BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: October 24, 2002

To: Board of Governors

From: Staff[1]

Subject: Revisions to Discount Window Programs

Summary and Recommendations

This memorandum summarizes the public comments on the Board's recent proposal for the adoption of new discount window programs and presents the staff's recommendations for implementation of such programs. The staff recommends that the Board approve and publish the draft *Federal Register* notice that appears in the appendix to this memorandum. The draft notice contains amendments to Regulation A and D, effective on January 9, 2003, to implement primary and secondary credit programs, to ensure that discount rates can be set appropriately in emergency circumstances, and to base the charge for reserve requirement deficiencies on the primary credit rate.

Summary of May 24 Proposal

On May 24, the Board published in the *Federal Register* a proposal to implement primary and secondary credit programs as replacements for the current adjustment and extended credit programs. Under the proposal, primary credit would be available for very short terms as a backup source of liquidity to depository institutions that are in generally sound financial condition. It would be extended at a rate that would be above the usual level of short-term market interest rates, including the federal funds rate. Reserve Banks would establish the primary credit rate, subject to review and determination by the Board

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[1] Division of Monetary Affairs: B. Madigan, V. Reinhart, W. Nelson, J. Clouse, G. Gillum, L. Kumasaka; Legal Division: V. Mattingly, S. Martin, A. Threatt; Division of Banking Supervision and Regulation: S. Schemering, D. Palmer; Division of Reserve Bank Operations and Payment Systems: P. Bettge. This proposal also reflects the contributions of other officials and staff members at the Board of Governors and Federal Reserve Banks.

of Governors, using a procedure identical to that currently used for the basic discount rate. Under the proposal, the interest rate on primary credit would initially be set 100 basis points above the target federal funds rate. Eligibility for primary credit would be restricted to institutions in generally sound financial condition. Reserve Banks would judge financial soundness based primarily on supervisory ratings and capitalization, but, when available, could also use supplementary information. By restricting eligibility to generally sound institutions and by eliminating the incentive for institutions to borrow to exploit the positive spread of money market rates over the discount rate, the primary credit program should considerably reduce the need for the Federal Reserve to review the funding situations of borrowers. The Board noted that, as a result of this reduced administration, institutions' willingness to use the window when money markets tighten appreciably should increase, potentially limiting outsized movements in the federal funds rate. Secondary credit would be available in appropriate circumstances to depository institutions that do not qualify for primary credit. Reserve Banks would extend secondary credit at an interest rate 50 basis points above the primary credit rate. Lending under all discount window programs would remain at the discretion of the Reserve Banks. The Board did not propose any changes to the seasonal credit program but solicited comment on whether small depository institutions still lack reasonable access to funding markets; on the desirability of eliminating the seasonal lending program; and on the appropriate setting of the seasonal lending rate, particularly in view of the proposed establishment of a primary credit program with an above-market rate.

Summary of Public Comments

The Board received a total of sixty-one comment letters.[2] More than half were directed exclusively at the seasonal credit program. The commenters expressed a range of views on the primary and secondary credit programs, with some supporting, some opposing, and some expressing mixed sentiment on the proposed changes.

[2] The official public comment period lasted ninety days, from May 24 through August 22, but a number of comments were received after August 22. The staff included all comments received in its analysis.

Public Comments on Primary and Secondary Credit Programs

Of the thirty letters that addressed the primary and secondary credit programs, about fourteen clearly favored the proposed changes. Those who supported the new programs included money center banks, community banks, academics, bankers associations, and Reserve Banks. Some commenters indicated that the proposal as stated would achieve its objective of improving the functioning of the window. A few commenters specifically noted that it would be valuable to have the window as a reliable backup source of liquidity. Some said that the proposed 100-basis-point initial spread of the primary credit rate over the target federal funds rate was suitable, but a significant fraction of the generally supportive letters thought that the initial spread of 100 basis points was too high. Some commenters expressed concern that the proposal, particularly with a 100-basis-point spread, could lead to heightened volatility in the federal funds market. One bankers' association suggested that the Federal Reserve conduct additional research into the optimal spread.

Several letters from differing sources expressed mixed sentiment about the proposal. These commenters generally expressed skepticism that the proposal would fully achieve its objectives. Some stated that the proposal was unlikely to reduce stigma because discount window borrowing would still be viewed by the market as a possible indication of distress. Others asserted that the 100-basis-point spread would contribute to lingering stigma and would so deter use of the window that depository institutions would not become comfortable with their borrowing privilege.

Eight commenters opposed the proposed changes. They expressed similar concerns about stigma and volatility but concluded that the proposal would result in a worsening of the functioning of the window. These letters came from super-regional and money center banks. The most common conclusion in these letters was that the changes would tend to increase variability in the federal funds rate because the rate would move up 100 basis points in response to moderate reserve shortfalls. A couple of these letters suggested that instead of the proposed changes, the Federal Reserve should more clearly communicate depository institutions' borrowing privileges under adjustment credit and seek to ensure more consistency in implementation across districts. Some commenters agreed that the primary credit rate would act as a cap on the federal funds rate but indicated that the Federal Reserve should not implement such a cap without putting in place a mechanism to establish a floor.

Few commenters specifically addressed the secondary credit program. One professor suggested that the availability and terms of secondary credit should be even tighter than proposed. Another professor questioned the rationale for setting a higher rate on secondary credit than on primary credit. This commenter stated that the requirement that discount window loans be collateralized essentially eliminates risk to the Federal Reserve, and suggested that a higher interest rate for less-sound borrowers could be justified only by its incentive effects.

Public Comments on Seasonal Credit Program

The thirty-nine letters in support of the seasonal credit program were almost entirely from community banks or from associations of community banks, although a large commercial bank and a Reserve Bank also expressed support for the seasonal credit program. The authors generally stated that seasonal credit has been an important funding source for their institutions and that seasonal borrowers' other funding options are extremely limited. Some authors asserted that their bank would go out of business without seasonal credit, and several others thought that without seasonal credit they would be forced to rely more heavily on borrowings from the Federal Home Loan Banks (FHLBs). Several letters noted that while the FHLBs provide alternatives to seasonal credit, FHLB advances are more expensive and that diversification of funding options is desirable. Three Reserve Banks, one professor, and a large credit union proposed that either the seasonal lending program be dropped or the eligibility and terms of the program be tightened because the program was no longer needed. In addition, a corporate credit union argued that smaller institutions did have sufficient access to market sources of funds.

Analysis of Key Points Raised by Commenters

The Initial Spread of the Primary Credit Rate over the Target Federal Funds Rate

A number of commenters indicated that the proposed 100-basis-point initial spread of the primary credit rate over the target federal funds rate would be too wide. These commenters based this comment variously on the observations that the rate would make primary credit unattractive and that federal funds rate volatility could increase and the belief that bank profits could be adversely affected.

The staff agrees that the proposed initial spread should discourage most eligible depository institutions from using the program as a routine funding source. The proposed substantial spread should give most depository institutions the incentive to obtain regular funding from market sources rather than from the discount window. However, the discount window would be a reliable source of short-term backup funding, and depository institutions likely will turn to the facility particularly when funds are not available in the market or are not available at reasonable cost.

The staff also agrees that there is some possibility of increases in certain measures of volatility of the funds rate but believes that the potential for extreme movements in the funds rate should be reduced. Under current arrangements, with the discount rate below the target federal funds rate, banks almost always have some pecuniary incentive to use the discount window, even when federal funds are trading at the target rate. Consequently, the Federal Reserve must administer access to adjustment credit to prevent an undue exploitation of the subsidy and a resulting expansion in the supply of reserves, which would lower the funds rate to the discount rate and thus inappropriately affect the stance of monetary policy. When the federal funds market tightens, say because of a shortfall in the supply of nonborrowed reserves, the incentive for institutions to use the window increases. The resulting increase in discount window borrowing and associated expansion in the supply of reserves moderates the increase in the federal funds rate. By contrast, if the primary credit program works as intended, most institutions will not have any incentive to borrow from the window until the funds rate rises to the primary credit rate. At that point, banks—both those seeking to meet their own reserve needs and those willing to relend in the money market—likely will be willing to borrow from the window. As a result, some measures of federal funds rate volatility—in particular, those that give some weight to small deviations from the target, such as the intraday standard deviation of the federal funds rate—could increase as a result of implementation of the primary credit program. However, measures that give weight mainly to extreme movements in the federal funds rate may not increase at all or may decline because, if the program functions as intended, the federal funds rate should not rise significantly above the primary credit rate. Thus, the staff continues to believe that the program could limit potential volatility in the federal funds rate.

The staff also believes that the level of volatility that is likely to prevail under the proposed programs would not pose substantial difficulties either for monetary policy implementation or for market participants. For one thing, the FOMC announces its target for the federal funds rate, so there is no risk of a mispricing of financial assets because of any confusion about the federal funds rate being pursued by the Federal Reserve. For another, the averaging and carryover provisions for reserve positions in Regulation D, which allow many institutions to meet their reserve requirements on average over a two-week reserve maintenance period and, to a degree, over even longer periods, will continue to damp volatility of the federal funds rate. However, an argument can be made that more extreme, unintended movements in the federal funds rate are costly for markets because they tend to occur in the context of, and can exacerbate, conditions of market stress. Again, if the program functions as intended, such tendencies for sharp upward movements should be truncated at, or perhaps slightly above, the primary credit rate.

The staff believes that setting the initial primary credit rate at an appreciable spread over the target federal funds rate is necessary for the success of the program. Thousands of depository institutions will be eligible for primary credit, and given the large number of such institutions and the tremendous variation in size and other characteristics, there is a correspondingly wide variation in their access to market sources of funds. As a result, setting the primary credit rate at a relatively narrow spread over the target federal funds likely would mean that a significant number of institutions, including less creditworthy institutions that nonetheless are generally sound and small institutions that do not have access to market sources of funds, frequently would find the primary credit program, rather than the open market, to be the most attractive source of funds. In such cases, the Federal Reserve would need to exert administrative pressure to deter institutions from employing primary credit as a regular funding source rather than as the backup facility it is intended to be. Heavy administration probably would lead to a continuation of sound institutions' reluctance to use the window, undermining one of the major goals of the program.

Given the large number and wide variation in the characteristics of U.S. depository institutions, it is difficult to determine an optimal initial spread. However, some empirical evidence suggests that an initial spread of 100 basis points is not too wide.

First, the Federal Reserve established a discount window program, the Special Liquidity Facility (SLF), for approximately seven months surrounding the century date change on January 1, 2000, to help address any unusual liquidity strains that might arise at that time. The SLF was similar in many respects to the currently proposed program: Eligibility was restricted to financially sound institutions (and, thus, these institutions would be eligible for the proposed primary credit program if their financial condition has not deteriorated), and administration of the facility was intentionally quite limited. However, the interest rate on SLF credit was set at a fixed spread of 150 basis points above the target federal funds rate (that is, 50 basis points above the staff's proposal for the initial primary credit rate), and institutions were permitted to borrow for the entire period for which the facility was operating. The facility was not heavily used, presumably because of the above-market SLF interest rate and because nonborrowed reserves remained ample throughout the period. Nevertheless, a number of institutions evidently were not deterred by the relatively high interest rate and seemed to view the facility as an attractive longer-term funding source. Specifically, despite the penalty rate, there were fourteen instances in which depository institutions borrowed from the facility for more than ten consecutive days, and another forty-two instances of borrowing for two to ten consecutive days. This evidence suggests that some financially sound institutions either did not have access to market sources of funds at rates less than 150 basis points above the target federal funds rate or that their funding managers did not face incentives within their own organizations to maximize profits by obtaining funds from the least expensive source. Under the staff's proposal, with an initial spread of 100 basis points rather than the 150 basis points under the SLF, if anything the incidence of such behavior would increase; an even narrower spread than 100 basis points obviously would tend to increase further the incentive to use the window routinely. As the tendency for such behavior rose, the administration that Reserve Banks would need to apply to ensure that depository institutions use the primary credit program as a backup source of short-term credit would correspondingly need to intensify.

