

Box A: Recent Changes to US Federal Reserve Instruments

In recent months, the US Federal Reserve (Fed) has implemented a number of policy changes to address liquidity strains associated with the deterioration in credit markets. The latest initiatives are an extension of the changes introduced since August and provide the Fed with greater flexibility with respect to the term of operations, the range of eligible counterparties and collateral, as well as the mix between direct provision of liquidity and auction facilities.

The first set of changes can be broadly categorised as lowering the cost of funds through interest rate reductions. In March, the Fed narrowed the gap between the discount rate and the federal funds rate by a further 25 basis points, making direct loans from the central bank to major depository institutions cheaper. The Fed has subsequently lowered the discount rate by a further 100 basis points in line with the federal funds rate. Since the onset of the financial market turbulence in August, the Fed has cut the discount rate by a cumulative 400 basis points and the federal funds rate by 325 basis points.

Prior to the recent changes, only a limited set of core institutions were able to obtain funding from the discount window. To address this, the recent changes have expanded the number of eligible counterparties by introducing some new facilities, extended the term of operations, and relaxed the criteria for eligible collateral.

To bolster the provision of liquidity to depository institutions, the Fed lengthened the term of the discount window facility from 30 days to 90 days in March. This extended the changes made in August 2007, when the term was lengthened from overnight to 30 days. In addition, the Fed announced an increase in the maximum amount available under its Term Auction Facility (TAF) from an initial US\$60 billion to US\$150 billion. The TAF has the advantage of circumventing the negative stigma associated with accessing emergency funding through the discount window since funds are obtained through competitive bidding against the same set of collateral as the discount window, which includes highly rated private-label asset-backed securities (ABS). Until late March, the bid-rates paid on funds borrowed through the TAF had remained around the target federal funds rate. However, the bid-rates for the last four TAF auctions have risen above official rates. The bid-rate also rose above the corresponding LIBOR for the first time in early April.

The discount window and TAF are both limited to depository institutions. This means that around half the primary dealers, such as investment banks not involved in retail banking, are unable to access funds through these means. There were concerns that the liquidity provided through these facilities was not being distributed adequately to those institutions which needed it. In order to directly assist primary dealers, the Fed supplemented its existing facilities by introducing the 'Primary Dealer Credit Facility' (PDCF) mid March. The PDCF provides overnight loans to primary dealers at the discount rate in exchange for a broad range of

investment-grade collateral, and functions in a similar manner to the discount window facility. The facility has been available since 17 March, and will be in place for at least six months. Since its inception, primary dealers have accessed a considerable amount of funding through this facility. The Fed has also initiated a series of 28-day repurchase transactions with primary dealers against collateral eligible in its normal market operations, with the transactions expected to amount to US\$100 billion. These operations are in addition to regular operations, which typically have a shorter term of up to 14 days.

To promote market liquidity in the ABS and particularly mortgage-backed securities (MBS) markets and aid the process of price-discovery, the Fed introduced a 'Term Securities Lending Facility' (TSLF) to lend up to US\$200 billion of Treasury securities to primary dealers for a wide range of asset-backed collateral, including private-label commercial and residential MBS. The TSLF is an expansion of the existing securities lending program, and has a term of 28 days rather than overnight. Because the Fed conducts TSLF operations by lending out securities that it already holds, overall system liquidity is unaffected by these weekly operations. The initial TSLF auctions were oversubscribed, but with the Fed already holding a large share of the market's private-label assets, demand for Treasuries at the later auctions has been undersubscribed. This may reflect a preference by primary dealers for obtaining direct funding through the PDCF.

The Fed has also increased the temporary currency swap lines with the European Central Bank (ECB) and the Swiss National Bank (SNB) to provide US dollar funding to non-resident financial institutions in other markets. Non-resident institutions had been creating tensions early in the New York trading day in attempting to secure US dollar funding. The Fed will now provide up to US\$50 billion to the ECB and US\$12 billion to the SNB as required through to 30 January 2009. This will allow institutions to access US dollar funding in the European trading day. ↗