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1st Session } { No. 91-8

FEDERAL RESERVE DISCOUNT MECHANISM: SYSTEM PROPOSALS FOR CHANGE

REPORT

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

TOGETHER WITH

SUPPLEMENTARY VIEWS

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February 6, 1969.—Ordered to be printed
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Mr. Proxmire, from the Joint Economic Committee, submitted the following

REPORT

together with

SUPPLEMENTARY VIEWS

INTRODUCTION

Current proposals by a Federal Reserve intra-System Committee calling for redesign of the discount window—the device by which the Fed lends to member banks seeking to enlarge their reserves—are likely to strike many people as essentially technical questions of interest only to the member banks themselves. They are, after all, the ones who come to "the window," or at least have access to it, and hence are directly affected by lending policies, procedures, and attitudes which confront them there. The brief hearings which the Joint Economic Committee held on September 11 and 17, 1968, dealing with the System Committee's proposals—involving the first major overhaul of the discount mechanism in well over a decade—amply demonstrated that a great deal more is involved in the regulations governing advances and discounts than the parochial concern of member banks alone.

Just how much more is involved is suggested by the range of expert testimony received by our committee. On the one hand, there was recommendation that any overhaul had best provide no window at all, calling for complete elimination of the discounting apparatus as an "anachronistic" and "disturbing element" in the monetary system.

[Note.—Senator Symington states: "Because of other committee assignments, I was not able to participate fully in the hearings on which this report is based; therefore, I wish to reserve judgment on the conclusions and recommendations contained herein."]

This position was matched at the other extreme by recommendation for a more venturesome experiment calling for removal of existing regulatory constraints in order to provide a window with a substantially enlarged outlook "freely open during business hours at a posted rate or rates."

The limited hearing which we had, convinced the members of this committee who were able to participate that the proposals for redesign call for further study by the Banking and Currency Committees of Congress before being put into effect by administrative order of the Board of Governors.

The proposed redesign of the discount window should be an occasion for congressional reexamination of other related parts of the structure. Going beyond the proposed detailed procedural changes, consideration should be given to the place of discounts and advances in a modern central bank and their impact, through the interest rate pattern, on mortgage-oriented thrift institutions. Especially worthy of consideration, in depth, is the present statutory policy which limits direct access to the discount mechanism to member banks—less than half of the commercial banks of the country, albeit large ones—and provides effective contact for the rest of the Nation's financial system scarcely at all.

Perhaps the best way to expose the issues is to ask: What should be the functions of the discount mechanism? What useful public and private services should be expected of it?

I. Uses of the Discount Mechanism

The rationale and appraisal of the discount mechanism can best proceed by distinguishing its possible service to at least three different objectives. First is its role as an instrument of monetary policy affecting the reserve position of the banking system and thereby controlling the money supply and promoting economic stabilization. Second is its role in providing a source of credit to individual member banks enabling them to adjust reserves to meet short-term, seasonal and emergency, needs. Finally is its role as a backstop to widespread financial disturbance serving as a "lender of last resort"—an institution charged with the sovereign responsibilities to create money and provide liquidity when and as required by the national interest.

II. The Discount Mechanism as a Tool of Monetary Policy

Although often cited, along with open market operations and changes in member bank reserve requirements, as one of the available instruments for monetary regulation, the discounting mechanism, unlike the others, depends too much upon the initiative of the private member banks to be rated high as a tool for monetary management or control of the money stock. The role of the monetary managers in "discounting" is largely passive, limited to posting a rate to be charged on advances and then approving or disapproving loan applications put forward by would-be borrowers. The monetary policy impact of advances granted to individual banks may either be accommodated or offset in terms of the Nation's monetary aggregates with a considerable degree of precision by other actions taken at the option of the monetary authorities.

The minor role of the discount window in the service of monetary management or controlling the money stock was underscored at our recent hearings. The report of the System Committee emphasizes that its proposals are expected to have little significance to overall monetary supply in saying:

> * * * 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.