Second, Federal Reserve staff conversations with representatives of correspondent banks and other depository institutions found that the overnight funding options for banks without access to the national money markets were priced from 3/16 to 1 percentage point over the federal funds rate. The largest spread was charged by an institution that preferred that its customers look first to other lenders for short-term funding. Because primary credit is intended to be a backup funding source and is not intended to compete with market lenders, this information also suggests that a 100 basis point initial spread again would be reasonable.

Third, a spread on the order of 100 basis points has been used by several (but not all) foreign central banks on their Lombard discount window facilities—for example, the European Central Bank. Conversations with staff of some of these central banks indicate that the experience with spreads of this size generally has been positive.

One bankers' association argued that the spread of 100 basis points was too high, in part because, according to the association, the higher spread would unfairly impinge on bank profits. However, a substantial adverse effect on bank profits is highly unlikely. During the one-year period ending on September 30, 2002, the volume of adjustment credit outstanding averaged about $36 million. If borrowing remained at that level under the primary credit program, increasing the discount rate from its recent level 50 basis points below the target funds rate to a level 100 basis points above the target funds rate would reduce annual bank profits by less than one one-thousandth of a percent. Moreover, depository institutions should benefit from the reduction in nonpecuniary costs associated with the reduced administration under the program as well as from the ceiling on overnight financing costs.

Another practical consideration also supports the need for a substantial spread. As discussed in more detail below, the primary credit rate would not be set through a formula. As a result, some variation in the spread would be possible. For example, economic circumstances could arise in which Federal Reserve policymakers judged that an increase in the target federal funds rate was appropriate, but an increase in the primary credit rate was not, resulting in a narrowing of the spread. Also, even if a 100-basis-point spread was viewed as still consistent with economic conditions, in some cases there could be a short lag between increases in the FOMC's target federal funds rate and boards of directors' proposed increases in the primary credit rate. These situations would involve a narrowing, either temporary or longer-term, in the spread between the primary credit rate and the target federal funds rate. If the initial rate spread were relatively narrow, a further narrowing could require a considerable increase in administration by Reserve Banks, which, again, could be counterproductive in achieving the objectives of the program. A wider initial spread would be less likely to result in such undesirable outcomes.

Potential Reduction in Stigma

Some commenters disagreed that the proposed revisions would reduce the stigma of borrowing at the discount window. Some noted in particular that analysts and counterparties that had evidence that a bank was paying 100 basis points above the target federal funds rate might infer that the bank could not obtain funds at market rates and therefore might be in financial difficulty.

The staff continues to believe that the Federal Reserve can expect to achieve, over time, some reduction in stigma as a result of the primary credit program. First, only generally sound institutions will be eligible to borrow primary credit. Any discount window loans extended to weaker institutions would need to be secondary credit. Thus, market participants would have no reasonable basis for inferring that an institution believed to have borrowed primary credit was unsound. Second, institutions will no longer be required to bid for funds in the market before borrowing from the window, implying that an institution with a shortfall of reserves would not need to advertise that fact in the markets before receiving discount window credit. Third, with credit no longer offered at a subsidy rate, the Federal Reserve would be able to reduce substantially the administrative burden that is imposed on borrowers. Fourth, depository institutions should have no concerns that regulators would view occasional use of primary credit as a potential indication of difficulties. Fifth, a significant proportion of primary credit borrowing is likely to occur when the overall money market has tightened significantly. Because occasions of tight markets are well known to all money market participants and analysts, it will be easy for them to recognize that such instances of borrowing in all likelihood reflect a general market situation rather than conditions particular to a single institution. And the borrowings of those institutions that are believed to be lending the proceeds of discount window credit into a tight federal funds market clearly will indicate nothing adverse about their financial condition.

Delaying Implementation until a Floor on Rates can be Put in Place

Some commenters suggested that the Federal Reserve should not act to put a cap on fluctuations in the federal funds rate through a primary credit program without also putting in place a floor on rates. One bankers' association noted that banks that are net sellers of federal funds are disadvantaged by declines in the federal funds rate. However, the most effective means of establishing such a floor would be to pay interest on excess reserve account balances and, to date, the Federal Reserve has not been granted explicit statutory authority to pay interest on reserve account balances. The staff believes that the potential advantages of the proposed changes to the Federal Reserve's lending programs warrant proceeding with their implementation.

Staff Recommendations

The staff recommends that the Board adopt revisions to Regulations A, as well as a technical amendment to Regulation D, to implement primary and secondary credit programs. These recommendations are discussed in greater detail below as well as in the draft *Federal Register* notice. The staff is also proposing that the Board take this opportunity to make certain technical revisions to reorganize and otherwise improve Regulation A. The latter changes are explained in the draft *Federal Register* notice.

Primary Credit Program

Initial Primary Credit Rate

As noted above, two main considerations bear on the selection of the initial spread of the primary credit rate over the target federal funds rate. First, some measures of volatility of the federal funds rate could increase, although tendencies for extreme movements in the funds rate should be truncated. A narrower spread would tend to limit any increase in volatility. Second, a relatively narrow spread would require that Reserve Banks more frequently use administration to discourage borrowings by institutions that find primary credit to be an attractive source of routine funding. Given the large number and diverse characteristics of depository institutions, the rate at which various institutions would begin to find the program to be routinely attractive likely approximates a continuum, and thus it is difficult to determine that any particular rate level is optimal.

On balance, however, the staff continues to recommend that the System adopt a 100-basis-point rate spread initially. First, experience under the Y2K Special Liquidity Facility suggests that some institutions will find the primary credit program to be an attractive source of regular funding even with such a spread. With a narrower spread, even more institutions would see primary credit attractive as a regular source of funding, increasing the required amount of administration to the detriment of the program. Second, the limited available anecdotal information on the pricing of correspondent lines of credit, as cited above, suggests that market spreads for some banks are as much as 100 basis points. In addition, if the program works as intended, such a spread would truncate spikes in the federal funds rate at a reasonable level. Finally, several central banks have successfully operated Lombard-type facilities with spreads on the order of 100 basis points. If experience eventually suggests that a narrower spread would be desirable, the Board and Reserve Banks could establish primary credit rates closer to the target funds rate with little difficulty.

The Federal Reserve Act charges the Reserve Bank boards of directors with establishing discount rates, subject to review and determination by the Board of Governors. The Board's initial proposal did not involve setting the primary credit rate via a formula, and more specifically it did not involve setting the primary credit rate at a permanently fixed spread over the target funds rate. Similarly, the current staff proposal does not recommend a permanently fixed spread or formula for the primary credit rate. Nevertheless, in view of the integrated structure of nationwide money markets in the United States, the primary credit rate should be uniform across the Federal Reserve System, except possibly for very short periods when Reserve Banks are in the process of adjusting their rates. And, in particular, a single, unified primary credit rate should be set nationwide at the outset of the program. The staff recommends that the System set a uniform primary credit rate on January 9 at a level 100 basis points above the FOMC's target federal funds rate. The draft *Federal Register* notice in the appendix indicates that the Board views that initial spread as appropriate and anticipates that a primary credit rate consistent with such a spread will be established as of January 9. After January 9, Reserve Bank boards of directors would continue to establish primary credit rates at least every two weeks, subject the Board's review and determination, just as has been done in the past for the basic discount rate.

Eligibility for Primary Credit

In general, commenters either did not address or seemed supportive of the Board's proposal to limit eligibility for the primary credit program to generally sound depository institutions. The staff continues to believe that limiting eligibility to institutions that are in no danger of failing in the foreseeable future is a crucial step in the Federal Reserve's efforts to reduce the phenomenon of stigma that has limited the willingness of sound depository institutions to use adjustment credit even when money markets are tight. With reasonably stringent eligibility criteria, counterparties and market analysts should recognize that banks that use primary credit are, by definition of the program, generally sound. In virtually all circumstances, usage of the primary credit window would signal nothing other than a temporary shortfall in liquidity or reserves.

During the public comment period, the Board staff consulted with the Subcommittee on Credit, Reserves, and Risk Management (SCRRM) regarding specific criteria to assess whether a bank was "generally sound" and therefore would be eligible for primary credit.[3] Under the initial proposal, eligibility would be determined mainly by supervisory ratings and capitalization, although supplementary information, when available, could also be employed. The Board proposed that institutions rated CAMELS 1 or 2 or SOSA 1 that are at least adequately capitalized would almost certainly be eligible for primary credit; institutions rated CAMELS 4 or 5 would almost certainly not be eligible; and institutions rated CAMELS 3 or SOSA 2 that are at least adequately capitalized might be eligible, depending on supplementary information.[4] The staff noted that this recommendation aligned very closely with the categorization of institutions for purposes of determining access to daylight credit.

SCRRM supported the staff's general recommendations for determining eligibility, suggesting that they be revised only slightly to bring them into exact alignment with the method for determining eligibility for Federal Reserve daylight credit. Specifically, depository institutions would be eligible for primary credit unless they were classified by the Reserve Bank into one of two risk management groups—those that exhibit "heightened emerging risk" or those that "pose the highest risk." Institutions in the first group (heightened emerging risk) exhibit unsafe or unsound practices or conditions and have serious financial or managerial deficiencies. Institutions in the second group exhibit extremely unsafe or unsound practices and critically adverse characteristics. Their viability is questionable, and they have a highly probable, if not

[3] SCRRM is a subcommittee of the Committee on Credit, Reserves, and Risk Management, which is a committee of the Conference of Presidents.

[4] CAMELS (Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risk) ratings, applicable to domestically chartered institutions, are set on a scale of 1 through 5 with 5 representing the highest degree of supervisory concern. SOSA (Strength of Support Assessment) ratings, applicable to foreign banking organizations, are set on a scale of 1 through 3, with 3 indicating the highest degree of supervisory concern.

imminent, likelihood of failure or intervention by the Federal Deposit Insurance Corporation (FDIC). Institutions may be classified into one of these categories based on CAMELS (or SOSA and ROCA) ratings, capitalization, and at the Reserve Bank's discretion, supplementary information.[5] Institutions not so classified would be eligible for primary credit. More specifically, institutions that are at least adequately capitalized and rated CAMELS 1 or 2 (or SOSA 1 and ROCA 1, 2, or 3) would almost certainly be eligible for primary credit. Institutions that are at least adequately capitalized and rated CAMELS 3 (or SOSA 2 and ROCA 1, 2, or 3) generally would be eligible. Institutions that are at least adequately capitalized and rated CAMELS 4 (or SOSA 1 or 2 and ROCA 4 or 5) would be eligible only if an ongoing examination indicated a substantial improvement in condition. Institutions that are not at least adequately capitalized, or that are rated CAMELS 5 (or SOSA 3 regardless of ROCA), would not be eligible for daylight or primary credit.

