

# On the Effectiveness of the New Facilities

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*THE FUTURE ROLE OF CENTRAL BANKING POLICY:  
URGENT AND PRECEDENT-SETTING NEXT STEPS*  
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# Tale of Three Liquidity Facilities

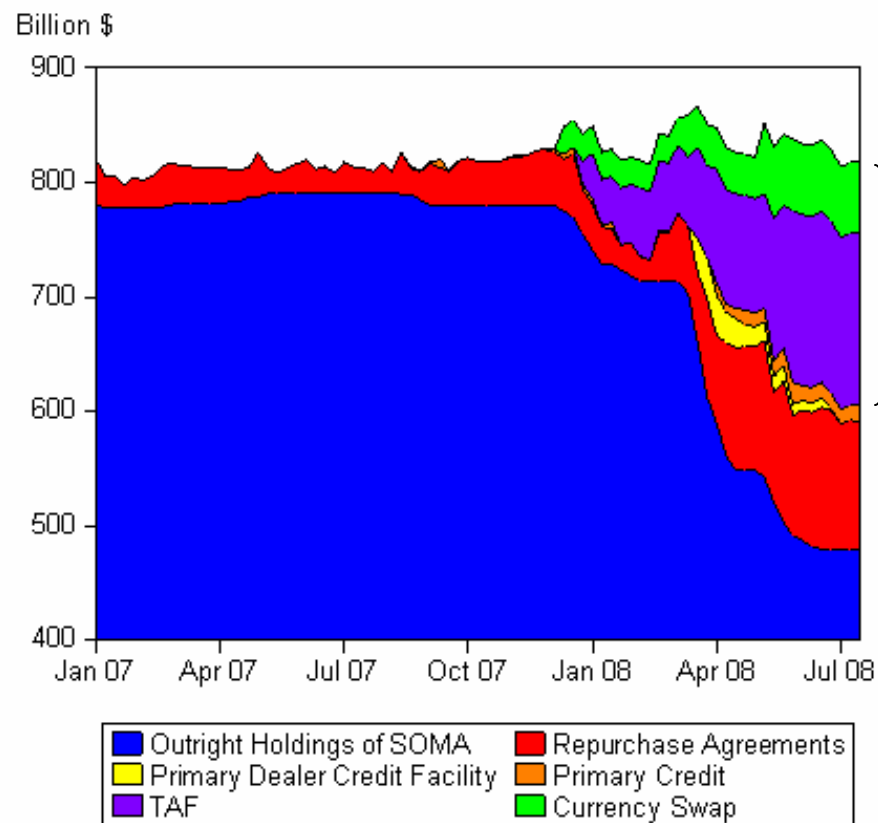
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- Term Auction Facility (TAF): announced Dec. 12, 2007
  - One-month collateralized loans to banks, fixed amount, rate set at auction.
  - Current loan balance (incl. ECB/SNB swaps): [\\$212 bn.](#)
  
- Term Securities Lending Facility (TSLF): March 11, 2008
  - Collateralized one-month loans of Treasury securities to primary dealers, fixed amount, rates set at auction.
  - Current loans outstanding: [\\$114 bn.](#)
  - Also, Fed initiated one-month RPs (announced March 7, 2008)
  
- Primary Dealer Credit Facility (PDCF): March 16, 2008
  - Collateralized discount window loans to primary dealers.
  - Current loans outstanding: [\\$9 bn.](#)

