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Cooperation Between Home And Host Central Banks Rather Than Fragmentation Of International Banks

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Abstract

The global move toward requiring international banking organizations to preposition liquidity at foreign subsidiaries and even branches reflects the more intense focus on entity-level and local jurisdictional-level resilience and resolvability since the global financial crisis. To some extent, the increased prepositioning is a consequence of strains that developed during and after the financial crisis in the informal understanding between central banks over the provision of lender of last resort support to an international banking organization. Stronger cooperation among authorities could allow for reduced prepositioning. Because fewer liquid assets are necessary to meet the liquidity needs of a global organization when those resources can be deployed flexibly across jurisdictions, increased cooperation would allow for more bank resources to be devoted to lending to businesses and households while achieving the same level of financial stability.

Key words: Lender of last resort, central bank cooperation, international banking, fragmentation

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1. **Introduction**

The global move toward requiring international banking organizations to preposition liquidity at foreign subsidiaries and even branches reflects the more intense focus on entity-level and local jurisdictional-level resilience and resolvability since the global financial crisis. To some extent, the increased prepositioning is a consequence of strains that developed during and after the financial crisis in the informal understanding between central banks over the provision of lender of last resort support to an international banking organization. Stronger cooperation among authorities could allow for reduced prepositioning. Because fewer liquid assets are necessary to meet the liquidity needs of a global organization when those resources can be deployed flexibly across jurisdictions, increased cooperation would allow for more bank resources to be devoted to lending to businesses and households while achieving the same level of financial stability.

2. **Need for central bank cooperation on lender of last resort (LOLR) lending to a global institution**

Liquidity needs can materialize quickly at a banking entity, requiring the host central bank to lend to the entity on short notice. For example, if a U.S. branch of a non-U.S. bank ends up with an overdraft in its Fed account late in the day, its only option to cover the overdraft at that time may be the discount window. In almost all instances, such a loan by a host central bank is unremarkable and requires no involvement by home country authorities. But in two situations, coordination is necessary.

First, if the borrowing bank needs a loan on different terms than are on offer from the host central bank, coordination is necessary. The terms on which central banks extend loans vary considerably across jurisdictions. The Federal Reserve, for instance, lends against a very wide range of collateral (essentially all assets a bank can hold), but only overnight or at most for a few days. The Bank of England accepts a broad range of collateral and will lend for longer terms. The European Central Bank (ECB) offers longer-term loans and is happy to be an ongoing source of funding, but accepts a narrower range of collateral (only securities issued in the Euro-area). As a result, if, for example, a U.S. branch of a European bank borrows from the Fed but needs funding for more than a few days, the ECB (coordinating with relevant national central banks within the Eurosystem) may need to step in and replace the Fed as the lender.

Second, in some cases liquidity needs result from market concerns about the financial situation of the borrowing bank. The home supervisor has a superior understanding of the bank’s consolidated balance-sheet and financial strength and makes any final decisions about the bank’s viability. In such cases, and in some others discussed here, any central bank lending ultimately should be handled by the home jurisdiction. This division of responsibility is certainly the case for branches but is likely to be the case too for the subsidiaries in groups subject to single-point-of-entry (“SPE”) resolution strategies.

3. **Pre-crisis arrangement: Coordination since the 1970s**

Central banks have had an informal understanding of how such situations are to be handled since at least the mid-1970s, when the Basel Committee on Banking Supervision was formed. The Committee was formed after German authorities closed Herstatt Bank at the end of the day German time but the middle of the day New York time, resulting in a severe disruption to foreign exchange markets. Under the informal understanding, the home central bank is ultimately responsible for providing LOLR liquidity (or not) although the host central bank could lend initially with the home central bank covering the loan within a few days. In September 1974, the central bank governors of the Bank for International Settlements (BIS) stated:

>The governors also had an exchange of views on the problem of the lender of last resort in the Euromarkets. They recognized that it would not be practical to lay down in advance detailed rules...
and procedures for the provision of temporary liquidity. But they were satisfied that means are available for that purpose and will be used if and when necessary.2

Although the language is vague because many central banks prefer to be vague about their willingness to provide LOLR assistance, the recognition that coordination between central banks was necessary and that “means were available” was enough to increase banks’ and other market participants’ confidence that central banks would act as effective liquidity backstop. In October 1974, Fed Governor Henry Wallich testified before Congress that the Fed was prepared to offer dollars to a Fed-member U.S. bank to cover any sudden withdrawal of petro-dollars from its home office or foreign branch. Wallich went on to indicate that foreign central banks are prepared to do the same, citing the BIS press communiqué.

