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SHORT THOUGHTS

June 4, 2024

Discount Window Stigma & The Transition To Ample Reserves

- Discount window borrowing viewed as stigmatized, much to Fed's consternation
- Bankers report little appetite to turn to the DW in case of funding squeezes
- Real money demand for T-bills is falling, probably due to lack of supply

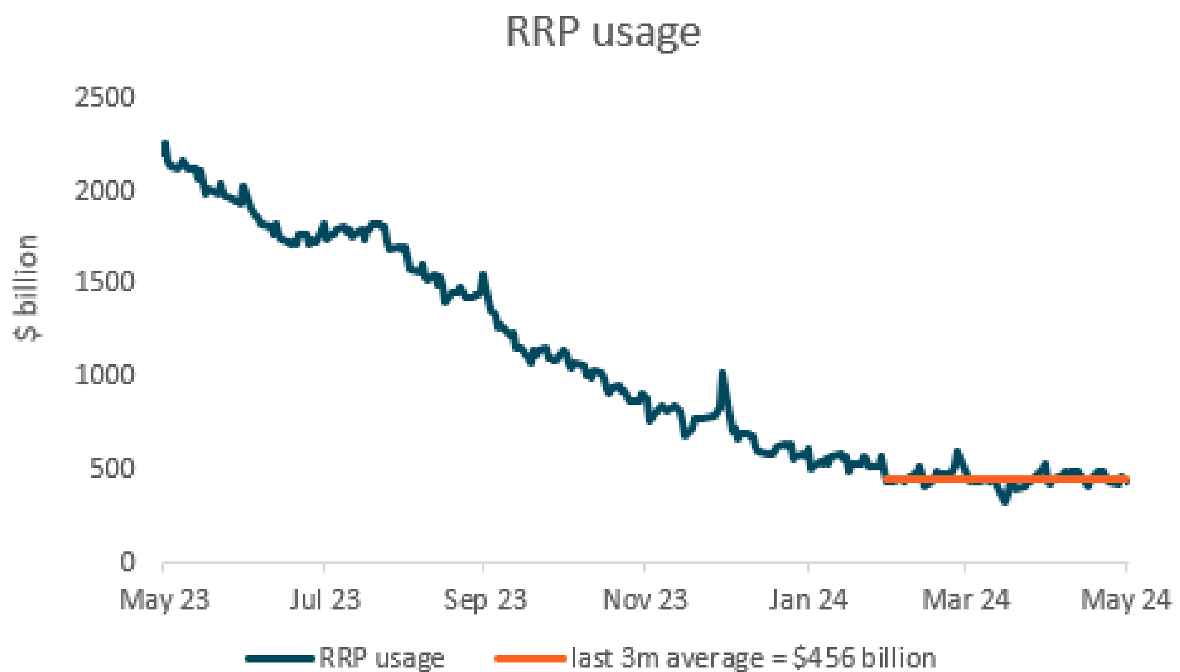
Window Of Last Resort

The stigma associated with use of the Federal Reserve's discount window has been cited as an impediment to its use. Banks are generally reluctant to make use of it for fear that it signals weakness to markets and actually increases the chance of runs on a bank that uses it. The Fed is aware of this dilemma. In a recent post on the New York's Fed's Liberty Economics blog, the results of an academic paper are discussed, and it is found that once use of the DW is stigmatized, “removing that stigma is difficult”.

The stigma-driven lack of willingness for banks to tap the DW could complicate the Fed's balance sheet policy. As we wrote about several weeks ago (see here), the Fed is currently operating in an 'abundant' reserves regime, where changes in front-end rates don't move reserve holdings. Banks' demand curve for reserves in this regime is flat versus rates.

Reserves are currently quite abundant, well over $3trn. They will decline thanks to quantitative tightening – even though the pace of the Fed's balance sheet reduction has been slowed recently – and what we presume will be a resumption in the decline of participants' usage of the reverse repo facility (RRP), even though that process has taken a breather in recent months. The chart below shows how RRP drainage has paused – the average take-up in the facility has been around $450bn since the end of March.

