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Proposal and Comment Information

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BETTER MARKETS

December 9, 2024

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
Docket No. OP-1838
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Request for Information and Comment on Operational Aspects of Federal Reserve Bank Extensions of Discount Window and Intraday Credit; Docket No. OP-1838; Document No. 2024-20418; 89 Fed. Reg. 73415 (Sept. 10, 2024)

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the request for information ("Request") from the Board of Governors of the Federal Reserve System ("Fed") regarding operational aspects of the discount window.[2]

The discount window was established to serve two vital functions in support of the economy and financial system: facilitating the implementation of monetary policy and stabilizing the banking system as a source of liquidity for individual banks.[3] For the discount window to function effectively, banks must be both ready and willing to borrow during times of stress when or when liquidity is needed to head off bank failure. While the data show that borrowing from the discount window did increase in response to financial market stress during 2008-2010 and 2020,[4] there is clear evidence that a lack of readiness and willingness to borrow persists.

Evaluations of the spring 2023 bank failures show that the discount window problems have continued and that it failed to support financial stability. The Fed's analysis of the failure of Silicon Valley Bank ("SVB"), for example, shows how SVB was not prepared to use the discount window

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 Request for Information and Comment on Operational Aspects of Federal Reserve Bank Extensions of Discount Window and Intraday Credit; Docket No. OP-1838; Document No. 2024-20418; 89 Fed. Reg. 73415 (Sept. 10, 2024), https://www.federalregister.gov/documents/2024/09/10/2024-20418/request-for-information-and-comment-on-operational-aspects-of-federal-reserve-bank-extensions-of.

3 *Id*. at 73145-46.

4 Susan McLaughlin, *Discount Window Stigma: What's Design Got To Do With It?*, YALE SCHOOL OF MANAGEMENT PROGRAM ON FINANCIAL STABILITY (Apr. 2, 2024), https://som.yale.edu/story/2024/discount-window-stigma-whats-design-got-do-it.

as a source of contingent liquidity.[5] While proper preparation may not have fully prevented the failure of SVB, a lack of adequate preparation certainly accelerated it.

Moreover, the Fed's development of alternate funding mechanisms to provide liquidity to banks, such as the Bank Term Funding Program ("BTFP"),[6] is an implicit admission that banks' reluctance or inability to borrow from the discount window is a problem. The BTFP was developed to have less stringent preparation requirements than the discount window, to address the problem of a lack of readiness to borrow. Moreover, as a new funding facility, the BTFP was not stained with the stigma associated with the discount window.

We appreciate this Request and the Fed's continued efforts to improve the operations of the discount window. Banks certainly face operational hurdles associated with the use of the discount window and those should be addressed. In addition, however, many banks' lack of readiness to borrow coupled with the stigma associated with the use of the discount window loom even larger as obstacles that threaten Main Street Americans and financial stability. Therefore, as we argue below, the Fed should focus on these challenges as well as the operational aspects of the discount window.

BACKGROUND

The discount window has been in operation since the Fed was established in 1913. It has existed for more than 110 years to support the banking system's stability, provide liquidity to banks, and facilitate monetary policy.[7] The discount window is intended to support financial stability in three key ways:[8]

- Mitigating run risk: Allowing a bank to borrow when needed to meet short-term, unexpected liquidity needs.

- Mitigating fire sale risk: Providing access to a liquidity backstop helps banks avoid the need to sell assets—potentially at low prices that spiral down—to generate liquidity.

- Mitigating contagion risk: Averting stress spread through banking and capital markets by providing confidence to bank depositors and investors to avoid bank runs.

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[5] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK 60 (Apr. 2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

[6] Board of Governors of the Federal Reserve System, Press Release, *Federal Reserve Board Announces It Will Make Available Additional Funding to Eligible Depository Institutions to Help Assure Banks Have the Ability to Meet the Needs of All Their Depositors* (Mar. 12, 2023), https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm.

[7] *See* Philip N. Jefferson, *The Fed's Discount Window: 1990 to the Present*, Board of Governors of the Federal Reserve System (Oct. 9, 2024), https://www.federalreserve.gov/newsevents/speech/jefferson20241009a.htm.

