Lessons for the Discount Window from the March 2023 Bank Failures

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Lessons for the Discount Window from the March 2023 Bank Failures

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Abstract

The speed of the bank runs that occurred in the United States in March 2023 took most by surprise. The ensuing policy debate about reform has focused very little on the role of the Federal Reserve’s discount and how it could be made more fit for purpose in mitigating risks to financial stability emanating from the banking system. Making the discount window a more effective financial stability tool will require actions both to reduce the stigma associated with borrowing and improve the operational agility and readiness of the Fed as lender and banks as borrowers. A number of frictions exist that undermine the discount window’s effectiveness as a financial stability tool and amplify the stigma associated with discount window borrowing. These frictions may have been tolerable during bank runs that unfolded over a period of days but are problematic in a world where bank runs can transpire in a matter of hours.

Keywords: discount window, financial stability, lender of last resort, liquidity, regulation

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1 A version of this note was published on the Yale School of Management’s Systemic Risk blog on September 19, 2023.

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Introduction

In March 2023, the unprecedented pace of the runs on Silicon Valley Bank (SVB) and Signature Bank (Signature) took many by surprise. Much has already been done to identify ways to mitigate the risk of such runs and the threat they pose to financial stability. Indeed, in the US, several proposals to strengthen bank regulation and bank recovery and resolution planning have already been released for public comment, and work on possible modifications to the deposit insurance framework and to supervision of “novel activities” is already underway (FDIC 2023b; Fed 2023a; Fed and FDIC 2023; Fed, FDIC, and OCC 2023).

One part of the financial stability toolkit that has been less frequently mentioned is the ability of the Federal Reserve (Fed) to act as lender of last resort to the banking system through the discount window. While lender-of-last-resort tools cannot by themselves ensure financial stability—and are most powerful when well aligned with good bank regulatory and supervisory frameworks—they can help address banks’ short-term liquidity needs and mitigate bank run risk and contagion risk. The events of March 2023 provide an opportunity to reflect on ways to improve banks’ willingness and ability to use the discount window, which can be particularly important in a world where runs can occur over hours rather than days. This note draws on observations about the SVB and Signature failures to offer some suggestions on steps that can be taken to reduce discount window stigma, improve operational readiness and agility, and meet the challenges presented by today’s fast-moving banking system.

What is the discount window?

A foundational responsibility of any central bank is to serve as the lender of last resort to the banking system to facilitate the ongoing flow of credit to the economy. In the United States, Section 10B of the Federal Reserve Act authorizes the Fed to extend credit (on both an intraday and overnight basis) to US-chartered depository institutions (including commercial banks, thrift institutions, and credit unions) and US branches of foreign banking organizations (Fed 1913). (This note uses the term “banks” throughout to include all these types of institutions.)

The Fed’s discount window provides overnight and term credit to banks as needed to support the ongoing flow of credit to US households and businesses. The Fed operationalizes discount window lending through its 12 regional Federal Reserve Banks, all of which rely on the same technology infrastructure, follow the same collateral policy and lending guidelines, and operate with a common set of lending documents (Fed n.d.a.; Fed n.d.e.).

A bank that requires a discount window loan borrows from its local Reserve Bank on a collateralized basis. A bank’s need for a discount window loan typically stems from a late-day funding need owing to an unexpected withdrawal or a failure to receive expected funds. Sometimes, it occurs as a result of a bank’s temporary inability to repay its intraday borrowing from the Reserve Bank by the end of the day. However, the need for credit can arise at any point in the day.
There are three types of discount window credit: primary, secondary, and seasonal credit (Fed n.d.b.). Primary credit loans serve as the principal safety valve for ensuring adequate liquidity in the banking system and are available to banks that are in generally sound financial condition, as determined by their primary regulator. Secondary credit loans are available to banks not eligible for primary credit, and these loans come with a higher rate, higher haircuts, and a shorter term. Primary credit loans are supposed to be granted with “no questions asked”; secondary credit loans are subject to more restrictions on usage of the funds borrowed. Seasonal credit is available to banks with deposits of less than $500 million that can demonstrate liquidity needs of a seasonal nature. Primary credit typically makes up the bulk of discount window loans outstanding.

