



# Bank Examiner Preferences Are Obstructing Monetary Policy

Bill Nelson | Sept. 19, 2022

To withdraw monetary policy stimulus, the Federal Reserve is shrinking its portfolio of securities, a process often referred to as “quantitative tightening” or “QT.” But the Fed can’t shrink its assets without also shrinking its liabilities — in particular, reserve balances of banks. One would expect that repaying liabilities would be relatively easy, but the Federal Reserve’s examination practices are frustrating that effort.

In particular, bank examiners continue to tell banks that they must hold reserves in massive amounts, and that in assessing the strength of their liquidity, they will prefer reserves to Treasury securities, even though those securities are highly liquid in the market and can be swapped for cash at the Fed’s new Standing Repo Facility. Partly as a result, banks have shown little interest in the SRF.

Examiners also discourage or mandate against any liquidity contingency planning that includes use of the discount window, possibly any use of the SRF and perhaps even any collateralized daylight credit, even though the Federal Reserve Board policy states that banks are free to use all three.

U.S. banks are currently holding over \$3 trillion in reserves — effectively, cash. A rational assessment of their liquidity position, including the collateral banks have pledged to the Fed to back daylight credit and discount window loans, would allow most of those reserves to be freed up for lending to businesses and consumers.

The Fed should take action to reverse these examiner preferences. Recent actions by the Bank of England provide a model for how to do exactly that.

## Introduction

As part of its monetary policy, the Federal Reserve is currently allowing its vast holdings of Treasury securities and agency MBS to mature without reinvestment, steadily reducing the size of its portfolio over time. The Fed acquired the securities as part of its response to the economic consequences of the COVID-19 pandemic. The FOMC’s normalization plans state that it intends to shrink its portfolio of securities to the minimum level consistent with conducting monetary policy effectively and efficiently, which will do the following:

- Return the Fed to its traditional background role in our country’s financial system;
- Reduce the Fed’s interest rate risk by increasing the fraction of Fed securities funded with currency as opposed to interest-paying liabilities; and
- Position the Fed to expand again if necessary, should the country enter a recession and the Fed need to do more than return interest rates to zero.

When the Fed allows its securities to roll off, its liabilities shrink too, particularly reserve balances, which are the deposits of commercial banks and thrifts and credit unions at Federal Reserve banks. Just as household deposits are a source of funding for banks, bank reserve balances are a source of funding for the Fed. Those deposits are commercial banks' checking accounts, a store of immediately available and riskless cash that banks can use to meet their immediate liquidity needs.

The Fed can get no smaller than the size necessary to create the amount of reserve balances demanded by banks and still conduct policy using its current framework. If it tried, interest rates would rise above the level the FOMC intends. But the level of reserve balances demanded by banks is being unnecessarily inflated by bank examiner preferences. As a result, the Fed has to remain a lot bigger than it would otherwise be. Examiner preferences boost bank demand for reserves in two ways. First, even though liquidity regulations recognize many assets as potential sources of liquidity for banks, examiners prefer reserve balances for their safety and immediate liquidity. Second, examiners view bank borrowing from the Federal Reserve negatively. This contributes to the stigma attached to discount window credit—the type of ordinary borrowing necessary for monetary policy implementation. Banks hold massive amounts of reserve balances in part to reduce the chance that they would ever have to borrow from the discount window to near zero.

As this note discusses, these examiner preferences run contrary to the intent of liquidity regulations and discount window policy, but the Fed's multi-year effort to change them has been largely unsuccessful. To understand how we got to this point, the note reviews the history of this conflict between monetary policy and bank supervision. The unfortunate outcome is a Fed immensely larger than it used to or needs to be.

It does not have to be this way. As described below, the Fed could take several steps to restore the dominant position of monetary policy as the determinant of the Fed's balance sheet.

First, as discussed in a recent BPI [note](#), the Fed could forgo its plan to keep reserve balances well above the level that banks demand. Instead, it could follow the Bank of England's plan to shrink its balance sheet until reserves become sufficiently scarce that banks will borrow regularly from the BoE's lending facilities. Making borrowing normal and regular is a critical step for reducing stigma. To further reduce it, the BoE has instructed the U.K. bank regulator that borrowing from the BoE is to be seen as a business decision, not a sign of liquidity problems.

