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Discount Window Stigma: We Have Met the Enemy, and He Is Us

Bill Nelson | Aug. 10, 2021

Paraphrasing former Fed Governor and former bank CEO Betsy Duke when she was asked to explain why banks are reluctant to use the discount window: "Borrowing from the discount window is like borrowing from your parents. You'll do it if you have to, but nobody wants to." Putting it a bit more extremely, the U.S. treasurer of a foreign bank explained that when he took his job, he was told that if he borrowed from the discount window, there would be two phone calls: one to the CEO from the New York Fed asking why the bank borrowed, and one to him from Human Resources instructing him to clear out his desk.

Because banks are extremely reluctant to borrow from the discount window, the window is a less effective tool for monetary policy implementation and for responding to a financial crisis. Although less important under the Fed's current large-balance-sheet monetary policy operating framework, the discount rate is supposed to put a ceiling on the federal funds rate. This is because banks should be willing to borrow from the discount window rather than borrow at a higher interest rate in the market. But in practice, it is an ineffective ceiling, because banks will pay much more in the market to avoid borrowing from the window.

Similarly, discount window lending should act as a safety valve when there are widespread liquidity concerns, both because of actual lending and because banks know that they and their bank counterparties can borrow. As described by Federal Reserve Board economists Mark Carlson and Jonathan Rose in "Stigma and the Discount Window" (2017), the stigma associated with the discount window impaired its effectiveness in meeting bank demands for liquidity following the October 1987 stock market crash and in easing banks' liquidity concerns in August 2007. Indeed, in 2008, both the President's Working Group on Financial Markets and the Financial Stability Forum (since renamed the Financial Stability Board) identified the stigma associated with borrowing from the Federal Reserve's discount window as a significant threat to financial stability.[1] Moreover, if banks are unwilling to borrow from the discount window, they will each demand much higher levels of reserve balances (deposits at the Federal Reserve Bank) to meet liquidity contingencies, increasing the size of the Federal Reserve's balance sheet necessary for monetary policy implementation.

Over the past 50 years, the Federal Reserve has twice revised Regulation A (the regulation that covers discount window lending) in efforts to reduce stigma. In 1971, the Board established a "basic borrowing privilege" so that banks' ability to use the window to meet liquidity contingencies was more transparent.[2] Going further, in 2003, the Fed switched to extending discount window loans, no questions asked, relying on an above-market rate and financial soundness criteria to prevent banks from using the window as a continuous source of funding.[3]

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[1] The President's Working Group on Financial Markets, March 2008, p. 9; FSF Working Group on Market and Institutional Resilience, April 7, 2008, p. 8; and FSF Working Group on Market and Institutional Resilience, October 10, 2008, p. 35.

[2] "Report of a System Committee," *Reappraisal of the Federal Reserve Discount Mechanism*, Volume 1, August 1971, p. 10.

[3] Madigan, Brian, and William Nelson (2002), "Proposed revision to the Federal Reserve's discount window lending programs," *Federal Reserve Bulletin*, July 2002, pp. 313–319. https://www.federalreserve.gov/pubs/bulletin/2002/0702lead.pdf

What is usually overlooked is that discount window stigma was deliberately manufactured by the Fed. From early in its history, the Federal Reserve offered banks loans but also considered it inappropriate for banks to borrow, and that cognitive dissonance toward the window persists to this day.

In "Evolution of the Role and Functioning of the Discount Mechanism," Clay Anderson noted:

> Soon after the System began operations Reserve Bank officials became concerned over the general attitude of member banks toward borrowing from Reserve Banks. Many banks thought of borrowing from the Reserve Bank in the same way as borrowing from a correspondent—a source of funds to lean on when its own resources were short. Reserve Bank officials tried to inculcate in bankers the philosophy that Reserve Banks should be regarded as lenders of last resort.[4]

In the first half of the 1920s, about 260 Federal Reserve member banks failed. Most of them had been habitual borrowers at the discount window, with many borrowing continuously for one or two years. In response, the Federal Reserve took steps to reduce continuous borrowing. As a result, the number of member banks borrowing continuously for a year or more was cut in half between August 1925 and the end of 1927.[5]

The Fed conducted a study of the discount window that was published in 1954 because it was again worried about excessive borrowing. The study made recommendations for revisions to Regulation A that were adopted in 1955. The study again noted that a Fed preference that banks not borrow from the discount window was longstanding.

