billion loss on its balance

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[51] FDIC (2023 March 12). Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC. https://www.fdic.gov/news/press-releases/2023/pr23017.html.

[52] S&P Global S&P Regional Banks Select Industry Index. https://www.spglobal.com/spdji/en/indices/equity/sp-regional-banks-select-industry-index/#overview.

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sheet.[53] The announcement of this loss on March 9 only accelerated customer fear and deposit withdrawals, which totaled $42 billion or 25 percent of SVB's total deposits on that date alone.[54] The bank failed the next day.

2. FHLBSF Funding

At the beginning of 2022, SVB had no outstanding advances from the FHLB System. Its borrowings from the FHLBSF, where it was a member, began in the first quarter of 2022 and accelerated through March 2023. The pace of SVB's borrowings mirrors its loss of uninsured deposits during the same period. At the time of its failure on March 10, 2023, SVB had $30 billion in outstanding FHLBSF advances.[55]

In its 2022 10-K, SVB disclosed that it borrowed $13 billion in short term funding from the FHLBSF, and $2 billion in long term funding, up from zero in each category the previous year.[56] Public filings suggest that much of that FHLBSF funding was procured in the third and fourth quarters of 2022, when the bank experienced a decline in deposits of about $25 billion in the fourth quarter.[57] In its 2022 10-K, SVB disclosed that it had pledged approximately $44.9 billion in collateral to FHLBSF, of which $25.9 billion was available to support future borrowings, subject to SVB's financing availability limit with the FHLBSF and haircuts applied to the collateral.[58]

In 2023 before its failure, SVB doubled its FHLBSF advances from $15 billion to $30 billion and increased its pledged collateral to $50.3 billion.[59] The borrowing progression was as follows:

- As of January 1, 2023, SVB had $15 billion in outstanding FHLBSF advances.
- Advances increased to $16.5 billion on February 1, then to $20 billion by March 1.
- By March 9, advances increased 50 percent to $30 billion.
- SVB failed on March 10.

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[53] SVB (2023 March 8). Strategic Actions/Q1'23 Mid-Quarter Update. https://s201.q4cdn.com/589201576/files/doc_downloads/2023/03/Q1-2023-Mid-Quarter-Update-vFINAL3-030823.pdf.
[54] Weil, J. (2023 March 10). WSJ. Retrieved October 11, 2024: https://www.wsj.com/livecoverage/stock-market-news-today-03-10-2023/card/svb-tapped-home-loan-bank-for-15-billion-in-funding-at-end-of-2022-o8l8AvXWyMBFgUicgTwp.
[55] U.S. GAO (2024 March 8). Federal Home Loan Banks: Actions Related to the Spring 2023 Bank Failures. GAO-24-106957 Q&A Report to the Committee on Financial Services, House of Representatives. https://www.gao.gov/products/gao-24-106957.
[56] SVB 2022 10-K. https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/f36fc4d7-9459-41d7-9e3d-2c468971b386.pdf.
[57] Weil, J. (2023 March 10). WSJ. Retrieved October 11, 2024: https://www.wsj.com/livecoverage/stock-market-news-today-03-10-2023/card/svb-tapped-home-loan-bank-for-15-billion-in-funding-at-end-of-2022-o8l8AvXWyMBFgUicgTwp.
[58] SVB 2022 10-K. https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/f36fc4d7-9459-41d7-9e3d-2c468971b386.pdf; *and* SVB March 31, 2022 10-Q. https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/6550de96-0f49-4f02-a28b-5e1753020c9c.pdf.
[59] U.S. GAO (2024 March 8). Federal Home Loan Banks: Actions Related to the Spring 2023 Bank Failures. GAO-24-106957 Q&A Report to the Committee on Financial Services, House of Representatives. https://www.gao.gov/products/gao-24-106957.