Another factor which tends to downgrade the role of the discount mechanism in monetary policy is the attractive alternative channels which are available to banks as sources for needed reserves. There is, first, a well-organized, active and resilient market for purchase and sale of reserves, the so-called Federal Funds market, by which available reserves may be passed about and better mobilized among member banks without recourse to the regional Reserve bank or adding to the aggregate of available reserves in the System. There is also an effective Euro-dollar market through which banks with foreign branches may draw upon foreign sources. During the "credit crunch" in the last half of 1966, U.S. banks actually decreased their borrowing through the Federal Reserve discount window by several hundred million dollars while increasing their liabilities to foreign branches by over $2 billion. Currently, although borrowings at the Federal Reserve are sizable by historical standards, they amount to only one-tenth the amounts supplied by European sources.

Whatever else may be said about discounting, one would have to say that any instrument which (1) depends for its use initially upon the actions of the private commercial bankers; (2) can have its effect offset or sterilized at will by the monetary managers; and (3) may be so easily and satisfactorily bypassed, hardly merits description or concern as a tool of general monetary policy.

III. The Discount Rate as a Tool of Monetary Policy

In keeping with the concept of a more automatic, predictable discount window and this committee's earlier recommendation for more precise guidelines governing growth in the money stock, we approve the intra-System proposals which would minimize the so-called announcement effect of discount rate change.

Although the discounting mechanism itself can be dismissed as a significant monetary tool, the discount rate—the rate of interest charged borrowing banks—has often been characterized as a useful symbolic device supporting and pointing the way of monetary policy.

One difficulty with the widespread supposition that the Fed is trying to say something through sporadic and infrequent changes in the discount rate—there have been only eight changes in the past 8 years—is that the message comes through ambiguous and unclear. Is the Fed leading the market and initiating a new phase in monetary policy or is it simply adjusting to or moving in tandem with market rates?

Even more serious than the risk of misinterpretation is evidence in published reports of Open Market Committee meetings that from time to time the Federal Reserve seems to have done things it ought not to have done, or left undone those things which it ought to have done, because it has been afraid of the unpredictable announcement effects.

The move to link the discount rate to market rates through more frequent change and by relatively small increments should achieve a better and more active pattern of communication within the System and the financial community. When the Fed wants to announce something it should do it in plain English, and say what it means, and not talk mystique through the discount rate.

IV. The Discount Mechanism as an Aid to Individual Banks

Policies and procedures at the discount window should provide clear-cut access for member banks to Federal Reserve lending facilities on objectively defined terms and conditions with the minimum opportunity for differences in administration from one borrowing member to another and from one regional Reserve bank to another. To the extent that the proposals of the intra-System Committee promote this end, they are to be commended.

Rules governing monetary processes should be as clear, consistent, and unambiguous as possible. The Joint Economic Committee has long urged this principle. At a broader policy level than the discount window itself, this recommendation for predetermined standards and guidelines lies behind the committee's insistence upon some rule—specifically a rule keyed to the rate of economic growth—in governing expansion of the money supply. Obscurity and mystique have too long characterized operations of central banks.

V. The Discount Mechanism in National Financial Emergencies

The ultimate source of liquidity for the Nation's economy—the ability to meet financial obligations promptly when they come due—rests on the constitutional power to create and regulate the value of money. The Federal Reserve System, to which this power over money has been delegated, may consequently be required on occasion to lend to financial institutions other than member banks. In this role, the System is often referred to as a "lender of last resort" although the responsibility should more accurately emphasize its role as "supplier of liquidity" than its lender aspect.

It is in this area of emergency assistance that the current functioning of the discount mechanism seems most in need of rethinking to eliminate ambiguities and possible inadequacies. The System Committee sets up a set of qualifications for lending or offering to lend to nonmember institutions indicating that the responsibility for carrying out this function is to be related only to genuinely emergency conditions. The Committee says:

> 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.