> Because of this costly lesson [the failures of borrowers in the early 1920s], it was possible by the mid-Thirties to speak of an established tradition against member bank reliance on the discount facility as a supplement to its resources.[6]

The review went on to state, "Future discount policy . . . should build on the tradition [against reliance on the discount window] *as a keystone"* (p. 13, emphasis added). A 1971 study of the discount mechanism summarized one of the main objectives of the 1955 revision:

> That member banks are generally reluctant to borrow is . . . in the public interest. In order to prevent a weakening of this attitude, it is necessary that Regulation A be formulated so as to give support to the extant "tradition against borrowing."[7]

The 1971 report on the discount window describes how the Fed administered discount window borrowing to support the "tradition against borrowing" after the 1955 revision to Regulation A. While initial requests for credit were almost always granted,

> Beyond this initial accommodation, the administrative process can, for purposes of analysis, be broken down into three consecutive stages: (1) surveillance of the borrowing bank; (2) a decision with respect to the "appropriateness" of the borrowing; and (3) in cases where an "inappropriate" decision is reached, the undertaking of "administrative counseling" or "discipline" aimed at securing repayment and "educating" the borrower in the appropriate use of the discount window. (p. 42)

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[4] Clay J. Anderson, "Evolution of the Role and Functioning of the Discount Mechanism," *Reappraisal of the Federal Reserve Discount Mechanism*, Volume 1, August 1971, p. 1.
[5] Bernard Shull, "Report on Research Undertaken in Connection with a System Study," *Reappraisal of the Federal Reserve Discount Mechanism*, Volume 1, August 1971, p. 35.
[6] System Committee on the Discount and Discount Rate Mechanism, "Report on the Discount Mechanism," March 12, 1954, p. 12.
[7] Bernard Shull, "Rationale and Objectives of the 1955 Revision of Regulation A," *Reappraisal of the Federal Reserve Discount Mechanism*, Volume 1, August 1971, p. 120.

Borrowing from your parents, indeed. As we have noted, both the 1971 and the 2003 revisions to Regulation A were efforts to reverse the effects of the 1955 revision and reduce the stigma associated with borrowing from the discount window.[8]

After the 2003 revision, the Federal Reserve and the other banking agencies made it clear that banks were encouraged to include use of the discount window in their liquidity plans. Supervisory guidance established jointly by all the federal banking agencies in 2003 instructed supervisors to recognize that the discount window is an important tool for liquidity management:

> The new primary credit program has the following attributes that make the discount window a viable source of back-up or contingency funding for short-term purposes:
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> - A less burdensome administrative process than applied under the previous adjustment credit program makes primary credit a simpler and more accessible source of back-up, short-term funding;
> - Primary credit can enhance diversification in short-term funding contingency plans;
> - Discount window borrowings can be secured with an array of collateral, including consumer and commercial loans;
> - Requests for primary credit advances can be made anytime during the day; and
> - There are no restrictions on the use of short-term primary credit.[9]

Going further, the National Credit Union Association (NCUA) *requires* its larger members to establish backup funding sources either through its "Central Liquidity Facility" or at the Federal Reserve's discount window.

Notably, the banking agency guidance runs directly contrary to the earlier efforts to reduce "member bank reliance on the discount facility as a supplement to its resources," described above.

Moreover, marking a sharp change from the Fed's previous attitude, the 2003 guidance encourages banks to borrow from the discount window to take advantage of interest rate differentials. The Federal Reserve System's discount window FAQs state:

> There are no restrictions on the use of primary credit. In particular, borrowers are not prohibited from using primary credit to finance sales of federal funds.[10]

Such relending is helpful for monetary policy implementation because, if the federal funds rate is above the discount rate, the bank that needs the funds need not borrow from the discount window, as long as another bank is willing to borrow and then relend the funds to the bank that came up short.

The Fed has also taken further steps to reduce stigma since the 2003 revision. During the global financial crisis (GFC) of 2007–09, the Fed created the Term Auction Facility (TAF) to provide banks with discount window funding in a manner intended to be largely stigma-free. In particular, the TAF distributed one- and three-month discount

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[8] Confusingly, by adding to stigma, the Fed saw itself as accomplishing essentially the same objective of later Fed attempts to reduce it. "From the standpoint of effective reserve banking operations, such a tradition [against borrowing] permits the discount facility to serve as a safety valve, easing temporarily the special reserve pressures on individual banks." System Committee on the Discount and Discount Rate Mechanism, "Report on the Discount Mechanism," March 12, 1954, p. 12.

[9] "Interagency advisory on the use of the Federal Reserve's primary credit program in effective liquidity management," (July 23, 2003), p. 4. https://www.federalreserve.gov/BoardDocs/press/bcreg/2003/20030723/attachment.pdf

[10] https://www.frbdiscountwindow.org/pages/general-information/faq

window loans at interest rates determined at periodic auctions, thus reducing the implication that the borrowing bank was desperate for funding.

