The discount window and liquidity regulations

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Outline

- Discount window basics
- Liquidity regulation basics
- Meetings with bank treasurers
- Discount window borrowing capacity and liquidity regulations

Discount window, a little history

- The Panic of 1907 was made worse by rigid reserve requirements and finite reserves. Even when banks still had reserves, they shut their doors to depositors to avoid violating their requirements.

- The Fed was created in 1913 in part so banks could be confident that they could borrow against loan collateral (“discounts of commercial paper”) to replenish their reserves.

- Access to the discount window also made it safe to reduce reserve requirements, increasing the amount that banks could lend.

Discount window history, some relevant quotes

“Each bank retreats into its own citadel at the sound of danger and at a time when it should be drawing upon its reserves to help the business man of the community, it stays aloof, piling up reserves like Pelion upon Ossa, and the business men have to care for themselves as best they can. Witness the condition of some of our banks during the financial panic of 1907, with reserves of 60 and 70 per cent, although the legal requirement was 15 per cent.”
Charles Hamlin, First head of the Federal Reserve Board, 1914

“The mobilization of reserves and the turning of commercial paper into a liquid investment, will enable every bank to draw down its reserves with confidence that it can replace them at will if it has proper commercial paper at its disposal.”
Charles Hamlin

“This system has also made it perfectly safe to cut down the amount of reserves required to be kept. In the country banks, for instance, 15 percent of deposits are now required to be kept as reserves and cannot thus be used. It is perfectly safe to cut this down to 12 per cent as the Glass bill does, because if more money is needed it is instantly obtainable. This cut of 3 percent will release many millions of dollars for use in commerce and production.”
Rep. Samuel Beakes (D-MI)

Global Financial Crisis and liquidity assessments

- Prior to the GFC supervisory liquidity assessments emphasized diversified reliable funding and the ability to borrow from the discount window.
- After the GFC, assessments are based primarily on the amount of "high-quality liquid assets" (HQLA).
- Two weeks before SVB failed, I argued that this shift was a mistake and called for a holistic review of liquidity requirements.
- In the event, SVB failed awash in HQLA in part because it was funded with non-diversified unreliable liabilities and unable to borrow from the discount window.

Discount window laws and regulations

- The Fed extends regular discount window loans to depository institutions as collateralized advances (not discounts anymore) under Section 10B of the Federal Reserve Act.
    - The Fed Board sets the terms and conditions in Regulation A, but each Reserve Bank makes its own lending decisions.
    - The loans must be collateralized and generally cannot exceed four months maturity.
    - The Fed is discouraged by FDICIA (1991) from extending a loan to a critically undercapitalized bank for more than 5 days.
- The Fed extends emergency loans to nonbanks under Section 13(3) of the FRA.
- Details on individual regular loans including identity of the borrower are published after 2 years, on emergency loans after 1 year.

Types of regular discount window loans

- **Seasonal credit** is provided to small banks with seasonal swings in deposits and loan demand.
  - The credit is intended to allow the banks to lend more to their community rather than maintain stockpiles of securities to buffer their funding swings.
- **Primary credit** is provided to sound financial institutions (CAMELS 1, 2 or 3 rated and adequately capitalized) on a no-questions-asked basis at an above-market rate.
- **Secondary credit** may be provided to banks that do not qualify for primary credit as a bridge to better condition or to resolution.

Standing Repo Facility

- In July 2021, the Fed opened a new lending facility – the standing repo facility (SRF)
- The facility conducts fixed-rate, full-allotment auctions of overnight repos of Treasuries and agency MBS once each day at 1:30 PM.
- The SRF charges the same rate and applies essentially the same haircuts as the discount window.
- Primary dealers are counterparties and banks that sign up (33 so far).
- The Fed's objective was for the SRF to look and feel different from the discount window, hoping there would be no stigma against using it.
- Also intended to reduce repo market volatility but may not be helpful because hedge funds are not counterparties.

