The Federal Reserve Discount Window

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1. Introduction

When the Federal Reserve System was established in 1913, lending reserve funds through the Discount Window was intended as the principal instrument of central banking operations. Although the Window was long ago superseded by open market operations as the most important tool of monetary policy, it still plays a complementary role. The Discount Window functions as a safety valve in relieving pressures in reserve markets; extensions of credit can help relieve liquidity strains in a depository institution and in the banking system as a whole. The Window also helps ensure the basic stability of the payment system more generally by supplying liquidity during times of systemic stress.

The purpose of this information is to clarify the policies that govern the use of Federal Reserve credit and describe Federal Reserve lending programs. Discount Window policies and programs have evolved in response to the changing needs of the economy and financial system. For Example, the primary and secondary credit programs replaced the adjustment credit and extended credit programs effective January 9, 2003. The primary credit program is the principal safety valve for ensuring adequate liquidity in the banking system and a backup source of short-term funds for generally sound depository institutions. Most depository institutions qualify for primary credit. Secondary credit is available to meet backup funding needs of depository institutions that do not qualify for primary credit. Seasonal credit is available to depository institutions that can demonstrate a clear pattern of recurring intra-yearly swings in funding needs. As always, Discount Window loans must be secured by collateral acceptable to the lending Reserve Bank.

Much of the statutory framework that governs Discount Window lending is contained in the Federal Reserve Act, as amended. The programs and policies that implement the statutory framework are set forth in Regulation A, and are summarized below.

2. Types of Credit

Primary Credit

Primary credit is available to generally sound depository institutions on a very short-term basis, typically overnight, at a rate above the Federal Open Market Committee's (FOMC) target rate for federal funds. Depository institutions are not required to seek alternative sources of funds before requesting occasional advances of primary credit. The Federal Reserve expects that, given the above-market pricing of primary credit, institutions will use the Discount Window as a backup rather than a regular source of funding.

Primary credit may be used for any purpose, including financing the sale of federal funds. By making funds readily available at the primary credit rate when there is a temporary shortage of liquidity in the banking system, thus capping the actual federal funds rate at or close to the primary credit rate, the primary credit program complements open market operations in the implementation of monetary policy.

Reserve Banks ordinarily do not require depository institutions to provide reasons for requesting very short-term primary credit. Rather, borrowers are asked to provide only the minimum information necessary to process a loan, usually the amount and term of the loan. Should a pattern of borrowing or the nature of a particular borrowing request strongly indicate that a depository institution is not generally sound or does not satisfy the conditions described in the two previous paragraphs, a Reserve Bank may seek additional information.

Primary credit may be extended for periods of up to a few weeks to depository institutions in generally sound financial condition that cannot obtain temporary funds in the market at reasonable terms. Large and medium-sized institutions are unlikely to meet this test. Longer-term extensions of credit are subject to increased administration.

Secondary Credit

Secondary credit is available to depository institutions that are not eligible for primary credit. It is extended on a very short-term basis, typically overnight, at a rate that is above the primary credit rate. Secondary credit is available to meet backup liquidity needs when its use is consistent with a timely return to a reliance on market sources of funding or the orderly resolution of a troubled institution. Secondary credit may not be used to fund an expansion of the borrower's assets. The secondary credit program entails a higher level of Reserve Bank administration and oversight than the primary credit program. A Reserve Bank must have sufficient information about a borrower's financial condition and reasons for borrowing to ensure that an extension of secondary credit would be consistent with the purpose of the facility.

Seasonal Credit

The Federal Reserve's seasonal credit program is designed to assist small depository institutions in managing significant seasonal swings in their loans and deposits. Seasonal credit is available to depository institutions that can demonstrate a clear pattern of recurring intra-yearly swings in funding needs. Eligible institutions are usually located in agricultural or tourist areas. The interest rate applied to seasonal credit is a floating rate based on market rates.

Under the seasonal program, borrowers may obtain longer-term funds from the Discount Window during periods of seasonal need so that they can carry fewer liquid assets during the rest of the year and make more funds available for local lending. To become eligible for seasonal credit, an institution must establish a seasonal qualification with its Reserve Bank. An institution that anticipates a possible need for seasonal credit is encouraged to contact its Reserve Bank to ascertain its eligibility and make arrangements in advance. Making arrangements does not obligate the institution to borrow.

