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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

**STRICTLY CONFIDENTIAL (FR)**
**CLASS II - FOMC**

TO: Federal Open Market Committee DATE: March 22, 1991

FROM: Normand Bernard NB.

President Corrigan has asked that his attached letter and New York staff memorandum on a special discount window lending facility be distributed to the Committee. Since this issue is not under active consideration, it has not been placed on the agenda for Tuesday's post-FOMC luncheon meeting.

Attachments

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FEDERAL RESERVE BANK OF NEW YORK
NEW YORK, N.Y 10045
AREA CODE 212 720-6173

E GERALD CORRIGAN
PRESIDENT

February 21, 1991

The Honorable Alan Greenspan
Chairman
The Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

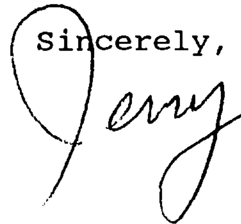
Dear Alan:

As you know, we have been giving some further thought to a special discount window facility along the broad lines I mentioned at the last FOMC. The results of those further deliberations are contained in the enclosed memorandum, a copy of which has also been made available to Don Kohn--but to no one else at this time.

I am sending this to you with some reservation since I, myself, blow hot and cold as to whether I really believe something along these lines should be actively considered in the immediate setting. On the other hand, if we have a real problem such as a run on the commercial paper market, it could prove very useful.

At this point, my instincts are to let a select group of staff who are not as close to the proposal take a look at the approach suggested--recognizing that there are any number of ways to fine tune the approach--and get their reactions. However, unless there is very strong support for pushing ahead now, I would be inclined to keep the concept on the shelf, at least for now.

Sincerely,



Enclosure

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February 21, 1991

FEDERAL RESERVE BANK OF NEW YORK

## I. Program Overview and Rationale

The purpose of this memorandum is to set forth for consideration a temporary program for providing fully secured term liquidity to the banking system through the discount window at a "market" rate of interest. The stated purpose of the program would be to insure that individual banks have access to a stable and predictable source of liquidity in order to better finance the credit needs of creditworthy borrowers. A second, and unstated purpose of the program would be to encourage a more positive attitude regarding the use of the discount window on the part of depositories and on the part of personnel within the Federal Reserve.

The main features of the proposed discount window facility would be to provide term loans for periods up to six months, secured by a broadened range of eligible collateral--all of which would be subject to haircuts sufficient to fully protect the Reserve Banks from loss. To encourage use of the facility, a low market rate of interest could be charged to the participating banks. The rate could be as low as some moving average of the fed funds rate or as high as a six month CD rate depending on how aggressively the Federal Reserve wished to encourage use of the program. Alternatively, the rate could be something like the average funds rate plus 10 to 50 basis points. Such an approach might create the perception of a penalty, but would also give the Federal Reserve some control over how much the program is used by

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varying the penalty between 10 and 50 basis points. The rate would be established by Reserve Bank Directors. Eligibility would be open to all depository institutions, with the exception of those prohibited from any expansion by their primary regulator. The program, as announced, would have a firm six month sunset provision but could be extended depending on circumstances and experience.

The key features of the program are as follows.

| | |
|---|---|
| Eligibility | All depository institutions not currently prohibited from any expansion by their primary regulator would be eligible. |
| Collateral | A broad range of collateral would be taken subject to adequate haircuts to ensure no risk to the Federal Reserve. |
| Interest Rate | A market interest rate would be charged, possibly as low as the average fed funds rate, or some penalty above the funds rate (determined by Reserve Bank Directors), or perhaps a rate as high as the six-month CD rate. |
| Term of Loan | Loans for as long as six months would be permitted. |
| Length of Program | The program would be put in place for six months. Depending on the results and economic conditions at the end of six months, the program could be extended. |

The program is being suggested with several thoughts in mind. First, it would work in the direction of augmenting the

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public perception that the Federal Reserve is taking timely and aggressive steps to provide adequate liquidity during a time when there is a widespread belief that a serious credit crunch is restraining growth in the economy. As an extension of this, the program might also provide some insights into whether the recent very slow growth of money and bank credit is predominantly a supply or demand phenomenon. At the very least, it might help dispel the notion that slow money and credit growth is the "fault" of the Fed due to its unwillingness to supply sufficient liquidity to the economy. As a corollary, it might also work in the direction of changing attitudes of discount officers toward discount window administration.