The classification scheme for access to daylight credit summarized in the preceding paragraph is well developed, and the staff believes that it provides a good measure of the general soundness of depository institutions. Moreover, the use of a single set of criteria for determining eligibility for primary and daylight credit would streamline Reserve Bank procedures and simplify explanations of Reserve Banks' credit programs to depository institutions and to the public. Accordingly, the Board staff has incorporated SCRRM's recommendation into this proposal.

In summary, the staff recommends that the Board in Regulation A limit eligibility for primary credit to institutions that are in generally sound financial condition. The Reserve Banks would be responsible for determining the general soundness of the institutions in their districts using the criteria that are already used for determining eligibility for daylight credit.

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[5] ROCA (Risk management, Operational controls, Compliance, and Asset quality) ratings apply to the U.S. operations of a foreign banking organization. They are set on a scale of 1 to 5, with a rating of 5 indicating the highest degree of supervisory concern.

Terms and Use of Primary Credit

The staff recommends that the Board indicate in Regulation A that Reserve Banks may extend primary credit on a very short-term basis, usually overnight, as a backup source of funding to depository institutions that are in generally sound financial condition in the judgment of the Reserve Bank.[6] Unless the nature of the borrowing request suggested that the credit extension would not meet the conditions specified above (that is, the request was not for short-term funds, did not appear consistent with the backup nature of the facility, or raised questions about whether the institution remained generally sound), primary credit would be extended with minimal administrative burden on the borrower. Under the staff recommendation, Reserve Banks also could extend primary credit, as a backup source of funding, with maturities up to a few weeks, if the Reserve Bank judges that the institution is in generally sound financial condition and that the institution cannot obtain such credit in the market on reasonable terms. Ordinarily, only very small institutions would be eligible for such term funding. In all cases, borrowings would have to be collateralized to the satisfaction of the Reserve Bank. Reserve Banks would apply the same collateral requirements as have been applied for adjustment credit.

The specific regulatory language that the staff is proposing for the availability and terms of primary credit, as included in the appendix, is shown immediately below. This language is very similar to that in the Board's May 24 proposal but indicates explicitly that the primary credit facility is a backup source of funding, as opposed to a regular funding source.

> A Federal Reserve Bank may extend primary credit on a very short-term basis, usually overnight, as a backup source of funding to a depository institution that is in generally sound financial condition in the judgment of the Reserve Bank. Such primary credit ordinarily is extended with minimal administrative burden on the borrower. A Federal Reserve Bank also may extend primary credit with maturities up to a few weeks as a backup source of funding to a depository institution if, in the judgment of the Reserve Bank, the depository institution is in generally sound financial

[6] The current prohibition in Regulation A against using discount window credit to finance sales of federal funds would be removed. Institutions could use primary credit "as a backup source of funding" to finance such sales.

> condition and cannot obtain such credit in the market on reasonable terms. Credit extended under the primary credit program is granted at the primary credit rate.

The indication that primary credit is a backup source of funding would not require depository institutions to seek funding elsewhere before requesting primary credit. Rather, it reflects an expectation that, given the pricing of primary credit, depository institutions will not rely on the discount window as a regular source of funding. Depository institutions seeking primary credit ordinarily will be asked only for the minimal amount of information necessary to book the loan. Depository institutions would be counseled about the appropriate uses of primary credit only when a pattern of behavior indicated strongly that they were not using it as a backup funding source.

<u>Secondary Credit Program</u>

The staff recommends that the Board establish a secondary credit program along the lines of its May 24 proposal. Specifically, very short-term secondary credit would be available as a backup source of funds to depository institutions that do not qualify for primary credit if such a credit extension would be consistent with the institution's timely return to a reliance on market funding sources. In addition, longer-term funding could be extended under the secondary credit program if necessary for the orderly resolution of a troubled institution that does not qualify for primary credit, subject to the limits on lending to troubled institutions in Section 10B of the Federal Reserve Act that were added by the Federal Deposit Insurance Corporation Improvement Act. Unlike primary credit, the secondary credit program would not be a "minimal administration" facility. Rather, Reserve Banks would obtain information necessary to provide reasonable assurance that secondary credit is being used as a short-term backup source of liquidity, consistent with a timely return to a reliance on market sources of funds, or that an extension of longer-term secondary credit was necessary for the orderly resolution of a troubled institution, consistent with statutory requirements.

In recognition of the less-sound condition of borrowers under this program, secondary credit would be extended at an interest rate 50 basis points above the primary credit rate. Less-sound banks may have an incentive to use discount window credit to expand their balance sheets, and such expansion by weak institutions would threaten to distort resource allocation. The higher interest rate on secondary credit is intended to reduce that incentive. Even with the higher rate, however, some institutions that qualify only for secondary credit may have an incentive to rely routinely on such credit, so administration of secondary credit will be necessary.

Terms and Use of Secondary Credit

The specific regulatory language that the staff is recommending for the availability and terms of secondary credit, as included in the appendix, is shown immediately below. Again, the language is very similar to that included in the Board's May 24 proposal but states explicitly that short-term secondary credit is available as a backup source of funding, as opposed to a regular source of funding.

> A Federal Reserve Bank may extend secondary credit on a very short-term basis, usually overnight, as a backup source of funding, to a depository institution that is not eligible for primary credit if, in the judgment of the Reserve Bank, such a credit extension would be consistent with the timely return to a reliance on market funding sources. A Federal Reserve Bank also may extend longer-term secondary credit if the Reserve Bank determines that such credit would facilitate the orderly resolution of serious financial difficulties of a depository institution. Credit extended under the secondary credit program is granted at a rate above the primary credit rate.

Initial Rate on Secondary Credit

The staff recommends that the System set an initial secondary credit rate at a level 50 basis points above the primary credit rate established as of January 9, 2003. The draft *Federal Register* notice indicates that the Board continues to view a 50-basis-point spread of the secondary credit rate over the primary credit rate as appropriate at the outset of the program. Subsequently, the boards would vote on a formula every two weeks that establishes the secondary credit rate at a level 50 basis points above the primary credit rate, subject to review and determination by the Board of Governors. The 50-basis-point spread would not be established permanently by regulation, but rather could be changed from time to time, if appropriate, by adjusting the formula. This procedure would be somewhat similar to that used currently for the extended credit rate, under which the boards approve a formula setting the extended credit rate 50 basis points above the average of the effective federal funds rate and the ninety-day secondary market CD rate, subject to the review and determination of the Board of Governors.

Seasonal Credit Program

The staff recommends no change to the seasonal credit program at this time.

Required Reserve Deficiency Penalty

Regulation D, which sets reserve requirements for depository institutions, also establishes charges for deficiencies in a depository institution's required reserve balance after application of a privilege that allows carryovers of surpluses and deficiencies from one maintenance period to the next. Currently, the Board authorizes Reserve Banks to assess charges for reserve deficiencies at a rate of 200 basis points per year above the lowest rate in effect for discount window borrowings from the Federal Reserve bank on the first day of the calendar month in which the deficiencies occurred. Under the staff recommendations presented in this memorandum, the lowest rate in effect for discount window borrowings would usually be the seasonal credit rate.[7] The staff believes that it would be preferable to use the primary credit rate, rather than the seasonal credit rate, as the base rate for setting the penalty on required reserve deficiencies. Most depository institutions would be eligible for primary credit, but relatively few are eligible for seasonal credit, and thus the seasonal credit rate would be irrelevant to most depositories in their account management decisions. Similarly, the staff believes that the primary credit rate would be preferable to either the target federal funds rate or the effective federal funds rate, because relatively few institutions in fact have access to the brokered federal funds market, while a large majority of institutions are likely to have access to primary credit. An argument could be made for basing the reserve deficiency penalty applied to those banks that are not eligible for primary credit on the secondary credit rate,

[7] However, if the yield curve were unusually steep, or risk premiums on bank CDs especially high, it is possible that the formula for the seasonal credit rate would produce a rate above the primary credit rate, so that the primary credit rate in those circumstances would be the lowest rate in effect for discount window borrowings.

because that is the interest rate that would be paid for any discount window borrowings by such institutions. However, the staff believes that this additional complexity would not be worthwhile, given the relatively small fraction of institutions that likely will be ineligible for primary credit, the costs of modifying systems to accommodate the change, and the fact that, since Reserve Banks counsel institutions that experience reserve deficiencies, the penalty is not the only incentive in place for avoiding deficiencies.

The staff believes that in general the Board's current approach to addressing required reserve deficiencies works well. Specifically, the general level of the required reserve deficiency penalty appears to be roughly appropriate, as evidenced by a modest incidence of required reserve deficiencies. Accordingly, the staff does not believe that an appreciable change in the general level of the charge is required. Setting the penalty 200 basis points above the primary credit rate would represent a noticeable increase in the effective reserve deficiency penalty. Instead, to maintain approximately the existing pecuniary incentive for institutions to meet their reserve requirements, the staff recommends that the Board amend Regulation D to set the penalty 100 basis points above the primary credit rate. The effective penalty can be evaluated in terms of the federal funds rate, at least for those institutions for which the federal funds rate is the most relevant marginal cost of funds. In the recent past, the adjustment credit rate has consistently been set 50 basis points below the target federal funds rate; therefore, the reserve deficiency charge has been 150 basis points above the target federal funds rate. Under the revised formula, if the primary credit rate is 100 basis points above the target federal funds rate the reserve deficiency charge will be 200 basis points above the target federal funds rate. The staff does not believe this slight difference is significant, given the infrequency of reserve deficiency charges, the ability of the Reserve Banks to waive the charges under certain circumstances, the potential for future variations in the spread between the target federal funds rate and the primary credit rate, and the continued important role of implicit costs in the form of administrative measures that discourage reserve deficiencies.[8]

Recommended Date for Implementation of New Programs

The staff recommends that the primary and secondary credit programs be implemented on January 9, 2003. Discussions with SCRRM indicate this date would allow adequate time to determine which depository institutions are eligible for primary credit, to explain the new programs to depository institutions, to train Reserve Bank staff, and to make the necessary modifications to systems. The recommended date is the first day of a fourteen-day reserve maintenance period. In addition, the date is nearly three weeks before the next scheduled meeting of the Federal Open Market Committee, reducing the odds that the associated changes in discount rates would be mistaken for a change in the stance of monetary policy. All discount window loans previously extended under the adjustment and extended credit programs would mature that day, and no further loans would be made under those programs.

Procedures for Setting Discount Rates in an Emergency

Under normal, non-emergency circumstances, the primary credit rate would be substantially above the target federal funds rate.[9] In periods of crisis, the tendency for the substantial markup of the primary credit rate over the target federal funds rate to limit discount window use would be detrimental. A reduction in the primary credit rate in such circumstances could help to prevent a tightening of money markets if, for example, disruptions to the financial infrastructure prevented the System from providing the desired amount of nonborrowed reserves, reserve management by depository institutions

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[8] Consideration also could be given to basing the penalty for overnight overdrafts on the primary credit rate, rather than on the effective federal funds rate as at present. However, because the staff is developing a proposal for altering the charges for daylight overdrafts based on the availability of collateral, and because of the possibility of restructuring the charges for overnight overdrafts along similar lines, the staff recommends that the Board defer consideration of this issue for the time being.

[9] As explained earlier in this memorandum, under normal (non-emergency) circumstances, the process for establishing the primary credit rate would be identical to current procedures. Specifically, the board of directors of each Federal Reserve Bank would establish that bank's

became much more cautious, or disruptions impeded the ability of markets to redistribute reserves to where they are needed late in the day.

