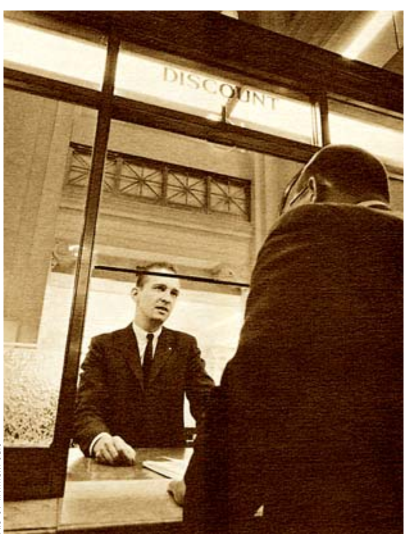
Ready to Lend

The Discount Window's Evolving Role as a Liquidity Lifeline for Depository Institutions

BY CHARLES GERENA



FRB OF MINNEAPOLIS

In the early days of the Federal Reserve, bankers visited the discount window when they needed to borrow reserves unexpectedly.

In the past, people visited their friendly neighborhood banker to borrow money for a new house. Now, consumers can get mortgages online.

In the early days of the Federal Reserve System, bankers visited the friendly neighborhood discount window to borrow reserves when there was a run on deposits or an unexpected rise in loan volume. They brought their collateral to a teller window at a Federal Reserve Bank.

The window doesn't operate from the lobby of the Richmond Fed's downtown office anymore. It occupies a corner of the 18th floor, where the men and women of the Loans Department work the phones and computers to help depository institutions establish lending agreements and pledge collateral.

The department's most significant activity isn't processing loans, though. "We make a handful of loans a month on average, but we have to be prepared to lend to hundreds of institutions," says Senior Manager Gregory Robinson. "We have to constantly monitor the collateral that would secure those loans if institutions come to us."

Borrowers also don't have to physically take their collateral to the Fed. They can pledge assets, such as a portfolio of consumer or commercial loans, and maintain possession of them.

Amid these and other changes, the mission of the discount window remains — to relieve liquidity strains on individual institutions and the banking system as a whole. Over the years, the Fed has tried to balance the window's role in keeping financial markets stable against the need to curtail lending that may unintentionally support financially troubled institutions.

The latest attempt to address this issue was in January, when the Fed reorganized the window's operations. To understand the significance of these changes, however, they must be viewed against the backdrop of the discount window's continuing evolution.

When the Federal Reserve System was created in 1913, the discount window was its primary instrument of monetary policy. By affecting the amount of reserves held by banks, the Fed could influence the amount of money and credit available in the U.S. economy.

The window provides reserves through two vehicles — discounts and advances. With the former, a bank provides the Fed with an asset like a short-term business loan. In return, it receives credit equal to the asset's value at maturity minus a "discount" based on the discount rate, which is the interest charged on the loan. When the asset matures, the Fed returns it to the bank and receives a cash payment equal to the maturity value.

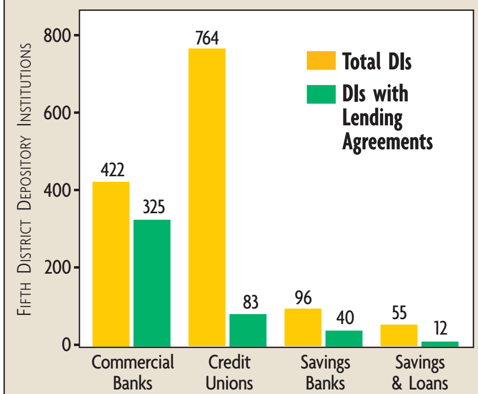
An advance is much simpler than a discount. A bank pays interest at the discount rate to receive a loan from the Fed against acceptable collateral. Currently, the window supplies all of its reserves in the form of advances.

Each of the Federal Reserve's 12 banks could change the discount rate in response to economic conditions in its district. When the supply of money and credit tightened, it lowered the rate and made it easier for banks to increase their reserves. When there was too much money, it made it harder for banks to boost reserves. (Today, discount rates across the Federal Reserve System are normally in sync.)

