At 6190

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045

AREA CODE 212 732-5700

July 23, 1968

REAPPRAISAL OF THE FEDERAL RESERVE DISCOUNT MECHANISM

To the Chief Executive Officer
of the Member Bank Addressed:

Enclosed is a copy of a report, entitled "Reappraisal of the Federal Reserve Discount Mechanism," together with a copy of a statement on the report, made public yesterday, by the Board of Governors of the Federal Reserve System. The report sets forth the conclusions and recommendations of a System steering committee appointed to reappraise and, where necessary, recommend redesign of Federal Reserve lending facilities.

As the statement indicates, none of the committee's recommendations has been acted upon by the Board of Governors; the report is being made generally available so that comments and suggestions of the banking community and the public at large may be considered before any revision of Regulation A is published. Time will be allowed for careful and intensive consideration of the proposals both within and without the System before any final decisions on the matter are made by the Board.

In view of the importance of the proposed changes for our member banks and of the benefits that should result from an improved discount mechanism, we would urge you to give the report your close attention and study and to communicate your views on the report to us.

If you should have any questions on the report, the officers of our Loans and Credits function, or our Bank Relations representative to your bank, will be glad to discuss them with you.

ALFRED HAYES
President

FEDERAL RESERVE

RELEASE

On July 22, 1968, the Federal Reserve made public the report of a System committee which has completed an intensive, three-year restudy of Federal Reserve lending policies. The document, entitled "Reappraisal of the Federal Reserve Discount Mechanism," reaffirms three long-established principles of Federal Reserve lending, but it also proposes several significant changes in lending policies and procedures aimed at providing more liberal and clear-cut access for member banks to Federal Reserve lending facilities. Thus redesigned, the "discount window"--as the Federal Reserve Banks' lending facilities are often called--is expected to play a more active part in enabling commercial banks to more effectively meet their communities' credit needs.

Basic principles reaffirmed

First among the basic principles governing the use of Federal Reserve credit is that Federal Reserve System lending is to accommodate bank asset and liability adjustments over limited time periods and to meet essentially short-term fluctuations in member bank needs for funds. Coordinately it is intended that individual member banks shall not be continuously and permanently in debt to the Federal Reserve.

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 drouths, 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 the conduit of member banks, the Federal Reserve is prepared to supply liquid funds to other groups of financial institutions when such assistance is not available elsewhere and is necessary to avoid major economic disruption.

Significant new elements

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 limited amounts of funds 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 help meet all 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," are not precluded from short-term borrowings from their Reserve Banks pending a prompt 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 member bank borrowings from their Reserve Banks.

A final major new idea 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 that the discount rate be changed considerably more frequently, to keep it reasonably closely in line with the movements in other money market rates.

Status of the discount report

The report was adopted unanimously by a study committee made up of three members of the Board of Governors and four Federal Reserve Bank Presidents. None of its recommendations has been acted upon by the Board. The report is being made generally available so that comments and suggestions of the banking community and the public at large may be considered before any revision of Regulation A, the Board's rule governing lending to member banks, is published. Time will be allowed for careful and intensive consideration of the proposals both within and without the System before any final decisions on the matter are made by the Board.

Evolution of the discount mechanism

The proposed redesign represents 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. During the next twenty years, 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 recognized in a formal 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 themselves were capable of reasonably meeting 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. Moreover, at many banks more sophisticated portfolio management has pared liquidity positions substantially. Borrowings from other sources than the Federal Reserve have expanded. 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.

Basic borrowing privilege

The most commonly used of the new lending provisions for member banks in good standing would undoubtedly be the basic borrowing privilege because it would provide credit up to specified time and amount limits on a virtually no-questions-asked basis.

The size of each bank's basic borrowing privilege would be established as a proportion of that bank's capital stock and surplus. The present proposal calls for each bank to have a basic borrowing privilege equal on a reserve period average basis to between 20 per cent and 40 per cent of its capital stock and surplus up to $1 million, between 10 per cent and 20 per cent of its capital stock and surplus between $1 million and $10 million and 10 per cent of its capital stock and surplus in excess of $10 million. Thus a bank with $1 million of capital stock and surplus could borrow between $200 and $400 thousand on each day of the seven-day reserve period or between $1,400 and $2,800 thousand on one day during the period.

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 asset adjustments and in most cases permit orderly adjustment to longer-term movements of funds.

The proposed frequency limitation would allow access to credit so long as the bank is indebted in no more than half the reserve periods in the interval--i.e., so long as the bank does not use adjustment credit

in more than 6 (or up to 13) of the 13 (or up to 26) consecutive reserve periods ending with the current period. Thus, whether a member bank is eligible to use its basic borrowing privilege at any time is established by examining its record of borrowing at the window for adjustment purposes for the previous 12 (or up to 25) reserve periods.

Before the plan is finally made effective, choices will be made in the light of comments received as to the particular percentages within the indicated ranges 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 exceed the ability of the Federal Reserve to undertake any necessary offsetting open market operations. (Adjustment credit beyond these limits will be available, as described elsewhere, to any member bank having a justifiable need larger or longer in duration than could be accommodated within the basic borrowing privilege, and therefore the basic borrowing privilege does not represent the maximum Federal Reserve credit to which the member bank could have access and need not encompass all bank needs which may be expected to arise.)

Borrowing within the basic borrowing privilege limitations could, as noted, take place virtually upon request, unless the Reserve Bank has notified the member bank that its over-all condition is unsatisfactory as determined by such factors as adequacy of capital, liquidity, soundness, management, or noncompliance with law or regulation and that such unsatisfactory condition is 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 being continued in the interest of precluding retailing operations in Federal Reserve credit obtained through the discount window. It is, of course, recognized that circumstances might occur as a result of miscalculations or large unforeseen movements in the bank's position, in which net selling of funds would be extremely difficult to avoid. In such infrequent situations this rule would be waivable.

Other adjustment credit

It is recognized that basic borrowing privileges 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 the case 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 are referred to in the report as "other adjustment credit" and are virtually identical to the arrangements presently existing for the use of discount credit on such a scale.

When a member bank uses "other adjustment credit," it should expect that the circumstances of its borrowing would come under examination in some detail. In many cases this would consist of a review of information available at the Reserve Bank. Hence it would involve no immediate contact with the member bank, especially if this review clearly showed continued credit extension to be appropriate. However, if the use of "other adjustment credit" becomes more extended in amount and time, the Reserve Bank would follow the case more closely and directly. In due course, the bank would be expected to outline its plan and timetable of adjustment and thereafter to carry it out. The circumstances surrounding individual borrowing cases will differ widely, and as now the precise timing and nature of these administrative actions would be related to such differences. Close contacts among the Federal Reserve Banks' discount officials will be maintained in the interest of dealing uniformly with similar cases.

Seasonal borrowing privilege

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 4 weeks and exceeding a minimum relative size. It is expected that this borrowing privilege will be of value principally to smaller unit

in agricultural or resort areas in which seasonal swings have a substantial impact on the entire community and where access to the 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. Totally new seasonal pressure, such as might be occasioned if a new industry with a strong seasonal pattern moved into a small town, would not justify establishment of a seasonal borrowing privilege in the first year. The resulting credit needs could be accommodated under other adjustment credit arrangements, however, with recognition that this was in fact a justifiable need, and in succeeding years a seasonal borrowing privilege could be formally established.

The establishment of a qualifying seasonal swing in net availability of funds (defined as the net of deposits minus loans to customers in the bank's market area) would ordinarily be fixed by negotiation once a year. The basic data to be used in this determination would in most cases be already on file at the Reserve Banks. The proposal suggests that where feasible the determination of a seasonal borrowing privilege might best be accomplished prior to the actual credit need, since this would permit more orderly planning on the part of both the borrowing bank and the Reserve Bank.

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 also serves 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 precise level of the deductible percentage would lie in the range of 5 to 10 per cent of average deposits, with the final choice again to be made by the Board in the light of comments received.

The amount of credit arranged for during the original negotiation of a seasonal borrowing privilege would not normally be revised in mid-season, but the proposal recognizes that unforeseen developments essentially beyond the control of the borrowing bank may significantly affect the need for seasonal credit. In such unusual circumstances renegotiation would be allowed. Likewise, the Reserve Bank would, under normal circumstances, abide by the original negotiations. Only in the case of a clear and significant change in the bank's need or flagrant abuse of the seasonal borrowing privilege would a Reserve Bank exercise its option to curtail an outstanding seasonal credit arrangement.

Borrowings under the seasonal borrowing privilege would not be counted in determining a bank's eligibility to use its basic borrowing privilege as described above.

Emergency credit.

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, ad hoc 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.

In addition, the redesigned window would recognize the possibility that the Federal Reserve, in its role as lender of last resort to other sectors of the economy, might in extreme conditions find it necessary to extend circumscribed credit assistance to institutions other than member banks. This action would be taken only when all other sources of credit had 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 its problems. Credit would normally be extended through a conduit arrangement with a member bank and would be provided at a significant penalty relative to the prevailing discount rate.

Related considerations.

