

**FEDERAL RESERVE SYSTEM**  
**12 CFR Part 201**  
**[Regulation A; Docket R-1038]**  
**Extensions of Credit by Federal Reserve Banks**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Proposed rule.

**SUMMARY:** The Board is proposing to amend its Regulation A to establish a special lending program under which Federal Reserve Banks will extend credit at a rate above the Federal Open Market Committee's targeted federal funds rate to eligible institutions to accommodate liquidity needs during the century date change period. Unlike adjustment credit, borrowers would not be required to seek credit elsewhere first, uses of funds would not be limited, and the loans could be outstanding for a considerable period.

**DATES:** Comments must be submitted on or before July 2, 1999.

**ADDRESSES:** Comments, which should refer to Docket No. R-1038, may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, D.C. 20551. Comments addressed to Ms. Johnson also may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in Room MP-500 between 9:00 a.m. and 5:00 p.m.

**FOR FURTHER INFORMATION CONTACT:** James A. Clouse, Chief, Monetary and Financial Market Analysis Section (202/452-3922), or William R. Nelson, Economist (202/452-3579), Division of Monetary Affairs; Oliver I. Ireland, Associate General Counsel (202/452-3625), or Stephanie Martin, Senior Counsel (202/452-3198), Legal Division. For the hearing impaired only, contact Diane Jenkins, Telecommunications Device for the Deaf (TDD) (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, D.C. 20551.

**SUPPLEMENTARY INFORMATION:** The Board is requesting comment on proposed amendments to its Regulation A (12 CFR part 201), Extensions of Credit by Federal Reserve Banks, to provide an additional mechanism under which Federal Reserve Banks will make discount window credit available to depository institutions in the months surrounding the century date change. The Board expects that, with advance planning, depository institutions will be able to meet their liquidity needs during the century date change period relying on their usual sources of funds, including adjustment credit at the discount window. The Board recognizes, however, that uncertainty surrounds potential developments over the period. The proposed Special Liquidity Facility is intended to provide that an assured source of funds is available to relieve unusual liquidity pressures that depository institutions may experience.

## **Background**

Depository institutions and their customers are now making plans to meet possible credit needs in the period surrounding the century date change. Uncertainty exists, however, as to the extent of demands and the cost and availability of credit in the market during the year-end period. Furthermore, banks are handicapped in playing their traditional role as lenders to non-banks by the possibility that the banks themselves will be under some liquidity pressure at that time. Liquidity pressure could come from conversion of deposits to currency and shifting of credit demands to banks from markets. Moreover, the incidence of credit demands is extremely difficult to predict and could involve pressures on small or medium-sized depository institutions that are customarily suppliers of funds to larger institutions and markets and hence would not have well-established borrowing relationships.

To a considerable extent, Federal Reserve open market operations can meet liquidity demands in reserve markets, such as the large seasonal increase in demand for currency in November and December of each year. During the century date change period, however, demands for and supplies of reserves will be very difficult to predict. The unusual funding situations of institutions and uncertainty about the status of potential borrowers may disrupt the normal distribution of reserves and liquidity through markets. Volatility in the demand for reserves could be compounded by a drop in required reserve balances at the Reserve Banks as depository institutions increase vault cash holdings to meet potential customer demands.

Banking supervisors have urged depository institutions to make firm contingency plans for meeting unexpected liquidity demands during the century date change period. Supervisors have encouraged depository institutions to make the Federal Reserve's discount window part of those plans. Although borrowing through the usual adjustment credit facility of the discount window should be adequate to meet most unusual needs and alleviate possible pressures on money markets, in practice depository institutions have been reluctant in the past to take advantage of such credit. Moreover, adjustment credit requires borrowers to seek funds elsewhere first, limits uses of such credit, and is usually limited in duration.

## **Special Liquidity Facility**

The proposed Special Liquidity Facility would make collateralized Federal Reserve Bank credit more freely available, albeit at an interest rate somewhat above depository institutions' normal cost of funds. By assuring the availability of Reserve Bank credit, the Facility should enable depository institutions and their customers to commit to meeting possible credit needs with greater confidence. The Facility should also help to damp any tendency for money markets to tighten owing to transitory imbalances in the supply and demand of reserves.

