Statement for the Record

On Behalf of the

American Bankers Association

Before the

Subcommittee on Financial Institutions and Monetary Policy

of the

House Financial Services Committee

February 15, 2024

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The American Bankers Association (ABA)[1] appreciates the opportunity to provide a Statement for the Record for this hearing, Lender of Last Resort: Issues with the Fed Discount Window and Emergency Lending. The U.S. banking system is wider and deeper than in any other market in the world. The industry's strength is in its numbers and diversity of bank size and business model. With over 4,600 banks, including 3,616 community banks under $1 billion in assets, the U.S. banking system remains strong, and employs more than 2 million professionals, safeguards $18.6 trillion in deposits, and extends $12.3 trillion in loans.

ABA and its members understand and acknowledge that robust liquidity risk measurement, monitoring, and management are critical for making both individual banks and the U.S. financial system resilient. The discount window, established to help banks weather a liquidity storm, is an essential component of liquidity risk management. For a variety of reasons, however, many banks tend to turn to other sources of funding during times of stress.

To make the discount window a preferred source of funding during periods of stress, it needs to meet the needs of modern banking for banks of all sizes. We thank the committee for holding this hearing to examine whether the discount window is serving its purpose effectively. We make several recommendations below that would help reposition the discount window as a useable and preferable source of contingent liquidity for all banks. The recommendations provided here are intended to broaden the discussion rather than offer an exhaustive list of changes. There are many complex and intertwined policy questions that need to be explored when considering the discount window, including if usage should be limited to emergencies, appropriate levels of usage and who is charged with monitoring levels of usage for individual banks. Additionally, efforts to improve the discount window should not undermine or disadvantage other critical sources of liquidity, such as the Federal Home Loan Bank system (FHLB), or lock-up high-quality collateral at the Federal Reserve. The current period of calm is an ideal time to consider these issues.

[1] The American Bankers Association is the voice of the nation's $23.4 trillion banking industry, which is composed of small, regional and large banks that together employ approximately 2.1 million people, safeguard $18.6 trillion in deposits and extend $12.3 trillion in loans.

Improve Operational Ease

As a threshold matter, there is a potential mismatch between when a bank has liquidity needs and the speed at which the Federal Reserve can supply the needed funds. For example, the current East Coast-centric operating hours of the discount window are ill-suited to meeting banks' liquidity needs in today's global, 24/7 operating environment. At a minimum, the hours when collateral can be placed with the Fed should be expanded to include West Coast business times. Similarly, the hours of operation for Fedwire, the means of transmitting funds to banks, should be expanded to encompass West Coast business times. Moreover, streamlining the set-up process and continued automation for collateral recognition and borrowing will decrease operational bottlenecks going forward. We recommend that the Federal Reserve bring process elements of collateral eligibility in line with current market standards (e.g. physical documentation requirements, wet-ink signature requirements, assignability clauses in bi-lateral loans). Additionally, the Federal Reserve should work with other providers of secured borrowing to ensure that collateral can be transferred smoothly, under tight timeframes.

Update Pricing of Collateral

The discount window collateral haircuts are set to ensure that the Fed faces no credit losses in all but the most extreme situations. In addition, collateral is valued periodically based on models of cash flows, credit characteristics and historical price volatility, using the assumption that the Fed would need to seize the collateral and sell it to recoup its loan. Our view is that discount window requirements should be re-examined.

The Federal Reserve should improve the transparency of its collateral pricing to ensure banks understand their borrowing capacity and what is driving changes to collateral valuation. Once pledged, valuation can change significantly with no explanation. Added information regarding the drivers of the change will avoid unexpected movements in price which could have adverse outcomes. Further, we encourage a reconsideration of how much credit risk the discount window should take on, and, by extension, what are the appropriate collateral haircuts, particularly for high quality collateral such as Treasury securities. Steep discounts protect the Fed from potential, and often very unlikely, credit losses but discourage banks from thinking of the discount window as a source of funding in all but the most extreme circumstances and, as a result, undermine its statutory objective.

One of the defining characteristics of a financial stress event is a sharp drop in asset prices across a broad range of asset classes and markets. When thinking about the central bank's role of lending against good collateral during stressed market conditions, central banks should be lending against the fundamental value of the collateral rather than temporarily impaired market prices. One of the factors that made the Bank Term Funding Program (BTFP) successful is that it accepted bank holdings of high-quality collateral at face value, so as not to penalize the very collateral banks were holding for purposes of liquidity management. It is worth considering whether the stress of March 2023 could have been significantly lessened if SVB were able to borrow against the par, rather than current market, value of its Treasury holdings, and without any collateral haircuts.