No unusual measures are needed to set the discount rate in an emergency if both the Board of Governors and the boards of directors of the Reserve Banks are available. In such a case, if the Board deems action appropriate, it can request that the boards of directors establish a lower primary credit rate.

However, advance measures are desirable to deal with the contingency that either the Reserve Banks or the Board of Governors cannot act. The staff has developed the following proposal for emergency rate-setting procedures in consultation with Vice Chairman Ferguson, other members of the Board, and the Reserve Bank presidents.

To deal with the possibility that one or more full boards of directors are not available to act on a Board request that the Reserve Bank establish a lower rate in a financial emergency, the staff recommends that each board delegate authority to request discount rate changes to its executive committee, president, and appropriate officers. Such delegation should be sufficient to reduce to a very low level the probability that a Reserve Bank will not be able to act to lower rates in a financial emergency. Nonetheless, there will always be the possibility that a Reserve Bank and the Board cannot communicate in an emergency, or that a Reserve Bank, despite delegation of authority to its officers, cannot act. To deal with such situations, the boards of directors of each Reserve Bank would pass a resolution establishing, subject to review and determination by the Board of Governors, a primary credit rate equal to the targeted federal funds rate if a financial emergency exists and the appropriate officials at the Reserve Banks and the Board cannot communicate in a timely manner. By submitting this request in advance, boards of directors maintain their involvement in the rate-setting process; thus, the usual balance of responsibilities within the System would not be affected by adoption of the procedure. This would be underscored by including a one-

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discount rate at least every two weeks subject to review and determination by the Board of Governors.

year sunset clause in the submitted board resolutions, which would require the Reserve Bank boards to revisit and renew the advance request every year.

Because the Board is responsible for reviewing and determining discount rate proposals, the staff also recommends that the Board address the contingency that a quorum of the Board is not available. In particular, the Board has the responsibility to ensure that it can determine an appropriate rate in response to a financial emergency even if a quorum of the Board is not available at the time of the financial emergency. The staff proposes the following approach. The Board would approve in advance any request made by a Reserve Bank to establish the discount rate at the target federal funds rate in a financial emergency provided that such approval would become effective only if a properly authorized official certified that a quorum of the Board was not available. This approval would be published as part of Regulation A, as included in the appendix. By including a definition of a financial emergency and by limiting the responsibility of an individual official to certifying the absence of a quorum, the mechanism would be essentially self-executing.[10] The officials authorized to make the quorum certification would be designated in advance by the Chairman. The chain of authority could be: Chairman, Vice Chairman, most senior Board member, next most senior, etc. The Chairman could also authorize the Chairman of the Conference of Presidents, or in his or her absence, the Vice Chairman of the Conference of Presidents, to make the quorum certification based on information provided by available senior Board staff members so that action on discount rates could be taken even if no Board member were available. Apart from any available Board members, Board staff members are likely to be in the best position to determine whether a quorum of the Board is available.

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[10] The staff proposes that a financial emergency be defined for these purposes as a significant disruption to the U.S. money markets resulting from an act of war, military or terrorist attack, natural disaster, or other catastrophic event.

Appendix

FEDERAL RESERVE SYSTEM

12 C.F.R. Part 201

Regulation A; Docket No. R-1123

Extensions of Credit by Federal Reserve Banks

12 C.F.R. Part 204

Regulation D; Docket No. xxxx

Reserve Requirements of Depository Institutions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule; technical amendment.

SUMMARY: The Board of Governors is publishing final amendments to Regulation A that replace the existing adjustment and extended credit programs with programs called primary and secondary credit and also reorganize and streamline existing provisions of Regulation A. The final rule leaves the existing seasonal credit program essentially unchanged. The final rule is intended to improve the functioning of the discount window and does not indicate a change in the stance of monetary policy.

The Board also is amending the penalty provision of Regulation D, which is calculated based on the discount rate, to conform the calculation of penalties for reserve deficiencies to the new discount rate framework.

DATES: This final rule will become effective on January 9, 2003.

FOR FURTHER INFORMATION CONTACT: Brian Madigan, Deputy Director (202/452-3828) or William Nelson, Senior Economist (202/452-3579), Division of Monetary Affairs; or Stephanie Martin, Assistant General Counsel (202/452-3198) or Adrianne Threatt, Counsel (202/452-3554), Legal Division; for users of Telecommunication Devices for the Deaf (TDD) only, contact 202/263-4869.

SUPPLEMENTARY INFORMATION:

Background

Existing Regulation A and the Board's Proposed Rule.

Under existing Regulation A, three credit programs are available to depository institutions: (1) adjustment credit, which is available for short periods of time, usually overnight, when a depository institution has exhausted other sources of funds; (2) extended credit, which is available for somewhat longer periods when assistance is not available from other sources; and (3) seasonal credit, which is available largely to small banks with a pronounced seasonal funding need. Over the past decade, the interest rate on adjustment credit has been 25 to 50 basis points below the federal funds rate, which is the rate that applies to uncollateralized overnight loans in the interbank market. The rates for extended and seasonal credit are set by formulas based on market interest rates and typically have been at or above the basic discount rate.

The below-market rate for adjustment credit creates incentives for an institution to borrow at the discount window to exploit the spread between the discount rate and the higher market rate for short-term funds. The current regulation therefore requires that an institution first exhaust other available sources of funds and explain its need for adjustment credit. The regulation also prohibits the use of discount window credit to finance the sale of federal funds. Because of these restrictions, a Reserve Bank must evaluate the financial situation of each borrower to determine that both the reason for borrowing at the discount window and the depository institution's use of borrowed funds are appropriate.

Reserve Bank administration of adjustment credit tends to create uncertainty among depository institutions about their access to discount window credit. In addition, institutions that have borrowed at the discount window after advertising their need for funds in the market have expressed concern that borrowing at the window signals weakness and is a source of stigma. Concerns such as these in some cases have deterred depository institutions from borrowing at the discount window during very tight money markets when doing so would have been appropriate. This in turn has hampered the ability of the discount window to buffer shocks to the money markets.

To improve the operation of the discount window, the Board proposed to replace the existing adjustment and extended credit programs with primary and secondary credit programs (67 FR 36544, May 24, 2002). The Board proposed that primary credit be available to generally sound institutions on a very short-term basis, usually overnight, with little or no administrative burden on the borrower and that borrowers of primary credit not be required to exhaust other funds sources before obtaining short-term primary credit. The Board also proposed that primary credit be available for periods of up to a few weeks to generally sound institutions that cannot reasonably obtain such funding in the market. The Board proposed no restrictions on the purposes for which the borrower could use primary credit. The proposal contemplated that Reserve Banks would establish a System-wide set of criteria, based on supervisory and other relevant information, which would be used to determine whether an institution was in generally sound financial condition and thus eligible for primary credit. The Board proposed that primary credit normally be available at a rate above the target federal funds rate of the Federal Open Market Committee (FOMC) and that the initial primary credit rate be 100 basis points above the target federal funds rate.

Under the proposed rule, institutions not eligible for primary credit would be permitted to borrow secondary credit to meet temporary funding needs, consistent with the institution's timely return to a reliance on market funds. A Reserve Bank also could extend secondary credit to facilitate the resolution of serious financial difficulties of an institution. The Board proposed that the initial rate be set by formula 50 basis points above the primary credit rate. The Board's proposal contemplated that the secondary credit program would require more Reserve Bank administration than the primary credit program.

The proposed regulation retained the existing seasonal credit program without substantive change, although the Board specifically requested comment regarding whether that program was still necessary and, if so, what the applicable interest rate should be.

Overview of Comments Received

The Board received 61 comments on the proposed rule from depository institutions of various sizes, trade associations that represent depository institutions, individuals, and Reserve Banks. This section presents an overview of the main points contained in the comments received. The section-by-section analysis of the final rule, set forth below, discusses the comments in greater detail and responds to the major concerns expressed by commenters.

Support for the Proposal.

Of the 30 letters that addressed the primary and secondary credit programs, approximately 14 generally supported moving to an above-market discount window framework. These commenters indicated that replacing the existing below-market discount window facility with an above-market framework would provide more easily accessible funding on more predictable and transparent terms with less burden on borrowers and would remove incentives to borrow in order to exploit interest rate spreads. Owing to the removal of the requirements that a borrower exhaust other funding sources and prove its need for credit and the addition of the requirement that primary credit borrowers be in generally sound financial condition, some supporters of the proposal thought that the stigma associated with discount borrowing would decrease. Commenters also indicated that an above-market framework would provide depository institutions with an incentive to manage their liquidity more prudently under normal market conditions in order to avoid paying the penalty rate but would make it easier for banks to obtain overnight funding during periods of very tight money markets. Supporters also stated that an above-market lending facility would be more akin to the lending facilities of other central banks.

Questions about the Need for Proposed Changes.

Some commenters questioned the underlying reasons the Board gave for proposing an above-market framework. Several commenters questioned the Board's statement that some depository institutions were deterred from coming to the discount window because of perceptions that discount window borrowing indicated financial weakness. One commenter asserted that, because of limits on lending to undercapitalized institutions, borrowing at the window was more likely to indicate strength than weakness, while others asserted that market participants did not view borrowing as an important factor when assessing financial strength.[11] Still another commenter argued that the current low volume of borrowing did not indicate reluctance to borrow, but rather indicated that depository institutions were using the window appropriately as a backup rather than primary source of liquidity.[12] Other commenters questioned the need for an above-market rate for purposes of limiting volatility in the federal funds market because they thought that the existing controls and incentives adequately limited volatility.

Concerns about the Proposal.

Sixteen commenters, eight of whom opposed the proposal, expressed various concerns about the proposal. Commenters' concerns focused mainly on the proposed 100-basis-point spread between the target federal funds and primary credit rates. Other commenters expressed concern that lending funds at an above-market rate inappropriately would introduce a profit motive into actions related to monetary policy, thereby creating a conflict of interest for the Federal Reserve System.[13]

Many commenters expressed concern that the proposal either would not address or would exacerbate the problems that the Board identified as reasons for changing to an

[11] One commenter argued that the manner in which discount window borrowing is reported makes it difficult to identify individual borrowers. Others thought that discount window activity was at best a secondary indicator of financial strength because market participants rely on other sources when determining an institution's soundness.

[12] The Board believes that a number of factors, including improved account management by depository institutions, contribute to the relatively low level of borrowing at recent spreads of the federal funds rate over the discount rate. However, the Board also believes that the current framework of below-market lending, with its attendant need to administer lending heavily, remains a potential deterrent to appropriate borrowing, especially during periods when the overall condition of the financial sector is weak.

[13] Another commenter argued that if a depository institution were to deteriorate as a result of reselling funds obtained through the primary credit program, the public might blame the Federal Reserve.

above-market framework. Although some critics of the proposal thought that the new framework would prevent extreme spikes in the federal funds rate, many commenters thought that volatility, especially intraday volatility, would increase rather than decrease. Other commenters thought that depository institutions would be at least as reluctant as they are currently to seek discount window credit because stigma would remain or because the above-market rate would deter borrowing. Still other commenters asserted that the Board's proposal would not be less burdensome for borrowers.

Suggested Alternatives to and Suggestions Regarding the Board's Proposal.