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 attempting to solve this problem through the discount window would involve socio-economic and political decisions outside the proper scope of System responsibility. It was also felt that financing the expansion of loan portfolios far beyond the limits of deposits through the provision of long-term discount credit would seriously and in some cases dangerously distort the normal balance sheet structure of commercial banks. The Steering Committee concluded that an appropriate and effective solution to the 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.

While Federal Reserve open market operations are still envisioned as the main tool of monetary policy, the proposed changes in discount operations would be expected to lead to a generally higher level of borrowing being done by a

rotating group of member banks. Such a higher level of borrowing would not, however, mean a corresponding increase in total reserves, since increased borrowing would be expected to be about offset by correspondingly smaller net System purchases of securities in the open market.

The study committee recognizes that a period of transition would undoubtedly be required before the full potential of the proposed redesign of the discount window could be realized by either the Federal Reserve or the member banks. However, it believes that this redesign can bring the mechanism into closer touch with the prevailing economic climate and lead to a more effectively functioning member banking system.

The table attached to this release summarizes the proposals contained in the current report. It outlines the several complementary arrangements for borrowing at the window, each designed to provide credit for a specific type of need. These are the basic borrowing privilege (column (1)), other adjustment credit (column (2)), the seasonal borrowing privilege (column (3)) and emergency credit assistance, both to member banks (column (4)) and to other financial institutions (column (5)).

Supporting research.

Besides the final report of the committee itself, there has also been prepared a summary report on the research undertaken in connection with the study that will be made available to the public on request:

"Report on Research Undertaken in Connection with a System Study," by Bernard Shull, Director of Research Projects.

In addition, the System plans to make available to interested persons copies of various of the individual research papers prepared for the discount study. Copies of the following six papers can be requested currently:

"The Discount Mechanism in Leading Industrial Countries Since World War II," by George Garvy.

"Evolution of the Role and Functioning of the Discount Mechanism," by Clay J. Anderson.

"A Review of Recent Academic Literature on the Discount Mechanism," by David Jones.

"A Study of the Market for Federal Funds," by Parker Willis.

"A Secondary Market for Negotiable Certificates of Deposit," by Parker Willis.

"Reserve Adjustments of the Eight Major New York Banks During 1966," by Dolores Lynn.

The Availability of other research papers will be announced as their preparation is completed.

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.

REAPPRAISAL OF THE FEDERAL RESERVE DISCOUNT MECHANISM

REPORT OF A SYSTEM COMMITTEE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

REAPPRAISAL OF THE FEDERAL RESERVE DISCOUNT MECHANISM

REPORT OF A SYSTEM COMMITTEE

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

PREFACE

The following report sets forth the conclusions and recommendations of a System steering committee appointed to reappraise and, where necessary, recommend redesign of Federal Reserve lending facilities. This report is the result of a three-year System-wide study. The proposals for the redesign of the discount mechanism are the product of a combination of research, experience, and judgment on the part of those involved in the study.

The Steering Committee, made up of members of the Board of Governors and Presidents of Federal Reserve Banks, was chaired by Governor George W. Mitchell. Other members included Governors Sherman J. Maisel and William W. Sherrill and Presidents Karl R. Bopp of Philadelphia, Edward A. Wayne of Richmond, Charles J. Scanlon of Chicago, and George H. Clay of Kansas City. Governor Charles N. Shepardson and President Harry A. Shuford of St. Louis served as earlier members of the Steering Committee until their respective retirements from the System, and I served as a member of the committee, *ex officio*.

A staff Secretariat had the responsibility for developing proposals for Steering Committee review, and implementing the study outline as determined by the parent committee. This group was chaired by Mr. Robert C. Holland, Secretary of the Board. Serving on the Secretariat were Mr. Harold Bilby, Vice President and Senior Adviser of the New York Reserve Bank, Mr. David C. Melnicoff, Vice President and chief lending officer of the Philadelphia Reserve Bank, Mr. M. H. Strothman, Jr., First Vice President of the Minneapolis Bank, Mr. Philip E. Coldwell, now President of the Dallas Bank, and Mr. A. B. Merritt, First Vice President of the San Francisco Bank. Representing the Board staff were Mr. Howard Hackley, Assistant to the Board, Mr. John Farrell, Director of the Division of Bank Operations, and Mr. Frederic Solomon, Director of the Division of Bank Examinations. Prior to his retirement, Mr. Ralph A. Young, Senior Adviser to the Board and Director, Division of International Finance, also served on the Secretariat.

Mr. Bernard Shull of the Division of Research and Statistics was a member of this group and also served as Director of Research Projects with primary responsibility for the implementation and coordination of research activity in connection with the study. Miss Priscilla Ormsby was Secretary for the Secretariat. Others who contributed to the work of the Committee were: Mr. George Garvy, New York; Mr. Edward A. Aff, Philadelphia; Mr. Kyle K. Fossum, Minneapolis; Mr. T. R. Plant, Dallas; Mr. John B. Williams, San Francisco; and Mr. Brenton C. Leavitt, Mr. James C. Smith, Mr. Robert Forrestal, Mr. Walter Doyle, Mr. John Kiley, and Mr. Robert Gemmill, all of the Board staff. Special note should be made of the study of discount mechanisms in other major industrialized countries, an extensive review of foreign experience under the direction of Mr. George Garvy.

Several academic scholars also contributed to the Committee's deliberations through conferences and writings. These efforts were organized by Professor Lester V. Chandler, Chairman, Department of Economics, Princeton University, and Academic Consultant to the Discount Study.

The Board is indebted to those named above and to numerous others who have cooperated in the activities of this important and far-reaching study, culminating in the preparation of the final report.

Wm. McC. Martin, Jr., Chairman,
Board of Governors of the Federal
Reserve System

July 15, 1968

Price: 25 cents a copy; in quantities of 10 or more sent to one address, 20 cents each. Copies may be obtained from Publications Services, Division of Administrative Services, Board of Governors of the Federal Reserve System, Washington, D.C., 20551, and remittance should be made payable to the order of the Board of Governors of the Federal Reserve System in a form collectible at par in U.S. currency. (Stamps and coupons not accepted)

PUBLISHED IN JULY 1968

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contents

Report of a System Committee

Report of a System Committee

I. SUMMARY OF THE PROPOSED REDESIGN OF THE DISCOUNT WINDOW

The proposed redesign of the discount mechanism has as its chief objective increased use of the discount window for the purpose of facilitating short-term adjustments in bank reserve positions. A more liberal and convenient mechanism should enable individual member banks to adjust to changes in fund availability in a more orderly fashion and, in so doing, should lessen some of the causes of instability in financial markets without hampering overall monetary control.

Central bank lending operations can provide funds to individual banks on either of two bases—continuous or intermittent. In the first case, banks are always in debt to the central bank, and the discount rate is varied in accordance with economic conditions to affect indirectly bank lending terms and prices. But the bulk of monetary influence is exercised by the imposition on the lending policies of commercial banks of such restrictions as the central bank believes suitable to the environment. This system, with variations, is typical of many foreign countries.

In the United States, on the other hand, banks in recent decades have not been, and, in the view of this report, should not be, permitted to remain continuously in debt to the Federal Reserve. Given the highly developed character of the U.S. economy and its financial structure, open market operations in Government securities by the central bank serve effectively as the preponderant means of secular reserve provision and the leading edge of monetary policy implementation. The role of the discount mechanism, on the other hand, is to cushion the strains of reserve adjustment for individual member banks and, thereby, for financial markets. In this context the discount window can beneficially assume an increased part of the burdens of intramonthly and seasonal reserve adjustments which are currently borne by open market operations. This increased use should come about both as credit is provided more liberally to individual banks faced with these adjustment needs and as increased numbers of banks are led to regard the window as a useful source of temporary or seasonal funds.

Two major and interrelated changes are included in the general design of the proposed discount window. These are: (1) a move toward more objectively defined terms and conditions for discounting; and (2) the inclusion of several complementary arrangements for borrowing at the window, each designed to provide credit for a specific type of need. These changes look forward to a generally higher level of borrowing being done by a rotating sample of member banks. However, such a higher level of borrowing would not mean a corresponding increase in total reserves, since increased borrowing would be expected to be about offset by correspondingly smaller net System purchases of securities in the open market.

The first of these changes will be accomplished by introducing specific quantity and frequency limitations on a part of borrowing and by increased reliance on the discount rate. These moves will permit a clearer and more unequivocal communication of discounting standards and limitations to member banks and will help to insure uniformity of window operation among districts and among banks.

No one of these types of controls can be expected to bear the entire burden of regulating discount-window use, however. The rate charged on borrowing, while normally expected to have a significant influence on a bank's use of the window, is not a dependable deterrent to excessive borrowing under pressure and, at the extreme, may actually become only a minor consideration. Limitations on the quantity and frequency of borrowing would also prove inadequate alone as methods of controlling borrowing. It would be impossible to construct a matrix of limitations a priori in such a way that they exactly accommodate, no more and no less, the varying and often unforeseeable needs of member banks for discount credit. For these reasons, the move toward objectively defined terms and conditions for lending at the window, important as it is seen to be, cannot be completely sufficient. Only through the application of administrative judgment over some part of the borrowing done at the window can the System adequately accommodate the widely differing needs of individual member banks, while at the same time maintaining the necessary monetary control.