While the discount window is an important tool to ensure that banks have access to the liquidity they need to intermediate credit to support the economy, the events of March 2023 showed that stigma remains. As concerns about the health of many regional banks in the United States prompted an acceleration in depositor withdrawals in early March, borrowing from Federal Home Loan Banks (FHLBs) increased sharply relative to discount window borrowing, and we subsequently learned that many banks were utterly unprepared to use the discount window as a source of backstop liquidity (Cecchetti, Schoenholtz, and White 2023; Saphir 2023). The Fed could take several steps to reduce the stigma associated with primary credit and improve banks’ incentives to use it as a contingency funding source. These steps would strengthen the effectiveness of this tool in mitigating run risk for banks of all sizes.

It is useful to recall that for much of the Fed’s history before 2003, discount window credit was extended at a below-market rate—but only when the borrower had exhausted other sources of funding. This attestation, combined with the significant administrative oversight and monitoring that also accompanied the extension of discount window credit, served to stigmatize discount window borrowing. Historically, policymakers had concerns about the moral hazard risk associated with possible bank overuse of the window, as well as concerns about how to ensure that Fed credit was not fueling speculative activity (Fed 1953, Fed 1954). These concerns gave rise to a strategy of “constructive ambiguity” among some Fed policymakers—dating back to the Great Depression—regarding the discount window, in which there was no precommitment about its availability to any bank on any given day. This attitude is perhaps understandable in the period preceding the establishment of rigorous prudential supervision for all types of banking organizations operating in the United States. However, it serves to discourage use of the discount window and has created stigma that continues to the present day.

In 2003, the Fed endeavored to reboot and destigmatize the discount window by establishing two main tiers of credit: a primary tier that would be lent on a “no questions asked” basis to sound institutions at an above-market rate and a secondary tier that would be lent to less-sound institutions on more restrictive terms (Madigan and Nelson 2002). Fed policymakers have since 2003 attempted on many occasions to communicate to the public that primary credit is a legitimate source of funding that banks may use when needed with “no questions asked.” Indeed, since the onset of the COVID-19 pandemic in the spring of 2020, the Fed has redoubled its efforts to signal the message that primary credit should be used when needed;
it extended the term of primary credit to 90 days and reduced the spread of the primary credit rate over the upper bound of the fed funds rate target range to zero.\textsuperscript{3}

Yet stigma is still present despite this communication. Why? Observers have pointed to the greater disclosure required under 2010’s Dodd-Frank Wall Street Reform and Consumer Protection Act, as well as the presence of cheaper alternatives to primary credit such as the FHLBs.\textsuperscript{4} But one key driver of stigma that gets less attention is the mixed messaging that has come from the Fed and other banking regulators on the topic of discount window usage. As discussed in more detail below, supervisory and regulatory practices, requirements, and language are often at odds with the “no questions asked” policy stance on primary credit.

**Steps to reduce stigma**

**Communicate clearly and regularly to the public that primary credit is a legitimate source of liquidity for banks to utilize when needed.**

A more comprehensive communication strategy that aligns words and actions is needed to combat discount window stigma and overcome the long memories of bank managers, market participants, reporters, and even bank regulatory staff themselves that “discount window borrowing” is to be questioned or avoided. When bank treasurers are grilled by their risk management committees or their regulators about why they borrowed from the window, this perpetuates stigma. When market commentary and press pieces speculate about which bank was behind the borrowing activity seen in the Fed’s weekly H.4.1 data release, this perpetuates stigma.\textsuperscript{5} These dynamics will be difficult to disrupt without clear, intentional, and repeated communication from the Fed about its stance on primary credit. This communication must be mirrored in supervisory and regulatory practices and in adjustments to how primary credit is administered.