Second, again like the BoE, the Fed needs to instruct examiners and educate the public and Congress that bank borrowing from the discount window, which is overcollateralized and at an above-market rate, is not a bailout. The Fed has recently created a new lending vehicle—the Standing Repo Facility—specifically designed as a normal-course-of-business place to get repo liquidity. As part of the Fed's examiner education, the Fed needs to allow banks to plan on using the SRF in their liquidity stress tests. In the United Kingdom, for example, banks are allowed to assume that they will convert assets into cash at regular BoE lending facilities.

Third, the Fed should go further. Their assessments of banks' liquidity conditions need to recognize the liquidity benefit of borrowing from the Fed against over \$1 trillion in prepositioned collateral. The Fed can do so in a structured way where banks pay the Fed for a line of credit, a method already recognized by the international standard for liquidity regulations.

If the Fed were to take these steps, not only would it be able to get much smaller, but it would also enable banks to devote more of their balance sheet to lending to businesses and households, which would foster economic growth and employment.

## The Fed was right to intervene with extraordinary measures in response to the economic fallout from the COVID-19 pandemic.

In response to severe stress on financial markets and a depression-level contraction in economic activity during the COVID-19 pandemic, the Fed bought trillions of dollars of Treasury securities and agency MBS. This expanded the Fed in size to 36 percent of GDP. At times, it was buying 60 percent of some Treasury securities and nearly all of some mortgage-backed securities. The Fed is now allowing those securities to roll off as they mature, returning steadily to a noncrisis footing. It is important that it do so.

Shrinking its balance sheet returns the Fed to its backseat position in U.S. financial markets. It also reduces the interest-rate risk in the Fed's portfolio by increasing the fraction of Fed securities funded with currency as opposed to interest-paying liabilities. In addition, it positions the Fed to expand again if necessary, should the country enter a recession and the Fed need to do more than return interest rates to zero. Less obviously, but perhaps more importantly, a vast and unbounded Federal Reserve balance sheet can be an irresistible temptation for Congress as an off-budget way to pursue non-monetary policy objectives.

## Now is the time for the Fed to step back from those measures, but bank examiners are standing in the way by artificially keeping up demand for reserves.

Bank examiners see reserve balances as the perfect bank asset. This is no doubt because bank examiners define success as ensuring that their banks never fail. A perfect bank would be funded entirely with equity and invest only in reserve balances. But such a bank would not contribute to economic growth and prosperity. When a bank makes a loan to a small business or a new household, it is taking risk. Businesses and households value bank deposits because they offer liquidity on demand. Banks specialize in managing the liquidity risk inherent in funding loans with deposits. They manage liquidity risk by holding liquid assets in addition to loans and by raising funds besides deposits quickly in wholesale markets.

Funding loans with deposits is not just a source of liquidity risk, it is also part of what makes banks uniquely able to support the economy in difficult times. That's because deposits and loans both tend to increase in times of stress. Between Feb. 12 and April 1, 2020, bank lending rose by over \$700 billion, largely because banks were funding draws on lines of credit as big and small businesses sought to stockpile cash. By contrast, Fed emergency lending peaked at about \$130 billion at the beginning of April 2020. Banks were able to meet those draws without significant liquidity strains, because deposits rose by more than \$1 trillion over the same seven weeks.

Regulations recognize that a wider range of assets than just reserve balances can serve as a source of liquidity. This is perhaps because bank regulations are often designed by senior government officials, who take a broader view than bank examiners. Consider, in particular, the Liquidity Coverage Ratio requirement, which requires banks to hold High-Quality Liquid Assets sufficient to meet 30 days of liquidity needs. The LCR requirement was designed by the Basel Committee, staffed by senior central bank and Treasury officials, with input from the Economic Consultative Committee, staffed by central bank governors. It was then adopted in the United States after receiving notice and comment from the public and approval by the leadership of the Fed, the OCC and the FDIC. The LCR recognizes that many assets can qualify as HQLA; even the top tier consists of both reserve balances and Treasury securities. As discussed further below, the international standard for the LCR (although not the U.S. implementation) also recognizes that lines of credit from a central bank are excellent sources of liquidity.

But banks have to meet liquidity requirements other than the LCR, and those tend to be more binding. In particular, banks are required to conduct monthly internal liquidity stress tests and report the results to their examiners. They are then required to model for and hold sufficient liquidity to fund their resolution should they

fail. In contrast to the LCR, both of these requirements reportedly embed a preference for reserve balances. Moreover, even an informal examiner preference for reserve balances can strongly influence bank behavior.

