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Public Reaction to the Proposed Changes in the Operation of Federal Reserve Discount Facility

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at the

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of

The American Bankers Association

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My purpose in appearing before you today is to review the comments we have received on the proposal published last summer to revise the regulation governing discounting at Federal Reserve Banks.

The majority of written comments received was clearly in favor of the proposal or some close variant. The volume of comment was larger than usual for a proposed System regulatory action. The typical letter praised the Federal Reserve for undertaking a study--which some suggested was long overdue--offered a general endorsement of the results, and then presented a few comments, objections and/or suggestions for change with regard to specific aspects of the proposal.

Some respondents, however, raised questions concerning the Federal Reserve's motives in proposing the redesign. Was it simply a scheme to gain members? Was the System trying to make member banks more dependent on the discount window, with the goal of exerting stronger influence over their operations, perhaps through selective credit controls? The answer, incidentally, to both of these comments is "no," even though I would admit to trying to make membership more attractive on many fronts, including this one.

The probable effect of the proposed changes on overall monetary policy was a topic of interest to many commentators, but there was little consistency in the views expressed. A few respondents suggested that the generally more liberal standards for discounting were inherently inflationary. Others, while not fearing any long-run inflationary impact, expressed concern at the additional lag which any no-questions-asked credit, even on a limited basis, might introduce. In the response of the market to monetary policy moves this could be troublesome when the System was trying to move toward a more restrictive policy stance.

At the other end of the spectrum, respondents predicted that the proposals would not complicate or dilute the effectiveness of monetary action but would, in fact, complement it and smooth its impact. Several academics stressed the fact that the proposal as a whole would probably shift an increasing part of the burden for day-to-day reserve adjustment to the individual member bank. This would tend to relieve open market desk of some of the responsibility for accommodating short-run fluctuations in reserve needs and allow it to give increased attention to longer-run objectives.

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Probably the greatest expressed concern as regards money market implications involved the Federal funds market. Numerous respondents felt that greater availability of discount credit would cause a significant contraction in funds activity. This possibility was felt to be small, however, by a majority of the special American Bankers Association committee commenting on the proposals. There was some concern that the restriction on bank sales of Federal funds while using the basic borrowing privilege might adversely affect the funds markets, but the more important question here seemed to be the impact on an individual bank's flexibility of operation.

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More frequent changes in the discount rate were generally endorsed by respondents, although several urged the changes not be automatic and the increment of change not be too small. Some respondents expressed an interest in the use of a differential, or penalty, discount rate as a deterring influence on the use of other adjustment credit above some amount, and advocated seeking the enabling legislation.

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The principle of a basic borrowing privilege, providing credit on a no-questions-asked basis, was widely endorsed by respondents. It was predicted that such a move toward more objectively defined discount window access would increase the usefulness of the window for member banks and help to promote uniformity of operations among the various Districts.

Reservations voiced regarding the general principle fell into two categories: (1) concern for effective monetary management if there were virtually automatic credit access limited only by rate, and (2) some skepticism, chiefly among smaller banks, as to whether access would in practice prove to be automatic, and if it did, whether its use would result in the bank becoming more dependent upon the Federal Reserve and thus more subject to its control.

The graduation in the basic borrowing privilege formula, granting relatively larger privileges to smaller banks, was commented on in the responses of most of the larger banks. A few questioned the equity of the differential arrangement. Others noted that their basic borrowing privilege would be too small to be of any regular significance to them in making reserve adjustments, although many implied that they would use such credit as was available under the program.

However, in general these banks were not seriously disturbed by the principle that smaller banks be given relatively larger privileges, and several specifically supported this principle as being consistent with the greater flexibility of large banks. This endorsement generally hinged on the availability of discount credit, under whatever name, to them when and in the amounts needed for temporary adjustment purposes. In some cases, these respondents did suggest changes to increase somewhat their own basic borrowing privileges, but these remarks were frequently followed by an alternative: "or define more clearly the conditions under which other adjustment credit will be available."