**Recalibrate supervisory and regulatory practices and language to support the communication strategy about primary credit.**

US bank supervisory and regulatory practices undermine the “no questions asked” message by disincentivizing primary credit borrowing relative to other funding alternatives. For example, the liquidity coverage ratio (LCR) requires banks to hold high-quality liquid assets (HQLA) sufficient to cover their expected net outflows over a 30-day period. In the US, banks

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\textsuperscript{3} Section 10B of the Federal Reserve Act restricts discount window lending to a maximum tenor of four months; the Board of Governors of the Federal Reserve System has some discretion within that constraint to set the maximum term (Fed 1913).

\textsuperscript{4} Leaving aside the question of whether the large-scale lending by FHLBs to banks such as SVB and Signature is consistent with the policy objective for which the FHLBs were established in 1932, the fact is that many banks prefer to borrow from their local FHLB rather than their Federal Reserve Bank, as it is often cheaper than the discount window and does not carry the same stigma.

\textsuperscript{5} The Federal Reserve took an important step to mitigate this type of speculation in March 2020 by discontinuing the district-level reporting of discount window borrowing on its weekly report on factors affecting reserve balances. See Fed 2020b.
with assets of over $50 billion are subject to either a standard or modified LCR. But assets considered HQLA by US banking regulators are limited to certain types of marketable securities that represent a relatively small share of the assets that can be pledged to the window as collateral (Fed n.d.a.; Fed n.d.d.; OCC, Fed, and FDIC 2014). Banks receive no credit for other types of assets, such as loans, that are prepositioned at the discount window, even though these assets can be monetized on a same-day basis through a primary credit loan.

Additionally, supervisory guidance limits the ability of a banking organization to rely on primary credit as a source of liquidity for its depository institutions in its recovery and resolution plan (R&RP) to “only a few days,” even though the process of recovery or bridging to a resolution outcome could take longer than that.6 And banks are not required to incorporate primary credit into their contingency funding plans (CFPs) as a backstop source of funding. Recalibrating supervisory expectations to better align with the idea that primary credit is a legitimate source of short-term funding would help to improve the incentives for banks to use it.

**Use supervisory authority to require banks to be prepared to use the discount window if needed, as a matter of prudent contingency liquidity planning.**

In the US, the onus is currently on banks to make the effort to obtain access to the discount window and conduct test borrowings periodically, ahead of a need to borrow. Many banks do this; however, the postmortem reports by the Fed on SVB and the Federal Deposit Insurance Corporation (FDIC) on Signature make clear that neither bank was operationally prepared to use the discount window when they needed it (Barr 2023; FDIC 2023a). SVB had identified the discount window as a source of funding in its CFP, but the bank had not tested its discount window borrowing arrangements in the year before its failure and was not prepared to manage within the cutoff times for movement of collateral within its time zone. Signature’s CFP was overly reliant on the Federal Home Loan Bank of New York and did not include the Fed’s discount window (Ostrander 2023). Signature had not tested its discount window borrowing arrangements for five years before its failure and tried repeatedly in its final days to pledge collateral that was, based on publicly available information, clearly ineligible.

A chorus of Fed speakers have since reinforced the need for banks to be operationally ready to use the discount window. On July 28, 2023, the Fed and other US banking regulatory agencies took a step in this direction by issuing amended supervisory guidance for Category II and III firms7 that emphasizes the discount window’s value as a contingency funding tool and encourages banks to take the steps to be operationally ready to borrow, including small-value test borrowing and prepositioning collateral (Fed, FDIC, NCUA, and OCC 2023). But guidance is not a requirement and still leaves some discretion to banks, which seems suboptimal from a systemic risk perspective.

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6 See also the joint Federal Reserve Board–Federal Deposit Insurance Corporation February 2019 guidance for global systemically important banks (Fed and FDIC 2019).