Some commenters who expressed general concern about the proposed above-market structure suggested that the Board modify or consider alternatives to its proposal. One commenter suggested that the problems with the current discount window programs were not burden and stigma, but rather were uncertainty about the programs and inconsistent requirements and expectations throughout the System. This commenter suggested leaving the current discount window programs in place but clarifying the Reserve Banks' credit policies, expectations, and requirements and applying those criteria more consistently throughout the Federal Reserve System.[14] Another commenter proposed that the Board try to cap the federal funds rate through late-day open market operations rather than change its credit programs. Other commenters thought that the Federal Reserve should make credit available continuously and at market rates.[15]

Comments Regarding Seasonal Credit.

Over half the comments the Board received were in response to the Board's solicitation for comment about the continued need for the seasonal credit program. Forty-five commenters addressed the seasonal credit program, with 39 in favor of retaining and six in favor of eliminating the program. These comments are discussed in detail below in the section on seasonal credit.

[14] The Board notes that the Federal Reserve System has taken steps over the past decade that have been intended to clarify requirements and decrease stigma.

[15] The Board notes that this approach would be inconsistent with operation of primary and secondary credit facilities as backup sources of liquidity and reserves for depository institutions.

Summary of Final Rule

For the reasons discussed in detail below in the section-by-section analysis, the Board's final amendments to Regulation A substantively are nearly identical to the rule the Board proposed in May 2002. Most notably, the final rule replaces the existing adjustment and extended credit programs with primary and secondary credit programs, and the Reserve Banks will offer these new types of credit at rates that exceed the FOMC's target federal funds rate. The Board has included in the final rule a section under which the primary credit rate could be lowered in a financial emergency in the absence of a quorum of the Board. The Board is retaining the seasonal credit program with only minor technical changes.

Section-by-Section Analysis

The Above-Market Lending Framework -- §§ 201.4 and 201.51.

The Above Market Framework Generally and Market Volatility.

A number of commenters argued that moving to an above-market discount window framework generally would increase volatility, especially in light of the proposed 100-basis-point initial spread of the primary credit rate over the target federal funds rate, and therefore would not accomplish one of the Board's stated goals.[16]

It is possible that certain measures of volatility of the federal funds rate — particularly those that give some weight to small deviations from the target, such as the intraday standard deviation of the federal funds rate—will increase under the above-market framework. However, the Board believes that an above-market framework will reduce the potential for more extreme, unintended movements in the funds rate. These extreme movements arguably are more problematic than smaller ones because they tend to occur in the context of, and can exacerbate, conditions of market stress. Most depository institutions will not have an incentive to borrow from the window until the federal funds rate rises to the primary credit rate, at which point institutions likely will view the window as an attractive alternative. The presence of the discount window as a funding option should ensure that the federal funds rate will not rise significantly above the primary credit rate, so the primary credit rate effectively will serve as a cap on and limit potential volatility in the federal funds rate.

Some commenters stated that an above-market discount window framework would place an upper limit on the federal funds rate but argued that the Board should not establish a ceiling on the federal funds rate without also establishing a floor, noting that net sellers of federal funds are disadvantaged by declines in the federal funds rate. The most effective means of establishing a floor would be for the Federal Reserve to pay interest on excess reserve account balances, because a depository institution would have no incentive to lend or sell reserves at a lower rate than the rate of interest those reserve balances could earn. However, the Federal Reserve does not have explicit statutory authority to pay interest on reserve balances at this time.

Although it might be desirable to limit both upward and downward volatility, those limits need not be implemented simultaneously in order to produce beneficial results. The potential advantages of the proposed discount window changes are considerable even in the absence of a rate floor, and delaying implementation of the above-market framework would unnecessarily defer those advantages without any countervailing benefit. The Board therefore has determined that implementation of the above-market framework should proceed without delay.

Primary Credit.

Reserve Banks will extend primary credit at a rate above the target federal funds rate on a very short-term basis (typically overnight) to depository institutions that the Reserve Banks judge to be in generally sound financial condition. Reserve Banks will determine eligibility for primary credit according to a set of criteria that is uniform throughout the Federal Reserve System and based mainly on examination ratings and capitalization, although supplementary information, including market-based information when available, also could be used. An institution that is eligible to receive primary

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[16] These commenters generally thought that an above-market structure would allow sellers routinely to increase the federal funds rate all the way up to the ceiling established by the discount

credit need not exhaust other sources of funds before coming to the discount window, nor will it be prohibited from using primary credit to finance sales of federal funds. However, in view of the above-market price of primary credit, the Board expects that a depository institution will continue to use the discount window as a backup source of liquidity, which is the intended purpose of a central bank lending facility, rather than as a routine one. Reserve Banks will extend primary credit on an overnight basis with minimal administrative requirements, unless an aspect of the request for funds suggests that the credit extension would not meet the conditions of primary credit. Reserve Banks also may extend primary credit to eligible institutions for periods of up to several weeks if such funding is not available from other sources. However, longer-term extensions of primary credit will be subject to greater administration than are overnight loans. The text of § 201.4(a) is essentially the same as that of the Board's proposal, although the final rule includes language highlighting the backup nature of the primary credit facility.

1. Interest rates for primary credit.

Several commenters supported the Board's proposal that the initial primary credit rate be 100 basis points above the target federal funds rate. These commenters thought that a 100-basis-point spread generally was appropriate and would encourage most financial institutions first to seek credit elsewhere. One commenter thought the proposed spread was acceptable because the Federal Reserve does a good job of keeping the federal funds rate near the target.

The Board received numerous comments, however, that expressed specific concern about the proposed initial primary credit rate. Many commenters, even those that generally supported the proposal, argued that the 100-basis-point spread the Board proposed was too wide and would undermine the Board's articulated goals for the primary credit program. These commenters thought that a discount rate of the target federal rate plus 100 basis points was too high because it was overly punitive, would deter institutions from borrowing at the discount window, and would allow sellers of federal funds to bid the federal funds rate up during periods of limited trading, low

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rate, thereby increasing the cost of funds generally.

reserve volume, or late-day trading. Other commenters thought that a 100-basis-point spread between the target federal funds and discount rates would thwart the Board's efforts to remove the stigma associated with discount window borrowing and to encourage depository institutions and industry analysts to view the window as a normal liquidity source for sound institutions.

Several commenters liked the idea of setting the primary credit rate at rate above the target federal funds rate but suggested that a spread of as few as 25 to as many as 50 basis points would be preferable to the 100-basis-point initial spread the Board proposed.[17] Other commenters suggested alternative mechanisms for setting the rate, such as setting the rate at a certain percentage, rather than a certain number of basis points, above the target federal funds rate.[18]

The Board notes that an appreciable spread between the primary credit and target federal funds rate is necessary for the success of the above-market discount window programs. Given the large number of financial institutions in the United States and the tremendous variation in their sizes and other characteristics, the availability and price of market funding sources available to U.S. financial institutions also vary widely. If the primary credit rate were not at least as high as the highest rate on sources of comparable funding in the market, then some depository institutions frequently would find the primary credit program, rather than the open market, to be the most attractive source of funds. If routine use of the window occurred, the Federal Reserve still would need to administer the discount window heavily to deter institutions from making undue use of primary credit.

[17] Although most commenters who suggested a particular rate did not explain their rationale, one commenter argued that a 50-basis-point spread would be appropriate because the commenter asserted that approximately half the large spikes in the federal funds rate were at about that level. Another commenter indicated that a 50- to 60-basis-point spread would be appropriate because that would ensure that the central bank rate was slightly higher than the market rate but would keep the market rate from becoming excessive.

[18] One of these commenters suggested that the amount of the spread should depend on the level of the target federal funds rate, such that the lower the federal funds rate, the lower the spread and vice versa. Another commenter suggesting tying the primary credit rate to the collateralized repo rate than the federal funds rate.

Although it is difficult to determine the appropriate rate at which to extend primary credit to ensure that it remains a backup funding source, empirical evidence from several sources suggests that 100 points above the target federal funds rate is an appropriate initial rate. These data cast doubt on whether a lesser spread would accomplish this goal of ensuring that the discount window remains a backup source of liquidity.

Experience with the Special Liquidity Facility (SLF) that the Federal Reserve System established to address unusual liquidity strains that arose during the months surrounding the date change on January 1, 2000, is instructive. The SLF was similar to the primary credit program in many ways because eligibility was limited to financially sound institutions, administration of the facility intentionally was quite limited, and funding was available at a fixed spread of 150 basis points above the federal funds rate. Despite the penalty rate, there were 42 instances in which institutions borrowed from the SLF for a period of two to ten consecutive days and 14 instances in which institutions borrowed for periods of more than ten consecutive days. This suggests that the SLF was an attractive source of longer-term, rather than overnight, funding for some institutions despite the 150-basis-point spread above market rates, which in turn suggests that those financially sound institutions might not have had access to cheaper funding in the open market.

In addition, Federal Reserve staff conversations with representatives of correspondent banks and other depository institutions found that the overnight funding options for banks without access to the national money markets were priced from 3/16 to 1 percentage point over the federal funds rate, with the largest spread being charged by an institution that preferred that its customers first exhaust other sources of short-term funding.

Moreover, a spread on the order of 100 basis points has been used by some, but not all, foreign central banks on their Lombard discount window facilities. Perhaps most notably, the European Central Bank generally has employed a spread of 100 basis points. Conversations with staff of some of these central banks indicate that the experience with spreads of this size generally has been positive and has been consistent with achieving those central banks' goals.

In view of the foregoing evidence, the Board believes that an initial spread of 100 basis points is appropriate and anticipates that a primary credit rate consistent with such a spread will be established as of January 9, 2003. The Board notes, however, that this is only the initial rate. The Reserve Banks are required to establish the primary credit rate, subject to the review and determination of the Board, at least every two weeks or more often if the Board deems necessary. The System can therefore set a primary credit rate at a lesser, or greater, spread above the federal funds rate as needed in light of actual experience with the primary credit program.[19]

Because a change in the stance of monetary policy between now and the recommended initiation of the new programs on January 9, 2003, cannot be ruled out, it is uncertain at this point what level of the primary credit rate will correspond with a spread of 100 basis points on that date. Section 201.51(a), which describes the primary credit rate, therefore at this time simply will state that the primary credit rate is a rate above the target federal funds rate of the Federal Open Market Committee. When the Reserve Banks establish and the Board determines the rate to be in effect on January 9, 2003, the Board will amend § 201.51(a) to indicate the initial primary credit rate for each Reserve Bank. The Board's amendment will be effective on January 9, 2003.

2. Eligibility criteria.

The Board proposed that eligibility for primary credit be determined mainly by a depository institution's supervisory ratings and capitalization, although supplementary information, when available, also could be used. Under the Board's proposed rule, institutions that were rated CAMELS 1 or 2 or SOSA 1 and at least adequately capitalized almost certainly would be eligible for primary credit, while institutions rated

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[19] One commenter expressed concern that the Reserve Banks would establish and the Board determine the spread between the federal funds and primary credit rates, rather than setting the actual rate. The Board notes that the primary credit rate will not be determined by establishing a fixed spread above the federal funds rate or by using any other formula. Rather, the Reserve

CAMELS 4 or 5 almost certainly would not be eligible. Institutions rated CAMELS 3 or SOSA 2 that are at least adequately capitalized might be eligible, depending on supplementary information.[20] The Board noted that this recommendation aligned very closely with the categorization of institutions for purposes of determining access to daylight credit.

