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Statement of

George W. Mitchell,

Member, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

on the

Report of the System Steering Committee on Reappraisal of the Federal Reserve Discount Mechanism--Its Rationale and Implications

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Mr. Chairman:

I am glad to appear before this Committee today to discuss the recently released Federal Reserve report proposing changes in lending facilities for member banks. The studies and research on which the Report is based were undertaken to be sure our lending operations--popularly called our discount mechanism--were appropriate to present-day banking institutions and environment. To be more effective in meeting changing community credit needs, commercial banks need central bank assistance as well as supervision. We are pleased to discuss our findings with you.

The redesign suggested by the Report would represent the latest in a series of evolutionary changes in Federal Reserve lending policies and procedures. When first established by the Federal Reserve Act in 1913, the discount mechanism was expected to operate by member banks presenting certain types of short-term customer notes (termed "eligible paper") as collateral for borrowing at the Reserve Banks. During most of the first twenty years of Federal Reserve operation, member banks borrowed a sizable proportion of their total required reserves on the security of such customer notes.

After 1934, however, member banks accumulated large amounts of Government securities and other liquid assets; accordingly, they did very little borrowing from their Federal Reserve Banks, and collateralized such borrowing as they did with Government securities. This marginal role for the discount window was formally recognized in a change in 1955 in the Board's Regulation A covering loans to member banks; under that revision, bank borrowings from the Federal Reserve were to be limited to assistance over the peaks of temporary, seasonal or emergency needs for funds that exceeded the dimensions that the banks could reasonably be expected to meet out of their own resources.

In the last decade or so, however, credit demands on banks have grown and loan-to-deposit ratios are much higher, rising from 47% to 60%. Moreover, at many banks portfolio management has pared liquidity positions substantially, and borrowings from sources other than the Federal Reserve have expanded. In addition, a small but growing number of banks has also been led to withdraw from membership in the Federal Reserve System, chiefly in order to avoid reserve requirements and thus enable them to invest a greater portion of their resources in earning assets. In view of these developments, the proposed redesign of the discount mechanism is aimed at relating Federal Reserve lending more clearly and closely to the changing banking and community needs.

Before I outline the new proposals which have been made for our lending facilities, it might be well for me to mention three long-standing basic principles of Federal Reserve lending that were reaffirmed by our study.

First among these is that Federal Reserve credit is extended primarily to accommodate bank asset and liability adjustments over limited time periods and to meet essentially short-term fluctuations in member bank needs for funds.

The second principle reaffirmed, however, is that Federal Reserve Banks always stand ready to lend to any of their member banks caught in special regional or local adversities--such as droughts, drastic deposit drains, or other emergencies--for as long as reasonably needed for the bank to work out of these circumstances.

Thirdly, the report recognizes that the Federal Reserve serves as "lender of last resort" to buttress the entire financial system in the event of widespread emergency. Within the limits of existing law, and lending primarily through member banks as intermediaries, the Federal Reserve is prepared to supply liquid funds to other types of financial institutions when such assistance is not available elsewhere and is necessary to avoid major economic disruption.

Along with these continuing principles, the Report suggests several modifications of lending operations to better serve emerging needs. Let me summarize the main new suggestions briefly, and then outline each one in somewhat greater detail.

To provide more clear-cut access to Federal Reserve lending facilities, the report proposes that each soundly operated member bank be given a "basic borrowing privilege," enabling it to borrow up to a specified limit from its Reserve Bank upon request in as much as half of its weekly reserve periods.

In addition, it is proposed that any member bank foreseeing large seasonal bulges in its needs for funds would be able to arrange for loans from its Reserve Bank to meet such needs in excess of a specified minimum. This arrangement, more explicit and more liberal than currently provided, is termed the "seasonal borrowing privilege."

Member banks experiencing drains of funds that are not of a seasonal or emergency nature, but that are bigger or longer in duration than can be accommodated under the new "basic borrowing privilege," could also arrange for additional credit pending an expected and timely reversal of their fund outflows or an orderly adjustment of their assets and liabilities. Such borrowings would be subject to essentially the same kinds of administrative procedures now applied to similar situations.

