



FEDERAL RESERVE BANK OF DALLAS

2200 N. PEARL ST.
DALLAS, TX 75201-2272

July 29, 2003

Notice 03-40

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

Agencies Issue Guidance on Appropriate Use of Discount Window

DETAILS

The federal banking, thrift, and credit union regulatory agencies have issued guidance on the appropriate use of the Federal Reserve's new primary credit discount window program in depository institutions' liquidity risk management and contingency planning.

The guidance provides background on the Federal Reserve's discount window programs, including new primary and secondary credit programs introduced in January. It also reiterates well-established supervisory policies on sound liquidity contingency planning, and discusses sound practices in using primary credit program borrowings in liquidity contingency plans.

Adequate liquidity contingency planning is critical to the ongoing maintenance of the safety and soundness of any financial institution. The guidance notes that sound liquidity contingency plans ensure adequate diversification of the potential sources of funds to be used in a contingency. By enhancing the availability of discount window credit, the Federal Reserve's new primary credit program offers depository institutions an additional source of backup funds for managing short-term liquidity risks and thus can enhance the diversification of contingency funds.

The guidance notes that appropriate use of primary credit for contingency situations requires institutions to ensure that:

- 1) the necessary documentation and collateral arrangements are in place;
- 2) primary credit lines are periodically tested;
- 3) viable takeout or exit strategies exist to replace primary credit borrowings; and
- 4) appropriate cost/benefit analyses are conducted in light of the cost of primary credit borrowings relative to other sources of short-term contingency funds.

Finally, the guidance notes that occasional use of primary credit for short-term contingency funding should be viewed as appropriate and unexceptional by both management and supervisors. At the same time, the guidance emphasizes that the primary facility is only one of many tools institutions may use in managing their backup liquidity needs, and that institutions should maintain access to a diversified array of funding sources.

The use of primary credit, or any other potential source of contingency funding, is a management decision that must be made in the context of safe and sound management practices.

ATTACHMENT

A copy of the interagency guidance is attached.

MORE INFORMATION

For more information, please contact Finlay Higgins, Discount and Credit Department, at (877) 682-3256. Paper copies of this notice or previous Federal Reserve Bank notices can be printed from our web site at www.dallasfed.org/banking/notices/index.html.

**Board of Governors of the Federal Reserve System
Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Office of Thrift Supervision
National Credit Union Administration**

INTERAGENCY ADVISORY ON

**THE USE OF THE FEDERAL RESERVE'S
PRIMARY CREDIT PROGRAM IN EFFECTIVE LIQUIDITY MANAGEMENT**

Most depository institutions have liquidity contingency funding plans that identify use of the Federal Reserve's discount window advances in certain situations. The revisions to the Federal Reserve's Regulation A established new Federal Reserve discount window programs that can alter the manner in which some depository institutions use discount window borrowings in their liquidity management and contingency planning. This interagency advisory presents information on the new discount window programs and provides to the directors, management, examiners, and supervisors of depository institutions guidance on the appropriate use of primary credit in effective liquidity management.

Background on New Federal Reserve Discount Window Programs

On January 9, 2003, the Federal Reserve replaced two of its discount window programs – adjustment credit and extended credit – with new primary and secondary credit programs.¹ Under the new primary credit program, Reserve Banks may extend short-term credit to eligible depository institutions at a rate above the target federal funds rate. An important goal of the primary credit program is to reduce institutions' reluctance to use the window as a source of back-up, short-term liquidity. Accordingly, Reserve Banks normally extend primary credit with significantly less administration than under the former adjustment and extended credit programs. Reserve Banks may extend secondary credit to depository institutions that do not qualify for primary credit when the loan would be consistent with the institution's prompt return to market sources of funds or would facilitate the resolution of significant financial difficulties. Information on the new discount window programs, including the revised Regulation A, is available on the Federal Reserve's discount window web site located at www.frbdiscountwindow.org.

The primary credit program is the Federal Reserve's principal safety valve for ensuring adequate liquidity in the banking system and is intended to serve as a backup source of short-term funds for eligible institutions. The interest rate for primary credit was set initially at a level 100 basis points above the Federal Open Market Committee's target for the federal funds rate.

