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LENDER OF LAST RESORT: ISSUES WITH THE FED DISCOUNT WINDOW AND EMERGENCY LENDING

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND MONETARY POLICY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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Thursday, February 15, 2024

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LENDER OF LAST RESORT: ISSUES WITH THE FED DISCOUNT WINDOW AND EMERGENCY LENDING

Thursday, February 15, 2024

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND MONETARY POLICY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Andy Barr (chairman of the subcommittee) presiding.

Present: Representatives Barr, Posey, Luetkemeyer, Loudermilk, Rose, Timmons, Fitzgerald, Kim, Donalds, De La Cruz, Ogles, Foster, Sherman, Scott of Georgia, Green, Beatty, Vargas, and Casten.

Chairman BARR. The committee will come to order. Without objection, the chair is authorized to declare a recess of the committee at any time.

This hearing is titled "Lender of Last Resort: Issues With the Fed Discount Window and Emergency Lending."

Without objection, all members will have 5 legislative days within which to submit extraneous materials to the chair for inclusion in the record.

I now recognize myself for 5 minutes to give an opening statement.

OPENING STATEMENT OF HON. ANDY BARR, CHAIRMAN OF THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND MONETARY POLICY, A U.S. REPRESENTATIVE FROM KENTUCKY

In performing lender of last resort functions, central banks have long been told to abide by recommendations memorialized by British journalist Walter Bagehot in the late 1870s. Bagehot advised that in panics and times of unusual liquidity needs, central banks should lend freely at a penalty interest rate to solvent borrowers who post good collateral.

Following the speed of the bank runs last March, perhaps lending freely also means that the Federal Reserve (Fed) should be prepared to lend quickly on good collateral.

There are two main ways in which the Fed performs its lender of last resort function. One is by lending to financial institutions at the Fed's discount window against good collateral to solvent borrowers. Another is by using lending authority in Section 13(3) of

the Federal Reserve Act to make emergency loans in unusual and exigent circumstances.

Among other things, today we will explore the difference between the discount lending and emergency 13(3) lending, whether we are to rely on the Fed too much in times of stress and the issue of stigma that banks face in accessing the discount window.

The recent history of increasing Fed intervention into private markets traces back to the financial crisis in 2008. At that time, the Fed used its emergency powers to lend, to save individual companies that were teetering on the brink of failure, such as Bear Stearns and American International Group (AIG). Those actions proved unpopular, as the Fed appeared to be propping up individual companies and potentially exposing innocent taxpayers to private sector losses.

In partial response, the Fed's emergency lending authority was amended in the Dodd-Frank Act to provide greater clarity on liquidity requirements, more transparency in Fed emergency lending, and approval of the Treasury Secretary.

Emergency lending was also changed to try to prevent the Fed from acting to save an individual firm by requiring that emergency lending must be undertaken in a broad-based program to provide support for more than just one single firm.

Next, in 2019, in the face of liquidity shortages and volatility in money markets, including markets for Treasury securities, the Fed intervened, using repo facilities that were eventually made permanent.

Following that, at the onset of the pandemic, the Fed intervened further in markets. The CARES Act provided backstop funding at the Treasury to help the Fed use its 13(3) authorities to massively expand its reach, lending far and wide, as Congress instructed.

Most recently, the Fed set up a new lending facility called the Bank Term Funding Program in response to the March 2023 bank failures and interest rate risks facing financial institutions.

Following the bank failures, the Fed has reportedly been working to reexamine operations of its discount window, given that operations appeared, as Chair Powell has stated, clunky. Part of that reexamination involves the role played by Federal Home Loan Bank loans in the provision of liquidity to banks, which we can discuss today, though I am skeptical that Home Loan Banks were integral to the Fed's emergency lending clunkiness last March.

As the Fed reexamines its operations, an open question is whether legislation may be needed to address some of the problems in the Fed's liquidity provision present last March. Meanwhile, Federal banking agencies appeared to be examining new liquidity rules for financial institutions, some of which could have implications for markets, for Treasury securities. Let us hope that the Fed does better at analyzing such things than it did with its under-analyzed recent Basel bank capital proposal.

I thank our witnesses for appearing today and look forward to hearing their views on all these important issues.

The chair now recognizes the ranking member of the Subcommittee On Financial Institutions And Monetary Policy, the gentleman from Illinois, Dr. Foster, for 4 minutes for an opening statement.

OPENING STATEMENT OF HON. BILL FOSTER, RANKING MEMBER OF THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND MONETARY POLICY, A U.S. REPRESENTATIVE FROM ILLINOIS

Mr. FOSTER. Thank you, Chairman Barr, and to our witnesses today.

When the Federal Reserve was created in 1913, one of its core roles was to serve as a lender of last resort, providing emergency liquidity to banks during times of financial stress. Since then, the Fed's role as an emergency liquidity provider has evolved.

The Great Depression led Congress to grant the Federal Reserve authority to provide liquidity to firms, in quote, "exceptional and exigent circumstances," under Section 13(3) of the Federal Reserve Act.

These authorities were ultimately narrowed and safeguards were placed by the Dodd-Frank Act following the 2008 financial crisis when the Fed made targeted and controversial loans to individual firms, like Bear Stearns and AIG. The depression also spurred the creation of the Federal Home Loan Bank system, which developed over the years to become an important liquidity tool for banks, credit unions, insurance companies and Community Development Financial Institutions (CDFIs).

It also provided key competitive advantages due to the smaller institutions that they serve, and this I believe is one of the things where there is strong bipartisan concern about maintaining a healthy size distribution in banks.

I know from my time starting a small business and watching it grow, it is hard for small businesses to get the attention of very many banks for the small amount of business they have, and it is a huge advantage for small businesses to have a variety of institutions of different sizes bidding for their business. That will not happen if the natural forces as banks become more digital cause them to consolidate more and more.

So having institutions like the Federal Home Loan Bank system that level the playing field to some extent between the larger and smaller institutions is another key role that we should not overlook.

In this hearing, we are going to be discussing how the Fed's discount window and other emergency lending authorities have performed during recent economic shocks, and the stigma associated with the use of the discount window, and the interplay between the Fed's liquidity tools and the other government lending programs, like those operated by the Home Loan Banks and the National Credit Union Administration's (NCUA's) Central Liquidity Facility.

As we saw with the regional bank failures last spring, the social media and the 24-hour banking have the potential to accelerate bank runs, by facilitating the rampant deposit withdrawals and exacerbating shifts in market behavior.

I am afraid we are soon going to be living in a world where individuals' artificial intelligence financial advisers on their phones will be continuously monitoring social media buzz, seeing if the bank at which you have your deposits looks like it is rumored to be getting in trouble and pulling your money automatically.

We are talking about something that will not proceed at the speed of social media but at the speed of artificial intelligence. We have to make sure that we have some defense against this, which is not so much prepositioned capital but prepositioned capital flight, which is what I am afraid we are going to see when everyone has their financial advisers automated or at least enough people to really put banks at risk.

Then there is the whole separate issue of short sellers and deliberate attacks on a bank when banks depend so much on their reputation. If a deliberate attack is made on a bank's reputation for illegitimate reasons, which is not a rare thing to happen on social media, we have to make sure that there is a defense for well-run banks against this kind of attack.

You know, we saw probably the first big example of this when Silicon Valley Bank's depositors were spooked by announcements that the bank was seeking additional capital, just saw the thing amplified on social media and the whole thing take off.

Anyway, and we also saw just an incredible rate of capital flight, $42 billion within 24 hours. We have never seen anything like that, and it is only going to get worse.

So this is an important hearing. I want to thank our witnesses and our chairman for convening today.

Chairman BARR. Thank you, Dr. Foster.

Finally, the chair recognizes the ranking member of the committee, the gentlewoman from California, Ms. Waters, for 1 minute.

STATEMENT OF HON. MAXINE WATERS, RANKING MEMBER OF THE COMMITTEE ON FINANCIAL SERVICES, A U.S. REPRESENTATIVE FROM CALIFORNIA

Ms. WATERS. Thank you very much. It has been nearly a year since we faced the sudden failures of Silicon Valley Bank, Signature Bank, and First Republic Bank. I was pleased Treasury Secretary Yellen, the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) took swift action to stabilize the situation.

Going forward, I support efforts by Biden's regulators to encourage the use of the Fed's discount window by banks that need liquidity. I also support Federal Housing Finance Agency's (FHFA's) work to ensure Federal Home Loan Banks use their advances to support housing and community development instead of propping up failing banks.

Last, I hope we can act on my bill to address NCUA's bipartisan request to give small credit unions access to emergency liquidity through the Central Liquidity Facility, as we did during the pandemic.

I look forward to hearing the witnesses' testimony this morning on these issues.

I yield back.

Chairman BARR. Thank you.

Today, we welcome the testimony of Professor Hal Scott. Mr. Scott is the Nomura Professor of International Financial Systems at Harvard University.

Mr. William Nelson. Mr. Nelson is Executive Vice President and Chief Economist at the Bank Policy Institute. Professor Simon

Johnson. Mr. Johnson is the Ronald A. Kurtz Professor of Entrepreneurship at MIT Sloan School of Management.

We thank each of you for your time and being here today. We would ask each of you, after being recognized for your 5 minutes, to give an oral presentation of your testimony.

Without objection, each of your written statements will be made part of the record.

Professor Scott, you are now recognized for 5 minutes for your oral remarks.

STATEMENT OF PROFESSOR HAL SCOTT, NOMURA PROFESSOR OF INTERNATIONAL FINANCIAL SYSTEMS, EMERITUS, HARVARD UNIVERSITY

Mr. SCOTT. Thank you, Chairman Barr, Ranking Member Foster, and members of this subcommittee, for inviting me to testify before you today on this topic of lender of last resort.

My testimony is my own and does not necessarily reflect the views of the Committee on Capital Markets Regulation or its members.

The Fed's lender of last resort function is of critical importance to the U.S. financial system. It needs reform to better respond to today's financial panics.

Here are my recommendations:

First, the Fed needs to clarify its collateral policies. Under the discount window, the Fed need only have collateral to its own satisfaction. After Silicon Valley Bank (SVB) failed, the Fed established the Bank Term Funding Program under Section 13(3) of the Federal Reserve Act and valued hold-to-maturity government securities at par rather than at market, as they had done under the discount window. Why did the Fed not make this adjustment under the discount window before SVB failed, as it had the power to do so? So it needs to, I think, clarify its collateral policies, particularly in crisis.

Second, operational improvements to lender of last resort are necessary. The failure to extend the operating hours of Fedwire on March 9 to allow SVB to borrow from the Fed contributed to SVB's failure. Recent proposals have suggested that banks preposition collateral at the Fed in sufficient amount to cover their runnable liabilities. A more workable and perhaps less costly approach would be to design a system by which collateral and funds can be instantly transferred at the push of a button.

Third, acting as lender of last resort should be the responsibility of the Fed alone. I do not think the Federal Home Loan Banks should have this role, as lender of last resort.

Fourth, lender of last resort facilities just for banks should occur through the discount window and not under Section 13(3). Whereas discount window lending is within the sole discretion of the Fed, Section 13(3) lending requires Treasury approval. To my knowledge, the 2023 crisis was the first time Section 13(3) has been used to create a lending facility just for banks. This facility was not needed to value government securities collateral at par. This could have been done under the discount window. It was not necessary to avoid stigma. Stigma potentially comes from borrowing from any lender of last resort facility. The Fed may be seeking to pull back

from acting as lender of last resort on its own under the discount window, seeking cover from the Treasury approval required under Section 13(3), but the Fed needs to maintain its independence as a liquidity provider, given its clear mandate under Section 10(b) to act independently.

Fifth, the respective roles of lender of last resort and deposit insurance in stemming contagion must be re-examined. In the 2023 crisis, the Treasury invoked the systemic risk exception to protect the uninsured depositors of SVB and Signature when they were already in receivership. Due to Dodd-Frank, this power can only be used for banks in receivership. It can no longer be used to protect all depositors of the banking system without a joint resolution of Congress, which I regard under these circumstances as impractical. Congress should consider restoring the ability to increase deposit insurance in a crisis, and it should also consider increasing the general limits for accounts that present greater run risks and cannot be managed to the current $250,000 limit, such as business payments.

Sixth, under—and I stress this—appropriate circumstances, executive compensation should be clawed back if a bank has received lender of last resort funding from the Fed or has imposed cost on the FDIC or the government more generally.

Seventh, the Fed's emergency lending facilities—and this is a lesson from the coronavirus disease (COVID)—should be limited to liquidity provision and not entail fiscal policy, which results when there is substantial credit risk to the Fed, as was the case with lending to small businesses, nonfinancial firms, under COVID's main street lending program and other facilities that the Fed designed.

In summary, we need to reform the lender of last resort role of the Federal Reserve to better deal with financial panics.

Thank you again for inviting me.

[The prepared statement of Mr. Scott follows:]

Testimony of

Hal S. Scott

Emeritus Professor, Harvard Law School;

President of the Committee on Capital Markets Regulation

Before the

Subcommittee on Financial Institutions and Monetary Policy

of the

Financial Services Committee

United States House of Representatives

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Thank you, Chairman Barr, Ranking Member Foster, and members of this Subcommittee for inviting me to testify before you today on the topic of lender of last resort. My testimony today is my own and does not necessarily reflect the views of the Committee on Capital Markets Regulation or its members.

The lender of last resort ("LLR") function is of critical importance to the U.S. financial system. Before the creation of the Federal Reserve in 1913 and throughout the nineteenth century, U.S. banks underwent recurring liquidity crises – instances where banks, despite possessing assets greater than their liabilities, could not monetize their assets quickly enough to honor rapid withdrawals of their deposit liabilities. Without funding, the banking system could and did fail and the U.S. economy went into deep recession. After the panic of 1907, the Congress in 1913 created the Fed as the nation's first central bank and empowered it to extend emergency liquidity lending

to banks experiencing liquidity crises – i.e., to act as a lender of last resort to the banking sector. This was the original purpose of the Fed, before it undertook to conduct monetary policy. This role has often been controversial, since it involves public support of the private financial system. And this concern, which went back to the creation of the First Bank of the United States by Treasury Secretary Hamilton in 1791, was partly responsible for delaying the U.S. creation of a central bank long after central banks had been established in England and Europe.

Over the last century the lender of last resort function has remained a central part of the Fed's mission. Congress has periodically expanded the Fed's lender of last resort powers including by increasing the Fed's discretion to set the terms of LLR lending and granting it certain powers to lend to the non-bank sector. But concern with lending to non-banks during the great financial crisis of 2007-2008, particularly to AIG, led to certain restrictions being placed on the Fed in lending to that sector under the Dodd-Frank Act.

The 2023 banking crisis and the 2020 COVID crisis each revealed vulnerabilities in the current design and application of the lender of last resort function. In the case of the 2023 banking crisis, Silicon Valley Bank ("SVB"), the 16th largest bank in the United States, entered an FDIC receivership and was sold to a private acquirer after it experienced a bank run of a size and speed that were unprecedented in U.S. banking history, having received no lender of last resort funding from the Fed before its failure. The SVB failure set off runs on two other large U.S. banks, Signature and First Republic, which were also forced into receivership and sold to private acquirers. In 2020, the Fed's use of its lender of last resort powers to lend to *non-financial institutions* pushed the boundaries of the original purpose of lender of last resort, straying into fiscal policy.

My testimony focuses on identifying the issues and questions that these events raise about the lender of last resort function and identifies potential solutions.

The specter of the 2023 crisis has recently rearisen following New York Community Bancorp's release of its fourth quarter 2023 financial results on January 31. NYCB was the acquirer of Signature's assets and deposits in March 2023. That acquisition pushed NYCB's total assets above $100 billion in assets.

NYCB's Q4 2023 results showed a loss of $252 million. NYCB's stock fell 38% on the day the results were reported. The bulk of the losses are reportedly attributable to two specific real property loans, one of which defaulted and one of which the bank wrote down in expectation of a coming sale of the loan. It is far from clear that NYCB's losses indicate a systemic vulnerability among real property lenders or regional banks generally. However, the 2023 crisis, and previous runs on the financial system, show that bank runs can begin quickly and unexpectedly and can arise through irrational fears.

The 2023 banking crisis also raises important questions about the process of bank resolution, including how the Fed uses its lending powers to lend to banks that have already failed—so-called bridge banks—which my testimony does not focus on.

1. **The Fed should clarify its LLR collateral policies**.

The discount window statute (Section 10B of the Federal Reserve Act), the primary mechanism for LLR lending, provides that the Fed may make advances to member banks provided they are "secured to the satisfaction of [the Fed]."[1] The Fed thus has considerable discretion to determine

[1] FEDERAL RESERVE ACT § 10B(a).

how much collateral it requires, which assets it accepts as collateral, and how those assets are valued.

My analysis of publicly available information indicates that SVB possessed hold-to-maturity government securities that could have been pledged as collateral in a sufficient amount to cover the run on its deposits, even under the Fed' haircut policy of valuing these assets at market value rather than at their par value, the standard accounting treatment.

But the Fed could, if necessary, have changed its valuation approach if the market value of those assets had fallen short of needed collateral. The Fed has discretion under Section 10B to value government securities collateral at par rather than market value, or indeed to waive collateral requirements entirely. While these value adjustments could entail a risk of loss to the Fed, this risk must be weighed against the risk of permitting contagion to spread through the banking system by not keeping a bank afloat.

Indeed, after SVB failed, the Fed established the Bank Term Fund Program ("BTFP"), as an additional emergency lending facility, this time under Section 13(3) of the Federal Reserve Act, where its collateral policies are much more constrained than under the discount window. Under the BTFP, hold-to-maturity government securities were valued at par. Why didn't the Fed make these adjustments under the discount window before SVB failed? Was it lack of time or just confusion? Was there a collateral game plan? These questions must be addressed before the next crisis arises.

2. Operational improvements to lender of last resort are necessary.

The events of March 2023 show that bank runs can occur faster than they did in the past. To illustrate this point: SVB experienced a total outflow of 25% of deposits in one day, Thursday

March 9. A further outflow of 62% of SVB's deposits was anticipated to occur on the following day. By comparison, when Continental Illinois experienced a run in 1984, it took seven business days (10 days in total) for 30% of deposits to be withdrawn. SVB's high percentage of uninsured deposits played a role in accelerating the run. As of two months before its failure, only 6.2% of SVB's deposits were insured by the Federal Deposit Insurance Corporation. This was the highest percentage of total deposits that were uninsured of any U.S. bank with at least $50 billion in assets. However, the events of March 9, 2023 suggest that the Fed was operationally unprepared for the unprecedented speed of the run.

On March 9, during business hours on the West Coast, SVB asked its custodial bank to transfer $20 billion in collateral to the Fed to support discount window borrowing. Such transfers take place via the Fedwire system, which has a daily cutoff of 4pm PT/7pm ET. Although SVB's custodial bank attempted to complete the transfer before this deadline, the Fed required a "test trade" to take place before the actual collateral transfer. This test trade could not take place before the deadline, and the Fed declined to extend the deadline to facilitate the transfer. It is unclear why the deadline was not extended. As a result, at close of business on March 9, SVB did not have sufficient cash to cover all outstanding deposit withdrawal requests, and it ended the day with a negative cash balance of approximately $958 million.

The next day, the Fed kept Fedwire open until 11:30pmET/8:30pmPT to facilitate a collateral transfer by Signature, indicating that the Fed then realized that confining Fedwire to normal hours of operation was risking further contagion. In the future, at the first sign of a crisis, the operating hours of Fedwire and any other systems necessary to transfer collateral in support of liquidity lending should be extended as long as necessary.

