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Discount Window Stigma: What's Design Got to Do with It?¹

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Abstract

This article utilizes discount window transaction data, which the Federal Reserve began disclosing in 2010, to assess how the Fed's 2003 redesign of the discount window has affected banks' use of the window. The data show that while the discount window remains stigmatized and relatively little used outside periods of funding market stress, secondary credit has at times played a role in supporting bank recovery and resolution, as envisioned by the 2003 redesign. This development raises a policy question: has the two-tiered design of the discount window implemented in 2003, in which a lending facility for sound banks operates alongside one for weaker banks, served to stigmatize primary credit by association with secondary credit?

Keywords: banking, central banking, crisis management, financial institutions, financial stability, liquidity, LOLR

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Introduction

Since the bank failures of 2023, Federal Reserve (Fed) policymakers have frequently spoken publicly about the importance of bank readiness to use the discount window in times of liquidity stress. We saw that neither Silicon Valley Bank (SVB) nor Signature Bank had prepared to use the window as a contingent source of funding before their depositors ran. Although these banks had more fundamental problems that could not have been solved purely by discount window lending, a prompt decision to use the discount window could have limited the fallout for other regional banks.

However, readiness alone is not sufficient—for the discount window to be effective in promoting financial stability, banks must also be willing to use it. The stigma associated with discount window borrowing in the US is well documented and is a multifaceted phenomenon, as described in an earlier *Journal of Financial Crises* article (McLaughlin 2024b).

The Fed's efforts to redesign and rebrand the discount window in 2003 were explicitly aimed at removing the stigma for borrowing by adequately capitalized³ banks while also retaining a source of central bank liquidity to facilitate the recovery and/or resolution of weaker banks. This article examines the performance of the 2003 rebranding in light of those goals, to see whether we can learn anything about further improvements that policymakers can pursue to make the window a more effective policy tool going forward.

Why Is Discount Window Stigma Bad for Financial Stability?

The discount window, like any other central bank tool for liquidity provision, can mitigate systemic risk during periods of instability in the financial system, in three ways:

- By allowing a bank to borrow when needed to meet short-term, unexpected liquidity needs, the discount window creates confidence among depositors and investors that the bank will continue to have access to the funding it needs to meet its obligations—thus mitigating **run risk**.
- A bank's access to a liquidity backstop such as the discount window avoids the need for the bank to sell assets to generate liquidity—thus mitigating **fire sale risk**.
- Availability of this liquidity backstop can also mitigate **contagion risk** by providing confidence to a broader set of bank depositors and investors to avoid bank runs—thereby averting the spread of stress through banking and capital markets.

The central bank's ability to mitigate systemic risk by providing a liquidity backstop is most effective in stemming runs and bolstering market confidence when it can be done quickly,

³ Here, I am using the term “adequately capitalized” as defined by the Federal Deposit Insurance Corporation Improvement Act of 1991 (Todd 1992).

early in a liquidity stress event, and in sufficiently large size. If banks are reluctant to borrow early in a stress event and wait until conditions worsen and a run is underway, it is too late.

The 2003 Redesign of the Discount Window: An Attempt to End Stigma

It is useful to recall the origins of the current design of the discount window, which features two principal tiers of lending based on a bank's financial condition.⁴ Before the 2003 redesign, the Fed's discount window also provided liquidity to banks through two programs: **adjustment credit**, which provided reserves to adequately capitalized banks experiencing a temporary reserve deficiency they could not fund in the interbank market, and **extended credit**, which provided longer-term funding to support banks that had lost access to the funds market and needed time to identify alternative funding sources (Todd 1992).

Importantly, both types of loans were made at below-market rates. This design reflected the view of policymakers in the early days of the Fed's existence that Bagehot's principle of lending at an above-market rate would not be practical for the United States, given the wide variation in interest rates across regions and loan types at that time (Anderson 1966). Additionally, during the 1920s and 1930s, policymakers used the discount window as a tool to ensure that bank lending was supporting productive not speculative activity (Anderson 1966).

Given the moral hazard accompanying central bank lending priced substantially below market rates, and the desire to discourage speculative activity by banks, discount window borrowing was accompanied by substantial administrative scrutiny and constraints for decades thereafter, such as the requirement for a borrower to demonstrate it had exhausted all other sources of credit and a prohibition on selling funds obtained at the discount window credit into the market (Madigan and Nelson 2002).