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The timing and amount of FHLBSF borrowing corresponds with the loss of uninsured deposits at SVB (and not to an increase in lending). The change in deposit levels and corresponding FHLBSF advances are shown in the chart from the GAO below.[60] Over the course of 2022, total consolidated assets *decreased* by 4 percent or $8.6 billion (from $220.4 billion in Q1 to $211.8 billion in Q4), and net loans increased modestly by 7.9 percent or $5.4 billion (from $68.2 billion to $73.6 billion over that same period).[61]

Figure 2: Funding Composition of Failed Banks and Peer Banks in 2022, by Quarter

Source: GAO analysis of Federal Financial Institutions Examination Council call report data. | GAO-24-106957

At the time of failure, the FDIC created a bridge bank to receive the liabilities and substantially all assets of SVB. This new entity, Silicon Valley Bridge Bank, NA, assumed the FHLBSF advances previously held by the failed bank. The FDIC could have continued to hold the advances at the bridge bank or transferred them to an eventual buyer should that be agreed. However, the bridge bank prepaid all $30 billion in outstanding advances by March 17, 2023, ahead of the sale of the bridge bank to First-Citizens Bank & Trust Company on March 27, 2023.[62]

In return for the advance prepayments, the FHLBSF released the collateral to the bridge bank, representing 168 percent of the advances at a market value of approximately $50.3 billion. Further, the FHLBSF repurchased SVB's FHLBSF stock in the amount of $810 million.[63]

B. ALTERNATIVE SCENARIOS

The pattern of SVB's borrowings from the FHLBSF indicate that the advances supported the bank during its liquidity crisis, starting with the loss of deposits in 2022, which accelerated in February

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[60] Ibid.
[61] SVB 2022 10-K. https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/f36fc4d7-9459-41d7-9e3d-2c468971b386.pdf; *and* SVB March 31, 2022 10-Q. https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/6550de96-0f49-4f02-a28b-5e1753020c9c.pdf.
[62] U.S. GAO (2024 March 8). Federal Home Loan Banks: Actions Related to the Spring 2023 Bank Failures. GAO-24-106957 Q&A Report to the Committee on Financial Services, House of Representatives. https://www.gao.gov/products/gao-24-106957.
[63] Ibid.

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and March 2023. The speed of deposit flight was extreme, with withdrawals on March 9 alone totaling over *$40 billion*.[64] SVB experienced what amounted to a technology-enabled run on the bank, with the industry concentration of SVB customers in the technology space fueling the run. Without the FHLBSF advances, SVB would likely have become insolvent sometime in the middle of the week beginning March 6, 2023, forcing the California Department of Financial Protection and Innovation to close the bank and appoint the FDIC as receiver in a less orderly manner.

When the California Department of Financial Protection and Innovation closed SVB, the FDIC, Federal Reserve, and Secretary of the Treasury invoked the systemic risk exception to the least cost resolution directive of the FDIC.[65] This exception could have been invoked earlier in the week to prevent a disorderly resolution. Without this exception, a midweek seizure of a major regional bank with deep ties to the technology industry would have had serious—and deleterious—effects on the financial system. It would likely have been messier than allowing the FDIC to arrange a bridge bank over the weekend beginning on March 10, 2023.

In the face of increasing demands for liquidity as a result of continuing deposit withdrawals, SVB had few options for raising funds. During the acute phase of the liquidity crisis (during the week of March 6, 2023), SVB attempted to borrow more from the FHLBSF. Late in the afternoon on March 9, the bank requested $20 billion in additional advances. The FHLBSF was unable to fulfill this large request on short notice late in the trading day.[66] The Office of Finance (which manages fundraising for all of the FHLBs) generally must issue debt on the open market to raise cash for advances requested by FHLB members. A sizable $20 billion placement would have taken some time to arrange and was operationally impossible to fulfill on the same day.

SVB's only other realistic alternative was borrowing from the Discount Window. At the end of 2022, SVB had $5.3 billion in pledged collateral at the Discount Window, all of which was unused and available to collateralize borrowings.[67] SVB requested that the FHLBSF transfer excess collateral to the Discount Window on March 9. The FHLBSF began that process, but it was not yet complete as of the bank's failure on March 10.[68]

Unlike the FHLBs, the Discount Window can instantly grant access to large amounts of liquidity (with the proper collateral in place). This stands in contrast to the FHLB System's funding mechanisms of open market bond offerings, which take some time. However, for those institutions without collateral in place, and who have not drawn from the Window previously, the process for

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[64] Ibid.

[65] Congressional Research Service (2024 April 24). Bank Failures: The FDIC's Systemic Risk Exception, IF12378 Version 3. https://crsreports.congress.gov/product/pdf/IF/IF12378.