The run on SVB also showed that there may be critical deficiencies in the communication protocols and unclear division of responsibility between the regional Fed banks and the Fed board and staff in the event of a liquidity crisis. Before the next liquidity crisis, the Fed must create a comprehensive operational plan with clear assignments of responsibilities and red flag procedures with reserve banks providing for immediate notification of top decisionmakers at the Board. This plan should include a "war room" in Washington, from which the Fed's response is coordinated, that is convened at the first sign of a potential bank run.

In addition, policymakers must consider how instant transfer capabilities, of collateral and funds, can speed necessary lender of last resort lending. Recently the Acting Comptroller of the Currency Michael Hsu and the Group of Thirty have suggested that these operational and collateral issues could be addressed by a requirement that banks pre-position collateral at the Fed in a sufficient amount to cover their runnable liabilities, to support their need of any future borrowing. This approach finds its origin in a similar recommendation in 2016 by former Bank of England Governor, Mervyn King. But this approach would require constant adjustments based on changes in collateral values and runnable liabilities and would also tie up bank collateral that could be used elsewhere, to borrow in the private market, to be used for clearing and settlement of securities, or for securities lending. The implementation of a pre-positioning requirement would also require revisiting and substantially revising bank liquidity requirements, since the pre-positioning of collateral would represent a standing source of substantial liquidity for banks. More generally, it is important to remember that run-like behavior and contagion can spread to non-bank financial institutions, which like banks transform short-term liabilities into long-term capital, but which do

not have access to the discount window, as occurred in 2008.[2] A pre-positioning requirement specific to banks would not address the risk of runs on non-bank financial institutions. What is needed is an operational system that allows the transfer of collateral and funds at the push of a button.

3. LLR should be the responsibility of the Fed alone.

Another exacerbating factor in the failure to make use of the LLR function for SVB was the diffusion of LLR responsibilities between the Fed and Federal Home Loan Banks ("FHLBs").

The original mission of the FHLB system upon its founding in 1932 was to support mortgage lending by thrifts and insurance companies. Membership was thus traditionally limited to these institutions. In 1989, following the savings and loan crisis, FHLB membership eligibility was expanded to any bank with more than 10% of its assets in residential mortgage-related assets.

The FHLBs provide loans upon request to their members with the intention that the proceeds will support mortgage lending by the member institution. Over time however, FHLB member banks have come to rely increasingly on FHLB advances as a source of general short-term liquidity. The FHLBs have thus become de facto general lenders to the banking system and are now also effectively acting as alternative lenders of last resort alongside the Fed.

The events of March 2023 show that having two lenders of last resort creates a coordination problem and that the FHLBs are not effective lenders of last resort. Because SVB had excess collateral at the San Francisco FHLB, it first sought to obtain liquidity loans through FHLB. Only when it could not do so did it approach the Fed. This caused a delay which impeded SVB's ability

[2] HAL S. SCOTT, CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS Ch. 7 (2016).

to respond to the run. More generally, FHLBs are less suited to the role of lender of last resort for the simple reason that they cannot create money as the Fed can. FHLBs must issue bonds to create funding capacity. Further, when a FHLB lends, it requires a general lien over the borrower's assets. The existence of this lien can delay the ability of the Fed to obtain the perfected security interest it needs to extend a discount window loan to the same bank, when timing is critical.

On November 7, 2023, the Federal Housing Finance Agency, the agency responsible for oversight of the FHLB system, released the results of their internal review of the FHLB's lending policies. Their report concluded that FHLBs should no longer be a part of any lender of last resort process. Indeed, FHLBs should likely not function as lenders more generally beyond providing support for mortgage lending. Lender of last resort responsibilities should henceforth be confined to the Fed.

4. LLR should occur through the discount window (Section 10B) and not under the emergency lending statute (Section 13(3)).

As noted above, after the failure of SVB, in an effort to stem the contagion, the Fed created an additional emergency lending facility, the BTPF, under Section 13(3) of the Federal Reserve Act. Whereas discount window lending under Section 10B is within the sole discretion of the Fed, Section 13(3) lending, post Dodd-Frank, requires Treasury approval, which the Fed obtained in order to establish the BTFP. To my knowledge this was the first time Section 13(3) has been used to create a lending facility just for banks. Why was this done under Section 13(3) rather than opening the new facility under its Section 10B discount window authority? Fed officials have suggested that establishing a new facility under Section 13(3) allowed them to value collateral at par.[3] But as indicated above, this could have been done under Section 10B.

[3] Richard Ostrander, FEDERAL RESERVE BANK OF NEW YORK, *Remarks on the Panel "Bank Crisis Framework: Learning from Experience - Paris Meeting of the Committee on International Monetary Law of the International Law Association* (June 17, 2023), https://www.newyorkfed.org/newsevents/speeches/2023/ost230617.

It has also been suggested that this new facility was necessary because banks are reluctant to incur the stigma that would result from discount window borrowing. But the stigma, to the extent it exists, comes from the borrowing itself. Moreover, the disclosure requirements for Section 13(3) loans are more rigorous than for Section 10B loans. Section 13(3) requires disclosures of borrowings to Congress within seven days (as compared with two years for the discount window), thus if anything increasing the prospect of stigma. Furthermore, one can seriously question whether stigma is really a consideration for banks in the existential situation faced by SVB, Signature, and First Republic.

There was, however, an important difference between using the discount window under Section 10B and the BTFP under Section 13(3). Whereas the Fed intentionally maintains the interest rate for discount window loans at a penalty rate, a rate above the prevailing rate Fed funds rate (i.e., the rate banks pay on overnight loans from other banks) the Fed did not apply the same higher interest rate on BTFP advances. Instead, the rate was equal to the one-year overnight index swap rate plus 10 basis points. As a result, the BTFP rate could be lower than the Fed funds rate and in recent months the BTFP rate has been significantly lower. At some volume this could pose an issue for maintaining the Fed funds rate, a key tool of monetary policy. While this lower rate may give banks cover from stigma by allowing them to claim that BTFP loans are attractive because they are cheap, it has also created an arbitrage opportunity where banks borrowed under the BTFP and deposited the proceeds in their higher paying Fed accounts, reaping the spread between those two interest rates. Only in January did the Fed shut down this arbitrage opportunity by imposing a floor on the BTFP rate. A better approach to rates might be for the Fed to use an auction mechanism through the discount window such as the Term Auction Facility (TAF) it used in December 2007,

so the rate of borrowing would be set by an auction, and banks could still claim they borrowed at an attractive rate rather than because they were in serious difficulty.

An unstated motivation for the Fed's establishment of the BTFP under Section 13(3), which requires Treasury approval, may be to shield it from attack on its role of lender of last resort. These attacks in the past have come from across the political spectrum. For example, in 2008 Republican legislators harshly criticized the Fed for extending $85 billion in credit to avert the bankruptcy of failing insurance company AIG. Democratic legislators also voiced criticism of the Fed and Treasury's support for the financial sectors in 2008.

As a result, the Fed may be seeking to pull back from acting as lender of last resort on its own under Section 10B and instead may be seeking political cover from the Treasury approval under Section 13(3). However, the Fed needs to resist such pressure and maintain its independence as a liquidity provider to banks, given its clear mandate under Section 10B to act independently.

5. The respective roles of LLR and deposit insurance in stemming contagion must be examined.

Deposit insurance at sufficient levels not only protects depositors but also has a stabilizing effect that can stem contagion.[4] As former Treasury Secretary Tim Geithner has noted, deposit insurance is part of the "well-developed safety net for banks" that provides "strong protections against banks runs."[5] Deposit insurance clearly had a key role in stemming contagion during the 2007-2008 crisis. The level of uninsured deposits in the U.S. banking system has grown substantially since the early 1990s. In 1990, roughly 20% of U.S. deposits were uninsured. This figure grew to roughly 40% by 2008 before dropping to 20% again by 2010. By December 31, 2022, uninsured deposits

[4] HAL S. SCOTT, CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS 146 (2016).
[5] Timothy F. Geithner, The Early Phases of the Financial Crisis: Reflections on Lender of Last Resort (2019), https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=1011&context=journal-of-financial-crises

had grown to about 43% of all deposits.[6] Withdrawals by large uninsured depositors were instrumental in spurring the runs on SVB and Signature.

During the 2008 financial crisis, the FDIC acted under the pre-Dodd Frank version of the systemic risk exception of the Federal Deposit Insurance Act to temporarily lift any limit on deposit insurance for banks' non-interest-bearing transaction accounts, to mitigate the run. But in 2010, Dodd-Frank prohibited the FDIC from taking the same action in the future without congressional approval in the form of a joint resolution. Under the CARES Act, adopted in 2020 in response to the COVID crisis, Congress again provided the power to the FDIC to guarantee all bank deposits in non-interest-bearing transaction accounts.[7] But this approval expired at the end of 2020. Obtaining the joint resolution of Congress necessary to renew this authority during the events of March 2023 crisis would have been impracticable and would be similarly impracticable in a future crisis.

In the 2023 crisis, the Treasury invoked the systemic risk exception to protect uninsured depositors of two banks (SVB and Signature) that were already in receivership proceedings. The power to do so for banks in insolvency was unaffected by the more general limitation in Dodd-Frank. While the *ad hoc* protection of uninsured depositors of already insolvent institutions may have helped stem the 2023 contagion, most uninsured depositors of other banks will not be greatly comforted by the prospect of only being protected if their bank becomes insolvent; they would rather avoid having to deal with an insolvency situation altogether. Congress should therefore consider

[6] FDIC, *Options for Deposit Insurance Reform* 21 (2023), https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-section-3.pdf

[7] CARES Act Section 4008. FDIC, *Options for Deposit Insurance Reform* 19 (2023), https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-section-3.pdf.

restoring the ability to increase deposit insurance in a crisis or to increase the current deposit insurance limit of $250,000.

On the other hand, if deposit insurance is expanded, it can undermine the market discipline exerted on banks by uninsured depositors, to the extent such discipline can practically be exercised.[8] Some have argued for unlimited deposit insurance as a means to prevent future crises,[9] but this is accompanied by another recommendation to then control the exposure of the government by giving it a more wide-ranging role in determining which activities and risks banks are permitted to undertake, including a return to Glass-Steagall. Overall, this would be an undesirable interference in use of the market to allocate lending.

Unlimited deposit insurance would also entail banks paying much higher premiums for deposit insurance given the enhanced protection, which would likely be passed on to customers in the form of higher service fees.[10]

While a dramatic reform to the current deposit regime on the sole basis of the SVB crisis may be unwarranted, Congress should consider whether deposit insurance should take on more of the burden of preventing runs relative to lender of last resort and if so to what extent deposit insurance limits should be raised so that it can better perform this function without undermining market discipline.

One approach which the FDIC described in its 2023 report on deposit insurance reform, would be to increase limits for specific types of accounts that present greater run risks and that cannot be

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[8] Brian A. Johnson & Hal S. Scott, *Controlling the Long-Term Problem of Short-Term Funding* (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2910217.
[9] MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION (2017); Lev Menard & Morgan Ricks, *Scrap the Bank Deposit Insurance Limit* THE WASHINGTON POST (Mar. 15, 2023), https://www.washingtonpost.com/opinions/2023/03/15/silicon-valley-bank-deposit-bailout/.
[10] Johnson & Scott, *supra* note 8.

managed to the current $250,000 limit, particularly business payment accounts.[11] Appropriately calibrated deposit insurance coverage could be sufficient to effectively stem contagion if it works in conjunction with a strong lender of last resort function that reflects the needed reforms discussed herein.

6. Executive compensation should be clawed back, under appropriate circumstances, if a bank's reliance on LLR funds imposes costs on the Fed or the DIF.

If, due to mismanagement by a bank's executives, a bank must rely on loans from the Fed to avert insolvency or receives loans from the Fed in insolvency or the FDIC's Deposit Insurance Fund incurs costs in connection with the resolution of a failed bank, compensation received by the bank's executives should be subject, under appropriate circumstances, to clawback in proportion to those costs. A bipartisan bill has been proposed that would implement a clawback mechanism with respect to compensation received by bank executives within the five years immediately preceding a rescue.[12] The proposal however omits any clear mechanism for calculating the amount of a clawback, and does not precisely define the types of support that would trigger a clawback or link the imposition of a clawback to mismanagement by the failed bank's executives. More nuanced proposals along these lines should be considered.

7. The Fed's emergency lending facilities should be limited to liquidity provision and not entail fiscal policy.

During the COVID-19 pandemic, the Fed used its emergency lending powers under Section 13(3) to create temporary credit facilities under which it loaned to non-bank corporations and small businesses, including, among other programs, the Main Street Lending Program. The Treasury

[11] FDIC, OPTIONS FOR DEPOSIT INSURANCE REFORM (2023), https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf.
[12] The Failed Bank Executive Clawback Act, *available at* https://www.documentcloud.org/documents/23731796-failed-executive-clawback-act-3-29-23.

provided credit protection to the Fed, necessitated in part by Section 13(3)'s requirement that loans thereunder be collateralized, given the fact that many small businesses could not provide collateral.

The Fed's assumption of this role as a lender to the non-financial sector, as well as the sharing of responsibility between the Fed and Treasury for these programs under Section 13(3), raises significant policy issues.[13] In particular, this lending to non-banks entailed potentially significant credit risk to the Fed. Notwithstanding Treasury backing, this credit risk could have put the Fed's reputation and credibility at risk, especially if the losses had been high (which fortunately they were not).

Further, the Fed's role in lending to the non-financial sector during the COVID crisis exposed the Fed to extensive public criticism for doing either too little or too much. But the Treasury's approval right over Fed lending under Section 13(3) means that the Treasury effectively has the power to design the terms of that lending. This puts the Fed at risk for the failure of programs it does not design or control.[14]

Fiscal policy, where the Fed faces substantial credit risk, as with the Main Street Lending Program, should be exclusively the role of the Treasury and not the Fed, since decisions about fiscal policy should be made by elected government officials that are accountable to voters, not independent agencies such as the Fed. More generally, jointly tasking two institutions with the execution of lending decisions, as is currently the case under Section 13(3), with no clear division of responsibility, means that it is difficult to decide where responsibility actually lies. The Fed's lending facilities should be limited to providing liquidity as lender of last resort to the financial

[13] Hal S. Scott, *An Essay on the Fed and the U.S. Treasury: Lender of Last Resort and Fiscal Policy*, HARVARD JOURNAL OF LAW AND PUBLIC POLICY PER CURIAM 1-2 (2021).
[14] *Id.*

system where there is no substantial credit risk, not providing credit to corporate America, a matter best left to Congress and the Executive branch.

Chairman BARR. Thank you.

Now, Mr. Nelson, you are recognized for 5 minutes for your oral testimony.

STATEMENT OF WILLIAM NELSON EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, BANK POLICY INSTITUTE

Mr. NELSON. Chairman Barr, Ranking Member Foster, members of the subcommittee, thank you for the opportunity to testify today. My name is Bill Nelson, and I am the Chief Economist of the Bank Policy Institute.

Prior to joining Bank Policy Institute (BPI), I was the deputy director of the Division of Monetary Affairs at the Federal Reserve Board, where I helped develop the Fed's discount window policy and oversaw the lending operations of the 12 Federal Reserve Banks, including regular discount window lending to banks and emergency lending to nonbanks.

The Fed extends discount window loans as collateralized advances under the authority granted under Section 10(b) of the Federal Reserve Act. Loans can generally be extended for maturities of up to 4 months and must be secured to the satisfaction of the lending Reserve Bank. Most discount window collateral is prepositioned at a Federal Reserve Bank, and 80 percent of that collateral is loans to businesses and households.

Most central bank lending to banks is unremarkable. Prior to the global financial crisis, discount window lending was an important tool for monetary policy implementation. If the Fed inadvertently left the system short of reserves on any given day, the Fed fund's rate would rise up until some bank borrowed, creating more reserves.

Smaller banks borrowed to address short-term funding needs, such as might be caused by losing a large municipal deposit, for example. To be sure, the discount window is also and has always been the Fed's first line of defense against broader financial turmoil.

In part because of the dual nature of discount window lending, both unremarkable monetary policy tool and source of contingency funding, there has been a stigma associated with borrowing from the discount window at least since the 1920s. Tapping your contingency funding inevitably suggests something has gone wrong.

Stigma got much, much worse in the aftermath of the global financial crisis, when borrowing from the discount window was conflated with having received a bailout, even though the loans were fully collateralized, extended at an above market rate, and all repaid on time with interest. Because of the pillorying banks that borrowed received, many banks now refuse to borrow under any circumstances except perhaps an obvious glitch affecting the entire payment system. Consequently, one of the Fed's most important monetary policy and financial stability tools does not work well.

Another source of stigma is that the post-Global Financial Crisis (GFC) liquidity requirements do not recognize access to the discount window and prepositioned collateral as a source of liquidity. Banks are not allowed to assume that they borrow from the discount window in either their liquidity coverage ratio or their internal liquidity stress tests.

Not only do these restrictions depart from reality, a bank prepared to use the window is more liquid than one that is not. They miss an opportunity to create a strong incentive for banks to be so prepared. Moreover, efforts by the banking agencies to convince banks that they should be willing to borrow from the discount window ring hollow if banks are told that contemplating such borrowing is verboten when the banks test their liquidity needs under stress.

In the wake of the bank failures in spring 2023, there has been an increased recognition of the importance for liquidity risk management of being prepared to borrow from the discount window. There appear to be several different approaches floating around for encouraging such readiness, but all involve requiring banks to have discount window borrowing capacity that, when combined with deposits at the Fed, exceed some proxy for short-term funding needs under stress.

A common thread across the proposals is a recognition that a bank that is prepared to borrow from the discount window is more liquid than one that is not, and that weaving that thread into the weft of regulatory and supervisory assessments of bank liquidity will make those assessments more accurate and increase incentive for banks to be prepared to borrow.

A critical ingredient of any such new requirement is reducing discount window stigma. While there is no easy way to reduce discount window stigma, as a first step the leadership of the Fed and other banking agencies need to educate the public, Congress, bank examiners and bank investors that borrowing from the discount window is a business decision of the borrowing bank and neither a bailout nor an indication that the bank is in trouble.

Any requirement that banks maintain minimum amounts of discount window borrowing capacity would, of course, need to go through a notice of common process. In this case, given the novelty, importance, and systemic implications of any such requirement, a better approach would be through an advance notice of proposed rulemaking, which would allow the agencies to receive input on the general idea from bankers, central bankers, academics, and other stakeholders before drafting a specific rule.

Thank you. I would be happy to answer any questions.

[The prepared statement of Mr. Nelson follows:]

BANK POLICY INSTITUTE

Testimony of Bill Nelson

Bank Policy Institute Executive Vice President and Chief Economist

Before the U.S. House Financial Services Committee, Subcommittee on Financial Institutions and Monetary Policy

"Lender of Last Resort: Issues with the Fed Discount Window and Emergency Lending"

February 15, 2024

Chairman Barr, Ranking Member Foster and members of the Subcommittee, thank you for the opportunity to testify today. My name is Bill Nelson, and I am the Chief Economist of the Bank Policy Institute, which is a research and advocacy group supported by banks with more than $100 billion in U.S. assets. Prior to joining BPI, I was a deputy director of the Division of Monetary Affairs at the Federal Reserve Board, where I worked for 24 years. Beginning in 1998, I helped develop the Fed's discount window policy and eventually oversaw the lending operations of the 12 Federal Reserve Banks, including regular discount window lending to banks as well as emergency lending to nonbanks. In that role, I participated in the major revamp of the discount window in 2003 and oversaw all the Fed's post-Lehman credit facilities. I have written extensively on the discount window and lender of last resort. I was also one of the architects of the liquidity regulation regime put in place after the Global Financial Crisis.