RRP Usage Stabilizes



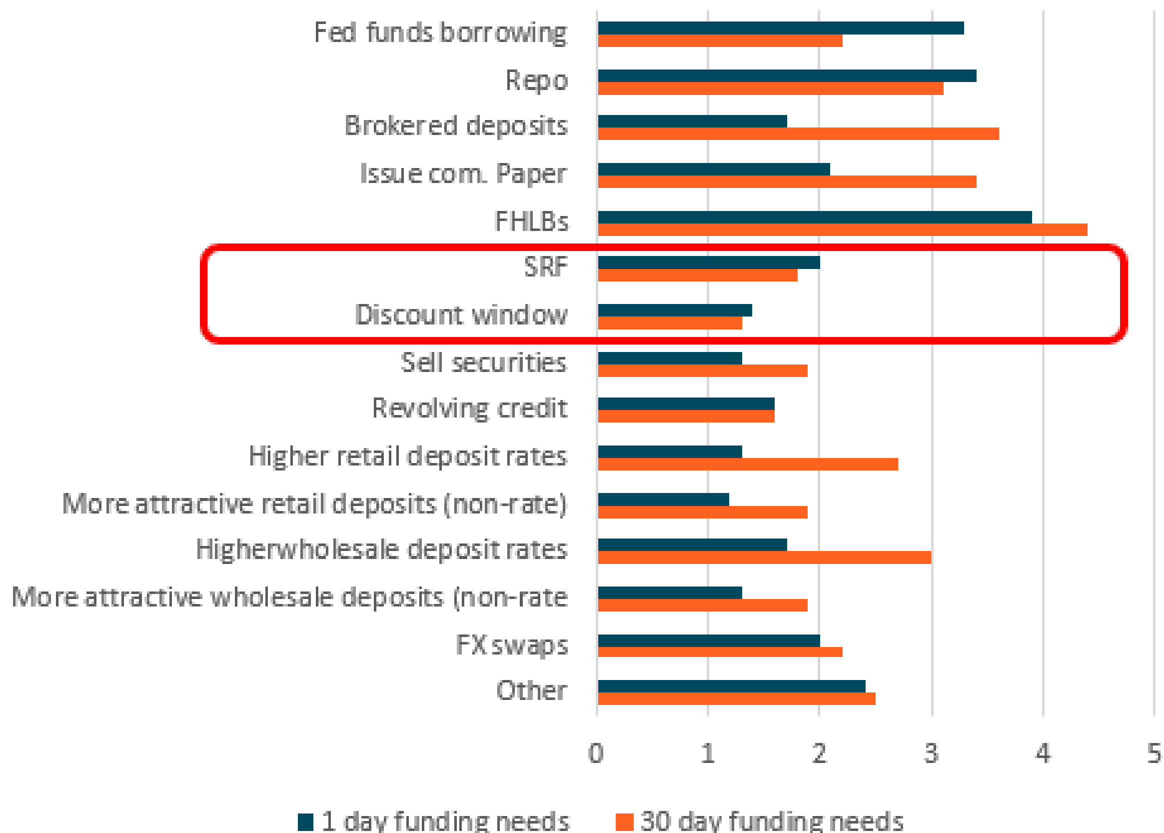
Source: BNY Mellon Markets, Federal Reserve Bank of New York

What happens if and when reserves reach their 'lowest comfortable level' under the current regime, and the system threatens to move from abundant reserves to merely 'ample'? At the point of transition, it’s possible that funding stresses could emerge. Indeed, to some degree the Fed has accepted that it will not know when reserves transition to the ample regime without reading tea leaves in markets. One of these tea leaves could be in rising repo rates.

If and when strains emerge – or indeed, if and when some banks run into liquidity constraints – one mechanism to address ill-functioning funding markets would be usage of the discount window. But if usage of the DW is so stigmatized, it may not be tapped for much, if any, liquidity support from the Fed. There is now a Standing Repo Facility where banks can face the Fed for funding, but it has been untested in times of stress and there are some anecdotal points that lead us to believe the SRF could carry similar stigma.