The Fed's 2003 redesign of the discount window preserved the two-tiered construct, with **primary credit** lending to adequately capitalized banks and a **secondary credit** program for weaker banks that is priced at a higher rate and with higher collateral haircuts than for primary credit. But it adopted a penalty rate approach to pricing credit that is more consistent with the classic Bagehot model of lender-of-last-resort tools. And it featured two notable design changes aimed at destigmatizing primary credit borrowing (Madigan and Nelson 2002).

- The primary credit facility was positioned as **an integral part of the Fed's monetary policy implementation framework**. The primary credit rate was designed and communicated to the public as constituting a ceiling on the Fed's monetary policy instrument—the federal funds rate—and was presented as an essential part of the

⁴ This article does not discuss a third type of discount window lending, seasonal credit, which has a very specific purpose of supporting the seasonal liquidity needs of small banks financing agricultural activity and is thus not stigmatized. Seasonal credit represents a very small share of overall discount window borrowing.

corridor-type system the Fed had adopted to ensure rate control in its implementation of monetary policy (Keister 2012).

- Primary credit borrowing involved **no administrative scrutiny or constraints**—adequately capitalized banks could borrow on a “no questions asked” basis. Indeed, banks were encouraged to borrow when primary credit was cheaper than the prevailing fed funds market rate and arbitrage the difference in rates by selling those funds into the market at the higher rate. In this way, primary credit was envisioned as a tool to contain spikes in the effective fed funds rate that would otherwise have complicated the Fed’s implementation of monetary policy in a “reserves scarcity” framework.⁵

Importantly, the redesign also aimed to restore the discount window’s power as a financial stability tool—by destigmatizing it. As explained in an article by staff at the Federal Reserve Board of Governors previewing the new design:

Besides serving as a marginal source of aggregate reserves to the market and a backup source of liquidity to sound depository institutions, the discount window can also, at times, serve as a useful tool for promoting financial stability by providing temporary funding to depository institutions that are experiencing significant financial difficulties. The provision of central bank credit can help guard against the sudden collapse of depository institutions by addressing liquidity strains while an institution is making a transition to sounder footing.” (Madigan and Nelson 2002)

A destigmatized primary credit facility could serve not only as a safety valve to provide reserves to banks on days when open market operations provided fewer reserves than demanded, or when the interbank market was not effectively redistributing reserves to where they were needed, but also as a liquidity backstop that could mitigate the risk of runs, fire sales, and contagion.

Is the 2003 Design Working as Envisioned?

The answer is clearly no with respect to primary credit—which remains stigmatized despite the efforts to normalize it. The original 100-basis-point level of the penalty rate, widespread criticism and misunderstanding of the purpose of discount window lending during and since the Global Financial Crisis of 2007–2009, a failure to align primary credit borrowing with supervisory and regulatory requirements governing banks’ liquidity risk management, the operational challenges involved in establishing access and pledging collateral, the presence of the Federal Home Loan Banks as a less-stigmatized source of financing, and Dodd-Frank Act requirements for the (lagged) public disclosure of loan details (including borrower name) have all played a part in perpetuating stigma. Secondary credit, on the other hand,

⁵ “Reserves scarcity” refers to a framework for monetary policy implementation in which the central bank supplies a relatively low level of reserves to the banking system and adjusts supply as needed to manage the policy rate to its target level. For more details, see Afonso et al. (2022).

seems to be playing the role that was envisioned for it as a tool to facilitate weak banks' recovery and/or resolution, if only to a limited extent (Kelly, McLaughlin, and Metrick 2024; McLaughlin 2024b).

Secondary Credit Usage

As shown in Figure 1, secondary credit usage has been small and infrequent to date. Quarterly discount window borrowing transaction data available from Q3 2010 through Q2 2022 reveal that over this period, 288 depository institutions borrowed secondary credit. Most secondary credit borrowing was done by relatively small depository institutions—mainly community banks and credit unions. The Federal Reserve's transaction data do not distinguish between test and actual borrowings; using an assumption that loans below \$100,000 were done for operational testing purposes, only 5% of these transactions appear to have been actual, not test, borrowings (Fed n.d.b).⁶

Figure 1: Primary and Secondary Credit Usage, 2003–2023



Source: Fed n.d.b.