A final innovation proposed by the report is to make the discount rate--the interest rate charged by Federal Reserve Banks on their loans to member banks--more flexible than heretofore. It is recommended in the Report that the discount rate be changed considerably more frequently and by smaller amounts, keeping it reasonably closely in line with the movements in other money market rates.

The most commonly used of the new lending provisions for member banks in sound condition would undoubtedly be the basic borrowing privilege. The size of each bank's basic borrowing privilege would be established as a proportion of some base drawn from the bank's balance sheet; the current proposal suggests capital stock and surplus. Frequency of use of the basic borrowing privilege would also be limited. This is necessary because Federal Reserve credit is not properly a long-term or permanent addition to the loanable funds of individual member banks. The aim is to make credit available over a long enough period to cushion the bulk of short-term fluctuations or portfolio adjustments and in most cases permit orderly adjustment to longer-term movements of funds.

The proposed frequency limitation would allow assured and virtually automatic access to credit so long as the bank is indebted in no more than half the reserve periods in the specified interval.

Before the plan is finally made effective, choices will be made in the light of comments received as to the particular percentages which would apply to the amount and frequency limitations. The considerations will be that individual credit access should not be so small or so infrequently available as to be insignificant to the member banks, nor should total access be so liberal as to interfere with Federal Reserve open market operations aimed at carrying out national credit policy objectives.

Borrowing within the basic borrowing privilege limitations could, as noted, take place virtually upon request, unless the Reserve Bank had notified the member bank that its over-all condition was unsatisfactory as determined by such factors as adequacy of capital, liquidity, soundness, management, or non-compliance with law or regulation and that such unsatisfactory condition was not being corrected to the Reserve Bank's satisfaction. The only other circumscription on the actions of a qualified borrowing bank would be the avoidance of net sales in the Federal funds market during the reserve periods in which it was borrowing from the Federal Reserve. This administrative rule, already in force, is retained in the new proposal in the interest of precluding retailing operations in Federal Reserve credit obtained through the discount window.

It is recognized that the basic borrowing privilege would not be large enough to encompass every member bank's needs for funds in all instances that justify the use of discount credit. This is particularly true in cases of the larger banks which borrow infrequently but for rather large amounts, but it is also true in cases of smaller banks faced with sharp temporary drains of funds. Arrangements are therefore recognized as necessary to permit member bank borrowings outside the basic borrowing privilege up to the limits of appropriate needs on as convenient and understandable terms as possible. These arrangements, referred to in the Report as "other adjustment credit," would be available pending an expected and timely reversal of fund outflows or an orderly portfolio adjustment. Such borrowings would be subject to essentially the same kinds of administrative procedures now applied to similar situations, with the precise timing and nature of administrative actions determined as at present by the circumstances surrounding individual cases. Close contact among the Federal Reserve Board staff and the Federal Reserve Banks' discount officials will be maintained in the interest of dealing uniformly with similar cases.

The third general category of credit which would be available to member banks at the proposed discount window is called the "seasonal borrowing privilege." A Reserve Bank would be prepared to establish such a seasonal borrowing privilege for any member bank experiencing demonstrable seasonal pressures persisting for a period of at least four consecutive weeks and exceeding a minimum relative size. It is expected that this borrowing privilege would be of value principally to smaller unit banks in agricultural or resort areas in which seasonal swings have a substantial impact on the entire community and where access to the national money markets or other adjustment resources is not always readily available.

The existence of seasonal pressures would be judged on the basis of past years' patterns of loan and deposit fluctuations. The establishment of a qualifying seasonal swing in net availability of funds (defined as deposits minus loans to customers in the bank's market area) would ordinarily be fixed by negotiation once a year. Once the existence of a qualifying seasonal need was established, the Reserve Banks would agree to extend discount credit up to the qualifying amount and for the length of time the need was expected to persist, up to 90 days. The 90-day maximum is imposed by statute; however, should the need extend over a longer period than this, the Reserve Banks would regard renewals of credit as in accordance with the initial seasonal credit negotiation. Seasonal credit needs would normally be expected to last for several months, but in exceptional cases could range up to as much as nine months.