For example, a blog [post](#) by Fed economists in April 2019 noted:

Internal liquidity stress tests apparently assume a significant discount on Treasury securities liquidated in large volumes during times of stress, so that Treasuries are not treated as cash equivalent. We have heard that banks occasionally feel under supervisory pressure to satisfy their HQLA requirements with reserves rather than Treasuries.

As a case in point, in spring 2018, the Fed was trying to shrink its balance sheet—which had been swollen by QE1, 2 and 3—just as it is doing now. In April 2018, the New York Fed projected that the shrinking would continue until reserve balances were \$600 billion, the minimum level it judged necessary for monetary policy, and a level it projected would be reached in 2021. In May 2018, Randal Quarles, then the Board’s Vice Chair for Supervision, was asked if examiners were expressing a preference for reserve balances as a source of liquidity. Couldn’t those preferences prevent the projected level of reserve balances from being reached? Quarles [responded](#):

So I do know that that message has been—that message has been communicated, at least in some supervisory circumstances, in the past. I would say that it’s—that’s in the—that’s in the process of being rethought.

In any case, in September 2019, when reserve balances were \$1.4 trillion, money markets experienced a bout of severe turmoil. This happened in part because reserve balances had quickly fallen below levels that banks demanded. Recently, looking back on that episode, Quarles [observed](#):

I do think that one of the drivers of that disruption in 2019 was our, not so much liquidity regulation, but liquidity supervisory policy, which put a pretty heavy thumb on the side of the scale of preferring reserves over Treasury securities in satisfying your liquidity obligations.

The Fed now projects that it needs to supply \$2.3 trillion in reserve balances to conduct monetary policy efficiently. Unfortunately, that extraordinary level already appears to acquiesce to examiner preferences, guaranteeing a Fed much larger than necessary or healthy for our society. It remains to be seen if even that level is achievable or if changes in examiner preferences have once again pushed the necessary level higher still.

## **Demands for reserve balances are pushed even higher by the stigma of borrowing from the Fed, which is also in part the result of examiner preferences.**

Part of the reason why banks hold such high levels of reserve balances is a strong desire to avoid ever needing to borrow from the Fed’s discount window. Again, that outcome is the opposite of what the Fed intended for its monetary policy purposes. In 2003, the Fed revamped its discount window lending operations so that banks would be willing to borrow freely when market rates were above the discount rate. It even encouraged banks to borrow to on-lend to others if other banks were reluctant to borrow (see [here](#)).

Willingness to borrow was critical for the discount window to act as an effective monetary policy tool, putting a ceiling on money market rates. A centerpiece of the change was moving the discount rate to an above-market rate and making the discount window a no-questions-asked lending facility. Moreover, borrowing was supposed to be kept secret from examiners, unless there was an underlying safety and soundness issue. Federal Reserve monetary policy staff met with banks and encouraged them to borrow freely and make the discount window integral to their liquidity plans. The Board staff also visited Reserve Banks to ensure discount window loans were being offered on a no-questions-asked basis and that borrowing information was not shared with examination staff unless there was

a question about safety and soundness. In support of these efforts, the federal banking agencies collectively issued a supervisory letter encouraging banks to include the discount window in their liquidity contingency plans ([SR-Letter 03-15](#)).

This all changed after the Global Financial Crisis (GFC). *During the crisis*, the Fed encouraged banks to borrow from the discount window, and even created a new discount window lending facility that auctioned discount window loans specifically to overcome stigma and encourage use (the Term Auction Facility or TAF). Moreover, all discount window loans were overcollateralized and repaid in full, on time, with interest. Even so, *once the crisis ended*, banks that borrowed from the discount window were castigated for having received a “bailout.” Bank CEOs were hauled before Congress to explain why they borrowed. The Fed proposed tougher liquidity requirements for U.S. branches of foreign banks, in part because the branches borrowed from the TAF.

Recent interviews of BPI bank treasurers indicate that examiner views of the discount window remain negative, and the Fed’s treatment of borrowing is far from what was intended in 2003 (summarized [here](#)). Rather than borrowing being kept secret from examiners and viewed as unremarkable, all the treasurers noted that if they borrowed, they would immediately inform their bank examiners. In most cases, this notification would occur before borrowing. One bank stated that the notification of their examiner would be automatic, because borrowing is one of their “early warning indicators.” Another emphasized that if they did not tell their examiner, the examiner would be “furious.” Several banks noted that while discount window staff at their Reserve Bank and officials at the Board wanted them to be willing to borrow, they believe it would be viewed quite differently by their examiners, including those from the Federal Reserve. All stated that even if the examiner indicated in the moment that it was OK to borrow (such as happened in spring 2020), borrowing could be viewed as a red flag leading to further supervisory scrutiny down the road (as happened to FBO branches). One bank noted that its internal guidelines state that if the bank borrowed from the discount window, it would be required to immediately submit a repayment plan to the Fed. That is what the bank had once been told by a Fed examiner, possibly in reference to borrowing for more than one night.

