The Fed's Discount Window Lending

Bill Nelson | March 17, 2023

As has been widely reported, Federal Reserve lending increased sharply over the past week. That increase should not be surprising, as this situation is exactly the scenario for which its lending programs were designed. For those interested in the specifics, see below an explanation of the various programs and how they work.

On Thursday afternoon, the Fed released its weekly balance sheet data, the H.4.1. statistical release, available here. As shown in the rightmost column of table 1, the Fed was lending depository institutions $308 billion on Wednesday (excluding PPP loans), up from $5 billion a week earlier. The lending took three forms, regular discount window lending ("primary credit"), lending to the bridge banks the FDIC created for SVB and Signature, and lending through its new Bank Term Funding Program.

Primary Credit (a/k/a "Discount Window Credit")

The Fed was lending banks $153 billion of primary credit on Wednesday. Primary credit is what is normally called discount window credit, and it is extended at the primary credit rate, what is normally called the discount rate. Primary credit is extended under Section 10B of the Federal Reserve Act (see here). Regulation A (here) sets out the rules on all Fed lending, although it can get stale when those rules change fast.

The primary credit rate is 4.75 percent, the top of the FOMC's target range. It is an overnight rate that varies with the FOMC's target. It is not called the discount rate because it used to be below the market rate (mid-1960s to 2003). It is called the discount rate because the credit used to take the form of discounting a note. Loans now all take the form of advances, not discounts.

The Fed accepts essentially all bank assets as collateral for the discount window, including, in particular loans. Banks typically pre-pledge collateral to the discount window so that they have the capacity to borrow when needed. That collateral usually consists of large books of loans. Collateral—loans and securities—is valued at fair value to which a haircut is applied to get the lendable value. The Fed's haircut schedule is available here.

A few days ago the haircuts on Treasuries, agency debt, and agency MBS were 1-5 percent depending on the duration of the security. As of Tuesday, however, those haircuts were all dropped to zero. That is, the Fed is lending the full market value of those securities. Haircuts on other assets pledged to the window, including the loans that make up most of the collateral, appear to have been unchanged.

The arrangements under which the bank keep the loan documents (as opposed to giving to the Fed) are called "borrower in custody" arrangements. As of Feb. 26, 2020, banks had collateral pledged to the Fed with borrowing capacity of $1.6 trillion (see the footnote to table 5 on page 13 of the Fed's quarterly balance sheet report, available here).

Primary credit is only available to financially sound depository institutions defined as at least adequately capitalized and CAMELS 3 rated. These are relatively mild financial condition requirements.

For eligible banks, primary credit is intended to be provided on a "no questions asked" basis, although reportedly, even if the discount officer doesn't ask the reason for borrowing, the bank's examiners will ask the reason (see "Bank Treasurers' Views on Liquidity Requirements and the Discount Window").

During the COVID crisis, the Fed extended the initial allowable maturity on primary credit loans 90 days (the maximum legally allowed), "renewable and repayable on request," and that policy remains in place. H.4.1 data indicate only $5 billion in loans had maturities between 16 and 90 days, so banks were not availing themselves of the option to borrow at term (see table 2).

The 1991 FDIC Improvement Act placed guidelines on Fed discount window lending to undercapitalized banks. If the Fed lends to an undercapitalized bank for more than 60 out of 120 days, or to a critically undercapitalized bank for more than 5 days, it must pay a modest fee. The fee is the lesser of the interest the Fed earned on the loan or the increase in resolution costs to the FDIC resulting from the Fed lending. The restrictions were put in place because Fed lending had been seen as adding to the FDIC's resolution costs by financing the flight of uninsured creditors, with the Fed getting the remaining good assets as collateral.

For more information on discount window lending, see https://www.frbdiscountwindow.org/ or my recent Odd Lots podcast available here.

Lending to FDIC Bridge Banks

Remarkably, on Wednesday, the Fed was also lending $143 billion to the bridge banks the FDIC established for SVB and Signature. Footnote 7 of the H.4.1 states

> Includes loans that were extended to depository institutions established by the Federal Deposit Insurance Corporation (FDIC). The Federal Reserve Banks' loans to these depository institutions are secured by collateral and the FDIC provides repayment guarantees.

As far as I know, the Fed has provided no other information on these loans. The loans may largely be discount window loans that had been extended to the institutions before they closed.

Bank Term Funding Program

The Fed was only lending $12 billion under its new "Bank Term Funding Program" on Wednesday. The Fed announced the program on Sunday. Eligible borrowers are commercial banks and other insured depository institutions that are eligible for primary credit (that is, they are financially sound). The program extends one-year term loans to DIs at the one-year OIS swap rate plus 10 basis points (a fixed rate). The loans are collateralized by Treasuries, agency debt and agency MBS. The term sheet for the program is available here, and the Fed's explanatory letter to Congress (just sent yesterday) is available here.

Currently the one-year swap rate is 4.61 percent, so the BTFP rate would be 4.71 percent. Even though that is below the primary credit rate, that doesn't necessarily make it cheaper than primary credit. The BTFP is a one-year fixed-rate loan, so the relevant comparison is roughly the average expected primary credit rate over the next year. That said, the loans can be repaid without penalty, so if you borrowed today and repaid tomorrow, it would be slightly cheaper than primary credit.

What makes the program different is that the Fed will lend up to the full par value of the securities. Normally the Fed provides a modest haircut (1 to 5 percent for these securities) against the market value of the securities, although, as noted, those haircuts have now been dropped to zero. Because the BTFP lends the full par value, the Fed loan is essentially unsecured for the difference between the par and market value. The Treasury has provided the Fed $25 billion in credit protection using the exchange rate stabilization fund presumably to cover the unsecured parts of the loans. Unlike many of the Fed's emergency programs, the loans are extended with recourse. That means that if the borrower defaults and the collateral doesn't cover the loan, the Fed and Treasury can go after all the assets of the defaulted bank, joining other general creditors, although behind depositors.

The loans are extended under 13(3), the Fed's emergency authority. Usually 13(3) is used to lend to nonbanks, but this program is for banks. The Fed may have used 13(3) because the term of the loans is one year, beyond the 90-day limit on regular 10B loans.

Borrowing under the facility may be so low because banks that need credit are borrowing primary credit instead. They may prefer to borrow against the loan collateral they have pre-positioned at the window, holding their government securities to meet other needs. Or it could just be that banks are more familiar with regular discount window credit.

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