The Basel Concordat, which was issued in 1975 and is still in effect, is about supervision, not LOLR, but it discusses a similar division of labor concerning liquidity supervision. In the first instance, the liquidity of foreign subsidiaries is supervised by the host banking agencies, but ultimately it is the responsibility of the home supervisor. That said, central banks have been keen to avoid confirming any direct connection between the Concordat and home-host responsibilities for LOLR.3 For example, the Bank of England noted in 1981 that the Concordat was “never intended to be an agreement about the provision of lender of last resort facilities to the international banking system . . . there is no automatic link between . . . responsibility for supervision and the assumption of a LOLR role.”4

The informal understanding between central banks became more concrete in advance of Y2K. In a paper on LOLR cooperation, Philip Turner, a former senior official of the BIS, observed:

For instance, discussions among central banks in the preparations for Y2K confirmed the general presumption that the host country central bank would have the initial responsibility for providing liquidity support to a foreign bank. But it was also recognized that the home country central bank might become responsible very soon after such support became necessary.5

Despite the informal agreement that prevailed before the financial crisis, there were challenges to cooperation. For example, the New York Department of Financial Services has always been explicit in requiring New York branches of FBOs to operate with a positive net asset position—in effect, a type of branch-based solvency requirement. If the FBO failed, the department would then be able to perform its role as receiver to repay creditors of the branch by refusing to release from the U.S. local assets until U.S. creditors were repaid. Those plans made it difficult to expect the home central bank to lend to cover a loan to the branch, especially if the collateral pledged to the Federal Reserve to cover the initial loan was needed to collateralize the loan from the home country central bank.

The host central bank can never be certain that the home central bank will be willing or able to take over a loan. Central banks all only lend to solvent banks, but the financial soundness requirements differ across

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central banks. Moreover, collateral policies differ considerably across central banks. If the Fed lends to a U.S. branch of a European bank against CRE loans—assets that are not eligible collateral at the ECB—there may not be sufficient eligible collateral at the parent for the ECB to lend.

The home central bank also may not have a sufficient amount of the host central bank currency. Before currency swap lines were established between the major central banks during the financial crisis, extending a loan in a foreign currency meant either depleting foreign currency reserves or purchasing that foreign currency in the open market. Both are actions the home central bank may be reluctant to take.6

4. Crisis and post-crisis developments: Strains in the informal understanding
During the financial crisis, the Fed and ECB had experiences that called into question the home-host arrangement. In the case of the Fed, U.S. branches of FBOs received a disproportionate amount of discount window lending (through both the regular discount-window lending facility (primary credit) and the Term Auction Facility (TAF) set up and operated during the financial crisis).7

Foreign banking organizations (including branches, agencies, and subsidiaries) accounted for about 85 percent of discount window credit from the start of the crisis through the end of 2009. . . . Similarly, foreign banking organizations accounted for more than 60 percent of TAF borrowing over the life of that program, and usage of the single-tranche repo program by broker-dealer subsidiaries of foreign banking organizations accounted for about 75 percent of the total.8

The relatively large amount of borrowing occurred because the financial crisis disrupted wholesale markets for short-term dollar funding, and U.S. branches of FBOs, which do not have deposit franchises, were reliant on those markets for funding. Indeed, the global U.S. dollar-denominated activities of FBOs were primarily funded in those markets. The discount window lending was consistent with the Fed’s terms and conditions and did not generate any losses for the Fed, but the lending drew public criticism.9 Moreover, a couple of U.S. branches were quite slow to pay down their loans when the Fed shifted out of war footing and wished only to extend short-term credit.