[66] U.S. GAO (2024 March 8). Federal Home Loan Banks: Actions Related to the Spring 2023 Bank Failures. GAO-24-106957 Q&A Report to the Committee on Financial Services, House of Representatives. https://www.gao.gov/products/gao-24-106957.

[67] Purchase and Assumption Agreement (2023 March 27). Federal Deposit Insurance Corporation, Receiver of Silicon Valley Bridge Bank, National Association, Santa Clara, California, Federal Deposit Insurance Corporation and First-Citizens Bank & Trust Company, Raleigh, North Carolina. https://www.fdic.gov/system/files/2024-07/silicon-valley-p-and-a.pdf.

[68] U.S. GAO (2024 March 8). Federal Home Loan Banks: Actions Related to the Spring 2023 Bank Failures. GAO-24-106957 Q&A Report to the Committee on Financial Services, House of Representatives. https://www.gao.gov/products/gao-24-106957.

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arranging a draw or pledging collateral can be slow.[69] SVB had limited collateral already pledged to the Discount Window, and this collateral was insufficient to access the amount needed to cover the outflow of deposits it experienced in the day before it failed. Further, SVB had not tested operational use of the Discount Window in over a year, making it difficult to execute in an emergency. The Federal Reserve's own report on the failure of SVB noted that "while contingent funding [from the Discount Window] may not have been able to prevent the failure of the bank after the historic run on the bank, the lack of preparedness may have contributed to how quickly it failed."[70] Even if SVB had attempted to use the Discount Window, the Federal Reserve still would have had to approve the loan, which it is not required to do and could have turned down based on supervisory information.

C. SVB AND CRITICISMS OF THE FHLB SYSTEM

How does the study of SVB's failure reflect on the three primary criticisms of FHLB activity and its purported negative effect on the FDIC's deposit insurance fund? The FDIC estimates that the resolution of SVB will cost the insurance fund approximately $20 billion. The resolution of SVB involved an interim bridge bank before the sale of substantially all liabilities and $72 billion of loans of the bridge bank to First Citizens Bank & Trust, at a discount of $16.5 billion. The FDIC retained approximately $90 billion of securities and other assets for disposition.[71] Here we examine the situation of SVB versus the concerns of the "super lien," prepayment fees, and moral hazard.

1. "Super Lien"

As discussed above, the FHLB typically has a perfected security interest in the collateral that is legally required for advances it provides to members, as is prudent practice for any secured lender. At the time of SVB's failure, FHLBSF had a security interest in $50.3 billion in collateral, substantially more than the advances it provided of $30 billion. To access this collateral, the receiver and successor institution (in this case, Silicon Valley Bridge Bank) would have to prepay the advances. The FDIC chose to do this, and all advances were prepaid by March 17, 2023.

The Purchase and Assumption agreement between the FDIC and First Citizens shows that the assets purchased by First Citizens from the FDIC were transferred at book value. The public version of the agreement lists anonymized loans that were not purchased by First Citizens. Given the collateral eligibility requirements set by Congress and the FHFA, the collateral pledged by SVB to the FHLBSF likely consisted of high-quality assets and, therefore, were those purchased by First

[69] Wessel, D. (2024 March 12). How to fix what ails the Fed's discount window. Brookings. https://www.brookings.edu/articles/how-to-fix-what-ails-the-feds-discount-window/.
[70] Board of Governors of the Federal Reserve System (2023 April 28). Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank. https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.
[71] FDIC Press Release (2023 March 26). Retrieved October 11, 2024: https://www.fdic.gov/news/press-releases/2023/pr23023.html.

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Citizens in the transaction.[72] The agreement further contemplates a loss and recovery arrangement whereby the FDIC and First Citizens share losses above $5 billion, as well as any recoveries.[73]

The purchase of $72 billion in assets at a $16.5 billion discount represents a roughly 23 percent haircut by the purchaser. A similar haircut on FHLB securities would have priced the $50.3 billion in pledged collateral at $38.7 billion, well in excess of the $30 billion in outstanding advances held by SVB at its failure. Therefore, the FDIC made an economically sound choice to prepay the advances to access the underlying collateral and facilitate a sale of the bridge bank.

As would be the case with any other secured creditor, the FHLBSF had a first priority lien only on collateral on which it had perfected its security interest.