Several medium-sized banks commented more strongly on the equity of the graduated formula. They pointed out that they did not enjoy the ready access to market sources of funds of the large banks but were being similarly limited in their privilege access.[1/] Contributing to this concern was a more skeptical attitude on the part of these banks toward the probable availability of other adjustment credit. While often calling for more explicit guidelines as to its use, the money-market

1/ The amount of the maximum basic borrowing tranche suggested was 40 per cent of the first million of capital and surplus and 20 per cent of the next nine million. Beyond 10 million all banks are treated alike at 10 per cent.

banks generally seemed confident that they would have the access to this credit that they needed. Medium-sized banks, on the other hand, tended more to regard the basic borrowing privilege as the limit of discount credit they could expect under any normal conditions.

There was widespread dissatisfaction with the proposed use of capital stock and surplus as a base in calculating the basic borrowing privilege. The most frequent suggestion for change was for a broader capital measure, specifically the inclusion of undivided profits. However, still more strongly supported arguments were offered, albeit by somewhat fewer respondents, for the use of required reserves. The chief reason cited for such a change was that required reserves bear a clearer and more direct relationship to a bank's probable need for adjustment credit than does any capital measure.

While not widespread, some concern was expressed regarding the requirement that a bank be in satisfactory internal condition to be eligible for the basic borrowing privilege. No one said that a bank in clearly unsatisfactory condition should have unquestioned access to discount credit. Rather the concern was expressed at the methods that might be employed in determining eligibility and some saw the potential of discriminatory requirements.

The second qualifying condition for the basic borrowing privilege, the prohibition of net sales of Federal funds while borrowing, as I noted earlier, also caused some concern. In the present context some said that the condition, if rigidly enforced, could inhibit the flexibility of member banks in responding to developing conditions, in their own positions and in the market. At least one money market bank also questioned the logic of singling out Federal funds transactions from among the various means of short-term adjustment in the money market.

The other aspects of the proposal--the seasonal borrowing privilege and emergency credit assistance--drew only limited comments. The small amount of comment on the seasonal borrowing privilege may be traceable to the technicalities of measuring eligibility. The great majority of banks seem to have assumed, accurately or perhaps because of confusion as to the specifications, that they would not be eligible for a seasonal borrowing privilege. It is perhaps significant, however, that so few of these banks expressed any opposition to the extension of such a privilege to other banks which might demonstrate a qualifying need.

The failure of most respondents to comment on the emergency credit arrangements should be interpreted as tacit approval of this very necessary provision. Some opposition has been expressed to the extension of emergency credit to nonmember financial institutions, but in almost all cases by respondents who clearly feared a significantly more liberal policy on the availability of such credit than was intended.

As noted earlier, the great majority of respondents viewed the proposals for redesign as a significant move toward increasing the usefulness of the discount window to the member bank. However, an almost equally significant group were of the opinion that two relatively serious problems exist in current discount window operations which are not touched upon by the proposals. The first of these is the relatively narrow collateral restrictions on advances to member banks at the discount rate. Liberalizing these collateral restrictions would require legislation and was not incorporated in the current discount proposals for this reason. However, responses stress the concern on this matter among bankers and emphasize the need to continue to press for the required statutory change.

The second of these problems concerned the mechanics of borrowing. Numerous respondents pointed out that borrowing at the discount window, with the requirements of submitting a note and in some Districts an application form as well and pledging specific collateral, was far more cumbersome than, for instance, buying funds in the Federal funds market. They questioned why this should be so and predicted that unless borrowing at the window were simplified they would probably continue to obtain needed funds elsewhere in spite of other offsetting advantages which might attach to a redesigned discount mechanism.

Numerous suggestions, of widely varying feasibility, were made for simplifying current procedures. Among the more practical were suggestions that application forms be eliminated in the Districts where they are still used and that a continuing loan agreement be executed between Reserve Bank and member bank to replace the individual notes now required. Several respondents felt that the basic borrowing privilege would provide an ideal opportunity for eliminating virtually all the "red tape" presently involved in borrowing and urged that credit within the privilege limits be granted on an unsecured basis. This latter suggestion also would require legislative change.