These restrictions effectively rule out emergency aid, direct or indirect, to small or parochial nonmember banks or institutions. Only distress of the very largest, more pervasive national institutions is likely to have significant impact, under the formula, on the financial structure of the country as a whole. Let there be no misunderstanding; the smaller banks, nonbank institutions, and even whole sectors of the economy it would seem, must look elsewhere for their "lender of last resort" and they would continue having to do so under the proposed revision of discount facilities. This they have, in part, in the Federal home loan banks, which are authorized to provide credit reserve for their 5,000 savings and loan, building and loan, and insurance company member institutions. During "the great depression" emergency "lenders of last resort" were established in the Reconstruction Finance Corporation, the Home Owners' Loan Corporation, and Federal Farm Mortgage Corporation. In ordinary times such emergency agencies are, of course, not available. For those institutions who do not have access to established or emergency "windows," aid must come through the conduit provided by correspondents or member banks.

The competitive position of nonbank financial institutions could be threatened, and particularly mortgage-oriented thrift institutions which are the keystone to the Nation's housing industry. Given present access and, under the proposals, even more ready access to the discount mechanism as a source of liquidity, the commercial banks are in a far better position to weather credit stringency such as that which faced the economy in 1966. At that time the housing industry was badly pinched by high rates and the unavailability of loanable funds while other businesses managed to carry on with internal funds and commercial bank loans. It is a questionable monetary policy which makes the housing industry bear the brunt of restrictive credit policy. For this reason the Banking and Currency Committees will want to examine thoroughly the discount window proposals and their implications to the thrift institutions.*

The compatibility of the activities expected of the Federal Reserve System (1) as manager of the Nation's money supply, (2) as a source of needed liquidity for individual member banks, and (3) as a source of emergency aid to institutions which lend at long term and have not themselves accepted the obligation of membership in the Federal Reserve System, is a major issue which needs further examination. Congress should certainly leave no room for misunderstanding of the System's responsibility for the performance of each of these several functions.

One school of thought presented to our committee was that the Federal Reserve should be expected to make no commitment to support any individual sector of the economy. This school of thought would keep the Federal Reserve relatively pure as an instrument in monetary policy, charged with supplying reserves, focusing its energies upon money supply and the problems of inflation, deflation, and national economic health.

*Governor Mitchell in his testimony noted that "The Federal Reserve Act authorizes direct advances to nonmembers, but only if collateralized by U.S. Government securities. Since most nonmember institutions of the types apt to require emergency credit assistance do not have sizable holdings of this asset, credit would normally be extended through a conduit arrangement with a member bank."

On the other hand, there is substantial support for the view, both in Congress and elsewhere, that the Federal Reserve System may properly be charged, for example, with supporting the long-term versus the short-term market for credit. Participants in more recent discussions have urged Federal Reserve purchase of obligations of intermediate financial institutions.

The choice between these two concepts of the proper role of a central bank's "discount window" calls for further study and action by the Congress, leading to legislative directives, removing all doubt as to the meaning of "lender of last resort" in the context of the Federal Reserve authorities.

SUPPLEMENTARY VIEWS OF REPRESENTATIVE PATMAN

While I agree with the views expressed by my colleagues in this report, I believe that one facet of the Federal Reserve Board's planned redesign of the discount mechanism merits considerably greater attention.

In recognition of the great pressure placed on nonbank financial intermediaries by restrictive monetary policies, the Federal Reserve proposes to implement its role as "lender of last resort" for these institutions, under certain conditions. These conditions are so restrictive, however, as to make access to the discount window all but impossible for the thrift institutions. On the other hand, the ease with which commercial banks will be able to avail themselves of the discount facilities provides them with an additional competitive advantage over the other financial intermediaries, an advantage which I feel is unwarranted and unsound in terms of public policy.

The "credit crunch" of 1966 presented us with clear evidence that it is the nonbank financial intermediaries—the savings and loan associations, mutual savings banks, and credit unions—far more than the commercial banks, that are in greatest need of a safety valve in tight-money periods. The Federal Reserve proposals will aggravate, rather than ease, the inequitable burden placed on these institutions by stringent monetary policy.