Critically undercapitalized institutions are not eligible for seasonal credit. Undercapitalized or significantly undercapitalized institutions may be eligible, but only after careful review of their condition and prospects.

Emergency Credit

In unusual and exigent circumstances, the Board of Governors may authorize a Reserve Bank to provide emergency credit to a participant in a program or facility with broad-based eligibility. Such programs and facilities must be approved by the Secretary of the Treasury, and lending Reserve Banks must obtain evidence that participants in the program or facility are unable to secure adequate credit accommodations from other banking institutions. When not secured by U.S. government or agency securities, loans of this type would require the affirmative vote of at least five members of the Board of Governors of the Federal Reserve System. (If fewer than five but at least two Board members are available, the available members may approve an extension of emergency credit by unanimous vote, subject to the conditions set forth in section 11(r)(1) of the Federal Reserve Act)

3. Interest Rates on Primary, Secondary, and Seasonal Credit

By statutory requirement, each Federal Reserve Bank must establish its discount rates at least every 14 days, subject to review and determination by the Board of Governors. Reserve Banks currently establish discount rates for three lending programs:

Primary Credit

The primary credit rate is above the FOMC's target for the federal funds rate. The spread between these two rates may vary.

Secondary Credit

The secondary credit rate is above the primary credit rate. The spread between these two rates also may vary.

Seasonal Credit

The seasonal credit rate is based on market interest rates. It is reset on the first business day of each two-week reserve maintenance period to reflect movements in market interest rates over the previous maintenance period.

Because primary credit is the Federal Reserve's main Discount Window program, the Federal Reserve at times uses the term "discount rate" to mean the primary credit rate.

The interest rates applied to primary and secondary credit will change periodically to complement changes in the FOMC's target for the federal funds rate and to achieve broad monetary policy goals.

The Federal Reserve has adopted mechanisms through which it could quickly reduce the primary credit rate to the FOMC's target for the federal funds rate in the event of a significant disruption to the U.S. money markets resulting from an act of war, military or terrorist attack, natural disaster, or other catastrophic event. Should these mechanisms be invoked, the secondary credit rate also would be reduced.

4. Eligibility to Borrow

By law, depository institutions that maintain reservable transaction accounts or nonpersonal time deposits (as defined in Regulation D) may establish borrowing privileges at the Discount Window. Eligibility to borrow is not dependent on or related to the use of Federal Reserve priced services.
U.S. branches and agencies of foreign banks that hold reserves are eligible to borrow under the same general terms and conditions that apply to domestic depository institutions. Foreign banks with more than one branch or agency operating in the United States may have access to the Discount Window in more than one Reserve District. Any Discount Window loans to those branches or agencies will be made by the Reserve Banks where the borrowing branches or agencies maintain accounts. Reserve Banks coordinate and monitor lending to such branches and agencies on a nationwide basis.

Bankers' banks, corporate credit unions, and other financial institutions are not required to maintain reserves under Regulation D, and so do not have regular access to the Discount Window. However, the Board of Governors has determined that such institutions may obtain access to the Discount Window if they voluntarily maintain reserves.

5. Eligibility for the Primary and Secondary Credit Program

To qualify for primary credit, a depository institution must have access to the Discount Window and be in generally sound financial condition as determined by its Reserve Bank. A Reserve Bank reviews an institution's condition on an ongoing basis using supervisory ratings and capitalization data. Supplementary information, when available, may also be used. The same criteria that are used to determine eligibility for daylight credit under the Board of Governors' Payment System Risk Policy are used to determine eligibility for primary credit. In brief:

- An institution assigned a composite CAMELS rating of 1, 2, or 3 (or SOSA 1 or 2 and ROCA 1, 2, or 3) that is at least adequately capitalized is eligible for primary credit unless supplementary information indicates that the institution is not generally sound.

- Institutions assigned a composite CAMELS rating of 4 (or SOSA 1 or 2 and ROCA 4 or 5) are not eligible for primary credit unless an ongoing examination or other supplementary information indicates that the institution is at least adequately capitalized and that its condition has improved sufficiently to be deemed generally sound by its Reserve Bank.

- Institutions assigned a composite CAMELS rating of 5 (or SOSA 3 regardless of ROCA) are not eligible for primary credit.

