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Thoughts on the Fed's release of information on crisis measures

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The Fed published information about programs to combat the crisis. The data indicate that the PDCF (Primary Dealer Credit Facility), under which the Fed loaned money against securitized assets, helped prevent a fire sale of assets, and that the TAF, which originally was used by the largest financial institutions, increasingly came to support regional banks. They suggest as well that collateral-based LOLR (Lender of Last Resort) facilities like the TSLF (Term Securities Lending Facility) have become a part of central banks' toolkit. The Fed also created a framework for dollar operations by the world's central banks by extending swap lines. However, the frequent use of TAF (Term Auction Facility) and others by non-US financial institutions raises the question of how home- and host-country central banks should share responsibility for supplying liquidity during a crisis.

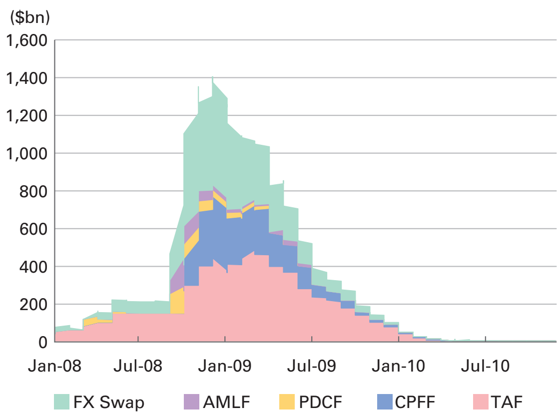
Introduction

The Fed complied with the provisions of the Dodd-Frank bill by releasing details on its response to the financial crisis. I would like to discuss the implications of this data with reference to my January 2010 report, which considered possible revisions to the Federal Reserve Act 13 (3) , including disclosure of the Fed's LOLR activities.

Fed's LOLR activities

In January I argued that building a framework for ex-post verification of LOLR activities was necessary for the objective analysis of such activities. I think the Fed's recent release provides needed information for such an analysis.

Exhibit 1. Outstanding of short-term facilities



Source: FRB

Early in the crisis, for example, the Fed introduced a variety of facilities to stabilize the CP market. Macro-level data have already shown that AMLF (Asset-Backed Commercial Paper Money Market Fund Liquidity Facility) was most frequently used. But the recent disclosure highlights the systemic nature of the crisis in the CP market at the time, noting that fully 156 funds took advantage of the facility.

It was also interesting that the largest institutions availed themselves of measures like the TSLF, under which the Fed did not provide funds per se but exchanged assets to facilitate repo transactions. As long as appropriate conditions for participation are set, such policies have the advantage of winding down automatically as the crisis wanes. Given that a similar program implemented by the Bank of England was also effective, I think the central banks of the developed economies were able to add to the toolkits a new tool that might be described as collateral-based LOLR (or the application of SLFs during a crisis).

The PDCF was introduced to supply funds to primary dealers. My impression was that a relatively large percentage of the loans under this facility were secured by corporate and securitized assets. This suggests that the program not only created a way for the Fed to serve as LOLR for the investment banks but also helped limit fire sales of securitized assets to raise cash. The latter played an important role in prevent further dysfunction in

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the securitization market as well as systemic risk triggered by undershooting asset prices and consequent damage to financial institution balance sheets

Of the domestic facilities by the Fed, the TAF was the largest and most-utilized. The recent data also show that the way it was used changed over time. In 2008, and particularly in the spring and autumn, when large financial institutions were failing or being rescued, domestic and overseas large institutions frequently borrowed. But starting in the second half of 2009, regional banks began to borrow more. A look at funds supplied under the program by the various regional Feds shows the New York Fed accounting for half of all funds initially, with its outsized share gradually being divided among the other branches. This change is consistent with how confidence in the large institutions was restored in the first half of 2009 following the stress tests and the rebound in asset prices, while the recession's impact on local economies, particularly those suffering a drop in housing prices, gradually grew more severe.

Exhibit 2-1. Top 5 users of TSLF ($mn)

Citi	RBS Securities	Deutsche Bank	Credit Suisse	Goldman Sacks
297,297	250,339	239,248	224,535	193,020

Exhibit 2-2. Composition of PDCF transactions based on the kinds of collateral

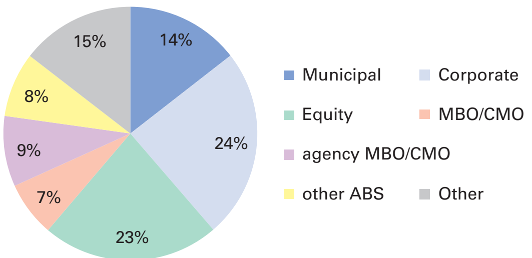

Exhibit 2-3. Number of TAF transactions and those by FRBNY

	until 2008/Ⅰ	2008/Ⅱ	2009/Ⅰ	2009/Ⅱ	2010/Ⅰ
Total	612	904	1,335	1,085	277
by FRBNY	300	376	465	362	56
Share %	49.0%	41.6%	34.8%	33.4%	20.2%