What is needed to redress this imbalance between the commercial and thrift institutions is some action to give the latter meaningful access to the discount window in times of financial difficulties. I believe that the provisions of the bill, H.R. 19417, which I introduced in the House this past September, would accomplish this goal.

In times of credit scarcity, the commercial banks have several sources from which they can obtain the liquidity needed by their business customers. They can sell holdings of Government securities; they can attract funds by raising the interest offered on certificates of deposit; they can borrow on the Euro-dollar market. As a result of the suggested redesign of the Federal Reserve discount window, they would have an extra easy source of credit.

The thrift institutions have none of these options. When credit gets tight, they suffer a loss of funds to the more powerful investment opportunities. The major casualties of this loss of liquidity are the housing industry and home-mortgage seekers.

The Federal Reserve now proposes to act as lender of last resort to the nonbank financial intermediaries; however, this would be limited to emergency situations of major economic significance. Moreover, it would employ commercial banks as a conduit, and require that the financial intermediaries pay a rate higher than the basic discount rate paid by the commercial banks. All of these restrictions effectively nullify any benefits which the Fed appears to be offering nonmember financial institutions, and they would weigh the competitive balance further in favor of commercial banks.

The commercial banks will be able to avail themselves of the discount window at any time they find it necessary. Restricting the use of these facilities by the thrift institutions to times of emergency places them at a severe disadvantage. The further stipulation of the Board that "failure of the troubled institutions * * * [must] have significant impact on the economy's financial structure" before they are granted relief effectively removes this source of aid from all but the major nonbank financial intermediaries. What will happen to the small, local savings and loan association which is experiencing difficulties in supplying its local customers with mortgage credit?

The use of commercial banks as the conduit through which Federal Reserve funds are to flow to the thrift institutions seems a highly unrealistic proposal. In the first place, the commercial banks are competitors of the savings and loan associations and mutual savings banks, and it is unreasonable to provide the commercial banks with control over the ability of their competitors to do business. Furthermore, in times of credit scarcity, it is to be expected that the banks will prefer to satisfy the needs of their regular, major business customers rather than those of a competitive organization.

The higher interest rate that would be required of the nonbank financial intermediaries for this indirect discount window credit is also inequitable. The housing and home-financing industries are highly sensitive to changing interest rates. By forcing the thrift institutions to pay higher rates to obtain funds, and thus to pass these higher rates on to their customers, the housing sector pays the double penalty of credit being both scarce and more expensive than in other sectors of the economy.

One means of preventing these undesirable consequences of the Federal Reserve's redesign proposals is contained in the bill I submitted to the House, providing for direct use of the discount window facilities by thrift institutions. By extending these facilities on a regular basis to the thrift institutions, and by broadening the definition of "eligible paper" which the Federal Reserve can discount or accept as collateral to include home mortgages and consumer finance paper, this bill would extend to the nonbank financial intermediaries the same outlet in periods of financial difficulty enjoyed by the commercial banks.

Prior to these Joint Economic Committee hearings on the Federal Reserve discount window proposals, I wrote a letter to Governor George W. Mitchell of the Federal Reserve Board, requesting his views on the measure I had introduced in the House.

The letter is printed below with Governor Mitchell's reply:

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C., September 5, 1968.

Hon. GEORGE W. MITCHELL,
Member, Board of Governors, Federal Reserve System, Washington, D.C.

DEAR GOVERNOR MITCHELL: It is my understanding that you will appear before the Joint Economic Committee on September 11 at 10 a.m., to discuss the changes proposed in the Federal Reserve System's discount window operations. Due to a prior commitment it will be impossible for me to attend this session which, as you know, is on a subject in which I have a great deal of interest.

You may be aware of the fact that on September 4 I introduced a bill, H.R. 19417, copy enclosed, which would amend the Federal Reserve Act to broaden the eligibility for use of the discount privilege. This bill has as its singular objective allowing institutions insured by the Federal Savings and Loan Insurance Corporation, mutual savings banks, and Federal Credit Unions to make direct use of the discount window facilities.

