The Role of Discount Window Policy in Balance Sheet Reduction

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Reducing the Federal Reserve's balance sheet

- Motivation: reduce the Fed's distortionary "footprint" in financial markets
  - Monetary Policy Task Force on Balance Sheet Policy to "Examine the costs, benefits, and institutional implications of the Federal Reserve's current balance sheet regime"
- Among various measures proposed to facilitate balance sheet reduction:
  Allow banking organizations to count their unused discount window capacity toward various regulatory and supervisory liquidity requirements
- Unwise:
  - Would undermine the purpose of liquidity constraints
  - Would increase moral hazard associated with discount window access
- Better:
  - Reconsider antipathy to transitory volatility in money market spreads
  - Alter the *composition* of the Fed's balance sheet

Liquidity Constraints

- Regulatory and Supervisory Liquidity Requirements:
  - Liquidity Coverage Ratio
    [High Quality Liquid Assets ≥ 30-day outflow under "stress scenario"]
  - Net Stable Funding Ratio [one-year "stress" horizon]
  - Internal Liquidity Stress Tests
  - Resolution Planning provisions
    [Resolution Liquidity Adequacy and Positioning & Resolution Liquidity Execution Need]
  - *(Note: HQLA pledged to DW <u>does</u> count toward liquidity constraints: issue is non-HQLA)*
- Created after GFC under authority of the Dodd-Frank Act (2010)
- Purpose:
  - Counteract banks' incentive to hold too little by way of liquid assets
  - Mitigate the moral hazard effects created by the expectation that Fed lending and/or official support would be forthcoming in the event of financial distress

Why were liquidity constraints adopted?

"Capital, liquidity, and risk-management requirements for systemically important firms will need to be strengthened to help **counteract moral hazard effects**, as well as the greater potential risks these institutions pose to the financial system and to the economy." – Tarullo/Bernanke, July 2009

"Because of the presence of a **lender of last resort**, banks may not hold socially optimal levels of liquid assets. The LCR buffer established by the proposed rule **offsets the moral hazard** to a degree and lowers the probability of a liquidity crisis and may limit the severity of liquidity crises when they do occur." – LCR NPR 2013

"Covered companies are expected to maintain appropriate levels of liquidity **without reliance on central banks acting in the capacity of lenders of last resort**." – LCR Final Rule 2014

"They [LCR and NSFR] will also help central banks **limit the use of LOLR**." – Tarullo, November 2014

The economic logic of liquidity constraints

Private Lines of Credit

- Commitment to lend at preset spread
- Contingent on agreed *loan covenants*
  - Sometimes include minimum holdings of liquid assets
- Terms presumably ex ante efficient
  - Reflect informational constraints, agency problems, ex post conflicts of interest
- Borrower: "May I count my unused loan commitment toward my liquidity covenant?"
- *Covenant would be increased to offset*

Discount Window

- Availability discretionary
- Borrower must be in "generally sound condition"
  - Linked to supervisory ratings and capital and liquidity constraints
- Terms presumably balance ex ante social costs and benefits
- "Let's count unused DW capacity toward liquidity constraints."
- *Constraints should be increased to offset*

Historical Perspective

- Discount window was central to **monetary policy** operations at Fed's founding
  - Envisioned as the method of adjusting the supply of monetary liabilities
  - Eclipsed by open market operations over time
- DW **subservient** to OMOs after 1951 Treasury-Fed Accord
- 1960s: Discretionary (sterilized) lending to protect creditors of failing banks
  - The rise of **Too Big To Fail**: Expectation of Fed intervention to mitigate ex post costs
- Does the Fed lend to conform to an ex ante optimal lending arrangement?
  - Mitigating ex post costs and "spillovers"
- Or does the Fed lend in response to perceived political costs
  - Because it simply cannot commit not to defray private ex post costs
- 2009 testimony of Tarullo/Bernanke suggests the latter
  - Otherwise, why not just (credibly) alter lending policy?

Reassess “Ample Reserves” instead?

- FOMC ended balance sheet reduction after Sept 2019 spike in overnight rates
  - Banks and money market funds seemed unwilling to increase lending in repo market
  - Rate spike was transitory: over in two days, rate futures moved 2 basis points
- Year- and quarter-end rate spikes have been quite common, reflecting known regulatory accounting asymmetries across banks (daily-average vs. quarter-end)
  - Fed typically “looks through” these transitory spikes, since longer-term rates are unaffected
- The Lucas Critique seems relevant
  - Reluctance to lend in repo market in 2019 said to reflect banks’ organizational arrangements
  - Likely to be endogenous w.r.t. “regime” = average level of reserves, propensity to intervene,…
- Calls to mind William McChesney Martin (1952) re “official mothering”
  - Price support inhibits the “natural strength and resilience” of market-making institutions
- Balance Sheet Task Force should revisit assessment of “ample reserves”

But why reduce the *size* of the balance sheet?

- Motivation: Reduce the Fed's "footprint" in financial markets in order to minimize the distortionary effects of the Federal Reserve's financial market presence
- Arguably, the ***composition*** of the Fed's balance sheet matters more than ***size***
- Given the quantity of bank reserves supplied by the Fed, shifting into T-bills arguably would reduce financial market distortions
  - *Agency MBS → T-bills*
  - *Longer-term Treasury securities → T-bills*
- Balance Sheet Task Force should reassess the composition of the Fed's portfolio
  - *Why should the Fed ever depart from Bills Only?*