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Liquidity support from the Bank of England: the Discount Window Facility

Speaking in London today, Paul Fisher – the Bank's Executive Director for Markets and member of both the Monetary Policy Committee (MPC) and the interim Financial Policy Committee (FPC) – speaks about the Bank's operations to provide liquidity insurance to the banking system, and in particular the Discount Window Facility.

Paul Fisher starts by outlining the principles underpinning the provision of liquidity insurance to the banking system. He notes that the Bank will only lend to commercial banks that are, in its judgment, solvent and viable for two policy related reasons. First, the need for a central bank to guard against moral hazard and, second, the imperative of protecting the central bank balance sheet (and hence public money) against the risk of loss.

Paul Fisher moves on to note that, since the start of the crisis in 2007, the Bank has implemented a series of public and transparent reforms to its facilities which constitute an almost complete overhaul of the Bank's Sterling Monetary Framework (SMF). One of the most significant changes to the Bank's arrangements for the provision of liquidity support was the introduction of a Discount Window Facility (or DWF) in 2008.

Paul Fisher explains that "the design of the Bank's DWF was shaped, in part, by lessons learnt from the Special Liquidity Scheme (SLS)". Drawings are typically structured as a liquidity upgrade, with a very wide range of collateral eligible. But "other features of the DWF are very different from those underpinning the SLS". DWF borrowings typically have a term of 30 days and are intended only to provide short-term liquidity support to banks. Crucially, he notes, the DWF is priced to encourage banks to self-insure and to mitigate the risk of moral hazard. "The DWF charges fees which make it unattractive in normal times, but which would be more attractive under stressed market conditions".

Paul Fisher describes the various initiatives underway since late 2008 to develop the DWF further, including the eligibility of portfolios of unsecuritised loans and encouraging banks to 'pre-position' collateral. He explains that "there is now over £265bn of collateral pre-positioned for use in the DWF". After applying appropriate haircuts, "this means the Bank could, subject to solvency and viability assessments and repayment plans, lend around £160bn in the DWF without the complications of further detailed collateral

checks." Although not a substitute for firms building up their own holdings of high quality liquid assets to a more satisfactory level, he says "that represents a very substantial 'war chest' of potential liquidity in the event of significant adverse shocks." The Bank hopes to continue to both sign up new counterparties and encourage firms to further increase the quantity of pre-positioned collateral over time.

Paul Fisher acknowledges market contacts' concerns that the facility might be stigmatised to some degree. But, he emphasises that the DWF is not there to support a failing firm; "when borrowing from the DWF, firms must have convinced the Bank of their ability to repay". The risk is that the perception of stigma might delay an application to borrow, making a firm's liquidity position more perilous. "The solution to this problem requires the Bank to work closely with both the supervisors and the commercial banks themselves, to ensure appropriate timing of any use."

Paul Fisher highlights the introduction of the Extended Collateral Term Repo Facility (ECTR) in December 2011. The purpose of the ECTR, he says, is to make liquidity available against the least liquid collateral, to the market as a whole. Although the Bank has not yet offered any operations under the ECTR, it would revisit this decision "in the event of any marked deterioration in market conditions".

Paul Fisher concludes, saying "The new Sterling Monetary Framework, which has been reformed almost in its entirety since 2007, reflects our experience during the crisis and lessons from some of the temporary measures that had to be put in place. Doubtless the Framework will continue to evolve in future, but the provision of such published facilities should help to make the system more resilient in the years to come."

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