Depository institutions that do not qualify for primary credit are eligible for secondary credit when use of such credit is consistent with a timely return to a reliance on market sources of funding or the orderly resolution of a troubled institution, subject to limitations described below.

6. Restrictions on Lending to Undercapitalized Institutions

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended the Federal Reserve Act to restrain extensions of Federal Reserve credit to an FDIC-insured depository institution that has fallen below minimum capital standards or has received a composite CAMELS rating of 5 (or its equivalent) from its federal regulator. Such institutions may request secondary credit, but Federal Reserve lending to a depository institution that is undercapitalized, significantly undercapitalized, or rated a composite CAMELS 5 (or its equivalent) is generally limited to 60 days in any 120-day period. Ordinarily, an institution that is critically undercapitalized may receive Discount Window credit only during the five-day period that begins on the day it becomes critically undercapitalized. Reserve Banks apply the same rules to institutions that are not insured by the FDIC but that are otherwise eligible to borrow at the Discount Window. For more information on this topic, see "FDICIA and the Discount Window" on page 975 of the November 1994 issue of the Federal Reserve Bulletin.

Any depository institution subject to one of the above-mentioned limits should maintain liquidity sufficient to keep its needs for Discount Window credit within appropriate bounds. If it appears that liquidity may prove inadequate, the institution should consult with its Federal Reserve Bank as far in advance as possible. Such consultations may also include discussions of collateral arrangements needed to ensure the orderly continuation of Federal Reserve payment services.

7. Arrangements for Borrowing

Any depository institution that expects to use the Discount Window should file the necessary lending agreements and corporate resolutions under the terms set forth in the Federal Reserve's lending agreement, Operating Circular No. 10 [PDF; 249K]. Depository institutions that do not envision using the Window in the ordinary course of events are encouraged to execute the necessary documents because a need for Discount Window credit could arise suddenly and unexpectedly. Institutions also are encouraged to contact their Reserve Bank to discuss collateral requirements and arrangements before a need to borrow arises.

8. Pledging of Collateral

All extensions of credit must be secured to the satisfaction of the lending Reserve Bank by collateral that is acceptable for that purpose. Most performing or investment grade assets held by depository institutions are acceptable as collateral. Collateral in which a special industry lender retains a superior legal interest is not acceptable. Reserve Banks require a perfected security interest in all collateral pledged to secure Discount Window loans.

Assets accepted as collateral are assigned a lendable value (market or face value multiplied by a margin) deemed appropriate by the Reserve Bank. The financial condition of an institution may be considered when assigning values. The following assets are most commonly pledged to secure Discount Window advances:

- Commercial, industrial, or agricultural loans
- Consumer loans
- Residential and commercial real estate loans
- Corporate bonds and money market instruments
- Obligations of U.S. government agencies and government-sponsored enterprises
- Asset-backed securities
- Collateralized mortgage obligations
- U.S. Treasury obligations
- State or political subdivision obligations

Reserve Bank staff can offer guidance on other types of collateral that may be acceptable.

Assignments of collateral are made by the borrower under the terms and conditions of the Federal Reserve Bank's lending agreement, Operating Circular No. 10 [PDF; 249K]. For an overview of the Federal Reserve's Discount Window collateral program, please refer to The Federal Reserve System's Collateral Guidelines [PDF; 193K].

Arrangements for pledging collateral should be reviewed with the Reserve Bank. Securities issued by the U.S. government and most securities issued by U.S. government agencies are held in an automated book-entry records system at the Federal Reserve. Other securities pledged as collateral generally are held by a depository or other agent through a custodian arrangement. Loans (customer notes) pledged as collateral typically are held by a custodian or under a borrower-in-custody arrangement. Physical securities, promissory notes, and other definitive assets may, however, be held on the Reserve Bank's premises.

9. Posting of Discount Window Credits and Debits

Discount Window loan proceeds and loan repayments normally are posted after the close of Fedwire®. However, in those instances where a depository institution must make unanticipated payments during the business day, the Reserve Bank may post the loan during the business day and post the repayment at the same time on the date it is repaid.

On an exception basis, a borrower may repay a loan before 24 hours, or a multiple thereof, has passed. A need for early repayment might be associated with a borrower's need to obtain release of securities pledged as Discount Window collateral in time to permit same-day transfer, for example.

Intraday posting of Discount Window loans and repayments is subject to review and approval by the lending Reserve Bank.