The discount window remained the

Who Knocks at the Window?

About 460 of the Fifth District's 1,300 depository institutions have lending agreements with the discount window. The other 11 Federal Reserve Districts combined have about the same ratio of institutions ready to use the window—5,500 out of 16,700.



SOURCE: Federal Reserve Bank of Richmond

Federal Reserve's dominant monetary policy tool until the effectiveness of Open Market operations emerged in the 1920s. Through this tool, the Fed buys government securities to pump money into the financial markets, or sells securities to absorb money. Open Market operations are effective only when financial markets are broad and deep, and America's markets had reached that point.

George Kaufman, director of the Center for Financial and Policy Studies at Loyola University, Chicago, points out several advantages of Open Market operations. "It reduces the political pressures on [the Fed] to assist all entities in financial distress, in particular, financially weak but politically strong entities," he wrote in a November 1999 paper. "The private market is less likely to direct additional funds ... to such entities."

Also, "efficient markets price funds provided through Open Market operations at the current market rate for the particular risks involved. In contrast, funds provided through the discount window are priced administratively and, if priced incorrectly, may both misallocate resources and reduce the effectiveness of the assistance."

As Open Market operations took center stage at the Fed, the discount window stepped into the sidelines in subsequent decades. According to economist Allan Meltzer at Carnegie Mellon University, the Fed discouraged banks from window borrowing. "They took the position that borrowing was a privilege, not a right," explains Meltzer, who recently wrote a historical account of the Federal Reserve from 1913 to 1951. "In the early days, they would do it by restricting the kind of collateral that they would take. Later ... they would talk to banks about [the potential problems of] continuous borrowing."

Staff at the discount window explained that credit was intended only to meet unexpected shortfalls in reserves on a limited basis. Also, Federal Reserve regulations required borrowers to exhaust all other sources of credit before coming to the window. A depository institution wasn't supposed to borrow from the window to boost its normal lending capacity, or to exploit the spread between the discount rate and the federal funds rate, which is the interest that institutions charge to borrow reserves from each other.

At the same time, alternative sources of credit expanded like the federal funds market, which Meltzer believes is more efficient than window borrowing because reserves flow to where they are most needed. Bankers also learned to manage their reserves better.

Window volume spiked during the 1980s when reserves flowed to troubled savings and loans, but it has generally remained low as the discount window began to be regarded as "a lender of last resort." Institutions have obtained credit from other sources, including the federal funds market, the nationwide Federal Home Loan Bank System, and larger institutions with which they have a correspondent relationship.

According to the team at the Richmond Fed's discount window, large complex banking organizations in the Fifth District don't frequent the window very often. "But when they come, they usually have a big need," notes Robinson. "Something has happened in the financial markets, and they can't get the funds that they need."

A prominent example was Sept. 12, 2001, the day after terrorists struck the World Trade Center and the Pentagon. Loan volume reached $45 billion that day. But there have been other instances when large banks have employed the window. For example, The Bank of New York got a $23 billion loan in 1985 when a computer glitch interrupted its transaction processing.

Regional and community banks usually borrow small amounts of reserves periodically for less dramatic reasons, says Rebecca Snider, assistant vice president of the Loans Department. It can be late in the afternoon and a bank official realizes that reserves are running short due to human error or an operational problem.

But, smaller institutions visit the discount window more often than larger ones because they have fewer funding sources with earlier cutoff times for filing requests, notes Nita Tinsley, one of the department's senior analysts. "We are here 'til the cows come home, or a half hour afterwards." (The window stays open 30 minutes after the close of Fedwire, which transfers funds between depository institutions until 6:30 p.m.)

Bad weather also accounts for some window borrowing by smaller institutions. Tinsley says that even when bank employees can't make it to work, transactions still post to the institution's reserve account. "Bankers don't know what their balance is, so they'll call to get the balance and borrow to cover whatever is needed."

Seasonal changes don't drive smaller borrowers to the Fifth District's discount window as they do elsewhere. Normally, seasonal credit flows from the window into agricultural communities because farmers withdraw funds and request loans at the beginning of every growing season to plant crops. This can drain a bank's deposits and increase loan volume, explains Robinson. But agriculture is more prominent in other regions like the Midwest.

