Constructive Disambiguity About the Discount Window

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Recently, we’ve written how the stigma associated with borrowing from the Fed was a key cause of the recent turmoil in money markets (see “Bank Regulations and Turmoil in Repo Markets”). An important reason for the stigma associated with the discount window is ambiguity about whether the Fed actually wants banks to use it. In April, we wrote that the Fed is sending mixed signals about how it views use of the window (see “The Fed wants banks to [be] willing to avoid borrowing and hold [fewer] more excess reserves”). Specifically, at the same time that the Fed is discussing establishment of a new standing repo facility as a way to lend to banks that it hopes will be free of stigma, it is also floating new liquidity requirements on U.S. branches of foreign banking organizations because the branches used the discount window during the financial crisis—even though that usage was in full compliance with all applicable rules and policies.

We were interested, therefore, to see that the Bank of England's (BoE) Prudential Regulatory Authority (PRA) yesterday proposed changes to its guidance intended to clarify for banks that the BoE's liquidity facilities are “open for business” and are not intended to be used only as a last resort. Moreover, the BoE encouraged banks to incorporate the Bank’s liquidity facilities into resolution plans.

OLD TEXT THE PRA SUGGESTS DELETING:

5.2 [Deleted] The terms of the Bank of England's liquidity insurance facilities are set to ensure counterparties have the incentive to manage their liquidity primarily through private markets in normal times. Consistent with this, for limited liquidity shocks, it is appropriate for firms to draw initially on their holdings of HQLAs. For larger or more severe liquidity outflows, the Bank of England expects firms to consider using the Discount Window Facility or other liquidity insurance facilities alongside, rather than after, using a significant proportion of their liquidity buffer. As noted in the PRA’s approach document, the PRA expects firms to have credible options in their liquidity contingency plan for restoring their HQLAs following firm-specific or market-wide stress.

NEW DRAFT TEXT INSERTED INSTEAD:

5.2A All of the Bank of England’s liquidity facilities are intended to be open for business. As such there is no presumptive order of use for firms between using the Bank of England’s liquidity facilities, including the Discount Window Facility (DWF), and drawing down of their liquidity buffers to meet a liquidity need. Firms should exercise their own judgement in applying for, and using, the Bank of England’s liquidity facilities. Although the PRA does not expect firms to rely on the DWF for routine day-to-day liquidity management, neither is it intended to be a last resort.

5.2B As noted in SS9/17 ‘Recovery Planning’, firms are expected to have credible options to restore their financial position under different types of stresses. Firms might consider the use of central bank facilities, whether at the Bank of England or other central banks, in their recovery plans. As part of recovery planning, firms are required to consider the circumstances in which they would need to access these facilities and also test the operational aspects of their plan for accessing central banks facilities. They should undertake an analysis of eligible assets and the drawing capacity against these, and ensure that an appropriate amount of assets are pre-positioned.

As the Fed continues to assess what happened in money markets last month, it could take a cue from the BoE and remind banks that Fed’s Regulation A says the discount window is a no-questions-asked facility that banks are encouraged to use, and that interagency guidance (from the Fed, OCC, FDIC, OTS, and NCUA) states that the discount
window can be an important component of banks’ liquidity management. The Fed and FDIC could also encourage banks to consider incorporating use of the discount window into their resolution plans.

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