So perhaps not surprisingly, all the bank treasurers indicated that they would be unwilling to borrow from the discount window in almost all circumstances. But because banks can be hit late in the day with unforeseen cash outflows or unexpectedly delayed cash inflows, the only way to be certain that your bank will never have to borrow from the discount window is to hold a vast amount of reserve balances in your bank’s account at the Fed.

It’s even gotten to the point where banks may be reluctant to incur a collateralized daylight overdraft. Banks pledge hundreds of billions of dollars of collateral to the Fed to establish daylight overdraft capacity, with no charge for incurring a daylight overdraft. The Board’s Payment System Risk Policy is specifically designed to support ready use of collateralized daylight overdrafts so that banks don’t hoard liquidity at the start of the day.

But a lack of familiarity breeds distrust. Because of the extraordinarily high levels of reserve balances, daylight overdrafts have become exceedingly rare, and bank examiners view such rare daylight borrowing from the Fed with suspicion. Banks are not allowed to plan on incurring a daylight overdraft in their liquidity stress tests or resolution plans. It’s hard to argue that you won’t incur an overdraft if you just have. Indeed, Jamie Dimon, CEO of JPMorgan Chase, [explained](#) that a reluctance to approach a daylight overdraft contributed to money market turmoil in September 2019:

... we have a checking account at the Fed with a certain amount of cash in it. Last year, we had more cash than we needed for regulatory requirements. So repo rates went up, we went with the checking account which paid IOER into repo. Obviously makes sense, you make more money. ... [T]he cash in the account ... is still huge. It’s \$120 billion in the morning, and it goes down to \$60 billion during the course of the day and back to \$120 billion at the end of the day. That cash, we believe, is required under resolution and

recovery and liquidity stress testing. And therefore, we could not redeploy it into repo market, which we would've been happy to do.

To avoid even a daylight overdraft, let alone a discount window loan, even higher levels of reserve balances are required.

To make banks willing to borrow, the Fed has taken a page out of its own 2003 playbook and created a new lending program, the Standing Repo Facility. The SRF offers large banks and primary dealers loans at the discount rate against Treasury securities or agency MBS as collateral. To date, not many banks have signed up, in part because it is not clear what added purpose the SRF serves. In particular, the Fed has given no guidance that banks can plan on using the SRF in their liquidity stress tests or resolution plans.

## The Bank of England has a better plan for reducing the size of its balance sheet, one not stymied by preferences of bank examiners.

In June 2022, the BoE shared more details on its plan for shrinking its balance sheet, and it is a better plan than the Fed's. The Fed plans on shrinking until reserve balances are a couple of hundred billion dollars higher than the minimum amount it can get away with. The BoE plans on shrinking to where reserve balances are a little lower than the amount banks demand, so that banks have to come in and borrow to get the remainder. Under the Fed's plan, money market rates will be a little lower than the interest rate the Fed pays on reserve balances, because those balances will be in excess supply. Under the BoE plan, market interest rates will be a little higher than the BoE pays on reserve balances, because banks will need an incentive to borrow.

Why is the BoE's plan better? First, as Dimon observed, when market rates are above the interest rate on reserve balances, banks have an incentive to reduce their holdings of reserve balances and find other sources of liquidity. The Fed plan creates no such incentive; in fact, it creates the opposite. Whatever level the Fed provides, banks and bank examiners will get used to it. If anything, that level will creep higher, because the Fed wants to build in a buffer above whatever level becomes normal.

Second, bank borrowing from the central bank will become a regular thing in the United Kingdom. BPI treasurers indicated that a crucial step to reduce stigma is to make borrowing ordinary—a business decision rather than a sign of stress. That can only happen if borrowing becomes frequent. The BoE plans on shrinking until it sees banks borrowing regularly. Because the Fed plans on continuing to massively oversupply reserve balances, borrowing will remain extremely rare and therefore taken as a sign of trouble.

Third, just as the Fed has created the SRF, the Bank of England is creating a new lending facility, the Short-term Repo (STR) operation. But the BoE has [made it clear](#) that bank examiners will view using the facility as an ordinary business decision:

The Bank intends that the STR should be used freely from the point of introduction, as a way for counterparties to access reserves as necessary. The [Prudential Regulation Authority] would judge use of the STR as routine participation in sterling money markets and intends that it should be seen as such by bank boards and overseas regulators.

