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July 25, 2002

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. R–1123; Proposed Amendments to Regulation A: Extensions of Credit by Federal Reserve Banks; 12 CFR Part 201; 67 Federal Register 36544; May 24, 2002

Dear Ms. Johnson:

The Board of Governors of the Federal Reserve System ("Board") has proposed amendments to the Federal Reserve System's discount window credit programs. The Board proposes to replace the existing adjustment and extended credit programs with new discount window programs called primary credit and secondary credit, respectively. The proposed amendments could affect all commercial banks and savings associations that are eligible to borrow from the discount window. The American Bankers Association ("ABA") brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership - which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks - makes ABA the largest banking trade association in the country.

In summary, ABA's positions are:

- A movement away from the non-price allocation of credit from the Federal Reserve is an improvement over the current system.
- The penalty spread of 100 basis points on Primary Credit should be lowered.
- The appropriate spread should be justified with research by the Board.
- Implementation of the change in Discount Window operations should be delayed until the Federal Reserve receives the statutory authority to pay interest on sterile reserves.
- The Federal Reserve's Discount Window Seasonal Credit Program should not be altered.

Primary Credit Program

According to the Board, the implementation of the proposal would not entail a change in the Federal Reserve's monetary policy position. This proposal does not necessitate a change in the practice of targeting the federal funds rate or the level of interest rates more generally.

The proposed rule establishes a new type of discount window credit, to be called primary credit, which would replace adjustment credit, currently the Federal Reserve's main lending program. Primary credit would be available for very short terms as a backup source of liquidity to depository institutions that are in generally sound financial condition. The Board envisions that the interest rate on primary credit will be set at a rate above the targeted federal funds rate – initially 100 basis points above the targeted federal funds rate.

The Board cites several reasons for changing the basic structure of how the discount window operates:

1. Reduces federal funds rate volatility.
2. Creates a greater degree of consistency in credit administration across Federal Reserve Districts.
3. Eliminates the incentive for banks to engage in arbitrage.
4. Eliminates the stigma associated with borrowing from the Federal Reserve.
5. Aligns lending practices with other central banks.

According to the proposal, the prohibition on lending the proceeds of a primary credit loan to other depository institutions will be eliminated. Unlike adjustment credit, which is priced at a below-market rate, primary credit would be extended at a rate that would be above the usual level of short-term market interest rates.

The proposal restricts eligibility to generally sound institutions and eliminates the incentive for institutions to borrow to exploit the below-market discount rate. The primary credit program should considerably reduce the need for Federal Reserve discount officers to review the funding situations of borrowers. And since only sound institutions will be using primary credit, the Board believes that banks should be less concerned that their use of the window would signal incorrectly that they were experiencing significant funding difficulties. As a result, the Federal Reserve expects that institutions will be more willing to use the window. This increased willingness, and the ability of institutions to resell the proceeds of discount window loans, should improve the functioning of the window as a safety valve for the reserve market and for individual institutions.

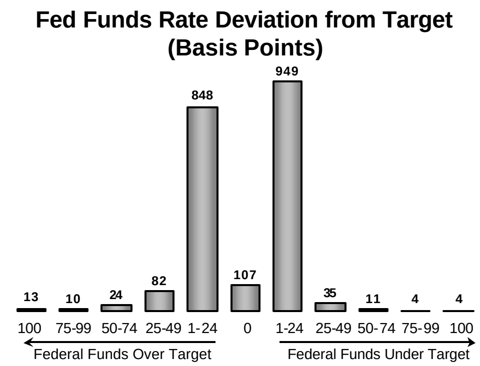
The interest rate for primary credit would be set through a procedure identical to that currently used for the basic discount rate. That is, the boards of directors at Reserve Banks would set the rate, subject to review and determination by the Board of Governors. In the proposal, it is envisioned that the interest rate on primary credit would initially be set 100 basis points above the target federal funds rate. If adopted, the Federal Reserve anticipates that this program would align its lending practices to those of other major central banks.

ABA's Position on Primary Credit

The ABA believes that a movement away from the non-price rationing of credit from the Federal Reserve will represent a general improvement in the operations of the discount window. However, we have several concerns that we believe need to be addressed before the proposal is implemented. As proposed, we believe that the new approach is inconsistent with several of the reasons mentioned by the Board for change in the operations of the discount window.