Secondary Credit as a Tool for Troubled Bank Recovery

As shown in Figure 2, the Fed's quarterly transaction data for Q3 2010 through Q2 2022 show 132 instances in which a bank borrowed secondary credit and subsequently borrowed primary credit at a later date. All but four of these borrowers were community banks (in

⁶ Of the 828 secondary credit loans reported between Q3 2010 and Q2 2022, only 45 were for amounts greater than \$100,000.

other words, banks with assets under \$10 billion) or credit unions; three were foreign banking organizations, and one was a regional bank. Secondary credit does appear in some cases to serve as a source of funding for banks that are working their way back to better health (typically smaller institutions) (Fed 2021).

Figure 2: Instances of Secondary, then Primary Credit Borrowing, Q3 2010–Q2 2022

Time elapsed between most recent secondary credit loan and first subsequent primary credit loan	Number of banks
< 1 year	49
1–2 years	54
2–3 years	13
3–4 years	5
> 4 years	11
TOTAL	132

Source: Fed n.d.a.

Secondary Credit as a Tool for Bridging to Bank Resolution

Figure 3 maps the Fed’s quarterly transaction data for discount window borrowings to Federal Deposit Insurance Corporation (FDIC) data on bank failures, to see whether banks that borrowed before they failed were typically eligible for secondary credit. This mapping reveals 46 depository institutions that borrowed at the window between Q3 2010 and Q2 2022 that subsequently failed. As expected, the majority were secondary credit borrowers, consistent with the idea of secondary credit as a tool for transition to FDIC resolution. The time span between secondary credit borrowing and failure over this period ranged from just 11 days (Pacific State Bank) to 4.6 years (Proficio Bank) and averaged just under one year.

Notably, six banks that borrowed primary credit in this period have since failed. However, only two of these—Trust Company Bank and Washington Federal Bank for Savings—failed during the period for which we have loan data. Washington Federal failed 85 days after receiving its last primary credit loan; Trust Company Bank failed 3.6 years after its last primary credit loan. Complete discount window loan data for the full period before the closures of Silicon Valley, Signature, First Republic, and Republic First in 2023 and 2024 are not available, so it is not yet possible to quantify the time between last borrowing and failure. However, given the media and supervisory reports of borrowing by some of these banks much closer to the dates of their failures, the numbers in Figure 3 for these four institutions likely overstate the length of the lag.

