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SHORT THOUGHTS

January 23, 2024

Fed's Discount Window In The Spotlight

Trying To Remove The Stigma

- Regulators to require banks to use the discount window once a year
- If stigma to use it fades, the window could become a crucial tool if liquidity falls
- T-bill curve inverted, pricing in rate cuts; how will MMFs respond?

Discount Window Changes Coming

Last week, the Federal Reserve and two other US regulators, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), were said to be putting together a plan to require eligible banks to use the discount window at least once a year. Among other things, this regulation – currently in development – is being positioned as a way to reduce the stigma often associated with banks' participation in the facility. Furthermore, such intermittent use, even for small amounts, is aimed at making sure that a bank that does need to access the window can do so from an operational perspective.

This discount window is rarely used, in large part due to stigma concerns. Investors – and more importantly, depositors – could view such use of the facility in a negative light, for example, an indication that the borrowing institution is somehow under stress. Furthermore, the current interest it charges against eligible collateral is 5.5%, much higher than the 4.91% borrowing rate on the soon-to-be mothballed Bank Term Funding Program (BTFP) that was set up to address the regional banking strains of last spring. Fed Vice Chair for Supervision Barr indicated that the BTFP will not be extended after it expires on March 11. As swap spreads have come in and the borrowing rate has fallen, BTFP usage – which also has generous collateral valuations associated with it – has risen in recent weeks as institutions exploit an arbitrage between BTFP rates and those available elsewhere in short-term markets (see here for a discussion of the BTFP's final days).

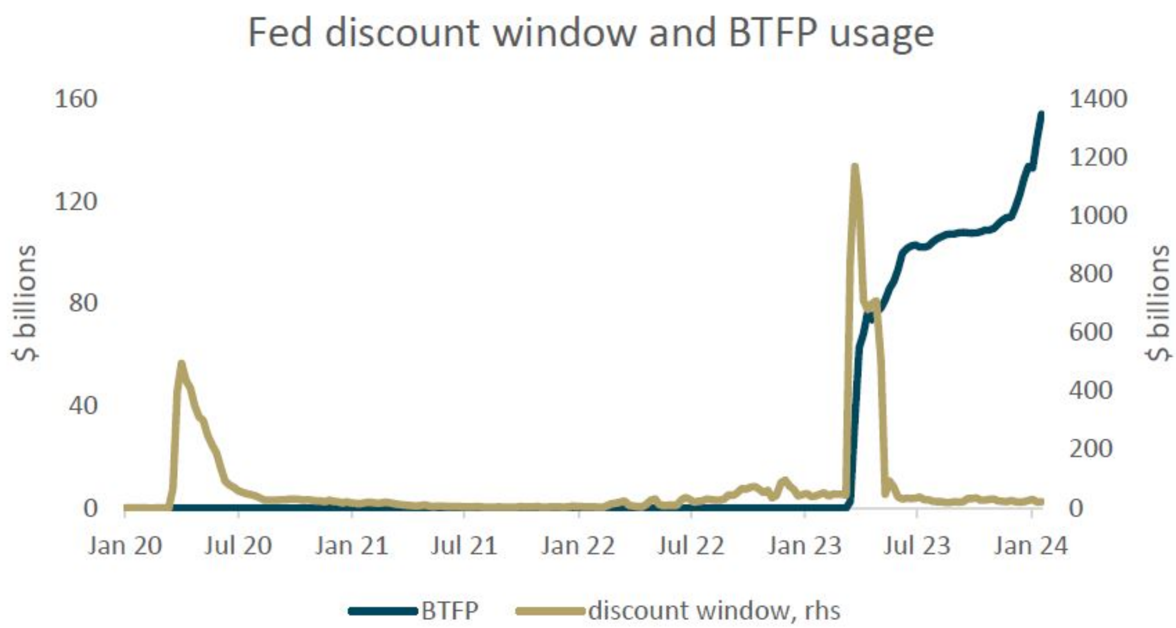
The most recent use of the window was in the immediate weeks after the COVID lockdowns were put in place; its use was encouraged by the Fed. After liquidity concerns had been addressed during the lockdowns, discount window usage dropped to nearly zero. However, as can be seen in the chart below, it ramped up again last March while the BTFP was getting set up and running. Use of the discount window presently is limited.

We think that this proposed regulatory setup – to require banks to do occasional operations at the window – was inevitable. At least since the pandemic, Fed officials have frequently noted in public remarks with reference to the discount window that it was available for liquidity needs, trying to reduce the stigma with which it's associated. Furthermore, if the discount window does become destigmatized over time, it could serve as a useful funding vehicle for banks that have temporary (or more long-lasting and severe) liquidity needs. If it eventually gets regular use, it could alleviate pressure on reserves over time.

