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Highlights

- Fed's "Term Auction Facility" repackages the discount window facility as an auction. This should reduce some of the "stigma" associated with borrowing from the discount window.
- Four auction dates set: December 17 (\$20 billion), December 20 (up to \$20 billion), January 14 and January 28 (amounts to be announced). Swap lines with foreign central banks may add up to \$24 billion more.
- While this more targeted approach may alleviate some strain in the interbank market, we still believe that the Fed needs to further reduce the federal funds rate to help steepen the yield curve.

Fed's Term Auction Facility (TAF): Not a Panacea

On December 12, the Federal Reserve announced the **Term Auction Facility ("TAF")** plan in response to ongoing liquidity strain in the interbank lending market. Based on the details released so far, here are some thoughts on TAF:

What exactly is the TAF? The plan takes the discount window lending facility (where depository institutions can borrow directly from the Fed on good collateral) and repackages it as an auction. **Why do this?** Five reasons stand out:

- a) 100 basis points worth of cuts to the federal funds rate have not worked. Dislocation in the interbank market remains. LIBOR usually moves with the federal funds rate, but remains elevated.
- b) Banks are reluctant to lend to one another, but the Fed is *more than willing*.
- c) The auction format provides anonymity but also may circumvent the "stigma" associated with the discount window.
- d) The auction might allow for borrowing below the "penalty rate" available at the discount window as the auction price will be "market-determined."
- e) Over the past four months, several billion dollars have been borrowed from the discount window. This plan initially makes \$40 billion available.

As we noted before, several Fed policymakers have registered their disappointment that the discount window was not being used by banks, keeping the interbank market clogged. We thought the Fed would look for ways to make it a more attractive option and TAF emerged to meet that challenge. But, TAF is really no different than the discount window, as it accepts the same collateral from the same participants. It is a discount window with a rate set by auction rather than Fed fiat.

Why use the TAF instead of open market operations (or other existing Fed "tools")? Open market operations are done with primary dealers (of which there are 20) covering only Treasuries, Agencies and Agency-backed mortgage-backed securities (MBS) as collateral. The auction format linked to the discount window criteria will allow the Fed to inject term funds through a broader range of banks and accept a wider range of collateral than open market operations.

Why coordinate with other central banks? Strong bids by foreign banks in the dollar-funding markets have frustrated the Fed's management of the federal funds target. The swap lines with other central banks may alleviate this problem by making dollar funds available in other central banks' jurisdictions. The FOMC approved the swap lines for six months, including \$20 billion available to European Central Bank and \$4 billion to Swiss National Bank.

When? Auction dates: December 17 (\$20 billion), December 20 (up to \$20 billion), January 14 and January 28 (amounts to be announced).

How? Depositories will submit bids through their local Federal Reserve Banks. The minimum bid rate for the auctions will be established at the overnight indexed swap (OIS) rate corresponding to the maturity of the credit being auctioned. The OIS rate is a measure of market participants' expected average federal funds rate over the relevant term. As of yesterday, the one-month OIS rate was at 4.18%. The discount rate is at 4.75%.

Will TAF create MORE liquidity? In other words, is this a liquidity boost or a "Helicopter drop"? That question will be answered as events unfold but this does not necessarily mean a huge addition of net, new liquidity. In fact, if the Fed plans to keep the target federal funds rate at 4.25%, they will need to offset any new liquidity from the auctions with fewer repo operations or by redeeming more Treasuries (i.e., draining other cash from the system and reducing the monetary base).