Basics Of Bank Regulators' Push For Discount Window Use

By **James Bergin, David Freeman and Trevor Kirby** (February 29, 2024)

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The discount window is currently in focus for the federal banking agencies. In reflecting on the banking turbulence of the spring of 2023, officials at the banking agencies have highlighted the importance of liquidity risk management and, in particular, banks' operational readiness to use the Federal Reserve's discount window.

This article offers a short primer on the discount window and a discussion of recent policymaker statements about it. It also covers the Federal Reserve's discontinuance of the Bank Term Funding Program, and recent supervisory remarks regarding liquidity risk in light of domestic and foreign banking turbulence.

As highlighted by Fed Vice Chair for Supervision Michael Barr and the Office of the Comptroller of the Currency's acting chief Michael Hsu, banks should ensure they are ready to use the discount window prior to acute stress events. Hsu also recently suggested the possibility of a new short-term liquidity requirement.

As the potential speed of deposit outflows continues to evolve, so too may liquidity requirements.

The Federal Reserve's Discount Window: A Primer

Under Section 10B of the Federal Reserve Act, the Federal Reserve may extend credit, generally on either an intraday or overnight basis, to most depository institutions chartered in the U.S., as well as U.S. branches and agencies of foreign banking organizations.[1]

Discount window lending occurs at each of the 12 Federal Reserve Banks through three main lending programs: primary credit, secondary credit and seasonal credit.

Primary Credit

Primary credit is generally available to all sound depository institutions, as determined by the relevant Federal Reserve Bank, using information from their primary regulator. Primary credit is available on a short-term basis, up to 90 days.

Secondary Credit

For those depository institutions not eligible to access primary credit, secondary credit may be extended on a very short-term basis, usually overnight. Subject to more restrictions than primary credit, these loans also come with higher rates and higher haircuts.

Seasonal Credit

Under the seasonal lending program, a depository institution with deposits of less than $500 million and demonstrated liquidity pressures of a seasonal nature may qualify for funding for

up to nine months of the calendar year.[2]

Terms and Procedures

Operating Circular No. 10 sets forth the terms and procedures under which Federal Reserve Banks extend credit through the discount window to depository institutions.[3] It also forms the lending agreement for Federal Reserve Bank advances.

Notably, all loans must be secured by collateral acceptable to the appropriate Federal Reserve Bank, and all discount window loans must be fully secured. Borrowers may contact the discount window staff at their applicable Federal Reserve Bank with questions.[4]

The Federal Reserve discloses discount window loans in the aggregate on a weekly basis and discloses individual borrowers after a two-year lag.[5] Stigma has been a long-running issue for discount window usage.[6]

Winding Down the Bank Term Funding Program

On March 12, 2023, the Federal Reserve Board announced the creation of the Bank Term Funding Program, offering loans to depository institutions that pledged U.S. treasuries, agency debt and agency mortgage-backed securities as collateral.[7]

Unlike the regular discount window, pledged assets were valued at par and were offered for terms up to one year. Authorized under Section 13(3) of the Federal Reserve Act, the BTFP was designed to assure the public that banks would have sufficient liquidity to safeguard deposits.[8]

The Federal Reserve Board has confirmed that the BTFP will cease making new loans to eligible depository institutions on March 11, 2024, as originally scheduled.[9]

Remarks by Vice Chair for Supervision Michael Barr

In December, the Federal Reserve's vice chair for supervision advised the banking sector that discount window access should figure prominently into liquidity risk management plans.[10] Barr's remarks echo that of other Federal Reserve officials and recent interagency liquidity guidance.[11]

Barr suggested that there are "two key aspects of discount window readiness." First, banks must be prepared to access the discount window by ensuring they have the appropriate legal agreements in place, of which most do. Moreover, banks should be "engaging in [discount window] testing through actual transactions at regular intervals." Most have not, observed Barr.

Second, banks should pre-position an adequate amount of collateral at the discount window. Noting that certain types of collateral may require additional time to pledge, Barr warned against bank expectations of immediate liquidity at the discount window, particularly for less liquid collateral.

Barr stated that the events of spring 2023 showed that banks could have had greater operational readiness to use the discount window, suggesting that there were "operational challenges in quickly identifying and moving collateral" to pledge. Barr advised that the lessons from the stress events of last spring could help other banks when facing less acute events.