The proposed redesign contains varied arrangements for the Federal Reserve to provide short-term adjustment credit, seasonal credit, and emergency credit. Short-term adjustment credit is further divided into the "basic borrowing privilege"—which provides credit on an automatic basis, within specified limits on amount and duration, to all member banks meeting the conditions specified in Section III—and other adjustment credit. The latter is available, under administrative control, to meet needs larger in amount or longer in duration than can be accommodated under the basic borrowing privilege. Seasonal credit will be provided to accommodate recurring demands over and above a minimum relative amount, for such amounts and duration as the applying member bank is able to demonstrate a need.

The redesigned discount window provides that the Federal Reserve will continue to supply liberal help to its member banks in general or isolated emergency situations. In addition, the redesigned window recognizes, and provides for, the necessity that—in its role as lender of last resort to other sectors of the economy—the Federal Reserve stand ready, under extreme conditions, to provide circumscribed credit assistance to a broader spectrum of financial institutions than member banks.

Each of these various types of credit accommodation, as well as the issue of discount rate policy, is discussed in some detail in later sections of this report.

II. BACKGROUND OF THE PROPOSED REDESIGN OF THE DISCOUNT WINDOW

A. Scope of the study

The Fundamental Reappraisal of the Discount Mechanism was launched in mid-1965. The study has involved a review of the effectiveness of the current discount mechanism, an appraisal of the extent to which operating rules might need to be altered in view of the changing economic

environment, and the formulation of specific proposals for implementing such changes as were found to be desirable.

The study has been under the over-all direction of a Steering Committee made up of three members of the Board of Governors and Presidents of four of the Federal Reserve Banks. Under this Steering Committee, a staff Secretariat was responsible for developing proposals for Steering Committee review and implementing the study outline as determined by the parent committee.

Over 20 individual research projects commissioned by the Committee provided historical perspective and quantitative and theoretical background for considering policy alternatives. Most of these projects were undertaken by members of the research staffs of the Board of Governors and the Reserve Banks, although several papers were also prepared by academic economists. Central bank lending experience was reviewed closely, both in the United States and in other major industrialized countries of the world. The System also had the benefit of a survey by the American Bankers Association of bank attitudes toward borrowing.

Drawing upon the results of this research, as well as ideas and suggestions from System personnel, bankers, and academic and other economists outside the System, the staff Secretariat formulated specific proposals for the redesign of the discount window. These proposals, with amendments and refinements growing out of further discussion within the Steering Committee and among other System personnel, are presented in this document.

B. Historical summary of the role of the discount window

The Federal Reserve Act in its original form contemplated use of the discount mechanism as the principal tool of central bank policy. In fact, the proportion of total reserves supplied via discounting never fell below 37 per cent during the 1920's and reached a peak of more than 80 per cent in 1921. During the 1920's, however, open market operations gradually but steadily began to displace discounting as a means of supplying reserves to the banking system. This trend was interrupted in the years 1928–30 and 1932–33, when discounting was relied upon heavily by many member banks to assist in their adjustments to the financial pressures that developed in those periods. After 1934, borrowing fell to negligible levels as banks became extremely liquid, reflecting a number of influences including enhanced wariness of indebtedness in any form, sizable reserve injections from gold inflows, and the liberal and increasingly sophisticated use of contracyclical open market operations. Throughout the 1940's the excess reserves accumulated during the middle and late 1930's and Federal Reserve purchases of U.S. Government securities at pegged prices provided ample reserve funds to meet wartime and postwar needs, and discounting activity was minimal.

The Treasury–Federal Reserve accord in March of 1951 freed the Government securities market from pegged rates, at a time when private demands for credit were strong. The immediate result was an upsurge in discounting activity—although still only to a monthly peak of $1.6 billion, or about 7 per cent of total reserves, in December of 1952. This increase was attributable in part to heavy loan demand but perhaps more significantly to the profitability of borrowing under the provisions of the excess profits tax temporarily in effect. In ensuing years credit demands eased, and the Government securities market continued to develop to an extent which per-

mitted effective implementation of the bulk of policy decisions through System purchases and sales of these assets. At the same time, most banks held ample supplies of these liquid securities; such holdings were an aftermath of war financing and enabled banks to make most adjustments in their reserve positions by selling Government securities in a generally efficient and flexible market.

Thus, despite the abandonment of the open market policy of pegging rates in effect before the accord, the discount window continued to serve only a marginal role as a supplier of reserves. It provided banks with assistance over the peaks of temporary, emergency, or seasonal needs for funds that exceeded the dimensions that the banks themselves were capable of reasonably meeting out of their own resources. To reinforce a policy of limited bank use of the discount window, the 1955 revision of Regulation A was issued, placing chief reliance upon bank reluctance to borrow, buttressed as and where necessary by disciplinary contacts by discount officers. Given this kind of discount policy, open market operations could be undertaken with a new degree of vigor and precision, secure in the knowledge that only marginal reserve additions would be introduced through the discount window. The chart on page 5 shows the amounts of Federal Reserve credit supplied by each of the three possible means—open market operations, discounting, and float—over the years, and Table 1 shows the relative proportions supplied by each for selected periods.

In the ensuing years, the discount window has been of less and less day-to-day significance in the operation of the monetary system, as banks have increasingly turned elsewhere to meet their short-term reserve needs. Even in this marginal role, the window has continued to fill needs which can be met in no other way. Distributive mechanisms among both economic and geographic sectors in the United States are often imperfect and in some cases clearly inadequate. This results in problems of reserve distribution which the Federal Reserve can compensate for only through a technique such as discounting. The window can meet the temporary needs of particular banks directly as they arise, without waiting for the sometimes sluggish distributive mechanisms to carry credit injected into the central money market to the point of actual need.

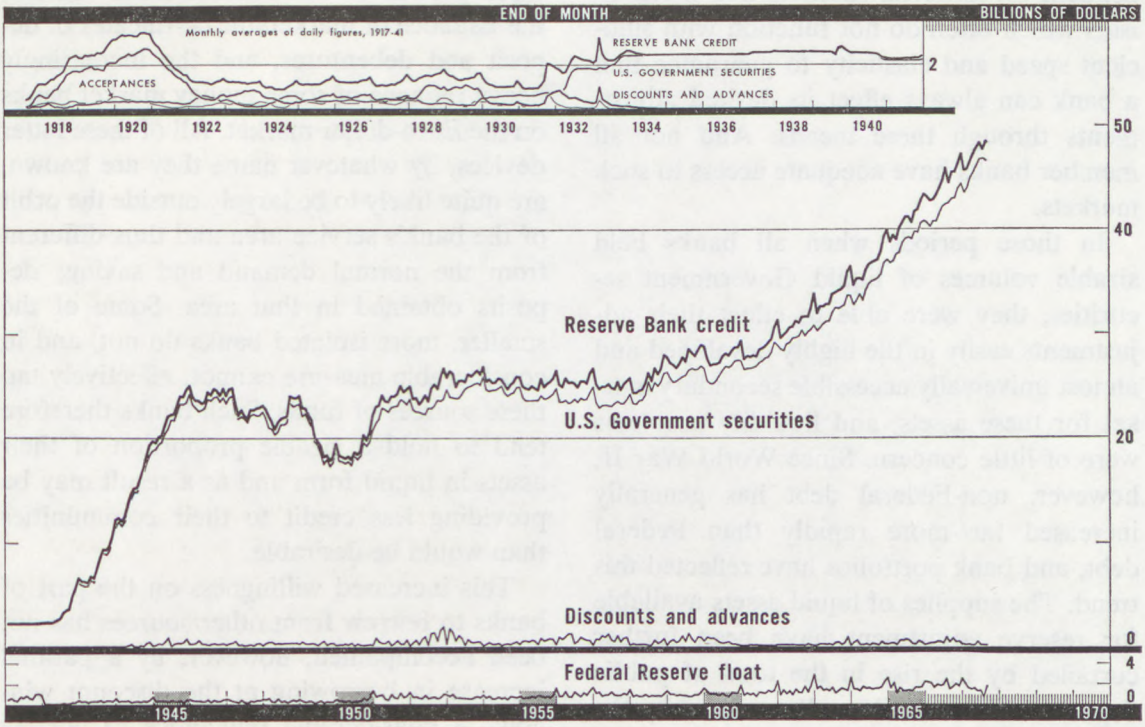
Discounting can also serve as an important adjunct to open market operations in the implementation of monetary policy. It is often difficult to determine in advance the exact degree of stringency which a given level of open market operations will create in the banking system as a whole, and virtually impossible to predict its impact on any single bank or group of banks. The existence of the discount mechanism, however, provides a means for individual banks to cushion temporarily the impact of such policy moves and therefore enables the Trading Desk of the Federal Reserve Bank of New York to carry out the System's open market operations more aggressively than would otherwise be practicable. In addition,

TABLE 1

SOURCES OF RESERVE BANK CREDIT
(Percentage of total)

Period	Open market operations	Discounting	Float	Total
1920–27	37	59	4	100
1928–33	65	33	2	100
1934–44	96	1	3	100
1945–50	97	1	2	100
1951–53	95	2	3	100
1954–59	95	2	3	100
1960–66	95	1	4	100

RESERVE BANK CREDIT



the level and dispersion of borrowing serves as a meter of disaggregated market forces and financial pressures, providing increased certaintity in the implementation of monetary policy.

