BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: July 19, 1999

To: Board of Governors

From: Staff[1]

Subject: Century Date Change Special Liquidity Facility

ACTION REQUESTED: Adoption of an amendment to Regulation A establishing a Century Date Change Special Liquidity Facility to make discount window credit readily available to depository institutions in sound financial condition from October 1, 1999, to April 7, 2000. Under this facility, loans would be made at a rate 150 basis points above the Federal Open Market Committee's target federal funds rate. The loans would need to be adequately collateralized, but, in contrast to adjustment credit, borrowers would not be required first to seek credit elsewhere, uses of funds would not be limited, and the loans could be outstanding for any period while the facility is open.

BACKGROUND**:** Depository institutions and their customers are now making plans to meet possible credit needs in the period around the century date change. Their planning is complicated by uncertainty about the cost and availability of funds to individual depositories in the period surrounding the rollover. Unusual liquidity strains might arise from the conversion of deposits to currency, heightened credit demands, greater lender and depositor caution, and potential market disruptions. While some banks may experience a surge in deposits as investors pull back from institutions and markets perceived as more vulnerable, the degree and incidence of shifts in liquidity demands and supplies are extremely difficult to predict. They could well involve pressures on small and medium-sized depositories that customarily are suppliers of funds to larger institutions and

1. Messrs. Kohn, Ireland, Schemering, Madigan, Clouse, Gillum, Nelson, and Ms. Martin.

markets. These smaller institutions might have difficulty obtaining relatively large volumes of funds because they typically do not have access to national funding markets and have limited borrowing relationships with other banks.

To a considerable extent, greater aggregate liquidity needs in reserve markets can be met using open market operations, as they are, for example, in November and December of each year when there is a large seasonal increase in demand for currency. However, forecasts of reserve market pressures will be subject to considerable uncertainty, and the normal distribution of reserves and liquidity through markets may be disrupted by the unusual funding situations of institutions and uncertainty about the status of potential borrowers. Volatility in the demand for reserves is likely to be compounded by a decline in required reserves as customers replace transactions accounts with currency and by a drop in required reserve balances at the Federal Reserve as banks augment their holdings of vault cash to meet potential customer demands. Consequently, undesirable tightness and distortions in short-term funding markets would be a possibility if reliance were to be placed almost entirely on open market operations to meet liquidity needs.

Depository institutions have been urged by their supervisors to make firm contingency plans for meeting unexpected liquidity demands, and they have been encouraged to make the Federal Reserve's discount window part of those plans. Although borrowing by depositories through the usual adjustment credit facility of the discount window should be adequate to meet most unusual needs and relieve possible pressures on credit markets, in practice depositories have been somewhat reluctant in the past to utilize such credit. Moreover, adjustment credit requires borrowers to seek funds elsewhere first, constrains the uses of the funds, and is normally very limited in duration. The Federal Reserve is prepared to be more flexible in the administration of the adjustment credit program over the year-end, but some underlying restraints on adjustment credit must necessarily remain because the basic discount rate is below market interest rates.

SPECIAL LIQUIDITY FACILITY: In May 1999, the Board requested comment on a Special Liquidity Facility designed to facilitate private-sector contingency planning and help ensure that aggregate liquidity needs are met in a period of possible unusual pressures associated with the century date change. This facility is intended to relieve these pressures by making collateralized Federal Reserve credit freely available at a rate above the FOMC's target federal funds rate. By ensuring the ready availability of funds from the Federal Reserve to qualified depository institutions, such a facility should enable depositories and their customers to enter into agreements to meet possible credit needs with greater confidence. The facility should also help to damp any tendency for money markets to tighten owing to inevitable difficulties encountered by the Desk in gauging the overall supply and demand for reserves each day.

Comments on key issues

The Board received ninety-two comment letters on the proposed Special Liquidity Facility. Virtually all the letters supported the creation of the Special Liquidity Facility. The commenters frequently noted that even though the financial services industry was well prepared for Year 2000, the facility would provide a desirable degree of certainty that funds would be available to meet liquidity demands around year-end. Only three commenters opposed the facility, all of them stating that existing discount lending programs would be sufficient to meet year-end funding contingencies. The comments generally focused on five issues: the lending rate, the period of operation, eligibility, differences from adjustment credit, and collateral.

Rate. The Board proposed that credit under the Special Liquidity Facility be available at a spread over the Federal Open Market Committee's target federal funds rate. The Board tentatively proposed that the spread be set at 150 basis points, but specifically requested comment on whether the size of the proposed spread is appropriate.