7 For a description of the institutions that are governed by Category II and III standards, see OCC (2019).
Why not require any bank that has access to primary credit to include it as a source of funding in its CFP? Making this inclusion a requirement would increase the likelihood that banks are ready to borrow from the discount window when and if needed. Further, any bank that is relying on primary credit in its CFP could be required to do the test borrowing and collateral prepositioning needed to ensure readiness to borrow. Testing will ensure that banks are aware of the mechanics of the borrowing and collateral-pledging processes, operational cutoff times in their time zones, and collateral eligibility guidelines. Readiness to use the discount window should be a supervisory expectation for contingency liquidity risk management against which banks should be assessed and, if found to be noncompliant, required to take corrective action.

Consider ways to decouple administration of the primary and secondary credit programs to support the destigmatization of primary credit.

The 2003 redesign of the discount window was intended to destigmatize primary credit borrowing by distinguishing it from troubled banks’ secondary credit borrowing. But the fact that primary credit is administered in tandem with secondary credit may in fact have contributed to stigma; much of the Fed’s communication on its lender-of-last-resort tools speaks in terms of “the discount window” or simply “advances” in a manner that does not distinguish between the two programs. Consider the following language from Section 14.1 of the Federal Reserve Operating Circular No. 10, which governs discount window lending: “The (Reserve) Bank is not obligated by the Lending Agreement or otherwise to make, increase, renew or extend any Advance to the Borrower” (Federal Reserve Banks 2023, 10). Such language appears to reflect wariness about lending to unhealthy banks, which seems entirely appropriate messaging for secondary credit. But this messaging is not consistent with the idea of a “no questions asked” primary credit backstop and reflects the lingering effects of the constructive ambiguity doctrine that has served to stigmatize discount window borrowing over time. Indeed, this language was embedded in the Federal Reserve Act itself, well before the 2003 redesign of the discount window. Clarity on the central bank’s stance on primary credit could be supported by administering the primary and secondary credit programs separately and communicating about them more distinctly.

Develop and communicate a longer-term approach to pricing primary credit that is intended to mitigate stigma.

Part of the 2003 redesign of the discount window included pricing of primary and secondary credit at a penalty rate, defined as a spread above the fed funds target rate. Initially, the spread for the primary credit rate was 100 basis points over fed funds; with the onset of the

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8 The FDIC Improvement Act of 1991, passed in response to the savings and loan crisis, amended the Federal Reserve Act to add Section 10B(b)(4), which states: “A Federal Reserve bank shall have no obligation to make, increase, renew, or extend any advance or discount under this Act to any depository institution” (US Gov’t 1991).

9 Other central banks generally do not have different tiers of access in their lender-of-last-resort standing facilities; financial institutions are either eligible or not eligible.

10 Since the Federal Open Market Committee’s adoption of a target range for the policy rate in December 2008, the top of the target rate has been the reference point for the spread.
Global Financial Crisis, the Fed reduced the spread to 50 basis points in August 2007 and then to 25 basis points in March 2008 as dollar funding market stress intensified (Fed 2007; Fed 2008). The spread returned to 50 basis points in February 2010 when the crisis-era terms for primary credit lending were partially reversed (Fed 2010). In March 2020, as part of a set of measures to support the flow of credit to households and businesses amid the onset of the global COVID-19 pandemic, the Fed reduced the spread to 0 basis points, where it has remained since (Fed 2020a).

This lineage raises interesting questions about the classical Bagehot idea of a penalty rate for lender-of-last-resort facilities (Bagehot 1873). A penalty rate is surely appropriate for standing facilities that lend to undercapitalized institutions, or that are established for crisis liquidity facilities that lend to a wide range of borrowers not usually eligible for central bank liquidity. But is a penalty rate consistent with the idea of short-term liquidity provision to sound banks with “no questions asked”? And if so, is there a level at which the penalty rate can be set that would minimize stigma? Should the penalty vary in stress and normal funding market environments? Consideration should also be given to the appropriate relationship of the primary credit rate to the pricing of other sources of contingency funding available to banks. Does it make sense that banks can borrow more cheaply from the FHLBs, for example?11 What is the appropriate relationship between the primary credit rate and the lending rates at FHLBs (net of dividends) and other sources of contingency funding for banks? Can that relationship be calibrated to minimize stigma? A framework for pricing primary credit that answers these questions would be an extremely useful component of a broader communication strategy about discount window borrowing.