In the case of the ECB, in autumn 2008, Lehman Brothers Bankhaus AG defaulted on refinancing operations undertaken by the Eurosystem. The collateral, which mainly consisted of asset-backed securities, ultimately covered the extension of credit, but for a period the ECB had to book a mark-to-market loss.10 Worse, the Lehman crash also prompted the biggest payout in the history of the German banking industry's deposit guarantee fund. Lehman's German subsidiary had been a member of the

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mutual-aid arrangement, in which banks jointly guarantee the safety of customer deposits. By contrast, the Fed had no losses on any loans to Lehman (or on any other loans).

Other post-crisis developments further strained the understanding. In the United States, central bank lending, especially to an FBO, became politically unpopular, which increased the reluctance of the Fed to lend to the U.S. branch of an FBO. Lending to an FBO whose liquidity problems stemmed from legal difficulties within the United States would likely be especially unattractive. The increased stigma associated with borrowing from the window (especially in the United States) and the political sensitivity of lending to foreign banks made the Fed and commercial banks less willing to even discuss the prospect that any bank would ever need to borrow from a central bank, hindering efforts to develop home-host LOLR understandings.

In addition, the Dodd–Frank Act worsened the asymmetries between the lending authority of the Fed and authorities of other central banks, making it difficult to establish a symmetrical division of responsibilities. Dodd–Frank removed the Fed’s ability to lend to an individual nonbank (including a bank holding company) using its emergency lending authority under section 13(3) of the Federal Reserve Act (FRA) except as part of a broad-based facility. Under no circumstances can the Fed lend under 13(3) to prevent a failure (even as part of a broad-based facility). Importantly for potential home-host LOLR cooperation, the Fed now cannot lend under 13(3) to a U.S. broker-dealer sub of a troubled FBO. Furthermore, if a host central bank lends to the foreign broker-dealer or foreign bank sub of a U.S. bank holding company, the Fed cannot step in and replace the host central bank, because the Fed cannot lend to the holding company (or the foreign subsidiaries) under the revised 13(3). Because it cannot step in and cover certain loans, the Fed also cannot offer reciprocity to other central banks if they extend similar loans to entities in their jurisdiction.

5. **Less cooperation, greater balkanization**

The cracks that appeared in the framework for international cooperation on LOLR lending contributed to the Fed’s decision to require that the non-branch activities of large foreign banking organizations be collected under a single holding company with separate liquidity (and capital) requirements. When the Federal Reserve requested comment on its Intermediate Holding Company (IHC) proposal, it cited reduced cooperation as a reason. The request for comment stated, “[a]ctions by government authorities highlighted the fact that . . . centralized management of capital and liquidity . . . can increase the chances of home and host jurisdictions placing restrictions on the cross-border movement of assets in a crisis.” It also noted that foreign jurisdictions were adopting or considering adopting “increased requirements for liquidity to cover

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12 The high level of excess reserves in the banking system post-crisis makes it difficult to directly observe the high level of stigma, although anecdotes about bankers’ unwillingness to borrow from the discount window abound. The Federal Reserve Board’s February 2019 Senior Financial Officer Survey asked how likely it is that the respondent’s bank would borrow from the discount window to cover a short-term shortage of reserves. Seventy of the 72 respondent banks indicated it was very unlikely; the other 2 said it was unlikely. Unfortunately, there was no similar survey conducted before the financial crisis to serve as a point of comparison.
13 Appendix A presents a summary of the Fed’s avenues for providing LOLR assistance.
14 However, the Fed could cover a loan to a foreign subsidiary or branch of a U.S. commercial bank by lending to that bank using its authority under section 10B of the Federal Reserve Act to make an ordinary discount-window loan. For a further discussion of the Fed’s LOLR authorities, see Stanley Fischer, “The Lender of Last Resort Function in the United States,” remarks at “The Lender of Last Resort: An International Perspective,” conference sponsored by the Committee on Capital Markets Regulation, Washington, DC, February 10, 2016. https://www.federalreserve.gov/newsevents/speech/fischer20160210a.htm
local operations of domestic and foreign banks and nonbanks.” The request also stated that “[actions] by a home country to constrain a banking organization’s ability to provide support to its foreign operations . . . have called into question . . . the ability of the Board, as the host supervisor, to rely on a foreign banking organization to act as a source of strength to its U.S. operations when the foreign banking organization is under stress.”