It would be appreciated if you would supply for the record when you appear before the Joint Economic Committee your views on this matter and if possible the views of the rest of the members of the Federal Reserve Board on this legislation.

Your cooperation in this matter will be greatly appreciated.

Sincerely yours,

WRIGHT PATMAN, *Chairman*.

BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM,
Washington, D.C., October 9, 1968.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your letter of September 5 in which you requested my views on a bill, H.R. 19417. I believe that my colleagues on the Board generally concur with the following.

This bill would amend the first sentence of the second paragraph of section 13 of the Federal Reserve Act (12 U.S.C. 343), pertaining to discount of commercial, agricultural, and industrial paper. It would, as we interpret it, change the System's authority in this area in two ways. First, it would extend the discount privilege on a regular basis to institutions other than member banks—i.e., federally insured savings and loan associations, mutual savings banks, and Federal credit unions. Secondly, it would expand the present definition of so-called eligible paper to include home mortgages and consumer finance paper.

The bill would, however, apparently not change the last sentence of the second paragraph of section 13, which states that "notes, drafts, and bills admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than 90 days, exclusive of grace." In view of this, it seems doubtful that this bill would result in any large increase in the amount of paper actually eligible for rediscount, since most home mortgage and consumer paper could not meet this maturity requirement.

The more significant aspect of H.R. 19417 is clearly the first change referred to; namely, the extension of the discount privilege on a regular basis to institutions other than member banks. As a general principle, the Board is opposed to extending discount window access on a regular basis to financial institutions other than those that maintain specified levels of required reserves and related day-to-day reporting ties with the Reserve banks.

These reserve requirements serve a fundamental purpose of monetary policy, imposing a finite limit on the expansion of bank credit which can result from a given base. Without this kind of control

monetary policy would lose a key element in its ability to influence economic activity, and reserve requirements therefore have a public benefit reaching far beyond that of the subject institutions. In addition, the requirement that institutions maintain these reserves on a week-by-week basis is one of the major factors creating needs for credit assistance of a kind that can be met at the discount window.

In addition to fulfilling reserve requirements, member banks, the only institutions now meeting the above conditions, are subject to day-to-day scrutiny by the System through daily reporting of reserve operations in their clearing accounts. These reports are augmented by reports of condition and other regular statistical reports submitted by the banks as well as by periodic examinations. In addition, Federal Reserve banks hold in custody significant amounts of the most marketable assets owned by member banks. As a result of these relationships, the Reserve banks make loans to member banks with a substantial awareness of the current circumstances of the borrowing bank. Such would not be the case with other financial institutions, and only by maintaining a direct day-to-day reporting relationship with institutions can the System stay adequately informed to undertake a day-to-day lending relationship.

This should not be taken to imply that the System does not recognize the possible need to lend to other institutions under emergency conditions. As this committee is aware, section 13, paragraph 13 of the Federal Reserve Act, authorizes lending to "any individual, partnership or corporation." Such action was seriously contemplated in the summer of 1966 in the case of mutual savings banks, and, in fact, specific arrangements were set up to carry out such an operation. While use of these arrangements did not then prove necessary, the recently published report of the System committee on redesign of the discount mechanism articulated and reaffirmed these arrangements as being the appropriate way to deal with emergency conditions when Federal Reserve action becomes necessary for any class of nonmember financial institutions.

Under the current statute, this kind of credit extension must in most cases be done indirectly, using a member bank or, where appropriate, the responsible Government agency as a conduit, since direct loans must be secured by U.S. Government or agency securities, and those latter assets are not held in any sizable volume by most nonmember institutions. The conduit procedure, whereby the Federal Reserve would lend funds to a cooperating member bank which would, in turn and by prior agreement, make loans to the nonmember institutions, is a workable and logical extension of established business practices. This procedure could be used in emergencies without great difficulties.