Apart from these functions of the discount mechanism largely concerned with reserve creation, the window provides a unique vehicle for direct communication between Reserve Banks and member banks. It has the potential to make an invaluable contribution to bankers' understanding of monetary trends and thus to their appreciation of and cooperation with Federal Reserve policies and actions.

C. Need for an appropriately redesigned discount window

Short-term and seasonal fluctuations in loans and deposits are fundamental facts of commercial banking. They can be relatively large for individual banks and, in the absence of readily available and efficient means of adjustment, can cause problems not only for individual bank managements but also for the smooth functioning of the entire financial system.

Banks' difficulties in adjusting to such fluctuations in their funds are compounded by several factors. The U.S. banking system is composed of a very large number of individual institutions, each of which is subject to a variety of short-term pressures. In the net aggregate, these pressures may not normally appear severe. However, the gross size and distribution of swings in fund flows can produce abrupt pressures on individual banks for which they can prepare only at the cost of excessive liquidity and a significant limitation on the credit resources they make available to their communities. More-

over, the liquidity instruments used are dependent on financial markets and mechanisms which often do not function with sufficient speed and elasticity to guarantee that a bank can always effect its desired adjustments through these means. And not all member banks have adequate access to such markets.

In those periods when all banks held sizable volumes of liquid Government securities, they were able to effect their adjustments easily in the highly developed and almost universally accessible secondary market for these assets, and liquidity problems were of little concern. Since World War II, however, non-Federal debt has generally increased far more rapidly than Federal debt, and bank portfolios have reflected this trend. The supplies of liquid assets available for reserve adjustment have been further curtailed by the rise in the total of public deposits which must be collateralized by the hypothecation of specified kinds of assets, most of which are fairly liquid.

As banks in recent years have placed a much larger share of their resources into municipal obligations and into business, consumer, and mortgage loans, their supply of readily salable assets has been less and less of a cushion against unexpected deposit fluctuations. Part of the answer to this problem has been found in the sale of such portfolio assets. Secondary markets for these assets are decidedly inferior to the Government securities market, however; they range from the municipal bond market—fairly well developed at least for the bonds of larger and better-known municipalities, but subject to large price fluctuations—to those for conventional mortgages and agricultural paper —rudimentary or virtually nonexistent.

More striking has been increasing bank resort to the issuance of short-term liquid liabilities. This trend can be seen in the rapid growth of the Federal funds market, the issuance of marketable certificates of deposit and debentures, and the increasingly heavy reliance of some money market banks on the Euro-dollar market. All of these latter devices, by whatever name they are known, are quite likely to be largely outside the orbit of the bank's service area and thus different from the normal demand and savings deposits obtained in that area. Some of the smaller, more isolated banks do not, and in considerable measure cannot, effectively tap these sources of funds. Such banks therefore tend to hold a sizable proportion of their assets in liquid form and as a result may be providing less credit to their communities than would be desirable.

This increased willingness on the part of banks to borrow from other sources has not been accompanied, however, by a parallel increase in borrowing at the discount window. A considerable reluctance to borrow from the central bank has in fact been maintained, largely through the application of the current Regulation A, which emphasizes that banks should resort to borrowing from the Federal Reserve only on a short-term basis when other sources of funds fall short of their appropriate needs.

Thus the present window continues to serve well to hold the volume of reserve additions introduced through borrowing to a minimum. However, with short-term reserve needs of individual banks persisting and in many cases growing, and the historically important methods of meeting these needs declining in usefulness, very low totals of borrowing from the Federal Reserve are no longer consistent with optimum performance of the banking system.

Complicating these problems arising from the changing financial environment has been the fact that the current administration of

the discount window has not been well understood by many commercial bankers. Failure of the Federal Reserve to communicate clearly, consistently, and unambiguously with member banks regarding the availability of discount–window accommodation has caused many of these banks to view this as an uncertain source of credit. In addition, occasional Federal Reserve counsel as to what would be regarded as appropriate adjustments for borrowing banks has led many banks to regard the window as having too great a potential for interfering with bank management decisions. As a result, many banks having temporary needs for funds often make adjustments by more costly, less efficient avenues than that afforded through the discount window, sometimes to the detriment of adequate credit availability for their local communities.

Furthermore, the design and language of the current Regulation A, relying as it does primarily upon bank reluctance to borrow and, where necessary, administrative actions by the Federal Reserve, provides considerable opportunity for differences in administration from one district to another and from one case to another. Many of the apparent nonuniformities of administration are considered justified, since no two borrowing cases are identical and actions must be adapted to fit the differing circumstances of borrowing banks. However, comments of participants in borrowing transactions and such objective evidence as can be brought to bear argue that at times such administrative differences have been greater than could be explained by differing circumstances of individual banks.

What emerges from this review is a picture of a Federal Reserve discount mechanism which must be modernized and redesigned if it is to play a significant role in the changing financial environment. It is believed that the redesign of the discount window herein proposed can bring the mechanism into closer touch with the prevailing economic climate and lead to a more effectively functioning member banking system.

III. SHORT-TERM ADJUSTMENT CREDIT

The adjustment action initiated by banks in financial markets in response to temporary loan and deposit fluctuations can at times contribute to excessive short-run market instability, particularly since the precise timing and amplitude of temporary swings are not predictable. In addition, short-run fluctuations in loans and deposits give rise to operations that impair to some extent the efficient operation of the financial system. The impairment is the result of otherwise needless transactions which commercial bank managers must conduct in order to maintain a margin of liquidity sufficient to meet unforeseen swings. If the adjustment alternatives open to the bank are limited in number and availability, this liquidity margin may have to be disproportionately large or costly in terms of foregone yield or potential capital loss on security sales.

For those reasons, one of the basic functions of the Federal Reserve System has been to provide temporary additions to commercial bank reserves through loans to member banks, in order to cushion the process of adjustment within the financial mechanism. Such credit accommodation undoubtedly leads to somewhat wider short-run fluctuations in aggregate reserves; but such movements, usually quickly reversed,

are regarded as less destabilizing than the fluctuations in pressures on financial markets and institutions that would otherwise result.

A. Basic borrowing privilege

A key objective of the proposed redesign of the discount mechanism is to formalize the terms of limited and temporary access to the window through the establishment of a "basic borrowing privilege" for each member bank unless and until otherwise notified. A basic borrowing privilege is defined as access to Federal Reserve credit by member banks upon request through the discount window within the limits of the law and according to precisely stated limits on amounts and frequency. To some extent, these borrowing privileges represent a formalization of the existing practice of providing temporary credit over a period of time whenever requested by member banks, but under existing practices neither the amount nor the duration of such limits is specified in the Regulation.

Through a basic-borrowing-privilege arrangement, however, the Federal Reserve would make unambiguously clear to member banks the terms of their access to this type of temporary credit. With clearly defined, precisely stated limits, a high degree of uniformity of administration of the basic borrowing privilege should be assured to all member banks.

The explicit nature of the borrowing privilege arrangement will enable member banks to use the Federal Reserve discount window more readily when they need funds for short-term adjustment purposes and find no more convenient alternatives at hand at comparable cost. This facet of the redesigned mechanism should be particularly attractive to the great majority of small member banks that currently make no recourse to the discount window.

The Federal Reserve does not now provide permanent additions to the loanable funds of individual banks through the discount window, and the proposal herein advanced does not alter that fundamental principle. Therefore, it is necessary to impose some limitation on the frequency and duration of credit provided to a member bank through a basic borrowing privilege. The recommended operational objective is for temporary credit accommodation to be extended over a long enough period to cushion short-term fluctuations and permit orderly adjustment to longer-term movements; but not for so long as to invite procrastination in the making of needed adjustments by individual borrowing banks or to delay unduly the response of the banking system to a change in general monetary policy.

On the basis of extensive review of past bank balance sheet fluctuations and borrowing patterns, the Steering Committee has concluded that the above objective is appropriately served by the following limitation: a bank shall not be empowered to draw on its basic borrowing privilege if such borrowing would cause it to be indebted to its Federal Reserve Bank (within or in excess of its basic borrowing privilege, but excluding any use of its seasonal borrowing privilege as provided on pages 14–16) in more than__(6–13) out of the last __(13–26) reserve periods.[1] The__(13–26) period interval is conceived of as a moving span; hence, eligibility for temporary adjustment

[1] The ranges indicated here and below extend from those limitations felt to provide the minimum meaningful assistance to member banks to the maximums believed compatible with the aims of monetary management. Final choices of limitations within these ranges will be made on the basis of experience and further deliberations.

credit under the basic borrowing privilege in the current reserve period is based upon adjustment borrowing frequency (both within a bank's basic borrowing privilege and in excess of that amount) during the immediately preceding — (12–25) periods.