And finally, the U.K.'s bank regulators, the Prudential Regulation Authority, allow banks to plan on monetizing assets at the Bank of England's regular lending facilities when assessing each bank's liquidity situation.

## By giving banks liquidity credit for discount window capacity, the Fed can support economic growth and also ensure that banks maintain healthy liquidity profiles.

When a bank makes a loan, funded with a deposit, liquidity requirements make it necessary to hold additional liquid assets. At least 60 percent of those assets have to be reserve balances or Treasury securities. Currently, 20 percent of bank assets are HQLA. Moreover, banks have to fund the loans and the HQLA in part with equity capital. Adding it all up, the regulations increase the cost of lending. They force banks to use their balance sheets to lend to the federal government directly by owning Treasury securities or indirectly by maintaining reserve balances at the Fed, which in turn buys Treasury securities. The Bank for International Settlements [reports](#) that complying with liquidity regulations reduces bank lending to business and households by up to 26 percent.

But there is an alternative. U.S. banking agencies could instead adopt the approach used in Australia and accept committed, collateralized lines of credit from the central bank as a source of liquidity. Because these lines can be collateralized by business and household loans, they allow banks to make loans rather than buy government securities, while still remaining highly liquid. After all, a committed line of credit from the Fed is economically equivalent to a reserve balance—both are promises by the Fed to provide funds on demand.

Committed Liquidity Facilities (CLFs) are central bank facilities that offer commercial banks guaranteed collateralized lines of credit for a fee, with the interest rate on draws on the line set above market rates (for more information, see [here](#)). Because the Fed would be more than compensated for the minimal risk associated with offering such lines and making loans under them, the CLFs would be neither subsidies nor bailouts. The collateral to back the CLFs is already available and positioned at the Fed. Depository institutions maintain large pools of collateral of about \$1.6 trillion in aggregate (lendable value), mostly business and household loans, pledged to the Fed to collateralize discount window loans and daylight overdrafts.

As noted above, the international LCR standard allows jurisdictions to count CLFs as HQLA, but only for a relatively small fraction of HQLA, and only if the CLF charges an onerous fee that makes the facilities unworkable (see [here](#)). There is an exception for jurisdictions like Australia that have a shortage of government debt. Of course, despite that, the Reserve Bank of Australia could always have created reserve balances by simply acquiring assets or making loans. However, the Basel Committee did not want to force a central bank to change its balance sheet policies just to comply with a bank regulation.

*But the objective of preventing liquidity regulations from dictating central bank balance-sheet policy applies to the U.S. situation as well.* The Fed should not need to hold a massive amount of Treasury securities and agency MBS so that it creates enough reserve balances for banks to comply with liquidity requirements when CLFs would accomplish the same objective.

## Committed Liquidity Facilities can help fix the capital framework too.

Moreover, if the Fed were to offer CLFs to banks as a replacement for a significant share of reserve balances, this would also address harmful distortions in the capital framework. When the Fed designed the post-GFC capital framework, reserve balances were expected to return to their pre-crisis level of about \$60 billion. Because they are currently \$3 trillion and expected to fall no lower than \$2.3 trillion, the framework is not working as intended.

Most obviously, the supplementary leverage ratio, which treats all assets as equally risky and was designed to be a backstop to risk-sensitive capital requirements, has ended up closer to binding than intended. Banks have been discouraged from making markets in, or providing funding for, Treasury securities—both activities that entail investing in low-risk assets (Treasuries and Treasury reverse repos). There is broad agreement that the SLR needs to be fixed. The Fed indicated in April 2021 that it would propose fixes to the requirement, but no proposal has

been forthcoming. The high level of reserve balances has also boosted the Fed’s projections of expected losses in the stress tests. Noninterest expense is linked to bank size (inflated by reserve balances) and boosted the extra capital charges applied to the largest banks (GSIB surcharges), which depend in part on bank size (for more information, see [here](#)).

All of these distortions would be reduced if the Fed allowed banks to satisfy their liquidity requirements largely with CLFs, because CLFs are bank assets.

