Panel Presentation on Lender of Last Resort

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The lender of last resort ("LLR") function is of critical importance to the U.S. financial system. After the panic of 1907, the Congress in 1913 created the Fed as the nation's first central bank and empowered it to extend emergency liquidity lending to banks experiencing liquidity crises – i.e., to act as a LLR to the banking sector. The 2023 banking crisis and the 2020 COVID crisis each revealed vulnerabilities in the current design and application of the LLR function.

Let me briefly outline the most important issues and questions that these events raise about the LLR function and identify potential solutions.

1. **The Fed should clarify its LLR collateral policies**.

The discount window statute (Section 10B of the Federal Reserve Act), the primary mechanism for LLR lending, provides that the Fed may make advances to depository institutions provided they are "secured to the satisfaction of [the Fed]." The Fed thus has considerable discretion to determine how much collateral it requires, which assets it accepts as collateral, and how those assets are valued, and to change those requirements as when there is a contagion threat.

My analysis of publicly available information indicates that SVB possessed hold-to-maturity government securities and loans that could have been pledged as collateral in a sufficient amount to cover the run on its deposits, even under the Fed's pre-existing haircut policies valuing hold-to-maturity government securities at their market value rather than par. But the Fed did not lend.

But even if my analysis is wrong, the Fed could, if necessary to stop contagion, have changed its valuation approach of government securities to par value, the normal accounting treatment. Indeed, after SVB failed, the Fed established the Bank Term Fund Program under Section 13(3) of the Federal Reserve Act under which hold-to-maturity government securities were valued at par.

2. Operational improvements to LLR are necessary.

The events of March 2023 show that bank runs can occur faster than they did in the past. To illustrate this point: SVB experienced a total outflow of 25% of deposits in one day, Thursday March 9. A further outflow of 62% of SVB's deposits was anticipated to occur on the following day. SVB's high percentage of concentrated and uninsured deposits played a key role in accelerating the run. However, the events of March 9, 2023, suggest that the Fed was operationally unprepared for the unprecedented speed of the run.

On March 9, during business hours on the West Coast, SVB asked its custodial bank to transfer \$20 billion in collateral to the Fed to support discount window borrowing. Such transfers take place via the Fedwire system, which has a daily cutoff of 4pm PT/7pm ET. Although SVB's custodial bank, BNYM, attempted to complete the transfer before this deadline, the Fed required a "test trade" to take place before the actual collateral transfer. This test trade could not be completed before the time deadline, and the Fed declined to extend the deadline to facilitate the transfer.

The next day, the Fed kept Fedwire open until 8:30pmPT/11:30pmET to facilitate a collateral transfer by Signature, indicating that the Fed then realized that confining Fedwire to normal hours of operation was risking further contagion. In the future, at the first sign of a crisis, the operating hours of Fedwire and any other systems necessary to transfer collateral in support of liquidity lending should be extended as long as necessary.

In addition, policymakers must consider how *instant* transfer capabilities, of collateral and funds, through adoption of changes in technology, could further speed necessary LLR lending.

3. Liquidity Requirements Need Revision

Even before the SVB crisis, there were significant questions about the utility of liquidity requirements in stemming contagion. First, if a run is severe enough, even a large store of liquid assets will be exhausted. Second, if a bank delays borrowing from the LLR because it initially seeks to stem a liquidity crisis by selling its buffers of liquid assets, the delay may allow a run to accelerate past the point at which LLR lending is effective. Third, by effectively requiring banks to hold substantial amounts of government securities, liquidity requirements can increase a bank's exposure to interest rate risk. Furthermore, by requiring all banks to hold a minimum amount of liquid assets, liquidity requirements have the unintended side effect of reducing the supply of liquid assets available to banks that need liquidity from banks that do not.

In my view, liquidity requirements should be reoriented around a bank's discount window borrowing capacity. Banks could be required to either pre-pledge or otherwise have assets available to pledge with the Fed to support discount window loans sufficient to withstand the withdrawal of a significant percentage of uninsured deposits within a short timeframe, thus substantially reducing the likelihood that transfers of additional collateral are necessary. This requirement could be paired with an enhanced commitment on the part of the Fed to provide banks with discount window loans on the basis of this collateral, as in the "committed liquidity facility" proposal set forth by former Bank of England Governor Mervyn King and the Bank Policy Institute.

There have been several preliminary proposals for borrowing capacity requirements in recent months that have been centered around the *prepositioning* of collateral. But framing such proposals as "prepositioning" requirements mixes two issues that ought to be analyzed separately: an operational issue and a liquidity issue. As an operational matter, prepositioning would be unnecessary if it were possible to pledge necessary collateral to the Fed instantaneously at the first sign of a crisis. Modern technology makes this possible.

If a new borrowing capability requirement is adopted, whether or not it involves prepositioning, it should supersede, rather than supplement, the liquidity coverage ratio. As the Group of Thirty Report notes, if banks are required to have enough collateral to support discount window borrowings to cover runnable liabilities, the liquidity coverage ratio becomes "largely irrelevant" during stress times.

