A Major Limit on the Fed's Crisis Toolkit: Shame

Bill Nelson and Patrick Parkinson | Jan. 25, 2021

Regulatory reforms implemented in the wake of the Global Financial Crisis have greatly increased the resilience of the banking system, as was evident from the severe real-world stress test supplied by COVID-19. But no set of regulations can fully immunize the banking system from external shocks. Thus, it remains critical that U.S. government authorities have effective crisis management tools, including a robust resolution regime and a set of federal safety-net tools. In this post, we argue that the effectiveness of Federal Reserve lending facilities, which are perhaps the most effective tools for addressing an incipient crisis, has been significantly impaired by the stigmatization of use of those facilities by banks and other potential users. We explain why this stigma is a threat to financial stability, identify the sources of stigma and recommend measures to diminish stigma and thereby boost the effectiveness of the Federal Reserve's liquidity tools and reduce systemic risk.

STIGMATIZATION OF FEDERAL RESERVE LENDING FACILITIES POSES A THREAT TO FINANCIAL STABILITY

Banks facilitate borrowers' access to stable long-term financing by engaging in maturity transformation, that is, by borrowing at short maturities at which depositors and other creditors prefer to lend and lending at longer maturities. These practices promote economic growth and wealth creation, but at the same time they are a potential source of risk, not only to the banks but also to borrowers and to the economy. If depositors and other creditors withdraw large volumes of deposits or short-term funds at maturity, banks could be forced to engage in fire sales of their longer-term assets or curtail the availability of new loans. In turn, the borrowers could be forced to retrench and therefore aggregate economic activity and employment could fall. The discount window and other Federal Reserve lending facilities, such as the recently created standing repo facility (SRF) and emergency facilities created under section 13(3) of the Federal Reserve Act, can in principle eliminate the risk and societal cost of the contraction of credit availability and employment by allowing solvent banks and nonbank financial institutions to meet their needs for cash by borrowing against their assets rather than selling them at steep discounts or pulling back from new lending.

But these facilities can produce these benefits only if banks and other financial institutions that have access to the facilities are willing to use them, and banks have become increasingly reluctant to use these facilities as their use has become much more stigmatized. If stigma renders these facilities unused and therefore ineffective, liquidity shocks can pose a significant threat to the financial system and to the economy. Indeed, in 2008 both the President's Working Group on Financial Markets and the Financial Stability Forum (the antecedent of 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] To protect the economy, the Federal Reserve may again feel compelled to engage in programs through which it purchased large amounts of commercial paper and corporate bonds. Such programs can expose the Federal Reserve to substantially more credit risk than collateralized lending programs, where haircuts applied to the collateral can be designed to avoid transferring risk from the borrowers to the Fed .[2]

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[1] 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] In March 2020 the Treasury used funds created by the CARES Act to provide credit support for those asset purchase programs. Such credit support is appropriate and arguably necessary to protect the Fed from losses, but, with or without such credit support, taxpayers still ultimately bear the risks.

Similarly, the Federal Reserve could judge that it had to again engage in massive purchase of Treasury securities and Agency MBS as it did in March and April 2020 when markets for those securities experience episodes of illiquidity and excessive volatility, exposing the Federal Reserve to interest rate risk. However necessary, such credit and asset-purchase programs can create moral hazard that subsidizes excessive risk-taking throughout the economy, which could threaten financial stability. Furthermore, because past asset purchase programs can be seen as a precedent for future programs, the Federal Reserve could come to play a major ongoing role in determining the allocation of credit. As departing Vice Chair for Supervision Randal Quarles said about 13(3) facilities:

> …extended provision of credit to broad sections of the economy through the mechanism of 13(3) without either a required appropriation or effective limit could easily prove an impossible lure for future Congresses to resist, under the guise of one "emergency" or another: having established the precedent that the Fed can lend to businesses and municipalities for the COVID event, there will inevitably be those whose plans are grand and whose patience with democratic accountability low who will begin to ask why the Fed can't fund repairs of the country's aging infrastructure, or finance the building of a border wall, or purchase trillions of dollars of green energy bonds, or underwrite the colonization of Mars.[3]

The Federal Reserve needs to identify and to the extent possible mitigate the sources of stigma that undermine the effectiveness of Federal Reserve liquidity facilities for which asset purchase programs are a problematic alternative.

SOURCES OF STIGMA

The stigma associated with the use of Federal Reserve lending facilities has existed since near the creation of the Fed, but it intensified significantly following the 2007-09 financial crisis (see "Discount Window Stigma: We Have Met the Enemy and He is Us"). This stigma has several different sources, each of which impact decisions by banks on whether to utilize the lending facilities. Knowledge that a bank has used a lending facility may spark adverse reactions by the bank's creditors, its supervisors or the public and its elected representatives.