Congress created the Federal Reserve System in 1913 in large part for two reasons: 1) To provide banks a safe place to keep the reserves backing deposits and currency, and 2) To extend collateralized loans to banks so that reserves can expand and contract as needed by the system as a whole, as well as to provide a bank immediate liquidity when necessary under stress, especially if experiencing a run. Congress recognized that when the Fed stands ready to lend to a bank experiencing a funding shortfall, it allows the bank to devote more of its resources to lending to businesses and households, supporting economic growth, rather than the bank having to hold an excessive amount of vault cash or unproductive reserves. Over time, in most circumstances, the Federal Reserve has shifted to adjusting the aggregate level of reserve balances for monetary policy purposes using cash or repo open market operations of government securities, but discount window loans are still used to provide reserves to the system as a whole if necessary late in the day, and also as the Fed's frontline tool for addressing banking system strains and financial crises.

Discount window loans are no longer extended as discounts of bank loans, although the name remains. Instead, the Fed extends collateralized advances under the authority granted under Section 10B of the Federal Reserve Act. The loans can generally be extended for maturities of up to four months and must be collateralized to the satisfaction of the lending Reserve Bank. The Fed seeks to take all bankable assets as collateral, provided that it can assign a fair value to the asset and obtain a perfected security interest. The Fed applies conservative haircuts to the fair value of the pledged asset to determine the lendable value – the amount of discount window credit the Fed will provide against that asset. As of February 2020, the last time the Fed provided the information, banks had collateral prepositioned at the discount window with a lendable value of $1.6 trillion. Most discount window collateral is loans rather

than securities, with consumer loans alone making up 40 percent of pledged collateral, and business loans another 20 percent. While the prepositioning of collateral has gotten a lot of discussion lately, discount window collateral has been prepositioned for many decades.

The Fed publishes aggregate data on its balance sheet, including discount window loans, once a week. In addition, the Dodd-Frank Act requires the Fed to publish information on each discount window loan, including the identity of the borrower, after two years.

The FDIC Improvement Act of 1991 restricts the Fed's ability to lend to undercapitalized and especially critically undercapitalized banks. Simplifying a bit, the Fed generally should not extend a discount window loan to a bank beyond five days after the bank becomes critically undercapitalized.

In addition to extending regular discount window loans to banks, the Fed also extends emergency loans, usually to nonbanks. The loans, which are made under Section 13(3) of the Federal Reserve Act, can only be extended in unusual and exigent circumstances, must be provided through a broad-based facility, and must be secured sufficiently to protect taxpayers from losses. The facility must not be intended to support a specific company and must be approved by the Secretary of the Treasury. The Fed must confidentially provide Congress with information on each Section 13(3) loan, including the identity of the borrower, within seven days. The Fed is required to publish loan-level information one year after the facility is closed. The Fed can also lend to anyone under any circumstances against Treasury and agency collateral under Section 13(13) of the Federal Reserve Act, but in practice this authority is rarely used.

Most central bank lending to banks is unremarkable. Looking outside the United States, loans to banks were initially the main asset of the ECB, following the practice of the Bundesbank before it. Those central banks judged buying government securities to be monetizing the debt and so be inflationary and lending to banks to be the least distortionary investment option available. In the case of the United States, prior to the Global Financial Crisis, discount window lending was an important tool for monetary policy implementation. If the Fed inadvertently left the system short of reserves on any given day, the fed funds rate would rise up until some bank borrowed, creating more reserves. The fact that some bank borrowed was not the result of that specific bank's liquidity situation. Smaller banks borrowed to address short-term funding needs, such as might be caused by losing a large municipal deposit, for example.

To be sure, the discount window is also and has always been the Fed's first line of defense against broader financial turmoil. Generally, the first action the Fed has taken when systemic financial strains materialize is to remind everyone that the discount window is open and operating and available for banks to use. Doing so reassures banks about their own, and their counterparties', abilities to secure the funding necessary to meet their obligations. That greater confidence reduces the likelihood that banks will curtail lending under stress, which would amplify the stress and reduce the supply of credit for businesses and households. The Fed has also provided discount window loans to individual banks that are experiencing funding strains, usually just temporarily, but in some cases so that the bank can operate until the FDIC shuts it down.

In part because of the dual nature of discount window lending, both unremarkable monetary policy tool and source of contingency funding, there has been a stigma associated with borrowing from the discount window at least since the 1920s. Tapping your contingency funding inevitably suggests something has gone wrong. Former Fed Governor Betsy Duke, who had been president and CEO of a community bank before becoming a governor, described borrowing from the discount window as like

borrowing from your parents – you'll do it if you have to, but nobody likes doing it. Several bankers have told me that even if the Fed assures a bank that it is OK to borrow, the bank's examiners will subsequently take the borrowing as indication that there is a problem with the bank's liquidity risk management.

Stigma got much, much worse in the aftermath of the GFC when borrowing from the discount window was equated with having received a bailout, even though the loans were fully collateralized, extended at an above-market rate and all repaid on time with interest. Because of the pillorying banks that borrowed received, many banks will now not borrow under any circumstances except perhaps if there is an obvious glitch affecting the entire payment system. Stigma was also worsened by the requirement in the Dodd-Frank Act that borrowing be made public, even with a two-year lag. One bank treasurer told me that if he borrowed from the discount window there would be two phone calls, one from the president of the local Federal Reserve Bank to the bank's CEO asking why the bank borrowed, and one from human resources to him telling him to clean out his desk.

Consequently, one of the Fed's most important monetary policy and financial stability tools doesn't work well. While it is tempting to conclude that stigma is irrelevant because a bank will borrow if it has to, that is incorrect for two reasons. First, in many cases it is not the borrowing bank that is experiencing the liquidity strains but rather a third party, and the Fed is seeking to get banks to intermediate to that third party. That indirect approach will not work if banks won't borrow. Second, a critical purpose of the discount window is to make banks confident that they will have the funds they need to meet draws on credit lines, deposit withdrawals or other cash outflows so that they are not forced to pull back from lending or sell assets at fire-sale prices, two actions that can turn liquidity strains into a systemic liquidity crisis. If using the discount window would get you fired, the fact that you technically have access to the window isn't going to provide much comfort.

Another source of stigma is that the post-GFC liquidity requirements do not recognize access to the discount window and prepositioned collateral as a source of liquidity. Banks are not allowed to assume that they borrow from the discount window in either the liquidity coverage ratio (LCR) or their internal liquidity stress tests (ILSTs). Remarkably, although this may be changing, they are not even allowed to point to the discount window or the Fed's standing repo facility as the means by which they would monetize their liquid assets in their ILSTs. Not only do these restrictions depart from reality – a bank prepared to use the window is more liquid than one that isn't – they miss an opportunity to create a strong incentive for banks to be so prepared. Moreover, efforts by the banking agencies to convince banks that they should be willing to borrow from the discount window ring hollow if banks are told that contemplating such borrowing is verboten when the bank tests its liquidity needs under stress.

In part because of these shortcomings, two weeks *before* Silicon Valley Bank failed, the Bank Policy Institute published a note calling for a holistic review of liquidity requirements. Before the GFC, liquidity assessments focused on ensuring that banks had well-diversified reliable sources of funding and contingency plans that included being prepared to borrow from the discount window. After the GFC, liquidity assessments focused on ensuring that banks had large stockpiles of high-quality liquid assets. In the event, SVB failed while awash in liquid assets but with unreliable, concentrated funding, and unprepared to borrow from the discount window. Signature Bank, which failed two days later, was also unprepared to borrow from the window.

In the wake of the bank failures in spring 2023, there has been an increased recognition of the importance for liquidity risk management of being prepared to borrow from the discount window. There

appear to be several different approaches floating around for encouraging such readiness. A month ago, a report by the Group of Thirty recommended that banks be required to have discount window borrowing capacity that when combined with deposits at the Fed exceeds uninsured deposits and short-term funding. The next week, acting OCC Comptroller Mike Hsu recommended that banks be required to have discount window borrowing capacity plus reserves in an amount at least as large as potential five-day outflows under severe liquidity stress. Another potential requirement that frequently comes up is that discount window borrowing capacity and deposits at the Fed exceed 40 percent of uninsured deposits.

The common thread across these and other related proposals is a recognition that a bank that is prepared to borrow from the discount window is more liquid than one that isn't, and that weaving that thread into the weft of regulatory and supervisory assessments of bank liquidity will make those assessments more accurate and increase incentives for banks to be prepared to borrow. Moreover, addressing greater needs for short-term contingency funds with discount window capacity rather than reserve balances allows banks to devote more of their balance sheets to lending to businesses and households – loans that can then be pledged to the Federal Reserve as collateral – rather than expanding even further their loans to the government in the form of even larger portfolios of Treasuries or deposits at the Fed. Enabling banks to shift away from deposits at the Fed as a liquid asset has the added benefit of allowing the Fed to get smaller and less involved in the financial system on a day-to-day basis.

These recommendations all bear a resemblance to the pawnbroker-for-all-seasons proposal by Mervyn King, the former Governor of the Bank of England. However, King's proposal goes much further. In particular, he recommends that each bank maintain discount window collateral with a lendable value equal to the total amount of all the bank's liabilities. Under this proposal, there would be no need for liquidity requirements, capital requirements or even deposit insurance. While the proposal is elegant and clever, given that discount window haircuts on loan collateral are often 50 percent or higher, implementation would require banks to fund themselves with similarly sized amounts of capital, radically changing the banking industry and reducing economic activity.

A similar but somewhat less radical proposal that I have urged for over a decade is that the Fed sell banks committed collateralized lines of credit, potential draws on which could be factored into banks' liquidity requirements and internal liquidity stress tests. One advantage of such so-called committed liquidity facilities is that banks would pay a market-based fee for the line, providing the bank a stronger incentive to reduce its liquidity risk, and raising funds for taxpayers. The interest rate on any draws on the lines would be well above market rates, creating a strong incentive for banks to only use the lines as a backup source of funding in contingencies and an incentive to repay any draws as soon as possible.

A critical ingredient of any such new requirement is reducing discount window stigma. It would be counterproductive to recognize the liquidity value of a bank's being prepared to borrow from the discount window if the bank is unwilling to borrow when the need arises. While there is no easy way to reduce discount window stigma, as a first step, the leadership of the Fed and other banking agencies need to educate the public, Congress, bank examiners and bank investors that borrowing from the discount window is a business decision of the borrowing bank and neither a bailout nor an indication that the bank is in trouble. A step that Congress could take is rescinding the Dodd-Frank requirement that the Fed identify borrowers. Even with a two-year lag, the disclosure requirement adds considerably to stigma.

As part of any effort to increase banks' preparedness to use the discount window, it would be worthwhile to investigate potential roadblocks to pledging collateral. The Fed has always sought to strike the right balance between ease of pledging collateral and ensuring that the Fed is protected from losses. For example, the Fed accepts loan collateral using what are called borrower-in-custody arrangements in which the bank pledges a large pool of loans but maintains possession of the loan documentation. The bank provides the Fed regular reports on the composition of the pledged pool and the Fed uses that information to determine lendable value. Nevertheless, the Fed should look, and no doubt is looking, for ways to improve the collateral pledging process.

One step each Federal Reserve Bank must complete when accepting loan collateral is resolving competing claims on the assets from the Federal Home Loan Banks. Congress has given the FHLBs the legal authority to secure their loans with blanket liens, meaning that all the assets of any bank with an FHLB advance outstanding are potentially encumbered. To overcome this challenge to getting a perfected interest in collateral pledged to the discount window, each Federal Reserve Bank and overlapping Federal Home Loan Bank work out a collateral-sharing agreement for each individual FHLB-member commercial bank that wishes to pledge collateral to the Fed. In those agreements, the FHLBs subrogate their interest for certain specific types of loans, such as consumer loans, to the Fed.

Any requirement that banks maintain minimum amounts of discount window borrowing capacity would, of course, need to go through a notice-and-comment process. In this case, given the novelty, importance, and systemic implication of any such requirement, a better approach would be through an advance notice of proposed rulemaking, which would allow the agencies to receive input on the general idea from bankers, central bankers, academics and other stakeholders before drafting a specific rule.

Chairman BARR. Thank you.

Professor Johnson, you are now recognized.

STATEMENT OF PROFESSOR SIMON JOHNSON, RONALD A. KURTZ (1954) PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL OF MANAGEMENT

Mr. JOHNSON. Thank you, Mr. Chairman.

I would like to make three points. In making the first point, I would like to read two statements or two quotes for the record. The first, and the quote begins, Silicon Valley Bank, like our mid-size bank peers, does not present systemic risks, end quote. That is a statement that Greg Becker, the CEO of Silicon Valley Bank, submitted to the Senate Banking Committee for their hearing on March 24, 2015.

The second quote is from a joint statement by the Department of the Treasury, the Federal Reserve, and the FDIC on March 12, 2023, which reads, "We are also announcing," in addition to what they are doing for Silicon Valley Bank, "a similar systemic risk exception for Signature Bank, New York. New York, which was closed today by its State chartering authority. All depositors of this institution will be made whole."

Now, the total assets of Silicon Valley Bank, as I am sure you know, Mr. Chairman, when it fell it was something slightly above $200 billion and Signature Bank was about $100 billion. While we have been discussing many of these issues for a long time among ourselves and with you and your colleagues, I think we have learned over the past 10 or 15 years that this category of banks around $100 billion or slightly over $100 billion can, indeed, pose systemic risks. I think Mr. Becker, unfortunately, in 2015 was not correct in his statement.

My second point is I think a combination, actually, of what you said at the beginning, Mr. Chairman, and what Dr. Foster said, which is I think there are three issues bundled together as we discuss the Fed discount window.

The first is, is it clunky? The answer is absolutely yes, you are quite right. I think Professor Scott and Dr. Nelson have both got proposals to make it less clunky, and I think we just need to find technically the better solution, and maybe we have a couple of them and have the Fed try them out.

The second issue is the stigma, and this is something that Dr. Nelson has spent a long time working on. I completely agree that we should press on these dimensions. It is a very hard problem to overcome because, as you know, Mr. Chairman, within banking this signaling virtue is done in various ways, and one of them is staying further away from anything that could look like on a regular basis being emergency lending. Now, if, of course, there is a systemic crisis and the Fed says, we are invoking 13(3), we will lend to you on very advantageous terms, that removes the stigma. That encourages people to come in. That was the dynamic of 2023. Very hard to overcome that.

I would like to overlay on this and emphasize what Dr. Foster said, which is the speed of these runs is only going to accelerate. I think Dr. Foster's world with the AI advisers is not an imaginary or futuristic world at all. I think that we already live in that world.

Having those advisers speed up the bank runs will be coming for sure.

So in addition to dealing with the clunkiness and removing or attempting to address the stigma, I do urge consideration of revisiting the Transaction Account Guarantee Program, which previously before Dodd-Frank could be put in place by a two-thirds majority of the FDIC board with the agreement of the Treasury Secretary, consulting with the President.

After Dodd-Frank, as you know, it is locked up and requires congressional approval. There is specifically a fast track process for approval of the Transaction Account Guarantee (TAG) through the Senate but not through the House, and I have not yet found someone who could explain to me why there is that differential. I think at least a fast-track process in the House to match the one in the Senate would be helpful, but I actually think that putting the ability to invoke the TAG back into the hands of the executive branch, the FDIC, the Fed could certainly be involved, and the Treasury Secretary. I think that would be wise as a complement to all the other measures that you are considering.

The third point that I want to make is a little more awkward, and I am sorry that I need to bring this up, but you mentioned Bear Stearns, Mr. Chairman, and I think that is a good parallel and an important historical example. I am sure you and others will remember that at the time the Fed provided support to the transaction, which was the purchase. Ultimately, JPMorgan Chase was able to buy Bear Stearns. A senior executive of JPMorgan Chase was on the board of the New York Fed, and the New York Fed was instrumental in designing and implementing that transaction.

Now, I understand the governance within the Federal Reserve system is complicated. We can talk about that. I know the Board of Governors ultimately has overriding authority, and I know that is true particularly with regard to bank supervision.

It is a very unfortunate fact that Mr. Becker, who I previously mentioned, who was still the CEO of Silicon Valley Bank in March 2023, was sitting on the board of the San Francisco Fed. This does not look good. It may just be an optics problem, but it really does not look good. It is not good for the Fed, and it is not good for any of these technical fixes or any of the other—all the political support they need to remove the stigma problem, for example.

So I understand Dodd-Frank attempted to address this. I know steps were taken. I understand the difference between Class A and B and C directors of Federal Reserve Banks, but I really think the banks should no longer—member banks should no longer sit on the board of directors of member banks of the Federal Reserve system. Thank you, sir.

[The prepared statement of Mr. Johnson follows:]

February 14, 2024

Written testimony of Simon Johnson, Ronald A. Kurtz (1954) Professor of Entrepreneurship, MIT Sloan School of Management, and Co-Chair CFA Institute Systemic Risk Council.[1]

Before the Subcommittee on Financial Institutions and Monetary Policy of the Financial Services Committee, United States House of Representatives. Hearing on "Lender of Last Resort: Issues with the Fed Discount Window and Emergency Lending," Thursday, February 15, 2024.

A. What Have We Learned?

1) In a traditional bank run, depositors lose confidence in one or more banks and seek to convert their deposits into cash. As some bank assets are not liquid, the role of the central bank is to "lend freely against good collateral," allowing banks to convert valuable assets into cash that can be paid out.
2) In the modern US economy, bank runs have taken on a different nature, with depositors engaging in a "flight to quality", whereby they seek to transfer funds out of troubled assets and also away from assets that are considered adjacent to trouble (which could be, for example, specific bank deposits, or money market funds, or hedge funds) into whatever instruments are considered by the market as "least likely to fail."
3) Modern herding runs can be self-fulfilling, as seen in the example of Silicon Valley Bank (SVB) in spring 2023.
    a. On Thursday, March 9, 2023, depositors attempted to transfer a large amount of funds from their SVB uninsured deposits to uninsured deposits at large money center banks, with J.P. Morgan Chase (JPM) being widely regarded as too big to fail.
    b. By the weekend, there was widespread discussion among chief financial officers and others around the country of the need to transfer operating funds from all small and medium-sized banks to the largest banks (and particularly JPM). In private sector and official circles, there was a well-founded fear that some form of contagion could cause a series of bank failures, with negative consequences for access to uninsured deposits as well as downward pressure on other asset prices, resulting in much tighter credit conditions and a potential contraction in the real (non-financial) economy.
    c. This run took place despite the fact that SVB was a member of the Federal Reserve system and as such had full access to existing Fed facilities, including the discount window. Signature Bank also faced a similar bank run on March 10 (and likely to intensify the next week), for related reasons.
    d. In response, "the Treasury Secretary, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve (Fed) announced on [Sunday] March 12, 2023, that the FDIC would guarantee uninsured deposits at those banks [Silicon Valley Bank

[1] All views expressed here are personal.

and Signature Bank] under the statutory systemic risk exception to least-cost resolution."[2]

e. This reassured depositors that they would not suffer losses on SVB and Signature deposits, and also sent a signal that other affected banks would also be covered by a similar guarantee if necessary.

f. In addition, invoking Section 13(3) of the Federal Reserve Act, the Federal Reserve created the Bank Term Lending Program (BTLP), as "an additional source of liquidity against high-quality securities, eliminating an institution's need to quickly sell those securities in times of stress."[3] Key elements include:

   i. Eligible collateral, such as US Treasury securities, is valued at par with "no haircut". "Advances made under the Program may have a term of up to one year."[4]

   ii. "Any U.S. federally insured depository institution (including a bank, savings association, or credit union) or U.S. branch or agency of a foreign bank that is eligible for primary credit under the Federal Reserve discount window is eligible to borrow under the Program."

   iii. This program was operational on March 12.

