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## Open for Business: Understanding the Fed's Discount Window

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“Providing liquidity in this way [the discount window] is one of the original purposes of the Federal Reserve System and other central banks around the world.”

—Board of Governors of the Federal Reserve System

### Introduction

In 1907, one of the largest trust companies in New York City, Knickerbocker Trust, did not have enough cash on hand to meet depositors' demand for withdrawals. With no deposit insurance or lenders to turn to, Knickerbocker failed, triggering a series of bank runs throughout the financial system. The panic caused by Knickerbocker's failure would ultimately lead to other bank failures and a deep recession.

This and other financial crises were the motivation driving Congress to pass the 1913 Federal Reserve Act to create the Federal Reserve System (the Fed). The Act specifically authorizes the Fed to lend to depository institutions when needed, to help them prevent these types of financial crises and **liquidity** failures.

The Board of Governors of the Federal Reserve System's [website](#) states that “lending to depository institutions plays an important role in supporting the liquidity and stability of the banking system and effective implementation of monetary policy.”



[Credit Discount Window at the St. Louis Fed](#), 1967. From FRASER, Federal Reserve Bank of St. Louis; accessed January 1, 2025.

### What Is the Discount Window?

The Fed is sometimes described as “a bank for banks.” This means the Fed offers services to depository institutions such as credit unions and banks, not unlike the way these depository institutions offer services to their customers. In this article, we'll just use the word banks to describe all depository institutions.

For example, member banks can have accounts at their District Federal Reserve Bank. The funds in these accounts are called “reserves,” and the Fed pays banks interest on their reserves, just like customers at a regular bank receive interest on their accounts. Banks can also obtain short-term loans from the Fed's “**discount window**” when they need funds for a short period of time. The interest the Fed charges for these loans is called the **discount rate**: It is one of the Fed's administered rates and is a tool used to implement monetary policy.

The name discount window comes from the historic practice of banks sending representatives to Reserve Bank teller windows to access short-term loans. Today, banks do not need someone to physically go to a Reserve Bank to access this service.

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### Why Would a Bank Need to Borrow Funds?

Banks make loans and in exchange receive interest payments, which they use to cover operating costs and to pay interest on customer deposits.

Imagine that many people come into Mainstreet Bank at the same time to withdraw large amounts of money from their accounts. The bank has the assets to cover the withdrawals, but what if they do not have enough **liquid assets** to cover all these withdrawals? Cash is the most liquid asset and usually what customers expect to be paid in. Treasury securities are also considered liquid assets because they can be easily converted to cash with very little loss of value in the conversion process. On the other hand, **non-liquid assets** such as outstanding loans or real estate are more difficult to convert to cash without losing value in the conversion process.

The bank cannot pay its customers in non-liquid assets, so in this example the bank needs a short-term loan to cover these withdrawals. The bank can request a short-term loan from its District Federal Reserve Bank to cover the withdrawal requests; in exchange, the bank will pay the discount rate when it repays the loan. By borrowing from the Fed, the bank is able to relieve its temporary liquidity strain without having to sell its non-liquid assets.

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### How Do These Loans Work?

For access to the discount window, banks must have active agreements on file with their District Federal Reserve Bank. These agreements include provisions ensuring that the bank is eligible to borrow and understands its obligations when taking out a discount window loan. When a bank makes a loan request, it must show that it has adequate **collateral**. Collateral comes in many forms, including loans or securities that could be seized if the borrower fails to repay.

Using our earlier example, imagine the many cash withdrawal requests total \$1 million. The bank does not have \$1 million in cash on hand, but it does have \$10 million in real estate assets, such as mortgages. Non-liquid assets such as these could be hard to sell quickly to cover the withdrawals, but they could serve as collateral for a discount window loan for the bank from the Fed.

As banks receive funds from loan payments and deposits, they repay their discount window loans to the Fed, sometimes as quickly as within a few hours or overnight. These short-term loans allow banks to continue to service their customers without disruption. See Figure 1 below.