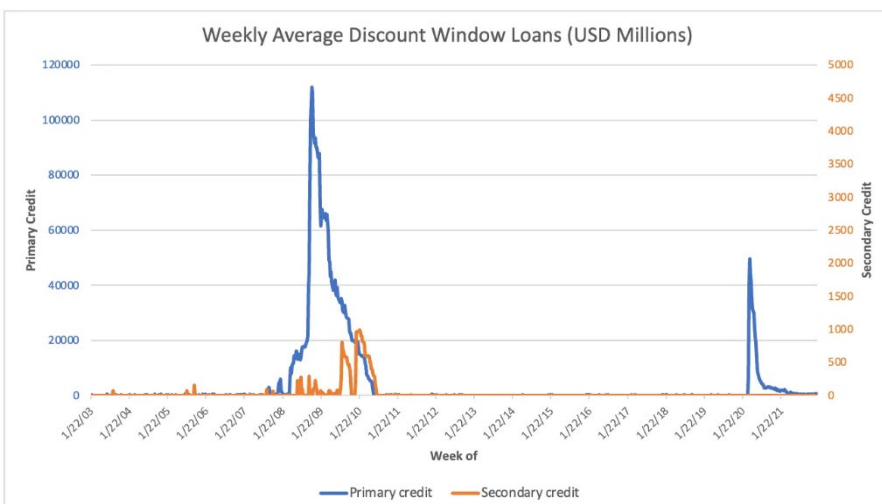
[8] McLaughlin, *supra* note 4.

However, as Fed Vice Chairman Phillip Jefferson explains, despite many different efforts by the Fed, the association between discount window borrowing and troubled institutions persists and impedes the discount window's effectiveness:

> Troubled institutions borrowed from the discount window for extended periods of time as the Federal Deposit Insurance Corporation (FDIC) sought to find merger partners or otherwise manage the closure of these institutions. As a result, the discount window became associated strongly with lending to troubled institutions. Healthy banks' reluctance to borrow from the discount window increased. ***The greater reluctance to borrow from the discount window made it less effective both as a monetary policy tool and as a crisis-fighting tool***.[9]

In 2003, the Fed again attempted to reduce the stigma associated with discount window borrowing. It established a two-tiered system: primary credit lending to adequately capitalized banks and secondary credit lending to weaker banks.[10] However, the data show that discount window borrowing has remained near zero except for periods of extreme stress in the banking system (see Chart 1).[11] Most of these transactions were below $100,000 suggesting they were merely tests. Based on Fed data, only about 5% of the discount window transactions were completed by banks experiencing stress or a real need for the funds.[12] In other words, the stigma associated with discount window borrowing remains firmly entrenched.

Chart 1



Source: Federal Reserve; includes test loans

9 Jefferson, *supra* note 7 (emphasis added).

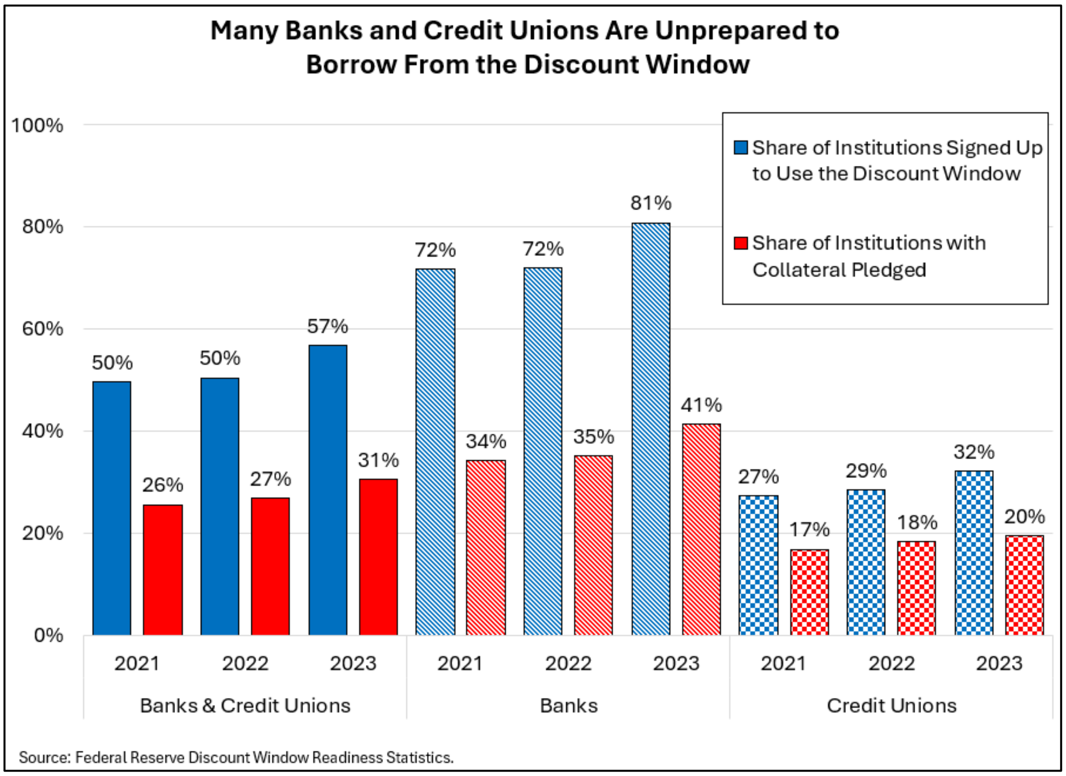
10 McLaughlin, *supra* note 4.