The generally favorable tone of the comments received has convinced us that the overall design of the original proposal is one which will work well and be of significant benefit to the individual member bank and the banking system in general. Therefore, we are planning no major changes in that design. On the other hand, some of the suggestions received on various more specific aspects of the proposal have led us to conclude that certain changes would represent improvements.

Several of the suggestions received and the changes which they have led us to favor I can comment on very briefly. It does seem to me, after further study and reflection in light of the preponderance of comments received, that required reserves are a better base for measuring the basic borrowing privilege than capital and surplus or capital and surplus plus undivided profits. There are some technical difficulties but they do not, in my opinion, outweigh the more direct relationship of needs for adjustment funds to required reserves. And from an equity standpoint, the reserve measure takes into account the significant differences that presently exist in reserve requirements.

As to the size of the basic borrowing privilege, I am inclined toward the top of the range of the limits proposed, on the grounds that as large a share of total discounting as possible should be on a more certain and market-oriented basis. I agree with the ABA Committee finding that, within the ranges proposed, loss of monetary control is highly unlikely, given the continuous flow of information on changes in the nature and extent of discount window use and the ability of open market operations to adapt to such changes.

I would like to comment more extensively on several other issues raised by the comments. The two requiring the most attention, it seems to me, are the relationship of the redesigned discount mechanism to the Federal funds market and the administration of other adjustment credit.

One of two qualifying conditions to be applied to the basic borrowing privilege was an administrative rule that a bank should not be a net seller of Federal funds in the same reserve week in which it is borrowing from its Reserve Bank. Exceptions to this rule, which is a continuation of a policy presently in force, were to be allowed in cases of infrequent transactions that result from miscalculations or large, unforeseen movements in the bank's position. Its general enforcement was deemed necessary, however, to guard against a large day-to-day retailing operation in Federal Reserve credit obtained through the discount window.

The intent of the restriction was not to discourage or curtail activities in the Federal funds market, and the exception noted earlier was to be allowed in recognition of the possibility of changes in a bank's overall position during the reserve week which could make it difficult for the bank to maintain its intended

Federal funds position. Thus a bank which normally bought funds would not be penalized if, during a week in which it used its basic borrowing privilege, unforeseen circumstances developed which made it necessary for it to reverse its normal practice and sell more funds than it bought. Conversely, if a bank were a net seller of funds on a regular basis, more typically true of the fairly small banks, it would not be denied access to its basic borrowing privilege on an infrequent basis because of its record of funds activity.

What needs to be precluded is a regular practice on the part of a bank of using the basic borrowing privilege and selling funds on a net basis simultaneously. None of the comments received seemed to reflect a belief that this should be allowed; the concern was rather with the possibility that, with a strictly enforced restriction, a bank would be prevented from responding in a flexible way to conditions as they develop in its own position and in the funds market in order to preserve access to the basic borrowing privilege.

The practice of selling funds while borrowing at the discount window could be effectively discouraged by a discount rate above the Federal funds rate, as a number of respondents suggested. However, it is highly doubtful that, under current circumstances, such a rate relationship could be maintained with the required consistency. It is therefore probably appropriate that the Federal funds restriction be retained as an administrative rule, but that it be liberalized somewhat so as to address itself chiefly to banks which repeatedly use the basic borrowing privilege while selling Federal funds on a net basis.

Turning to the second of these two issues, the report published last July described "other adjustment credit" as "credit to meet needs larger in amount or longer in duration than could be accommodated under the basic borrowing privilege." It stated that this credit would be "subject to administrative procedures broadly similar to those which have been progressively developed in recent years under existing discount arrangements."

Comments received on this provision were often tied in with reactions to the basic borrowing privilege, its adequacy for day-to-day adjustment needs and probable needs for credit in excess of these limits. Within this context, concern was expressed by a number of bankers that reflects dissatisfaction with current discount procedures and thus with the intention that they be continued in the form of other adjustment credit. Comments were also received suggesting that the introduction of a basic borrowing privilege might in practice lead to a more restrictive administration of other adjustment credit than prevails under existing discount practices.