In the final rule, the Board notes that it received many comments on the IHC proposal that suggested continued cooperation across jurisdictions would be a preferred solution. The Board responded, “Localized stress on internationally active financial institutions may trigger divergent national interests and increase systemic instability.”

More recently, the Board cited the fact that “foreign banking organizations borrow[ed] extensively from the Federal Reserve System [during the financial crisis] in order to continue operations” as evidence why a standardized liquidity requirement should potentially be applied to U.S. branches of FBOs.

6. **International efforts to promote cooperation**

At the same time, there have been countervailing efforts to promote continued coordination between central banks on the provision of liquidity to international banks. Top U.S. and U.K. financial authorities met twice (in 2014 and 2016) to discuss how to handle the resolution of the troubles of an international bank active in both of their jurisdictions, including associated liquidity issues. A third summit, in 2019, included officials from the European Union. In 2014, the Financial Stability Board (FSB) conducted a study of the resolution of global systemically important financial institutions. That effort culminated in an FSB report published in 2016 that stated that “Home and host authorities should cooperate to support the consistent and effective implementation of group-wide and local resolution funding plans.” The principles the FSB report identified were reflected in a subsequent FSB document in 2018 on the necessary components of a resolution funding plan.

More recently, a working group of the BIS’s Committee on the Global Financial System (CGFS) discussed the international coordination of liquidity assistance (LA) to a solvent international financial institution experiencing market-wide or firm-specific stress. The report recommended that there be “…ex ante clarity on the division of responsibility for providing LA…” (p. 2) although it did not make specific recommendations about how responsibility should be divided.

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7. Policy prescriptions

Advantages of cooperation

Despite the challenges, cooperation across central banks on LOLR responsibilities is preferable to the balkanization of the liquidity resources of international banks. Cooperation can lead to more economic activity without sacrificing financial stability. Alternatively, it can produce stronger levels of financial stability for a given amount of real economic activity.

An illiquidity failure of a solvent institution is an unnecessary deadweight loss for society caused by a market failure, so avoiding such failures is good public policy. Moreover, liquidity difficulties at one institution can generate concerns about similarly situated institutions and trigger a broader bank run.

Addressing the risk of liquidity pressures by insisting that banking branches and subsidiaries in each jurisdiction have their own liquidity resources can increase the probability of such crises occurring because liquidity is trapped within each jurisdiction, reducing the total amount of liquidity resources that can be allocated to meet a run on the bank.\textsuperscript{22} Addressing this risk by requiring international banking institutions each hold more liquidity in total, including at local branches and subsidiaries unnecessarily reduces economic growth. For instance, a 2016 study by the Bank for International Settlements found that the LCR requirement results in a 3- to 6-percent permanent decline in the level of bank lending. Since then, HQLA requirements appear to be growing further, given the advent of more local LCR requirements that ring-fence liquidity and force buffers to be held in more places, as well as Funding-in-Resolution requirements in other cases.

In the event of failure, SPOE resolution is consistent with the idea that liquidity should be the responsibility of the home jurisdiction. The first bulwark against a liquidity failure is the broader institution’s liquidity resources. The second is market access: Liquidity requires diversification. Cutting components of a banking entity off from those broader resources increases the likelihood that the entity will need to borrow from a central bank, the final bulwark against liquidity failure.

Steps to promote cooperation

Central banks and supervisory agencies can take certain steps to help facilitate cooperation. Most of these are also recommendations of the FSB and CGFS papers noted above.

The Fed could offer greater certainty to other major central banks that they will be able to draw on their dollar swap line whenever necessary. Currently, the FOMC authorization for the swap lines indicates that such lines can only be used to avoid negative consequences for U.S. financial markets and the U.S. economy.\textsuperscript{23} Absent certainty about their ability to source dollars through this channel, home central banks may be reluctant to commit to covering a loan by the Fed; the Fed, in turn, may, therefore, conclude that the FBO needs more prepositioned HQLA.