The Penalty Spread on Primary Credit Is Too High.

First, while the ABA understands that the Board of Governors wishes to dissuade banks from using primary credit for arbitrage, ABA has reservations regarding the magnitude of the proposed premium on the primary credit program. The Board has not provided a compelling reason as to why 100 basis points is the appropriate starting point. Furthermore, the Board has not provided any evidence that banks were engaged in arbitrage.



The above data represent daily closing rates, January 1, 1994 to May 28, 2002.

Chart 1 shows the distribution of the deviation of the closing federal funds rate relative to the targeted federal funds rate for the period of January 1, 1994 through May 28, 2002. On only 13 occasions during this time interval did the closing federal funds rate exceed the targeted federal funds rate by at least 100 basis points. On only one occasion in the past five years has the daily effective federal funds rate risen 100 or more basis points above the Federal Open Market Committee's ("FOMC") funds rate target. And only once in the past 39 weeks has the effective federal funds rate been more than 20 basis points above the FOMC's target rate. Furthermore, a 100 basis point difference between the effective closing federal funds rate and the targeted federal funds rate represents nearly a five-standard deviation event.

Moreover, the proposed magnitude of the penalty will likely lead to situations where nonborrowed reserve shortages will result in higher federal funds rates than would result under the current administration of the discount window. This will be a depressant to bank profits without any monetary policy benefit.

If borrowing from the discount window were a "right" for banks, then the federal funds rate would not rise above the discount rate. Why would a bank pay 1.75% for funds when it could go to the discount window to receive funds for 1.25%? However, with only a few exceptions, the federal funds rate has been above the discount rate in the past five years. Evidently, then, borrowing from the discount window is more of a "privilege" than a "right."

Because the discount rate currently is set at a level beneath the targeted federal funds rate, the Federal Reserve has to "administer" the discount window. That is, to make sure that a bank is not abusing its privilege of borrowing from the Federal Reserve at a subsidy rate, the Federal Reserve has to keep track of how many times a bank has borrowed within a certain period of time, whether a bank is bypassing its regular funding sources in favor of the cheaper Federal Reserve, and whether a bank is borrowing from the Federal Reserve at a lower rate and then re-lending those funds advantageously in the market. The upshot is that there are nonpecuniary costs of borrowing from the discount window. Moreover, these nonpecuniary costs can vary across time and across banks.

The following discussion compares the current system with the proposed rule and shows its impact on the federal funds rate.

Suppose that on the settlement Wednesday of the two-week reserve maintenance period, the Federal Reserve has provided too few nonborrowed reserves to the banking system. Banks that are short of their required reserves will start to bid for the fixed quantity of reserves – a quantity *less* than demanded by the banking system. This excess demand for reserves will start to drive up the price of reserve credit – the federal funds rate. The funds rate will continue to rise until some banks' demand for excess reserves – reserves above required reserves – declines and/or until some bank or banks go to the discount window for reserves. As the quantity of reserves increases via the discount window, the federal funds rate stabilizes or declines. What determines how high the federal funds rate will rise is the interest sensitivity of banks' demand for excess reserves and the degree of reluctance on the part of banks to be scrutinized by discount window officers.

Now, examine what would happen if there were a reserve shortage in the context of the Federal Reserve's 100-basis point penalty discount rate. Again banks would bid for scarce reserves. But in this case, because banks have no incentive to go to the discount window until the funds rate is 100 basis points over the target rate, the only factor that could possibly prevent a 100 basis point increase in the federal funds rate over the target rate would be the interest sensitivity of excess reserves. But if the quantity of excess reserves in the system were less than the shortfall in nonborrowed reserves relative to required reserves, then the funds rate would rise 100 basis points above its target rate.

In sum, the proposed change in the discount rate to a penalty rate *would* put a cap on the federal funds rate. But it would also create a strong presumption that the funds rate would rise to that cap level in cases of reserve shortages. The effective federal funds rate has seldom risen to a level 100 basis points over the target rate. A 100 basis point penalty discount rate spread would seem to unnecessarily impinge on bank profits <u>and</u> with no demonstrated benefits to the conduct of monetary policy.