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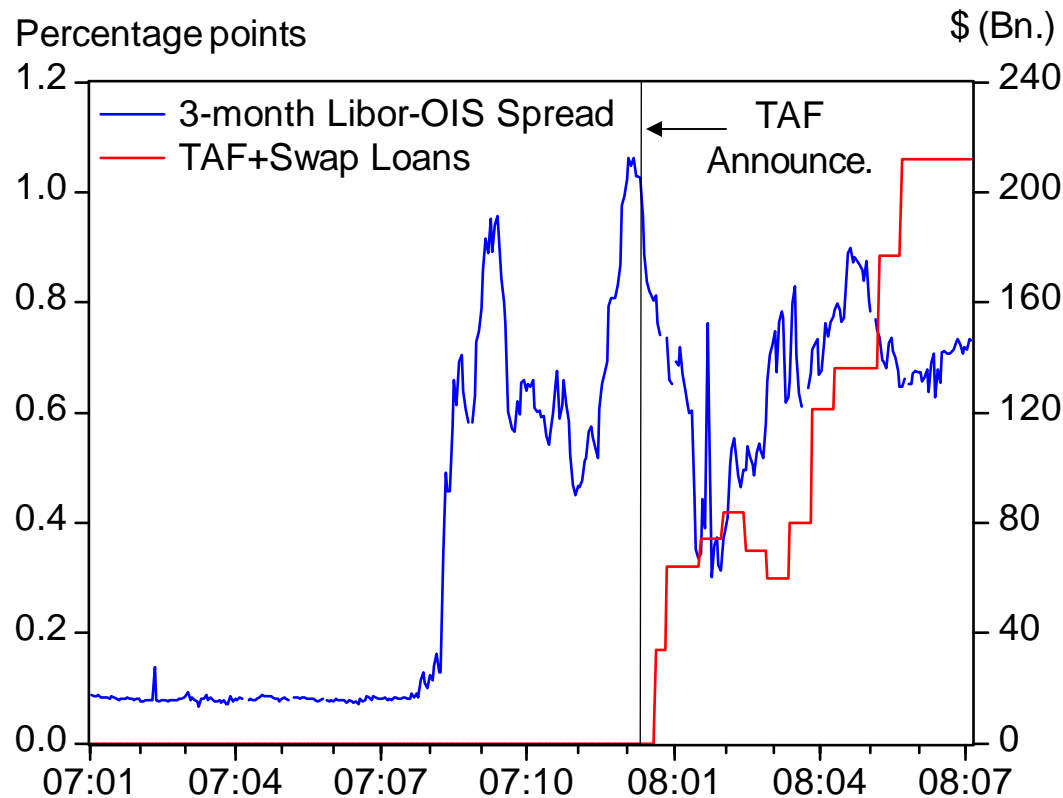
Current totals do *not* include Maiden Lane portfolio of \$29 bn.

# Liquidity Facilities Affect Composition, Not Size of Fed's Balance Sheet



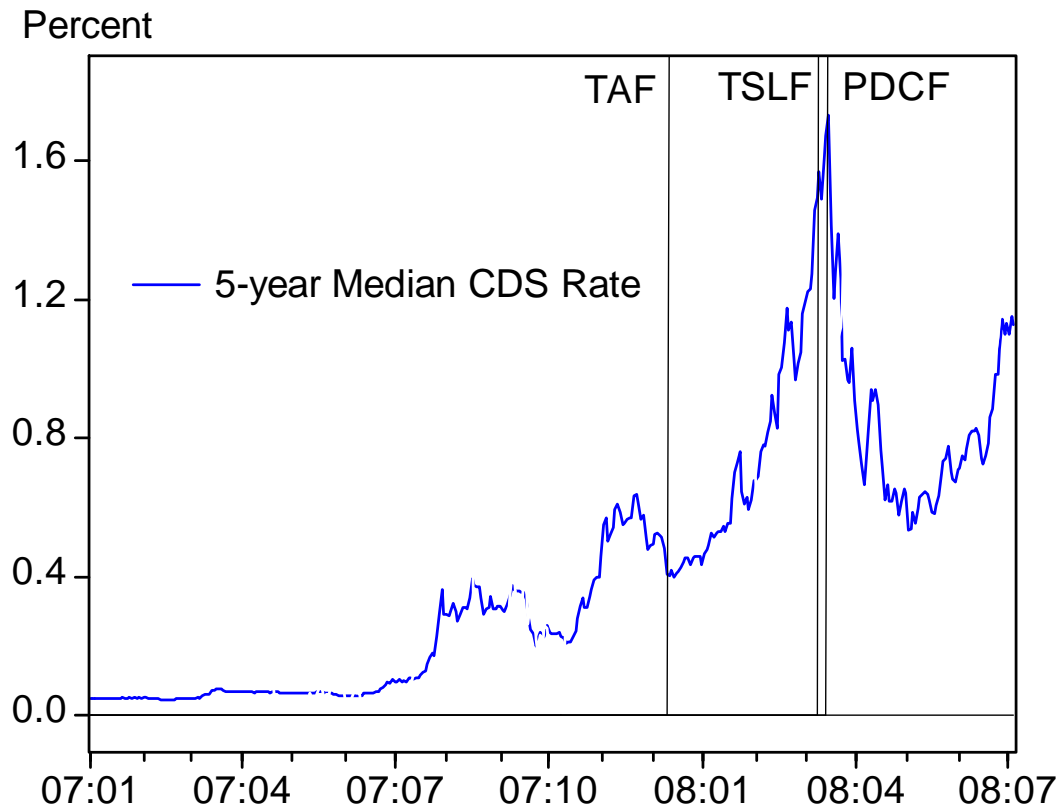
TAF + Swap = \$212 bn.