Whether it's a snowstorm or a

blackout, depository institutions of all sizes never know when a sudden shortfall in reserves will occur and credit won't be available. That's why Snider thinks they should establish access to the discount window before something happens. Lending agreements have been executed in just a few days during emergencies, but it is generally "not a quick process."

As of January, more than three-quarters of the Fifth District's 422 commercial banks had lending agreements with the window. But less than half of the region's 96 savings banks and only 11 percent of its 764 credit unions have such agreements (see graph on p. 3).

This brings us back to an important question—why don't more institutions use the window? One reason has been the stigma associated with window borrowing. No one is supposed to know about the transaction beyond the parties involved. However, examiners from various regulatory agencies, including the Fed, periodically review all of the loans on a bank's balance sheet. Therefore, bank officials have hesitated about using the window too often because it might serve as a red flag.

Also, the banking industry can often tell when someone borrows from the window, which can raise questions about the institution's financial strength. "If a large institution is in the marketplace looking for a large volume of money and all of a sudden it drops out, there is an assumption that it went to the window, especially if within that district there was a large amount of borrowing reported for that week," says Snider.

Another reason why depository institutions have been reluctant to borrow from the discount window is the time and effort involved with the application process. Also, it may take time for window staff to assess the borrower's collateral. Some forms of collateral are straightforward to evaluate, such as U.S. Treasury and agency securities, and investment-grade debt issued by state and local governments. But consumer and commercial loans can take longer to review, as well as new types of securities that the Richmond Fed hasn't dealt with before.

Last October, the Federal Reserve's Board of Governors approved changes to address the issues that have been blamed for discouraging appropriate use of the discount window. These changes went into effect Jan. 9.

The Fed eliminated the window's adjustment credit and extended credit programs. The former loaned reserves on a short-term basis while the latter provided loans over a longer time period, but only under exceptional circumstances. (The seasonal credit program wasn't changed.)

Two new programs have taken their place. Primary credit is extended for very short terms like adjustment credit, but Federal Reserve Banks must charge a discount rate that is above the federal funds rate. Secondary credit for banks that don't qualify for primary credit must be priced even higher. (In January, the discount rate for primary credit was 100 basis points above the Fed's target for the federal funds rate, while the rate for secondary credit was 50 basis points higher than primary credit.) Previously, adjustment credit was priced at the discount rate, which has been consistently lower than the federal funds rate since 1990.

Pricing window credit above the market rate is intended to create an economic disincentive for excessive borrowing, which is how many central banks operate their discount windows. This will substitute for what George Kaufman calls the Fed's "gentle persuasion" and scrutiny of borrowers. Fewer questions, if any, will be asked when a borrower comes to the discount window. Any financially sound institution can obtain credit for any purpose. Also, borrowers are not required to exhaust all market sources before utilizing the window.

The Board of Governors also approved these changes to address the perception that banks resort to window borrowing only when they are in financial trouble. Plus, it wanted to make borrowing administratively easier.

In 1980, Congress allowed depository institutions that weren't members of the Federal Reserve System to borrow from the window. But in 1991, in the aftermath of the 1980s S&L crisis, lawmakers restricted borrowing by banks that didn't meet minimum capital requirements. "Discount window borrowing was providing capital for banks that were basically insolvent," notes economist Anna Schwartz of the National Bureau of Economic Research. "That was not what the Federal Reserve Act of 1913 intended the window to be used for."

What will be the role of the discount window in the future? Most economists agree that the financial markets need a back-up source of liquidity during emergencies. However, others argue that the window has little value as a monetary policy tool as long as the Fed can use Open Market operations to influence the supply of money and credit.

Of course, that could change if the federal government stops its deficit spending and resumes generating surpluses. "If we ever ran a series of surpluses and reduced the amount of government debt," says Allan Meltzer, this might leave fewer government securities for the Fed to buy and sell in its Open Market operations. "There would have to be another mechanism." **RF**

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