Even though banks that borrow from the Fed have to be solvent, creditors may infer that a bank using these facilities is financially troubled, which may induce them to curtail funding of the bank. Ironically, in this case the use of a facility intended to mitigate the adverse effects of a run on a bank may in fact spark or intensify a run on the bank. This source of stigma is particularly important for banks that rely significantly on sources of funds other than insured deposits. Even though details about discount window loans are not disclosed for two years, and details about emergency loans not for one year, borrowers can be concerned that borrowing will become known. The Fed elected to disclose details about borrowing from programs funded in part by the CARES Act after only a few months.

Supervisors may punish a bank for using a Federal Reserve lending facility if they conclude that use of the facility was a result of inadequate liquidity risk management by the bank.[4] Since the Global Financial Crisis, bank supervisors have implemented a large and complex set of regulations and supervisory policies regarding the management of liquidity risk. Some of those rules and policies can be read to imply that use of the discount window or other Federal Reserve liquidity facilities is not an appropriate component of banks' contingency funding plans. Bankers indicate that their supervisors would consider borrowing from the Federal Reserve as evidence that the bank had not managed liquidity risk effectively. This may be indicative of a disconnect between top officials at the Federal Reserve, who encourage banks to utilize the discount window, and banks' primary supervisory contacts, who seem to hold a different view. Even during periods when the Fed has encouraged banks to use the

[3] https://www.federalreserve.gov/newsevents/speech/quarles20211202a.htm

[4] See Discount Window Stigma: We Have Met the Enemy, and He Is Us - Bank Policy Institute (bpi.com) for examples.

discount window, banks judge that their supervisors would hold such borrowing against them later on. (See "Bank Treasurers' Views on Liquidity Requirements and the Discount Window.")

True liquidity facilities take the form of collateralized lending at haircuts (discounts of collateral to current market values) that are designed to avoid any losses to the Federal Reserve in the event that the bank fails to repay the loan. Nonetheless, such collateralized loans have been characterized by some (including members of Congress) as "bailouts."

Examples are legion, but just to name two: Sen. Bernie Sanders (I-VT) stated in 2011, "When JPMorgan Chase was telling the world about their great financial success, it seems like they were using the Fed's discount window as a giant piggy bank."[5] Regarding discount window borrowing by U.S. branches of foreign banking organizations, then-Rep. Ron Paul (R-TX) stated in a 2011 hearing, "Do you think this is a good idea that a foreign bank, all they have to do is open up and get these bailouts?"[6]

Banks have internalized these sources of stigma in their policies, practices and attitudes toward use of Federal Reserve liquidity. Indeed, bank treasurers indicate that the view that discount window borrowing should be avoided at all costs is deeply ingrained within their corporate culture and practices. In many cases, borrowing would require approval from a senior internal bank committee. Some treasurers indicate that they would never borrow, while some indicate that they would borrow only if they needed to because of payment system breakdown or other operational issues. All indicated that they would alert their bank supervisor to the borrowing immediately, and in some cases prior to the borrowing.

PRACTICAL MEASURES TO DIMINISH STIGMA

Practical measures are available to reduce each of these sources of stigma. As noted by the President of the San Francisco Federal Reserve Bank at the July 2016 meeting of the Federal Open Market Committee, the measures nearly all entail the Federal Reserve changing its practices:

> It's not about who's causing the stigma. It's us, right? We're the central bank, and the policies that we set and the decisions we make are what cause banks not to want to come to the discount window…And so I think that when we say we want to reduce stigma, we might look maybe a little more inwardly and think harder about why it is that we developed that situation in the first place.[7]

Healthy banks should be encouraged to make occasional use of the discount window and other liquidity facilities, so as to invalidate assumptions by creditors that use of the facilities indicates that the user is financially troubled. In practice, the Federal Reserve would need to make changes to the terms of the facilities or how it implements monetary policy to make borrowing more common. In particular, the discount rate would either need to be closer to market rates, or the Fed would have to regularly leave money markets short of liquidity, or both, so that borrowing became a normal occurrence. Public statements by the Federal Reserve could also help reduce the stigma, but only if those statements had the desired impact by reducing the other sources of stigma, including views held by bank examiners and public officials.