Rate and duration. Credit under the Special Liquidity Facility would be available from November 1, 1999, to April 7, 2000, at a spread over the Federal Open Market Committee's targeted federal funds rate. The Board tentatively proposes that the spread be set at 1.5

percentage points, but the Board specifically requests comment on whether the size of the proposed spread is appropriate. The Board would like the spread to be high enough to encourage institutions to continue to make private-sector arrangements to meet potential funding needs, but low enough to provide a reasonable backstop should, contrary to the Board's expectations, concerns about the century date change or the change itself begin to put strains on funding and credit markets. The Board also requests comment on how long the facility should be open, in particular whether it should begin earlier so that loans under the facility would be available as one means to fund the build-up in the vault cash inventories expected to occur in the early fall.

Depository institutions will not be expected to make portfolio adjustments to repay loans promptly. Special Liquidity Facility loans may be outstanding for a considerable period--until the program expires. This is in contrast to adjustment credit, which is generally expected to be repaid expeditiously. Institutions that anticipate a very short-term need for Federal Reserve credit (such as meeting reserve requirements on the last day of a maintenance period), including institutions that have loans outstanding under the Special Liquidity Facility, could continue to obtain regular adjustment credit at the basic discount rate.

Collateral. The collateral requirements for Special Liquidity Facility credit would be identical to those for other discount window loans, all of which must be fully collateralized to the satisfaction of the Reserve Bank. Borrowing institutions must have pre-positioned collateral (as well as have the necessary authorizations signed) to have access to credit the day it is requested. Reserve Banks accept a wide range of loans and securities as collateral, but unless the collateral is traded in active markets, such as a Treasury or Agency security, Reserve Banks must have time to determine the lendable value.

Eligible borrowers. Although many normal discount window conditions would not apply, credit under the Special Liquidity Facility would remain discretionary. The Special Liquidity Facility would be available only to depository institutions in sound financial condition. For example, it would not be available to depository institutions that are undercapitalized or critically undercapitalized. Reserve Bank discounts for and advances to such institutions are limited by § 201.4 of Regulation A. That section implements amendments to section 10B of the Federal Reserve Act,<sup>1</sup> which discourages the Reserve Banks from making relatively long-term loans to inadequately capitalized institutions. Similarly, in the case of credit unions, credit under the Special Liquidity Facility would be available only to institutions with a net worth ratio (as defined in section 216 of the Federal Credit Union Act<sup>2</sup>) of at least six percent, which qualifies a credit union as adequately capitalized under that Act.<sup>3</sup> With respect to branches and agencies of foreign

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<sup>1</sup> 12 U.S.C. 347b(b).

<sup>2</sup> 12 U.S.C. 1790d(o)(3).

<sup>3</sup> Section 216 of the Federal Credit Union Act will take effect on August 7, 2000, except for special provisions regarding risk-based net worth requirements, which take effect on January 1, 2001. The National Credit Union Administration has initiated rule-making

banks, credit under the Special Liquidity Facility would be available only to a branch or agency that is subject to reserve requirements under Regulation D and where the borrowing bank meets the equivalent of the Basle Capital Accord's minimum standards for capital and is otherwise considered to be in sound financial condition.

Even where an institution meets these minimum requirements, a Reserve Bank may determine that the institution is not in sound financial condition and therefore is ineligible to borrow under the Special Liquidity Facility. As a part of making such determinations, the Board or Reserve Bank may discuss an institution's financial condition or other matters related to the loan with its U.S. supervisor or, in the case of a foreign bank, its home country supervisor or central bank.

Exhaustion of alternative liquidity sources. Although lending under the Special Liquidity Facility would continue to be discretionary, credit under the Facility would not be subject to the Regulation A requirement, applicable to adjustment credit, that the borrower exhaust alternative liquidity sources before coming to the discount window. This requirement is intended to assure that Reserve Banks are the lenders of last resort and that discount window adjustment credit, available at a subsidy to the market, does not substitute for or interfere with market mechanisms for distributing liquidity. In the case of Special Liquidity Facility credit, the elevated rate is expected to be sufficient to discourage most use except when market mechanisms are under stress.