Nearly 20 percent of the writers endorsed the facility without commenting on the proposed lending rate, and another 10 percent specifically stated that a 150 basis point spread was appropriate. However, about 70 percent suggested that the lending rate be set at a lower spread. Of these, nearly 20 percent stated they preferred a spread of 50 basis points, while the remainder were divided about evenly between those requesting less than 50 basis points, 75 basis points, 100 basis points, or simply stating the spread should be below 150 basis points. The commenters offered a variety of reasons why a lower spread would be desirable. Several stated that a rate of 150 basis points over the target federal funds rate is so far above their typical cost of funds that use of the facility would seriously reduce their profits, placing an undue burden on their institutions. Others stated that the proposed spread would discourage use of the facility until liquidity problems had become acute, noting that a lower spread would be sufficient to promote private-sector arrangements. Many institutions expressed concern that the proposed spread would become the standard for the pricing of year-end lines of credit. A few banks observed that institutions would not borrow at the proposed spread for fear that it would be taken as a sign of distress.

The lending rate should be high enough to encourage institutions to continue to make private-sector arrangements to meet potential funding needs, but low enough to provide a reasonable backstop should, contrary to the Board's expectations, concerns about the century date change, or the change itself, begin to put strains on funding and credit markets. It is difficult to determine precisely what spread fits these criteria in part because loans under the facility could be used for a variety of purposes and may be extended to a disparate set of depository institutions. A relatively narrow spread still may be high enough to offer incentives to large financial institutions of unquestioned credit quality with access to money and capital markets to seek private-sector alternatives to the facility, but a wider spread may be required for other institutions that are smaller or for whom markets perceive a significant credit risk.

A related difficulty in selecting a spread is that there are no close analogues to the facility against which to compare the pricing. Unlike most private or government agency alternatives, the Special Liquidity Facility requires no fee to establish and may be drawn on and repaid at any time over the life of the facility without penalty. The Federal Home Loan Banks (FHLBs) have been offering their members Y2K funding alternatives, but these typically involve restrictions, fees, or other costs not present in the Special Liquidity Facility. The implicit prices of FHLB alternatives range from well above that proposed here for the facility to somewhat below, depending on the length of time over which the fees are prorated. Informal discussions with commercial banks suggest secured lines of credit to high-quality, large banks would be priced at only a few basis points over LIBOR, but the spread on a similar line to small banks would be over 100 basis points (LIBOR is now about 25 basis points above the federal funds rate). Other central banks have arrangements through which they lend reserves overnight at a penalty rate. The spreads on these facilities range from 25 basis points in Canada, to 200 basis points in Switzerland; several central banks, including the European Central Bank, charge 100 basis points.

On balance, the staff believes that a spread of less than 150 basis points might not be sufficient to assure that many depositories still would have incentives to make private sector arrangements to meet potential shifts in the supplies of, and demands for, liquidity. Furthermore, a spread of 150 basis points probably is low enough to provide a reasonable backstop if concerns about the century date change or disruptions associated with the change itself begin to put strains on funding and credit markets, especially if these strains are short-lived. The federal funds rate has reached highs in excess of 150 basis points above the target rate on more than one-third of the final days of reserve maintenance periods since the beginning of 1994. A spread of 150 basis points is also well within the range of year-end premiums observed in the commercial paper market in past years.

Period of operation. The Board proposed that credit under the Special Liquidity Facility be available from November 1, 1999, to April 7, 2000. The Board requested comment on how long the facility should be open, in particular whether it should begin earlier.

A majority of commenters either expressed general approval of the facility as described, or specifically endorsed the start and stop dates. However, a significant minority--one-fourth--suggested an earlier start date, and a few commenters suggested either a later ending date or flexibility on the stop date depending on circumstances. Among those suggesting an earlier start date, most proposed the beginning of October, although a few requested September, August, or as soon as possible. A majority of those advising an earlier opening pointed to the need to fund a buildup of vault cash earlier in the fall as a reason. More broadly, other commenters stated that an earlier start date would be a prudent response to the great uncertainty about demands for liquidity in the fourth quarter, including the possibility that cash withdrawals could begin sooner than generally anticipated.

In light of these comments, the staff recommends that the facility be made available beginning October 1, 1999. The facility is meant to provide assurance to financial institutions that funds will be available if unforeseen difficulties arise. Given the expressed view that such insurance would be desirable earlier than proposed, there appears to be little reason not to open the facility sooner. The staff recommends the Board retain the closing date of April 7, 2000; the Board could at a later time move back the closing date if conditions warrant.