\textsuperscript{22} For a discussion of how trapping capital in each jurisdiction can increase bank risk, see D. Wilson Ervin, “The Risky Business of Ring-Fencing,” Credit Suisse, December 12, 2017. https://ssrn.com/abstract=3085649

\textsuperscript{23} The swap lines are reauthorized annually at the first FOMC meeting of the year. The minutes of the January 2019 FOMC meeting state, “Operations involving standing dollar liquidity swap arrangements and standing foreign currency liquidity swap arrangements shall generally be directed at countering strains in financial markets in the United States or abroad, or reducing the risk that they could emerge, so as to mitigate their effects on economic and financial conditions in the United States.”
There are several advantages when the Fed lends dollars to the home central bank, which then lends to the parent bank (as opposed to the Fed lending to the bank branch or subsidiary). The Fed is not exposed to credit risk and is less exposed to political fallout. The home central bank can lend against the broader pool of collateral available in the home jurisdiction and is better able to judge the solvency of the bank. If necessary, the home authorities would handle resolution.

An alignment between the authority responsible for solvency assessment and the authority that provides liquidity (irrespective of the currency) should make the international financial system more resilient. The European sovereign crisis is a good example of the issues that arise when roles are misaligned. At the time of the European sovereign crisis, the ECB was the provider of EUR liquidity to Eurozone banks. However, the supervision of banks was still the responsibility of competent national authorities. Because the ECB was only allowed to lend to “solvent banks” but had no direct capacity to assess the borrowing bank’s solvency, it had no other choice than relying on the solvency assessment of the national supervisor. Such a misalignment of interests was probably one of the reasons for creating the Banking Union and anchoring the Single Supervisory Mechanism under the umbrella of the ECB, realigning the solvency assessment and the provision of liquidity.

In the International Monetary Fund’s recent Financial Sector Assessment Program (FSAP) on France, the IMF notes:

74. The Banque de France ELA [emergency liquidity assistance] scheme, which is well aligned with the euro system framework, would benefit from enhancements.
Given the importance of FX wholesale funding in the banking system, establishing mechanisms and rules regarding ELA in FX is an avenue that needs to be explored while addressing the feasibility of advance agreements and the conditions for swap lines for this purpose.24

LOLR coordination is also facilitated if one central bank can take collateral on behalf of another. For example, in 1974, the Bank of England held the physical documentation of assets of Franklin National Bank that the New York Fed lent against.25 Such arrangements can help address situations where the collateral necessary for a home central bank to cover a loan is in the host jurisdiction. Similarly, central banks can expand their ability to take collateral in foreign jurisdictions from foreign or domestic institutions—for instance, by establishing accounts at foreign securities depositories.

Coordination can be enhanced by ensuring that host central banks have sufficient information about the financial condition of international banks operating in their jurisdiction to make a well-informed initial lending decision. Similarly, if the home central bank shared with the host central bank whether it would be willing to lend to an international bank (i.e., whether it considers the bank solvent), the host central bank could lend with confidence knowing that the home central bank would be willing to step in and take over the loan.

Although steps to enhance LOLR cooperation would ideally be implemented at a global level, they could be limited to a group of Central Banks essential to the well-functioning of the international financial system. Pragmatically, this would cover central banks that:

- Are issuing a currency used internationally;
- Are home to G-SIBs;
- Have consolidated liquidity regulations in place (including LCR by significant currency) that comply with BCBS requirements; and
- Have credible resolution plans supported by appropriate amounts of TLAC

**Implications for liquidity supervision and regulation**

If there are clear understandings between central banks that the host central bank may lend initially but the home central bank is ultimately responsible for LOLR lending, and if collateral and information sharing arrangements to facilitate the implementation of such understanding are in place, then there could be corresponding adjustments to liquidity prepositioning requirements to allow for greater economic growth without increased risk of financial instability.

While the purpose of bank capital regulations is clear – control the probability of bank default – the purpose of liquidity regulations is less clear. If the illiquidity of a solvent banks is a market failure that can be solved by a lender of last resort, liquidity regulations are a deadweight cost. In “Why do we need both liquidity regulations and a lender of last resort,” Carlson, Duygan, and Nelson (2015) argue that liquidity requirements buy time for central banks to determine if a bank experiencing liquidity difficulties is solvent before extending LOLR assistance. Restricting LOLR lending to solvent borrowers can reduce moral hazard, lessen the chance that the lending will increase costs for the deposit insurance authority, and reduce the likelihood of an inappropriate fiscal action by an independent central bank.\(^{26}\)

