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The Fed's Discount Window: 1990 to the Present

Remarks by

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Thank you, Steve, for that kind introduction and for the opportunity to talk to this group today.[1]

Let me start by saying that I am saddened by the tragic loss of life, destruction, and damage resulting from Hurricane Helene in North Carolina, and throughout this region. My thoughts are with the people and communities affected. For our part, the Federal Reserve and other federal and state financial regulatory agencies are working with banks and credit unions in the affected area to help make sure they can continue to meet the financial services needs of their communities.

Yesterday I shared my historical perspective on the discount window at Davidson College.[2] In 1913, when the Federal Reserve was established, the discount window was the main tool it used to provide the nation with a safer, more flexible, and more stable monetary and financial system. More than 110 years later, the discount window continues to play an important role in supporting the liquidity and stability of the banking system, and the effective implementation of monetary policy.

Today I would like to discuss with you how the discount window has evolved in the 21st century, including recent steps the Federal Reserve Board has taken to solicit feedback from the public on discount window operations. Before I address our most recent efforts, however, I will review some important episodes in discount window history that brought us to where we are today.

First, I will recount briefly events in the 1980s and early 1990s that provide important context for the reappraisal of the discount window in the early 2000s. Second,

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[1] The views expressed here are my own and are not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

[2] See Jefferson (2024).

I will summarize revisions to the discount window that the Fed made in 2003 and some additional changes made since then. Third, I will describe efforts that the Fed has taken to ensure that the discount window remains effective today, including the request for information that the Board recently issued on operational aspects of the discount window and intraday credit. After completing my discussion of the discount window, I will conclude with my outlook for the U.S. economy.

Events before the 2003 Discount Window Revisions

I would like to pick up today where I left off yesterday in my speech at Davidson College: the 1980s and early 1990s. This was a period of widespread problems in the commercial banking sector. Troubled institutions borrowed from the discount window for extended periods of time as the Federal Deposit Insurance Corporation (FDIC) sought to find merger partners or otherwise manage the closure of these institutions. As a result, the discount window became associated strongly with lending to troubled institutions. Healthy banks' reluctance to borrow from the discount window increased. The greater reluctance to borrow from the discount window made it less effective both as a monetary policy tool and as a crisis-fighting tool.[3] This led to a reassessment of the discount window in the early 2000s and to eventual revisions implemented in 2003.

[3] For more details about this period, see Clouse (1994). In response to the wave of depository institution failures, Congress placed legal limitations on Federal Reserve lending to troubled institutions. Specifically, section 142 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended section 10B of the Federal Reserve Act to place restraints on discount window lending to undercapitalized and critically undercapitalized insured depository institutions. FDICIA also imposed liability on the Board of Governors for excess losses incurred by the FDIC that are attributable to lending beyond those limits. The provisions of FDICIA were intended to reduce moral hazard in the banking system and limit taxpayer losses.

A Reassessment of the Discount Window in the Early 2000s

The key challenge in the reassessment of the discount window was to establish a lending program that would not only operate effectively and support monetary policy implementation, but also mitigate moral hazard and provide sufficient controls to minimize risk to Reserve Banks and, ultimately, to American taxpayers. After the reassessment, the Fed implemented several changes aimed to achieve the right balance.

The Board replaced the adjustment credit program, which was extended at a below-market rate, with a new type of discount window credit called primary credit. This new type of discount window credit became effective in 2003.[4] It is available as a backup source of liquidity to depository institutions in generally sound financial condition at an above-market rate. Making the discount rate a penalty rate is more consistent with the long-standing practice of other major central banks. This feature was intended to reduce the need for administrative pressures based on Reserve Bank staff judgment of inappropriate usage when the discount rate was below market rates. Although those measures effectively limited usage that was deemed inappropriate at the time, they also presented communication challenges regarding when it was appropriate to use the discount window and perpetuated the perception that the Fed discouraged its use.

Primary credit is a "no questions asked" facility in which eligible depository institutions are no longer required to have exhausted other sources of funding or be subject to restrictions on the use of the borrowed funds. The Fed initially set the primary credit rate 100 basis points above the target federal funds rate.[5] Since March 2020, the

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[4] For more details, see the October 31, 2002, Federal Reserve press release (Board of Governors, 2002b) and the final rule implementing the changes (Board of Governors, 2002a).

[5] In 2003, when primary credit was implemented, there was a single federal funds target rate. The Federal Open Market Committee adopted a federal funds target range on December 16, 2008.