Early in the COVID-19 crisis, on March 15, 2020, the Fed encouraged banks to use the discount window by cutting the discount rate and extending the initial maturity of discount window loans from overnight to 90 days.[11] The next day, the federal banking agencies issued a joint statement encouraging banks to use the discount window.[12] And when borrowing increased, the Fed issued a statement saying it was encouraged that the increase indicated that banks were willing to borrow from the discount window.[13]

Most recently, the Fed opened a standing repo facility at which the Fed will lend to primary dealers and eventually banks against Treasury collateral. One objective for such a facility is to lend banks money in a way that looks and feels different from the discount window, thereby potentially reducing stigma.

Working at cross-purposes with these efforts, the Fed more recently has taken steps that carry the message that borrowing from the discount window indicates there is something wrong with the borrowing bank. The main bank liquidity requirement, the Liquidity Coverage Ratio, does not recognize the discount window as a potential source of liquidity, nor do bank resolution liquidity requirements. Indeed, in May 2019 the Fed proposed that foreign banking organizations be subject to toughened liquidity regulations precisely because "analysis using Federal Reserve Board data on TAF usage in 2008 and 2009 finds that approximately 40 percent of foreign banking organizations borrowed from the facility during the financial crisis."[14] Recall that the TAF was designed so that banks would be willing to use it.

Congressional and public perceptions of the discount window have also contributed to the message that borrowing should be avoided. Even though, as we have described, the Fed encouraged banks to borrow from the discount window during the GFC, and every discount window loan was repaid on time with interest, borrowing during the GFC is often lumped together with the government's capital injections under the Troubled Asset Relief Program and described as bank bailouts. Indeed, while details on individual discount window loans had previously been kept confidential because such confidentiality is essential for potential borrowers to be comfortable using a backup funding source, post-GFC legislation requires the Fed to disclose loan details, albeit with a two-year lag.

Perhaps not surprisingly, stigma associated with borrowing at the discount window is therefore currently extremely elevated. In response to the Fed's Senior Financial Officer Survey in March 2021, less than 10 percent of respondents indicated that they would borrow from the discount window "if other funding sources are too expensive." Over 60 percent said they would borrow "only if other funding sources became less available due to market-wide conditions." Notably, over 10 percent of respondents listed no conditions under which they would borrow.

It is not necessary that the Fed keep relearning the same lesson. Those struggling to reduce stigma currently should take note of their predecessors' observations 50 years ago:

> Failure of the Federal Reserve to communicate clearly, consistently, and unambiguously with member banks regarding the availability of discount-window accommodation has caused many of these banks to view this as an uncertain source of credit. In addition, occasional Federal Reserve counsel as to what would be regarded as appropriate adjustments for borrowing banks has led many banks to regard the window as having too great a potential for interfering with bank management decisions. As a result,

[11] https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315b.htm
[12] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200316a1.pdf
[13] https://www.federalreserve.gov/newsevents/pressreleases/monetary20200319c.htm
[14] https://www.federalregister.gov/documents/2019/05/15/2019-07895/prudential-standards-for-large-foreign-banking-organizations-revisions-to-proposed-prudential

> many banks having temporary needs for funds often make adjustments by more costly, less efficient avenues than that afforded through the discount window, sometimes to the detriment of adequate credit availability for their local communities.[15]

The Fed is again failing to communicate "clearly, consistently, and unambiguously" about its views on whether banks should use the discount window. Regulation A is essentially unchanged since the 2003 revision, and the discount window is, at least in theory (and statute), a no-questions-asked source of credit that banks are encouraged to use as part of their liquidity plans. But the Fed's treatment of borrowers, and the design of post-GFC liquidity requirements, send a clear message: banks should not incorporate the discount window into their liquidity plans. Frankly, it would be best if they did not borrow at all.

The stigma associated with the discount window may not seem like a pressing problem currently, because the Fed is injecting an astronomical amount of liquidity into the banking system through its ongoing purchases of government securities. Eventually, though, those purchases will end, and the Fed may decide to reduce its balance sheet. The Fed will once again grapple with the question of why banks feel the need to keep massive deposits at the Fed sufficient to cover all liquidity contingencies without borrowing from the discount window. At that point, the Fed should learn from its own history and finally drop its come hither/stay away approach to managing the discount window.

The Fed could go a long way toward increasing transparency and reducing stigma if Fed officials were to state publicly that the 2003 revision to Regulation A remains applicable; that banks are encouraged to borrow and loans will be offered, no questions asked; and that the Fed and other Federal Banking agencies continue to encourage banks to include the discount window as part of their liquidity contingency plans. Moreover, the Fed could state plainly that its new Standing Repo Facility is a reliable source of funding and can be included in contingent liquidity plans, including resolution plans. Conversely, the Fed could again revise Regulation A to make it clear that borrowing will be seen as a sign that a bank is unsafe and unsound, and that banks should consider borrowing only as a last resort.

After 108 years, the Fed must accept that it can't have it both ways.

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[15] "Report of a System Committee," *Reappraisal of the Federal Reserve Discount Mechanism*, Volume 1, August 1971, p. 9.