4) This experience raises three questions:

   a. Should or could the Federal Reserve have intervened with "lender of last resort" facilities, in support of SVB or other financial institutions?

   b. Is there some other deficiency in our financial sector (depository institutions) emergency support mechanisms, including how decisions are made and by whom?

   c. More broadly, is the US well-prepared for future financial crises, in whatever form these may take.

5) Regarding the Federal Reserve: The creation of the Bank Term Lending Program was entirely consistent with the Fed's mandate, including the spirit of the Dodd-Frank reforms. This program (BTLP) was available to all depository institutions subject to existing eligibility requirements (i.e., being eligible for primary credit from the Fed).[5] This program was not intended to help just one or a few banks, and it did not reach beyond member banks.

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[2] https://crsreports.congress.gov/product/pdf/IF/IF12378. "Generally, the FDIC is prohibited from protecting "depositors for more than the insured portion of deposits" that would have the effect of increasing losses to the Deposit Insurance Fund. However, the Federal Deposit Insurance Act (FDI Act) includes a "systemic risk exemption" that enables the FDIC to take any other action "as necessary to avoid or mitigate" "serious adverse effects on economic conditions or financial stability." Pursuant to this authority, the FDIC will insure all deposits of the failed banks, which were transferred to the two bridge banks chartered by the Office of the Comptroller of the Currency." These quotes are from a leading private sector interpretation of events, written at the time: https://www.lexology.com/library/detail.aspx?g=58f2fc31-9eb2-4934-b7e1-023b390e9bfe.

[3] https://www.federalreserve.gov/financial-stability/files/bank-term-funding-program-faqs.pdf

[4] In contrast, "Advances under primary credit [the main discount window lending program for depository institutions] may be made for a term of up to 90 days."

[5] Primary credit is Fed lending through the discount window, for up to 90 days to well-capitalized depository institutions. There is sometimes a perceived stigma attached to discount window borrowing, i.e., because it may be perceived to indicate weakness on the part of borrowers.

However, the authorities were likely correct in their assessment that the BTLP by itself was not enough to stabilize the situation and prevent a widespread run on other small and medium-sized banks – hence the need to invoke the systemic exception (i.e., a permitted action by the FDIC, with the Treasury Secretary and Fed Board of Governors as the other two "key holders").[6]

6) Regarding other deficiencies: It is disturbing that the authorities had to invoke the systemic risk exception, particularly given that the prior expectation and assertion was that banks at the size of SVB (roughly $250 billion assets and without complex derivatives) could be resolved through the standard FDIC procedures. A major contributing factor was that Dodd-Frank changed the terms under which the Transaction Account Guarantee (TAG) program can be implemented by the FDIC.[7] This now requires congressional approval, with a fast-track procedure in the Senate (although not in the House). This process was likely seen by officials as too slow and cumbersome for the SVB moment.[8]
7) Regarding crisis preparedness in general. When a crisis hits, the key question is whether offsetting actions are needed (a) within weeks, or (b) within hours (or a few days). When a response within a few weeks is needed, Congress has shown that it can take decisive action (e.g., in the case of the CARES Act, to address COVID).[9] However, when a crisis is more intense and faster-moving, as is frequently the case with financial markets, the executive branch needs to have sufficient delegated authority. The main gap is the lack of authority for the FDIC to create a TAG program.

B. Overall Recommendations

1) An important goal is for the U.S. authorities to once again be able to put any bank into FDIC resolution, including with potential losses for uninsured depositors. Spillover effects can be intense and may manifest very fast. Hence there is a need for executive branch authority to apply the TAG (or a functionally equivalent program), with the goal of not protecting uninsured depositors in the failing bank, but rather preventing contagion effects on other banks.

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[6] The systemic risk exception to least-cost resolution requires support from a supermajority (two-thirds) of the FDIC board and the Fed Board of Governors, as well as the Treasury Secretary: https://crsreports.congress.gov/product/pdf/IF/IF12378.

[7] Sheila Bair has explained the motivation for TAG this way, "When I chaired the FDIC during the financial crisis, we instituted such a programme for uninsured transaction accounts used by institutions for payroll and other operating expenses. We did this to protect community banks who were losing uninsured business customers to banking giants such as JPMorgan Chase and Wells Fargo." https://www.ft.com/content/b860ebb6-f202-4ec6-a80c-8b1527c949f4

[8] Former FDIC Chair Sheila Bair spoke clearly on the importance of the TAG program and why it would have been helpful in March 2023. See, for example, https://www.washingtonpost.com/washington-post-live/2023/03/22/transcript-path-forward-banking-with-sheila-bair/.

[9] The TAG program was reauthorized by Congress as part of the CARES Act in 2020, as part of a package of measures intended to protect the financial sector as COVID swept around the world. However, while the COVID crisis was intense and unexpected, modern financial crises often move much faster – measured in hours, not weeks.

As discussed above, the TAG system should be restored to its pre-Dodd-Frank status, under the control of the FDIC board (requiring a super-majority of the FDIC board, with the agreement of the Treasury Secretary, in consultation with the President of the United States). Including the Treasury Secretary and the Federal Reserve Chair (or Fed Board under simple majority or super-majority rules) as required decision-makers would be reasonable and in line with current practice (and Dodd-Frank requirements). Having these three key holders is not burdensome and will not prevent decisions from being made fast enough to make a difference.

If this is not possible, it is essential to create a fast-track for TAG approval in the House, to parallel what exists in the Senate. (There is no obvious or well-documented reason why Dodd-Frank did not create parallel structures for rapid approval in both chambers.)

2) It is of paramount importance to continue improving bank supervision and the enforcement of sensible regulations. On these dimensions, the Fed seems to be heading in the right direction, although it is too early to assess all the changes that have been promised or put in place.[10]

However, we still need further governance reform of regional Feds. The fact that the head of SVB sat on the board of the San Francisco Fed is a huge embarrassment to the Fed System. Member banks should not sit on these boards. The fact that they continue to do so is a bizarre hold over from the 1913 Federal Reserve Act and amounts to a massive anomaly in modern American governance.

In addition, all records at the regional Feds should be subject to the same disclosure requirements as at the Board of Governors (and government records more generally). Sensitive documents can, of course, be published with an appropriate time lag. But too many regional Fed documents currently remain secret forever. This issue came up in the context of the 2007-08 Global Financial Crisis but has never been resolved in a satisfactory manner.

3) It is important for the US to complete the process of implementing Basel III. (Please see the recent CFA Institute Systemic Risk Council letter on this issue, including our emphasis on the ways in which "bank capital" is misunderstood or even, in some instances, potentially misrepresented.)[11]

Officials should continue to emphasize and communicate the need for strong capital and liquidity requirements, as well as market transparency and full disclosure, as appropriate for all banks. Systemically Important Financial Institutions (SIFIs) pose additional dangers to the US and global financial system, and it is appropriate that they should face additional requirements and scrutiny (as agreed under Basel III).

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[10] The Federal Reserve should be commended for the speed with which it produced a report on what happened: https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf. This report is remarkably clear and honest on at least some dimensions of the supervisory failures.

[11] Available here: https://www.systemicriskcouncil.org/2024/01/cfa-institute-systemic-risk-council-writes-in-support-of-agencies-efforts-to-implement-the-basel-iii-international-standards-for-large-banks/. The SRC has also written recently in favor of the proposed long-term debt rules: https://www.systemicriskcouncil.org/2023/12/cfa-institute-systemic-risk-council-writes-in-support-of-proposed-rules-on-long-term-debt-requirements/.

International official cooperation with regard to the regulation of SIFIs (and other banks) is important, to prevent or at least limit regulatory arbitrage. The UK, EU, and US are on the same page in terms of agreement, but the US needs to follow through on full and timely implementation.

Graduated requirements are fine (and entirely consistent with Basel III), but there should be no exemption for heightened scrutiny over mid-size banks (a threshold of no more than $50 billion continues to make sense, in line with my 2015 testimony to the Senate Banking Committee).[12] The CEO of SVB submitted a letter to the 2015 Senate Banking Committee hearing on raising the thresholds; all of his arguments have been demonstrated (by the failure of his bank in March 2023) not to hold.[13]

It would be unwise to allow cryptocurrency "stable coins" to acquire official status or any implicit government backing, including by becoming too important to fail.[14] While the failure of Signature Bank no doubt had myriad causes, its exposure to entities active in cryptocurrency space proved to be one destabilizing factor.

4) It makes sense to better prepare all depository banks to access Fed emergency lending under unexpected circumstances. This could be done by making sure that private sector information technology systems are set up so as to interface effectively and immediately with official systems. Tabletop exercises will likely reveal where friction currently exists.

C. Other Observations

As the work of this subcommittee includes monetary policy (and the interaction of financial institutions and the effectiveness of monetary policy), I would like to emphasize three other relevant points.

1) Concern about tighter credit conditions resulting from higher capital requirements is massively exaggerated. This is explained in the Systemic Risk Council comment letter on

[12] See, for example, Section B, "The Critical Threshold Issue," p.69, in my written testimony, https://www.govinfo.gov/content/pkg/CHRG-114shrg94375/pdf/CHRG-114shrg94375.pdf, which attempted to remind us of the dangers posed by financial institutions with around $100 billion in total assets. SVB had $166 billion in total deposits and a balance sheet of around $200 billion when it failed, https://oig.federalreserve.gov/reports/board-material-loss-review-silicon-valley-bank-sep2023.pdf. Signature Bank had total assets of just over $100 billion, https://www.reuters.com/markets/us/signature-bank-failure-due-poor-management-us-fdic-report-says-2023-04-28/#:~:text=The%20FDIC%20estimated%20the%20deal,state's%20Department%20of%20Financial%20Services.

[13] The written statement submitted by Greg Becker to the Senate Banking Committee in March 2015 is available here: https://www.govinfo.gov/content/pkg/CHRG-114shrg94375/pdf/CHRG-114shrg94375.pdf. Mr. Becker was CEO of SVB at that time, and he was also CEO when the bank failed (or came close to failing) in March 2023.

[14] Please the separate SRC letter on this issue: https://www.systemicriskcouncil.org/2022/02/cfa-institute-systemic-risk-council-urges-fsoc-to-address-the-risks-to-u-s-financial-stability-posed-by-unregulated-and-underregulated-stablecoins/.

Basel III, referenced above. Over the business/credit cycle, well-capitalized banks are better able to sustain lending than banks with relatively little capital (i.e., which fund themselves with more debt relative to equity).[15] Periodic and rolling testing of the Fed's discount window may also be called for, to improve operational practices on both sides.

2) The Federal Reserve retains strong control over the average and marginal pricing of credit (interest rates), as demonstrated repeatedly over the past two years. Interest rates have a material impact on the US economy. In no sense has monetary policy become ineffective. The problems encountered by SVB and Signature Bank were ultimately due to excessive risk-taking by management, not due to any problem with the functioning of monetary policy. Interest rates will always rise and fall in unpredictable fashion, sometimes due to policy and sometimes due to market reactions to non-monetary events.

[15] The economics of bank capital are explained clearly by Anat Admati and Martin Hellwig, https://press.princeton.edu/books/paperback/9780691251707/the-bankers-new-clothes.

Chairman BARR. Thank you for your testimony. We will now turn to member questions.

The chair now recognizes himself for 5 minutes for questioning.

Professor Scott, I will start with you.

Are we relying too much on the Federal Reserve to intervene in financial markets and the economy and sometimes expecting the Fed to engage in emergency lending that could be done as a fiscal policy operation using a program housed at the Treasury instead?

Mr. SCOTT. Yes. As one of my points that I mentioned in my oral testimony is I do not think that the Fed should be taking substantial credit risk when it makes loans and that occurs when there is not sufficient collateral. Under 13(3) during COVID, that gap was made up by Treasury's backing of the Fed's loans, but was this backing sufficient? The Fed was still taking risk, substantial credit risk. In my view, that is fiscal policy. That should be done by the Federal Government, not the Fed. So main street should be PPP, not main street, okay?

Second, when you loan under 13(3), there is kind of a dual sign-off. The Fed has to sign off and the Treasury has to sign off and I can tell you, during COVID in the operation of main street—and I wrote op-eds on this subject—it was very hard to say who was responsible for the design of main street. Was it the Treasury or is it the Fed? So when you have two sign-offs, as we have on 13(3), it is very hard to pin responsibility.

So, for those two reasons, I would say if the Fed is taking substantial credit risk, it should not be the Fed lending, it should be the government.

Chairman BARR. Thank you.

Mr. Nelson, what, if anything, would you recommend that the Fed do to reform its discount window or 13(3) policies, procedures, and operations?

Mr. NELSON. As part of a preparation of requiring banks to pledge more collateral to the discount window, I think the Fed should certainly review its discount window policy, collateral operations and procedures, to make sure that they are as efficient as possible.

I say that, but I also recognize that the Fed has always sought to make the collateral pledging process as efficient as possible, and almost all collateral is already prepositioned at the Fed subject to keeping the Federal Reserve and taxpayers safe. I am not really certain that there is a lot of low-hanging fruit available there. In fact, my guess would be that there is not, first of all because Fed staff would have already plucked it, but also because I have talked to many of my member banks of the The Bank Policy Institute (BPI) about this issue. Many of them indicated—they have not generally indicated dissatisfaction with the collateral pledging process from the Federal Reserve Bank.

In addition, I think that the Fed needs to go back to review how it is doing things, go back to its 2003 revision, the last time it revised Regulation A, and move the discount window to an above-market rate so that it could let the rate itself govern a bank's decision to borrow and remove any questioning.

I would go around and talk to the reserve banks and make sure that the borrowing was kept secret. We had a joint Supervision and

Regulation (SR) letter written by the supervisory agencies, recognizing that the discount window is an important tool for liquidity risk management.

So I think that the Fed needs to redouble—and that was working. Over time, that was gradually reducing the amount of stigma that was available. So I think going back to that, no questions asked, it is a bank's decision to borrow, educating the public, educating Congress about the importance of the discount window would be a critical change.

Chairman BARR. Yes. I am very intrigued by your recommendation, when you say banks are not allowed to assume that they borrow from the discount window in either the liquidity coverage ratio or their internal liquidity stress tests.

What does the Basel III end game proposal do about this in exacerbating that problem, and do you believe that Congress needs to legislate in that area to remove the stigma?

Mr. NELSON. Basel III does not mention the discount window. It does not come up.

Chairman BARR. Would it exacerbate the stigma?

Mr. NELSON. It should not really have an effect either way.

Chairman BARR. An effect. Would you recommend that Congress take action or just the Fed in the application of stress tests and the Liquidity Coverage Ratio (LCR)?

Mr. NELSON. One action that Congress could take that would help with stigma is to go back to keeping borrowing secret. It is true that when you borrow from the discount window, the names and the identities of the borrowers are released after a 2-year lag. That may not seem to matter much, but I have been assured by bankers that actually really does matter.

Moreover, when I used to go around to banks and try to assure them—try to convince them to use the window, it mattered a lot that I was able to say, this is kept secret. It is less compelling to say, this is kept secret for 2 years and then it is revealed.

Chairman BARR. My time has expired but, Professor Scott, if you could, in answers to other questions, throw in the lessons that you think we should take from the experiences of last March and ways to improve the Fed discount window lending and the role of the Federal Home Loan Bank lending to financial institutions.

With that, the gentleman from Illinois, Dr. Foster, is now recognized.

Mr. FOSTER. Well, thank you, Mr. Chair and our witnesses. I would just like to start out by saying that I agree with Professor Scott about the desirability of separating the Fed's role as a lender of last resort with basically bailing out businesses that were in trouble that we think deserve bailing out, and so I think if we can find a way to do that.

The issue that I saw at the time was just the capacity of the Fed when we had to get a lot of money to a lot of different businesses really fast. The Fed was the only—and so we have to preposition the pipelines to make—if we have to do a broad-based business bailout that we have to find a mechanism that is well-defined ahead of time to make that work.

Professor Scott, are there any specific proposals that you are aware of for separating those two functions explicitly?

Mr. SCOTT. I think the Fed could remain the distributor of funds without being the lender of those funds. So the critical thing to me is when we are dealing with fiscal policy, it should be the government.

The government can use the Fed to distribute those funds. The Fed can play an operational role in getting those funds to small business if the Congress and the government so order them.

So what I would like to see is the Fed not be the lender under those circumstances.

Mr. FOSTER. Okay. I agree with everyone's comment about the stigma. Just some elementary questions: Do the large banks at least exercise the ability to do transfers out of the window? Are the pipelines in place and are they tested with some trivial amount of money regularly?

I know of at least one bank where I have asked that question and they said, yes, of course. It is some microscopic amount of money so that they do not feel the stigma.

Is that a universal practice or should it be made a universal practice to at least exercise the window?

Mr. SCOTT. Actually—I am sorry.

Mr. FOSTER. Go ahead. Sure.

Mr. SCOTT. During March 9, when SVB was trying to transfer its collateral to the Fed through the bank of New York Mellon, it could not be done because we had to have a test procedure to determine whether such transfer could be made, okay?

That should be like automatic at this point. You should not be running test procedures when you have a bank in distress.

Just one further comment on stigma, because it has come up here. Part of the reason the Bank Term Funding Program (BTFP) was created or one of the aspects of it was the rate at which people could borrow from that facility compared to the rate that they could borrow from the window. It was lower.

As a result, it was so low that they could borrow from BTFP, and did, and make an arbitrage by putting their money in the reserves and getting a higher rate from the reserve account. The Fed put an end to that in January.

What it underlies is the response to stigma was to lower the borrowing rate so people could say, hey, I am not borrowing because I am in trouble. I am borrowing because it is a great rate, okay? In the financial crisis——

Mr. FOSTER. That was not optimal. There were letters in the Fed to—in preparation when the Fed made that move, because it is——

Could you say a little bit, any of our witnesses, about sort of the nuts and bolts of prepositioning capital at the window. What exactly—what does that mean? What are the downsides? What are the costs of doing that? Why is it not a uniform practice already to preposition an amount of capital?

Also, to do that, you have to understand what fraction of deposits and so on are actually flighty if you are going to say, you should preposition adequate for, quote/unquote, flighty capital. Are there clean definitions of what is required there?

Mr. Nelson, do you want to have a swing at it?

Mr. NELSON. So the Fed has always accepted collateral—at least for decades accepted collateral and maintained pools of collateral

from banks prepositioned at the window. That is how it is done. Eighty percent of the lendable value of bank collateral are loans to businesses and households, and those all have to be prepositioned.

Mr. FOSTER. When people refer to the costs of doing that, are the costs significant? Since nothing has actually happened if it is sort of prepositioned, is my understanding, they are not——

Mr. NELSON. Well, there are costs. There are a few costs to consider. One is that it does take time and work to set up the arrangement, and banks do need to provide the Fed with information on the loans that are pledged. The bank maintains possession of the loan collateral, but then provides the information that is necessary in order to value the collateral and apply a haircut to come up with a lendable value.

It is also true that banks use collateral for lots of things. They collateralize municipal deposits. They collateralize their Federal Home Loan Banks and those things. So there is a cost to keeping that collateral.

Mr. FOSTER. If, actually, any of you want to respond to the record of a stronger version of prepositioning collateral and the standards for how much you would have to preposition, what that could actually look like at a sort of operational level, I would appreciate it?

Chairman BARR. The witnesses can submit that for the record and the gentleman's time is expired.