11 *Id*.

12 *Id*.

In addition to stigma, significant challenges exist related to discount window operations. First and most concerning is the substantial number of banks and credit unions that have not completed the basic steps to qualify to borrow from the discount window. To use the discount window, banks must have legal agreements in place. They also must pre-pledge collateral to secure discount window borrowings. While improvements have been made in recent years related to these steps for preparedness, ***nearly 20 percent of banks (924 banks) have not even signed up for discount window access and nearly 60 percent of banks (2,828 banks) have not pledged collateral*** (see Chart 2).[13] The readiness of credit unions is even worse than banks.

Chart 2



These readiness problems are not merely theoretical or academic claims. They are real and have caused real problems for financial stability and Main Street Americans. For example, the Fed cited the lack of readiness to borrow from the discount window at Silicon Valley Bank Financial Group ("SVBFG") as a factor that contributed to its March 2023 failure:

[13] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, POLICY TOOLS: DISCOUNT WINDOW READINESS, https://www.federalreserve.gov/monetarypolicy/discount-window-readiness.htm (last accessed Dec. 5, 2024).

> The acute liquidity stress on March 9 was far beyond historical precedents for how quickly a large financial institution can fail. Still, weaknesses in SVBFG's preparedness for a contingent liquidity event may have contributed to SVBFG's inability to access contingent funding sources in a time of need. SVBFG was not able to monetize (immediately raise funds against) its investment securities. SVBFG had not arranged for enough access to repo funding and had not signed up for the Federal Reserve's Standing Repurchase Agreement facility. SVBFG had limited collateral pledged to the Federal Reserve's discount window, had not conducted test transactions, and was not able to move securities collateral quickly from its custody bank or the FHLB to the discount window. While contingent funding 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.[14]

In summary, the stigma associated with the discount window and the lack of preparedness by banks to borrow not only negatively impacts financial system stability but also affects Main Street Americans, small businesses, and taxpayers who are harmed when a bank fails or is bailed out by the government.[15]

SUMMARY OF THE REQUEST

With this Request, the Fed is assessing discount window operations and ways to improve them. For example, it seeks input on banks' experiences with submitting the legal documents that are required for discount window borrowing and pledging collateral.[16] However, the Fed does not address critical policy considerations such as a requirement for banks to achieve a basic standard of discount window borrowing readiness. It also fails to address the need to address discount window stigma, which continues to threaten the discount window ever achieving its intended purpose.

SUMMARY OF COMMENTS

As detailed in this letter, the discount window is vital to financial stability. Therefore, we strongly urge the Fed to consider changes and improvements to expectations around financial institutions' operational readiness to borrow from the discount window in times of stress. The data clearly show that there are large gaps in readiness, which when paired with the stigma that surrounds discount window borrowing, results in limited effectiveness of the discount window to meet its mandated purpose.

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14 Board of Governors of the Federal Reserve System, *supra* note 5, at 59-60.

15 *See e.g.*, BETTER MARKETS, COST OF THE CRISIS (Aug. 15, 2016), https://bettermarkets.org/newsroom/20-trillion-cost-financial-crisis-1/.

16 Request for Information and Comment on Operational Aspects of Federal Reserve Bank Extensions of Discount Window and Intraday Credit, *supra* note 2, at 73417.