**Steps to improve operational readiness and agility**

In a world of intraday runs, it seems worth considering ways to make it easier and faster for banks to use primary credit when they need it. The Fed could take several steps to modify the processes for establishing access to, and using, primary credit to better align that funding with the speed at which liquidity needs can arise.

**Establish access early in a bank’s life cycle.**

The discount window is an important financial stability tool to mitigate systemic risk transmission in the banking system. However, discount window access is not automatic; a bank must clear multiple hurdles before it can borrow from the discount window. First, a bank must affirmatively apply for a master account on the Federal Reserve’s books—or identify a correspondent bank with a master account through which to operate—as discount window borrowing and collateral pledging are executed via banks’ Fed accounts. Next, the bank must apply for discount window access, which requires the execution of several legal agreements and resolutions. Finally, the bank must pledge collateral.

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11 This question is admittedly beyond the Fed’s remit but is relevant to the current debate on FHLB reform.
This process is burdensome and prompts the question: Why not make the establishment of Fed master accounts and discount window arrangements an up-front part of the process for chartering a bank or establishing a branch in the US? The Fed has historically been quite careful in granting master accounts to banks given the risks account activity can pose to a Reserve Bank if the bank is not in sound condition. But perhaps newly established banks without a credit risk management track record could receive a master account that provides only the ability to borrow at the discount window up to the margined value of collateral they have pledged and does not provide access to other Fed services, such as intraday credit.

**Automate the loan approval process for primary credit loans.**

Once a bank has discount window access, the loan request and approval process is still quite manual. A bank requests the loan by telephone and waits for confirmation that it has pledged sufficient collateral value to support the amount requested. The Fed recently announced it is taking steps to automate the loan request process; another step it could take is to automate the loan approval process for primary credit loans (Fed 2023b). Automating the process of confirming that a bank has sufficient unencumbered collateral value to support the loan requested could speed the loan approval process modestly and, perhaps more importantly, provide another way to signal that primary credit is available with “no questions asked.” An ability to override the automated check manually could be created to deal with cases in which the condition of the bank is in question.

It is useful to note that a shift to this “automatic” access paradigm for primary credit would need to be accompanied by improvements in the quality and frequency of supervisory updates to the national supervisory ratings database. This is because counterparty risk management for discount window lending happens primarily at the supervisory level. All US banking supervisory agencies are responsible for monitoring and rating bank safety and soundness—and for providing ratings for the banks they oversee to the national database. These ratings feed into Reserve Banks’ assessments of borrower condition and drive determinations about primary and secondary credit eligibility (as well as intraday credit access). There is a long history of poor and/or stale assessments of bank condition (IndyMac, Washington Mutual, etc.) before March 2023. At times of stress, the boundary between solvency and insolvency can be fuzzy; bank supervisors that are monitoring the bank’s condition on an ongoing basis are best placed to provide an assessment of it.

**Explore ways to expand the feasibility of late-day pledges of collateral to the discount window.**

While all eligible types of securities collateral can be pledged on a same-day basis in theory, in practical terms, the devil is in the details. Figure 1 summarizes the information on cutoff times for securities pledges that is provided on the Fed’s webpage on pledging discount window collateral as of September 2023 (Fed n.d.a). As Figure 1 shows, depending on the location of a bank’s collateral and the time zone in which the bank is operating, a late-day pledge may or may not be feasible in practical terms. Indeed, SVB ran up against this issue in March 2023.
Figure 1: Operational Cutoff Times for a Bank’s Securities Pledges to a Reserve Bank