Discount window collateral

- The Fed seeks to take all bank assets as collateral.
  - The Fed needs to be able to value the asset and get a perfected security interest.
- The Fed applies conservative haircuts to the fair (not par) value of the assets.
- Collateral is prepositioned. Banks maintain pools of collateral at the window to secure borrowing if needed.
  - At the end of 2023, there was $2.8 trillion in collateral prepositioned (lendable value).
- 80 percent of collateral is loans. 40 percent is consumer loans, 20 percent is business loans.
- Loan collateral is maintained in borrower-in-custody (BIC) arrangements – the bank keeps the loan documents.

Liquidity requirements, Basel III

- Liquidity Coverage Ratio (LCR): Requires banks to have more HQLA than projected net cash outflows under stress at the end of 30 days.
  - HQLA consists mostly of reserve balances, Treasury securities and agency MBS.
  - HQLA is calculated at market value (including securities classified as held-to-maturity).
- Net Stable Funding Ratio (NSFR): Requires banks to have sticky liabilities to fund core assets over 1-year.
- These are not the binding requirements for most banks.

Liquidity requirements, U.S. specific

- The two sets of liquidity requirements that matter the most are not part of Basel III: Internal liquidity stress tests (ILSTs) and resolution-related liquidity requirements.

- Large banks are required to conduct ILSTs at the overnight, 30-day, 90-day, and one-year horizon, and report results to their examiners monthly.

- The largest banks must satisfy two liquidity requirements as part of resolution plans: The Resolution Liquidity Adequacy and Positioning (RLAP) and the Resolution Liquidity Execution Need (RLEN) requirements.

Feedback from bank treasurers

- So far in 2024, I have met with 17 bank treasurers and their teams to discuss how they manage liquidity risk, liquidity regulations, use of FHLBs, and views of the discount window.
  - Regional banks, GSIBs, FBOs, custody banks.
- Dealing with liquidity stress
  - Banks adjusted to the deposit outflows in 2022 by borrowing from FHLBs and other wholesale funding sources.
  - Banks adjusted to the prospect of a run in 2023 by borrowing more from FHLBs or other sources to build up cash holdings.
  - Held-to-maturity securities are as liquid as available-for-sale securities.
    - They can be repo’d or used as collateral at SRF or the discount window.
- Deposit stickiness
  - Deposits of customers with long-standing relationships, collateralized deposits, and deposits used for business operations are stickier.
  - Excess deposits built up during Covid are flighty.
  - IntraFi and higher deposit rates may be offered to flighty large depositors.

Feedback on discount window and FHLBs

- Discount window
  - Reminded one treasurer of her childhood in Bulgaria.
  - Collateral procedures antiquated.
  - Conflicting messages from discount officers and supervisors over many years.
  - 2003 revisions were working, but GFC aftermath supercharged stigma.
  - Lots of concern about investors' views of borrowing.
- FHLBs
  - Banks use FHLBs all the time for BAU asset-liability management.
  - Operations more user friendly and business-like than discount window.
  - FHLBs only assign lendable value to mortgage-related collateral but are also secured by a blanket lien.
    - For each commercial bank, the relevant FHLB and FRB work out a collateral sharing agreement in which the FHLB subrogates its interest on specific types of loans, often consumer or business loans.

Feedback on examination

- Internal liquidity stress tests are divorced from how banks deal with liquidity risks.
  - The risk manager investigated how long a municipality would take to shift the deposit relationship—6 months—but the examiner insisted on sticking with the LCR assumption of a 25 percent outflow each month.
- Banks cannot cite the discount window or the standing repo facility as the means of converting HQLA into cash in their ILSTs.
  - One treasurer was recently told he could count the SRF but not the discount window, so he now has collateral at FHLB, discount window, and BNY Mellon. It takes a day to move collateral between locations.
- Examiners have hammered home that borrowing from the discount window is not OK.