<u>Eligible borrowers</u>. The Board proposed that the Special Liquidity Facility would be available only to depository institutions in sound financial condition, specifically limiting eligibility to adequately and well capitalized institutions. With respect to branches and agencies of foreign banks, credit under the Special Liquidity Facility would be available only to a borrowing bank that meets the Basle Capital Accord's minimum standards for capital and is otherwise considered to be in sound financial condition.

Many commenters requested that loans under the facility remain available to depository institutions whose capital ratios have temporarily fallen below regulatory standards but otherwise remain sound. These commenters expressed concern that draws on lines of credit by correspondents or other institutions around the century date change or flight-to-quality inflows of deposits could expand their balance sheets, lowering their capital ratios until those unusual flows were unwound. An important purpose of the Special Liquidity Facility is to encourage depository institutions to extend lines of credit over year-end. Therefore, staff recommends that the eligibility for borrowing under the facility not be tied automatically to meeting minimum requirements for being adequately capitalized. Borrowers that had been adequately capitalized and in sound financial condition but whose capital ratios fell below minimum regulatory standards would be expected to consult with their lending Reserve Bank. In judging whether such a borrower remained in sound financial condition and should continue to have access to the facility, the Reserve Bank would take into account whether the decline in capital ratios owed to temporary balance sheet distortions associated with the century date change, as well as the financial condition of the institution before those distortions occurred. Even where an institution meets minimum capital requirements, a Reserve Bank may determine that the institution is not in sound financial condition and therefore is ineligible to borrow under the Special Liquidity Facility. As a part of making such determinations, the Board or Reserve Bank may discuss an institution's financial condition or other matters related to the loan with its U.S. supervisor or, in the case of a foreign bank, its home country supervisor or central bank.

Differences from adjustment credit. Special Liquidity Facility credit would differ from adjustment credit in several ways meant to provide greater flexibility and increase depositories' willingness to borrow. Borrowers would not be required to exhaust alternative liquidity sources, and there would be no limit on the use of funds. Furthermore, there would be no requirement that credit be repaid expeditiously; credit can remain outstanding until the program expires. Nor would Reserve Banks monitor or require additional reports of borrowers under the Special Liquidity Facility. Supervisory authorities may need to assess the condition of the borrowing institution if the use of Special Liquidity Facility credit is accompanied by signs of financial trouble. Borrowing itself, however, would not be taken as an indication of underlying problems and would not trigger intensified oversight.

Many commenters noted that placing few restrictions on borrowing should achieve the objective of making depository institutions willing to use the facility when needed. A couple of institutions expressing a desire for a lending rate lower than that proposed suggested that the Federal Reserve monitor borrowers to ensure they do not use the funds inappropriately. Such monitoring, however, conflicts with efforts to reduce the reluctance of borrowers to use of the facility.

Several commenters requested assurance that borrowing under the facility would not be required before adjustment credit would be available. Borrowing under the facility will not be considered a source of funds that would need to be exhausted before obtaining adjustment credit. Furthermore, institutions that experience a very short-term need for Federal Reserve credit (such as meeting reserve requirements on the last day of a maintenance period), including institutions that have loans outstanding under the Special Liquidity Facility, could continue to obtain regular adjustment credit at the basic discount rate.

A few commenters inquired whether there would be any restrictions on the number of loans under the facility, or whether there would be any penalty for early repayment. Borrowers will be able to adjust the amount they borrow as frequently as they desire, although all outstanding credit must be fully collateralized. Loans can be taken down and repaid at the borrowers' discretion at any time while the facility is operating, consequently there can be no penalty for early repayment. Technically, all discount window loans are payable on demand, and accordingly they have no maturities.

Collateral. The collateral requirements for the Special Liquidity Facility would be identical to those for other discount window loans--all loans must be adequately collateralized to the satisfaction of the Reserve Bank. This requirement has important implications for borrowing institutions. They generally would need to have executed the necessary borrowing agreements and to have pre-positioned collateral to have access to credit the day it is requested. Reserve Banks take loans of most types as well as securities as collateral, but in many cases Reserve Bank staff need time to determine the lendable value.[2] If many institutions that have not made collateral arrangements ahead of time request credit simultaneously, the resulting congestion could well prevent institutions from obtaining credit on the day they request it. For institutions in sound financial condition that have pre-positioned collateral, credit under the Special Liquidity Facility would generally be granted upon request, up to the predetermined lendable value of the collateral.