Seasonal credit obtainable at a Reserve Bank would be limited to the amount of the borrowing bank's seasonal swing in excess of a specified percentage of its average deposits in the preceding year. This "deductible" principle, requiring a bank to meet a part of its seasonal needs out of its own resources, is designed to encourage individual bank maintenance of some minimum level of liquidity for purposes of flexibility. It would also serve effectively to limit the aggregate amount of credit extended under the seasonal borrowing privilege to an amount consistent with overall monetary policy, while allowing the Federal Reserve to provide this assistance to all those member banks with relatively large seasonal needs.

The proposed redesign of the discount window would provide that the Federal Reserve continue to supply liberal help to its member banks in emergency situations. So long as the member bank is solvent and steps are being taken to find a solution to its problems, credit would be available on the same basis as it currently is, and, within the limits of the law, special and flexible arrangements would continue to be made where necessary. Assisting a bank in an emergency situation would generally require credit extension for periods longer than would normally be allowed at the window, but this would be expected and regarded as appropriate.

The Federal Reserve, in its role as lender of last resort to other sectors of the economy, may find it necessary to extend credit assistance to institutions other than member banks. This action would be taken only when other sources of credit have been exhausted and failure of the troubled institutions would have a significant impact on the economy's financial structure. When lending to nonmembers, the Federal Reserve would act in cooperation with the relevant supervisory authority to insure that steps are taken to find a solution to their problems. The Federal Reserve Act authorizes direct advances to nonmembers, but only if collateralized by U.S. Government securities. Since most nonmember institutions of the types apt to require emergency credit assistance do not have sizable holdings of this asset, credit would normally be extended through a conduit arrangement with a member bank. Most types of nonbank financial institutions have borrowing relationships with their commercial banks as a matter of course; and ideally, this indirect lending by the Federal Reserve could fit in with such business practice. Such credit would be provided at a higher rate than the basic discount rate.

The proposed discount window does not include the provision of intermediate- or long-term credit to meet the needs of banks servicing credit-deficit areas or sectors--that is, areas or sectors where the opportunities for profitable investment continuously outstrip the savings generated locally. While this is recognized as a problem of some significance, it was concluded that its solution lies outside the proper scope of the discount window. The Steering Committee concluded that an appropriate and effective solution to this problem was most likely to be found in the improvement of secondary markets for bank assets and liabilities. Detailed studies of the feasibility of actions to promote such improvement are expected to begin in the near future.

I should emphasize that Federal Reserve open market operations are still envisioned as the main tool of monetary policy. The proposed changes in discount operations, however, would alter to some degree the current relationship between these two methods of reserve injection, with the discount mechanism assuming a somewhat increased role. This would come about as a result of the accommodation of more of the day-to-day fluctuations of reserve needs at the window, the improved distribution of reserves brought about by injection of some reserves directly at the point of need, and more flexible and effective use of the discount rate as an influence on bank borrowing. The first and second of these benefits would entail a generally higher level of borrowing being done bv a typically rotating group of member banks. But this is not conceived to mean a corresponding increase in total reserves or a loss of control in this area, since the Federal Reserve would retain the ability to bring about and maintain the desired level of overall credit availability, taking into account the relatively small increase expected in credit outstanding at the window, through purchases and sales of securities in the open market.

To simplify my oral remarks this morning, I have avoided citing specific numbers, technical conditions, or underlying statistical evidence associated with the proposed changes in the discount mechanism. For your convenience, I have summarized these details in the two-page appendix table attached to my statement. If you have any questions about such matters, I will be glad to answer them either now or in subsequent correspondence.

Let me emphasize that all these details are provisional at this stage, and subject to review and modification in the light of our study of the comments and reactions received. The proposal at this stage represents a report of a Federal Reserve committee.