This concern is apparently somewhat more prevelant among small and medium-sized banks; as a rule large banks are more satisfied with current practices and less apprehensive concerning the availability of other adjustment credit. Banks from all size categories called for a more explicit articulation of the terms and conditions attaching to other adjustment credit, often fearing that the relatively vague provisions presently set forth in the report would prove conducive to nonuniformities in this aspect of discount administration among the various Districts.

Articulation of specific guidelines for the use of other adjustment credit could, however, run the risk of undermining the flexibility which is vital if the discounting mechanism as a whole is to be adequately responsive to the widely varying and often unforeseeable credit needs of banks. Consequently, the problems of access to other adjustment credit as seen by banks are probably best dealt with in general terms, making use of specific cases as they arise in actual operation to achieve consistency in theory and treatment.

There are, however, certain aspects of other adjustment credit, involving the application of general principles, which may benefit from further elaboration. One such issue, identified by the American Bankers Association Committee, is the relevance of past use of the basic borrowing privilege in evaluating a bank's borrowing under the other adjustment credit provision.

The proposal is clear in its intent that--except for the restriction on net sales of Federal funds--banks are to be allowed to use the credit available under the basic borrowing privilege as they see fit without challenge from the Federal Reserve discount officer. When a bank's borrowing exceeds these limits, the availability of credit would be based on an appraisal of the bank's adjustment needs regardless of its use of the basic borrowing privilege.

The situation is fairly clear-cut when a credit need is so large as to give immediate rise to the use of other adjustment credit. In such a case, past use of the basic borrowing privilege would be clearly irrelevant. The availability of other adjustment credit would be based on an appraisal of the appropriateness of the credit extension in assisting the bank in meeting temporary requirements or cushioning more persistent outflows pending an orderly adjustment of its assets and liabilities.

The situation becomes less clear-cut and may need to be treated differently administratively when the use of other adjustment credit represents a continuing borrowing for a need already met for a time by use of the basic borrowing privilege. Such borrowing needs and projections might be well understood by the discount officer on the basis of information available through regular reporting procedures unrelated to use of the basic borrowing privilege, and a planned adjustment may already have been initiated by the bank. If and when such information is, in the judgment of the discount officer, insufficient as a basis for evaluating the appropriatness of the "other adjustment" borrowing, a contact with the bank to ascertain the circumstances surrounding the borrowing and the prospects for adjustment may be made. In some cases, a credit request upon exhaustion of the basic borrowing privilege credit access may be the occasion for such contact.

In any case, the basis of an administrative contact would not be prior use of the basic borrowing privilege. It would rather result if the underlying facts suggested that the need for adjustment has already been in existence for a period of time. The question is whether the bank can realistically regard the need as temporary and destined to correct itself promptly or whether sufficient attention has been given to appropriate steps which might be taken to bring about the necessary adjustment.

A further set of circumstances might be identified in which a bank has been using the basic borrowing privilege for a purpose which, while unchallengeable within those limits, does not provide a justifiable reason for continued extension of Federal Reserve credit in the form of other adjustment credit. If such a borrowing does exceed the limits of the privilege, a plan for early adjustment should be requested. Such a request would likewise be forthcoming quite early in the borrowing span under current procedures, although it might be moved up slightly under the redesign (measuring from the use of other adjustment credit) simply because the situation might be easier to spot if the bank has already been borrowing. However, any such speed-up would reflect primarily improved intelligence rather than a change in policy. Further, the contact would not be an occasion for questioning the use of the basic borrowing privilege for the purpose in question, but should be based solely on the inappropriateness of the present supplemental borrowing.

This philosophy may at times prove rather difficult to communicate and to apply. Situations will seldom fall into the neat categories discussed above. However, reference to the basic principles described still seems the most justifiable and workable means of carrying out the intent of the proposal.