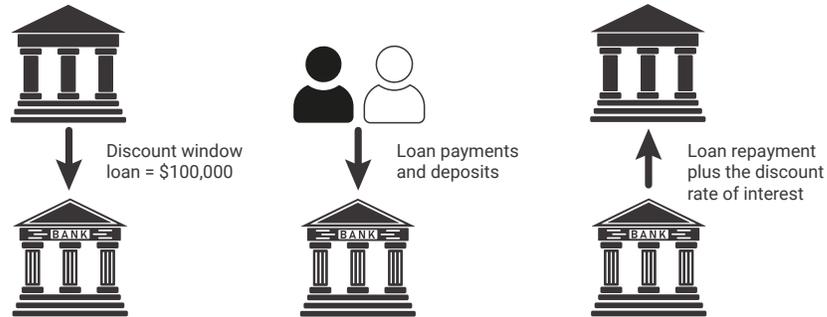
The Fed Board's [website](#) additionally states that "by providing ready access to funding, the discount window helps depository institutions manage their liquidity risks efficiently and avoid actions that have negative consequences for their customers, such as withdrawing credit during times of market stress. Thus, the discount window supports the smooth flow of credit to households and businesses."

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Figure 1



Instead of liquidating assets, Mainstreet Bank takes out a loan through the discount window to cover the additional liquidity needed to fill the customers' withdrawal requests. Throughout the day, other customers make loan payments and deposit funds with Mainstreet Bank. The bank is thus able to repay the discount window loan to the Federal Reserve before the next business day.

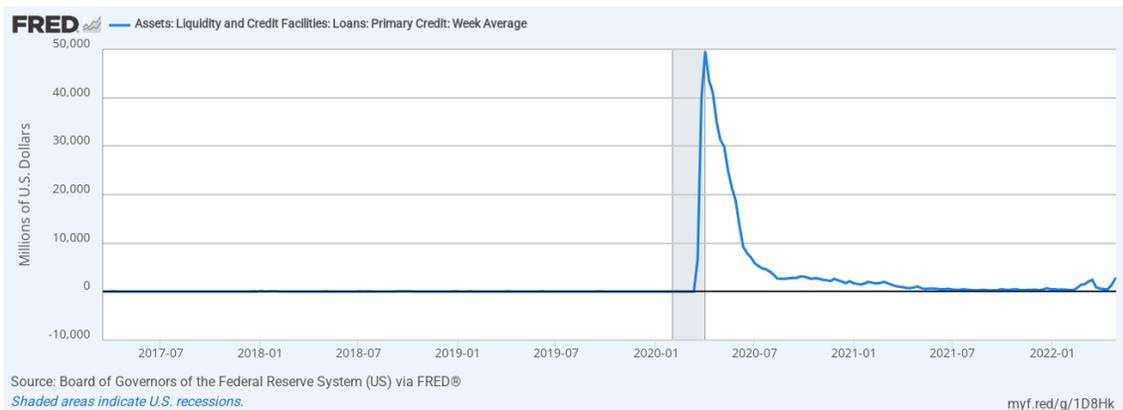


NOTE: By taking a short-term loan through the discount window, Mainstreet Bank is able to operate without delaying service to its customers or losing value by trying to convert its non-liquid assets into a liquid asset such as cash.

## The Discount Window During Financial Crisis

In normal times, when reserves are plentiful in the banking system, the Fed's discount window is typically not very active. See Figure 2 below. However, the discount window plays a very important role in supporting liquidity and financial stability during times of crisis. For example, in 2020, banks turned to the discount window seeking liquidity as the economy reacted to the severe economic shock caused

Figure 2



NOTE: The use of the discount window remains relatively inactive until 2020 when the COVID-19 pandemic creates a spike in its use. This illustrates how banks turn to the discount window during times of financial stress.

SOURCE: [Assets: Liquidity and Credit Facilities: Loans: Primary Credit: Week Average](#), Board of Governors of the Federal Reserve System via FRED, Federal Reserve Bank of St. Louis; accessed January 22, 2025.

by the COVID-19 pandemic. To be clear, the Fed typically uses several strategies to provide liquidity to the financial system during times of crisis, but the discount window stands ready to provide banks with loans to meet their financial needs in normal times and during crises.

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## The Discount Window as a Monetary Policy Tool

So far, we've described how banks can borrow funds from the Fed's discount window to meet short-term liquidity needs, but banks can also borrow reserves from each other to meet liquidity needs. The interest rate that banks pay to borrow reserves from other banks is called the **federal funds rate**. The federal funds rate is determined in the market by the supply and demand for reserves. It plays an important part in the monetary policy process: The Federal Open Market Committee (FOMC) sets a target range in which it wants the federal funds rate to fall; in setting this range the Fed communicates its monetary policy position. When the Fed lowers the target range it pulls other interest rates down, making borrowing more affordable for consumers and businesses, which can give economic activity a boost during a downturn. Or, the Fed can raise the federal funds rate target range, pushing interest rates higher and decreasing the demand for goods and services when inflation is too high. See Figure 3 below.