¹ Seasonal credit is unaffected by these changes.

This spread may change in light of experience with the new program. Generally, primary credit is extended on a very short-term basis, usually overnight. In some cases, primary credit may be extended for up to a few weeks to small institutions that meet eligibility requirements.

In general, there are no restrictions on the use of primary credit. The primary credit program does not require institutions to seek alternative sources of funds before requesting occasional short-term advances. Except in unusual circumstances, Reserve Banks will not question depository institutions about their reason for borrowing primary credit. The institution must have the necessary collateral arrangements and documentation in place with the appropriate Reserve Bank in order to utilize the primary credit program. Collateral arrangements and documentation remain the same as those required for adjustment credit.

An institution's supervisory examination rating and capital status largely determine its eligibility for primary credit. Therefore, given the confidential nature of CAMELS and SOSA ratings, regulators do not permit depository institutions to disclose publicly their primary credit eligibility.

In general, depository institutions with composite CAMELS² ratings of 1, 2, or 3 that are at least adequately capitalized are eligible for primary credit unless supplementary information indicates their condition is not generally sound. Foreign banking organizations with SOSA rankings of 1 or 2 and a ROCA, Combined ROCA, and/or Combined U.S. Operations rating of 1, 2, or 3 will also be considered eligible for primary credit unless supplementary information indicates their condition is not generally sound. Supplementary information for both domestic institutions and foreign banking organizations may include public debt ratings and information provided by examiners and market sources.

Federal Reserve Banks may extend secondary credit to depository institutions that do not qualify for primary credit. Reserve Banks extend secondary credit to assist in an institution's timely return to a reliance on traditional funding sources or in the resolution of severe financial difficulties. This program entails a higher level of Reserve Bank administration and oversight than primary credit. The secondary credit rate is above the primary credit rate. The spread was set at 50 basis points at the program's inception; it may vary.

² Credit unions are rated under the CAMEL Rating System (see Letter to Credit Unions No. 03-CU-04, CAMEL Rating System, March 2003).

Sound Liquidity Risk Management and Liquidity Contingency Planning

The Agencies have long advised depository institutions that sound liquidity risk management requires the following four elements³.

- Well-established strategies, policies, and procedures for managing both the sources and uses of an institution's funds across various tenors or time frames. This includes assessing and planning for short-term, intermediate-term, and long-term liquidity needs.
- Liquidity risk measurement systems that are appropriate for the size and complexity of the institution. Depending upon the institution, such measurement systems can range from simple gap-derived cash flow measures to very sophisticated cash flow simulation models.
- Adequate internal controls and internal audit processes. Internal controls and internal audit reviews are needed to ensure compliance with internal liquidity management policies and procedures.
- Comprehensive liquidity contingency planning. Contingency plans need to be well designed and should span a broad range of potential liquidity events that are tailored to an institution's specific business lines and liquidity risk profile.

Adequate liquidity contingency planning is critical to the ongoing maintenance of the safety and soundness of any depository institution. Contingency planning starts with an assessment of the possible liquidity events that an institution might encounter. The types of potential liquidity events considered should range from high probability/low impact events that can occur in day-to-day operations to low probability/high impact events that can arise through institution-specific and/or systemic market or operational circumstances. Responses to these events should be assessed in the context of their implications for an institution's short-term, intermediate-term, and long-term liquidity profile. A fundamental principle in designing contingency plans for each of these liquidity tenors is to ensure adequate diversification in the potential sources of funds to be utilized. Such diversification should not only focus on the

³This interagency advisory supplements and does not replace existing agency guidance or policy. See "Sound Practices for Managing Liquidity Risk in Banking Organizations," Basel Committee on Banking Supervision (February 2000). For national banks, see the *Comptroller's Handbook on Liquidity*. For state member banks and bank holding companies, see the Federal Reserve's *Commercial Bank Examination Manual* (section 4020) and *Bank Holding Company Supervision Manual* (section 4010). For state non-member banks, see the FDIC's Revised Examination Guidance for Liquidity and Funds Management (Trans. No. 2002-01) (Nov. 19, 2001). For savings associations, see the Office of Thrift Supervision's Thrift Bulletin (TB) No. 77, Sound Practices for Liquidity Management at Savings Associations (June 19, 2001). For credit unions, see Letter to Credit Unions No. 02-CU-05, Examination Program Liquidity Questionnaire (March 2002).

number of potential funds providers but on the underlying stability, availability, and flexibility of funds sources in the context of the type of liquidity event they are expected to address.