With regard to the other principal provision of H.R. 19417, the inclusion in the eligible paper definition of home mortgages and consumer finance paper, the Board would question the efficacy of this type of "piecemeal" broadening of eligibility requirements. As this committee is aware, the Board is concerned about the current narrow restrictions on the types of paper which may be accepted from member banks for discount or as collateral for advances. Shortages of bank holdings of these types of paper as well as of U.S. Government and agency securities not otherwise pledged can needlessly complicate the lending operation and could at times have serious implications for the

operation of the discount window, forcing member bank borrowings to be done under section 10(b) at a penalty rate of interest. In addition, the eligibility concept is based on an outmoded and disproven theory—that the legitimate needs of the economy for bank credit would always be exactly reflected in the volume of these short-term, self-liquidating loans—and causes unnecessary administrative burdens for both the member banks and the Reserve banks.

The possibility of a serious shortage of eligible paper is of course lessened to a degree by any broadening of the restrictions, even one so slight as we feel would in fact result from H.R. 19417. However, the Board feels that a far more practical approach in the long run would be the complete elimination of the eligibility concept, to be replaced by a provision that would permit loans collateralized by any asset acceptable to the Reserve bank. Such a change is embodied in the Senate-passed bill, S. 966, now pending in the House. The Board would favor the broader provision of that bill on the issue of eligibility requirements and strongly urges its passage.

As noted earlier, an even narrower restriction—limitation to U.S. Government and agency securities—is imposed by paragraph 13 of section 13 on the kinds of collateral which may be accepted from nonmember institutions borrowing directly from the Federal Reserve under the emergency provisions. The conduit arrangement which would generally be necessitated by this restriction is viewed as workable, as has also been noted. However, speaking for myself, I would favor a broadening of this requirement also to any acceptable asset, paralleling that recommended for member banks. It would seem likely that such a change would at least in some cases simplify the procedures of emergency lending for all those concerned, and there appears to be no strong logical reason for the current requirement which would offset the benefits that might be gained by liberalizing it.

On a purely technical matter, we might note that H.R. 19417 would allow *advances* on the security of the enumerated kinds of paper to member banks, but would limit other institutions to the *rediscount* procedure. (See sec. 13, par. 8.) This presumably would not be an insuperable obstacle, but over the years member banks have come to rely almost exclusively on the advance route, and it is the near-unanimous view of those involved that this is far more workable than rediscounting.

In sum, with regard to the major issue involved in H.R. 19417, the Board cannot endorse the principle of regular lending to institutions which bear none of the costs of System membership and with which the System has no direct day-to-day relationship. Rather it feels that the normal credit needs of these institutions should continue to be met through established channels, where a regular business relationship already exists. Most types of nonbank financial institutions have borrowing relationships with commercial banks as a matter of course, and it would seem that in most cases these should prove adequate to meet normal credit needs. In addition, in some areas, an appropriate central lending agency exists. The Federal Reserve would, of course, continue, in its role as lender of last resort to all sectors of the economy, to backstop commercial banks, central lending agencies, and where necessary the institutions themselves to forestall any major economic disruption.

Sincerely yours,

GEORGE MITCHELL.

In his response, Governor Mitchell admits that the present eligibility requirements are too narrow. However, he questions what he terms the "piecemeal" approach to broadening these requirements that he sees in my bill, and he objects to the extension of the Federal Reserve System's discount facilities to nonmember institutions which do not fulfill all the requirements of member banks, particularly those pertaining to reserves.

I do not agree. The question of reserve requirements for nonbank financial intermediaries is one which can be resolved. More important, however, is the fact that there are far more compelling reasons for commercial banks to hold reserves since, under our fractional reserve system, they have the enormously influential power to create money in our economy.

As to the question of methods of broadening eligibility requirements, Governor Mitchell completely bypassed the major point of this entire issue: the responsibility of the Federal Reserve as a public agency should be to make public credit available to all institutions.

Recent crises have proven that the thrift institutions in our financial sector are subject to great pressure from changing monetary conditions. The Federal Reserve System is responsible for guiding the monetary system in the interests of the Nation as a whole, not in those of the commercial banking system in particular. We must therefore develop the means of responding to the needs of the total economy, with no discrimination in favor of an individual sector at the expense of the remainder of the Nation.

WRIGHT PATMAN.