The Discount Window and the Future of Contingent Liquidity – Lessons from abroad

Exploring Conventional Bank Funding Regimes in an Unconventional World

Federal Reserve Bank of Dallas

July 19, 2024

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Stigma isn't a universal problem

- There are central banks whose banks do use their standing liquidity facilities when needed
- I looked at four of them to see what lessons we can learn
  - Bank of Canada
  - Bank of England
  - European Central Bank
  - Swiss National Bank
- Found four main takeaways for the US

1. Redesign the toolset

- Draw a brighter line between on-demand and emergency lending tools
  - Administration, governance, communication, access
- Integrate the on-demand facility into the Fed’s monetary policy implementation framework, where possible
  - Frame on-demand facility as tool for rate control
    - May be more credible when reserves are less ample
  - Make banks counterparties for non-SRF repo operations
    - Makes bank borrowing a more common feature of operating framework, in periods of easing

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2. Rebrand the toolset

- Reducing stigma requires careful word choice
  - "discount window", "primary credit" are toxic
  - "lender of last resort" connotes desperation that is inconsistent with an on-demand facility for healthy banks
- We need two key messages to reduce stigma:
  - "Open for business"
  - For healthy institutions only (not a sign of weakness)
- Keep saying it!
- Supervisory agencies need to say it too!
- **Constructive clarity** – not constructive ambiguity

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3. Integrate tools into supervisory expectations

- Supervisory rules and requirements for liquidity risk management don’t count Fed borrowing capacity as contingent liquidity
  - Include capacity to borrow from the on-demand facility in contingency funding plans
  - Require banks to test it periodically
  - Include borrowing capacity in liquidity stress tests
  - Include borrowing capacity in recovery / restructuring plans

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4. Make access about solvency, not ratings

- Composite CAMELS rating isn't an optimal cutoff for eligibility
    - Not a pure measure of financial condition
    - Ratings are often stale
- Creates two problems
    - Type I error: downgrade to 4 → automatic move to secondary credit, reduces borrowing capacity
    - Type II error: Stale ratings allow weak bank to borrow primary credit
- Other central banks use a "solvency" criterion
    - Not precisely defined
    - Allows for real-time judgment in lending decisions

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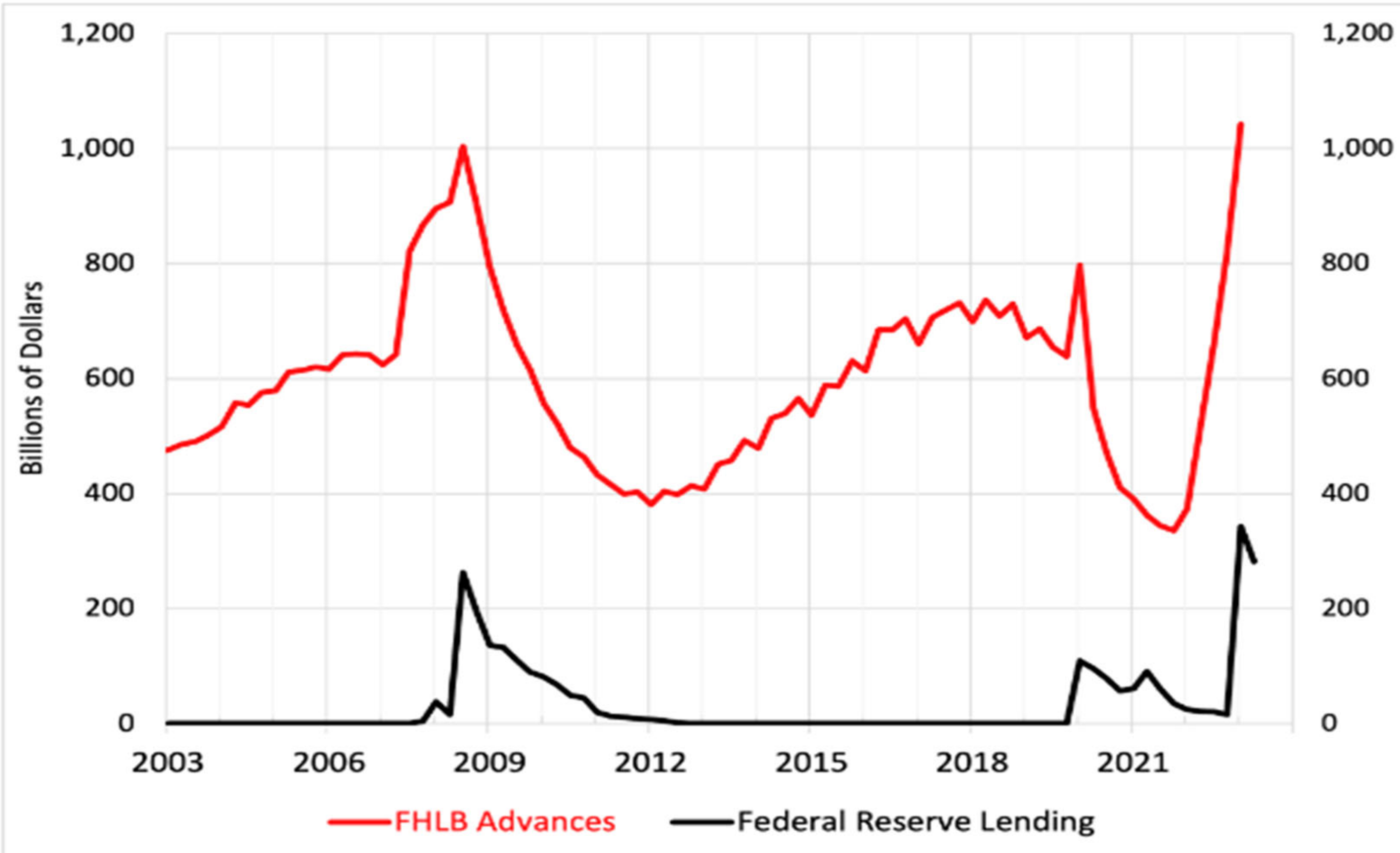
Unique challenges for the US

The U.S. has more depository institutions than any other country

Fed is required to disclose all details of all central bank loans, including borrower name, publicly (at a lag)

A set of quasi public banks (FHLBs) that lend in size to banks, often on more favorable terms—until they don't

FHLB Advances to FHLB Members and Federal Reserve Lending to Banks, (Billions of U.S Dollars)
Q1 2003–Q1 2023



Source: Cecchetti, Schoenholtz and White (2023)

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