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# Federal Reserve's Discount Window: Policy Issues

The failure of three large banks in the spring of 2023 put the discount window (DW) of the Federal Reserve (Fed) back in the spotlight. DW lending suddenly spiked, reaching an all-time high of $295.7 billion. This In Focus discusses policy issues raised by this episode. Congress has focused on the DW in its oversight capacity, as evidenced by a recent House hearing.

## Background

The Fed was created in 1913 in response to a perceived need for a lender of last resort (LOLR). The Fed fills this role by making short-term loans to depository institutions, such as commercial banks, through its DW. Typically, the Fed's LOLR operations are minimal because banks can borrow privately. But during periods of financial instability, such as the 2007-2009 financial crisis and the COVID-19 pandemic, DW lending grew rapidly as private sources of liquidity dried up.

To borrow from the DW, banks pledge assets as collateral, temporarily converting illiquid assets into liquid reserves. Banks that are adequately capitalized and are not poorly rated by their supervisors use *primary credit* and can borrow for up to 90 days with "no questions asked." Poorly capitalized or rated banks must use *secondary credit*, which is shorter term and subject to close oversight. *Seasonal credit* is also available for small banks to manage seasonal inflows and outflows. The Fed sets the *discount rate* charged for loans. Traditionally the primary credit rate was set above market rates, but since the pandemic it has been set at the top of the federal funds rate target range. The secondary credit rate is still higher. In addition to the limits on secondary credit, risks to the Fed are minimal because loans are short term, must be repaid even if collateral loses value, and are backed by assets worth more than loan value.

## Policy Issues

### Stigma

An effective LOLR is one where banks do not use the DW in normal conditions and readily use it in times of financial stress. Although DW lending has ramped up in crises, policymakers express concern that stigma associated with the DW reduces its use. Stigma may create reluctance to borrow from the DW because depositors or other creditors will view this as a signal that the bank is troubled and run on the bank—a fear that is most likely to manifest during stress periods when usage is desired. If true, stigma makes the DW less effective at mitigating systemic risk.

The Fed discouraged DW use in normal conditions until 2003, when it reformed DW operations partly to reduce stigma by removing moral suasion and by making loan approval easier. The Fed now states that primary credit can be obtained "no questions asked" for any purpose, including "arbitrage opportunities," such as to lend for profit. Nevertheless, concerns about stigma remain. Despite official policy, almost 40% of surveyed domestic banks said supervisory disapproval made them reluctant to use the DW. The Fed has promoted the idea that there should be no stigma, but it has also tacitly acknowledged that stigma exists by creating various "untainted" alternative lending facilities and by convincing large banks to publicly announce borrowing from the Fed during crises.

Stigma could be reduced by making DW borrowing confidential, which it was until the 2010 Dodd-Frank Act (P.L. 111-203) required the identities and terms of borrowing to be publicly disclosed with a two-year delay. Three-quarters of surveyed banks said these disclosures discouraged them from using the DW.

### Lending to Failing Banks

Banks can fail because they are illiquid (they cannot access cash) or insolvent (their assets are worth less than their liabilities). The DW is meant to protect illiquid—not insolvent—banks, which arguably did not occur in 2023, as three banks borrowed from the DW and failed anyway.

DW lending to problem banks is meant to be limited because they may use it to "gamble for resurrection." Yet the three large banks that failed in 2023 remained eligible for primary credit until shortly before their failures. Post-mortem regulator reports found that examiners did not downgrade them as quickly as they should have: All three were considered well capitalized by regulatory standards until they failed. Although Silicon Valley Bank (SVB) and Signature failed very suddenly and unexpectedly, First Republic's failure was more drawn out, and it was able to borrow $109 billion through primary credit after experiencing depositor runs that made its weakness a high-profile story. It remained eligible for primary credit until three days before its failure when the FDIC downgraded its supervisory rating.

Although all DW loans to the failed banks were fully repaid, the episode nevertheless raises concerns about the effectiveness of limitations on lending to failing banks. It is unclear whether the loans increased or reduced risk to the taxpayer, notably in the case of First Republic. DW lending might have delayed its inevitable failure, and resolving banks at least cost typically requires a failing bank to be resolved as soon as possible. Alternatively, DW loans may have reduced costs by allowing for its more orderly resolution, in contrast to SVB and Signature, which required emergency guarantees of uninsured deposits.

### Preparedness by Banks

DW loans can be made quickly if banks have signed up and pre-pledged collateral in advance. Although not the underlying cause of SVB's and Signature Bank's failures, difficulties accessing the DW sparked their failures. Because they were unprepared, they could not move collateral quickly enough. Signature attempted to pledge ineligible collateral, and SVB struggled to pledge collateral on the day of its failure. Signature had not tested its DW access in five years and was unfamiliar with basic procedures. In July 2023, the depository regulators issued updated guidance encouraging—but not requiring—banks to be prepared to use the DW, including by pre-pledging collateral, and to periodically test their preparedness. There was an increase in the number of banks signed up to use the DW (to 3,900, compared to a total of 4,824) and pledging collateral (to 1,996 pledging $2.6 trillion) in 2023.

