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Banking on the Federal Reserve *Discount Window*



Once cast as the lender of last resort for troubled institutions, the Discount Window has emerged through new credit programs that have recast its role in providing funding and liquidity for depository institutions.

The Discount Window, as it historically has been referred to, is a source of temporary funding for eligible financial institutions. Each of the 12 Reserve Banks has a Discount Window and is responsible for lending within its area.

While the “Discount Window” name still is commonly used, it bears little resemblance to

the days when banks “discounted” their notes at the Federal Reserve and borrowing required other sources of funding had been exhausted.

Today, the process is electronic but, more importantly, the programs have changed. And the Federal Reserve is working to ensure any stigma associated with borrowing from it is left behind, says Kevin Moore, vice president of Supervision and Risk Management at the Federal Reserve Bank of Kansas City.

“The perception is changing because the Window is now more suited to the needs of financially sound institutions,” he says. “Every bank is encouraged to incorporate the



Discount Window into their liquidity plans. That may mean borrowing to meet an unexpected need, or simply including it in their contingency plans and testing its availability.”

There are three Discount Window lending programs: primary (short-term funds for sound financial institutions); secondary (similar, but available to most depository institutions not eligible for other credit); and seasonal (smaller institutions with cyclical funding needs, usually tied to agriculture or tourism).

How it works

The Discount Window is available to depository institutions, regardless of whether they are a member or have a Federal Reserve account. Interested institutions contact the Federal Reserve Bank in their district to obtain the necessary borrowing documentation and pledge collateral—all Federal Reserve lending must be secured, says Lisa Klose, manager of Credit and Risk Management at the Federal Reserve Bank of Kansas City.

“Once borrowing documents are signed and collateral is made available, all it really takes is a phone call from the banker for us to advance the funds,” Klose says.

Most often used by financial institutions to prevent an overdraft or a deficiency in meeting reserve requirements, the Discount Window also may serve to stabilize the markets during times of crisis.

The day after the 9/11 terrorist attacks, the Federal Reserve loaned about \$46 billion to financial institutions, Moore says. In a typical day, lending totals about \$150 million.

“Our goal is to provide Discount Window funding in an efficient manner to relieve tight

liquidity for individual institutions,” he says. “We strive to maintain financial stability, and we try to work with institutions on preparedness as part of their contingency planning.”

Depository institutions decide to borrow from the Discount Window based on the lending rate and their own liquidity needs. Lending rules are established by the Federal Reserve Board of Governors, and the interest rates are set by the Federal Reserve Banks and approved by the Board.

Borrowing from the Window

Primary credit is available to any institution in sound financial condition. The program became available in 2003 and serves as a tool for ensuring adequate liquidity in the banking system, Moore says.

Generally, primary credit is granted on an overnight basis and is made available through a “no-questions-asked” streamlined process.

Because the interest rate is set above the target federal funds rate, the higher rate serves as an inherent credit administrator in rationing funds, and goes

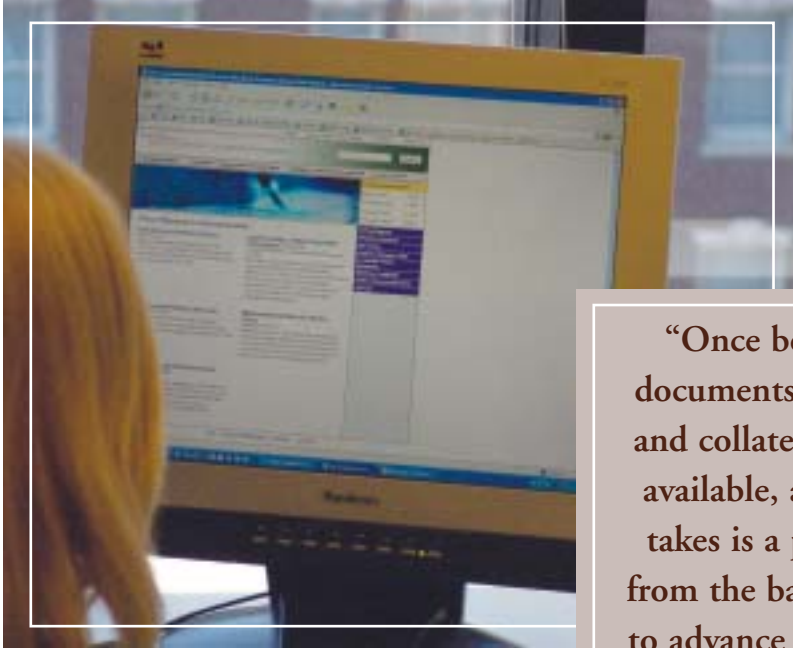
hand-in-hand with the Federal Reserve asking few questions when an institution requests a loan.

Primary credit differs considerably from the previous program, which required the Federal Reserve to ensure an institution exhausted all other funding options before turning to the Discount Window. This is why it previously was known as the lender of last resort.

James C. “Pat” Thompson Jr., divisional executive vice president of UMB, an \$8 billion financial institution in Kansas City, Mo., says the Discount Window’s primary credit has been a part of UMB’s contingency-funding plan from the beginning.

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ALTHOUGH THE NAME IS THE SAME, borrowing from the Federal Reserve "Discount Window" is now an electronic process. More importantly, the programs have changed and the old stigma is being left behind.



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"It's critical," Thompson says, adding UMB looks at the Discount Window for liquidity purposes. This is its primary goal. The Discount Window can serve as a critical player in a contingency situation when other funding sources aren't available, Moore says. Less dire circumstances also may dictate the need for an institution to access primary credit. An institution may discover an internal accounting error at the end of the day that results in a potential overdraft or reserve-requirement deficiency. In July 2003, the Federal Reserve and other supervisory agencies issued the Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management, which supports consideration of the primary credit program in institutions' liquidity contingency plans. The advisory supports testing the institution's ability to borrow at the Discount Window to prevent

complications if it needs to be used. For Montezuma (Kansas) State Bank, the Discount Window is also vital. In fact, for this \$50 million bank in southwest Kansas, the seasonal credit program is the backbone of its short-term funding sources.

That's how the bank meets its agricultural loan demand, says Doug Moore, Montezuma vice president and cashier, adding the bank is stronger and more stable as a result.

Montezuma grants loans predominately to farmers. Because the loan volume coincides with area crop growth and harvest cycles, customers are borrowing at the same times each year. The Discount Window ensures the bank has funds available to meet its customers' demands during peak times.

For smaller financial institutions (those with deposits less than \$500 million), funding options may be limited and the seasonal credit program offers a dependable source of funding, which benefits their customers, Klose says.

In the District, institutions with agricultural cycles lasting up to nine months often qualify for and benefit from the seasonal loan program. Additionally, tourist areas may also find the seasonal program helpful in meeting cyclical funding needs.

"I do think a lot of banks could benefit from the Discount Window," Doug Moore says. "It's definitely working for us."

"It fits perfectly with our needs."

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COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.