There were several requests that the procedures for positioning collateral be made simpler or that more types of collateral be acceptable. The Federal Reserve currently accepts an extremely broad range of collateral and staff strives to accommodate the needs of depository institutions seeking access to discount window credit. However, the Federal Reserve will work aggressively to expand the range of acceptable collateral and to expedite and make more flexible the procedures to accept collateral.

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2. Treasury and many agency securities can be pledged late in the day because they are easily valued and because they are recorded in the Federal Reserve's National Book Entry System (NBES). This system allows securities to be repositioned from a depository's safekeeping account to a discount window pledge account until 7:00 p.m. (Eastern Standard Time).

A few commenters requested clarification as to whether pre-positioned collateral and borrowing agreements established for adjustment credit would be sufficient to obtain access to Special Liquidity Facility credit. There will be no separate borrowing agreements, so those institutions that arrange, or have already arranged, access to adjustment credit will have access to Special Liquidity Facility credit. Similarly, pre-positioned collateral will be available to secure either type of credit.

Appendix

Summary of Additional Comments on Special Liquidity Facility (Docket R-1038)

This appendix discusses comments received on key issues other than those pertaining to the interest rate on SLF borrowing and the dates of operation of the program, which are discussed in detail in the memorandum. The commenters were distributed as follows:

Type of institution	Number
Commercial Bank	62
Trade Association	9
Savings Bank	7
Credit Union	5
Federal Reserve Bank	2
Investment Bank	2
Government Agency	2
Government Sponsored Agency	1
Clearing House	1
Consultant	1
Memo: Total	92

Collateral

Several commenters stated that the Board should expand the types of collateral that are eligible to be pledged for a loan under the Special Liquidity Facility. Commenters stated that they would like to pledge collateral held at the pledgor bank, eligible securities maintained at Euroclear, bank debentures and certificates of deposit (with a generic haircut of 15 percent), GNMA and municipal securities, corporate securities, and shares of mutual funds that invest in allowable fixed-income securities (which are commonly held by credit unions). One international bank commenter requested that it be able to use collateral it maintains in the United Kingdom, possibly by pledging it through the Bank of England, which would hold it on account for the Reserve Bank. Two commenters suggested that the Board informally encourage Reserve Banks to be flexible, expeditious, and practical in their consideration of additional asset classes, haircuts applied in the valuation of collateral, and methods of perfection. One commenter stated that the collateral procedural requirements should not be as cumbersome as those for existing discount window arrangements. Another commenter asked for clarification as to whether collateral will be fungible for purposes of borrowing under existing discount window arrangements and the Special Liquidity Facility.

One commenter asked for clarification on additional operational issues regarding collateral, such as what the minimum notification period would be for using the facility on a collateral-by-collateral-type basis, whether borrowers will be able to substitute collateral, and what the acceptable delivery mechanism would be (delivery-versus-payment, tri-party, or held-in-custody). Another commenter requested that the Reserve Banks and the appropriate Federal Home Loan Banks ("FHLBs") coordinate on the terms of collateral agreements to enable FHLB members to determine their available collateral in the most efficient manner.

One commenter stated that many banks have already pledged many of their assets to secure public deposits or to the FHLBs, leaving little available to pledge to the Reserve Banks. This commenter suggested that the Reserve Banks could waive collateral requirements for loans to well-capitalized institutions without meaningfully increasing their credit risk.

Eligible borrowers

Four commenters stated that there may be situations where it would be appropriate to provide access to the Special Liquidity Facility for undercapitalized institutions. One commenter stated that denying access to these institutions could cause a public reaction that would increase the institution's vulnerability and precipitate customer withdrawals. Another commenter suggested that, rather than prohibit undercapitalized institutions from using the facility, the Board could place more limited controls on undercapitalized institutions that balance the need to provide emergency funding with appropriate measures to prevent the inappropriate use of those funds, such as restrictions on the purpose and duration of borrowing and enhanced supervision.

One commenter stated that the eligibility of U.S. branches and agencies of foreign banks for the Special Liquidity Facility should be determined by a combination of supervisory ratings and investment information such as independent agency ratings.

One commenter noted that section 201.6(d) of Regulation A prohibits an institution from acting (without permission) as a medium or agent of another institution in receiving Federal Reserve credit. The commenter asked that the Board clarify that section 201.6(d) does not preclude eligibility for a bank that is a net provider of funds to other institutions or needs to use the Special Liquidity Facility because of an unexpected drawdown on a line of credit provided to another institution.