The total amount of credit available to member banks—through the temporary adjustment credit program as well as through other types of borrowing at the discount window—must also be controllable if over-all objectives of monetary policy are to be achieved. In determining the maximum credit exposure which could be tolerated, consideration must be given not only to the absolute amount of credit provided but also to the potential fluctuations in borrowing from reserve period to reserve period. The recommended operational objective is for basic borrowing privileges to be large enough individually to be significant to each member bank, and large enough in the aggregate to cushion a significant part of the swings in market factors affecting reserves, but not so large in total as to exceed the capacity of open market operations to offset any excessive reserve creation or destruction resulting from the total of coincident bank drawing on or repayment of their basic borrowing privileges.

From the point of view of equity and efficient administration, the distribution of the sum total of borrowing privileges among banks needs to be simple and fairly stable, based on a formula that is easily verified and related in some reasonable way to the needs and creditworthiness of the borrowing bank. All things considered, the most practical method of establishing the basic borrowing privilege is deemed to be as a fixed percentage of each bank's capital stock and surplus. The combined total of a bank's capital stock and surplus is a conventional measure of its ability to service and repay indebtedness. Furthermore, it is a relatively stable item, and changes therein are promptly reported to the Reserve Banks in connection with the required purchases of Federal Reserve stock. Moreover, use of capital stock and surplus as a base discriminates least against newly organized banks in their access to the basic borrowing privilege.

The distribution of basic-borrowing-privilege access among member banks might, at first glance, seem to be most equitably accomplished by according the same percentage of capital stock and surplus to all; however, the practicalities of a manageable swing in aggregate credits and of vast differences in bank size argue for higher percentage limits on the basic borrowing privilege of small banks than on that of large banks. A constant percentage constraint applied to all banks which would result in a tolerable total credit exposure would provide so little credit to small banks that the program would be of relatively little use to them. If the percentage limit were increased uniformly so as to provide a reasonable amount of credit to most banks, the aggregate basic borrowing privilege would be excessive and could jeopardize the ability of the Federal Reserve System to meet its monetary policy objectives.

Analytical evidence also supports such a distinction. Studies have confirmed that, while the largest banks often experience wide deposit fluctutaions on a very short-time basis, small banks tend to face relatively larger fluctuations over periods of several weeks or longer than do large banks. This results in the main from their more limited opportunities for geographic and functional diversification of depositors. Though the empirical work done on the asset side is thus far less extensive, these same considerations would almost certainly apply

to loan totals. An inverse relationship between loan and deposit changes may be traced to the fact that both bank borrowers and depositors are influenced by common or related factors.

On the other hand, large banks needing to borrow funds to meet temporary outflows have more ready access to money market sources here and even abroad. They generally have more and cheaper alternatives because of their proximity to corporate, institutional, and governmental lenders of funds, the continuous information flow between themselves and these lenders, the ability and initiative of many of their specialized money managers, and finally their ability to tailor liability offerings to the size and maturity preferences of a wide range of customers.

These considerations indicate that large banks have, on the whole, less relative need for and greater access to external sources of credit and therefore have less relative need for assured short-term credit accommodation from the Federal Reserve.

Given all these considerations, and after review of the historical borrowing experience of various classes of banks, the Steering Committee recommends granting to each qualified member bank a basic borrowing privilege, measured by reserve period averages, equal to the following proportions of the bank's total capital stock and surplus:—(20–40) per cent on the first $1 million; —(10–20) per cent on amounts between $1 million and $10 million; and —(10) per cent on amounts in excess of $10 million.

Although the maximum credit extension which could currently result under this plan, again a reserve-period-average basis, is estimated as approximately —($2.5–$3.8) billion, the credit actually extended under the basic borrowing privilege would almost certainly be significantly less than this figure. Because of the diversity of fund flows among banks and the restriction on frequency of use discussed above, not all banks should be expected to be making full use of their basic borrowing privileges in the same reserve period.

The initial quantitative limitations suggested above may well need to be adjusted from time to time as experience with the use of the basic borrowing privilege develops. It is not intended, however, that such limitations should be changed so frequently as to disturb orderly bank planning for the utilization of such privileges in the course of reserve adjustment operations.

While temporary adjustment credit under the basic–borrowing–privilege program is to be generally available upon request, it is necessary to impose two specific qualifying conditions in addition to those general conditions arising from statute. First a bank, to be entitled to use of its basic borrowing privilege, must be in satisfactory internal condition. Otherwise access to discount window credit will be subject to administrative review. In such cases the Reserve Bank will determine the over-all condition of the bank, taking into consideration capital adequacy, soundness of loans, liquidity, and quality of management. If the Reserve Bank, after taking into account all these factors, judges that the bank's over-all condition is too poor to warrant access to discount credit without administrative review, that bank's basic borrowing privilege will be withdrawn until sufficient improvement is shown in its condition. During that interval, any adjustment borrowing which the bank undertakes at the discount window would be immediately subject to administrative review. Notification of such withdrawal would be given in timely

fashion, and in the absence of such direct notification, a bank would be able to rely on assured access to discount credit so long as it stayed within the previously defined limits on amount and frequency.

The second qualifying condition is an administrative rule that a bank borrowing under its basic borrowing privilege refrain from simultaneously providing net new funds to the money market—specifically, aside from possible infrequent transactions that result from miscalculations or large, unforeseen movements in the bank's position, it should not be a net seller of Federal funds in the same reserve period in which it is borrowing from a Reserve Bank. This restriction, a continuation of a policy already in force, is retained to preclude a large day-to-day retailing operation in Federal Reserve credit obtained through the discount window. It is recognized that banks could undertake to accomplish much the same purpose by resort to more indirect means, but currently the funds market is the only vehicle that can handle extensions of credit among banks on very short notice near the ends of reserve periods, when banks would probably be most interested in doing so. If obvious practices of circuitous transfers of credit in evasion of this provision should develop, consideration will be given to broadening and strengthening the scope of the provision commensurately.

The basic–borrowing–privilege program is both desirable and practical. Its adoption would serve as a clear communication to member banks that the discount window is changed. The program promises to contribute to more effective relations between member banks and Federal Reserve Banks while it improves the efficiency of the financial system in general by providing a ready access to at least a measure of temporary adjustment credit for both large and small member banks.

B. Other adjustment credit

The basic borrowing privilege described in the previous section would be the normal method of extending short-term credit to member banks, but it is not conceived as adequate to encompass all of the varying credit needs of banks which justify the use of temporary adjustment credit. Experience has shown that circumstances will arise when adjustment credit is required in larger amounts or for longer duration than can be accommodated under the limits of the basic borrowing privilege. Such supplemental credit should also be available on as unambiguous terms as possible. This credit, it should be emphasized, is in addition to and not in substitution for the other types of credit described in this paper—namely, the basic borrowing privilege, the seasonal borrowing privilege, and emergency credit.

Borrowing beyond the privilege limits would be subject to administrative procedures broadly similar to those which have been progressively developed in recent years under existing discount arrangements. These procedures can be thought of as a sequence of administrative actions ranging from review, which would include informational concern as to the nature of the borrowing bank's portfolio policies and the sources of its lendable funds, through conferences, during which Reserve Bank officials would consult with the management of the borrowing bank as it endeavors to develop a solution to its problems, to actual discipline, when the bank would be asked to begin paying off its loan.

In any case where a member bank, dur-

ing a consecutive —(12–26)-week period, has received short-term adjustment credit in any amount in more than —(6–13) weeks (that is, when the frequency limitation on the basic borrowing privilege is exceeded), the Reserve Bank will appraise the situation, perhaps in consultation with the bank, and make a determination as to the appropriateness of continued credit extension to that bank. This determination will be made in light of any specific indications that a timely forthcoming paydown of Federal Reserve indebtedness will occur by reason of expected inflows of funds or some other orderly program of balance sheet adjustment. Even if an extension is deemed justified by the surrounding circumstances, continuous review will be maintained throughout the course of the borrowing. Should the initial or any subsequent analysis indicate the absence of circumstances warranting a continued provision of supplemental credit, the Reserve Bank will initiate action with a view toward obtaining an appropriate adjustment. The precise timing and nature of such administrative action will, as now, remain at the discretion of the Reserve Bank, taking into account the circumstances in the individual case.

In actual fact, the basic-borrowing-privilege limitation on amount may be exceeded more often than the limitation on frequency. The former event, like the latter, will call for an internal review of the case. Such borrowing above base will probably occur from time to time as a result of bank efforts to cushion sharp temporary drains, and therefore, as now, could usually be expected to be quickly repaid without any need for Reserve Bank intervention. However, if the balance sheet of the bank suggested that factors other than such temporary drains were responsible for the borrowing, the Reserve Bank could undertake administrative actions and, if it were called for, might request an early adjustment by the bank. In all cases, the scope and thrust of the adjustment required would be related, as it currently is, to all aspects of the bank's position and historical borrowing record and to the desirability of achieving an orderly program of realignment of bank assets and liabilities, with the choice among alternative adjustment procedures continuing to rest with the bank's own management.