One last area in which we've made some changes in the proposal is the seasonal borrowing privilege. As I indicated earlier, relatively few comments were addressed to this aspect of the redesign. Large banks in general regard it as inapplicable to their own situations and have for the most part ignored it. Specific comment from smaller banks regarding the seasonal borrowing privilege has also been rather limited, but in general terms small banks, particularly in agricultural and resort areas, have applauded the principle of more liberal seasonal credit at the discount window. A number of them regard the current proposal as excessively complex.

This pattern of comment is consistent with the intention, implicit in the report, that the seasonal borrowing privilege be essentially a small bank provision with the chief purpose of improving the ability of rural unit banks, limited in access to outside sources of credit, to serve communities with relatively narrow and undiversified economic bases. No special provisions were included in the proposal to preclude larger banks from using the privilege, providing that the fluctuations in their net fund availability met the adopted specifications.

However, our own statistical work on potential seasonal needs has raised the possibility that larger banks could on occasion qualify for seasonal privileges under the published specifications. While the comments certainly do not suggest any major interest on their part in obtaining such privileges, our results would seem to create some question as to whether the proposal is, in its current form, appropriately designed to serve its basic purpose.

We propose several changes in the specifications to minimize this possible problem. First, we plan to set the "deductible" percentage (the part of a seasonal need which a bank must meet out of its own resources) at the more liberal 5 per cent of total deposits. At the same time we plan to lengthen to 60 days the minimum duration of a qualifying seasonal need. This is felt to be consistent with the fact that, in general, small banks experience seasonal swings of somewhat longer duration than do large banks. It also seems consistent with the concept of somewhat longer-term needs for which the seasonal privilege was designed.

A further change would incorporate in the measure of "fund availability" used to measure seasonal needs a "local loan" concept. In general banks would count in the establishment of qualification only customer loans arising out of the needs of locally situated borrowers. This would focus the seasonal privilege directly on community banks without ready access to outside sources of funds and subject to large swings in deposits and loan demand keyed to the local economy, as was intended in the proposal.

You will recognize, I believe, that the comments received have dealt primarily with detailed aspects of the proposal and with certainty of understanding of our intent. The semantic difficulties of a borrower-lender relationship cannot be underestimated and I hope we can make our lending terms crystal clear. I feel encouraged that the philosophy in the broad design of the original proposal has been so widely accepted.

That broad design reflects the long-standing central bank attitude that the discount window is a source of temporary adjustment credit only. Federal Reserve credit, via the discount window, is not long-term credit even in seasonal and emergency categories. In these instances, the window does no more than assist the member bank in meeting temporary fluctuations in fund availability, pending an expected seasonal turn around or, in more critical circumstances, a basic institutional or portfolio adjustment.

On the other hand, the proposed redesign does include some significant departures from past practices. We hope one of the most useful of these will be the introduction of as much certainty as possible into borrowing arrangements. We intend through this means to avoid the use of uncertainty on ensuing reluctance to borrow as a control factor over the level or frequency of borrowing--something that we all know has played a significant part in bank use of the window in the past.

In a related vein, the redesigned window would use the discount rate more flexibly and deliberately as a deterrent or non-deterrent to borrowing. Such use should contribute to the introduction of greater certainty as to the changing thrust of monetary policy, and also should confine the announcement effects of discount rate changes, so far as is feasible, to cases where such effects are intended.

Another aspect of the proposal, one which I have neglected largely because it has met with general acceptance, is a broader and more explicit recognition than heretofore of the Federal Reserve System's role in supplying liquidity to the financial community at large in general emergency situations. This shift in posture may not seem important because the contingency is remote but recent experience suggests that the System's preparedness to undertake such an operation, should the need ever arise, could be a vital factor in restoring stability to the workings of the financial markets and institutions.

Lastly, I might also note that, while we hope and expect that the proposed redesign will contribute to the smoother and more effective functioning of the banking system, and thereby promote more effective monetary policy, its impact per se on overall monetary conditions should be neutral. We expect a somewhat larger share of reserve injection through the discount window to result, but adjustments in open market operations will maintain the desired overall credit availability under changing economic conditions.