

THE AMERICAN

A Magazine of Ideas - Online at American.com

The Fed's New Alphabet Soup

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Monday, March 24, 2008

Filed under: Economic Policy

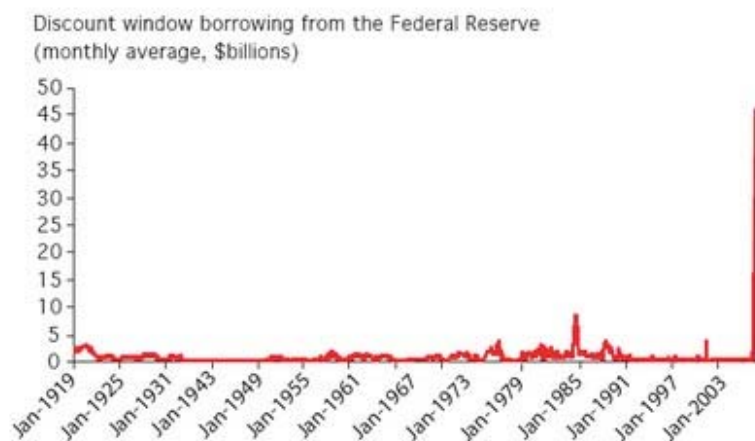
Federal Reserve officials have effectively rewritten the rules on the role of a central bank in a market economy.



Over the past few weeks, the Federal Reserve added to its alphabet soup of new facilities to deal with ongoing strains in financial markets. Taken together, these programs represent a clever gamble to provide large institutions some time to get their financial houses in order. Fed officials have effectively rewritten the rules on the role of a central bank in a market economy.

First, the mnemonics. On March 14, the Federal Reserve extended access to its discount window to a non-depository, Bear Stearns, for the first time since the 1930s. (The discount window is the Fed's lending facility, where loans are made at a rate above the federal funds rates and can be secured with a wide variety of collateral.) According to the Federal Reserve Act, lending to such an individual, partnership, or corporation (an IPC) requires the affirmative vote of five of the governors of the Federal Reserve Board. Moreover, the Federal Reserve must attest that there are "unusual and exigent" circumstances and that failure to lend would impair the economy. On March 16, the Fed granted other investment banks access to its lending facility.

On the prior Tuesday, the Fed had introduced a new program called the Term Securities Lending Facility (TSLF), under which it will loan some of the Treasury securities currently on its balance sheet to key financial market participants in return for other securities as collateral. The term of these transactions is 28 days, and the fee paid for the loan of Treasury securities will be set in an auction.



Source: Federal Reserve

For the past few months, the Fed has been holding regular auctions for depositories of its discount window credit, also for a term of 28 days. This is referred to as the Term Auction Facility (TAF), in which depositories bid for credit. Earlier this month, these auctions were bumped up to total \$100 billion per month. To put that sum in perspective, the amount of discount window loans outstanding this month will likely be *nine times* the previous monthly record from 1919 to the inception of the TAF (see the nearby chart). And if the TAF continues at its recent pace through June of this year, the Federal Reserve will have extended a greater volume of loans over the first eight months of the program than it had cumulatively lent over the prior 90 years.

Last but not least, the Fed also announced that it will loan another \$100 billion in the form of 28-day term repurchase (RP) agreements. RPs are the bread-and-butter of a central bank's open market operations. In the typical RP, the Fed lends money to its dealer counterparties for a fixed term, taking collateral in the form of Treasury securities or the debt and mortgage-backed securities of the government-sponsored lenders, Freddie Mac and Fannie Mae.

If we tally up all these new programs, the Federal Reserve appears willing to commit almost one-half of its balance sheet, around \$400 billion, to promote the renewed health of financial markets. Given its open-ended invitation for investment banks to follow the Bear Stearns route and tap the Fed's discount window, it may wind up committing even more.

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Why do Fed officials think these programs will work? To households, mortgages are the obligations that make home purchases possible. But to financiers, mortgages are collateral. Those loans are pooled together so that their combined payments provide a steady stream of income in a variety of mortgage-related securities. The problem is that mortgage defaults of the magnitude we are now experiencing even dry up payments to "safe" securities. Some of those securities are quite complex and difficult to price. Even worse, they are held in part on balance sheets of financial institutions that are opaque and difficult to understand.

Investors have withdrawn from the entities they fear are tainted by these losses. But because they cannot pin down precisely who bears the brunt of the losses, the retreat from risk taking has been spread across a broad front. As a result, there is no effective market price for some of these securities—because the market has disappeared.

Losses across large financial firms could mount considerably beyond what has already been announced. If so, those firms will have to retrench to conserve their capital. Credit will be more expensive and harder to get.

Ultimately, the industry needs more capital. That infusion may come from elsewhere in the private sector: possibly from hedge funds and long-term investors, or from official sources abroad. (Here another mnemonic comes to mind—SWF, or sovereign wealth funds.) But if it does not come from those sources, it will likely require government intervention, which is the way banking crises around the world are often resolved.

The Federal Reserve is using its balance sheet as a safe harbor for the financial industry until that capital arrives. It is doing so by transforming mortgage-related securities—for which there is currently no effective market—into something useful. Financial institutions can now pledge them with the Federal Reserve in open market operations (via RPs) or at the discount window (via the TAF and IPC lending). Or, they can swap those securities for Treasury securities via the TSLF. For 28 days, those firms get better assets on their balance sheets, which allow them to postpone the unloading of their mortgage-related holdings.

Let's be clear: the Federal Reserve is accepting an unprecedented degree of credit risk. If one of its counterparties fails in the 28-day window of an outstanding transaction, the Fed will potentially be left holding illiquid mortgage paper. Such unusual policies cannot be extended indefinitely. Financial institutions have to come to grips with their losses, and their management has to swallow hard and find more capital, which is likely to be very costly. They should not use the Fed's largesse as an excuse to delay.

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