### The Fed’s policy should also return to recognizing that a bank’s most important source of liquidity is other banks.

If banks used to hold only \$60 billion in reserve balances, how could they have had sufficient liquidity? Before the GFC, banks met their liquidity needs primarily through the interbank market. Most of the time, if one bank was short liquidity, then another bank had excess. At the end of the day, banks would lend to and borrow from each other in the interbank market, primarily the overnight federal funds market. By diversifying liquidity risk across the banking system through the interbank market, banks could invest most of their portfolio in loans to businesses and households.

Pre-GFC, bank examiners in the United States were taught that when evaluating a bank’s liquidity situation, they should first look for access to alternative sources of funds, including especially market funding. Reserve balances, which did not pay interest, were not mentioned as a possible form of liquid asset.

A confluence of simultaneous events changed the picture during and after the GFC. First, term interbank markets—markets for loans beyond overnight—broke down, requiring the Fed to intervene. Second, the Fed received the authority to pay interest on reserves. Third, the Fed’s balance sheet expanded massively in size, creating a vast number of reserve balances.

In that environment, officials designed the post-crisis regime with a fundamentally different view of liquidity. Rather than relying significantly on the interbank market to diversify liquidity risk across banks, regulators now think of liquidity as bullion in the vault, or in modern terms, deposits at the central bank or government securities that could be immediately sold or repoed. What they misunderstand is that the *overnight* interbank market functioned well throughout the GFC. Offering emergency liquidity is what central banks were designed to do. Ironically, by designing a regime where the Fed would never have to lend in an emergency, they created a regime in which banks rely on the Fed as their primary source of liquidity every day.

With reserves a super-abundant and inexpensive source of liquidity, they have taken an ever-expanding role as the preferred solution to a bank’s liquidity management problem. The Fed has periodically estimated the minimum amount of reserves the banking system needs to meet its liquidity needs. As noted, and as shown in Table 1, that estimate has grown steadily and exponentially over time.

Date	Level
April 2008	\$35 billion
March 2016	\$100 billion
March 2018	\$600 billion
September 2019	\$1.3 trillion
May 2022	\$2.3 trillion

In 2010, such a dynamic led the Norges Bank (the central bank of Norway) to switch from a system with abundant reserves to one with more scarce reserves. When seeking comment on their decision, they [indicated](#):

When Norges Bank keeps reserves relatively high for a period, it appears that banks gradually adjust to this level. . . . With ever increasing reserves in the banking system, there is a risk that Norges Bank assumes functions that should be left to the market. It is not Norges Bank's role to provide funding for banks. . . . If a bank has a deficit of reserves towards the end of the day, banks must be able to deal with this by trading in the interbank market.

## Conclusion

With economic activity having recovered from the severe shock of the onset of the pandemic, the Fed is now normalizing its balance sheet, shrinking to a size more appropriate for our market-based financial system. But by boosting bank demand for reserve balances, bank examiners and examination policy may be standing in the way. Even though liquidity regulations recognize that assets other than reserve balances are a source of liquidity, in the past, examiners have demonstrated a preference for reserve balances. In addition, banks are unwilling to risk having to borrow from the Fed and incur examiner disapprobation. The only way to be certain of not having to borrow is to have a massive amount of reserve balances to meet late-in-the-day funding needs. Both of these developments boost bank demand for reserves, preventing the Fed from getting as small as it could.

The Fed should consider adopting a normalization strategy similar to the Bank of England's. The BoE plans on shrinking until banks have to borrow, and it has told examiners to consider borrowing a normal-course-of-business event. If the Fed were to follow the same approach, the interest rate the Fed pays on reserve balances could be moved below rather than above market rates, giving banks an incentive to economize on their holdings. Moreover, if borrowing became an ordinary event, the severe stigma associated with borrowing from the Fed would likely decline. If the Board were to give examiners clear and dispositive guidance that borrowing is appropriate and is not to be viewed as a bailout, and that banks can plan to use the SRF to monetize their assets, this could help reduce stigma even further. The Board also needs to take action to ensure that Congress and the public understand that fully collateralized loans to banks are not "bailouts."

More broadly, when a bank makes a loan funded with a deposit, it now also has to invest in liquid assets and then hold capital for both the loan and the HQLA. Liquid assets—essentially all loans to the federal government or government-sponsored agencies (directly or via the Fed)—make up a considerable amount of bank balance sheets, crowding out loans to businesses and households. The Fed could support lending to Main Street without sacrificing bank safety and soundness by allowing banks to count CLFs collateralized by those loans as liquid assets. We should reconsider the post-GFC view of liquidity as something that comes from assets in the basement vault, versus the access to interbank markets or correspondent banks that comes when a bank is financially sound.

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