The Board of Governors has not yet taken any substantive action on the proposals contained in the Report nor published any change in its Regulation A which governs borrowing. We have already received a good many comments on the Report from a variety of sources, including both bankers and banking organizations and others. We've had assistance from the reactions and suggestions of numerous academic scholars; several leading economists have contributed analytical papers on one question or another related to the discounting area, and the Board has scheduled two different seminars with a number of professors of economics at which ideas on this subject could be exchanged.

I can assure you that the views expressed in these hearings also will be taken into account by the Board.

As we now see it, the shape of the proposal under consideration can be encompassed within the framework of existing legislation. It may be, however, that certain aspects of the studies and of comments received might make it desirable for the Board to request some amendments in the language of certain governing statutes in order to permit the revised discount mechanism to be as effective as possible. As you know, the Federal Reserve has already proposed a bill (S.966)--popularly termed the "eligible paper" bill--which would make certain changes in the provisions of the Federal Reserve Act relating specifically to lending to member banks. It would seem likely that most, if not all, of the changes suggested by our studies could be encompassed by the language in that bill. Of course, neither the eventual changes which might be made in the mechanism nor any resultant need for legislation can be finally settled at this stage, but at a somewhat later date we may need to address a communication to the Congress regarding the pending or possibly additional amendments to the statute.

All of us involved in this reappraisal recognize that, even after any of the suggested changes were introduced, a period of transition would undoubtedly be required before the full potential of the discount mechanism could be realized either by the Federal Reserve or the member banks. However, I believe that there is a good possibility that this redesign can bring this mechanism in closer touch with the prevailing economic climate and lead to a more effectively functioning banking system that is better equipped to serve evolving needs of the community.

APPENDIX TABLE--p.1

Summary of Proposal for Redesign of Discount Mechanism

	Basic Borrowing Privilege (1)	Other Adjustment Credit (2)	Seasonal Borrowing Privilege (3)	Emergency Credit to Member Banks (4)	Emergency Credit to Others (5)
Definition	Member bank access to credit upon request, within precisely stated limits on amounts and frequency and on specified conditions.	Supplemental discount accommodation, subject to administrative procedures, to help a member bank meet temporary needs that prove either larger or longer in duration than could be covered by its basic borrowing privilege.	Member bank access to credit on a longer-term and, to the extent possible, prearranged basis to meet demonstrable seasonal pressures exceeding minimum duration and relative amount.	Credit extended to member banks in unusual or exigent circumstances.	Credit extended to institutions other than member banks in emergency circumstances in fulfilling role as lender of last resort to the economy.
Rate	Discount rate.	Discount rate.	Discount rate.	Discount rate.	Significant penalty above discount rate.
Quantity Limitations	_____(20-40) % of first $1 million capital stock & surplus plus _____(10-20) % of next $9 million of plus _____(10) % of remainder.	None specified.	Seasonal needs in excess of _____(5-10) % of average deposits subject to reserve requirements in preceding calendar year.	None specified	None specified
Frequency or Duration Limitations	_____(6-13) of any _____(13-26) consecutive reserve computation periods.	None specified.	Need and arrangement must be for more than four weeks. Maximum nine consecutive months.	None specified.	None specified.

	Basic Borrowing Privilege (1)	Other Adjustment Credit (2)	Seasonal Borrowing Privilege (3)	Emergency Credit to Member Banks (4)	Emergency Credit to Others (5)
Administrative Procedures	None other than general discouragement of net selling of Federal funds by borrowing banks.	Appraisal and, where necessary, action broadly similar to procedures developed under existing discount arrangements.	Prearrangement involves discussion between discount officer and bank management concerning amount, duration, and seasonality of need. Administrative review maintained during borrowing to prevent abuse or misuse.	Continuous and thorough-going surveillance. Require that bank develop and pursue workable program for alleviating difficulties.	Continuous and thorough-going surveillance (may have to be thru conduit). Require that institution develop and pursue workable program for alleviating difficulties.
Other Restrictions	Must not have been found to be in unsatisfactory condition.	None specified.	None specified.	None specified.	Required to use all other practicable sources of credit first.
Method of Provision	Direct.	Direct.	Direct.	Direct.	(1) through central agency; (2) direct; (3) conduit thru member bank.