# Term Auction Facility (TAF) and Bank Term Lending Rates



- In the past, the spread between 3-month Libor and OIS (a proxy for expected overnight rates) averaged about 10 basis points and has been stable.
- Since Aug. 9, 2007, it has averaged 65 basis points and has been highly volatile.
- Similar pattern seen in other bank term lending spreads (CDs, term fed funds, Eurodollar, CP).
- Since introduction of TAF, mean spread is unchanged and spreads still volatile.

# Bank Counterparty Risk: Credit Default Swaps (CDS)



- Measures of bank counterparty risk of have risen sharply since August 2007.
- CDS rates fell modestly at TAF announcement.
- CDS rates spiked in March 2008 and then fell sharply following PDCF/Bear Stearns announcement.
- CDS rates have surged again to early March 2008 levels.

Median CDS: median Credit Default Swap rate of set of major banks.

# Econometric Evidence on Effects of TAF on 3-month Spreads

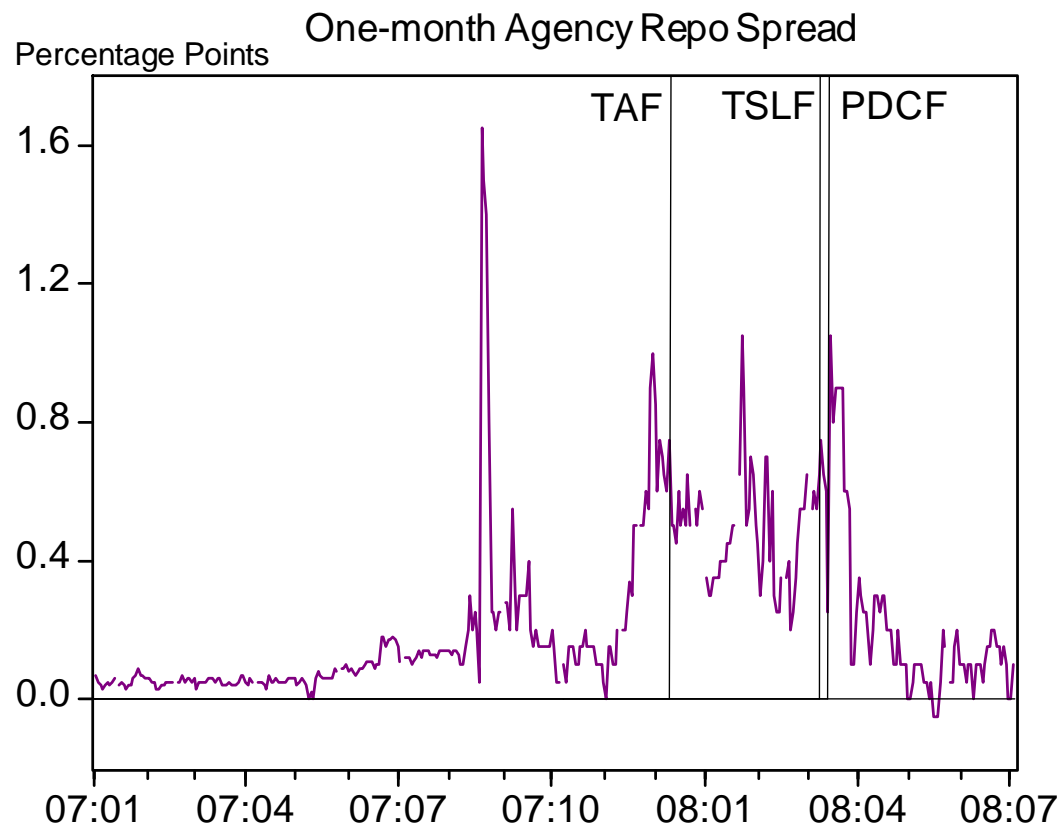
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- Econometric evidence of effects of TAF auctions on spreads is mixed and sensitive to assumed timing of effects, risk measures, and measure of inter-bank lending rate.
  - Estimated current effect of TAF auctions range from -30 bp. to +15 bp.
  