In the most recent bank Senior Financial Officer Survey, out last week, the Fed reports that using the DW is one of the most unpalatable options banks have. The SRF is not viewed much more attractive as a funding source if necessary. The chart below reports, on a scale of 1-5, banks’ preferences for funding alternatives in case of a 1- and a 30-day funding shortage. Out of 15 potential actions, the discount window scores an attractiveness of just 1.4 out five for a 1-day funding squeeze, better than only potentially raising deposit rates or offering non-rate incentives to retain both retail and wholesale deposits, as well as selling securities. For a 30-day funding shortage, the DW scores last amongst potential remedies (1.3 out of 5), while the SRF rates a bit higher but still towards the bottom.

DW And SRF Usage Not A High Priority

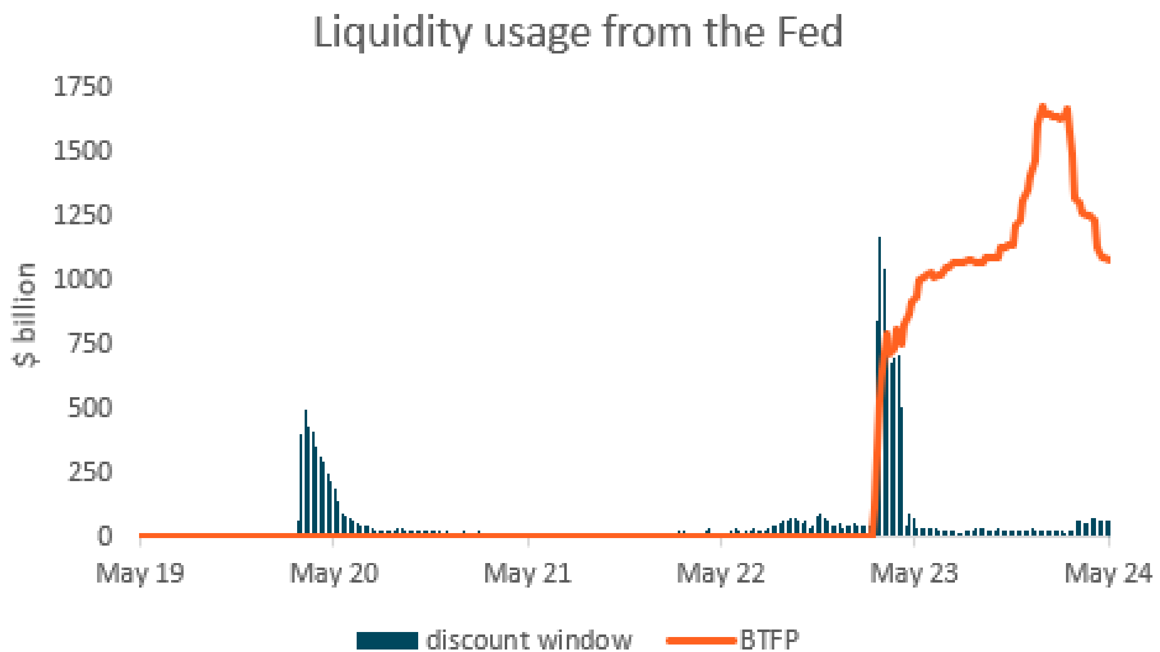


Source: BNY Mellon Markets, Federal Reserve Board of Governors. *Preferences ranked on a 1-5 scale.

The Fed wishes for the DW to be stigma free, although its own research suggests that this is a laudable but potentially elusive goal. Steps to make banks tap the DW even in normal times have been suggested, as randomized usage might help “hide” actual usage tied to funding needs. We take a dim view of this, as when funding strains emerge, they don’t usually affect one or a few banks, but several at a time. This means that if DW usage spikes above the “normal” randomized usage of the facility, markets will know who is in trouble.

The chart below shows usage of both the DW and a separate facility, the Bank Term Funding Program (BTFP), which was launched in response to the regional bank strains of last spring. BTFP usage during the acute phase of the crisis almost matched DW usage. Owing to attractive terms, the BTFP remained in use, even though the rates arbitrage that existed when it was initially set up has been eliminated by the Fed since then. The BTFP was closed on March 11, 2024. Remaining funds in it are simply waiting to roll off the remaining maturities of pledged collateral.