Therefore, ABA believes that the premium between the interest rate on primary credit and the targeted federal funds rate should be lowered. Possibly, a spread of 25 basis points to 50 basis points above the targeted federal funds rate will achieve the same outcome. In fact, the Federal Reserve could offer to lend reserves at the Federal Open Market Committee's target federal funds rate provided that the bank borrower presents the same kind of collateral presented to the Open Market Desk when the Federal Reserve engages in repos with dealers. This would alleviate shortfalls in the funds rate from its target when there are unwanted reserves in the banking system.

However, if the Federal Reserve is concerned about end of day spikes or spikes in the federal funds rate on settlement Wednesday, the Board may wish to consider some variant of peak load pricing, where the price of primary credit is tiered based upon proximity to the close.

The ABA would like to see the Board research the appropriate premium before making the decision to set it at 100 basis points above the targeted federal funds rate. ABA would be pleased to work with the Federal Reserve.

Proposal Should Be Implemented Only When the Federal Reserve Gets Statutory Authority to Pay Interest on Reserves.

By setting the interest rate on primary credit above the targeted federal funds rate, the ABA believes that the Federal Reserve will have effectively put in place a ceiling on the federal funds rate. However this proposal does not address the downside volatility in the federal funds market. Since many community banks are net sellers of federal funds, they are adversely affected by downside volatility in the federal funds rate.

Moreover, the Federal Reserve justifies charging a penalty rate for discount window borrowings because it will align its practice with other central banks. However, the proposal does not acknowledge that the central banks of the European Monetary Union pay interest on reserves.[1] It appears to us that there is a *quid pro quo* between interest on reserves and the pricing of discount window borrowings by other central banks.

If the Board wishes to make the proposed changes in the operations of the discount window, there should be a collar set around the targeted federal funds rate. Our recommendation is to delay the implementation of this proposal until the Federal Reserve is granted the statutory authority to pay interest on sterile reserves. The payment of interest on sterile reserves would allow the Federal Reserve to set a floor for the effective federal funds rate. This would allow the Federal Reserve to set a range in which the federal funds rate could move.

The Federal Reserve Should Not Penalize Banks Asked to Borrow to Ensure Payment System is Functioning.

Several bankers have informed ABA that the district Federal Reserve Banks, on occasion, have encouraged their institutions to use the discount window to ensure that the payment system is functioning, even when they have no need for the funds. To assess the bank a penalty rate above the targeted federal funds rate when they are providing a benefit to the Federal Reserve appears to be onerous and will discourage participations in testing the payment system. ABA believes that the Board needs to put in place procedures so as to not penalize these institutions, which are providing a benefit to the Federal Reserve.

Stigma Remains, But Now at a Higher Price.

The Federal Reserve argues that the stigma associated with borrowing from the Federal Reserve will be eliminated because only sound institutions could now borrow from the primary credit program. The Federal Reserve proposes that institutions that do not qualify for the primary credit program could borrow from the secondary credit program, which will replace the extended credit program.

Unfortunately, it is not shown in the proposal that market participants will be able to differentiate between the two programs. Discount borrowings from both programs will appear the same. Due to the opaqueness of the two programs, the stigma will remain; but now at a higher cost.

However, the answer is not increasing transparency so market participants can differentiate between borrowers from the two programs. If the Federal Reserve disclosed whether a bank was borrowing primary credit versus secondary credit from the Discount Window, this could generate unintended consequences of fueling silent runs on banks' borrowing from the secondary credit window. Moreover, less sound institutions that need liquidity would refrain from using the secondary credit program for fear of signaling to the market they are in distress.

Clearly, the Federal Reserve is left with a conundrum. If it discloses the information, it could generate silent runs and discourage less sound institutions from using the discount window to meet short-term liquidity needs in fear of sending an adverse signal. But if the Federal Reserve does not disclose, informational asymmetries will cause sound banks to refrain from using the window when they have short-term liquidity needs.[2]

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[1] Testimony of Carl Tannenbaum, On Behalf of the American Bankers Association, Before the Committee on Banking and Financial Services, United States House of Representatives, May 3, 2000. Also see: Richard Kopcke, "The Practice of Central Banking in Other Industrialized Countries," *New England Economic Review,* Federal Reserve Bank of Boston (Second Quarter 2002).

[2] George Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* (August l970).

Despite these concerns, ABA does not believe that the Federal Reserve should disclose whether institutions are borrowing from the primary credit or secondary credit program. If the Federal Reserve were to release this information, it would be substituting its judgment for the markets.