We also encourage the Fed to engage in efforts to update and change the discount window policy. Federal Reserve officials, academics, and other experts have recognized and documented the shortcomings of the discount window program, particularly in the context of modern bank failures.[17] It is therefore in the best interest of Main Street Americans and financial stability to take a more holistic look at the discount window operations and make changes that will lead to more effective discount window functionality.

- Require discount window preparedness for all banks. For the discount window to function effectively and support financial stability, ***banks must be able to actually borrow from it***. However, as detailed in this letter, the data show a significant and dangerous lack of preparedness. Regulators should promptly address this risk by requiring all banks to have at least a minimum level of readiness, as a part of regularly evaluated operational risk.

- Expand beyond operational improvements to address and overcome the discount window's stigma. In practice, the discount window has been ***both*** a bridge to recovery as well as a bridge to failure.[18] However, it cannot seem to escape the latter reputation. The Fed's development of alternative liquidity programs such as the Term Auction Facility ("TAF") in December 2007 and the BTFP in March 2023 have worsened the stigma. While these programs each met a short-term need to provide liquidity to the banking system in periods of extreme stress, they also exacerbated the stigma of the discount window.

COMMENTS

I. REQUIRE DISCOUNT WINDOW PREPAREDNESS FOR ALL BANKS.

For the discount window to function effectively and support financial stability, banks must be able to actually borrow from it. Vice Chair for Supervision Michael Barr ("Vice Chair Barr") recently detailed the importance of discount window borrowing readiness as a vital component of liquidity management:

> While, as discussed, the discount window provides ready access to funding to help banks manage liquidity risks in normal conditions, it is also incredibly important that it be available to banks dealing with idiosyncratic or market-wide stress events. ***When other forms of funding or related market infrastructure are not immediately available, readiness to borrow via the discount window—including with prepositioned collateral—is even more crucial***. . . .

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17 *See* Jefferson, *supra* note 7; Philip N. Jefferson, *A History of the Fed's Discount Window: 1913–2000, Board of Governors of the Federal Reserve System*, Board of Governors of the Federal Reserve System (Oct. 8, 2024),https://www.federalreserve.gov/newsevents/speech/jefferson20241008a.htm; Susan McLaughlin, *Lessons for the Discount Window from the March 2023 Bank Failures*, 6 JOUR. OF FIN. CRISES 72-84 (July 23, 2024), https://elischolar.library.yale.edu/journal-of-financial-crises/vol6/iss2/3; Michael S. Barr, *The Importance of Effective Liquidity Risk Management*, Board of Governors of the Federal Reserve System (Dec. 1, 2023), https://www.federalreserve.gov/newsevents/speech/barr20231201a.htm.

18 *Id*.

> ***There are two key aspects of discount window readiness: preparedness to access the discount window and prepositioning adequate amounts of collateral.*** In terms of preparedness, the majority of banks that are eligible to borrow from the discount window have the legal agreements in place. This is the first step. ***However, many of these banks had not recently tested their discount window access prior to the stress event. Engaging in testing through actual transactions at regular intervals is a key component of operational readiness. In the case of some banks, the amount of collateral prepositioned was also a tiny fraction of potentially flight-prone liabilities going into the stress event.*** This lack of pre-pledging is a concern for several reasons, including that certain collateral types can require more time to pledge. Less liquid collateral can take longer to be assessed and valued at the discount window, meaning that banks should not expect they can gain immediate liquidity against these assets. But these are the very assets that would be best pledged to the discount window, so that more liquid assets are held for other uses.[19]

As detailed earlier, the data reveal a significant and dangerous gap in preparedness. Vice Chair Barr says that the majority of banks are ***eligible*** to borrow from the discount window, but that is a far cry from actual readiness to borrow, which raises serious concerns. For example, nearly 20% of banks—or one out of every five—have not completed the legal documentation required to borrow from the discount window, and about 60% of banks—nearly two out of every three—have not pledged collateral. Moreover, fewer than 300 institutions have conducted test borrowings from the discount window to actually practice borrowing from the discount window before stress arises.[20]

The Fed's analysis of SVB's failure provides a detailed example of how a lack of readiness contributed to disastrous results and the bank's eventual failure. Regulators should promptly address this risk by requiring all banks to have at least a minimum level of readiness, as a part of regularly evaluated operational risk.