Permissible uses of funds. Similarly, credit under the Special Liquidity Facility is not subject to restrictions on use as is adjustment credit, which is intended to be used for temporary shortfalls of funds. Depository institutions could use Special Liquidity Facility credit to meet funding shortfalls caused, for example, by customers drawing down deposits to obtain currency, but they could also use such credit to make loans or investments.

Monitoring. To assure compliance with the conditions for adjustment credit, Reserve Banks monitor the activities of borrowing institutions, especially when adjustment credit is outstanding longer than overnight or when the institution has become a relatively frequent borrower. Depository institutions supply balance sheet data to discount window officers to facilitate this process. Such monitoring and reporting usually would not occur under the Special Liquidity Facility. Supervisory authorities may need to assess the condition of the borrowing institution if the reliance on Reserve Bank credit is accompanied by signs of financial trouble. Borrowing by itself, however, will not be taken as an indication of underlying problems and will not trigger intensified oversight.

### **Regulatory Flexibility Act Certification**

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procedures to adopt rules to implement the Act, but no final rules are yet in place. See 64 FR 27090, May 18, 1999.

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 605(b)), the Board certifies that proposed amendments to Regulation A will not have a significant adverse economic impact on a substantial number of small entities. The rule would not impose any additional requirements on entities affected by the regulation but rather would make an additional lending facility available to meet depository institutions' liquidity needs related to the century date change.

### **List of Subjects in 12 CFR Part 201**

Banks, banking, Credit, Federal Reserve System.

For the reasons set out in the preamble, 12 CFR part 201 is proposed to be amended as set forth below:

### **PART 201 - EXTENSIONS OF CREDIT BY FEDERAL RESERVE BANKS (REGULATION A)**

1. The authority citation for 12 CFR part 201 continues to read as follows:  
Authority: 12 U.S.C. 343 et seq., 347a, 347b, 347c, 347d, 348 et seq., 357, 374, 374a and 461.

2. In § 201.2, new paragraphs (j) and (k) are added to read as follows:

#### **§ 201.2 Definitions.**

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(j) Eligible institution means--

(1) A depository institution as defined in paragraphs (c)(1) (i)-(iii), (v), or (vi) of this section that is in sound financial condition and is not subject to the borrowing limitations in § 201.4(a) and (b); or

(2) A depository institution that is a credit union defined in paragraph (c)(1)(iv) of this section that is in sound financial condition and has a net worth ratio as defined in section 216 of the Federal Credit Union Act (12 U.S.C. 1790d(o)(3)) of not less than 6 percent.

(k) Targeted federal funds rate means the federal funds rate targeted by the Federal Open Market Committee.

3. In § 201.3, new paragraph (e) is added to read as follows:

**§ 201.3 Availability and terms.**

\* \* \* \* \*

(e) Special liquidity facility for century date change. Federal Reserve Banks may extend credit between and including November 1, 1999, and April 7, 2000, under a special liquidity facility to ease liquidity pressures during the century date change period. This type of credit is available only to eligible institutions. This type of credit is granted at a special rate above the basic discount rate and other market rates for funds, is available for the entire length of the period, and is not subject to the conditions regarding specific use or exhaustion of other liquidity sources as is adjustment credit under paragraph (a) of this section.

4. In § 201.7, the introductory text is designated as paragraph (a), and a new paragraph (b) is added to read as follows:

**§ 201.7 Branches and agencies.**

\* \* \* \* \*

(b) This part applies to a United States branch or agency of a foreign bank in the same manner and to the same extent as an eligible institution if the foreign bank is in sound financial condition and holds capital equivalent to the minimum levels that would be required under the Capital Accord of the Basle Committee on Banking Supervision.

5. In § 201.52, a new paragraph (c) is added to read as follows:

**201.52 Extended credit for depository institutions.**

\* \* \* \* \*

(c) Special liquidity facility. The rate for credit extended to eligible institutions under the special liquidity facility provisions in § 201.3(e) is equal to the targeted federal funds rate plus 1.5 percentage points on each day the credit is outstanding.

By order of the Board of Governors of the Federal Reserve System, May 21, 1999.

(Signed Jennifer J. Johnson)

Jennifer J. Johnson,  
Secretary of the Board.