Barr also emphasized that use of the discount window will not be viewed negatively. Rather, Barr identified the discount window as an important tool that banks should be ready and willing to use in both good and bad times. And given the speed of bank runs and the difficulty of raising funding quickly in private markets, Barr noted that "it may be necessary to reexamine our requirements, including with respect to self-insurance standards" — that is, liquidity requirements — "and to discount window preparedness."

Barr further observed that "the lessons from March also indicate that some forms of deposits, such as those from venture capital firms, high-net-worth individuals, crypto firms, and others, may be more prone to faster runs than previously assumed."

It is not clear yet just what alterations to self-insurance standards Barr has in mind. Federal banking authorities implemented a number of liquidity requirements for large banks in the U.S. in the wake of the financial crisis of 2008, including contingency funding plans; stress testing; high-quality liquid assets, or HQLA; the liquidity coverage ratio, or LCR; and net stable funding ratio requirements, or NSFR, as tailored to the size and type of the institution.

Barr has since reiterated challenges with the monetization of HQLA in times of acute stress.[12] At an economic policy conference on Feb. 14, Barr noted the challenges facing banks seeking to monetize HQLA that were designated as held to maturity. Barr observed that selling even a portion of a held-to-maturity portfolio could have resulted in a firm "needing to recognize losses across the entire portfolio."

Barr reported that the Federal Reserve has seen banks reduce reliance on held-to-maturity HQLAs, adjust the composition of HQLA portfolios and enhance the ability to tap different sources of liquidity, including the discount window. To achieve individual firm resilience and wider financial stability, Barr committed to improving discount window operations, "while banks do their part to get operationally ready."

After the events of last spring, the Basel Committee on Banking Supervision published a report on the regulatory and supervisory implications of the recent bank failures, both with respect to domestic organizations and Credit Suisse.[13] The Basel Committee's October report reflected on such matters as whether assets treated as HQLAs were actually available for use, whether firms were reluctant to utilize liquidity when it might cause them to draw down below their LCR requirements, and whether the LCR and NSFR were properly calibrated in general, including to take account of the speed of deposit outflows.

The report indicated that international supervisors will be taking a hard look at both regulatory requirements and supervisory standards for liquidity management. This carries the potential implication of effects on domestic standards.

Remarks by Acting Comptroller Michael J. Hsu

On Jan. 18, the acting comptroller of the currency gave a speech in which he sounded similar notes as Barr about the need for readiness to use the discount window, including identification and pre-positioning of collateral. In addition, Hsu suggested that a new liquidity measure, requiring "midsize and large banks to have sufficient liquidity to cover outflows over a five-day period," warrants serious consideration.[14]

According to Hsu, the numerator of this measure "should consider the liquidity value of pre-positioned discount window collateral, in addition to reserves," while the denominator

should consider uninsured deposit outflows. He advised that this same rule should also clarify "operational preparedness expectations" by the prudential regulators and perhaps even require banks to conduct periodic test draws at the discount window.

Hsu's proposal hopes to address two hurdles related to discount window access. First, Hsu suggested that there exists a discrepancy between the timing during which depositors can make withdrawals and banks can monetize assets. To account for the speed at which withdrawals can be made, Hsu suggested banks identify assets that can be pre-positioned and pledged at the discount window. Moreover, Hsu advised that banks periodically borrow from the discount window to ensure operational familiarity.

Second, Hsu suggested that his proposal could help to combat the stigma surrounding discount window borrowing. Despite regulatory pushback, Hsu noted that banks continue to worry "that news of their borrowing from the discount window could be perceived as a sign of weakness, thereby exacerbating a [bank] run."

Although Hsu emphasized the need to destigmatize use of the discount window, he also warned against inappropriate overreliance. For Hsu, a new regulatory rule could provide the space to balance "appropriate discount window usage ... while maintaining anti-bailout conservatism."

Takeaways

By facilitating the flow of credit to the economy, the Federal Reserve's discount window will continue to serve as an important tool for banks. The speed of the events of last spring seems to have renewed regulatory interest in short-term liquidity risk management and operational readiness.

As such, banks should expect regulators to continue to push for regular testing of discount window access, as well as identify and pre-position an adequate amount of collateral for borrowing. This has been a consistent theme of policymaker remarks and official guidance over the last year.

Nonetheless, stigma against discount window use has been a persistent issue for decades, despite official messaging. It is unclear whether the official encouragement, without more, will actually lead to more robust discount window usage, especially in an environment of concern about faster deposit flight more generally.