Federal Reserve Primary Credit and Liquidity Contingency Planning

By enhancing the availability of discount window credit, the new primary credit program offers depository institutions an additional tool for managing short-term liquidity risks. Management should assess fully the potential role that primary credit might play in managing their institution's liquidity and consider the appropriateness of incorporating it in their liquidity management policies, procedures, and contingency plans. In light of the new primary and secondary credit programs, institutions should update existing policies, procedures, and contingency plans and remove any reference to the Federal Reserve's former adjustment and extended credit facilities.

The new primary credit program has the following attributes that make the discount window a viable source of back-up or contingency funding for short-term purposes:

- A less burdensome administrative process than applied under the previous adjustment credit program makes primary credit a simpler and more accessible source of back-up, short-term funding.
- Primary credit can enhance diversification in short-term funding contingency plans.
- Discount window borrowings can be secured with an array of collateral, including consumer and commercial loans.
- Requests for primary credit advances can be made anytime during the day.⁴
- There are no restrictions on the use of short-term primary credit.

If an institution incorporates primary credit into its contingency plans, the institution should ensure that it has in place with the appropriate Reserve Bank the necessary collateral arrangements and documentation. This is particularly important when the intended collateral consists of loans or other assets that may involve significant processing or lead-time for pledging to the Reserve Bank.

It is a long-established sound practice for institutions to periodically test all sources of contingency funding. Accordingly, if an institution incorporates primary credit in its contingency plans, management should occasionally test the institution's ability to borrow at the discount window. The goal of such testing is to ensure that there are no unexpected impediments or complications in the case that such contingency lines need to be utilized.

Institutions should ensure that any planned utilization of primary credit is consistent with the stated purposes and objectives of the program. Under the primary credit program, the

⁴ Advances generally are booked at the end of the business day.

Federal Reserve generally expects to extend funds on a very short-term basis, usually overnight. Therefore, as with any other type of short-term contingency funding, institutions should ensure that any use of primary credit facilities for short-term liquidity contingencies is accompanied by viable take-out or exit strategies to replace this funding expeditiously with other sources of funding. Institutions should factor into their contingency plans an analysis of their eligibility for primary credit under various scenarios, recognizing that if their financial condition were to deteriorate, primary credit may not be available. Under those scenarios, secondary credit may be available.

Another critical element of liquidity management is an appropriate assessment of the costs and benefits of various sources of potential liquidity. This assessment is particularly important in managing short-term and day-to-day sources and uses of funds. Given the above-market rates charged on primary credit, institutions should ensure that they adequately assess the higher costs of this form of credit relative to other available sources. Extended use of any type of relatively expensive source of funds can give rise to significant earnings implications which, in turn, may lead to supervisory concerns.

It is also important to note that the Federal Reserve's primary credit facility is only one of many tools institutions may utilize in managing their liquidity risk profiles. An institution's management should ensure that the institution maintains adequate access to a diversified array of funding sources. That array has traditionally included, and should continue to include, liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings.

Supervisory and Examiner Considerations

Since primary credit can serve as a viable source of back-up, short-term funds, supervisors and examiners should view the occasional use of primary credit as appropriate and unexceptional. At the same time, however, supervisors and examiners should be cognizant of the implications that too frequent use of this source of relatively expensive funds may have for the earnings, financial condition, and overall safety and soundness of the institution. Over-reliance on primary credit borrowings, or any one source of short-term contingency funds, regardless of the relative costs, may be symptomatic of deeper operational and/or financial difficulties. Importantly, the use of primary credit, as the use of any potential sources of contingency funding, is a management decision that must be made in the context of safe and sound banking practices.