

## Seasonal Credit and Committed Liquidity Facilities

Bill Nelson | April 11, 2023

The failure of Silicon Valley Bank, half of whose assets were Treasury and agency securities and agency MBS, has prompted calls for banks to hold an even larger share of their assets in high-quality liquid assets (HQLA), which would reduce lending and economic growth. An important question, then, is whether there are policies that could improve the liquidity position of banks without imposing substantial societal costs.

Larger banks are subject to three different liquidity requirements: the liquidity coverage ratio, internal liquidity stress tests and resolution liquidity requirements. All three require banks, in one way or another, to hold on their balance sheets HQLA sufficient to meet projected net cash outflows under stress. HQLA is mostly the banks' deposits at the Federal Reserve Bank and Treasury securities, and also agency-guaranteed MBS. Since 2010, HQLA has gone from 10 percent of bank assets to 22 percent. As discussed in "[Is It Time For a Holistic Review of Liquidity Requirements?](#)," the required stockpiles of HQLA reduce bank lending and therefore economic activity and employment.

One of the ways the banking agencies could reduce the economic costs of liquidity requirements while preserving their benefits is to allow committed liquidity facilities provided by the Fed to count as HQLA. CLFs would be fully collateralized and available for a fee. Just like discount window loans, the CLFs would be collateralized by banks' loans to businesses and households (as well as other things). Banks would be allowed to anticipate drawing on their CLFs to meet cash outflows rather than holding as much balance sheet HQLA. That would free up space for the banks to make more loans to Main Street, which could, in turn, be used to collateralize their CLF.

As it turns out, this is far from a new idea, and we know that the idea would work. In 1973, the Federal Reserve began to offer a new type of discount window credit – seasonal credit – to smaller banks with large seasonal swings in deposits and loans. The program was opened on the recommendation from a System-wide study – “Reappraisal of the Federal Reserve Discount Mechanism”, published in 1971. The study states:

Banks in nonmetropolitan areas frequently experience a seasonal squeeze on funds through simultaneous withdrawal of deposits and expansion of loan demands. . . During off peak season of the year, funds that might otherwise have been committed to financing intermediate-term rural needs instead tend to be maintained in short-term Government securities, city bank accounts, or other forms that provide a high degree of liquidity, but that represent inefficient use of the financial resources of the community. . . With discount policy revised to allow rural banks to borrow a substantial portion of the funds required to meet seasonal outflows, these banks would have more funds for meeting community needs and would be able to handle their investment portfolios more satisfactorily. (Volume 3, p. 160)

By allowing banks to use seasonal credit to meet temporary funding needs, the program was intended to enable banks to lend to their communities rather than holding HQLA, boosting economic activity. And that's exactly what happened. In a recent working paper, "[Can the Federal Reserve Effectively Target Main Street? Evidence from the 1970s Recession](#)," Fed economist John Kandrak examined the difference in behavior of rural banks that were members of the Federal Reserve System, and so had access to the facility, from those that weren't. Kandrak found that seasonal credit borrowers increased their average loan-to-asset ratio by 4 percentage points relative to other

banks, and experienced loan growth that was 6 percentage points higher. Commercial and industrial, commercial real estate and agricultural loans all increased substantially.

Kandrac also found that the increased lending had a substantial positive effect on employment. Rural communities with only Fed-member banks experienced employment growth that was 1.5 percentage points faster on average in the years after the introduction of seasonal credit than communities with only nonmember banks.

As Kandrac observes,

The SCF helped eligible banks draw down their liquidity buffers in favor of additional credit that would not have otherwise been issued. The benefits of offering lending facilities so that banks do not need to hold liquidity buffers to safeguard against all contingencies has been a motivating principle in central banking at least since Bagehot (1873).

The seasonal credit program still exists, and in 2020, the last year for which data is available, it made 149 loans. However, the rationale for the program is much less clear now. The program is intended to help small banks “...that lack effective access to national money markets...”.<sup>1</sup> If the bank has access to wholesale funding, it could borrow in the market to cover its seasonal funding needs, accomplishing the same objective as seasonal credit. Now that deposits can be raised quickly and nationally, and small banks can borrow from correspondents and the FHLBs, it is not clear that the program is needed.

Ironically, CLFs can help the large banks subject to liquidity requirements lend more to Main Street even though these banks definitely do have access to national money markets. The reason CLFs can help is that the banks are assumed not to have access to market funding in their liquidity assessments. That assumption makes sense for contingency plans for liquidity stress, episodes characterized by market illiquidity, exactly situations that central bank funding is intended to address.

The impact on economic activity could be considerable. As of March 2020 (the latest available data), there was \$1.6 trillion in collateral pledged to the discount window – lendable value after deducting haircuts. There is about \$10 trillion in loans by banks to nonfinancial businesses and households. If a fraction of the discount window collateral were to back CLFs which, in turn, allowed banks to reallocate away from HQLA and toward lending, bank credit would rise substantially.

Moreover, the availability of CLFs could encourage banks to pledge additional collateral. Last-minute scrambles to get collateral occurred prior to the failures of Silicon Valley Bank and Signature Bank. CLFs would provide an incentive for banks to maintain robust stockpiles of collateral at their Federal Reserve Bank for contingencies.

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<sup>1</sup> Clouse (1994) p. 970.