The credit union industry raised specific concerns. Two commenters stated that the proposed 6 percent net worth ratio that must be met by eligible credit unions is unworkable for corporate credit unions, which are not subject to statutory net worth requirements. One commenter suggested that the Board leave the determination as to the eligibility of corporate credit unions to the Reserve Bank or, alternatively, deem a corporate credit union to be eligible if it meets an appropriate capital ratio as determined by its primary regulator. The other commenter suggested that the Board simply deem corporate credit unions to be eligible borrowers. One commenter requested that the Board lower the net worth requirement for eligible credit unions to 5.5 percent because of the likelihood that expenses associated with Y2K preparations may require some credit unions to reduce their capital. Another commenter suggested that an alternative to lowering the net worth percentage would be to average the credit union's capitalization over several reporting periods to determine eligibility. Another commenter objected to the Board using a statutory net worth requirement for credit unions that has not yet taken effect and suggested that the Board establish a definition of "sound financial institution" that would be flexible and take into account a variety of factors other than capital, such as risk and collateral. Another commenter suggested that any credit union with reasonable net worth and adequate collateral should be eligible.

Capital ratios and other regulatory/market concerns

Four commenters stated that the Board should permit institutions some liquidity and capital ratio flexibility during the century date change period, particularly in light of the possibility that bank behavior during the Y2K conversion, such as a "flight to quality" of bank deposits or the drawing down of lines of credit, could create temporary balance sheet distortions. One commenter urged the Board to take a leadership role on this issue as soon as possible and to educate rating agencies and the Securities Exchange Commission that possible temporary declines in capital ratios near year-end are not necessarily a sign of weakened condition. One commenter also requested that the Federal Reserve take steps to help banks respond to market fluctuations by adjusting its lending policies and by allowing late reserve adjustments.

One commenter stated that the Board should consider temporarily suspending certain provisions of the Federal Reserve Act, such as section 23A, over the century date change period and should expand the types of markets that it uses for open-market purchases to include, for example, asset-backed markets. Another commenter stated that the Board should review its payment system risk policy with a view towards increasing the net debit cap for international banks, given the significant changes in the market and in payments system practices since the caps were adopted in 1990. Another commenter stated that the Reserve Banks should pay interest on deposits of at least 100 basis points.

Term of loan and prepayment

Four commenters requested clarification as to whether an institution may make drawings from the Special Liquidity Facility at any time during the proposed period and whether the term of a borrowing must be stated upon drawing or whether the drawing may be made on an open basis. One of these commenters noted that section 10B of the Federal Reserve Act limits maturities on advances to four months, unless the advances are secured by mortgage loans covering one-to-four family residences. One commenter asked how often the Facility could be accessed and whether there were any minimum or maximum borrowing amounts. Another commenter asked the Board to clarify that advances under the Facility may be prepaid without penalty.

Other operational issues

One commenter stated that the Board should better define the circumstances for determining when an institution may borrow through the Special Liquidity Facility and when it may borrow adjustment credit. A credit union commenter asked for clarification that once the institution's application for discount window access is approved, it may access both adjustment credit and the Special Liquidity Facility. This commenter also requested clarification that a borrower need not consider the Special Liquidity Facility as a funding option that must be exhausted before requesting adjustment credit.

One commenter stated that the Federal Reserve will need to address a wide range of operational issues before implementing the Special Liquidity Facility, such as the loan request and approval process, reliance on the 21-day period for perfection of instruments under borrower-in-custody arrangements, and modifications to automated systems.

Public outreach

One commenter urged the Board and other banking agencies to expand Y2K outreach efforts to consumers in order to combat emotional overreaction due to unfounded rumors and sensational media stories. Another commenter recommended that the Federal Reserve actively educate depository institutions about the Special Liquidity Facility.

Operating circular

One commenter suggested that the Reserve Banks revise Operating Circular 10 (the lending circular) to eliminate the provision that requires a correspondent bank to object to any debit to its account for the amount of a loan repayment due from the borrower to the Reserve Bank within one hour of the time the payment is due or else the payment is irrevocable. The commenter stated that this provision requires the correspondent to become the unintended purchaser of the loan from the Reserve Bank without benefit of the collateral that had secured the loan. The commenter stated that neither the correspondent nor the Reserve Bank would face increased risk if the circular were to eliminate the notion of irrevocability of an unchallenged debit and require the correspondent to affirmatively transfer the loan repayment amount to the Reserve Bank.