Getting To Know the Fed Discount Window

risk management industry update

Summary: The Fed wants to make sure that all banks are aware of how the Fed Discount Window works and what it can offer during a crisis. Many small banks had problems using the Discount Window during the recent cash crunch. We summarize the Fed's new tips to ensure a smooth Fed Discount Window borrowing experience.

In talking about the opportunities and disappointments life offers, Alexander Graham Bell coined the phrase, "When one door closes, another opens." But he also said that people too often get so caught up in the distress of the closed door that they miss the new one opening before them.

There is another version of Bell's famous quote, and that is, "When one door closes, a window opens." It is that version that interests us here. The window, in this case, is the Fed Discount Window.

In the aftermath of the collapse of Silicon Valley Bank (SVB) and Signature Bank, other financial institutions faced a sudden run on deposits from rattled customers. But as the door suddenly closed on bank deposits, the Federal Reserve Discount Window remained open for those who needed emergency loans. Financial institutions lined up to borrow enough funding from the Fed in order to stabilize their balance sheets.

Problems Accessing the Discount Window

Although Discount Window borrowing the month after SVB and Signature Bank failed reached a record $153B, not all financial institutions jumped at the opportunity presented by that Discount Window. Some may have been too caught up in the distress to realize the option, but many others were simply unprepared.

The cash crunch arrived swiftly, and many financial institutions discovered that they hadn't planned for the operational process or anticipated any challenges that can arise when applying for emergency funds within the Fed Discount Window.

It was a particular problem for community financial institutions (CFIs). Indeed, the Dallas Fed president commented that he was surprised at the number of institutions caught flat-footed when it came time to access the Discount Window. Nearly all financial institutions with more than $50B in assets borrowed from the Discount Window at least one time from 2010 to 2021; only 40% of institutions between $250MM and $1B did the same. Financial institutions under $250MM in assets? Less than 20%. Why is the Fed Discount Window being underutilized by CFIs, and what can be done to help them access it?

Fed Issues New Guidance

In response, the Fed recently issued updated guidance on how financial institutions can use the Fed Discount Window. CFIs should include the Discount Window in their contingency plans for financial emergencies and may want to test and maintain their operating procedures for using the Discount Window.

The first step in working with the Discount Window is understanding exactly what it is. In the beginning, it was an actual teller window at Federal Reserve lobbies where bank employees could come to take out loans. It's a virtual window these days, with financial institutions applying with the Fed for short-term loans (usually just overnight) that provide quick infusions of cash to help with liquidity crunches.

According to the Fed's updated guidance, operational readiness for Discount Window borrowing includes several parts:

1. **Establish borrowing arrangements.** Be familiar with the Fed branch of your district and how to access its Discount Window. This includes developing a backup plan of other sources to borrow from besides the Fed Discount Window, as sometimes these lines become inaccessible during a crisis.
2. **Understand collateral requirements.** Emergency funding through the Discount Window requires collateral, so make sure sufficient collateral is available, and that you know the pledging process for multiple types of collateral.
3. **Pre-pledge collateral.** Pre-pledging collateral can help speed up the process, especially if the need for liquidity is sudden.
4. **Get familiar with the process.** Be familiar with the Discount Window website and the requirements for CFIs based on size. CFIs with over $250MM in assets, for instance, must prove borrowing access and maintain a membership to the Central Liquidity Facility, whereas a CFI under $50MM in assets need only create a written policy outlining how they will manage liquidity and what contingent liquidity sources they can tap into if the need arises.
5. **Test your readiness.** Periodically test readiness by making small Discount Window transactions. This will ensure that your employees maintain familiarity with how the whole process works.

The Fed Discount Window is an invaluable source for dealing with fast-moving cash crunches, but institutions need to be prepared to borrow by having solid Discount Window procedures as part of their financial emergency contingency plans. Following these new guidelines can increase your CFI's readiness in an emergency situation and lower the chances of any difficulties or hiccups in the process.

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ECONOMY & RATES

Rates As Of: 10/18/2023 08:18AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.62	0.07	1.20
6M	5.60	0.07	0.84
1Y	5.47	0.04	0.77
2Y	5.23	0.18	0.80
5Y	4.93	0.32	0.93
10Y	4.92	0.35	1.05
30Y	5.02	0.31	1.05

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.31	8.50	5.32