BANK POLICY INSTITUTE

Why Regulators Should Consider Banks' Borrowing Capacity from the Fed in Liquidity Assessments

Bill Nelson | March 30, 2023

Last week, a Wall Street Journal article, "How the Last-Ditch Effort to Save Silicon Valley Bank Failed," revealed that troubles getting SVB's collateral transferred from the San Francisco Federal Home Loan Bank to the Federal Reserve Bank of San Francisco was an important reason why the FDIC needed to close SVB in the middle of the day on Friday. If FRBSF had received the collateral, it could have lent SVB an additional $20 billion. If SVB had made it to the end of the day, the government would have had a much greater chance of working out the situation in an orderly way without taking emergency measures.[1]

Working out competing collateral claims between the FHLB and the FR Bank is a normal course of business activity. Federal Home Loan Banks secure their loans with blanket liens, that is, they get a claim on all the assets of the borrowing bank. The Federal Reserve Banks secure their loans by accepting a pledge of specific loans and securities. Banks pledge collateral to the Fed, often large books of loans, to establish borrowing capacity for contingencies. When a commercial bank that borrows from an FHLB pledges collateral to the Federal Reserve, the Reserve Bank and the Home Loan Bank work out their competing claims by carving out some collateral for the Fed that is not subject to the blanket lien. While it can take a little time, it is a perfectly ordinary transaction done for all the banks that borrow from an FHLB and want also to be able to borrow from the Fed.

However, it has to be done in advance. Because the existing blanket lien is superior to the Fed's claim, if the commercial bank has any credit outstanding from the FHLB, then if a carveout has not been arranged, the Fed is essentially an unsecured creditor because it does not have a perfected claim on the collateral. This is almost surely what the WSJ article was referring to when stating: "The transfer required procedural steps. SVB had outstanding loans at the San Francisco FHLB, which had to determine how much collateral it needed to hold, the people familiar with the matter said."

Unfortunately, banks do not have any regulatory or supervisory incentive to establish borrowing capacity at the Federal Reserve. In particular, in the case of SVB, its Reg YY-required internal liquidity stress tests provide no credit for discount window borrowing capacity or for the ability to use the Fed's standing repo facility. The SRF is a new facility that the Fed has created to convert Treasury securities and agency MBS into cash, exactly the kind of securities that SVB had in abundance.

Although SVB may have investigated signing up for the SRF, it likely did not do so for two reasons: 1) it was costly to get the required access to the repo market, and 2) it would not have been able to assume that it would use the SRF to convert its securities into cash in its ILST. Instead, SVB would have been told to treat the SRF like the discount window, and examiners do not allow banks to plan on using the discount window in their liquidity stress tests. Only one regional bank has signed up for the SRF, and regional bank treasurers have stated that the negative regulatory treatment is one reason why they have not signed up (see here).

[1] Chairman Gruenberg's recent testimony indicated that the Fed and FDIC also had to scramble to get collateral in position for Signature Bank, although in that instance they succeeded. "Bank management could not provide accurate data regarding the amount of the deficit, and resolution of the negative balance required a prolonged joint effort among Signature Bank, regulators, and the Federal Home Loan Bank of New York to pledge collateral and obtain the necessary funding from the Federal Reserve's Discount Window to cover the negative outflows. This was accomplished with minutes to spare before the Federal Reserve's wire room closed."

There are several reasons why liquidity regulations and assessments should take into account the capacity of a bank to borrow from the Fed. After all, as we have just painfully been reminded, a bank with that capacity is more liquid than a bank without that capacity, so taking the capacity into account makes the assessments more accurate. Relatedly, the recognition provides banks an incentive to pledge collateral to the Fed and establish borrowing capacity.

Here are a few of our past observations on this point.

- **"Against what liquidity risks should a bank self-insure?," Dec. 1, 2022:**
  This proposal [giving banks credit for access to Fed credit in liquidity assessments] presents several benefits. Most importantly, liquidity stress tests and resolution requirements would be more accurate and therefore create the right incentives. A bank with collateral pledged to its central bank is better prepared for contingencies than one that doesn't have collateral pledged; and if more banks pledge collateral and are willing to use primary credit, then the financial system is more resilient. [fn: Similarly, if a bank can assume SRF use in its liquidity stress test, the bank will have a stronger incentive to establish SRF access.] But if a bank does not benefit from pledging collateral to its Federal Reserve Bank, it has little incentive to do so.

- **"Give Banks Credit For Robust Contingent Liquidity Arrangements," May 29, 2019**
  Such an adjustment [allowing banks to use discount window borrowing capacity to count toward intra-30-day liquidity needs in the LCR] would not only result in a more accurate assessment of the bank's liquidity situation, it would also provide banks an incentive to be prepared to borrow from the discount window if necessary, enhancing financial stability.

- **"Recognizing the value of the central bank as a liquidity backstop," Jan. 6, 2017**
  Regulatory changes are often discussed in terms of a tradeoff between growth and financial stability – while a more stringent regulatory framework may enhance financial stability, economic growth may suffer. However, if the Federal Reserve were to create the facility [a committed line of credit that would count as HQLA], both growth and financial stability would be fostered: banks would be safer, financial crises would be less likely, and the Federal Reserve would be better able to respond to any crises that do occur. (p.1)
  …
  Moreover, the facility would provide commercial banks an incentive to pledge collateral to the Fed. Abundant collateral at the discount window increases the ability of the bank to address liquidity stress episodes and the ability of the Fed to respond to a financial crisis. (pp. 15)

- **"How can liquidity regulations increase financial stability?," March 27, 2012**
  Important supervisory message: being prepared to borrow from, and appropriate borrowing from, the central bank is desirable.

Last month, BPI called for a comprehensive review of liquidity requirements similar to Vice Chair Barr's ongoing "holistic" review of capital requirements – "Is It Time For a Holistic Review of Liquidity Requirements?," Feb. 23, 2023. We noted in particular that the focus in current regulations on banks' holdings of HQLA rather than on maintaining diversified and reliable sources of funding resulted in those external sources of funding atrophying. The unnecessarily disorderly failure of SVB demonstrates just how necessary such a review is.

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