<table>
<thead>
<tr>
<th>Type of pledge</th>
<th>Cutoff time to request same-day pledge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Move of securities among a borrower’s or correspondent’s own accounts on the Fedwire Securities Service</td>
<td>7:00 pm Eastern / 4:00 pm Pacific</td>
</tr>
<tr>
<td>Move of securities between two participants’ accounts on the Fedwire Securities Service</td>
<td>3:45 pm Eastern / 12:45 pm Pacific</td>
</tr>
<tr>
<td>Pledge of securities held at Depository Trust Company</td>
<td>5:00 pm Eastern / 2:00 pm Pacific</td>
</tr>
<tr>
<td>Pledge of securities held at Euroclear</td>
<td>12:15 pm Eastern / 9:15 am Pacific</td>
</tr>
<tr>
<td>Pledge of securities held at Clearstream</td>
<td>1:00 pm Eastern / 10:00 am Pacific</td>
</tr>
</tbody>
</table>

Note: Cutoff time assumes no request for extension is made by the pledging bank and granted by the Fed.

For this reason, the Fed has long urged banks to preposition collateral at the discount window so it is there if needed. However, there may be circumstances in which a bank loses access to funding on a given day and may need to move collateral to the Fed to support borrowing. The ability to execute same-day pledges may have been less of an issue in the past, when bank runs materialized over a period of days. But in a world where runs can occur within the space of hours, it is worth exploring opportunities to expand the windows within which pledges can be effected late in the US business day. Importantly, this is not a discount window infrastructure issue; rather, it reflects the design of the broader wholesale payments infrastructure, of which the Fedwire Securities Service and the custodial banks are part, and which was designed for a different financial market environment than exists today.

We also saw in March 2023 that the process of getting collateral from FHLBs to Federal Reserve Banks was time-consuming owing to a combination of legal and operational issues. Indeed, in the case of Signature, special ad hoc legal arrangements were required to effect a timely pledge of collateral to the Federal Reserve Bank of New York in a manner that would adequately secure the Reserve Bank’s loan (NYS DFS 2023). To the extent that banks continue to pledge large amounts of Fed-eligible collateral to their local FHLBs, it seems advisable to begin work now to address any outstanding legal or operational questions associated with collateral transferability between FHLBs and the Federal Reserve System—before the next liquidity event occurs.

**Explore ways to incentivize or even require banks to preposition a certain share of their loan portfolios as collateral pledges to their local Reserve Banks.**

Loans, which represent the majority of assets pledged to the Federal Reserve System and the bulk of assets pledged by smaller banks, can take even longer to pledge to a Reserve Bank than securities. Loans eligible to be pledged as collateral by banks must be pledged through
a held-in-custody arrangement. This process can take weeks to set up properly to ensure the Fed has perfected its security interest in the collateral. So, prepositioning is particularly critical for loans, which are pledged in large part by banks that are not large enough to have been deemed “systemically important” but whose activities can nonetheless give rise to financial instability in today’s environment.

**Conclusion**

While there are surely legal, technological, cultural, and risk management issues to overcome in moving to a more agile and truly “no questions asked” paradigm for primary credit lending to banks, the recommendations offered in this note would collectively help to reduce discount window stigma—and to avoid outcomes in which a bank needs liquidity before it has put the necessary operational arrangements in place. Timely discount window borrowing alone would not have saved SVB or Signature, given their risky business models, concentration and interest rate risks, and the associated solvency issues present in both institutions. But it might have slowed the run and mitigated contagion risk, while buying valuable time to execute resolution processes that were less costly for the Deposit Insurance Fund. And in the case of an otherwise solvent bank that is experiencing liquidity stress, timely access to discount window liquidity can make the difference between recovery and failure. The frictions in discount window access and usage described here seem to reflect the legacy of the constructive ambiguity doctrine, and they continue to contribute to the stigma associated with discount window borrowing. While these frictions were perhaps tolerable during runs that unfolded over a period of days, they are problematic in a March 2023 world, where runs can occur in a matter of hours.
References


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