Consistent with the view that the purpose of liquidity regulations is to buy time, greater central bank cooperation on LOLR lending reduces the need for HQLA to be prepositioned in host jurisdictions because a host central bank can expect the home country central bank to take over responsibility for a liquidity need quickly. In particular, sufficient HQLA is only needed to give enough time to arrange a handoff to the home authorities (or home institution).\(^{27}\)

In addition, if the host central bank can accept collateral in the home jurisdiction, then less HQLA needs to be ring-fenced ex-ante in the host jurisdiction. Moreover, that collateral can support lending in the United States to nonbank subsidiaries of a foreign holding company to which the Fed would be unable to lend.

If HQLA can be held at the parent institution and deployed when needed, then less HQLA is needed than under a more fragmented regime to achieve the same low probability of a liquidity default or distress with no central bank lending. Consequently, central bank cooperation on LOLR rather than excessive prepositioning of liquidity at branches and subsidiaries can achieve the same financial stability outcomes but with a larger share of bank resources devoted to providing credit to the real economy.

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\(^{26}\) On the importance of restricting LOLR lending to solvent banks see Tucker (2014).

\(^{27}\) Analogously, the LCR requirement for medium-sized banks in the United States is 70 percent of the full requirement, because the institutions would likely have less complicated liquidity issues that can therefore be addressed in 3 rather than 4 weeks. Similarly, U.S. branches of FBOs are already subject to a 14-day liquidity requirement.
REFERENCES


APPENDIX A

The Fed’s Avenues for Providing LOLR Assistance

1. Options for offering liquidity other than through section 13(3)
Although the Dodd–Frank Act curtailed 13(3) lending, the Federal Reserve still has several options for fostering liquidity. For 70 years before the financial crisis, the Fed handled LOLR situations using its standard discount-window authority to lend to depository institutions. These included U.S. branches and agencies of foreign banking organizations under section 10B of the FRA. It is likely that many future situations could also be handled using that authority.

The Fed can lend to a depository institution and the institution can onlend the funds to a nonbank subsidiary of the bank holding company, but section 23A of the Federal Reserve Act (FRA) limits such onlending to 10 percent of bank capital. Section 23A also applies to extensions of credit made by a U.S. branch of a foreign banking organization to affiliates engaged in the United States in certain financial activities in the U.S. such as securities underwriting and dealing. Section 23A can be waived, but only now.

However, Section 23A does not apply to intercompany transactions fully collateralized by Treasury or U.S. Federal government Agency collateral. Consequently, the commercial bank subsidiary could onlend funds received from the Fed if its lending to the affiliate is collateralized by such collateral. However, leverage ratio requirements may prevent the transaction because the borrowing and onlending by the commercial bank increases the size of the bank’s balance sheet.

Dodd–Frank did not change the Fed’s authority under section 13(13) of the Federal Reserve Act (FRA) to lend to essentially any entity against Treasury and Agency collateral. As a result, the Fed can lend directly to a U.S. broker-dealer of an FBO in distress that has available Treasury or Agency collateral.

It is worth noting that both the option of regular discount window lending with interaffiliate lending secured by Treasury or Agency collateral and the option of direct lending under section 13(13) secured by Treasury or Agency collateral may not prove helpful. A broker-dealer subsidiary with available Treasury and Agency collateral probably has no liquidity difficulties.

If liquidity problems were widespread, then the Fed could open a broad-based facility under 13(3) that lent to the U.S. nonbank subs of FBOs. For example, if statutory preconditions are met (including a required finding of “unusual and exigent circumstances”) the Fed could reopen the Primary Dealer Credit Facility (PDCF) that it operated during the financial crisis. Under the PDCF, the Fed conducted repos with large broker-dealers, including U.S. broker-dealer subs of FBOs, against a wide range of collateral.20 But the facility could not now be opened to help out an individual troubled institution, nor could it extend credit to an institution to help it avoid bankruptcy.

And if there is time, the home central bank can borrow dollars from the Fed under the swap lines and then lend to the broker-dealer, perhaps indirectly through the parent institution.