Seasonal Credit Program

The Board is also seeking comment on the seasonal credit program. The Board is requesting specific comment on whether small depository institutions still lack reasonable access to funding markets and on the continued need for the seasonal lending program. The Board would also like comment on the method for setting the seasonal credit discount rate, which is currently the average of the federal funds rate and a certificate of deposit rate. This rate would be well below the proposed primary credit rate.

Speaking before the Tennessee Bankers Association, Federal Reserve Governor Susan Bies stated that: "the seasonal credit program was established in 1973 to address the difficulties that relatively small banks with substantial intra-yearly swings in funding needs faced because of a lack of access to the national money markets. However, funding opportunities for smaller depository institutions have expanded significantly over the past few decades as a result of deposit deregulation and the general development of financial markets, calling into question the continued need for the seasonal program."[3]

ABA's Position on Seasonal Credit

While Gramm-Leach-Bliley Act expanded community financial institutions' access to the Federal Home Loan Banks, funding and liquidity issues remain a long-term concern for community banks, especially rural and agricultural banks.

According to the forthcoming *ABA Farm Credit: Survey Report*, nearly six out of ten rural and farm banks surveyed – down from 80 percent the previous year – used non-deposit sources of liquidity or loanable funds in 2001 with almost 16 percent of the banks using the Federal Reserve's seasonal borrowing program. Smaller banks under $100 million in assets were more likely to use the seasonal borrowing program than larger agricultural banks. Seasonal borrowings (median) as a percent of loanable funds were 4 percent.

In April 2002, the Nebraska Bankers Association ("NBA") surveyed its members about agricultural credit conditions. In the survey, 48 percent of the respondents stated that they experienced liquidity problems during peak lending periods. According to the NBA, 35 percent stated they resolved their liquidity problem by borrowing from the Federal Home Loan Bank, 27 percent borrowed federal funds, and 11 percent used the Federal Reserve Discount Window, presumably the seasonal credit program.

The *2000 ABA Farm Credit: Survey Report* found that rural and farm banks' use of non-deposit sources of loanable funds was limited by their cost.[4] Among banks where loan demand exceeded deposit growth; two out of three banks stated that the cost associated with non-deposit funds limited their use.

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[3] Governor Susan S. Bies, *Bank performance and corporate governance*, at the 112th Annual Meeting of the Tennessee Bankers Association, Hot Springs, Virginia, June 11, 2002.
[4] *ABA Farm Credit: Survey Report*, 2001.

For many community banks, access to Federal Home Loan Banks and the Federal Reserve's seasonal borrowing programs are the only games in town. Given supervisory concerns that a bank not become too dependent on a single source for funding and liquidity, maintaining the seasonal credit program gives most community banks another alternative. Moreover, the competition will help to discipline the Federal Home Loan Banks' pricing and other lending practices.

Therefore, the ABA believes that the Federal Reserve should not alter its seasonal borrowing program. The seasonal borrowing program remains an important tool for rural and farm banks, especially smaller institutions, to meet peak lending period needs. Any changes in the program may disadvantage rural and farm communities. Funding challenges for rural banks remain – perhaps temporarily abated by softness in the stock market. Over the longer run, this is a very necessary program for rural and agricultural banks.

Additionally, the rate differential between the seasonal credit program and the proposed primary credit program should not be a concern. ABA's own research suggests that rural and agricultural banks, particularly smaller financial institutions, rarely use the Federal Reserve's adjustment credit program. The evidence would indicate that the markets are segmented and financial institutions view the programs as poor substitutes for one another.

Conclusion

The ABA wants to thank the Board for soliciting comments from the industry regarding changes in the operation of the discount window. While we agree that the direction of the proposed changes represents an improvement over the current system, we believe there is substantial room for improvement. The administered penalty rate in our estimation is too high and will almost certainly result in a higher price for credit reducing bank profitability and system-wide liquidity. Moreover, the proposed change should be coupled with the ability of the Federal Reserve to pay interest on bank reserves. Finally, the ABA strongly encourages the Board to preserve the Seasonal Credit Program as is. Rural and agricultural banks still view the program as an important source of liquidity and funding for their communities.

If you have questions regarding our comment letter, please contact the undersigned at 202-663-5506.

Sincerely,

Keith Leggett
Senior Economist