Fed has set the primary credit rate at a level equal to the top of the target range for the federal funds rate.[6]

At the same time primary credit was established, another new program, called secondary credit, replaced the extended credit program. Secondary credit is available to depository institutions that are not eligible for primary credit. It was initially available at an interest rate 50 basis points higher than the primary credit rate, which is the spread in effect today. In contrast to primary credit, extensions under secondary credit are subject to higher collateral discounts and may involve ongoing oversight on the use of funds obtained under the program, reflecting the less-sound condition of secondary credit borrowers. Typically, Reserve Banks review a depository institution's plan to repay the loan and return to market sources of funding.

This two-tiered structure of providing the no-questions-asked primary credit program for healthy depository institutions and the secondary credit program for less-than-healthy depository institutions was designed primarily to instill public confidence in the health of institutions borrowing from the primary credit program and to reduce the reluctance of healthy depository institutions to borrow.[7] In addition, having two separate facilities would reinforce the notion that healthy and troubled depository institutions alike should regard borrowing from the Fed as an option in the event of a need for additional funds.

[6] For details on the change to the rate spread announced in March 2020, see the press release (Board of Governors, 2020). As will be discussed in greater detail later, before 2020, the spread between the primary credit rate and the target federal funds rate (or top of the target range) had changed a few times to address economic conditions during the 2007–09 financial crisis and the subsequent recovery.

[7] This design feature also would help Reserve Banks manage risk more easily by establishing a standardized approach and risk controls when lending through a facility reserved for troubled depository institutions. Loans to troubled depository institutions entail more risk to the lending Reserve Bank, and depository institutions that are undercapitalized or critically undercapitalized are subject to lending limitations under FDICIA.

In the early years of the switch to the new facilities, there were signs that healthy depository institutions became more willing to borrow from the discount window. For example, some research found that after the 2003 discount window revisions, banks borrowed more from the discount window when the federal funds rate spiked than they had previously.[8] This finding suggests that the redesign of the discount window was effective in reducing banks' reluctance to borrow. As a result, the discount window may have been more effective in placing a ceiling on short-term funding rates, aiding the implementation of monetary policy, and serving as a liquidity tool when needed.

Nevertheless, it is important to acknowledge that it is difficult to measure reluctance to borrow from the discount window. When the interest rate on primary credit is above the target federal funds rate and the federal funds rate is close to its target, the aggregate volume of primary credit is expected to be low. In other words, a low average level of discount window borrowing does not necessarily mean that there is a reluctance to borrow; instead, it could simply reflect a situation in which depository institutions do not currently need to borrow. In addition, when there is an abundance of liquidity in the banking system, as is the case in the current ample-reserves monetary policy regime, depository institutions may have less need to obtain additional liquidity via the discount window. Again, this does not necessarily mean that there is a reluctance to borrow. Conversely, the presence of discount window borrowing does not necessarily reflect the absence of a reluctance to borrow. It could be the case that, although aggregate usage increases, there are still some depository institutions that are willing to pay well above the primary credit rate even when they could have borrowed readily from the discount

[8] See Artuç and Demiralp (2010).

window. For these reasons, it is important that we complement data with market outreach information to assess the effectiveness of the discount window.

Changes and Challenges since the Introduction of Primary and Secondary Credit

Primary and secondary credit exist today, but some changes have been made to primary credit since its inception. For example, although the discount window was used extensively and played an important role in the emergency measures taken during the financial crisis of 2007–09, some depository institutions during this period still were willing to borrow funds from the market at rates above the discount rate.[9] This suggested that there was a reluctance to borrow before the crisis, and that reluctance appeared to grow over the course of the crisis. To promote the restoration of orderly conditions in financial markets and provide depository institutions with greater assurance about the cost and availability of funding, the Board approved temporary changes to its primary credit discount window facility during the crisis.[10] In addition, in late 2007, the Board established the Term Auction Facility (TAF).[11]

Concerns about lending to troubled depository institutions reemerged after the 2007–09 financial crisis. In the Dodd-Frank Wall Street Reform and Consumer

[9] See Bernanke (2009a) and Madigan (2009) for a retrospective that elaborates on some of the emergency measures taken during the 2007–09 financial crisis and the reasoning for discount window rate changes during the financial crisis.

[10] Throughout this crisis, the Board approved numerous reductions in the primary credit rate and narrowed the spread between the primary credit rate and the target federal funds rate twice. With the narrowing of the spread in August 2007 from 100 basis points to 50 basis points and in March 2008 to 25 basis points, the Board announced that the maximum term for primary credit loans would be extended, first to 30 days and then to 90 days, respectively. As economic conditions improved, in 2010, the Board increased the spread between the primary credit rate and the target federal funds rate to 50 basis points and shortened the maximum term for primary credit loans to overnight.