As this implies, the fact that a bank exceeds the amount or frequency limitation of its basic borrowing privilege does not mean that it is immediately contacted and asked to reduce its borrowing but only that it loses its immunity to such contact and administrative review. In contrast to the arrangements in some foreign countries, where a line of credit (similar in principle and design to the basic borrowing privilege) is designed to control *total* use of the discount window, the proposed redesign includes the borrowing privilege only as a limited source of reserves, with supplemental borrowing taking place from time to time as a normal occurrence, especially on the part of larger banks. Therefore, member banks can expect to receive such discount credit as they have a justifiable need for, in excess of the specific limits on the basic borrowing privilege.

An adjustment program compatible with the bank's situation will be expected of every borrower of supplemental credit, although in the case of clearly short-term and self-reversing fund flows this may require little or no overt action on the part of the borrowing bank. Supplemental adjustment credit should be thought of as temporary, and increasingly extended use will result in an increasing probability that the bank will be asked to work off its debt to the Federal

Reserve. Discount officials should be continuously informed and should undertake administrative discipline promptly in any situation where it becomes apparent that a bank is following the practice of using supplemental adjustment credit to finance a short-term position in money market assets.

The guidelines herein set down for the administrative control of supplemental adjustment credit have been general and may appear to leave too great latitude for the exercise of discretion by discount officers. To articulate any more specific rules or guidelines in this document is neither practical nor desirable, however. In the light of case-by-case decisions that would be made under the proposed procedures and subject to the underlying principle of equal treatment for banks in equal circumstances, standard operating procedures should develop in all discount offices. The final section of this report recommends arrangements to foster effective coordination of these procedures among all Federal Reserve offices.

IV. SEASONAL CREDIT ACCOMMODATION

A. Needs for seasonal credit assistance

Seasonal fluctuations in loans and/or deposits create asset-and-liability-management problems which many smaller banks seem unable to accommodate without impairing in one way or another the quality and adequacy of banking service they offer to their communities. Such recurring pressures, similar in nature and origin and probably to some extent overlapping the short-term fluctuations already discussed, tend to be the greatest in smaller communities where the economy is frequently dominated by agriculture or by a single industry of relatively small units. The consequence of such specialization is that the economic base in the communities is not sufficiently diversified to provide a supply of bank funds with adequate flexibility to meet marked seasonal changes in loan requirements and deposit positions. While the correspondent banking system provides a measure of credit to some of these communities, most often in the form of overline arrangements for loans exceeding the lending limit of the local banks, available evidence clearly indicates the need for more and in some cases differently structured credit to meet adequately the seasonal needs of the communities. Because of size, structure, and location, banks in small towns are often at a relative disadvantage in obtaining credit from other external sources, such as the issuance of large-denomination certificates of deposit or participation in the Eurodollar or Federal funds markets.

Regulation A currently provides that discount credit may be extended on a short-term basis to enable a member bank to adjust its asset position in cases of seasonal requirements for credit "beyond those which can reasonably be met by use of the bank's own resources." This policy, articulated in the revision of Regulation A in 1955, was adopted against the background of the heavily liquid positions of almost all banks during the earlier postwar years and their consequent ability to meet most seasonal drains effectively by selling assets.

With the passage of time, however, the liquidity positions of banks in many of the smaller communities described have been markedly reduced by expanding seasonal and secular demands for credit on the one hand and lagging community net income and deposit growth on the other. Particularly in agricultural areas, where credit

needs have been rising very rapidly, such trends seem likely to continue, progressively narrowing the ability of the local banks to meet the short-term credit demands in their communities. Despite these trends, the discount window has continued to provide only short-range and varying credit assistance to member banks experiencing seasonal fluctuations.

Under these circumstances, it has become appropriate to modify present seasonal lending practices at the discount window to provide increased assistance to member banks in accommodating seasonal demands upon them. The discount window can perform this function better than any other monetary tool, since only through it can the Federal Reserve make credit available directly where and when it is needed.

B. Seasonal borrowing privilege

It is proposed that each Federal Reserve Bank be authorized to establish a "seasonal borrowing privilege," renewable from one year to the next upon submission of appropriate evidence, for any of its member banks experiencing a seasonal need for funds of the kind and dimensions outlined below. The intent of the arrangement is to provide reasonably assured credit access to banks with definable and relatively substantial seasonal pressures for the approximate duration of such pressures, normally expected to be several months, but possibly ranging up to as much as 9 months in exceptional cases.

The seasonal borrowing privilege at the discount window is limited to cases in which the applicant member bank can demonstrate a probable recurring increase in its need for funds, arising from expanding demand for regular customer loans or shrinking deposits, or some combination thereof, which is expected to continue for a period of more than 4 weeks and is of sufficient size to be of significance in the asset and liability management of the bank. Loan and deposit fluctuations which are relatively small or which do not continue for as long as 4 weeks should be accommodated by internal bank policies or by recourse to adjustment credit assistance from the discount window and are not deemed to qualify a bank for special seasonal credit accommodation, despite frequency of occurrence.

The size of a bank's seasonal need for funds within any 12 months is to be measured by comparing the net intrayear changes in levels of deposits and loans to customers in the bank's market area. Since the minimum time period is fixed at four consecutive weeks, banks might have the option of using calendar months or, on a more refined basis, a 4-week moving average on which to base the estimate of their seasonal need. Seasonal estimates would be established essentially by projecting past years' experience, adjusted as appropriate to exclude nonrecurring movements.

In order for the bank to qualify for a seasonal borrowing privilege, its projected seasonal need for funds must exceed __(5–10) per cent of its average deposits subject to reserve requirements during the preceding calendar year. Any part of that need in excess of this limit is eligible for financing through the discount window subject to the other conditions described in this section. Use of such a "deductible" principle is designed to encourage individual bank maintenance of some minimum level of liquidity for purposes of flexibility and also to limit the aggregate total of seasonal borrowing privileges to an amount consistent with the aims of over-all monetary management.

Figures in Table 2 suggest the nature of the calculation of a seasonal credit need. In this illustration the total swing in net fund availability is $1.0 million, measured from the peak of $3.0 million in January, February, and March to the trough of $2.0 million in July, August, and September. Assuming an average level of deposits subject to reserve requirements of $5.0 million in the preceding calendar year, the swing clearly exceeds the minimum level of —(5–10) per cent of such deposits and therefore qualifies the bank for a seasonal borrowing privilege. The amount of the seasonal borrowing privilege at its maximum would be —($750,000–$500,000). Credit actually outstanding under the seasonal borrowing privilege would be expected to follow the pattern of gradual increase to a peak, followed by tapering off, as suggested in the table.

In the negotiation of a seasonal borrowing privilege, the Reserve Bank must have in its possession evidence demonstrating that the applying member bank has a significant seasonal need, what amounts of credit it expects to need, and the expected profile and duration of such needs. In many cases the bulk of this evidence will already be on file with the Reserve Bank. However, member banks should submit with their application any supplemental evidence they have at hand, especially with regard to altered seasonal demands which they have reason to expect. Such information is needed, preferably somewhat in advance of the actual takedown of credit, not only for scheduling and maintaining internal review over the seasonal borrowing but also to enable the System to conduct open market operations with some foreknowledge of the approximate volume and timing of seasonal injections of reserves which are expected to occur at the discount window. This knowledge will help to minimize the degree of unexpected fluctuation in borrowing which could make the achievement of monetary policy objectives more difficult.

TABLE 2

CALCULATION OF A SEASONAL CREDIT NEED

Month in base year	Total deposits	Total customer loans	Net fund availability		Seasonal swing from peak
1	5.3	2.3	3.0		.....
2	5.2	2.2	3.0	Peak	.....
3	5.2	2.2	3.0		.....
4	5.0	2.5	2.5		−.5
5	4.8	2.6	2.2		−.8
6	4.8	2.6	2.2		−.8
7	4.6	2.6	2.0		−1.0
8	4.7	2.7	2.0	Trough	−1.0
9	4.8	2.8	2.0		−1.0
10	5.0	2.5	2.5		−.5
11	5.4	2.4	3.0	Peak	.....
12	5.2	2.2	3.0		.....

Given a demonstrated seasonal need on the part of a member bank, the Reserve Bank will arrange to extend credit in the amount and for the duration needed (within the limits previously defined). Under current law, firm arrangements are limited to 90 days duration (except in the case of discount of eligible agricultural paper, for which the maximum duration is 9 months). However, in the event that a member bank's seasonal needs persist beyond the 90-day period, the Reserve Bank will consider sympathetically requests for further extensions of credit in accordance with the initial seasonal credit arrangement. In no case, however, would the duration of all seasonal borrowings under such an arrangement be permitted to exceed 9 consecutive months.

Under normal circumstances, the amount

of credit requested in the original arrangement should not be revised in midseason. The intention is that drawings of the seasonal credit, in accordance with projected needs, would be relatively firm and not subject to day-to-day or week-to-week fluctuations because of minor unexpected fund withdrawals or additions or resort to temporarily cheaper financing elsewhere. However, it is recognized that many factors of an unpredictable nature can accentuate or diminish the seasonal outflows, and the potentials for change, while probably not great in the aggregate, are sufficient in the case of the individual bank to make it impractical to bar all readjustments in the credit arrangement.