The gentleman from Missouri, Mr. Luetkemeyer, is recognized.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Thanks to the panel for being here this morning. Great thought leaders here.

Mr. Johnson, you brought up a subject that is kind of near and dear to my heart. That after the debacle of last spring with our banks, I came up with, as looking at this from outside the box here and coming up with some ideas of the kind of risks that we are taking there.

From the standpoint that the gentleman was sitting actually in Mr. Scott's seat, who was the chairman or the president of the board of SVB, and said he had $42 billion run out in 10 hours. To me, this is—as a result of a tweet.

We are living in a different world than we did 2 years ago, 5 years ago, 2 months ago. Now you brought up something in your comments with regards to artificial intelligence.

I sit on the China Select Committee. It scares the heck out of me, because we have just handed the Chinese the way to mess with our banking system and our economy. All you do is short sell tonight, go up tomorrow morning with a tweet, or have an artificial intelligence Facebook post of Larry Kudlow, Bloomberg, Dave Ramsey, somebody who is respected in the investment field.

It could be an artificial individual on there and nobody could tell the difference. I have seen these commercials myself. You cannot tell the difference between—and you have somebody of that reputation go up there and say, I have a hundred banks that are in trouble. Suddenly, it is like, wow. You have real-time payments. You have instantaneous ability to make these transfers. All of a sudden now you do have a run.

People kind of laugh at me when we talk about runs. I say we had a run on toilet paper 3 years ago. Do not tell me you cannot

have runs. I think people value their money more than their toilet paper.

One of the things I think that we need to do is have the ability of the regulators, the FDIC in this situation—and you made this comment with regard to transaction guarantee of accounts for a short period of time—to be able to stymie this sort of run, nip it in the bud before there is a contagion here that goes through the entire system.

I would appreciate your comments on that.

Mr. JOHNSON. Congressman, I think you are exactly right on all the dimensions there, including the fact that the AIs can already fake images and messages very credibly. Then the point made by Gary Gensler, actually, when he was still on the faculty of MIT before he joined the Securities and Exchange Commission (SEC), was we should think about a future in which financial institutions tend to use similar AI engines themselves internally, which will be reacting to the messages from the outside, which will just exacerbate the speed of runs.

So that is exactly why having the FDIC, with the Treasury and arguably with the Fed, because they can all move fast, giving them the ability to put a temporary Transaction Account Guarantee Program in place very quickly I think is exactly the right direction to go.

This would not be a substitute for the other things we are talking about today with the discount window, but it would be a complement and I think it would be very consistent with the objectives of this committee.

Mr. LUETKEMEYER. Oh, I think it is a tool. The regulators need to have a toolbox. I am not trying to protect a single bank here. I am trying to protect the system from going down. When you have a run, that can make contagion that can spread through everything.

Mr. Scott, I know your comments in your written testimony were similar along that line. Would you like to comment at all?

Mr. SCOTT. On this point?

Mr. LUETKEMEYER. Yes.

Mr. SCOTT. Well, I agree with Professor Johnson that I think this power needs to be restored. I think a key idea of the Congress at the time was it could restore by a joint resolution. I think, given the speed by which these runs occur, that is impractical. To get a joint resolution in time to actually get the authority to extend——

Mr. LUETKEMEYER. That is the point of my bill is the fact that we cannot sit here and wait for Congress. The regulator has to have this tool in a toolbox that they can instantly make this situation resolved and not have to wait on Congress.

Mr. SCOTT. Yes.

Mr. LUETKEMEYER. So for a short period of time they have the authority to do this. At the end of 30, 60 days, we pick a timeframe. Then Congress can extend it or not extend it, and then you are off and running, but we live in a different world where this instantaneous ability to do things today is such that we have to be able to instantaneously react. If we do not, I am fearful. I have a bill to do that, and I appreciate your comments on that.

Mr. Scott, with regards to the term funding, the short-term funding programs that the Fed has put together here, I would kind of like them to keep this program up and running. I know you are not a big fan of that.

So the question, I think it is a question that the problem that happened last spring in which you had some interest rate problems, some banks were upside-down interest rates in the long term/short term.

Have those rate problems dissipated yet? I guess, do we have some banks still with liquidity problems as a result of long-term assets being for lower rates?

Mr. SCOTT. I am sorry. I am a little hard of hearing sometimes.

Mr. LUETKEMEYER. Okay.

Mr. SCOTT. I do not think—no, I do not think they need to keep it in place, because my basic point is it is not necessary at all. If they are going to do this kind of thing, it should be through the window, through the discount window authority.

Mr. LUETKEMEYER. Is the window for short-term lending versus the need to have some long-term liquidity here?

Mr. SCOTT. In terms of having this liquidity?

Mr. LUETKEMEYER. Yes.

Mr. SCOTT. I think the policies under——

Chairman BARR. The gentleman's time has expired.

Mr. SCOTT. I do not think we need to extend those facilities.

Mr. LUETKEMEYER. Thank you. I yield back.

Chairman BARR. The gentlewoman from California, Ms. Waters, is now recognized.

Ms. WATERS. Thank you very much.

Professor Johnson, we will soon be marking the 1-year anniversary when we witnessed the sudden collapse of Silicon Valley Bank and Signature Bank last March and then shortly after the First Republic Bank. Those were three of the four largest bank failures in United States history.

On the weekend that SVB and Signature Bank failed, I convened a number of member calls with the regulators, and I was pleased to see how the Biden administration, led by Secretary Yellen, worked closely with the Federal Reserve and the FDIC and used their emergency tools to quickly stabilize the situation.

As part of their actions, the agencies invoked a systemic risk exception to protect uninsured depositors, and the Fed used its emergency lending authority to set up the Bank Term Funding Program to help other banks that had securities portfolios with large amounts of unrealized losses to be able to have access to liquidity.

Professor Johnson, do you think that these quick actions of Secretary Yellen, Chair Powell, and others were appropriate and helped prevent a broader financial crisis?

Mr. JOHNSON. Yes, Congresswoman. I think those actions, under the circumstances and given the constraints which we were just discussing in terms of the fact that the Transaction Account Guarantee Program was not available on short notice because of the terms of Dodd-Frank, I think the measures that they took, both individual measures and the packaging ways they put them together, were entirely responsible and saved us from a much more severe financial crisis.

Ms. WATERS. Thank you.

Professor Johnson, you also raised how important it is for banking regulators to finalize the Basel III end game proposal to strengthen bank capital requirements. I agree with you, but we received all sorts of statements from the banking industry claiming the sky will fall and banks will stop offering loans to underserved communities if the rule is finalized.

Should we believe their statements, like some believed SVB's CEO back in 2015 that it was okay to deregulate regional banks since they never pose a systemic risk? Would you discuss why this rule is so important.

Mr. JOHNSON. Congresswoman, so as I reference in my written testimony, I am the co-chair of the Chartered Financial Analyst (CFA) Institute Systemic Risk Council, the body that was founded by Sheila Bair, the former chair of the FDIC.

We sent a letter quite recently to the regulators with regard to Basel III and our position. The Systemic Risk Council is compromised of various Republican, Democratic, and international European former officials. Our view is that completing Basel III at this stage and at this moment for the United States is important.

We are not convinced by the arguments that it will cause economic exceptional difficulty. In fact, our view is that well-capitalized banks are more likely to be robust lenders throughout the business credit cycle; therefore, strengthens economic growth prospects for everyone in the United States.

Ms. WATERS. Well, I heard someone say, oh no, it had nothing to do with capital that caused those banks to fail. It was all about mismanagement.

Is not a lack of enough capital mismanagement? How could you separate the two?

Mr. JOHNSON. The lack of capital or potential insolvency is absolutely intertwined with issues of liquidity pressure in many financial crises, and it was absolutely in the case of Silicon Valley Bank, where investors came to believe, in part through the rumor mill but there was definitely some foundation for this, that Silicon Valley Bank had a potential solvency problem and, therefore, it might be a good idea to move their deposits, their uninsured deposits elsewhere.

So that the liquidity problem or the run on the bank as people were trying to not go to cash but go to other safer banks, that was absolutely intertwined and really tightly connected, Congresswoman, as you are saying, with the capital deficiency or the lack of capital and potential insolvency.

Ms. WATERS. Some believed SVB's CEO back in 2015, that it was okay to deregulate regional banks since they never pose a systemic risk.

Would you take a minute and discuss why this rule is so important.

Mr. JOHNSON. As I mentioned, Mr. Becker, the CEO of Silicon Valley Bank, did send a letter saying exactly that to the Senate Banking Committee in 2015. I testified to that committee on the other side of that argument.

I have to say I think Mr. Becker's letter is entirely wrong. I think that Silicon Valley Bank absolutely and manifestly did end up posing systemic risks.

Ms. WATERS. Thank you very much. I yield back.

Chairman BARR. The gentlelady yields.

The gentleman from Georgia, Mr. Loudermilk, the vice chair of the subcommittee, is now recognized.

Mr. LOUDERMILK. Thank you, Mr. Chairman. Thank you all for being here.

Mr. Nelson, earlier the chairman of the subcommittee outlined the number of times 13(3) has been used since 2008, and especially the increased frequency that it has been used in the last few years.

Do you see this increasing use of 13(3) facilities as a general trend toward reliance, or is it still as a response to specific conditions?

Mr. NELSON. I think that there is inevitability that once you start using it, you start to use it more. I think that there is a sense of general trend.

When I used to go out and talk to people about using the discount window back before the global financial crisis, at times I would be asked, well, would the Fed ever use 13(3)? My answer was always, no, absolutely not. They have not used it since the 1930.

Of course, the global financial crisis hit and they used it, and I was very involved in that, as appropriate. Then COVID came around. They immediately rolled out all the same facilities again.

So it is clear now that in response to troubles, opening a broad-based facility for nonbanks under 13(3) is on the table and that has moral hazard consequences. I remember talking to money market mutual funds about the effort to reform them after the global financial crisis. The answer was in some cases, well, why is that necessary? If there is trouble again, the Fed will just open up a new lending—a lending facility for us again. As COVID hit, that is exactly what happened.

So—and the risk is that the institutions that receive 13(3) loans generally tend to be ones that are not as stringently regulated as commercial banks. They do not have the same controls to control the moral hazard.

Mr. LOUDERMILK. Instead of an option of last resort per se as maybe it was intended, this has become the default go-to?

Mr. NELSON. I think that is probably going too far. I do not think it has become a default. Nevertheless, I am sure on everyone's mind is now that if sufficient trouble happens, the Fed will be able to open a 13(3) facility.

Mr. LOUDERMILK. The safety net is always there.

Mr. NELSON. The safety net is expanded.

Mr. LOUDERMILK. All right. With the Fed's progress toward real-time 24/7 services in other areas, do you believe it would be beneficial to extend the operating hours of the discount window?

Mr. NELSON. I do. I think the critical question is actually the operating hours of Fedwire and the National Book Entry System for securities. You could make a discount window loan in the middle of the night, but you could not book it to the institution's account, because Fedwire is closed.

So the Fed is studying and has expressed a desire to extend Fedwire to 24/7, and that would make a lot of things a lot simpler, but I do not know how difficult it is.

Mr. LOUDERMILK. Do you think if they did do this, would it reduce the reliance on special credit facilities during periods of instability?

Mr. NELSON. I think it would—not necessarily, because the institutions that would have access to those 24/7 facilities would all be commercial banks, ones with accounts at the Fed. So——

Mr. LOUDERMILK. Are there any technical or logistical obstacles that might prevent the Fed from doing this?

Mr. NELSON. I do not know. I am sorry.

Mr. LOUDERMILK. Can you explain how services like Fedwire might have played a role in preventing Silicon Valley or Signature Bank from accessing liquidity through the Fed's discount window?

Mr. NELSON. As Professor Scott mentioned and as was reported in the press during the efforts to keep Silicon Valley open, they had trouble getting securities from their correspondent bank in New York into their account so that they could lend against them.

The facilities close at 7 p.m., which is a normal time for things like that to close, but that is Eastern Time and so 4 o'clock Western Time, and extending the hours would have helped.

Mr. LOUDERMILK. Okay, thank you.

One of the requirements to use 13(3) authorities is to affirm that the participants cannot secure credit accommodations from any other institution. In theory, this is an important safeguard to prevent the misuse of 13(3) facilities.

How is this safeguard applied in practice under truly exigent circumstances?

Mr. NELSON. Each time the facility is used or created, the Fed looks at and determines that similar credit is not available elsewhere.

Mr. LOUDERMILK. Okay. Last March, the Fed set up the Bank Term Funding Program facility, a 13(3) facility. The BTFP lets borrowers pledge securities and get a loan at par value, not market value. Since then, the program's credit extensions have reached around $165 billion and is slated to expire in March of this year.

Do you believe that the program achieved its intended purpose?

Mr. NELSON. I do. I mean, viewed from the outside, it appeared that what happened was the Fed that SVB weekend looked around and looked at the uninsured deposits that were out there that could run and the amount of collateral that was pledged by the institutions subject to those runs, and they have judged that to be a necessary response.

It was one that allowed them to move collateral very quickly, because book entry securities can be moved immediately and in large amounts. I think it entailed a lot of risk, though.

Mr. LOUDERMILK. Thank you. I yield back.

Chairman BARR. The gentleman yields.

The gentleman from Georgia, Mr. Scott, is now recognized.

Mr. SCOTT of Georgia. Thank you, Chairman.

Mr. Johnson, welcome. Now, I truly believe that the Fed's discount window can be very helpful, but we got a problem. Our banks are scared to use it because they fear it is going to hurt them with

their investors and depositors. That is even if we are waiting 2 years before we even tell anybody that they are using it.

So what can we do? What else can we do to really deal with this problem?

Mr. JOHNSON. Well, Dr. Nelson has proposed to remove the requirement to disclose who borrows from the discount window. I think the problem with that is, Congressman, that there is already a great deal of concern that the deal that banks have with regard to the Federal Reserve is actually a pretty good deal and not available to other parts of the economy.

So I think actually making that secret again would be problematic, including given, as I mentioned, the governance structure of the regional Feds, where banks sit on the boards of these Feds which would then be giving them advantageous loans in secret. That is very difficult, I think, to make that work politically with the country.

I think, Congressman, that the Transaction Account Guarantee Program that we previously discussed would be very helpful to achieving your goals and the goals of this committee, because the point is that if that program is available, there can be losses for one entity.

Let us say Silicon Valley uninsured depositors might have lost five cents on the dollar. That is one reasonable estimate and they would have gotten a lot of their cash back, by the way, within a couple days. That is the way the FDIC operates.

The TAG would have been applied to all other banks throughout the system—small, medium, and large—on a temporary basis. That would have prevented the panic and the fear that was going to drive other depositors, other insured depositors to the mega banks in the following days.

So I think, as a belt-and-suspenders approach, as a backdrop to the discount window, for which I really do not think we are going to get past the stigma completely ever, I think you need the TAG program.

Mr. SCOTT of Georgia. If we are not going to be able to get rid of it ever, in your estimation, do you think that we will have more Silicon Valleys, more banks disruption, more hurt to our economy? Are you saying that this is something we are going to have to live with or can we solve it?

Mr. JOHNSON. I think we live in a very unpredictable world. As Dr. Nelson said, we have had four major—three major disruptions, three needs to use the 13(3) powers over the past 15 years. I do not think the world is going to become more stable, Congressman.

I think 13(3) is available. I understand Professor Scott's reservations about it, but it is available precisely when nonbanks are in trouble, so not member banks, or when you need to provide some support to banks and break through that stigma barrier.

The 13(3) powers, as we saw in the case of Silicon Valley Bank and Signature Bank, are not sufficient. That is why they did the systemic exception.

Mr. SCOTT of Georgia. Yes. You mentioned, Dr. Nelson—let me ask you. The Federal Home Loan Bank system is a source of collateralized borrowing that some banks tend to turn to when they

need liquidity. How do you feel about that? Is that a way out of this?

Mr. NELSON. The Federal Home Loan Bank system is an important means by which smaller and regional size banks conduct regular asset liability management when they need funding, and that is an important role and one—but at the same time there is a significant moral hazard and a problem with the Federal Home Loan Bank system in that the securities that it issues to fund itself are viewed as guaranteed by the government, but they are not guaranteed by the government, and that is a recipe for systemic risk.

Addressing that problem would require a lot of careful consideration, because of their role in the banking system. That said, one role that they are not suited for is to be lender of last resort, and that is for three reasons.

The first is that, as I mentioned, the Federal Reserve, as we have discussed, the discount window is open till the end of the day. It is the last mover. The second reason is that at times being lender of last resort requires lending vast amounts of money, and that money is not—the Federal Home Loan Bank system does not have that. They have to borrow it. That takes time and it can add to the stress in the financial system. The third reason is that when the Federal Reserve—sometimes being a lender of last resort requires adding reserves to the banking system. When the Federal Reserve makes a loan, that expands their balance sheet and it creates reserves, but not for Federal Home Loan Bank loans.

Mr. SCOTT of Georgia. Well, thank you. I think we can find a way out of this.

Chairman BARR. The gentleman's time has expired.

Mr. SCOTT of Georgia. I really do.

Chairman BARR. Thank you. The gentleman's time has expired.

The gentleman from Tennessee, Mr. Rose, is now recognized.

Mr. ROSE. Thank you, Chairman Barr and Ranking Member Foster for holding the hearing. Thank you to our witnesses for being here with us today and sharing your time and expertise.

Dr. Scott, in your testimony, you discussed how the development of transfer speeds has resulted in bank runs that have gone from taking 10 days down to, effectively, 1 day, maybe hours. What impact do instant transfers have on the ability of the Federal Reserve to respond to bank runs?

Mr. SCOTT. Well, for one thing, I think SVB teaches us that they have to be responding quickly because the runs are happening quickly, and their operations need to be set up to permit that. As I think we have discussed with Fedwire where they were not, they have to be improved.

I would like to see more operational improvements so people could transfer collateral to the Fed and receive funds instantaneously. Technically, this should be possible in the modern world. I think those are clear operational improvements that the Federal Reserve should make.

Mr. ROSE. As we think about technology, Dr. Scott, obviously, we will continue to advance, and we will see the quickness, the rapidity of these things probably increase, not decrease, as we go forward. Certainly, the ability to communicate concern in the market-

place is almost instantaneous at this point, and the ability to move funds is very quickly becoming instantaneous.

What does the Federal Reserve, besides the things that you have said, what changes in technology do they need to implement to respond to these runs quicker and quicker?

Mr. SCOTT. Well, I am not a techie, so I cannot give you the details, but I think if we have a world with AI, we can sort of figure out how to move funds fast and get collateral to the Fed. I am sure the technical people can figure that out pretty quickly and set up a system to do it.

Mr. ROSE. Is the Fed and the other regulatory establishment, are they equipped from a policy perspective to make such quick decisions?

Mr. SCOTT. Well, I think they learned a lesson here. By the way, the next day, when they were dealing on Friday with signature, they left Fedwire open until the end of the day. In terms of the operating hours issue, they learned a lesson.

I would like a lot of improvement here just from the movement of the collateral to the Fed instantaneously.

So, again, I cannot give you the technical way to do it, but I am sure that others can.

Mr. ROSE. Thank you.

Dr. Nelson, in March of last year, the Fed set up its Bank Term Lending Program to let eligible borrowers pledge eligible securities and get a loan to value equal to the par value of those securities, as opposed to the current market value.

Currently, credit extensions in the bank term funding program are about 165 billion, and the program is scheduled to expire in March of this year. Do you believe that the program was successful and was it useful?

Mr. NELSON. I believe it was successful. I think it is too bad that it was necessary, but I do think that it was successful in that it allowed the Fed to quickly gather a lot of collateral from institutions that depositors were worried about and enabled them to potentially meet runs.