2. The Fed’s lending authorities

Regular lending

The Fed is authorized to lend to depository institutions (commercial banks, thrifts, and credit unions) and U.S. branches and agencies of foreign banks under section 10B of the FRA. The loans can have maturities of no more than 4 months unless they are collateralized by home mortgages, and they must be secured to the satisfaction of the lending Reserve Bank. If the Fed lends to a bank for more than 5 days after the bank becomes critically undercapitalized, or if the Fed lends for more than 60 days in any 120-day period, the Fed is liable for any resulting increased resolution cost to the FDIC. This makes such lending unlikely.

Regular lending is often referred to as “discount window” lending, with the interest rate charged on such loans called the “discount rate.” The Fed extends discount window credit under three facilities. Under the primary credit facility, the Fed lends overnight (no questions asked) to financially sound banks (CAMELS rating of 3 or better). Under the secondary credit facility, the Fed lends to troubled banks. And finally, under the seasonal credit facility, the Fed offers credit to small banks to meet seasonal needs.

The Fed seeks to accept all “bankable assets” as collateral for discount window loans. In particular, the Fed accepts investment-grade securities (including some securities denominated in foreign currency and held abroad) and non-criticized loans. Most banks pledge a pool of collateral to the Fed, often a book of loans, and leave the collateral there for when it is needed. Loans are backed by all the collateral, not merely individual pieces.

During the financial crisis, the Fed auctioned term loans to financially sound banks under the “Term Auction Facility” or TAF. The TAF is still listed as a discount window lending facility in Regulation A.

The FRA, as amended by Doff-Frank, now requires the Fed to disclose information on all borrowing, including the identity of the borrower, 2 years after the loan is extended.

Emergency lending

The Fed is authorized to lend to nonbanks in “unusual and exigent circumstances” under section 13(3) of the FRA. Before the FRA was changed by Dodd–Frank, the restrictions were only that the lending be collateralized and that the borrower was unable to secure adequate credit from a banking institution.

Dodd–Frank added several restrictions. Most importantly, the loans must be made under a broad-based facility and cannot be intended to remove assets from the balance sheet of a specific institution or to help it avoid failure. In addition, the facility must be approved by the Secretary of the Treasury. The Fed must publish information on the loan, including the borrower, 1 year after making the loan. It must also submit borrowing information to Congress 7 days after making the loan.

Loans extended under section 13(3) are often referred to as emergency credit. The Fed used its 13(3) authority repeatedly during the financial crisis. It lent to individual nonbank institutions, put a floor on

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potential losses on pools of assets held by two large bank holding companies, and opened broad-based facilities. Only the broad-based facilities would be legal under current law.

Repos against Treasury or Agency securities

The Fed conducts open market operations (OMOs) under Section 14 of the FRA. On the open market, it is allowed to buy securities issued or guaranteed by the U.S. government or its agencies, as well as some other types of securities. Most importantly, the Fed buys and sells Treasury securities, Agency securities, and Agency MBS. The Fed has interpreted this authority as allowing it to engage in repurchase agreements (and reverse repurchase agreements) of such securities. A repo is essentially a collateralized loan. Consequently, Section 14 enables the Fed to “lend” against OMO securities.

During the financial crisis, the Fed used its Section 14 authority to lend under the PDCF against OMO collateral (in the form of repos), to swap OMO securities under the Term Securities Lending Facility, and to engage in “single-tranche” repos under which the New York Fed lent for 28 days against any securities it accepted under its regular repos.

Swap lines

Section 14 of the FRA also authorizes the Fed to buy and sell foreign exchange. Using that authority, the Fed has established currency swap lines with other major central banks. Under the “dollar liquidity swap lines,” the foreign central bank sells the Fed its currency for dollars at the prevailing exchange rate. At an agreed future time, the foreign central bank gives the dollars back, plus interest, and the Fed gives the foreign currency back. Under the “foreign-currency liquidity swap lines,” the Fed borrows foreign currency from other central banks in exchange for dollars. Currently, the Fed has both types of swap lines with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank.

Loans against Treasuries and Agencies

Section 13(13) of the FRA authorizes the Fed to make loans to anyone against U.S. government or U.S. agency obligations. The loans cannot have maturities greater than 90 days but are otherwise unrestricted.