[11] The TAF provided fixed quantities of term credit to depository institutions through an auction mechanism and seemed to have largely addressed banks' concern that borrowing from the Federal Reserve would imply weakness. According to Bernanke (2009b, paragraph 7), this was "partly because the sizable number of borrowers provides a greater assurance of anonymity, and possibly also because the three-day period between the auction and auction settlement suggests that the facility's users are not using it to meet acute funding needs on a particular day."

Protection Act, which was enacted in 2010, Congress required the Fed to publish detailed individual institution borrowing data with a two-year lag.[12] This action was intended to enhance the transparency and accountability of Federal Reserve lending while still preserving a measure of confidentiality to avoid discouraging depository institutions from borrowing.

More recently, in March 2020, the Fed announced changes to the provision of primary credit that were intended to encourage depository institutions to use the discount window to meet demands for credit from households and businesses in connection with the COVID-19 pandemic. These changes included setting the primary credit rate at a level equal to the top of the federal funds target range—a step that enhanced the ability of the discount window to support trading within the Federal Open Market Committee's (FOMC) target range for the federal funds rate—and communicating the terms of borrowing as 90 days, prepayable and renewable on a daily basis. To further encourage depository institutions to use the discount window, the Fed also made changes to its reporting of Reserve Bank–level aggregate weekly discount window borrowing. It consolidated amounts previously reported as "loans," which include discount window borrowing, into a broader category of assets.[13] The changes made in 2020 remain in effect.

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[12] See section 1103 of the Dodd-Frank Act, which amended section 11 of the Federal Reserve Act.

[13] The Board's H.4.1 statistical release, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks," is published weekly (https://www.federalreserve.gov/releases/h41). It presents a balance sheet for each Federal Reserve Bank, a consolidated balance sheet for all 12 Reserve Banks, an associated statement that lists the factors affecting reserve balances of depository institutions, and several other tables presenting information on the assets, liabilities, and commitments of the Federal Reserve Banks. For additional details on the consolidation of "loans" into a broader category of assets, see the March 19, 2020, H.4.1 announcement, available on the Board's website at https://www.federalreserve.gov/releases/h41/20200319.

During and after the spring 2023 stress events, the discount window again played an important role in supporting both monetary policy and financial stability. Depository institutions that came under severe stress turned to the discount window. The discount window also served an important role in providing ready access to funding, especially for depository institutions experiencing spillovers from the bank failures. To further ensure that depository institutions had the ability to meet the needs of all their depositors, the Board announced the creation of a new emergency program, the Bank Term Funding Program (BTFP). Although the BTFP was established pursuant to the Board's emergency lending authority in section 13(3) of the Federal Reserve Act, the BTFP used the discount window infrastructure to lend to eligible depository institution borrowers.[14] By relying on the existing discount window infrastructure, the BTFP was able to begin operating right away. The program ceased extending new loans on March 11, 2024, as scheduled.

Today the discount window continues to be an effective tool, but it is important to acknowledge that economic and banking conditions continue to evolve. Since the 2003 discount window reassessment, we have seen an increased focus on liquidity in banking regulation, including the advent of quantitative liquidity requirements for large banking organizations; technological changes in the banking system; a general trend toward faster and 24-7-365 payment systems; changes in the composition and posture of Federal Home

[14] As with the discount window, an eligible institution participated in the BTFP through its local Reserve Bank. The legal agreements and process for pledging securities in the BTFP also relied on those used in discount window lending. Nevertheless, the BTFP differed from the discount window in various ways, including the term of lending, scope of eligible collateral, collateral valuation, and interest rate. For more information on the differences between the BTFP and the discount window, see the response to question A.3 in Board of Governors (2024a, p. 3). For additional details on the BTFP, see the March 12, 2023, press release (Board of Governors, 2023).

Loan Bank lending; and the move to an ample-reserves monetary policy implementation regime.

In light of these developments, the Federal Reserve System has taken important steps to ensure that the discount window performs its functions successfully in the 21st-century economy. For example, last year the Board, along with the other federal banking agencies and the National Credit Union Administration, issued guidance on contingency funding plans that encouraged depository institutions to be ready to borrow from the discount window.[15] This includes taking steps to establish borrowing relationships with the Federal Reserve, such as providing certain legal documentation and ensuring that collateral to secure loans is ready to pledge. In connection with interagency initiatives, Reserve Banks have conducted outreach to depository institutions and made efforts to guide them in using the discount window.