The fact that the Fed was lending in a partially uncollateralized way at a low rate for long terms are largely inconsistent with standard lender of last resort practice.

A better approach and one—so it is great that we are having this hearing today—is that banks be prepared to borrow from the discount window, preposition large amounts of collateral in advance.

Mr. ROSE. Should the facility be maintained in its current form?

Mr. NELSON. No, Congressman. It should be ended.

Mr. ROSE. So thinking about that, the risks of this program, such as moral hazard that may be associated with it, comment on those.

Mr. NELSON. I would say that in general, the Federal Reserve should not be—I do not think it has ever happened before, to my knowledge, that the Federal Reserve has lent in a partially uncollateralized way, and so, that is—and particularly at a rate that is below market rate.

Once market shifted to expecting a decline in rates, the way the rate was calculated, as Professor Scott mentioned, it became an arbitrage to borrow from the program and simply deposit the money

at the Fed. Both of those are unattractive features of a central bank lending program.

Mr. ROSE. Are there any market implications from the program being terminated?

Mr. NELSON. I do not think so.

Mr. ROSE. All right.

Dr. Scott, you are aware during the 2023 Silicon Valley Bank crisis, the Federal Reserve stepped in and backstopped the deposits of investors that were uninsured. You have advised that Congress should restore the ability to increase deposit insurance in a crisis.

What would be benefits and harms of doing so, Dr. Scott?

I see my time has expired, so if you could answer that for the record, I would appreciate it.

Mr. Chairman, I yield back.

Mr. LOUDERMILK [presiding]. The gentleman yields.

The gentleman from California, Mr. Vargas, is now recognized for 5 minutes.

Mr. VARGAS. Thank you very much, Mr. Chairman and the ranking member. I appreciate the opportunity to speak here.

I especially appreciate the witnesses today. I think you have been tremendous in what you have said so far, and I also appreciate your service. I appreciate it very, very much.

I will have three areas I want to cover, climate change, insurance companies in the industry, and AI.

First of all, do you believe in climate change?

All three of you? That is refreshing because sometimes we hear that we do not.

I do think that the world has changed, and I think it is dramatic. We saw in San Diego recently a thousand-year flood that is happening all the time now. I say this because now insurance companies are starting to leave areas of the country or not renewing policies because of climate change and now the risks that they see.

We have been talking mostly about banking, the last resort of banks to loan, from the Fed, but also AIG was brought up earlier. I do want you to comment a little bit about that, about the potential for insurance companies here because I do think that we are going to run into some problems that some insurance companies are going to become insolvent because they are not appropriately reserving.

Could you comment on that? Because it is a very different type of collateral. It is a very different issue when you have an insurance company versus a bank.

Mr. JOHNSON. Perhaps I will go first on that, Congressman.

Mr. VARGAS. Yes.

Mr. JOHNSON. First of all, the AIG failed because the AIG financial products, which was an offshore London-based quasi hedge fund——

Mr. VARGAS. Hedge fund, sure.

Mr. JOHNSON [continuing]. took on massive exposures and that was an absolutely crazy idea.

That is one reason that Basel III, for example, emphasizes the need to have consistent—it is part of a package of consistent approach to regulation in the EU, the U.K., and the U.S. That is tremendously important for insurance and other parts of the financial

sector, and that is something that Systemic Risk Council has written about, thinks a lot about, that consistency.

With regard to the climate change impact, I am sure you are absolutely right that particularly extreme weather events in some parts of the United States pose major risks to everyone, including homeowners, including insurance companies.

I think the bigger risk you are going to see there, Congressman, is exactly the reports from Florida, for example, where insurance companies pull out because they cannot raise rates or are not allowed to raise rates or do not want to raise rates to match the risks.

So then who is left holding those risks? Is it the homeowners? Is it the States? Who else is it? I do not think we have seen that come through into banks. I think banks have other issues right now, including commercial real estate that are absolutely worthy of discussion, but I am not sure we have seen exactly that impact yet on the banks.

To the previous discussion, I think future financial crisis may come to us from many directions and having it come to us through climate change and extreme weather events is entirely possible.

Mr. VARGAS. Would anybody else like to comment? Yes, Professor—or

Mr. NELSON. Climate change is a serious problem, and it is appropriate that the regulatory agencies that are responsible for regulating carbon risk do so.

I think we can also agree, though, that bank supervisors should be focused on safety and soundness and financial stability risk. Study after study after study, including two by the New York Fed and one by the FDIC have failed to see or find any relationship, any negative impacts, material negative impacts on the banking system by climate events.

Moreover, if banks are required to devote resources to climate risk, that means those resources are coming from somewhere else.

I do think that, we need—I just remain concerned that the reasons why the banking agencies are focusing on climate risk is a well-intentioned desire to do something about it, as opposed to a carefully considered assessment that imposes potential instability or safety and soundness risk.

Mr. VARGAS. Well, I do not know that I would agree with you fully on that because you do see that banks loan—and, obviously, we are talking about the collateral and the business loans that they have and homeowner loans. A lot of these loans, of course, are the very expensive homes along the coast. So when you do have issues of climate change, obviously, that could affect those loans that are used for collateral.

So I am not sure that I fully agree with you, but if you would like to comment on that. No? Okay.

Well, I do want to go on to, for the last few seconds that I have here, AI. A scenario was given to you by Mr. Luetkemeyer about AI fraud, but what about AI that is not fraud? I mean, it seems that now we have a real issue here with AI that is not fraud that could cause some real problems for the banks.

Could you comment on that very quickly?

Mr. JOHNSON. Yes. So I recommend everyone to read Gary Gensler's paper. It was written before he joined the SEC, which, actually, it models—and I will not say exactly that, but completely legit AI adopted by banks and other financial institutions for entirely legitimate business purposes and making sense on an individual basis the way those AIs can interact, particularly if they are very similar to each other, could exacerbate run risk and create systemic risk.

That would not be because any individual firm was doing something stupid or irresponsible. It is the way that those risks would aggregate data through legitimate AI. That is a very serious possibility.

Mr. LOUDERMILK. The gentleman's time has expired.

Mr. VARGAS. Thank you.

Mr. LOUDERMILK. The gentleman from Wisconsin, Mr. Fitzgerald, is recognized for 5 minutes.

Mr. FITZGERALD. Thank you, Mr. Chairman.

Mr. Nelson, you note in your testimony that before a Federal Reserve bank can lend to a commercial bank, it must work out the subordination agreement with any Federal Home Loan Bank that has collateral pledged to them by that commercial bank. Obviously, this is because both Federal Reserve banks and the Federal Home Loan Banks are required to perfect their security interest in any collateral that they attempt.

My understanding is the home loan bank usually will take mortgage-related collateral while the Federal Reserve bank will take consumer, commercial, credit card, and other non-real estate loans as collateral.

I know that the Federal Home Loan Bank (FHLB) in Chicago provides regular quarterly reports to prudential regulators of its bank members about their boring.

Mr. Nelson, I will ask you first, what has your experience been with the communication and coordination between home loan banks and the reserve banks in times of crisis? Are there ways that you can think of that we could improve the coordination between the two entities?

Mr. NELSON. As you know, Congressman, for every Federal home loan bank member, commercial bank, the corresponding reserve bank and Federal home loan bank work out an agreement between them about what collateral will be pledged to the window because, as you know, the Federal Home Loan Banks are secured not just by individual assets but by a blanket lien on all of the assets of the institution.

Consequently, the Fed cannot get a perfected interest in the assets of that institution. So what happens is the two get together, and they identify categories of loans that can be pledged to the Federal Reserve, and the Federal Home Loan Banks subrogates its interest to the Federal Reserve for those categories.

Those tend to be ones that the Federal Home Loan Banks do not give lending value to for non-real estate assets, consumer loans and business loans. Now, obviously, that takes time and effort, and so it cannot be done in a crisis.

One change that could be considered would be to—it seems to me that a better arrangement, more appropriate to the role of the Fed-

eral Reserve as lender of last resort and the Federal Home Loan Banks as providing regular asset liability management lending would be to flip the situation and provide the blanket lien to the Fed and take it away from the Federal Home Loan Banks.

Mr. FITZGERALD. Very good.

As we take a comprehensive look at contingent liquidity and Federal emergency lending issues, I would ask that we also consider the credit unions and their importance of having strong backstops in place for those institutions.

In addition to FHLB advances and access to various Fed programs, credit unions have access to a central liquidity facility, a Federal function maintained by the National Credit Union Administration. It is essential that Congress ensures that the central liquidity facility is up-to-date and ready to provide efficient and adequate contingency liquidity to the credit union system in the event of liquidity stress or some type of distress.

Professor Scott, what is the most important reform that we could make to the lender of last resort function?

Mr. SCOTT. If I have to pick one, I would go back to my point about COVID.

Mr. LOUDERMILK. Could the gentleman turn your microphone on.

Mr. SCOTT. I am sorry.

If I had to pick one, I would go back to my point on COVID. The Fed should not be getting into situations where it is doing fiscal policy as it did with the main street lending facility during COVID. This should be a government role. It should be Treasury implementing that policy with appropriated money or appropriated guarantees.

So I think we need to get the Fed out of fiscal policy. That was the COVID lesson. It was not SVB but let us remember the Fed played a huge role in lending to main street, lending to corporations generally, providing credit. I do not think that is the way it will fit.

Mr. FITZGERALD. Very good. Interesting.

A recent report on 2023 banking crisis by a group of thirty, the Group of Thirty, proposed a requirement that banks preposition enough collateral with the Fed to support loan loss revenue, loans sufficient to cover all banks' runnable liabilities.

In recent remarks, Acting Comptroller of the Currency, Hsu, called serious consideration of a new liquidity requirement that would involve the prepositioning of collateral at the Fed.

Professor Scott, can I ask you, do you think such a prepositioning requirement is a necessary reform?

Mr. SCOTT. I do not object to prepositioning if the banks want to use it. They should be able to preposition collateral.

Mr. FITZGERALD. Thank you.

Mr. SCOTT. Where I draw a line is a requirement——

Mr. LOUDERMILK. The gentleman's time has expired.

Mr. FITZGERALD. Thank you, Mr. Scott.

I yield back.

Mr. LOUDERMILK. The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. Earlier we discussed AIG. I would point out that you had a management capable of bankrupting the whole institu-

tion by its crazy bets in the one entity that they had that was not regulated by State insurance commissioners. In spite of that management, that management was not able to bankrupt any of the regulated insurance companies.

I think this was the most impressive show of effective State regulation of insurance companies. It also shows that credit default swaps are basically insurance.

We could structure my fire insurance policy that if my house burns down, they do not write me a check. I just trade my deed for a short-term treasury bill. I guess you would say, well, then it is not an insurance policy. It is just a—no, this is—we need to realize that many things we call derivatives are actually insurance. At least we are regulating them better as derivatives.

The other thing I would point out is that there seems to be a tendency among bank regulators to undercount the importance of interest rate risk. A million dollar treasury bond issued 25, 30 years ago is worth $600,000 today.

Let me just ask Mr. Scott. Would the Fed discount window lend more than $600,000 on a million dollar treasury note that had a fair market value of $600,000? Would they lend more than current fair market value?

Mr. SCOTT. Well, not only would they, they did from the bank term facility program. Once they put this program in place, they valued securities not at their market value but at their par value. So . . .

Mr. SHERMAN. Wow.

Mr. SCOTT. Yep.

Mr. SHERMAN. This is kind of an unauthorized, uncongressionally authorized bailout when a bank can go to the government and say I have an asset that everybody in economics understands is worth $600,000, and you are going to loan me a million dollars against it.

I remember Troubled Asset Relief Program (TARP). We had to authorize that here in Congress.

So the Fed does lend money on assets based on the myth that it is worth more than you can sell it for. Do I have that right?

Mr. SCOTT. They do that, Congressman.

Under the discount window, which was not the BTFP facility, that was 13(3), the Fed is not required to have collateral. It is not required. They only need to have collateral to their satisfaction.

Mr. SHERMAN. Got you.——

Mr. SCOTT. So, and I think——

Mr. SHERMAN. I need to spend the rest of my time focusing on the Federal Home Loan Bank. There is this attitude that somehow it is a red flag. Although, in our area, we have seen JP Morgan, Wells Fargo, Bank of America be general—be major borrowers.

Is it a red flag for an institution? Does it symbolize that they are not solvent to borrow from the Federal Home Loan Banks, Mr. Scott?

Mr. SCOTT. No. I think they are borrowing from the home loan banks, as Bill Nelson said, to manage their assets and liabilities on an ongoing basis. I do not think, their borrowing from the Federal Home Loan Banks is actually as much seen as a stigma as they would be borrowing from the discount window.

Bill may want to comment on that.

Mr. SHERMAN. It is clear from the statute, the Competitive Equity Banking Act of 1987, that the Federal Home Loan Banks are a lender, not the lender, a lender of last resort. I ask unanimous consent to put in the record the conference report from that Act. I ask unanimous consent to——

Mr. LOUDERMILK. Without objection.

[The information referred to can be found in the appendix.]

Mr. SHERMAN. The Federal Home Loan Banks continue to serve an important source of liquidity for small community banks in the aftermath of the Silicon Valley. It took the Federal Reserve 3 weeks to establish a bank term funding program.

Dr. Nelson, had it not been for the Federal Home Loan Banks Act acting as a lender of last resort during those weeks, would we have had some bad consequences in the main street economy?

Mr. LOUDERMILK. The gentleman's time has expired. If the gentleman would answer for the record.

The gentlewoman from California, Ms. Kim, is now recognized for 5 minutes.

Ms. KIM. Thank you, Chairman.

I want to thank the witnesses for joining us today.

My home State of California saw firsthand some of the biggest bank failures in history with SVB, the First Republic Bank. In the case of SVB, we know that its failure was due to the perfect storm of the bank mismanagement, financial regulatory failures, liquidity, and social media panic.

Mr. Scott, in your written testimony, you mentioned that the Fed, in quotes, was operationally unprepared for the unprecedented speed of the run, end quote, of SVB.

Can you elaborate on why the Fed was so unprepared and can you point to any changes that the Fed has implemented since the bank failures to be better prepared?

Mr. SCOTT. Well, I cannot say why they were unprepared. I do not know, but I think I said a few times today that they were not prepared to extend the operating hours of Fedwire. They were not prepared to facilitate the transfer of collateral from the Bank of New York Mellon, which was holding collateral for SVB to the Fed. They were not prepared for that.

Why were they unprepared? I do not know.

Ms. KIM. Well, in your testimony, you also indicated that SVB possessed hold-to-maturity government securities that could have been pledged as collateral to cover the run on deposits. Can you elaborate on that, why SVB did not pledge this collateral to borrow from the Fed's discount window?

Mr. SCOTT. They could not get it there. The next day, when the Fed created this other facility, they agreed to value the hold-to-maturity assets at par. That they had a lot of value anyway, even a market value, and they could not transfer those assets over to the Fed.

My calculations, actually, even if you looked at the hold-to-maturity assets at market value we are talking $70 billion, something like that. So they had tremendous borrowing capacity from just those assets at market value, which they could not get to the Fed to borrow.

Ms. KIM. Okay, Mr. Scott, let me move on.

There is a stigma associated with borrowing from the Fed's discount window. Furthermore, current law also disincentivize banks from utilizing the Fed's discount window when there is a liquidity crisis.

Mr. Nelson, Chairman Barr touched on this earlier, and I would like to follow up on that. How could allowing banks to assume that they borrow from the discount window in the liquidity coverage ratio or internal liquidity stress test incentivize more banks to utilize the discount window?

Mr. NELSON. Making those changes, particularly the internal liquidity stress test, which is not something subject to an international agreement or international standard, would send a message to banks that being prepared to borrow from the discount window is something that we see as a tool that you should be using for your liquidity risk management and would create an incentive for banks to do so.

In fact, SVB was looking at the possibility of signing up for the standing repo facility and being prepared to use it, but when it learned that—but it learned that would not have actually helped them in the internal liquidity stress test and took away that incentive.

So it was a real missed opportunity.

Ms. KIM. Can you quickly tell us how EU countries, the U.K. or Canada treat their own discount windows in liquidity stress test?

Mr. NELSON. It is quite different. In the U.K., which has much less of a stigma problem, for example, institutions are—they cannot change the LCR but in their own internal liquidity assessments, institutions are encouraged to be planning on using U.K. facilities.

The U.K., the Bank of England has made repeated public announcements that this should be seen as a business decision on the part of banks. They ran tabletop exercises to get the supervisors and the banks together to practice using the window when it was appropriate to do so. So lots can be done.

Ms. KIM. Thank you. Thank you.

I am concerned that some proposals to change requirements in the preposition in collateral of banks at the Fed could tie up capital that could be used for lending to small businesses and families. On the one hand you could have had this proposal by the G30 countries, and on the other, the effect of the Basel III Endgame proposal to increase capital requirements.

Mr. Nelson, can you talk about how the lending for small businesses and families would be impacted by the combination of these two proposals?

Mr. NELSON. It is quite the opposite. It would actually encourage such lending because banks, instead of holding reserve balances or treasuries, which are, effectively, loans to the government as their source of liquidity, they could be making more loans to small businesses and pledging those to the discount window to get borrowing capacity.

Mr. LOUDERMILK. The gentlewoman's time has expired.

The chair recognizes the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank the ranking member as well, and, of course, I thank the witnesses for appearing today.

Is it true that a large number of the depositors at Silicon Valley exceeded the $250,000 FDIC guarantee? Is it true? If so, if you think so, raise your hand, please. Only one person? Only two?

Mr. JOHNSON. I am sorry. Say the last statement.

Mr. GREEN. The depositors at Silicon Valley, is it true that a large number of them exceeded the FDIC $250,000 guarantee?

Mr. NELSON. So 95 percent of their deposits were uninsured.

Mr. GREEN. Ninety-five percent.

Mr. Johnson, do you agree that it was a large number?

Mr. JOHNSON. It was a large share of deposits. Number of depositors, I cannot speak to that.

Mr. GREEN. Well, all right, let us make it deposits.

Mr. JOHNSON. Absolutely. A very large share of uninsured deposits.

Mr. GREEN. Do you agree that if all of them had been at or under $250,000, the run would not have been precipitated to the same extent that it was?

Mr. JOHNSON. There would be no—there is no run. Insured depositors do not run on American banks. That is not something that happens.

Mr. GREEN. If they do not run when you have your deposit insured, why would you? Your money is going to be accorded you from the FDIC. If you are not concerned about the run, then the question becomes this: Who was responsible for this large amount of people or depositors or deposits being above $250,000?

The bank itself is the first line of defense to make sure that you do not have this large—this excess of depositors for over $250,000. Without the bank's help, you find yourself where we were.

I am not sure that we can blame the regulators for this. Maybe we can find a way to get to them, but that bank had a duty to put itself in a position such that if you have a run, you will be prepared to take care of your deposits.

Mr. Johnson, your thoughts on this?

Mr. JOHNSON. Yes. I think, Congressman, you put it very well. I think this was a massive failure of risk management. The question is, as we have been discussing, how responsible management should prepare for the eventuality of a run by uninsured deposits?

So, for example, you might require, the regulators might require, as Dr. Nelson has been saying, that you pledge enough collateral so you can meet all of the runnable—all of the run risks. That is one possibility.

Yes, I agree. The onus here and the questions here are in the first instance and have been in the first instance been directed at bank management. What were they thinking?

Mr. GREEN. Yes, and they should suffer consequences.

Let us go on to something else.

What percentage of banks at $1 billion and under, what percentage of them use the discount window?