DW And BTFP Usage - BTFP More Attractive



Source: BNY Mellon Markets, Federal Reserve Board of Governors

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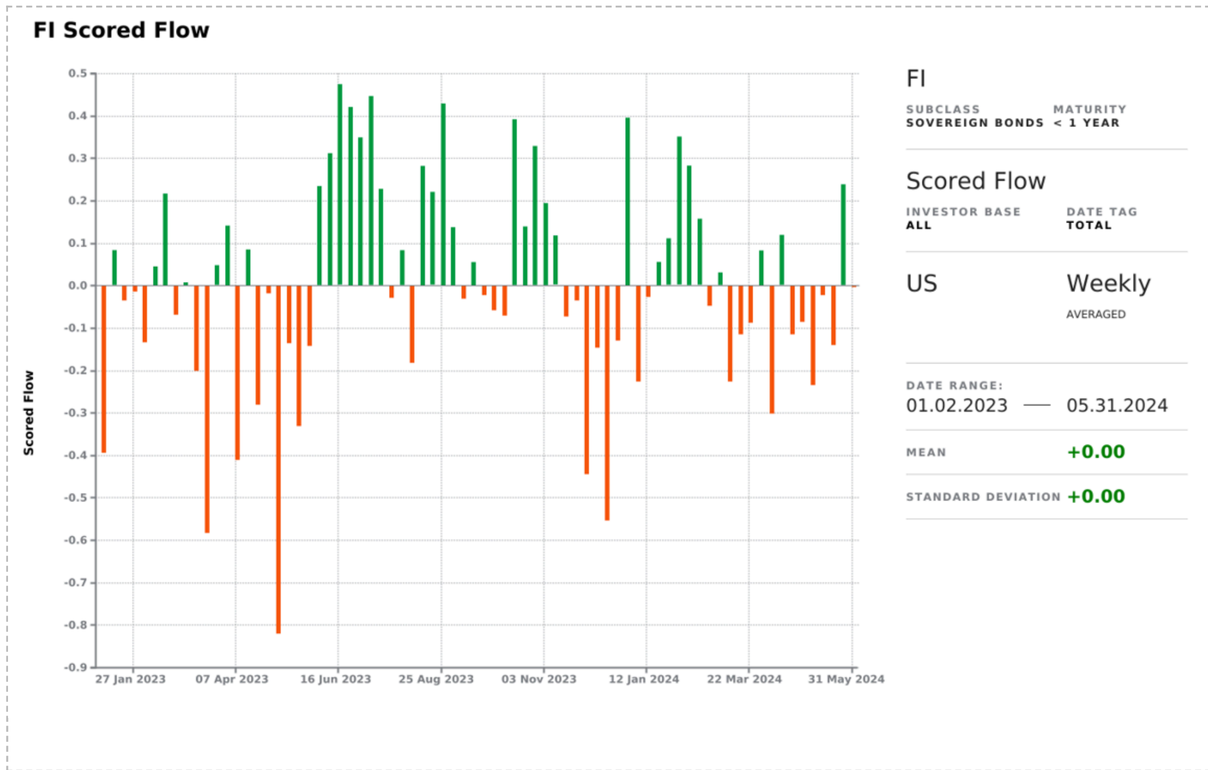
Demand for Bills Falls

Above we noted that RRP balances have stabilized around $450bn since the end of March, after having fallen steadily since last summer. A few weeks ago (see here), we dissected real money's demand for US Treasuries. Among the results presented, we pointed out that demand for short-term sovereign bonds (sub-1y in maturity) has fallen and is nearly flat.

In the chart below, we show weekly averages of flows into these short-term securities. In 11 of the last 15 weeks, investors have been selling bills (as well as other US government debt that has less than a year in maturity), with one week (recently) of notable buying.

We attribute this to the same phenomenon that has helped keep RRP balances steady: lack of bill supply. Since the end of March, net bill supply is down almost $200bn. Meanwhile, also noted in our recent piece, USTs with more than 1y to maturity are being bought, almost inexorably, by our client base. With bill supply looking to be further constrained over the next several weeks, at least, we expect the lack of demand there to continue.

Selling Bills In 11 Of Last 15 Weeks



Source: BNY Mellon Markets, iFlow

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Please direct questions or comments to: iFlow@BNYMellon.com

John Velis

AMERICAS MACRO STRATEGIST

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