4. LLR should be the responsibility of the Fed alone.

Another exacerbating factor in the failure to make use of the LLR function for SVB was the diffusion of LLR responsibilities between the Fed and Federal Home Loan Banks ("<u>FHLB</u>s").

The events of March 2023 show that having two lenders of last resort creates a coordination problem and that the FHLBs are not effective lenders of last resort. FHLBs are less suited to the role of LLR for the simple reason that they cannot create money as the Fed can. FHLBs must issue bonds to create funding capacity. Further, when a FHLB lends, it requires a general lien over the borrower's assets. The existence of this lien can delay the ability of the Fed to obtain the perfected security interest it needs to extend a discount window loan to the same bank, when timing is critical.

I agree with the recommendation of the Federal Housing Finance Agency that FHLBs should no longer be a part of any LLR process.

5. **LLR to banks should occur through the discount window (Section 10B) and not under the emergency lending statute (Section 13(3)).**

In the weekend after the failure of SVB, in an effort to stem the resulting contagion, the Fed created an additional emergency lending facility, the BTFP, under Section 13(3) of the Federal Reserve Act. Whereas discount window lending under Section 10B is within the sole discretion of the Fed, Section 13(3) lending, post Dodd-Frank, requires Treasury approval. To my knowledge this was the first time Section 13(3) has been used to create a lending facility just for banks. Fed officials have suggested that establishing a new facility under Section 13(3) allowed it to value government securities collateral at par. But that could have been done, as I have already discussed, under Section 10B. They have also suggested that this countered the stigma of borrowing from the window, but there is stigma from any Fed borrowing.

There was, however, another important difference between using the discount window under Section 10B and the BTFP under Section 13(3). The borrowing rate for BTFP, the one-year overnight index swap rate plus 10 basis points, was frequently lower than the discount window rate. While this lower rate may give banks cover from stigma—a general concern when borrowing from the Fed—by allowing them to claim that BTFP loans are attractive because they are cheap, it was so low as to create an arbitrage opportunity where banks borrowed under the BTFP and deposited the proceeds in their higher paying Fed reserve accounts. A better approach to rates might be for the Fed to use an auction mechanism through the discount window, such as the Term Auction Facility (TAF) it used in December 2007.

An unstated motivation for the Fed's use of Section 13(3), which requires Treasury approval, may be to shield it from attack on its role of LLR by having political cover from the Treasury. However, the Fed needs to resist such pressure and maintain its independence as a strong liquidity provider to banks, given its clear mandate under Section 10B to act independently.

6. **The respective roles of LLR and deposit insurance in stemming contagion must be examined.**

By December 31, 2022, uninsured deposits had grown to about 43% of all deposits. Withdrawals by large uninsured depositors were instrumental in spurring the runs on SVB and Signature.

During the 2008 financial crisis, the FDIC acted under the pre-Dodd Frank version of the systemic risk exception of the Federal Deposit Insurance Act to temporarily lift any limit on deposit insurance for all banks' non-interest-bearing transaction accounts, to mitigate the run. But in 2010, Dodd-Frank prohibited the FDIC from taking the same action in the future without congressional approval in the form of a joint resolution. In 2020 under the CARES Act, Congress again provided the power to the FDIC to raise insurance limits but this power expired at the end of 2020. Obtaining the joint resolution of Congress necessary to renew this authority during the events of March 2023 crisis was impracticable and would be similarly impracticable in a future crisis.

In the 2023 crisis, the Treasury invoked the systemic risk exception to protect uninsured depositors of SVB and Signature that were already in insolvency, a power unaffected by the more general limitation in Dodd-Frank. While the *ad hoc* protection of uninsured depositors of already insolvent institutions may have helped stem the 2023 contagion, most uninsured depositors of other banks would rather avoid having to deal with an insolvency situation altogether. Congress should therefore consider restoring the ability to increase deposit insurance in a crisis or to increase the current deposit insurance limit of $250,000, generally or selectively with respect to particular deposits.

7. **The Fed's emergency lending facilities should be limited to liquidity provision and not entail fiscal policy.**

During the COVID-19 pandemic, the Fed used its emergency lending powers under Section 13(3) to create temporary credit facilities under which it loaned to non-bank corporations and small businesses, including, among other programs, the Main Street Lending Program.

The Fed's assumption of this role as a lender to the non-financial sector, as well as the sharing of responsibility between the Fed and Treasury for these programs under Section 13(3), raises significant policy issues.

Fiscal policy, where the Fed faces substantial credit risk, as with the Main Street Lending Program, should be exclusively the role of the Treasury and not the Fed, since decisions about fiscal policy should be made by elected government officials. Also, jointly tasking two institutions with the execution of lending decisions, as is currently the case under Section 13(3), with no clear division of responsibility, means that it is difficult to decide where responsibility actually lies.