Mr. NELSON. I am sorry. I do not know, and that information is only available with a 2-year lag. I would say the same roughly—

I mean, I would say roughly the same percentage as large banks, which is it is very rarely used these days.

Mr. GREEN. Because there is a penalty associated with it, it is more likely that it would have—it would penalize them greater than it would the big banks because a small bank, you are a billion or under. You do not have a lot of margin for error.

It is not working? Pass him another microphone, please. Thank you, sir. Just be patient.

Mr. Chair, would you give me an additional 30 seconds?

Mr. LOUDERMILK. No problem.

Mr. GREEN. All right.

If you would, sir, let us hear your thoughts.

Mr. NELSON. When calibrating the size of the appropriate penalty in 2003, for example, where the goal of the Federal Reserve was to let the interest rate alone be the means by which banks chose on their own to only use the discount window as a backup source of funding, it was really the smaller banks that determined where that rate needed to be because larger banks have access to money market funds that are generally at a much lower rate.

So the opportunity cost of the other banks is actually higher for smaller banks. For them, the discount window might be more attractive.

Mr. GREEN. I am asking because smaller banks, as you know, especially those that are owned by African Americans, and there are very few, they have great difficulty accessing capital from any source, great difficulty. I would like to see the Fed find a way to assist these smaller banks.

Now, if you can, in writing, submit me your thoughts.

Thank you, Mr. Chairman.

Mr. LOUDERMILK. The gentleman's time has expired.

The gentleman from South Carolina, Mr. Timmons, is recognized for 5 minutes.

Mr. TIMMONS. Thank you, Mr. Chairman.

Before we get into today's topic, I cannot help but begin by reminding everyone that we would not be here without the reckless spending habits of my colleagues across the aisle led by President Biden. Their unbridled $7 trillion spending spree led to the highest inflation we have seen in my lifetime, which resulted in increased interest rates.

This caused millions of Americans to be priced out of home ownership, grocery bills to nearly double, and, ultimately, these banks to fail. Whether it is the southern border, the economy, or chaos on the world stage, the policies of this administration are hurting not only American citizens but the entire world.

Now the topic at hand.

In March 2023, we witnessed the three largest bank failures since 2008 when SVB, First Republic, and Signature all were unable to stave off bank runs and ultimately shut their doors due to poor risk management, concentrated client bases, and in some cases rapid expansion, all of which were exacerbated by the increase interest rate environment, these banks all tried to work with the Federal Reserve to access emergency forms of capital.

However, there were instances where failing banks were met with barriers to emergency funds that they really needed as quick-

ly as possible. For instance, Signature Bank attempted to pledge collateral to the discount window, but some of the collateral was encumbered by a Federal Home Loan Bank's super lien, leading to a delay in the bank being able to secure their loan through the discount window.

Trying to transfer collateral that had been pledged to an FHLB bank but not tapped for a loan over to the Fed's discount window seems to have been clunky and created lags in getting liquidity when time was really of the essence.

Dr. Nelson, what can and should the Fed and FHLB do on a more permanent basis to avoid this problem happening again?

Mr. NELSON. As I discussed, the Federal Reserve and the Federal Home Loan Banks, for each Federal home loan bank member bank, they work out an agreement in advance of who gets which collateral. That agreement is complicated by the fact that the Federal Home Loan Banks are secured by a blanket lien on all of the borrowing banks' collateral. That makes it challenging for the Federal Reserve to get a perfected interest and why that bank-by-bank agreement is necessary.

So what they do is they pick some type of bank loans, customer loans, business loans. They pledge those and the Federal Home Loan Banks subrogate their interest to the Federal Home Loan Banks.

Now, I think a preferable approach may be that the Federal Reserve has a blanket lien and the Federal Home Loan Banks do not, which seems more appropriate for the position of being a lender of last resort for the Federal Reserve. Whereas, a more normal asset liability management lending on the part of the Federal Home Loan Banks.

Mr. TIMMONS. How would that policy change be put into effect?

Mr. NELSON. It would require a change in the law.

Mr. TIMMONS. Okay. Thank you.

There have been reports that SVB was hit with a bank run and needed liquidity quickly. There may have been lags in obtaining liquidity from the Fed's discount window because SVB has never actually tapped into the discount window and had to navigate the process.

Dr. Nelson, again, should the regional Fed bank not, in this case the Federal Reserve Bank of San Francisco, be able to provide emergency assistance to a bank like SVB to quickly show them how to access the discount window?

Mr. NELSON. They could and I am sure that they would have been trying to help the institution. I think the challenges were that the institution did not have collateral pledged to the window and that took some time.

As Professor Scott has mentioned, some of that had to do with not keeping Fedwire open later, but I do not know the details of what went into that decision.

Mr. TIMMONS. My next question is actually on Fedwire. Can you explain what Fedwire is and whether the operations of Fedwire played a role in the reported clunky attempts of SVB or Signature Bank to get liquidity from the discount window?

Mr. NELSON. The Federal Reserve—so Fedwire is basically—each bank has a deposit at the Fed, and when money is transferred from

one bank to the other, the receiving bank's deposit is increased. The providing bank's deposit is reduced, and it is at the core of the entire U.S. payment system.

In addition, there is a similar system that transfers book entry securities, treasury securities, agency mortgage-backed securities (MBS) from one bank to another that is also operated by the Federal Reserve. It was necessary to keep those open later in order for the correspondent bank of SVB to get collateral in.

That wire is normally kept open until 7 P.M. Eastern time, which is standard. Nevertheless, 24/7 would be better if it is possible.

Mr. TIMMONS. Who has the authority to expand the Fedwire window?

Mr. NELSON. The Federal Reserve.

Mr. TIMMONS. They can do that without law, just a policy change?

Mr. NELSON. As far as I understand, yes.

Mr. TIMMONS. Okay, thank you.

There seems to be a legitimate need for tweaks or reforms to the Fed liquidity tools, especially the discount window.

I have a couple more questions, but I will send them to you in writing.

Thank you so much. I yield back.

Mr. LOUDERMILK. The gentleman has yielded.

The gentlewoman from Texas, Ms. De La Cruz is now recognized for 5 minutes.

Ms. DE LA CRUZ. Thank you, Mr. Chairman, for holding this hearing. Thank you to the witnesses for being here and appearing before us.

Mr. Scott and Mr. Nelson, I have a few questions for the two of you mainly focused on moral hazard. My first question is: Why are we in a situation where the Federal Reserve has to undertake tremendous interventions in our economy?

Mr. SCOTT. This problem of supporting the financial system and the presence of moral hazard have been with us from the time of Alexander Hamilton's establishment of the First National Bank. There is a tradeoff here. The more support that you get from the Fed as a lender of last resort to avoid contagion, which can destroy the economy, the more the potential moral hazard.

So we have to strike a balance between those two things.

Ms. DE LA CRUZ. Would you like to weigh in?

Mr. NELSON. I would just add that to some extent, the Federal Reserve has taken actions that have reduced financial market intermediation. In particular, I would point to the leverage ratio capital requirement, which treats all assets equally and, therefore, imposes a high capital requirement on things like treasuries and the tools needed to intermediate in treasury markets.

The Federal Reserve fixed that temporarily during COVID and that helped tremendously. Once that stopped, the Federal Reserve had to, because of its giant balance sheet, once again, increase its reach throughout the financial system.

Moreover, the capacity of primary dealers to intermediate has barely changed as the treasury debt has grown substantially. Meaning that the ratio has fallen by a quarter over the years. So

those actions have increased the need of the Federal Reserve to intermediate when there are very large flows, say, into the treasury market.

Ms. DE LA CRUZ. Well, my concern is really that if the Fed's footprint in our economy grows, market actors will come to expect the Fed to step in and bail them out when actors act badly. Do you expect, among the market participants, that the Fed will intervene to rescue markets and businesses, increase the potential for systematic financial instability?

Mr. SCOTT. I think we are dealing with the same problem here. One thing I think we should explore, it is politically difficult to alleviate the moral hazard when the Fed acts this way, is under—and I stress this, and I put this in my testimony. Under appropriate circumstances, we should make those people at the bank who are responsible for triggering this government support responsible in some way as to a clawback of executive comp.

Now, I underline under appropriate circumstances because a bank can fail through no fault of an executive or through the fault of executive A and not executive B.

So the bill that is out there really does not, in sort of dealing with this, does not get into how do we determine whether somebody should be responsible for this.

One way to alleviate moral hazard is to make those responsible for the failure of a bank that triggers government response somewhat responsible.

Mr. NELSON. If I could add to that?

Ms. DE LA CRUZ. Yes. Yes, sir.

Mr. NELSON. Another thing that has happened since the global financial crisis is that the Fed went from having assets that were 5 percent of Gross Domestic Product (GDP) to now they are about 26 percent of GDP, and they seem to be staying there. That is largely because the Fed has changed the way it conducts monetary policy.

It used to conduct policy by just providing the amount of reserve balances that banks needed. Now it vastly oversupplies that amount, and as it does that, that need gets bigger and bigger and bigger so that the Fed, whereas before it had a very small footprint in the financial system, now it has a vast footprint in the financial system.

At times, for example, in recent years, half of the assets of money market mutual funds, of government money market mutual funds were loans to the Federal Reserve system. By institutionalizing that bigger involvement of the Federal Reserve in the financial system, you are increasing the likelihood that people will come to expect them to solve all problems with their balance sheet.

Ms. DE LA CRUZ. Thank you. I yield back.

Mr. LOUDERMILK. The gentlewoman has yielded.

The gentleman from Tennessee, Mr. Ogles, is now recognized for 5 minutes.

Mr. OGLES. Thank you, Mr. Chairman. Thank you, witnesses, for being here. I had an opportunity to meet each of you prior to—I think what we have seen over the last few years is an increasing role of government and, perhaps, the regulatory burden, depending on the agency, across the banking and economic sector.

Mr. Nelson, under 13(3) there is authorization for the Fed to lend to bank and nonbank institutions under unusual and exigent circumstances as determined by the Board of Governors. Is unusual and exigent circumstances legally defined?

Mr. NELSON. No, not that I know of. It does require the Secretary of Treasury's approval as well.

Mr. OGLES. Mr. Scott, the Fed used section 13(3) to establish its bank term funding program in response to the bank failure earlier this year. While you question the rationale, the Fed claims that this was partly so it could value assets at par rather than market value. Is that correct?

Mr. SCOTT. That is what the Fed said.

Mr. OGLES. Well, accounting rules allow banks to value their long-term assets at par on their balance sheets. This is an accounting treatment. It is unlikely, in the event the Fed had to take these assets as collateral, that they would be worth that amount to the Fed. Is that correct?

Mr. SCOTT. Yes.

Mr. OGLES. The Fed cannot sell these assets at par, can they?

Mr. SCOTT. They could not sell them at the market at par, but we should remember that these were hold-to-maturity assets. Under standard accounting, the banks should and did value them at par because they did not intend them to sell them at par. If they held them to maturity, they would be worth par.

Mr. OGLES. Right. Seeing how they had to sell them early, then there was a reduction in said value, correct?

Mr. SCOTT. If they had sold them earlier, they actually, under our accounting rules, would have been marked down to market. This is why they did not want to sell them to cover the deposit withdrawal. Better to pledge them to the Fed and get the money from the Fed.

Mr. OGLES. If the bank is solvent, it can assess sufficient liquidity without relying on valuations at par. It makes me wonder if this program, the purpose of this program is their true value in how it is currently structured.

What recommendations or tweaks would you make as concern to valuation understanding that they may have to be held or they may have to be departed early?

Mr. SCOTT. Congressman, my first point—I am sorry. I am just a little bit hard of hearing.

Mr. OGLES. Yes, sir.

Mr. SCOTT. My first point on this facility is I do not think it should have been used at all. I think the borrowing should have been to the banking system through the discount window, not through this new facility.

I do think this new facility, which valued collateral at par, which was for a year of borrowing, which had a very low price to borrow, should be terminated, as is the plan, I think, in March.

Mr. OGLES. Switching gears, Mr. Nelson.

When the FDIC was established in 1933, deposit insurance covered up to about 56,000 in today's dollars. Over time the threshold has increased, market discipline has eroded, and moral hazard has gradually taken hold over the banking system.

Does lender of last resort increase moral hazard?

Mr. NELSON. There is a pretty robust debate in the academic literature among economists about whether or not it does. Lending on a secured basis, at a penalty rate, when you are extending a very safe loan and charging a high rate for it need not create moral hazard even more than receiving a similar loan from a financial institution would.

At the same time, if you are able to count on receiving that loan when you are in trouble, potentially then that can lead to taking activity that is not appropriately—in which you take on more risk, and there is moral hazard.

Mr. OGLES. Well, understanding there is a difference between the small borrower and someone that has assets over $10 billion. You take one company in particular that had, you know—worth 13 billion, had 486 in deposits at SVB, I mean, they have an obligation to, essentially, look at management practices. Would that not be fair?

Mr. NELSON. Absolutely.

Mr. OGLES. Mr. Chairman, I am almost out of time. I will yield back.

Mr. LOUDERMILK. The gentleman yields back.

The gentleman from Florida, Mr. Donalds, is now recognized for 5 minutes.

Mr. DONALDS. Thank you, Mr. Chairman.

Gentlemen, thanks for coming in.

Professor Scott, what concerns do you have about the recent push for the Federal Government to increase the use of the Fed's discount window more often?

Mr. SCOTT. Am I concerned with that? Is that the question?

Mr. DONALDS. Yes. Are you concerned and would you elaborate?

Mr. SCOTT. No, I am not concerned because I think that the availability—this goes back to Hamilton again. The availability of the discount window and the Fed's ability to lend in a financial crisis to avoid contagion is crucial to our economy because an unstemmed contagious run could destroy the financial system and then destroy the economy.

So that is why you invented the Fed, to deal with this. I think the lender of last resort function is essential to the health of the U.S. economy. Every other major country has a central bank that play a similar function.

On the other hand, we have to be cognizant of the problems of having this, which is moral hazard. We have to figure out a way to minimize that and strike the appropriate balance.

I think the Fed has done a good job generally in the crisis of using this facility to stem crises. I think if they had not done it here, we would have had a lot more hearings on why the economy was in depression, why we were in recession, why the Fed did not avoid it.

So I am not criticizing the Fed at all for exercising this power.

Mr. DONALDS. Let me ask you, as a follow up question, Professor Scott. Do you think that, in part, the reason why our financial system needs a lender of last resort is because we have various regulatory frameworks in our economy that can inhibit economic expansion or economic stability?

Mr. SCOTT. No. I think what happens, you have to—and I read a book on this, a connectedness and contagion advertisement.

Mr. DONALDS. Right.

Mr. SCOTT. Contagious runs on the financial system are often irrational.

Mr. DONALDS. I would argue, Professor Scott, human beings tend to do that as well.

Mr. SCOTT. If somebody gets—nothing that the bank did, but a bank failed and said, oh, my God, if this bank fails, every bank is going to fail. I am getting my money out.

This kind of—you know, noble prizes have been won by economists talking about this kind of thing.

So I think this is not an expansion of the economy that creates this. It is the fear that people have who are depositors and banks that once a bank fails or a bad situation develops, the financial system is going to fail, they try to get their money out.

Mr. DONALDS. Real quick, Professor Scott. Let us expound on this thought. Let us go back to 2008. Full disclosure, I was a credit manager, credit officer in banking prior to 2008. I was watching home mortgage underwriting become a flat-out joke as a credit underwriter as far as back as 2004, 2005, 2006, and 2007.

Is the cause of the financial crisis of 2008 more about terrible credit quality that was the contagion in lending or the issue that bank policy at-large was unable to be in the normal deposit taking and lending function?

Mr. SCOTT. Those poor credit policies were probably responsible for the failure of Lehman. Once Lehman failed, a lot of other people who have perfectly good credit policies were experiencing runs on their institutions because people said, well, if Lehman could fail, our bank could fail, or our nonbank could fail. I am getting my money out.

So the contagion part, or run really was irrational. Their institution might have been fine. They did not want to take the chance. Get my money out. That is why we need lender of last resort.

Mr. DONALDS. Okay.

Look, I think one of the things that I think we should try to analyze and really take hold of, especially from the 2008 crisis moving forward is the initial creation of the Federal Reserve. Obviously, there are people who have agreements and disagreements on that, and that is a discussion that is had a lot.

Post 2008, the Federal Reserve, none of us can deny, has taken on a much larger portion of our economy. That, in my view, is not healthy for a stabilized, growing, organic economic system. It is almost as if we are trying to make sure no problems exist, but then problems exist nonetheless.

Do you think that is a fair characterization?

Mr. SCOTT. My colleague, Bill Nelson, has talked about the increasing role of the Federal Reserve and our economy. I think that raises a lot of problems that we could have another hearing about.

I think the focus here is in terms of playing this role of lender of last resort in a financial crisis, I think they play an appropriate role. Whether the Fed should have the involvement in the economy as a whole that they have I think is a totally different and separate question.

Mr. LOUDERMILK. The gentleman's time has expired.

Mr. DONALDS. Thank you, Chairman.

Mr. LOUDERMILK. I would like to thank our witnesses for their testimony today.

Without objection, all members will have 5 legislative days within which to submit additional written requests for the witnesses to the chair, which will be forwarded to the witnesses for their response. I ask our witnesses to please respond as promptly as you are able.

The hearing is adjourned.

[Whereupon, at 11:56 a.m., the subcommittee was adjourned.]

A P P E N D I X

February 15, 2024

Statement for the Record

On Behalf of the

American Bankers Association

Before the

Subcommittee on Financial Institutions and Monetary Policy

of the

House Financial Services Committee

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The American Bankers Association (ABA)[1] appreciates the opportunity to provide a Statement for the Record for this hearing, Lender of Last Resort: Issues with the Fed Discount Window and Emergency Lending. The U.S. banking system is wider and deeper than in any other market in the world. The industry's strength is in its numbers and diversity of bank size and business model. With over 4,600 banks, including 3,616 community banks under $1 billion in assets, the U.S. banking system remains strong, and employs more than 2 million professionals, safeguards $18.6 trillion in deposits, and extends $12.3 trillion in loans.

ABA and its members understand and acknowledge that robust liquidity risk measurement, monitoring, and management are critical for making both individual banks and the U.S. financial system resilient. The discount window, established to help banks weather a liquidity storm, is an essential component of liquidity risk management. For a variety of reasons, however, many banks tend to turn to other sources of funding during times of stress.

To make the discount window a preferred source of funding during periods of stress, it needs to meet the needs of modern banking for banks of all sizes. We thank the committee for holding this hearing to examine whether the discount window is serving its purpose effectively. We make several recommendations below that would help reposition the discount window as a useable and preferable source of contingent liquidity for all banks. The recommendations provided here are intended to broaden the discussion rather than offer an exhaustive list of changes. There are many complex and intertwined policy questions that need to be explored when considering the discount window, including if usage should be limited to emergencies, appropriate levels of usage and who is charged with monitoring levels of usage for individual banks. Additionally, efforts to improve the discount window should not undermine or disadvantage other critical sources of liquidity, such as the Federal Home Loan Bank system (FHLB), or lock-up high-quality collateral at the Federal Reserve. The current period of calm is an ideal time to consider these issues.

[1] The American Bankers Association is the voice of the nation's $23.4 trillion banking industry, which is composed of small, regional and large banks that together employ approximately 2.1 million people, safeguard $18.6 trillion in deposits and extend $12.3 trillion in loans.