In addition, there is no reason for the Federal Reserve to disclose who is using the facilities. The public's need to know can be met by periodic disclosures of aggregated data on the use of the facilities. The notion that borrowers need to be identified is predicated on the view that use of the facilities is inappropriate; however, use of the facilities is not only appropriate but essential to ensure that liquidity shocks are not unnecessarily amplified into

[5] https://www.sanders.senate.gov/press-releases/release-sanders-statement-on-new-federal-reserve-lending-disclosures/

[6] Hearing of the Domestic Monetary Policy and Technology Subcommittee of the House Financial Services Committee, "Federal Reserve Lending Disclosure: FOIA, Dodd-Frank and the Data Dump," June 1, 2011, Bloomberg Government transcript.

[7] FOMC Meeting Transcript, July 26-27, 2016 (federalreserve.gov)

shocks that threaten a bank's solvency or the stability of the banking system and the economy. That said, current disclosure requirements are established by law and so would be difficult to change.

Bank supervisors can review the complex body of regulations and policies regarding bank liquidity risk management to make clear that use of the discount window and other Federal Reserve liquidity facilities is an appropriate component of banks' overall policies and contingency plans for managing funding liquidity risk. Any provisions of existing regulations and policies that imply that any use of the discount window to turn sound assets into cash is inappropriate should be amended.

The Fed's recently created standing repo facility illustrates many of these issues. At the SRF, the Fed would lend to primary dealers and large banks against Treasury and Agency collateral. The facility was created in part in the hopes that it would not be subject to the stigma associated with borrowing from the discount window even though its function is essentially the same. And, indeed, bank treasurers report that there is not currently any stigma associated with the facility because use would be considered a normal course of business event rather than an indication the borrower was in trouble. However, for that view to persist, the SRF is going to have to be used, and to date, no one has used it. Moreover, the Fed has not yet indicated how banks should incorporate the SRF into their liquidity projections under stress. If banks are not allowed to assume that they can use the SRF under stress, banks will not view it as a normal course of business facility.

Some observers indicate that stigma is not really a problem because if banks need the funds they will borrow one way or another. Such a view is based on a misconception of the purpose of central bank lending. The lending is intended to prevent liquidity strains at one institution from being amplified and transmitted by the institution selling assets at fire-sale prices or pulling back from lending to others. Moreover, in many situations, Federal Reserve lending is not intended to address liquidity strains at the borrower, but to encourage the borrower to provide liquidity to others. Such was the case, for instance, with the Asset-Backed Commercial Paper Money Market Mutual Fund Lending Facility and the Term Asset-Backed Loan Facility in the GFC, and those two facilities along with the Paycheck Protection Program Facility and the Main Street Lending Facilities in the 2020 crisis precipitated by COVID-19.

Indeed, there is long-standing precedent for encouraging banks to use the discount window to fund extensions of credit to others during a financial crisis. For example, Carlson and Wheelcock (2013) describe how the Fed used the discount window to respond to the turmoil in the commercial paper market following the failure of Penn Central:

> The Fed released no official statement regarding discount window borrowing, but the Wall Street Journal stated that a Federal Reserve official had indicated "that the circumstances imply a liberal stance towards any bank finding it necessary to borrow temporarily from a district Reserve Bank (WSJ 1970)."
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> …
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> Commercial paper outstanding declined following Penn Central's bankruptcy announcement but commercial and industrial (C&I) lending rose by about the same amount that commercial paper decreased. Banks were able to fund the increase in C&I loans first by borrowing temporarily at the discount window… pp. 19-20[8]

[8] https://s3.amazonaws.com/real.stlouisfed.org/wp/2012/2012-056.pdf

The Federal Reserve needs to make a concerted effort to explain why the discount window and other Federal Reserve liquidity facilities are a critical pillar of financial stability. They not only reduce risk to banks and other entities with direct access but enable maturity transformation while avoiding risks to bank safety and soundness and financial stability. And, properly designed (with appropriate collateral and haircut requirements) they do not constitute bailouts of the borrowers. Because of the haircuts on the collateral,[9] the risks of loss from holding the assets supported remain with the banks and other private sector holders and are not transferred to the Federal Reserve (and thereby not borne by taxpayers). By contrast, unsecured Federal Reserve lending in the form of purchases of debt issued by state and local governments or corporations does transfer the risk of the assets from existing holders of the assets to the Federal Reserve. Likewise, the purchase of Treasury securities and Agency MBS to forestall declines in their prices (equivalently, increases in their rates of return), as opposed to the monetary policy objective of reducing longer-term interest rates, transfers the considerable interest rate risk of those securities to the Federal Reserve from the current holders of the securities. These programs truly are bailouts and the stigma attached to that term is deserving.

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[9] In the case of the discount window, in addition to specific collateral, loans are extended with recourse to all the bank's assets.