Several commenters specifically addressed the eligibility criteria for primary credit. Most of these commenters thought that the proposed criteria generally were appropriate, although some suggested changes. Several commenters argued that the criteria should rely more heavily on examination ratings and minimize reliance on other types of information in determining eligibility for primary credit. One commenter thought that the guidelines would be more clear, concise, and uniform if the Federal Reserve only took supervisory ratings into account and did not allow supplementary information if a depository institutions were rated CAMELS 1 or 2.[21] Another commenter suggested that institutions that are rated CAMELS 5 or that are critically undercapitalized either should be precluded from obtaining credit or should be charged a much higher penalty rate than the Board proposed. In contrast, other commenters expressed concern that the proposed eligibility criteria relied too heavily on supervisory data. These commenters expressed concern that reliance on an institution's soundness was not appropriate in a system of secured lending and suggested that the Federal Reserve instead should base its lending programs and credit decisions on the type of collateral an institution offers.

Banks will establish the actual primary credit rate, subject to the review and determination of the Board.

[20] CAMELS (Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risk) ratings, applicable to domestically chartered institutions, are set on a scale of 1 through 5, with 5 representing the highest degree of supervisory concern. SOSA (Strength of Support Assessment) ratings, applicable to foreign banking organizations, are set on a scale of 1 through 3, with 3 indicating the highest degree of supervisory concern.

[21] This commenter argued that the other information the Board proposed to take into account was irrelevant to a Reserve Bank's risk regarding secured overnight loans and that considering such information would lead to uncertainty about borrowing privileges.

The Board believes that, in order to ensure uniformity of credit eligibility throughout the Federal Reserve System, the criteria must rely heavily on objective supervisory data, which reflect determinations made by an institution's primary regulator after an extensive review process. However, the Board also recognizes that an institution could experience significant changes in its financial strength between examinations, in which case the institution's supervisory ratings might not reflect its current soundness and creditworthiness. To protect the Reserve Banks from the risks and to avoid the allocative distortions that could be involved in lending to such an institution, the Board believes that the eligibility criteria must allow for the use of some amount of supplementary information, including market-based information when available, to confirm that an institution's most recent supervisory data accurately reflect the institution's current condition.

Under the final rule, the Board anticipates that the Reserve Banks will initially adopt criteria that are substantially similar to those articulated in the Board's proposal with some additional elements that will make the eligibility criteria identical to those for daylight credit. The classification scheme used by Reserve Banks for determining access to daylight credit is well developed and provides a good measure of the general soundness of depository institutions. Reserve Banks and depository institutions already have extensive experience with these criteria, and using them to determine eligibility for both the daylight credit and primary credit programs generally should be straightforward for the Reserve Banks and should be more transparent for borrowers. Using a single set of criteria for both programs also should simplify explanations of Reserve Bank credit programs to depository institutions and the public.

Under the criteria that would be applied at the outset of the program, institutions' eligibility would be based on CAMELS (or SOSA and ROCA) ratings, capitalization, and, at the Reserve Bank's discretion, supplementary information.[22] More specifically,

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[22] ROCA (Risk management, Operation controls, Compliance, and Asset quality) ratings apply to the U.S. operations of a foreign banking organization. They are set on a scale of 1 to 5; as with CAMELS ratings, higher numbers indicate increased supervisory concern.

institutions that are at least adequately capitalized and rated CAMELS 1 or 2 (or SOSA 1 and ROCA 1, 2, or 3) would almost certainly be eligible for primary credit. Institutions that are at least adequately capitalized and rated CAMELS 3 (or SOSA 2 and ROCA 1, 2, or 3) generally would be eligible. Institutions that are at least adequately capitalized and rated CAMELS 4 (or SOSA 1 or 2 and ROCA 4 or 5) would be eligible only if an ongoing examination indicated a substantial improvement in condition. Institutions that are not at least adequately capitalized, or that are rated CAMELS 5 (or SOSA 3 regardless of the ROCA rating), would not be eligible for daylight or primary credit.

In summary, eligibility for primary credit will be restricted to institutions that are in generally sound financial condition. The Reserve Banks will be responsible for determining the general soundness of the institutions in their districts. At the outset of the program, the Reserve Banks will use the criteria that are already used for determining eligibility for daylight credit.

3. Reduction of burden and stigma.

Some commenters disagreed that the proposed revisions would reduce the stigma of borrowing at the discount window and in particular noted that analysts and counterparties might infer that the bank could not obtain funds at market rates and therefore might be in financial difficulty if there were evidence that the bank were paying a premium for funds. [23]

The Board believes that the Federal Reserve can reasonably expect to achieve, over time, some reduction in stigma as a result of the primary credit program. Only generally sound institutions will be eligible to borrow primary credit, and the Board expects that most institutions will be eligible for primary credit. Market participants would have no reasonable basis for inferring that an institution believed to have borrowed

[23] Several commenters thought that stigma would remain until senior bank management, equity analysts, investors, rating agencies, and other market participants consider the discount window to be a "normal" source of liquidity. Some of these commenters suggested that only an intensive education campaign by the Federal Reserve targeted at those whose opinions influence perception of the discount window would achieve this result. Other commenters thought that financially sound institutions would not borrow at the window because the market would not be able to tell whether they obtained primary or secondary credit.

primary credit was unsound.[24] Also, with credit no longer offered at a subsidy rate, the Federal Reserve will no longer require a borrowing institution first to exhaust other funding sources. As a result, borrowers will not have to make their funding needs known to the market, which should eliminate a key source of stigma cited by depository institutions. Depository institutions and persons attempting to assess the strength of those institutions also should have no concerns that financial regulators will view occasional use of primary credit as a potential indication of difficulties. In addition, the borrowings of those institutions that are believed to be lending the proceeds of discount window credit into the federal funds market clearly will indicate nothing adverse about their financial condition. Finally, reflecting the incentives created by an above-market framework, a significant proportion of primary credit borrowing is likely to occur when the overall money market has tightened significantly. Because occasions of tightening markets are well known to all money market participants and analysts, it will be easy for them to recognize that borrowing at such times reflects a general market situation rather than conditions particular to a single institution.

Secondary Credit.

The Reserve Banks will offer secondary credit to institutions that do not qualify for primary credit. As with primary credit, secondary credit will be available as a backup source of liquidity on a very short-term basis, provided that the loan is consistent with a timely return to a reliance on market sources of funds. Longer-term secondary credit would be available if necessary for the orderly resolution of a troubled institution, although any such loan would have to comply with the limitations of § 201.5 regarding lending to undercapitalized and critically undercapitalized institutions. Unlike the primary credit program, secondary credit will not be a minimal administration facility because the Reserve Banks will need to obtain sufficient information about a borrower's financial situation to ensure that an extension of credit complies with the conditions of

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[24] Although the Federal Reserve System does not publish information on individual banks' use of the discount window, it is required by law to publish a weekly balance sheet for each Reserve Bank. The Federal Reserve also publishes weekly data on the aggregate amount the Federal Reserve System has lent under each discount window program.

the program. The description of secondary credit at § 201.4(b) closely tracks the language of the Board's proposed rule but states that short-term secondary credit is a backup funding source.

The rate for secondary credit will be set by formula and will be above the primary credit rate. Initially, the spread between the primary and secondary credit rates will be 50 basis points.[25] Less sound borrowers are riskier and might have an incentive to use discount window borrowings to expand their balance sheets in a manner that likely would distort resource allocation, and the higher rate on secondary credit is designed to reduce this incentive. Even with the higher rate, some institutions might tend to rely routinely on secondary credit, so administration of secondary credit remains necessary. If experience eventually suggests that a 50-basis-point spread above the primary credit rate is either too high or too low to achieve the objectives of the secondary credit program, the Federal Reserve could adopt a different formula.

Seasonal Credit.

The Board's proposed rule left the seasonal credit intact with two technical revisions. The Board proposed removing the requirement that a potential borrower first demonstrate that it has exhausted special industry lenders as a funding source, because in practice the Reserve Banks have not used this criterion for some time. In addition, the Board proposed eliminating the requirement that the seasonal credit rate be at or above the basic discount rate, because that requirement would not be consistent with the pricing of primary credit. The Board specifically solicited comment on whether the seasonal credit program is still needed and, if so, whether the current formula for determining the

[25] Although the Board received few comments specifically about the secondary credit program, those commenters that did reference the program generally thought that the proposed rate of 50 basis points above the primary credit rate was appropriate. However, one commenter suggested that a higher secondary credit rate should not reflect a risk premium, because all secondary credit would be collateralized fully. This commenter suggested that the higher rate was justified only by its "incentive effect." Presumably this commenter was referring to the incentive a higher rate provides to less-sound institutions not to use discount window funding to expand their balance sheets inappropriately.

rate remains appropriate. The majority of the comments that the Board received responded to this request.

Six commenters favored eliminating the seasonal credit program, arguing that small banks with seasonal needs had adequate access to other sources of liquidity and that the seasonal credit program was unnecessary. These commenters thought that the proposed primary and secondary credit programs could meet the needs of small banks. One commenter indicated that, if the Board kept the seasonal credit program, it should be available only to banks with less than $100 million in assets.

The Board received 39 comments from depository institutions, trade associations that represent small banks, and a Federal Reserve Bank urging the Board to retain the seasonal credit program, and most of these commenters also recommended retaining the existing rate formula.[26] The depository institutions argued that they continue to experience seasonal demand for which they have relatively few alternative funding sources. Some commenters indicated that they have no or very limited access to short-term capital markets and national money markets or that they can obtain credit through these channels only on unfavorable terms. Some small banks stated that they did not have access to the Federal Home Loan Banks (FHLBs), and some of those that did stated that FHLB loans are for longer terms than needed to meet seasonal demand. Although many small banks indicated that their deposits generally have increased because of the

[26] Commenters offered various suggestions regarding the seasonal credit program. Some thought that the seasonal credit rate should be even lower than the existing rate formula provides, and one asked that the Reserve Banks offer borrowers a choice of fixed or variable rates. Another commenter opined that the Reserve Banks should accept a broader range of assets as collateral, consider a "blanket pledging agreement" such as that used by the FHLBs, and stop demanding to take physical possession of the collateral. (The Board notes that in fact only a small fraction of collateral is held physically by the Reserve Banks. Most collateral is held by the pledging institution or pledged electronically.) One commenter suggested that Reserve Banks should allow depository institutions to borrow up to the entire amount of the assets they pledge as collateral (in other words, with no "haircut"). Some commenters indicated that the Federal Reserve should not require banks to demonstrate that their seasonal needs were for four consecutive weeks and should not vary an institution's seasonal credit line from month to month. Other commenters suggested that the Federal Reserve simplify both the eligibility criteria and the information requirements in connection with seasonal credit and requested that the Reserve Banks do more to promote awareness of the seasonal credit program.

recent decline in the equity markets, they expected that the availability of deposit funding would decrease as other investment options became more attractive. Some depository institutions also stated that obtaining liquidity by competing for additional deposits either was too expensive or was impossible because of a lack of core deposits in the community.

Several commenters indicated that eliminating the seasonal credit program would be harmful in other ways. Many institutions expressed concern that, without that program, the FHLBs would become their only viable alternative liquidity source and that they would be overly exposed to the FHLBs. Other depository institutions argued that if they could not obtain funding on terms comparable with those of the seasonal credit program, they in turn would not be able to compete effectively with other lenders, including the Farm Credit System, for agricultural loans.

Section 201.4(c) of the final rule leaves the seasonal credit unchanged, except for technical revisions contained in the Board’s proposal.

Lowering the Primary Credit Rate in Response to a Financial Emergency.