Liquidity requirements do not recognize a bank's capacity to borrow from the Fed

- Internal liquidity stress tests are typically the most binding liquidity requirements. Banks cannot anticipate using the discount window or (maybe) the standing repo facility to monetize their HQLA.

- The LCR does not give credit for discount window borrowing capacity.

Why should liquidity requirements give credit for discount window capacity?

1. Recognizing the ability to borrow from the central bank makes the assessments more accurate.
2. It enables banks to keep lending to businesses and households, pledging those loans to the Fed, rather than holding more reserve balances.
3. Efforts to convince banks it is ok to borrow ring hollow if banks are not allowed to anticipate borrowing in their liquidity stress tests.
4. It creates an added incentive for banks to be prepared to borrow.

- SVB was considering setting up the capacity to borrow from the SRF but lost interest when it learned that it would not count toward its ILST.

Ways to recognize DW capacity in liquidity assessments

- Add a new requirement that banks have enough cash and DW borrowing capacity to meet a run on their deposits.
  - Some variant of this appears to be under development.
- Maturity mismatch add on
  - The international standard for the LCR requires each bank to have enough HQLA to meet its funding need at 30 days.
  - The U.S. version requires banks to meet *peak* need over 30 days.
  - The difference is called the "maturity mismatch add-on."
  - DW borrowing capacity should be subtracted from the add-on.
  - The change would be Basel-compliant
- Internal liquidity stress tests
  - Banks cannot assume that they monetize their HQLA using the discount window or the standing repo facility.
  - Allow them to do so.
- Discount window borrowing capacity should not be counted unless banks are willing to borrow.

Committed Liquidity Facilities

- CLFs are collateralized, guaranteed, lines of credit from a central bank sold to commercial banks for a fee.
- The international standard for the LCR and the U.S. final rule both recognize CLFs as a potential valid source of liquidity. Could also be recognized in ILSTs.
- The Fed could sell the lines for a market-based fee on total capacity and charge an above-market rate on draws on the line.
    - Lines could only be canceled with 31-days notice, guaranteeing capacity over the LCR's 30-day horizon.
    - Draws would be regular discount window loans backed by discount window collateral.
- **Advantages**: Eliminates ambiguity, reduces moral hazard (banks are self-insuring), lessens stigma (banks are buying the access), earns money for taxpayers.
- **Disadvantages**: Fed has to commit to lend, canceling line for a financially unsound bank would be an accelerant (could switch to secondary credit), slightly Basel-noncompliant.

Additional readings

"Is It Time For a Holistic Review of Liquidity Requirements?"
https://bpi.com/wp-content/uploads/2023/02/Is-it-Time-for-a-Holistic-Review-of-Liquidity-Requirements.pdf

"10 Pitfalls to Avoid When Designing Any Additional Liquidity Requirements"
https://bpi.com/wp-content/uploads/2024/02/10-Pitfalls-to-Avoid-When-Designing-Additional-Liquidity-Requirements.pdf

"The Middle Course: What Fed History Teaches Us About Liquidity Requirements."
https://bpi.com/wp-content/uploads/2023/09/The-middle-course.-What-Fed-history-teaches-us-about-liquidity-requirements.pdf

"Against What Liquidity Risks Should a Bank Self-insure?"
https://bpi.com/wp-content/uploads/2022/12/Against-What-Liquidity-Risks-Should-a-Bank-Self-Insure.pdf

"Discount Window Stigma: We Have Met the Enemy, and He Is Us."
https://bpi.com/discount-window-stigma-we-have-met-the-enemy-and-he-is-us/

"Central Bank Contingency Funding in Resolution Plans."
https://bpi.com/central-bank-contingency-funding-in-resolution-plans/

"CLF Notes – What is a Committed Liquidity Facility?"
https://bpi.com/clf-notes-what-is-a-committed-liquidity-facility/