Figure 3



■ FEDERAL RESERVE BANK OF ST. LOUIS

By adjusting the administered rates, the Federal Reserve can affect market interest rates and overall financial conditions, helping achieve its goal of maximum employment and price stability. To learn more about the FOMC and how it targets the federal funds rate, [click here](#).

The discount rate plays an important role in keeping the federal funds rate near the Fed's target. Ihrig, Weinbach, and Wolla stated in their [2022 article](#), "Because banks will likely not borrow from others at a much higher rate than they can borrow from the Fed, the discount rate helps to curb any upward spikes in the federal funds rate."

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## Conclusion

The discount window is an important tool in the Federal Reserve's work to help promote stability and soundness in the financial system. It offers banks an opportunity to meet their short-term liquidity needs without major changes to services or disruptions to their customers.

## Glossary

**Collateral:** Property required by a lender and offered by a borrower as a guarantee of payment on a loan. Also, a borrower's savings, investments, or the value of the asset purchased that can be seized if the borrower fails to repay a debt.

**Discount rate:** The interest rate charged by the Federal Reserve to banks for loans obtained through the Fed's discount window.

**Discount window:** Federal Reserve lending to depository institutions to support the liquidity and stability of the banking system and the effective implementation of monetary policy.

**Federal funds rate:** The interest rate depository institutions charge each other to borrow or lend reserves in the federal funds market; these funds are immediately available.

**Liquid asset:** An asset that is easily convertible to cash with relatively little loss of value in the conversion process.

**Liquidity:** The quality that makes an asset easily convertible into cash with relatively little loss of value in the conversion process.

**Non-liquid asset:** An asset that is not easily convertible into cash with relatively little loss of value in the conversion process.

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Name \_\_\_\_\_ Period \_\_\_\_\_

## Reading Q&A

# Open for Business: Understanding the Fed's Discount Window

After reading the article, complete the following:

1. What was the primary motivation behind Congress creating the Federal Reserve System in 1913?
  - a. To increase government revenue
  - b. To prevent financial crises and support the stability of the banking system
  - c. To reduce the national debt
  - d. To promote international trade
  
2. What is the term for the funds that member banks have in their accounts at their District Federal Reserve Bank?
  - a. Deposits
  - b. Reserves
  - c. Investments
  - d. Savings
  
3. What is the term for the interest that the Federal Reserve charges for short-term loans accessed through the discount window?
  - a. Prime rate
  - b. Federal funds rate
  - c. Discount rate
  - d. Treasury rate
  
4. How did the discount window get its name?
  - a. From the historical practice of bank representatives going to a teller window at their District Federal Reserve Bank to access credit
  - b. From the discounted rate of interest that banks charged when borrowing from each other
  - c. From the historical practice of offering a discounted rate on credit if representatives came in person to their District Federal Reserve Bank
  - d. From the last name of the teller at one of the District Federal Reserve Banks
  
5. What type of assets can banks easily convert to cash with little loss of value?
  - a. Liquid assets
  - b. Non-liquid assets
  - c. Fixed assets
  - d. Equity assets

6. What type of assets can banks not easily convert to cash without losing value in the conversion process?
  - a. Liquid assets
  - b. Non-liquid assets
  - c. Fixed assets
  - d. Equity assets
  
7. Why might a bank need to borrow from the Federal Reserve?
  - a. To cover large withdrawals when they lack liquid assets
  - b. To match their non-liquid assets on their balance sheets
  - c. To pay off long-term debts
  - d. To increase their profit margins
  
8. What must banks provide to secure a discount window loan from the Federal Reserve?
  - a. Proof of customer deposits
  - b. Collateral
  - c. A detailed business plan
  - d. An external auditor's report
  
9. How do short-term loans from the Federal Reserve support the banking system?
  - a. By allowing banks to borrow from each other
  - b. By helping banks manage liquidity risks
  - c. By increasing a bank's non-liquid assets
  - d. By reducing the need for customer deposits
  
10. What is the interest rate called when banks borrow funds from each other?
  - a. Treasury rate
  - b. Discount rate
  - c. Prime rate
  - d. Federal funds rate