- Inter-bank term lending spreads fell between 4 and 7 basis points on days of major Fed announcements on TAF, controlling for counterparty risk.
  - Assuming announcements have long-lasting effects, cumulative current effect is about -20 bp.
  
- Puzzle: after controlling for movements in CDS rates, bank lending spreads since the TAF announcement are little changed from levels seen in 2007 up till then, which appears to be at odds with large long-lasting effects of TAF announcements and auctions on spreads.

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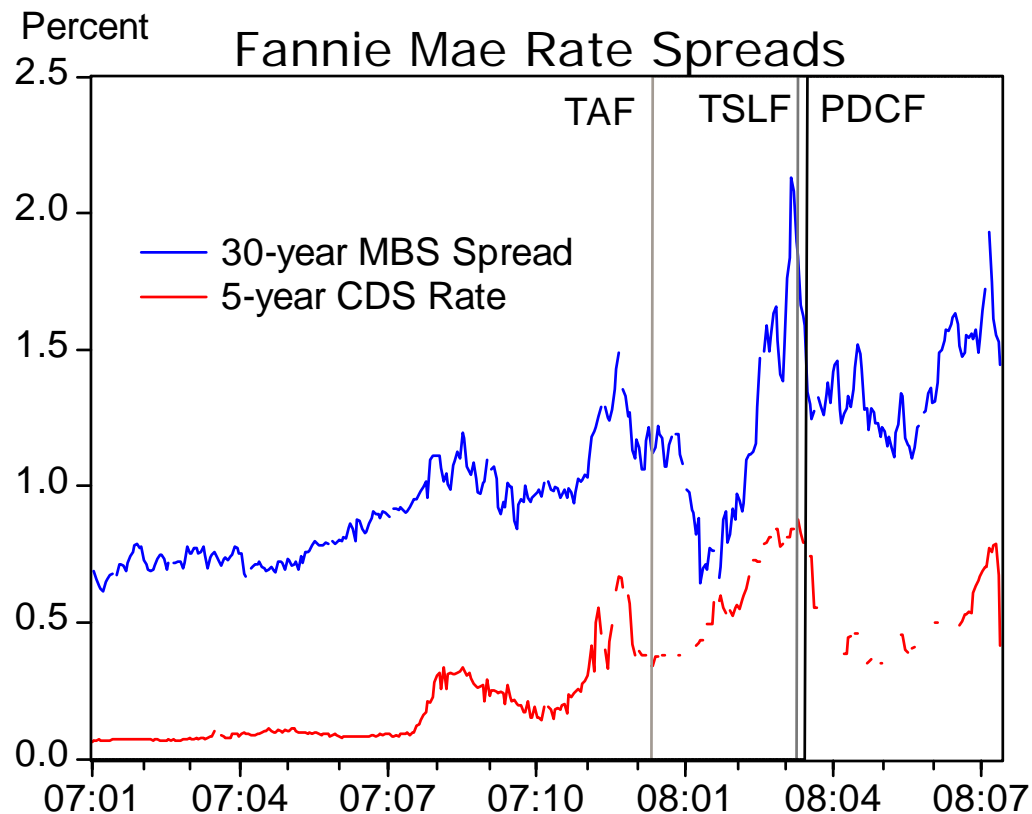
Sources: McAndrews-Sarkar-Wang (2008), Taylor-Williams (2008a,b), Wu (2008).

# Evidence on Effects of Term Securities Lending Facility (TSLF)



- Spreads between 1-month Agency and Treasury repos are typically about 10 bp. and stable.
- Since August 2007 agency repo spreads have been highly volatile and have exceeded 100 bp.
- TSLF was announced on March 11, 2008; first auction was held March 27, 2008.
- Agency repo spreads remained elevated after TSLF announcement, but declined sharply after first auction; they have remained near normal levels since then.