Improve Operational Ease

As a threshold matter, there is a potential mismatch between when a bank has liquidity needs and the speed at which the Federal Reserve can supply the needed funds. For example, the current East Coast-centric operating hours of the discount window are ill-suited to meeting banks' liquidity needs in today's global, 24/7 operating environment. At a minimum, the hours when collateral can be placed with the Fed should be expanded to include West Coast business times. Similarly, the hours of operation for Fedwire, the means of transmitting funds to banks, should be expanded to encompass West Coast business times. Moreover, streamlining the set-up process and continued automation for collateral recognition and borrowing will decrease operational bottlenecks going forward. We recommend that the Federal Reserve bring process elements of collateral eligibility in line with current market standards (e.g. physical documentation requirements, wet-ink signature requirements, assignability clauses in bi-lateral loans). Additionally, the Federal Reserve should work with other providers of secured borrowing to ensure that collateral can be transferred smoothly, under tight timeframes.

Update Pricing of Collateral

The discount window collateral haircuts are set to ensure that the Fed faces no credit losses in all but the most extreme situations. In addition, collateral is valued periodically based on models of cash flows, credit characteristics and historical price volatility, using the assumption that the Fed would need to seize the collateral and sell it to recoup its loan. Our view is that discount window requirements should be re-examined.

The Federal Reserve should improve the transparency of its collateral pricing to ensure banks understand their borrowing capacity and what is driving changes to collateral valuation. Once pledged, valuation can change significantly with no explanation. Added information regarding the drivers of the change will avoid unexpected movements in price which could have adverse outcomes. Further, we encourage a reconsideration of how much credit risk the discount window should take on, and, by extension, what are the appropriate collateral haircuts, particularly for high quality collateral such as Treasury securities. Steep discounts protect the Fed from potential, and often very unlikely, credit losses but discourage banks from thinking of the discount window as a source of funding in all but the most extreme circumstances and, as a result, undermine its statutory objective.

One of the defining characteristics of a financial stress event is a sharp drop in asset prices across a broad range of asset classes and markets. When thinking about the central bank's role of lending against good collateral during stressed market conditions, central banks should be lending against the fundamental value of the collateral rather than temporarily impaired market prices. One of the factors that made the Bank Term Funding Program (BTFP) successful is that it accepted bank holdings of high-quality collateral at face value, so as not to penalize the very collateral banks were holding for purposes of liquidity management. It is worth considering whether the stress of March 2023 could have been significantly lessened if SVB were able to borrow against the par, rather than current market, value of its Treasury holdings, and without any collateral haircuts.

Lessons from the BTFP

The BTFP was set up because the discount window could not provide sufficient liquidity quickly, efficiently and at a reasonable cost. Measured by participation, the program was a success. Going forward, the Fed should use the BTFP as a guide to experiment with discount window parameters, including offering face value on high quality securities, eliminating haircuts, experimenting with maturity terms and considering alternative interest rates.

- **Collateral valuation:** Even though current or fair value approaches would actually increase collateral values (and hence eligible loan amounts) when interest rates are falling, the uncertainties created by the current policy justify a review. The use of face value for high quality collateral such as Treasury securities may be appropriate in at least some cases.

- **Haircuts:** In addition to limiting loans to the market value of a bank's collateral, the discount window also applies haircuts to the collateral when determining the bank's discount window borrowing capacity. The BTFP parameters did not include haircuts which may have contributed to the success of the program. The rationale for discount window haircuts should be re-examined as part of discount window modernization and any re-evaluation of discount window exposure to credit risk.

- **Maturity terms:** The BTFP offered loans for up to one year in contrast to discount window loans which, by statute, must have maturities of less than four months. In practice, almost all discount window loans are for one business day. A systematic approach to discount window loans for longer maturities of, say one or three months, could reduce the perception that discount window activity is only conducted in urgent, crisis-type situations.

Liquidity Supervision and Regulation

Borrowing from the discount window is considered by many (bank executives, investors, and even supervisors) to be a sign of weakness. The acceptability of discount window usage needs to be absorbed by all stakeholders – bank executives, for example, are unlikely to make greater use of the discount window if supervisors accept that usage as normal course of business but bank investors do not (or vice-versa). This stigma, in combination with operational hurdles, has resulted in banks not using the discount window even when it is notionally preferable to alternative funding sources. The stigma problem was exacerbated by the Dodd-Frank Act's requirement that the Fed disclose discount window borrowers with a two-year lag. While a full menu of specific steps needed to "de-stigmatize" the discount window is not clear, supervisors can take steps that would unquestionably help. The recent supervisory emphasis on discount window readiness will have a positive effect. For supervisory purposes, banks that have regularly tested open lines, for example, should garner a higher "L" in CAMELS or LFI ratings.

Going forward, it is critical that Congress and the banking agencies have a deep understanding of how changes to liquidity supervision, regulations and related policy tools will flow across the

industry and affect markets and the economy. Recent speeches by Vice Chairman Barr[2] and Acting Comptroller Hsu[3] on bank liquidity risk management outlined some changes to supervisory expectations and the potential for new liquidity regulations. This is subsequent to the recent updates to supervisory expectations[4] whereby all banks are expected to take steps to ensure they are operationally ready to access the discount window when needed. Simultaneously, the banking agencies appear to be considering new targeted requirements that banks pre-position a pool of collateral at the Federal Reserve. While the details are not yet public, this requirement raises critical policy issues, including how a new requirement would affect moral hazard, interact with deposit insurance or impact other entities, such as the FHLBs, and more important, impact banks' availability to meet the credit and funding needs of US households and businesses. In addition, it will be important that the calibration of the targeted requirement take into account existing liquidity requirements and banks' current practices of pre-positioning collateral (which includes allowing assets to remain unencumbered) to avoid any trapped liquidity that could have economic and market impacts.

The Discount Window and the FHLBs

The interplay between the Fed's discount window and the FHLBs needs to be fully considered by Congress, the Federal Housing Finance Agency (FHFA) and the banking agencies. Under current statute the FHLBs provide banks with funding to meet day-to-day liquidity to support their lending and to achieve key housing goals across all market conditions. Moreover, the FHLBs offer smaller banks access to capital markets that would otherwise be unavailable or prohibitively expensive. The FHLBs have evolved to be a vital source of liquidity for banks in the modern financial system and unilateral or uncoordinated changes could be very disruptive to banks and the broader economy.

Concluding Thoughts

The Federal Reserve was established in 1913 to provide liquidity to the banking system, particularly in times of stress. To fill the gap between an aged governance system and modern financial markets, the Fed has resorted to ad hoc institutional structures to address instability (the BTFP's ancestors include the Term Auction Facility, the Term Asset-Backed Securities Loan Facility, and the Primary Dealer Credit Facility). Vice Chair Barr's recent speech suggests that the Fed has not given up on returning the discount window to its original purpose. To do so, simple fixes like the ones described above can help bring the discount window into the 21st century.

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[2] Speech by Vice Chair for Supervision Barr on Bank Supervision and Regulation, February. December 01, 2023. https://www.federalreserve.gov/newsevents/speech/barr20231201a.htm

[3] Speech by Acting Comptroller Hsu "Building Better Brakes for a Faster Financial World." January 18, 2024. https://www.occ.gov/news-issuances/speeches/2024/pub-speech-2024-4.pdf

[4] Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plans https://www.fdic.gov/news/press-releases/2023/pr23057a.pdf

FHLBANKS
A NATION OF LOCAL LENDERS

February 15, 2024

The Honorable Andy Barr
Chair
Subcommittee on Financial Institutions and
Monetary Policy
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Bill Foster
Ranking Member
Subcommittee on Financial Institutions and
Monetary Policy
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Barr and Ranking Member Foster:

On behalf of the Council of Federal Home Loan Banks (the Council), I am writing regarding the hearing entitled, "Lender of Last Resort: Issues with the Fed Discount Window and Emergency Lending." The Council is the trade association for the Federal Home Loan Bank System (FHLBanks) which includes the 11 FHLBanks and the Office of Finance. We appreciate the opportunity to submit this letter for the record of the hearing.

FHLBanks' role as a reliable liquidity provider to their members is fundamentally different than the role of the Federal Reserve Discount Window (the discount window), which typically offers limited duration liquidity and functions as the lender of last resort. In contrast, FHLBank members – banks, credit unions, insurance companies, and community development financial institutions – actively and continuously depend on, plan for, and incorporate our liquidity into their financial strategies. FHLBank advances and mortgage finance activity play a critical role in supporting community economic development, mortgage lending activity, maintaining mortgage market liquidity across varying economic cycles, and reducing mortgage costs. Each FHLBank operates as a member-owned, privately funded cooperative, with strong relationships within its district and a focus on ensuring members have reliable access to liquidity in all market environments. The ability of members of all sizes and varying charter types to rely on ready access to FHLBank liquidity maintains the diversity and vibrancy of the U.S. financial system.

Among other things, FHLBank liquidity allows members to offer longer-term mortgage loans at stable and lower interest rates, directly benefiting American homebuyers. The availability of FHLBank financing options is crucial for the health of the housing market and for broader economic stability. A 2020 study from the University of Wisconsin showed that the FHLBank System saves borrowers $13 billion in mortgage interest payments every year and leads to a more than 16 percent increase in mortgage originations.[1] Community lenders also rely on FHLBank liquidity to support small business, agricultural and agri-business lending.

We recognize the Federal Reserve's role as the lender of last resort for banks and credit unions. However, during times of market instability the FHLBanks have traditionally played a critical role of the first responder for otherwise healthy members, including during the Great Financial Crisis, the early days of the COVID-19 pandemic, and throughout March 2023. As financial first responders, the liquidity we provide serves to stabilize the mortgage market and the broader financial system. Economists Mark Zandi and Jim Parrot noted in a recent paper:

[1] Zhang, Dayin. "Government-Sponsored Wholesale Funding and the Industrial Organization of Bank Lending." October 2, 2020. https://business.wisc.edu/news/federal-home-loan-bank-may-save-borrowers-money-level-the-playing-field-for-small-banks/.

> This stabilizing role has been critical several times in recent memory alone, as alternative sources of capital fled the system, and the Fed was yet to step in as the lender of last resort. Without the FHLBs, these downturns in the economic cycle would have been significantly more painful, with greater swings in the cost and availability of credit, exacting greater damage on the economy.[2]

When FHLBank members face troubled circumstances, FHLBanks go through a methodical credit and liquidity analysis of the member, engage in regular communication and coordination with financial regulators, which have the authority at any time to instruct the FHLBank not to lend to a troubled member. The interaction and cooperation with our members' regulators positions FHLBanks to play a supportive role in the resolution of troubled institutions and enhances the resilience of the financial system. Importantly, in these circumstances, FHLBanks help ensure orderly resolutions and reduce costs to the deposit insurance fund.

In the aftermath of the March 2023 banking turmoil, FHLBanks have redoubled their efforts to coordinate with their respective Federal Reserve banks and members' regulators to ensure that members have established relationships and have tested their lines with the discount window. Work is also underway to ease the transfer of collateral between FHLBanks and Federal Reserve banks when necessary. This work will further facilitate cooperation and efficiency during times of crisis, enhancing overall financial stability.

While increased FHLBank coordination with the Federal Reserve Banks may be beneficial – and the FHLBanks are working with their members to ensure that they establish relationships with their Federal Reserve Banks – the longstanding role of the FHLBanks as a continual and reliable liquidity provider for their members should not be disrupted. The FHLBanks and the Federal Reserve have distinct, but complementary, roles within the U.S. financial system, both of which are ensconced in statute. Any reforms should recognize the importance of preserving both roles and both sources of financial institution support during a crisis.

FHLBanks have demonstrated throughout their nearly hundred-year history that they can work collaboratively with financial regulators and federal deposit insurers in crisis situations. The Council stands ready to work with Congress, the FDIC, the FHFA and the banking and credit union regulators, to constructively ensure that the FHLBanks remain a reliable liquidity source for their members and the mortgage market and continue to contribute to overall financial stability.

Thank you for holding this hearing and taking our views into consideration.

Sincerely,



Ryan Donovan
President and CEO

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[2] Parrott, Jim, and Mark Zandi. "In Defense of the Federal Home Loan Banks." Urban Institute, April 2023. https://www.urban.org/sites/default/files/2023-04/In%20Defense%20of%20the%20Federal%20Home%20Loan%20Banks.pdf.

100TH CONGRESS
1st Session
HOUSE OF REPRESENTATIVES
REPORT
100-261

COMPETITIVE EQUALITY BANKING ACT OF 1987

JULY 31, 1987.—Ordered to be printed

Mr. ST GERMAIN, from the committee of conference, submitted the following

CONFERENCE REPORT

[To accompany H.R. 27]

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 27) to facilitate the provision of additional financial resources to the Federal Savings and Loan Insurance Corporation and, for purposes of strengthening the reserves of the Corporation, to establish a forbearance program for thrift institutions and to provide additional congressional oversight of the Federal Home Loan Bank Board and the Federal home loan bank system, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the House recede from its disagreement to the amendment of the Senate to the text of the bill and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Competitive Equality Banking Act of 1987".

(b) TABLE OF CONTENTS.—

TITLE I—FINANCIAL INSTITUTIONS COMPETITIVE EQUALITY

Sec. 100. Short title.
Sec. 101. Amendments to the Bank Holding Company Act of 1956.
Sec. 102. Amendments to the Federal Reserve Act.
Sec. 103. Securities affiliations of nonmember insured banks.
Sec. 104. Amendments to savings and loan holding company provisions of the National Housing Act.
Sec. 105. Amendment to the Federal Home Loan Bank Act.
Sec. 106. Securities affiliations of FSLIC insured institutions.
Sec. 107. Mutual holding company amendments.
Sec. 108. Leasing authority of national banks.

75-860

all other reserves (e.g., the dividend stabilization reserve) to zero. Such an extraordinary dividend may be permitted where (1) a FHLBank incurs a charge off related to its investment in the Financing Corporation and (2) the Board determines there is an extraordinary need for payment of such dividends. Any such use of undivided profits or legal reserves will not affect the requirements for FHLBanks' investments in Financing Corporation stock.

Section 306(b) is meant to clarify that the sentences referring to the retirement of capital stock in subsection 402(h) of the National Housing Act do not cover either FSLIC stock or FSLIC certificates issued pursuant to this Act.

Phase-Down of the Special Assessment

Section 306(c) provides for a five-year phase-down (from 1987 through 1991) of the Special Assessment that FSLIC may charge (but not the special assessment that the Financing Corporation may charge), unless the Federal Home Loan Bank Board determines that severe pressures on the Corporation exist which necessitate an infusion of additional funds to the FSLIC. The Conferees believe that it is consistent with the Board's authority under section 404(c) for the Board to postpone the reduction in the special assessment until 1988, if the Board determines that such a postponement will improve the financing environment for selling obligations of the Financing Corporation.

Priority Lien Position for FHL Banks

Section 306(d) recognizes the special position of the FHLBanks as a lender of last resort and grants the FHL Banks a priority lien position, unless another creditor has obtained a perfected security interest in the property.

Section 306 (e), (f), and (g) contain technical and conforming amendments.

Moratorium on Exiting FSLIC

Section 306(h) contains the FSLIC exit fee and insurance termination moratorium discussed above.

Reports to Congress

Section 306(i) requires the FSLIC to report to Congress.

SECTION 307—SECONDARY RESERVE

The Conferees adopted an amendment offered by the House which permits insured institutions to offset against assessments the amounts that were previously part of the so-called "secondary reserve". The amount of the secondary reserve is referred to as the "statutorily prescribed amount". This amount is currently approximately $824 million but will decrease each year by the amount restored to FSLIC-insured institutions.

Under the amendment, institutions would be permitted to reduce or offset the amount of premiums they would otherwise pay to FSLIC—not the Financing Corporation—each year. There are two limitations to the premium offset during the initial 5 years. First, the offset may only apply to the special assessments charged by the

Questions for the Record

Representative Juan Vargas:

In 2022, the Government Accountability Office projected that "disaster costs [were] projected to increase as certain extreme weather events like drought or floods become more frequent and intense due to climate change." Consequently, the GAO recommended that "enhancing the government's climate resilience [through] planning and preparation for potential climate hazards can help it reduce potential future losses."

Unfortunately, these extreme weather events have impacted my constituents in southern San Diego. Recently, my district has experienced unprecedented floods that have destroyed homes, damaged businesses, and threatened our regional economy. These weather events have a direct impact on California's insurance markets as firms must manage their liquidity concerns while maintaining adequate coverage. Unfortunately, four insurance companies have already announced plans not to renew policies for California homeowners this year.

Given the potential risk of continued insurance flight in my state and across the country, I would like to know if insurance companies have access to the Fed discount window? I want to make sure liquidity isn't a problem for the insurance sector. Currently, insurance companies have access to the Federal Home Loan Banks, and I appreciate that access.

Appreciate the panel's thoughts on this question.

Questions for the Record

Ranking Member Maxine Waters:

Professor Hal Scott

1. Which of the following options best describes your self-identified race? (you may choose more than one)
    a. White or Caucasian
    b. Black or African American
    c. Hispanic/Latinx
    d. Asian
    e. Middle Eastern/North African
    f. Choose not to answer
    g. Prefer to self-describe (please specify)

2. Which of the following options best describes your gender identity?
    a. Woman
    b. Man
    c. Non-binary
    d. Transgender Man
    e. Transgender Woman
    f. Choose not to answer
    g. Prefer to self-describe (please specify)

Responses of Hal Scott to Questions for the Record [03.12.24]

Response to Representative Juan Vargas:

Eligibility to borrow at the discount window is limited to depository institutions. Because insurance companies are not depository institutions, they cannot access the discount window. However, an eligible depository institution affiliated with an insurance company could access the discount window. Moreover, the Fed is empowered to provide emergency liquidity lending to borrowers other than depository institutions, including insurance companies, under Section 13(3) of the Federal Reserve Act.

Response to Ranking Member Maxine Waters:

1. a. White or Caucasian
2. b. Man

Questions for the Record

Representative Juan Vargas:

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Appreciate the panel's thoughts on this question.

Questions for the Record

Ranking Member Maxine Waters:

Mr. William Nelson

1. Which of the following options best describes your self-identified race? (you may choose more than one)
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    b. Black or African American
    c. Hispanic/Latinx
    d. Asian
    e. Middle Eastern/North African
    f. Choose not to answer
    g. Prefer to self-describe (please specify)

2. Which of the following options best describes your gender identity?
    a. Woman
    b. Man
    c. Non-binary
    d. Transgender Man
    e. Transgender Woman
    f. Choose not to answer
    g. Prefer to self-describe (please specify)

April 2, 2024

The Honorable Patrick McHenry
Chair, House Financial Services Committee
2129 Rayburn House Office Building Washington, DC 20515

Dear Chairman McHenry,

Attached are my responses to the Questions for the Record submitted following the hearing held by the House Financial Services Subcommittee on Financial Institutions and Monetary Policy on February 15, 2024 titled "Lender of Last Resort: Issues with the Fed Discount Window and Emergency Lending."

Question from Representative Juan Vargas:

> Insurance companies do not have access to the Federal Reserve's discount window. The Federal Reserve extends discount window loans under the authority granted to it under Section 10B of the Federal Reserve Act. That section only authorizes the Federal Reserve to lend to depository institutions – commercial banks, thrifts, and credit unions.
>
> The Federal Reserve could lend to insurance companies under its emergency authority in Section 13(3) of the Act, but only through a temporary program created to address unusual and exigent circumstances. The Federal Reserve could lend to insurance companies on an ongoing basis using the authority granted in Section 13(13), but only if the loans are collateralized by Treasury securities, agency securities, or agency-guaranteed mortgage-backed securities.

Question from Ranking Member Maxine Waters:

> 1.a. White or Caucasian
> 2.b. Man

Sincerely,

William Nelson
Executive Vice President and Chief Economist
Bank Policy Institute

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