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Vice Chair Barr Speaks on Liquidity Risk Management and Preparation for Use of Discount Window

By Daniel Meade
Partner | Financial Regulation

Last Friday, Michael Barr, the Federal Reserve Board's ("FRB") Vice Chair for Supervision, delivered remarks to the ECB Forum on Banking Supervision in Frankfurt, Germany entitled The Importance of Effective Liquidity Risk Management.

Vice Chair Barr summed up his own remarks as focusing "on how banks manage liquidity risk, the role of the central bank's discount window lending in this process, and the importance of robust liquidity planning for good times and bad." He noted the bad times for some large regional banks this spring showed the impact that poor interest rate and liquidity risk management caused a lack of confidence among depositors that in turn caused "old-fashioned bank runs, the speed of which was anything but old fashioned."

While acknowledging that the spring bank failures could not have been prevented just through better use of the Federal Reserve's discount window, he said that one of the lessons learned was to be better prepared. He went on to note that "[g]reater operational readiness can provide for greater optionality when a bank hits a bout of turbulence. Ready access to sufficient liquidity provides breathing room for a bank to determine and execute its path forward." He highlighted that one important step to readiness is pre-positioning collateral and testing discount window access through actual transactions. Vice Chair Barr recognized that some banks may be afraid of perceived stigma to actually using the discount window, even in just a test, or when it was a rational choice because it was the cheapest funding. He went on to state that in response to that perceived stigma (including among examiners), "we at the Federal Reserve have been underlining the point to banks, supervisors, analysts, rating agencies, other market observers, and the public, through numerous channels, that using the discount window is not an action to be viewed negatively. Banks need to be ready and willing to use the discount window in good times and bad."

Vice Chair Barr's speech in Frankfurt was an important reminder that for the discount window to be an effective source of liquidity in times of stress, adequate planning and pre-positioning need to take place. He also noted in response to a question afterward that it may be just as important for supervisors and policy makers to continue making the point that is often made in an emergency (e.g., 9/11/2001) – that the discount window is open and available – should be made in good times too, so that prudent testing of the channel is not viewed by the market as weakness.