Lessons from the BTFP

The BTFP was set up because the discount window could not provide sufficient liquidity quickly, efficiently and at a reasonable cost. Measured by participation, the program was a success. Going forward, the Fed should use the BTFP as a guide to experiment with discount window parameters, including offering face value on high quality securities, eliminating haircuts, experimenting with maturity terms and considering alternative interest rates.

- **Collateral valuation:** Even though current or fair value approaches would actually increase collateral values (and hence eligible loan amounts) when interest rates are falling, the uncertainties created by the current policy justify a review. The use of face value for high quality collateral such as Treasury securities may be appropriate in at least some cases.

- **Haircuts:** In addition to limiting loans to the market value of a bank's collateral, the discount window also applies haircuts to the collateral when determining the bank's discount window borrowing capacity. The BTFP parameters did not include haircuts which may have contributed to the success of the program. The rationale for discount window haircuts should be re-examined as part of discount window modernization and any re-evaluation of discount window exposure to credit risk.

- **Maturity terms:** The BTFP offered loans for up to one year in contrast to discount window loans which, by statute, must have maturities of less than four months. In practice, almost all discount window loans are for one business day. A systematic approach to discount window loans for longer maturities of, say one or three months, could reduce the perception that discount window activity is only conducted in urgent, crisis-type situations.

Liquidity Supervision and Regulation

Borrowing from the discount window is considered by many (bank executives, investors, and even supervisors) to be a sign of weakness. The acceptability of discount window usage needs to be absorbed by all stakeholders – bank executives, for example, are unlikely to make greater use of the discount window if supervisors accept that usage as normal course of business but bank investors do not (or vice-versa). This stigma, in combination with operational hurdles, has resulted in banks not using the discount window even when it is notionally preferable to alternative funding sources. The stigma problem was exacerbated by the Dodd-Frank Act's requirement that the Fed disclose discount window borrowers with a two-year lag. While a full menu of specific steps needed to "de-stigmatize" the discount window is not clear, supervisors can take steps that would unquestionably help. The recent supervisory emphasis on discount window readiness will have a positive effect. For supervisory purposes, banks that have regularly tested open lines, for example, should garner a higher "L" in CAMELS or LFI ratings.

Going forward, it is critical that Congress and the banking agencies have a deep understanding of how changes to liquidity supervision, regulations and related policy tools will flow across the industry and affect markets and the economy. Recent speeches by Vice Chairman Barr[2] and Acting Comptroller Hsu[3] on bank liquidity risk management outlined some changes to supervisory expectations and the potential for new liquidity regulations. This is subsequent to the recent updates to supervisory expectations[4] whereby all banks are expected to take steps to ensure they are operationally ready to access the discount window when needed. Simultaneously, the banking agencies appear to be considering new targeted requirements that banks pre-position a pool of collateral at the Federal Reserve. While the details are not yet public, this requirement raises critical policy issues, including how a new requirement would affect moral hazard, interact with deposit insurance or impact other entities, such as the FHLBs, and more important, impact banks' availability to meet the credit and funding needs of US households and businesses. In addition, it will be important that the calibration of the targeted requirement take into account existing liquidity requirements and banks' current practices of pre-positioning collateral (which includes allowing assets to remain unencumbered) to avoid any trapped liquidity that could have economic and market impacts.

The Discount Window and the FHLBs

The interplay between the Fed's discount window and the FHLBs needs to be fully considered by Congress, the Federal Housing Finance Agency (FHFA) and the banking agencies. Under current statute the FHLBs provide banks with funding to meet day-to-day liquidity to support their lending and to achieve key housing goals across all market conditions. Moreover, the FHLBs offer smaller banks access to capital markets that would otherwise be unavailable or prohibitively expensive. The FHLBs have evolved to be a vital source of liquidity for banks in the modern financial system and unilateral or uncoordinated changes could be very disruptive to banks and the broader economy.

Concluding Thoughts

The Federal Reserve was established in 1913 to provide liquidity to the banking system, particularly in times of stress. To fill the gap between an aged governance system and modern financial markets, the Fed has resorted to ad hoc institutional structures to address instability (the BTFP's ancestors include the Term Auction Facility, the Term Asset-Backed Securities Loan Facility, and the Primary Dealer Credit Facility). Vice Chair Barr's recent speech suggests that the Fed has not given up on returning the discount window to its original purpose. To do so, simple fixes like the ones described above can help bring the discount window into the 21st century.

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[2] Speech by Vice Chair for Supervision Barr on Bank Supervision and Regulation, February. December 01, 2023. https://www.federalreserve.gov/newsevents/speech/barr20231201a.htm

[3] Speech by Acting Comptroller Hsu "Building Better Brakes for a Faster Financial World." January 18, 2024. https://www.occ.gov/news-issuances/speeches/2024/pub-speech-2024-4.pdf

[4] Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plans https://www.fdic.gov/news/press-releases/2023/pr23057a.pdf