The Role of the Federal Reserve in Today's Capital Markets – Part 2

February, 2009

The Federal Reserve

In May of 2008, we published an article entitled The Role of the Federal Reserve in Today's Capital Markets. The premise of the article was that, given the Fed's role of contributing to the long-run growth of the economy by maintaining price stability and full employment, it had been left with limited tools with which to influence the capital markets and effect monetary policy. The primary tool was the ability to change the Fed Funds rate, the rate at which banks lend to each other and ultimately influence capital formation and growth. The question being asked for several years leading up today was: is the Federal Reserve still relevant?

However, as the capital markets showed signs of deterioration toward the end of 2007, the Federal Reserve, under the leadership of a new chairman Ben Bernanke, took a direct role in working with financial institutions to shore up our financial system. The Federal Reserve, as America's central bank, moved quickly to establish new programs that were designed to assist banks in shrinking their balance sheets, shore up capital and monetize illiquid assets. To date, there are roughly twelve new programs that the Federal Reserve has structured as part of its sweeping efforts to stabilize the capital markets. For example, in order to relieve pressure on banks and broker-dealers and to move illiquid mortgage-backed securities off of their balance sheets, the Fed created the *Term Auction Facility* (TAF) and the *Term Securities Lending Facility* (TSLF) in December of 2007. These facilities were designed to allow banks and broker-dealers the ability to lend their illiquid mortgage-backed securities in exchange for U.S. Treasury securities. The desired effect was less pressure in the market to sell these illiquid securities and hopefully a more orderly, functioning capital market. It didn't work.

Also, in February of 2008, as the solvency of Bear Stearns became questionable as a direct result of its holdings in illiquid toxic mortgage backed securities, the Fed was directly involved in arranging JP Morgan's bailout of Bear Stearns and negotiating the terms of the deal. The result, Maiden Lane LLC was a separate funding vehicle that allowed for the purchase of toxic assets that JPMorgan wouldn't accept as part of the deal.

The Evolution of the Federal Reserve in our Capital Markets

The history of our American central bank is rather brief. The Federal Reserve will celebrate its 100th year of existence in 2013. Its formation in 1913 was a result of the financial panic of 1907 which gripped our banking system and curtailed lending. The Fed was slow to respond to the Market crash of 1929 and its policies in the 1930s helped to keep the economy in a deep depression for much of the decade.

As its role in managing price stability in our capital markets evolved after World War II, its function as an independent body was always held in question. While the Federal Reserve is recognized as an independent bipartisan central bank, historically Fed policy tended to favor the policies of the residing President. The independence of the Federal Reserve wasn't fully recognized until Paul Volker, under President Ronald Reagan, implemented a dramatic policy of higher short term interest rates to choke off inflation. Yet, as the capital markets have grown more complex and securities have become more sophisticated, our regulatory infrastructure is still rooted in 1933.

The Federal Reserve, as central bank and lender of last resort, is acting now to stabilize our financial system. In the past six months, the Fed has injected over $1 trillion of liquidity into the financial system, back stopped short term lending and reduced short term interest rates from 5.25% in August of 2007 to virtually zero today. Central banks have been built on financial crisis and we expect the role of the Federal Reserve will expand as a result of the current crisis.

New Central Bank Policies of the Federal Reserve

In response to the financial crisis and panic of 2008, The Federal Reserve established several new programs that provide lending support, liquidity and help to stabilize our financial system. These programs are listed below with a brief description.

1. Term Auction Facility Provides liquidity for nontraditional collateral by pledging as collateral for short term loans at an interest rate equal to the overnight Fed Funds Rate.

2. Primary Dealer Credit Facility Provides overnight collateralized loans to primary dealers at the same interest rate as that of the discount window. This program accepts a wide range of collateral.

3. Term Securities Lending Facility Provides the exchange of investment grade securities held by broker dealers and banks for Federal Reserve holdings of U.S. Treasury securities.

4. TSLF Options Program Gives primary dealers the option to draw on special short dated TSLF Auctions.

5. Maiden Lane LLC The company set up to acquire assets of Bear Stearns which JP Morgan found to risky to own as part of its acquisition of Bear Stearns in March of 2008.

6. Asset- Backed Commercial Paper Money Market Mutual Fund Facility Provides loans to banks and other depository institutions so they can purchase asset-backed commercial paper from money market mutual funds requiring liquidity.

7. Commercial Paper Funding Facility Through a special purpose vehicle managed by the Federal Reserve Bank of New York Fed, this facility purchases three-month unsecured and asset-backed commercial paper directly from eligible issuers.

8. Money Market Investor Funding Facility This facility provides up to $540 billion in cash liquidity to money market funds by purchasing assets directly out of money market funds.

9. Term Asset Backed Securities Loan Facility This facility lends up to $200 billion to holders pledging AAA rated credit card, student loan and small business loan ABS as collateral.

10. GSE Securities Program in which the Fed will purchase up to $100 billion in GSE direct obligations from primary dealers and $500 billion in qualifying mortgage backed securities in the open market.

President Obama is in a position to reshape the role of the Federal Reserve. We expect the role of the Federal Reserve as America's central bank to be expanded and modernized to address the complexity of the capital markets and different security types.

Gregory J. Hahn, CFA
President & CIO

Stephen P. Carr, CFA
Portfolio Manager