2. Prepayment Fees

For the bridge bank to access SVB's pledged collateral, the FDIC and bridge bank elected to prepay SVB's $30 billion in advances, resulting in $266.5 million in prepayment fees and $19 million in waiver fees, an amount was derided as "unusually large" in the media.

As discussed in this paper, prepayment fees are both a necessary and a statutorily-mandated feature of FHLB advances, allowing the FHLBs to match fund their member advances and manage their own interest rate risk. They are not "penalties," but rather compensation for the lost value of the future payments, given that the FHLB has issued its own bonds of a similar duration to the advance.[74] Without the prepayment fees, the FHLBSF would have lost money on the SVB advances, reducing the amount of liquidity available to other members—a decision that a fiduciary board of directors would be hard-pressed to approve.

In the SVB case, it is important to note that the member, its regulator, and the FDIC were aware that prepayment fees were a possibility for any prepayment, as each advance transaction confirmation set out the prepayment fee methodology. With this understanding, the FDIC nonetheless chose to voluntarily prepay the FHLBSF advance, which freed up the collateral held at FHLBSF. To avoid prepayment fees, the bridge bank and any successor could have retained the advances and paid them off over the course of their natural life, such as JPMorgan Chase chose to do when it acquired First Republic Bank.

Moreover, it is also worthy to note that in SVB's case, the prepayment fee was an outlier by historical standards. For the banks that failed from 2006 to 2023 (excluding SVB), the prepayment fees arising from early payment of FHLB advances by the FDIC ranged from $0.25 to $69 million—more modest numbers that arguably would not have garnered significant press attention. Although

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[72] Purchase and Assumption Agreement (2023 March 27). Federal Deposit Insurance Corporation, Receiver of Silicon Valley Bridge Bank, National Association, Santa Clara, California, Federal Deposit Insurance Corporation and First-Citizens Bank & Trust Company, Raleigh, North Carolina. https://www.fdic.gov/system/files/2024-07/silicon-valley-p-and-a.pdf.
[73] Clearly Gottlieb (2023 March 27). First Citizens Assumes All Deposits and Loans of Silicon Valley Bridge Bank from the FDIC. https://www.clearygottlieb.com/news-and-insights/publication-listing/first-citizens-assumes-all-deposits-and-loans-of-silicon-valley-bridge-bank-from-the-fdic.
[74] As described above, the FHLBs also offer a Symmetrical Prepayment Advance feature to help its member banks manage their interest rate risks.

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the calculation of prepayment fees considers a variety of factors, the size of SVB's prepayment fee stems, in part, from the sheer size of its outstanding borrowings. SVB had the largest amount of outstanding FHLB advances that were prepaid by the FDIC ($30 billion).[75]

3. Moral Hazard

The moral hazard argument against FHLB advances is essentially that insufficient levels of market discipline by buyers of FHLB debt can create perverse incentives for FHLBs, themselves usually highly collateralized, to imprudently over-extend credit to members who, in turn, use the funding irresponsibly.

The story of SVB's use of FHLBSF funding presents a different situation: SVB was using the advances to fulfill its obligations to uninsured depositors, not to fund risky bets to potentially reverse its fortunes. SVB did not avail itself of FHLBSF funding at all until it began to lose deposits in late 2022 and turned to the FHLBSF as an effective lender of last resort in its final days. The funds were used to plug holes in its liquidity position, and the advances were outstanding for a relatively short period of time, measured in months. To further support this point, as detailed above, over the course of 2022—including the periods when SVB started to draw on advances—SVB experienced no asset growth and modest loan growth. It seems clear from this fact pattern that SVB used FHLBSF advances for liquidity purposes rather than business line expansions or changes. In such a case, the moral hazard of improper market discipline leading to overextension of credit for risky activities did not apply: it was an emergency operation to stabilize the bank's liquidity.

It is important to note that at any point in the degradation of SVB's liquidity position, the bank's prudential regulators could have told the FHLBSF to stop advancing to SVB, but they did not. If anything, the FHLBSF advances bought time for the regulators to execute a more orderly liquidation than would have otherwise been possible.

[75] Yale School of Management (2024). Federal Home Loan Bank (FHLB) Advances to Banks that Failed from 2006 to December 31, 2023 (Source: FDIC). https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=3649&context=ypfs-documents2.

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