### Discount Window Modernization

Adding to SVB's and Signature's struggles to access the DW was the fact that, in the words of Fed Chair Jerome Powell, the DW "needs to be brought up technologically into the modern age," which he said is an ongoing project. According to one study, it "is too cumbersome, is not fully harmonized across the regional Federal Reserve Banks, and uses outdated processes and technologies." The DW did not have a web interface until 2024, and that interface still has limited functionality. The DW also closes at 7 p.m. Eastern time—before SVB, located on the west coast, could secure a loan. Critics argue that the speed of deposit runs in the digital age requires a nimbler DW.

### Interaction with FHLB Advances

One reason that SVB and Signature struggled to borrow from the DW is that they struggled to transfer collateral pledged to the Federal Home Loan Banks (FHLBs) to the DW. FHLBs are private government-sponsored enterprises that are a major alternative source of collateralized borrowing for banks. According to the FHLBs' regulator, "The reliance of some large, troubled members on the [FHLBs], rather than the Federal Reserve, for liquidity during periods of significant financial stress may be inconsistent with the relative responsibilities" of the FHLBs and the Fed. All three banks saw a 37%-50% jump in FHLB borrowing before their failures, and their peak FHLB borrowing exceeded $69 billion combined.

Unlike the Fed, FHLBs cannot serve as lenders of last resort, because they cannot provide unlimited liquidity and could even see their ability to create liquidity contract during widespread turmoil. The FHLBs have impeded the Fed from effectively operating as LOLR in three ways: (1) by exacerbating DW stigma—35% of surveyed banks said they were unlikely to borrow from the DW because of the availability of FHLB loans; (2) by potentially allowing banks to become overleveraged—the FHLBs are lending to maximize profits (whereas the Fed has a prudential mandate) and are repaid before the Fed and the Federal Deposit Insurance Corporation (FDIC) are in the event of a failure; and (3) by creating barriers to quickly and easily transferring collateral to the DW. The FHLBs frequently use blanket liens on all assets, and their priority must be subrogated before an asset can be pledged at the DW. The FHLBs' regulator has called for them to negotiate agreements with the Fed to ensure that collateral can be expeditiously transferred.

### Use by FDIC Bridge Banks

In the FDIC's resolution of the three banks, outstanding DW loans were assumed by bridge banks created by the FDIC, and the SVB and Signature bridge banks received new DW loans. The FDIC assumed responsibility for repaying the loans and was charged an interest rate one percentage point above the discount rate. DW loans to the FDIC peaked at $228 billion and were fully repaid (with interest) by November 2023.

FDIC use of the DW is not standard and is not explicitly contemplated in statute but was approved on the basis that bridge banks implicitly meet the criteria of an eligible institution. It is unclear why the FDIC borrowed from the DW instead of the standard practice of using its Deposit Insurance Fund and then its line of credit with the Treasury. The FDIC chair testified that the debt limit, which was binding at the time, was not the reason. Collateral and FDIC guarantees meant that the Fed faced no risk of losses. However, one study estimated that using the DW increased the FDIC's resolution costs by $2.5 billion, which was borne by banks to the taxpayers' benefit.

### Use of Emergency Authority as an Alternative

During crises, the Fed has created temporary ad hoc emergency facilities with fewer limitations under Section 13(3) of the Federal Reserve Act. To stabilize the banking system in early 2023, the Fed created the Bank Term Funding Program. By using Section 13(3), the program operated with more favorable terms than the DW—longer maturities, generally lower borrowing rates, and loans based on collateral's face value instead of market value. One could view this as an end run around the DW's statutory limitations. These features reduced the Fed's profits and increased the risk of taxpayer losses, but widespread use was achieved.

### Role in Liquidity Requirements

Large banks are subject to quantitative liquidity requirements, and all banks are supervised for liquidity adequacy. These requirements are based on the view that banks should be able to meet their liquidity needs privately. Therefore, banks do not get credit in the quantitative rules for DW access.

The 2023 bank runs call into question the adequacy and effectiveness of existing liquidity requirements, but requiring banks to hold more liquid assets or stable funding could raise the cost of credit. Some proposals would incorporate the DW in liquidity requirements by giving large banks credit toward liquidity requirements for their DW borrowing capacity, charging banks for mandatory credit lines at the DW, or requiring that banks pre-pledge minimum amounts of collateral at the DW (based on expected outflows under stress, uninsured deposits and short-term funding, or all short-term liabilities). Because DW collateral is subject to a haircut (i.e., banks can borrow less than the full value of the collateral), these proposals

could potentially increase the amount of long-term debt and capital a bank would be required to hold.

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