Figure 3: Banks that Borrowed before Failure, Q3 2010–Q2 2022

Date Last Borrowed	Fail Date	Name	ABA Number	Last Borrowing (Primary or Secondary Credit)	Loan to Failure (Days)
8/6/10	10/17/14	NBRS FINANCIAL BANK	55001986	Secondary	1,533
8/9/10	8/20/10	PACIFIC STATE BANK	121141482	Secondary	11
8/18/10	1/21/11	ENTERPRISE BANKING CO.	61211074	Secondary	156
9/14/10	7/15/11	ONE GEORGIA BANK	61020786	Secondary	304
9/21/10	1/27/12	BANKEAST	64101576	Secondary	493
10/7/10	11/18/11	POLK COUNTY BANK	73915342	Secondary	407
12/2/10	5/4/12	SECURITY BANK, NATIONAL ASS'N	67010512	Secondary	519
12/8/10	4/29/11	FIRST CHOICE COMMUNITY BANK	61120958	Secondary	142
12/20/10	9/28/12	FIRST UNITED BANK	71923750	Secondary	648
12/28/10	7/15/11	FIRST PEOPLES BANK	67014615	Secondary	199
1/21/11	5/20/11	FIRST GEORGIA BANKING CO.	61120369	Secondary	119
3/9/11	10/21/11	OLD HARBOR BANK	63115437	Secondary	226
3/30/11	8/5/11	BANK OF SHOREWOOD	71924775	Secondary	128
4/25/11	7/22/11	SOUTHSHORE COMMUNITY BANK	63115783	Secondary	88
5/3/11	1/27/12	TENNESSEE COMMERCE BANK	64108540	Secondary	269
5/17/11	1/27/12	FIRST GUARANTY BANK AND TRUST CO. OF JACKSONVILLE	63005628	Secondary	255
6/1/11	10/14/11	COUNTRY BANK	71126078	Secondary	135
6/21/11	1/18/13	1ST REGENTS BANK	91017170	Secondary	577
6/29/11	12/16/11	PREMIER COMMUNITY BANK OF THE EMERALD COAST	63216064	Secondary	170
7/13/11	8/18/11	PUBLIC SAVINGS BANK	231975836	Secondary	36
11/2/11	5/31/13	BANKS OF WISCONSIN	75917911	Secondary	576
11/23/11	7/20/12	SECOND FEDERAL SAVINGS AND LOAN ASS'N OF CHICAGO	271071279	Secondary	240
2/3/12	10/26/12	NOVA BANK	36076053	Secondary	266
3/21/12	4/26/13	DOUGLAS COUNTY BANK	61102507	Secondary	401
4/17/12	7/20/12	FIRST CHEROKEE STATE BANK	61104262	Secondary	94
4/20/12	1/23/15	HIGHLAND COMMUNITY BANK	71925509	Secondary	1,008
6/15/12	5/10/13	SUNRISE BANK	61220751	Secondary	329
7/31/12	3/3/17	PROFICIO BANK	124084779	Secondary	1,676
8/14/12	2/15/13	COVENANT BANK	71002095	Secondary	185
9/27/12	10/30/13	BANK OF JACKSON COUNTY	63205211	Secondary	398
10/9/12	4/29/16	TRUST COMPANY BANK	84304230	Primary	1,298
2/19/13	8/23/13	COMMUNITY SOUTH BANK	84302915	Secondary	185
6/5/14	7/18/14	EASTSIDE COMMERCIAL BANK	61120631	Secondary	43
11/7/14	2/13/15	CAPITOL CITY BANK & TRUST CO.	61004812	Secondary	98

Date Last Borrowed	Fail Date	Name	ABA Number	Last Borrowing (Primary or Secondary Credit)	Loan to Failure (Days)
12/22/14	5/8/15	EDGEBROOK BANK	71026385	Secondary	137
10/26/15	8/19/16	THE WOODBURY BANKING CO.	61104204	Secondary	298
10/29/15	5/6/16	FIRST CORNERSTONE BANK	31918637	Secondary	190
11/2/15	1/27/17	SEAWAY BANK AND TRUST CO.	71001216	Secondary	452
9/21/17	12/15/17	WASHINGTON FEDERAL BANK FOR SAVINGS	271071415	Primary	85
5/8/18	10/25/19	RESOLUTE BANK	41215812	Secondary	535
8/20/18	3/7/23	SILICON VALLEY BANK	121140399	Primary	1,660
11/14/18	3/12/23	SIGNATURE BANK	26013576	Primary	1,579
1/24/19	11/1/19	CITY NATIONAL BANK OF NEW JERSEY	21201639	Secondary	281
11/15/19	10/16/20	FIRST CITY BANK OF FLORIDA	63205664	Secondary	336
3/4/21	5/1/23	FIRST REPUBLIC BANK	121045106	Primary	788
6/28/22	4/26/24	REPUBLIC FIRST BANK D/B/A REPUBLIC BANK	36002247	Primary	668

Sources: FDIC n.d.; Fed n.d.a.

What's Design Got to Do with It?

It is clear that the redesign of the discount window in 2003 was not successful in achieving its goal of destigmatizing discount window lending to adequately capitalized banks, with well-documented adverse outcomes for the stability of the banking system in the spring of 2023. As noted previously, a number of factors contribute to discount window stigma. Could the current design of the discount window be another such factor? There is clearly a need for a central bank facility to provide funding to support the recovery or orderly, least-cost resolution of weaker banks, as secondary credit appears to have done at times since the redesign in 2003. But is it possible that the combination of a standing facility for adequately capitalized banks with one that is for weaker banks has muddied the waters and created stigma by association? "Eliminating Discount Window Stigma: What Can We Learn from Abroad" reviews how several other central banks have designed their liquidity provision mechanisms and whether we might draw lessons to improve the Fed's tools. (McLaughlin 2024a).

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