In a financial emergency, lowering the discount rate would help to prevent an undue tightening of money markets, even if the Federal Reserve’s ability to provide reserves through open market operations were constrained by the timing or effects of the conditions giving rise to the financial emergency. Especially in light of the events of September 11, 2001, when the System needed to make monetary policy and lending decisions quickly, the Board believes that it is desirable to ensure that the primary credit rate is lowered expeditiously in response to a financial emergency.

Section 201.51(d)(2) of the Board’s rule defines a financial emergency as a significant disruption to the U.S. money markets resulting from an act of war, military or terrorist attack, natural disaster, or other catastrophic event. Ideally, a quorum of the Board would be present to review and determine the primary credit rate at the time a financial emergency occurred. However, to ensure that the Board’s determination to lower the rate in response to a financial emergency could take effect even in the absence of a quorum, § 201.51(d) of the Board’s final rule provides that the primary credit rate is reduced to the FOMC's target federal funds rate if in a financial emergency a Reserve

Bank has requested that the primary credit rate be established at the target federal funds rate and the Chairman of the Board (or, in the absence of the Chairman, his designee) certifies at the time of the financial emergency that a quorum of the Board is not available. If the primary credit rate were lowered as a result of this provision, the primary credit rate then would float with the target federal funds rate, which the FOMC would continue to set. This provision of Regulation A implements the Board's decision that lowering the primary credit rate to the target federal funds rate in a financial emergency is the appropriate course of action. The Federal Reserve Banks are establishing analogous internal procedures to address the possibility that their boards of directors or other duly authorized officials might be unavailable or otherwise unable to communicate a rate request to the Board in a timely manner during a financial emergency.

Reorganization of and Changes to Other Provisions of Regulation A.

Section 201.1 Authority, Purpose and Scope.

The Board's final rule amends this section to include as sources of authority sections 11(i)-11(j) and 14(d) of the Federal Reserve Act, which respectively provide the Board with rulemaking authority and general supervisory authority over the Reserve Banks and authorize the Reserve Banks, subject to the review and determination of the Board, to establish discount rates. This section also gathers all existing provisions concerning the scope of Regulation A into one section by incorporating language from existing § 201.7(a) regarding the circumstances under which U.S. branches and agencies of foreign banks are subject to the regulation.

Section 201.2 Definitions.

This section remains unchanged except for the deletion of five definitions. The definition of "eligible institution" (existing § 201.2(j)) is unnecessary because it related only to the SLF that was established for use during the months surrounding the January 1, 2000, date change. The definition of "targeted federal funds rate" (existing § 201.2(k)) also originally was used only in connection with the SLF. Although the new emergency rate procedure provision also refers to the target federal funds rate, that provision explains precisely what the term means. The Board therefore believes that there is no need to define the term “targeted federal funds rate” in the definition section.

The Board also is deleting the terms “liquidation loss,” “increased loss,” and “excess loss,” (existing § 201.2(d)-(f), respectively). Liquidation loss and increased loss are used to derive the term excess loss, which is the amount the Board would owe the FDIC under section 10B(b) of the Federal Reserve Act if outstanding Reserve Bank advances to a critically undercapitalized depository institution increased the FDIC’s cost of liquidating that institution. Since the enactment of section 10B(b) in 1991, section 10B(b)’s payment provision has not been used. The Board continues to believe that the three definitions describe accurately and in detail the calculations required by section 10B(b) and, should it become necessary in the future, the Board would calculate the amount that it owed to the FDIC in accordance with the methods described in these three definitions. However, because the definitions only describe what the statute already requires, the Board believes that the regulation would be less cumbersome but no less accurate if § 201.5 of the final rule (regarding lending to undercapitalized and critically undercapitalized institutions) simply cross-referenced section 10B(b) of the Federal Reserve Act.

One commenter suggested that the Board amend its definition of “depository institution” to include banker’s banks, which specifically are excluded from the definition under existing Regulation A. The Board previously has determined that the discount window is an appropriate source of liquidity for depository institutions that are subject to reserve requirements, and the definition of the term “depository institution” in Regulation A therefore is based on the provisions in section 19 of the Federal Reserve Act and the Board’s Regulation D regarding those institutions that must maintain reserves. Those sections specifically exempt banker’s banks from maintaining reserves, and because banker’s banks generally avail themselves of that exemption the Board continues to believe that banker’s banks also generally should not have access to the discount window. The Board therefore is not changing its definition of “depository institution” for purposes of Regulation A. However, the Board notes that banker’s banks are free to choose to be subject to the reserve requirements of section 19 of the Federal Reserve Act and Regulation D. The Board previously has allowed Reserve Banks to grant discount window access to a banker's bank that voluntarily maintain reserves, and the Board expects that practice to continue under this final rule.

Section 201.3 General Requirements Governing Extensions of Credit.

The Board is adopting § 201.3 as it appeared in the proposed rule. This section prescribes the Board's general rules governing a Federal Reserve Bank's extension of credit and combines in one place all the existing provisions of Regulation A that relate to the Reserve Bank's authority to extend credit, how credit is extended, and the requirements that apply to extensions of credit. This section states that credit to depository institutions generally will take the form of an advance but preserves a Reserve Bank's discretion to lend through discounting eligible paper if the Reserve Bank determines that a discount would be more appropriate for a particular depository institution. Section 201.3 cross-references the Reserve Banks' authority under section 13A of the Federal Reserve Act to lend to an institution that is part of the farm credit system, and accordingly the Board is deleting existing § 201.8 that deals with that topic.

Section 201.3 preserves existing text of Regulation A stating that a Reserve Bank has no obligation to make, increase, renew, or extend any advance or discount to a depository institution, and that any extension of credit the Reserve Bank chooses to make must be secured to the satisfaction of the Reserve Bank. The collateral policies of the Reserve Banks, as described in the Reserve Banks' Operating Circular No. 8, will remain unchanged. Section 201.3 contains existing text from § 201.4(d) providing that a Reserve Bank should ascertain whether an institution is undercapitalized or critically undercapitalized before extending credit to that institution and includes new text stating that if a Reserve Bank extends credit to such an institution then the Reserve Bank must follow special lending procedures.

Regarding the rules that apply to a borrower's use of central bank credit, § 201.3(d) contains new language that explicitly permits an institution that receives primary credit to use that credit to fund sales of federal funds without Reserve Bank permission. Recipients of secondary or seasonal credit would continue to need Reserve Bank permission to use Reserve Bank credit to fund sales of federal funds. The Board is deleting existing § 201.6(a), which provides that a depository institution may not use Federal Reserve credit as a substitute for capital, because the Board believes that other provisions of the statutes and regulations that it administers adequately address this issue.

Section 201.5 Limitations on Availability and Assessments.

This section is unchanged from the proposed rule and describes the limitations on advances to an undercapitalized or critically undercapitalized depository institution set forth in section 10B(b) of the Federal Reserve Act and also applies those limitations to discounts for such institutions. In addition, § 201.5 discusses section 10B(b)'s requirement that the Board pay a specified amount to the FDIC if a Reserve Bank advance to a critically undercapitalized depository institution increases the loss the FDIC incurs when liquidating that institution. The existing regulation explains in detail through the definitions of "liquidation loss," "increased loss," and "excess loss" how the Board would calculate that amount. As discussed above, the proposed rule would delete these three definitions and simply provide that the Board will assess the Federal Reserve Banks for any amount the Board pays to the FDIC in accordance with section 10B(b) of the Federal Reserve Act.

Technical Amendment to Regulation D.

In connection with its amendments to Regulation A, the Board is adopting a conforming amendment to § 204.7 of Regulation D. This section currently provides that the penalty charge for reserve deficiencies shall be 2 percentage points per year above the lowest rate (generally the adjustment credit rate) in effect for borrowings from the Federal Reserve Bank. In the recent past, the adjustment credit rate has consistently been set 50 basis points below the target federal funds rate, and the reserve deficiency charge therefore has been 150 basis points above the target federal funds rate.

The amendment to § 204.7 will base the charges for reserve deficiencies on the new primary credit rate in Regulation A and will authorize the Reserve Banks to assess charges for reserve deficiencies at a rate of 1 percentage point above the average primary credit rate. Under the revised formula, when the primary credit rate is 100 basis points above the target federal funds rate the reserve deficiency charge will be 200 basis points above the target federal funds rate. The conforming amendment will maintain approximate uniformity between the current and new levels of the deficiency charge.

The Board does not believe the slight difference between the current and new deficiency charge formulas is significant given the infrequency of reserve deficiency charges, the ability of the Reserve Banks to waive the charges under certain circumstances, and the future potential for variations in the spread between the target federal funds rate and the primary credit rate.

Administrative Procedure Act

The provisions of 5 U.S.C. 553(b), relating to notice and public participation, were not followed in connection with the adoption of the technical amendment to Regulation D because this change merely adjusts the penalty charged for reserve deficiencies to conform with the amended borrowing rates of Regulation A, while approximating the current level of the reserve deficiency charge. The Board for good cause finds that delaying the change in the penalty charge for reserve deficiencies in order to allow notice and public comment on the change is unnecessary.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 605(b)), the Board certifies that the amendments to Regulation A will not have a significant adverse economic impact on a substantial number of small entities. The rule will not impose additional requirements on entities affected by the regulation but rather will improve the functioning of the discount window and reduce the administrative costs of obtaining credit at the discount window.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board has reviewed the final rule under the authority delegated to the Board by the Office of Management and Budget. The final rule contains no new collections of information and proposes no substantive changes to existing collections of information pursuant to the Paperwork Reduction Act.

12 CFR Chapter II

List of Subjects in 12 CFR Parts 201 and 204

Banks, banking, Credit, Federal Reserve System, Reporting and recordkeeping.

Authority and Issuance

For the reasons set forth in the preamble, the Board is amending 12 C.F.R. Chapter II to read as follows:

PART 201 EXTENSIONS OF CREDIT BY FEDERAL RESERVE BANKS (REGULATION A)

1. The authority citation for part 201 is revised to read as follows:

Authority: 12 U.S.C. 248(i)-(j), 347a, 347b, 343 et seq., 347c, 348 et seq., 357, 374, 374a, and 461.

2. Sections 201.1 through 201.5 are revised to read as follows:

§ 201.1 Authority, purpose and scope.

(a) Authority. This part is issued under the authority of sections 10A, 10B, 11(i), 11(j), 13, 13A, 14(d), and 19 of the Federal Reserve Act (12 U.S.C. 248(i)-(j), 347a, 347b, 343 et seq., 347c, 348 et seq., 357, 374, 374a, and 461).

(b) Purpose and scope. This part establishes rules under which a Federal Reserve Bank may extend credit to depository institutions and others. Except as otherwise provided, this part applies to United States branches and agencies of foreign banks that are subject to reserve requirements under Regulation D (12 CFR part 204) in the same manner and to the same extent as this part applies to depository institutions. The Federal Reserve System extends credit with due regard to the basic objectives of monetary policy and the maintenance of a sound and orderly financial system.

§ 201.2 Definitions. For purposes of this part, the following definitions shall apply:

(a) Appropriate federal banking agency has the same meaning as in section 3 of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1813(q)).

(b) Critically undercapitalized insured depository institution means any insured depository institution as defined in section 3 of the FDI Act (12 U.S.C. 1813(c)(2)) that is deemed to be critically undercapitalized under section 38 of the FDI Act (12 U.S.C. 1831o(b)(1)(E)) and its implementing regulations.