Regarding Hsu's proposed liquidity measure, it is also unclear whether other banking agencies will rally around his suggestion, or look to other adjustments to regulatory requirements or supervisory expectations. Recent Basel papers may offer a clue.

The Basel Committee's report suggests further study of the design and operationalization of liquidity requirements broadly.[15] The report emphasizes greater supervisory focus on liquidity going forward, with the possibility of modified requirements as supervisors grapple with the implications of deposits and funding that are not quite as sticky as they expected.

Independently, the Group of Thirty, or G30, a body comprised of eminent current and former economic and financial leaders, recently published a high-profile report taking stock of the events of March 2023. The January report focused on improving lender-of-last resort regimes.[16] The G30 made recommendations about how the discount window in the U.S. could be made more efficacious, including recommendations about pricing, terms of lending, stigma and, significantly, the mandatory pre-positioning of collateral sufficient to cover all

runnable liabilities.

Making pre-positioning mandatory might go a way toward combating the stigma against the discount window, yet it may also lead to a significant reshaping of banks' current funding profiles in ways that are hard to contemplate without substantial further work.

Still, the G30 report demonstrates that there may be continuing evolution in this space in the years ahead. As regulators continue to contemplate new realities, the interaction of liquidity regulation and backstop lending remains in flux.

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[1] See 12 U.S.C. § 347b; The Discount Window, Fed. Rsrv. Discount Window (Last Updated Aug. 28, 2023) ("By law, depository institutions that maintain reservable transaction accounts or nonpersonal time deposits (as defined in Regulation D) may establish borrowing privileges at the Discount Window."). https://www.frbdiscountwindow.org/Pages/General-Information/The-Discount-Window#eligibility.

[2] See Discount Window Lending, Bd. of Govs. of the Fed. Rsrv. Sys. (Dec. 29, 2023), https://www.federalreserve.gov/regreform/discount-window.htm; Discount Window, Fed. Rsrv. Bank of New York (last visited Feb. 1, 2024), https://www.newyorkfed.org/banking/discountwindow.

[3] https://www.frbservices.org/binaries/content/assets/crsocms/resources/rules-regulations/071613-operating-circular-10.pdf.

[4] See id.; Credit and Liquidity Programs and the Balance Sheet, Bd. of Govs. of the Fed. Rsrv. Sys. (May 13, 2021). https://www.federalreserve.gov/monetarypolicy/bst_lendingdepository.htm.

[5] See Federal Reserve Balance Sheet: Factors Affecting Reserve Balances - H.4.1, Bd. of Govs. of the Fed. Rsrv. Sys. (Updated Jan. 25, 2024). https://www.federalreserve.gov/releases/h41/.

[6] See Mark Carlson and Jonathan D. Rose, Stigma and the Discount Window, Bd. of Govs. of the Fed. Rsrv. Sys. (Dec. 19, 2017). https://www.federalreserve.gov/econres/notes/feds-notes/stigma-and-the-discount-window-20171219.html.

[7] https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm.

[8] See 12 U.S.C. § 343(3).

[9] See Federal Reserve Board Announces the Bank Term Funding Program (BTFP) Will Cease Making New Loans As Scheduled on March 11, Bd. of Govs. of the Fed. Rsrv. Sys. (Jan. 24, 2024). https://www.federalreserve.gov/newsevents/pressreleases/monetary20240124a.htm.

[10] https://www.federalreserve.gov/newsevents/speech/barr20231201a.htm.

[11] See Lorie K. Logan, Ample Reserves and the Friedman Rule, Fed. Rsrv. Bank of Dallas (Nov. 10, 2023), https://www.dallasfed.org/news/speeches/logan/2023/lkl231110; Michelle W. Bowman, Considerations for Revisions to the Bank Regulatory Framework, Bd. of Govs. of the Fed. Rsrv. Sys. (May 19, 2023); Bd. of Govs. of the Fed. Rsrv. Sys. et al., Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plans (2023), https://www.federalreserve.gov/newsevents/speech/bowman20230519a.htm.

[12] https://www.federalreserve.gov/newsevents/speech/barr20240214a.htm.

[13] See Basel Committee on Banking Supervision, Report on the 2023 Banking Turmoil (2023).

[14] https://www.occ.gov/news-issuances/speeches/2024/pub-speech-2024-4.pdf.

[15] See Basel Committee on Banking Supervision, Report on the 2023 Banking Turmoil 24-25 (2023).

[16] See Group of Thirty, Bank Failures and Contagion: Lender of Last Resort, Liquidity, and Risk Management (2024).