The Reserve Bank will periodically review the performance of the borrowing member bank, and should this review indicate that the seasonal need is not materializing as contemplated in the arrangement or that the bank is failing to operate in line with the arrangement in some other way, these factors would have a definite bearing on the Reserve Bank's evaluation of future applications for seasonal credit accommodation on the part of that bank. However, the Reserve Bank would also retain the option to curtail an outstanding seasonal credit arrangement which proves to be unneeded.

Because blocks of borrowed funds extended under seasonal credit arrangements will not be generating pressure on the borrowing banks to adjust assets or other liabilities in order to repay promptly (as do more conventional borrowings), they will be supplying reserves but will otherwise be neither adding to nor subtracting from the bite of general monetary policy. The reserve supply from takedowns of seasonal borrowing privileges can be offset to the extent desired by open market operations; conversely, these blocks of seasonal credit should prove sufficiently immune to any moderate changes in national reserve availability—particularly if the discount rate is kept reasonably closely in line with market rates—so as not to offset the latter changes substantially.

Given the other needs for credit at the smaller rural banks, for developmental capital as well as for day-to-day working capital, the more liberal granting of discount credit for seasonal purposes is regarded as one of the more important steps the System can take in this field. The assurance of adequate seasonal access should help to foster more definitive asset management by small banks and can also be expected to assist various larger banks which may qualify for seasonal credit accommodation.

V. EMERGENCY CREDIT ASSISTANCE

In its traditional central banking function, the Federal Reserve System is the ultimate source of liquidity to the economy. This role carries with it the responsibility to deal with emergency situations as they affect both member banks and the economy generally. Severe pressures encountered by banks and other financial institutions within the past few years, involving increasing illiquidity and interdependence and interaction among such institutions, emphasize the importance of the Federal Reserve's role in emergency situations.

The financial system's liquidity—excessive in the late 1940's, more than ample in the 1950's, and reasonably adequate at the start of the 1960's—has sometimes barely covered requirements in recent years. The asset structure of commercial banks and savings institutions reflects this downward trend, as

do increasingly aggressive efforts on the part of bank management to manipulate liabilities in pursuit of liquidity. Wide interest rate fluctuations in recent years attest to these factors.

Under present conditions, sophisticated open market operations enable the System to head off general liquidity crises, but such operations are less appropriate when the System is confronted with serious financial strains among individual firms or specialized groups of institutions. At times such pressures may be inherent in the nature of monetary restraint, in the sense that monetary policy actions, no matter how impersonally applied, often have, in fact, excessively harsh impacts on particular sectors of the economy. At other times underlying economic conditions may change in unforeseen ways, to the detriment of a particular financial substructure. And, of course, the possibility of local calamities or management failure affecting individual institutions or small groups of institutions is ever-present. It is in connection with these limited crises that the discount window can play an effective role as "lender of last resort."

This responsibility is not construed as placing the Federal Reserve in the position of maintaining the financial structure *in statu quo*. The System should not act to prevent losses and impairment of capital of particular financial institutions. If pressures develop against and impair the profitability of institutions whose operations have become unstable, inappropriate to changing economic conditions, or competitively disadvantaged in the marketplace, it is not the Federal Reserve's responsibility to use its broad monetary powers in a bail-out operation. Except in the case of member banks, where its responsibilities are somewhat more direct, the System should intervene in its capacity as "lender of last resort" only when liquidity pressures threaten to engulf whole classes of financial institutions whose structures are sound and whose operational impairment would be seriously disruptive to the economy.

A. Emergency lending to member banks

The Federal Reserve System has a clear responsibility to lend to member banks in both isolated and widespread emergency situations. It is expected that such assistance would often have beneficial effects for the economy as a whole, but in such cases the immediate responsibility of the System is directly to the member bank. This is one of the benefits of Federal Reserve membership—paid for in a sense by the maintenance of nonearning assets in satisfaction of reserve requirements—and a basic source of confidence in the banking system.

Therefore, the Federal Reserve will be prepared to give prompt and sympathetic consideration to providing the needed credit assistance to a troubled member bank, after having obtained the assurance of the chartering authority that the bank is solvent and that steps are being taken to find a solution to its problems. Emergency credit assistance through the discount window should be provided to member banks under essentially the same procedures as those employed in the case of short-term adjustment credit (in excess of the basic borrowing privilege). However, *ad hoc* exceptions or alterations in these arrangements—within statutory limitations—will at times be required to deal effectively with emergency situations.

Any member bank borrowing in an emergency situation will be under extensive administrative review. This review will include a program of coordination with the relevant supervisory and chartering authorities and will ordinarily take the form of counseling and such other direction as is needed

to work out of the situation. Administrative discipline may have to be applied in the case of an emergency caused by mismanagement or dishonesty (at least until the offending management is removed), but Federal Reserve efforts in an emergency situation would normally be geared to less drastic means of helping the member bank to reestablish a viable position. This will, in most cases, require credit for longer than would be permissible under the ordinary administration of temporary credit provision, but this will be expected and regarded as appropriate.

B. The System as "lender of last resort" to the economy through nonmember institutions

The role of the Federal Reserve as the "lender of last resort" to other financial sectors of the economy may, under justifiable circumstances, require loans to institutions other than member banks. The apparent general approval of recent instances of lending and offering to lend to nonmember institutions has strengthened the belief that the System's ability to carry out this function should be readily available for use when needed. In contrast to the case of member banks, however, justification for Federal Reserve assistance to nonmember institutions must be in terms of the probable impact of failure on the economy's financial structure. It would be most unusual for the failure of a single institution or small group of institutions to have such significant repercussions as to justify Federal Reserve action.[2]

The Federal Reserve Act places no explicit limitations on the types of institutions eligible for direct emergency credit assistance, since it authorizes direct advances to "any individual, partnership, or corporation"; but in fact, rather stringent limitations are imposed by the requirement that these advances be secured by "direct obligations of the United States." [3] In effect this means that, in an emergency, credit in any significant amount could probably be extended to nonmember, at least nonbank, institutions only by using a member bank as a conduit. That is, the Federal Reserve would lend funds to cooperating member banks that would in turn make loans to nonmember institutions. The relevant Federal agency can also sometimes serve in the role of a conduit, so long as that agency has lending authority and assets eligible for Federal Reserve acquisition. Thus the current law is not prohibitive of indirect lending to nonbank institutions, although it does involve additional arrangements and costs over those that would be involved in direct loans.

Decisions as to what types of institutions will be regarded, under justifiable circumstances, as eligible for emergency credit are best made in the light of the surrounding circumstances and relative severity of particular situations. Therefore, no inclusive or exclusive list of the types of institutions to which emergency credit may be extended should be established in advance of anticipated possible developments. Federal Reserve credit would be advanced to nonmember institutions only after other avenues of relief have been exhausted. Depositary institutions, the suppliers and holders of the na-

[2] An exception might be made in a case where the Federal Deposit Insurance Corporation requested Federal Reserve assistance for a nonmember commercial bank while the FDIC carried out a program to remedy the situation.

[3] In unusual and exigent circumstances the Board of Governors, by the affirmative vote of at least five members, may authorize any Federal Reserve Bank to discount eligible paper for any individual, partnership, or corporation which is unable to obtain adequate credit accommodation from other banking institutions. However, in practice this provision is of little use, since nonmember institutions typically have only very limited holdings of eligible paper.

tion's liquidity, are the most likely to encounter situations where this is necessary, and for this reason emergency credit would be accorded, in all but the most extraordinary circumstances, only to those institutions.

Supervised nonmember financial institutions would be required to obtain the support and assent of the relevant supervisory agency to receive Federal Reserve emergency credit. On the other hand, the Federal Reserve should not be obligated to lend to nonmembers merely on the request of their supervisor. While institutions can be declared insolvent only by the chartering authority or the courts (and such a declaration would effectively preclude Federal Reserve lending), the System should retain the option to reject requests for assistance even when the other agency considers the institutions solvent.

When lending to nonmembers, the System will require, in cooperation with the relevant supervisory agency, that the institutions develop and pursue a workable program for alleviating their difficulties and will follow the progress of the agreed-upon program closely. Credit will be provided only at a significant penalty rate vis-à-vis that charged member banks. This penalty rate can be thought of as offsetting, in part, the cost of maintaining reserves with the System which is continuously borne by member banks.

C. Support of distressed markets through the discount window

It is possible that, in periods of severe monetary stringency, markets for certain financial instruments, such as Federal, State, and local government securities, corporate securities, and mortgages, may become so distressed by disappearance of buyer interest, necessitous selling or "dumping" of issues, or other influences that a crisis develops which threatens the entire financial fabric of the nation. Under such circumstances, the Federal Reserve will be prepared to take action in a variety of ways to forestall the developing crisis.

Action through the Open Market Account, where possible, is the appropriate means for dealing with such a widespread problem. However, in a situation of extreme emergency, consideration would be given to making the discount window available to member banks (and, more remotely, to nonmember financial institutions) in order to reduce necessitous sales of these assets and thus to alleviate crisis pressures in the market.