Perhaps the most attractive aspect of the program lies in the flexible manner in which it could be used in connection with open market operations to maintain the broad thrust of monetary policy--especially in terms of interest rates--in a posture otherwise desired by the F.O.M.C. That is, if the program were widely used (which is possible but not likely), the added reserves supplied through the discount window could be fully sterilized by the desk as is the usual practice with regard to extended credit supplied through the window. If the program were, in fact, widely used, that alone might be telling us something about the diagnostics of the "credit crunch" which we have not fully understood. In those circumstances, a case might be made that it would be desirable to accommodate some part of

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the added reserves supplied through the window. Of course, if the program is not widely used and slow growth in money and bank credit persist, the Fed might benefit marginally from being able to say that the demand for liquidity is simply not there, even on favorable terms. The policy implications of that result might well be that policy--in underlying terms--might have to be eased further.

The Pros and Cons of the Program

The principle advantages of such a program can be summarized as follows.

First, it could well be a public relations plus in much the fashion of the special agricultural discount window program of the early 1980's.

Second, it might help with the diagnostics of the so-called credit crunch.

Third, it can, at least temporarily, liquify certain illiquid bank assets.

Fourth, because Desk operations can sterilize any unintended effects on interest rates and bank reserves, it need not alter the basic thrust of monetary policy.

Fifth, it might help encourage a more positive attitude toward the use of the discount window.

Finally, it might help, at least at the margin, the credit origination process by providing a stable and relatively inexpensive mechanism to fund loans to

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creditworthy borrowers. Indeed, in the event a liquidity crisis occurs, such as commercial paper issuers being forced to use their bank credit lines on a large scale, this program could turn out to be an important source of term liquidity for banks.

The major drawbacks of the program include the following.

First, it could be interpreted as a signal on the part of the Fed that things are worse than the public perceives thereby giving rise to even further retrenchment by borrowers and lenders alike.

Second, since many observers would argue that liquidity is not the core of the current problem, the program could be viewed as a naive and essentially pointless effort on the part of the Fed to paper over basic short-comings in policy.

Third, the program might involve the risk of setting a dangerous precedent, including the very unsettling precedent of a Federal Home Loan Bank "look-alike" lending program or the re-opening of the debate on the so-called "basic borrowing privilege" at the discount window.

Fourth, especially for weak depositories and foreign banks, the program could be difficult to administer with respect to insuring that it is used to finance new

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lending as opposed to substituting discount window credit for more expensive funding of existing bank credit. These problems, to the extent they arise, would have to be dealt with on a case by case basis and with a high degree of coordination across District lines in order to insure equitable treatment nationwide.

Finally, if the program is widely used, it may prove politically difficult to terminate it after six months.

Clearly, a program of this nature would be viewed as extraordinary. For that reason, a weighing of the "pros" and "cons" does not come easily. Therefore a judgement as to whether the potential benefits are worth the risks is not obvious. One thing is clear, however, and that is that the merits of such a program should not be judged on the basis of the risk that the program will not be used extensively, even if events were to prove that judgment correct. Indeed, even if it is not used at all, it would still (1) provide an additional safety valve during these troubled times, (2) diffuse the argument that the Federal Reserve is not taking enough steps to provide adequate liquidity, and (3) furnish us with additional information on the nature of the current financial problem. If, on the other hand, it is used extensively, it would be apparent that the current difficulties are not fundamentally demand related. In that case, the program would provide an additional tool to deal with the supply problem

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without necessarily abandoning other policy objectives. The reserve effects can be sterilized through open market operations to the extent necessary to avoid any undesired effects on interest rates and exchange rates. At the very least, and even if the program is just kept on the shelf for the time being, the program could turn out to be an important safety valve that could be implemented quickly if an unexpected liquidity crisis should emerge, possibly in the commercial paper market, for example.