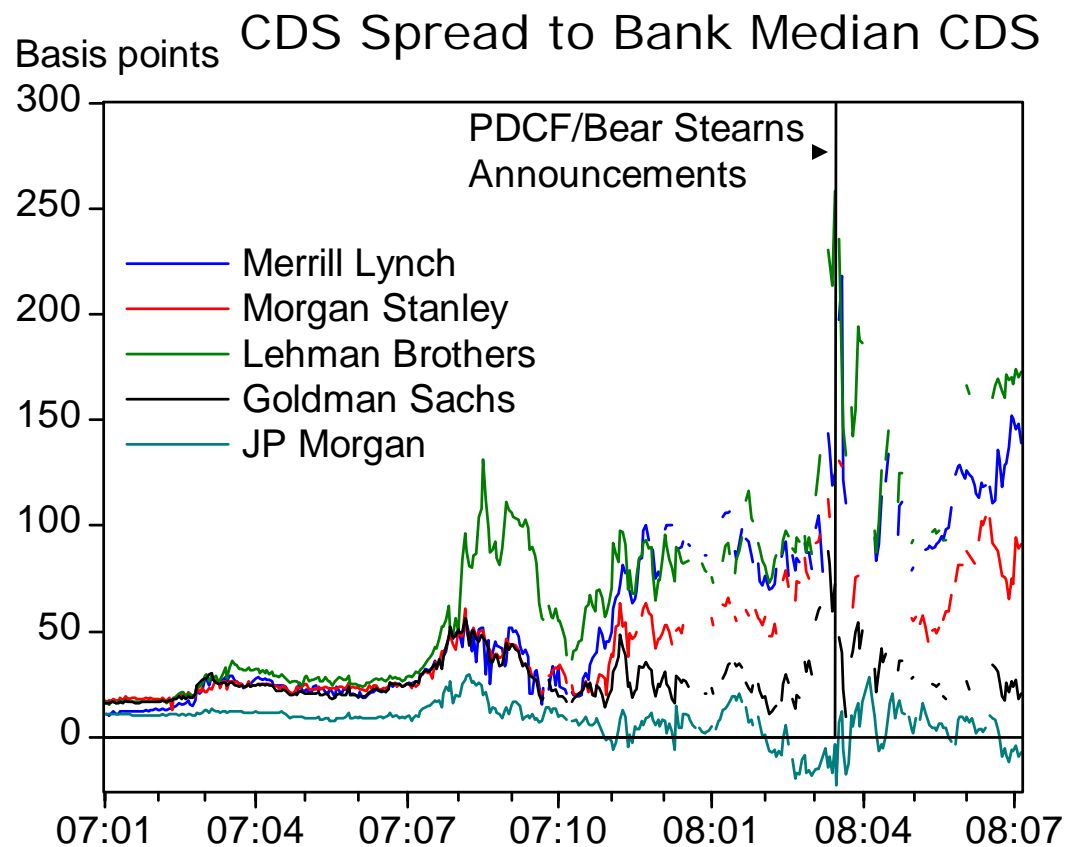
# Evidence on Effects of Term Securities Lending Facility (TSLF)



- Long-term agency MBS spreads fell after announcement of TSLF.
- Announcement of TSLF does not appear to have affected bank or GSE CDS rates.
- But, it's difficult to decipher effects of TSLF on other market conditions due to PDCF/Bear Stearns announcements that occurred a few days later.



# Evidence on Effects of Primary Dealer Credit Facility (PDCF): Investment Bank CDS Rates



- Independent investment bank CDS rates fell sharply after PDCF/Bear Stearns announcement, but so did CDS rates for other banks and GSEs.
- CDS rates for some independent I-banks fell by more than for other banks, suggesting some reduction of liquidity risk.
- But, I-Bank CDS rates and spreads to bank CDS rates are back up to early March 2008 levels or higher, indicating counterparty risk has intensified.

# Conclusion

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- TAF, TSLF, and PDCF narrowly targeted at improving market liquidity by temporarily taking illiquid assets onto the Fed balance sheet in exchange for liquid assets.

- Key issues:

Scope? What types of institutions should have access to the discount window?

Terms? Should fees and haircuts be set so that facilities are accessed only during periods of stress? How should these be determined?

Stigma? Should use of facilities be frowned upon except in times of crisis?

- Despite sizable liquidity measures, risk spreads are back to early March 2008 levels, indicating counterparty risk is the main issue affecting spreads today.
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