Remember also the Standing Repo Facility. This was set up when the latest bout of quantitative tightening (QT) was announced in June 2022, also stands ready to lend against Treasuries and Agency securities in times of need, and probably has a stigma attached to it, too. We have seen a fairly small (if slowly growing) list of signed-up counterparties.

We wonder if by trying to destigmatize the discount window, the Fed is also making sure that it is operational if needed. The Fed has already "talked about talking about" slowing the pace of QT, something we also commented on recently. Is the Fed preparing both the pipes and the optics of discount window usage because it may eventually be needed? After all, it was Dallas Fed President (and NY Fed veteran) Logan who mused if reserves were sufficiently unevenly distributed amongst member banks as a reason to consider reining in QT.

Rarely Tapped



Source: BNY Mellon Markets, Federal Reserve Board of Governors

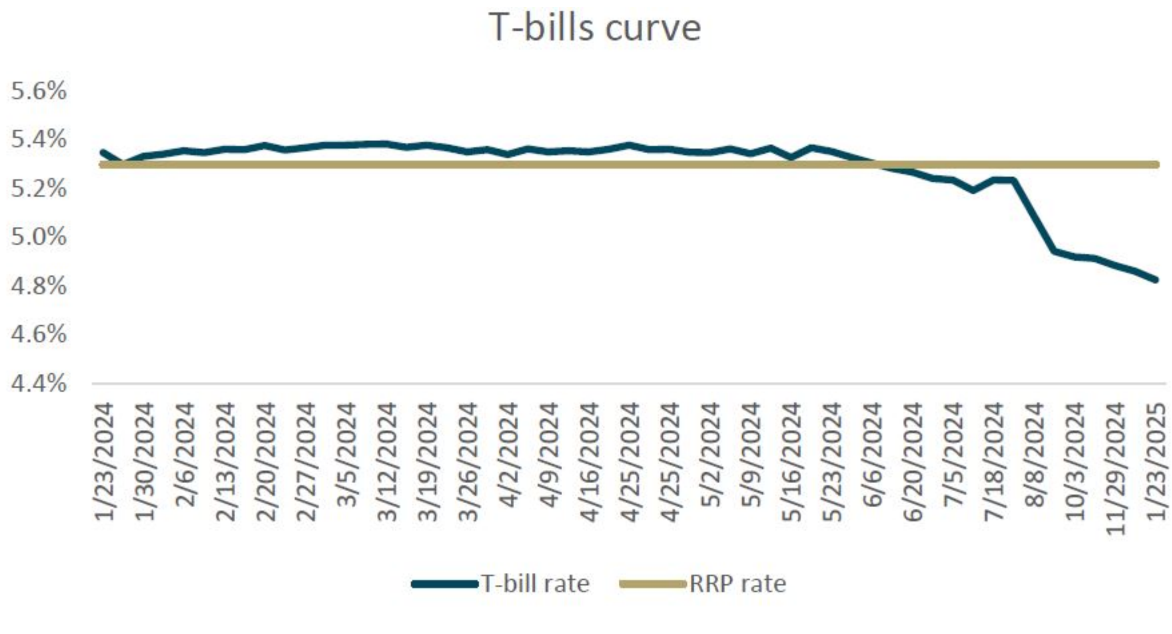
MMFs Facing Inverted T-bill Curve

The T-bill curve is inverted. Issues maturing past late-May are offering lower yields than the rate paid by the Fed on its overnight Reverse Repo operations (RRP). Obviously, this reflects the expectation of eventual rate cuts, and June is a reasonable representation of current market consensus, even if we have an earlier start in mind.

But with these later-date securities now offering yields below the RRP's 5.3%, would money market mutual funds (MMFs) be likely candidates to buy them, especially at the same clip that they have been since the middle of last year after the debt ceiling was postponed? In a yield-sensitive marketplace, how many bills can MMFs buy that pay less than RRP and have substantially longer duration?

According to Crane Data, the average weighted average maturity (WAM) of the Crane Money Fund Average index was 38 days on Jan. 19, 2024. We doubt WAMs will go much higher given the expectation of Fed rate cuts at some point, and the chance that cuts could be brought forward to May or March (the latter as we believe). MMFs might begin exercising caution when buying shorter-dated assets on the T-bill curve if they think rates could suddenly lurch lower. They will be following the macro data as well.

Will It Be Attractive To Go Out On The Curve?



Source: BNY Mellon Markets, Bloomberg

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