VI. DISCOUNT RATE POLICY

The proposed redesign of the discount window contemplates an increase in the numbers of banks regarding the window as a useful source of funds. One of the major obstacles acknowledged to exist currently in this area is the confusion on the part of member banks as to the terms and conditions for discounting. The redesign should substantially reduce banker uncertainty by the specific quantity-and-frequency limitations regulating the basic borrowing privilege. But the discount rate also has a significant role to play in this operation if the mechanism is to result in an improved adjustment process.

Achieving maximum effectiveness calls for maintenance of the discount rate consistently at a level reasonably close to rates on alternative instruments of reserve adjustment. The exact relationship to market rates

at any time will depend largely on current monetary conditions and policy objectives, but it would be expected that related market rates would move higher relative to the discount rate in periods of restraint and lower relative to the discount rate during periods of ease.

The closer linkage of the discount rate to market rates will probably call for more frequent changes in the discount rate than have been made in recent years. It is believed that such changes can be achieved by more active communication within the System and will become easier as the pattern of more frequent discount rate adjustments tends to reduce the unpredictable announcement effects which often attach to a given rate change. As banks come to regard the window as a more liberal and useful source of funds, with no risk of administrative pressures within the confines of the basic borrowing privilege and a clearer understanding of the limitations attaching to other borrowing, price will naturally become a more meaningful factor in their decisions. Thus rates on alternative means of adjustment will tend to cluster somewhat more closely around the discount rate. Because a measure of administrative review will continue to attach to some discounting, however, market rates are likely to be somewhat above the discount rate so long as reserves are in scarce supply and rate relationships are allowed to seek their own levels.

There are several limitations on using rate as the sole or even major instrument for control of borrowing. Complete rate flexibility is neither practical nor desirable. Under certain circumstances, too frequent or poorly timed changes could contribute to instability in the structure of market rates. This could be particularly true in a period of tightness when increasing reserve cost could rapidly escalate market rates.

Because of the Federal Reserve's role as the lender of last resort, the demand curve which it faces may be somewhat different from that applying to other lenders. Ordinarily, this difference should not be very significant, but during periods of stringency the demand for accommodations from the System could conceivably become highly inelastic, particularly in the very short run when banks may face liquidity or credit demands (including those from long-valued customers) without having immediate access to adequate alternative sources of funds. In such instances, the exclusive use of price as the allocator of funds at the discount window could be severely damaging to the long-run stability of financial institutions.

There may also be occasions when relationships between U.S. rates and those abroad, or between bank and market rates or those being paid at other financial institutions, are so delicately poised that Federal Reserve discount rate changes may have to be withheld in order to avoid triggering highly disadvantageous flows of funds. At such times, the overriding importance of other relevant national interests involved may compel the discount mechanism to operate with greater reliance upon its quantitative and administrative controls and less upon the impersonal criterion of rate.

These limitations should not, however, be thought to deprecate the role which the discount rate can play under normal circumstances; usually rate can serve as a pervasive, sensitive, clearly uniform, and flexible control mechanism. But the limitations mentioned demonstrate the impracticality of exclusive reliance on rate. Other controls —quantity and frequency limitations and, when necessary, administrative actions— must be not only available but also in use if the System is to be sure that discounting

operations do not subvert monetary control generally.

Under the present Regulation A, with the great bulk of Federal Reserve loans carrying maturities of 15 days or less, few problems arise with regard to outstanding loans when the discount rate is changed. The circumstances would become somewhat different, however, if a seasonal loan were to be outstanding for as long as 9 months. As an integral part of the proposal for redesign, therefore, it is recommended that all discount rate changes be made immediately applicable to all outstanding loans. The suggested provision would eliminate the tendency for banks to overestimate their seasonal needs in order to "lock in" credit in anticipation of an expected rate increase. The automatic rate adjustment would also be helpful in achieving the objectives of monetary policy, since it would avoid allowing relatively long-term loans to remain outstanding at the earlier rate, thereby increasing the lag in the impact of a policy-motivated rate change. Lastly, without this type of built-in adjustment, banks whose borrowing begins shortly before a rate decrease would be unfairly penalized or would be forced to go through the administratively burdensome procedure of repaying their loans and reborrowing at the lower rate.

Discount rates will continue to be established by the Boards of Directors of the Reserve Banks, subject to review and determination by the Board of Governors. This method of rate-setting carries with it the possibility of short-term inter-district differences in the discount rate. Such short-term differences are not viewed as a problem, and the proposed redesign contains no special provisions to prevent them, mainly because the machinery for achieving uniformity, through use of the requirement of approval by the Board of Governors, is available in the event that it is needed. In any case, it is probably somewhat unrealistic to contemplate the maintenance of wide inter-district rate differentials over any period of time in the highly interdependent economy of the Nation.

As noted in Section V, emergency credit to the economy through nonmember institutions should be provided only at a significant penalty relative to the discount rate. While the responsibility of the Federal Reserve to provide lender-of-last-resort credit to the economy through these institutions is generally recognized, it remains true that the benefits of membership in the System must be maintained and member banks should therefore receive some measure of preferential treatment. This penalty rate might be thought of as offsetting in part the cost of maintaining reserves with the System, which is continuously borne by member banks.

VII. ANCILLARY RECOMMENDATIONS OF THE STEERING COMMITTEE

A. Provisions for coordination of discount administration

The increased reliance on the discount rate and on quantity and frequency limitations to regulate borrowing behavior, which constitutes an essential part of the redesign of the discount mechanism, will permit a clear and unequivocal communication of these facets of discounting standards and limitations to member banks and will thereby help to promote uniformity of window operation among districts and among banks. However, the retention of a measure of administrative control is seen as necessary if the System is to accommodate adequately the widely differing needs of individual member banks while

at the same time maintaining the necessary monetary control. It is intended that such administrative control be applied in the most uniform and consistent manner possible in line with the principle of equal treatment for banks in equal circumstances. Regulation and machinery to help insure this objective are therefore regarded as appropriate.

One effective move in this direction will be the formalization of a practice already in existence. Recent years have seen a significant increase in the level and frequency of communication among the discount officers of the 12 Reserve Banks. These officials now hold an annual conference and monthly telephone conference calls in addition to the more informal contacts among individual districts.

These discussions are devoted in large part to the exchange of information on the ways in which individual borrowing cases are being handled. Out of this exchange administrative guidelines have been developing which can be referred to by discount officers faced with a new or unusual situation. This development is seen as an evolutionary process, with the character of the guidelines expected to change somewhat over time in line with experience and changes in the surrounding economic climate. However, the need for machinery for fostering the development of such guidelines and maintaining them (that is, currently existing and perhaps stepped-up contacts among all discount officers) is recognized, and such further arrangements as are felt necessary will be implemented as part of the redesigned discount window.

B. Changes in reserve regulations to facilitate end-of-period reserve adjustment

The Steering Committee endorsed the lagged reserve proposal adopted by the Board of Governors as an amendment to Regulation D. Under this plan, which will become effective September 12, 1968, all member banks have a 1-week reserve accounting period with required reserves based upon deposits 2 weeks earlier. Vault cash to be counted as reserves is also lagged 2 weeks. Banks are permitted to carry forward to the next reserve period excess reserves or reserve deficiencies of up to 2 per cent of required reserves. This plan, including a number of other less significant changes, should ease adjustment problems at the end of reserve periods and is a move complementary to the redesign of the discount mechanism fostering a smoother and more effectively functioning member banking system.

C. On-going studies of means of improving the shiftability of bank assets and liabilities

A possible type of credit accommodation not provided for in the redesigned window is long-term credit to meet the needs of banks servicing perennial credit-deficit areas or sectors. It was concluded that the solution to this problem does not properly lie within the scope of discount-window operations. To undertake to provide credit for such a purpose would enmesh the System in socio-economic and political problems beyond its proper scope and could distort the balance sheet structure of commercial banking in some communities by financing the expansion of loan portfolios far beyond the limits of deposits. More direct and fundamental answers to the credit-deficit problem are believed to lie in the improvement of secondary markets for bank assets and liabilities.

The Steering Committee therefore recommends that *ad hoc* task forces be established within the Federal Reserve System—possibly also drawing on the talents of other agencies

and groups—to pursue detailed studies of the feasibility of providing long-term credit assistance through some types of market-perfecting actions. It is recognized that extensive work has already been done in this area, with only limited success, but the Steering Committee nonetheless regards improvement of secondary markets as the most promising solution to the credit-deficit problem and feels that further investigation can be fruitful.

These studies will have to recognize and evaluate the possibility that the development and expansion of such markets may in itself impose further responsibilities on the Federal Reserve System in periods of extreme monetary stringency. As banks are led to concentrate an increasing portion of their adjustment efforts in these markets, the possibilities will increase that conditions in one or more of them could become so disrupted that it would become necessary to take action to forestall the developing crisis. Such action could include making the discount window available to banks to reduce necessitous sales of these assets, thus alleviating crisis pressures in such markets. Further consideration of this possibility is contained in Section V, "Emergency Credit Assistance."