Data suggest that this encouragement is working. By the end of 2023, 3,900 banks, or roughly 80 percent of all banks, had completed the legal documentation required to borrow from the discount window.[16] Of those, nearly 2,000 banks had pledged collateral, with an aggregate lendable value of over $2.6 trillion after applying appropriate discounts. These figures are notably above their levels at the end of 2021 and 2022. Although I am pleased to see the improvements in discount window readiness statistics, continued outreach is still important. To that effect, this summer, Federal Reserve Banks hosted an Ask the Fed® session to discuss the purpose of the discount

[15] See Board of Governors and others (2023).
[16] The statistics in this paragraph are available on the Board's website at https://www.federalreserve.gov/monetarypolicy/discount-window-readiness.htm.

window, its facilities, and recommendations for depository institutions on how to prepare to borrow from the Fed.[17]

Additionally, the Federal Reserve System has made important investments to enhance the technology that supports discount window activities. Earlier this year, the System launched Discount Window Direct, which is an online portal for depository institutions to request and prepay loans as well as securely message their local Reserve Bank.[18] Discount Window Direct generally is accessible 24 hours a day. We are actively encouraging the use of Discount Window Direct.

Seeking Feedback on the Discount Window

To complement our efforts to enhance discount window operations, the Federal Reserve Board recently announced that it is collecting feedback from the public on operational frictions associated with the discount window and intraday credit through the issuance of a request for information. As some of you may know, a request for information is a formal document through which a government agency solicits feedback. Members of the public can submit comments in response to the request for information until December 9, 2024.[19]

The Board requests input on various discount window and intraday credit operational practices, such as the process for requesting, receiving, and repaying discount window loans as well as Reserve Bank discount window and intraday credit communications practices. Through the request for information, the Board hopes to gain

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[17] More information on Ask the Fed is available on the Federal Reserve Bank of St. Louis's website at https://bsr.stlouisfed.org/askthefed/Auth/Logon.
[18] Additional details on Discount Window Direct can be found on the Federal Reserve Bank Services website at https://www.frbservices.org/central-bank/lending-central.
[19] See the information on discount window operations in section II.A of Board of Governors (2024b).

further insight into the operational aspects that are the most costly or burdensome for depository institutions. This will help the Fed consider further improvements to promote efficiency and reduce burden on depository institutions. Ultimately, the Fed's goal is to build on the current discount window operations and processes so that the discount window will continue to provide ready access to funding against a wide range of collateral in the future. I encourage members of the public to submit comments on the request for information, and I look forward to considering the feedback that we receive.

Economic Outlook

Before concluding, let me share with you a summary of my outlook for the U.S. economy, as I did yesterday with the audience at Davidson. Economic activity continues to grow at a solid pace. Inflation has eased substantially. The labor market has cooled from its formerly overheated state.

Personal consumption expenditures (PCE) prices rose 2.2 percent over the 12 months ending in August, well down from 6.5 percent two years earlier. Excluding the volatile food and energy categories, core PCE prices rose 2.7 percent, compared with 5.2 percent two years earlier. Our restrictive monetary policy stance played a role in restraining demand and in keeping longer-term inflation expectations well anchored, as reflected in a broad range of inflation surveys of households, businesses, and forecasters, as well as measures from financial markets. Inflation is now much closer to the FOMC's 2 percent objective. I expect that we will continue to make progress toward that goal.

While, overall, the economy continues to grow at a solid pace, the labor market has modestly cooled. Employers added an average of 186,000 jobs per month during July through September, a slower pace than seen early this year. The unemployment rate now stands at 4.1 percent, up from 3.8 percent in September 2023. Meanwhile, job openings declined by about 4 million since their peak in March 2022. The good news is that the rise in unemployment has been limited and gradual, and the level of unemployment remains historically low. Even so, the cooling in the labor market is noticeable.

Congress mandated the Fed to pursue maximum employment and price stability. The balance of risks to our two mandates has changed—as risks to inflation have diminished and risks to employment have risen, these risks have been brought roughly into balance. The FOMC has gained greater confidence that inflation is moving sustainably toward our 2 percent goal. To maintain the strength of the labor market, my FOMC colleagues and I recalibrated our policy stance last month, lowering our policy interest rate by 1/2 percentage point.

Looking ahead, I will carefully watch incoming data, the evolving outlook, and the balance of risks when considering additional adjustments to the federal funds target range, our primary tool for adjusting the stance of monetary policy. My approach to monetary policymaking is to make decisions meeting by meeting. As the economy evolves, I will continue to update my thinking about policy to best promote maximum employment and price stability.

Thank you.

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