Accordingly, we support Vice Chair Barr's recent suggestion that the Fed engage in additional work related to discount window borrowing readiness, especially considering the faster speed of modern bank runs:

> The speed of bank runs and the impediments to rapidly raising liquidity in private markets that may be needed in hours rather than days suggest it may be necessary to reexamine our requirements, including with respect to self-insurance standards and to ***discount window preparedness***.[21]

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19 Barr, *supra* note 17 (emphasis added).

20 Board of Governors of the Federal Reserve System, *supra* note 13.

21 Barr, *supra* note 17 (emphasis added).

Finally, recent developments to improve access to the discount window electronically through Discount Window Direct ("DWD") [22] may alleviate some operational challenges. However, the mere existence of an electronic system does not solve the current problems. Banks still must sign up for DWD, complete the steps to become eligible and prepared to borrow, and test borrowing capabilities.

II. EXPAND BEYOND OPERATIONAL IMPROVEMENTS TO ADDRESS AND OVERCOME THE DISCOUNT WINDOW'S STIGMA.

In practice, the discount window has been ***both*** a bridge to recovery as well as a bridge to failure. For instance, between 2010 and 2021, there were ***132 instances*** in which a bank borrowed secondary credit—indicative of the fact that the institution was in a troubled condition—and subsequently borrowed primary credit at a later date—indicative of the bank improving its condition.[23] Over the same period, 46 institutions borrowed from the discount window and then subsequently failed.[24]

The Fed should do more to communicate about discount window borrowing to dispel the myth that all borrowing is done by banks that are in a troubled condition. While the Fed publishes data to communicate about discount window borrowing in aggregate, there is a two-year lag in the reporting of borrowing by individual banks. While some believe that this secrecy is required to protect banks that borrow from the discount window, the framework also reinforces the stigma.

Readiness to borrow and the actual act of borrowing from the discount window should be signs of bank strength and operational health, not risk. The Fed has begun to explore how a readiness requirement could reduce stigma, as Vice Chair Barr explained:

> Incorporating the discount window into a readiness requirement would also re-emphasize that supervisors and examiners view use of the discount window as appropriate and unexceptional under both normal and stressed market conditions.[25]

Experts at the Fed as well as in academia show that discount window stigma is difficult—if not impossible—to eliminate. For example:

- One study details how during the 2007-2008 crisis, banks that were eligible to borrow at the discount window ***chose to borrow*** from the TAF and ***paid more to do it***. Recognizing that 2007-2008 was a stressful period for banks and could have led to lapses of judgment or logic, the study explored further. However, it confirmed the evidence of stigma. More

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[22] *See* The Federal Reserve Discount Window, Press Release, *Announcing the Discount Window Direct Application* (June 24, 2024), https://www.frbdiscountwindow.org/Articles/2024/06/24/12/05/DWD_20240624.

[23] McLaughlin, *supra* note 4.

[24] *Id.*

[25] Michael S. Barr, *On Building a Resilient Regulatory Framework*, Board of Governors of the Federal Reserve System (May 20, 2024), https://www.federalreserve.gov/newsevents/speech/barr20240520a.htm.

than half of the banks ***repeatedly*** bid at rates for TAF borrowing that were ***above*** rates they could have gotten at the discount window.[26]

- Another study showed that even making borrowing from the discount window ***free of charge*** would not eliminate the stigma that currently exists.[27]

In summary, we know that banks need adequate liquidity, both in times of stress and times of calm. Therefore, the Fed should increase its efforts to pursue alternatives that would provide stigma-free lending facilities or make changes that would overcome the discount window's current stigma.

CONCLUSION

We hope these comments are helpful as the Fed continues its efforts to improve discount window operations.

Sincerely,

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26 Olivier Armantier, Eric Ghysels, Asani Sarkar & Jeffrey Shrader, *Discount Window Stigma During the 2007–2008 Financial Crisis*, 118 JOUR. OF FIN. ECONOMICS 317-35 (Nov. 2015), https://doi.org/10.1016/j.jfineco.2015.08.006.

27 Olivier Armantier, *Can Discount Window Stigma Be Cured?*, Federal Reserve Bank of New York, LIBERTY STREET ECONOMICS (May 31, 2024), https://libertystreeteconomics.newyorkfed.org/2024/05/can-discount-window-stigma-be-cured/.