(c)(1) Depository institution means an institution that maintains reservable transaction accounts or nonpersonal time deposits and is:

(i) An insured bank as defined in section 3 of the FDI Act (12 U.S.C. 1813(h)) or a bank that is eligible to make application to become an insured bank under section 5 of such act (12 U.S.C. 1815);

(ii) A mutual savings bank as defined in section 3 of the FDI Act (12 U.S.C. 1813(f)) or a bank that is eligible to make application to become an insured bank under section 5 of such act (12 U.S.C. 1815);

(iii) A savings bank as defined in section 3 of the FDI Act (12 U.S.C. 1813(g)) or a bank that is eligible to make application to become an insured bank under section 5 of such act (12 U.S.C. 1815);

(iv) An insured credit union as defined in section 101 of the Federal Credit Union Act (12 U.S.C. 1752(7)) or a credit union that is eligible to make application to become an insured credit union pursuant to section 201 of such act (12 U.S.C. 1781);

(v) A member as defined in section 2 of the Federal Home Loan Bank Act (12 U.S.C. 1422(4)); or

(vi) A savings association as defined in section 3 of the FDI Act (12 U.S.C. 1813(b)) that is an insured depository institution as defined in section 3 of the act (12 U.S.C. 1813(c)(2)) or is eligible to apply to become an insured depository institution under section 5 of the act (12 U.S.C. 15(a)).

(2) The term "depository institution" does not include a financial institution that is not required to maintain reserves under § 204.1(c)(4) of Regulation D (12 CFR 204.1(c)(4)) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does business, and does not do business with the general public.

(d) Transaction account and nonpersonal time deposit have the meanings specified in Regulation D (12 CFR part 204).

(e) Undercapitalized insured depository institution means any insured depository institution as defined in section 3 of the FDI Act (12 U.S.C. 1813(c)(2)) that:

(1) Is not a critically undercapitalized insured depository institution; and

(2)(i) Is deemed to be undercapitalized under section 38 of the FDI Act (12 U.S.C. 1831o(b)(1)(C)) and its implementing regulations; or

(ii) Has received from its appropriate federal banking agency a composite CAMELS rating of 5 under the Uniform Financial Institutions Rating System (or an equivalent rating by its appropriate federal banking agency under a comparable rating system) as of the most recent examination of such institution.

(f) Viable, with respect to a depository institution, means that the Board of Governors or the appropriate federal banking agency has determined, giving due regard to the economic conditions and circumstances in the market in which the institution operates, that the institution is not critically undercapitalized, is not expected to become critically undercapitalized, and is not expected to be placed in conservatorship or receivership. Although there are a number of criteria that may be used to determine viability, the Board of Governors believes that ordinarily an undercapitalized insured depository institution is viable if the appropriate federal banking agency has accepted a capital restoration plan for the depository institution under 12 U.S.C. 1831o(e)(2) and the depository institution is complying with that plan.

§ 201.3 Extensions of credit generally.

(a) Advances to and discounts for a depository institution.

(1) A Federal Reserve Bank may lend to a depository institution either by making an advance secured by acceptable collateral under § 201.4 of this part or by discounting certain types of paper. A Federal Reserve Bank generally extends credit by making an advance.

(2) An advance to a depository institution must be secured to the satisfaction of the Federal Reserve Bank that makes the advance. Satisfactory collateral generally

includes United States government and federal-agency securities, and, if of acceptable quality, mortgage notes covering one- to four-family residences, state and local government securities, and business, consumer, and other customer notes.

(3) If a Federal Reserve Bank concludes that a discount would meet the needs of a depository institution or an institution described in section 13A of the Federal Reserve Act (12 U.S.C. 349) more effectively, the Reserve Bank may discount any paper indorsed by the institution, provided the paper meets the requirements specified in the Federal Reserve Act.

(b) No obligation to make advances or discounts. A Federal Reserve Bank shall have no obligation to make, increase, renew, or extend any advance or discount to any depository institution.

(c) Information requirements.

(1) Before extending credit to a depository institution, a Federal Reserve Bank should determine if the institution is an undercapitalized insured depository institution or a critically undercapitalized insured depository institution and, if so, follow the lending procedures specified in § 201.5.

(2) Each Federal Reserve Bank shall require any information it believes appropriate or desirable to ensure that assets tendered as collateral for advances or for discount are acceptable and that the borrower uses the credit provided in a manner consistent with this part.

(3) Each Federal Reserve Bank shall:

(i) Keep itself informed of the general character and amount of the loans and investments of a depository institution as provided in section 4(8) of the Federal Reserve Act (12 U.S.C. 301); and

(ii) Consider such information in determining whether to extend credit.

(d) Indirect credit for others. Except for depository institutions that receive primary credit as described in § 201.4(a), no depository institution shall act as the medium or agent of another depository institution in receiving Federal Reserve credit except with the permission of the Federal Reserve Bank extending credit.

§ 201.4 Availability and terms of credit.

(a) Primary credit. A Federal Reserve Bank may extend primary credit on a very short-term basis, usually overnight, as a backup source of funding to a depository institution that is in generally sound financial condition in the judgment of the Reserve Bank. Such primary credit ordinarily is extended with minimal administrative burden on the borrower. A Federal Reserve Bank also may extend primary credit with maturities up to a few weeks as a backup source of funding to a depository institution if, in the judgment of the Reserve Bank, the depository institution is in generally sound financial condition and cannot obtain such credit in the market on reasonable terms. Credit extended under the primary credit program is granted at the primary credit rate.

(b) Secondary credit. A Federal Reserve Bank may extend secondary credit on a very short-term basis, usually overnight, as a backup source of funding, to a depository institution that is not eligible for primary credit if, in the judgment of the Reserve Bank, such a credit extension would be consistent with a timely return to a reliance on market funding sources. A Federal Reserve Bank also may extend longer-term secondary credit if the Reserve Bank determines that such credit would facilitate the orderly resolution of serious financial difficulties of a depository institution. Credit extended under the secondary credit program is granted at a rate above the primary credit rate.

(c) Seasonal credit. A Federal Reserve Bank may extend seasonal credit for periods longer than those permitted under primary credit to assist a smaller depository institution in meeting regular needs for funds arising from expected patterns of movement in its deposits and loans. An interest rate that varies with the level of short-term market interest rates is applied to seasonal credit.

(1) A Federal Reserve Bank may extend seasonal credit only if:

(i) The depository institution's seasonal needs exceed a threshold that the institution is expected to meet from other sources of liquidity (this threshold is calculated as a certain percentage, established by the Board of Governors, of the institution's average total deposits in the preceding calendar year); and

(ii) The Federal Reserve Bank is satisfied that the institution's qualifying need for funds is seasonal and will persist for at least four weeks.

(2) The Board may establish special terms for seasonal credit when depository institutions are experiencing unusual seasonal demands for credit in a period of liquidity strain.

(d) Emergency credit for others. In unusual and exigent circumstances and after consultation with the Board of Governors, a Federal Reserve Bank may extend credit to an individual, partnership, or corporation that is not a depository institution if, in the judgment of the Federal Reserve Bank, credit is not available from other sources and failure to obtain such credit would adversely affect the economy. If the collateral used to secure emergency credit consists of assets other than obligations of, or fully guaranteed as to principal and interest by, the United States or an agency thereof, credit must be in the form of a discount and five or more members of the Board of Governors must affirmatively vote to authorize the discount prior to the extension of credit. Emergency credit will be extended at a rate above the highest rate in effect for advances to depository institutions.

§ 201.5 Limitations on availability and assessments.

(a) Lending to undercapitalized insured depository institutions. A Federal Reserve Bank may make or have outstanding advances to or discounts for a depository institution that it knows to be an undercapitalized insured depository institution, only:

(1) If, in any 120-day period, advances or discounts from any Federal Reserve Bank to that depository institution are not outstanding for more than 60 days during which the institution is an undercapitalized insured depository institution; or

(2) During the 60 calendar days after the receipt of a written certification from the chairman of the Board of Governors or the head of the appropriate federal banking agency that the borrowing depository institution is viable; or

(3) After consultation with the Board of Governors. In unusual circumstances, when prior consultation with the Board is not possible, a Federal Reserve Bank should

consult with the Board as soon as possible after extending credit that requires consultation under this paragraph.

(b) Lending to critically undercapitalized insured depository institutions. A Federal Reserve Bank may make or have outstanding advances to or discounts for a depository institution that it knows to be a critically undercapitalized insured depository institution only:

(1) During the 5-day period beginning on the date the institution became a critically undercapitalized insured depository institution; or

(2) After consultation with the Board of Governors. In unusual circumstances, when prior consultation with the Board is not possible, a Federal Reserve Bank should consult with the Board as soon as possible after extending credit that requires consultation under this paragraph.

(c) Assessments. The Board of Governors will assess the Federal Reserve Banks for any amount that the Board pays to the FDIC due to any excess loss in accordance with section 10B(b) of the Federal Reserve Act. Each Federal Reserve Bank shall be assessed that portion of the amount that the Board of Governors pays to the FDIC that is attributable to an extension of credit by that Federal Reserve Bank, up to 1 percent of its capital as reported at the beginning of the calendar year in which the assessment is made. The Board of Governors will assess all of the Federal Reserve Banks for the remainder of the amount it pays to the FDIC in the ratio that the capital of each Federal Reserve Bank bears to the total capital of all Federal Reserve Banks at the beginning of the calendar year in which the assessment is made, provided, however, that if any assessment exceeds 50 percent of the total capital and surplus of all Federal Reserve Banks, whether to distribute the excess over such 50 percent shall be made at the discretion of the Board of Governors.

3. Sections 201.6. 201.7, 201.8, and 201.9 are removed.

4. Section 201.51 is revised to read as follows:

§ 201.51 Interest rates applicable to credit extended by a Federal Reserve Bank.

(a) Primary credit. The rate for primary credit provided to depository institutions under § 201.4(a) is a rate above the target federal funds rate of the Federal Open Market Committee.

(b) Secondary credit. The rate for secondary credit extended to depository institutions under § 201.4(c) is a rate above the primary credit rate.

(c) Seasonal credit. The rate for seasonal credit extended to depository institutions under § 201.4(b) is a flexible rate that takes into account rates on market sources of funds.

(d) Primary credit rate in a financial emergency.

(1) The primary credit rate at a Federal Reserve Bank is the target federal funds rate of the Federal Open Market Committee if:

(i) In a financial emergency the Reserve Bank has established the primary credit rate at that rate; and

(ii) The Chairman of the Board of Governors (or, in the Chairman's absence, his authorized designee) certifies that a quorum of the Board is not available to act on the Reserve Bank's rate establishment.

5. Section 201.52 is removed.

PART 204 RESERVE REQUIREMENTS OF DEPOSITORY INSTITUTIONS (REGULATION D)

1. The authority citation for part 204 continues to read as follows:

Authority: 12 U.S.C. 248(a), 248(c), 371a, 461, 601, 611, and 3105.

2. Amend § 204.7 by revising the second sentence of paragraph (a)(1) to read as follows:

§ 204.7 Penalties.

(a) ***

(1) *** Federal Reserve Banks are authorized to assess charges for deficiencies in required reserves at a rate of 1 percentage point per year above the primary credit rate, as

provided in § 201.51(a), in effect for borrowings from the Federal Reserve Bank on the first day of the calendar month in which the deficiencies occurred. ***
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By order of the Board of Governors of the Federal Reserve System, October xx, 2002.

Jennifer J. Johnson
Secretary of the Board.
BILLING CODE 6210-01-P