Source: Compiled by the author using the Fed data

At the very least, the data confirm that those facilities open only to financial institutions meeting certain criteria helped keep the crisis from spreading. It is true that some of these measures overlapped or went largely unused as the crisis deepened. In general, though, I think the measures adopted by the Fed can be appreciated for the accuracy and effectiveness with which they identified and treated the problem. This may be attributable chiefly to the Fed's efforts to keep in close contact with market participants, as indicated in New York Fed President William Dudley's separately released timetable. And given that the desire to prevent “back-door bailouts” was one of the reasons why the Dodd-Frank bill required increased disclosure of the Fed's LOLR activities, it may be ironic that this very disclosure of detailed information ended up highlighting the appropriateness of the Fed's response.

Policy challenges implied by the disclosure (1): division of roles between home- and host-central banks

As was noted in the media immediately after the disclosure, it is clear that European financial institutions frequently borrowed from the TAF and TSLF. This activity may reflect the unwinding of investments in dollar assets as a result of the crisis.

The first implication of this—something already pointed out by many—is that the Fed played a role of global LOLR

Exhibit 3. Average amount of successful bids of TAF by large financial institutions in the US and Europe ($mn)

Bank of America	7,092
Wells Fargo	5,921
Wachovia	6,392
Citi	4,244
RBS Citizens	4,040
Regions	3,150
JPM Chase	7,143
First Tennessee	1,298
Barclays	4,740
Bank of Scotland	4,523
Societe Generale	4,442
Bayerische LB	2,924
West LB	2,178
Deutsche Bank	3,840
UBS	3,469
RBS	8,917

* Global average was 906

Source: Compiled by the author using the Fed data

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throughout the crisis. Just as it was no coincidence that overseas financial institutions accumulated dollar assets, the Fed did not supply large amounts of funds to overseas financial institutions by chance. This is reassuring to those who believe the US dollar will retain its position as global currency for now, at least as a means of settlement. Since this point has important ramifications for the future of the global financial system, I would like to discuss it in detail in a separate Note.

A second implication is that the recent crisis left open the question of how funds should be supplied to foreign financial institutions during a crisis. As this set of data show, the Fed not only supplied dollar funds to overseas institutions within the US but also set up swap lines with other central banks enabling them to supply dollars to institutions in their own countries. The question of how to coordinate these two approaches raises a number of key issues for the prevention of systemic risk.

From the micro perspective of supervising financial institutions, it may be preferable that central banks supply both domestic and foreign currency to their own institutions. The reason is that a financial institution that has difficulty obtaining market funding is likely to have problems of some kind. While banks that come under market attack tend to disparage claims as baseless rumor, in the end it is often a case of “where there's smoke, there's fire.”

It is therefore hoped that the central bank and supervisory authorities in the troubled bank's home country, which in theory should have the best understanding of its situation, will demand appropriate corrective measures and provide funds under the condition of their improvements. This kind of approach is incentive-compatible with the institution's efforts to rebuild itself. In addition, it is less likely to create political problems than when a home-country central bank supplies funds to overseas financial institutions—even if the funds must be supplied at preferential terms. As the problems in Europe demonstrate, general public tend to reject the use of public funds to rescue overseas financial institutions.

But what complicates this issue is that, in the event of systemic stresses to the global financial system, we cannot simply say that central banks in the developed nations will provide necessary currencies via swap lines while individual central banks deal with the funding problems at their own institutions.

Such an approach may be appropriate in the case of institution-specific problems. But when a financial crisis has left the market beset with doubts and fears, even financial institutions without serious issues can find it difficult to obtain funding simply because they happen to be from the same country or share a similar business model. The released data also suggest that a wide range of financial institutions—in terms of capital, asset quality, and subsequent outcomes—approached the Fed's facilities in a similar way. In such crises it may be the case that having one central bank supply local currency funds to all financial institutions active in the country will do more to stabilize the financial system (by easing fears) than having numerous central banks each take responsibility for supplying funds to their own financial institutions.

The question of how home- and host-country central banks should share responsibility for supplying funds is closely related to the issue of how to supervise financial institutions active in cross-border transactions. Achieving consistent roles for home- and host-country central banks is also important. In order to take advantage of both, we need to decide the areas responsibilities and the criteria for taking action.

Policy challenges implied by the disclosure (2): central bank risk exposure

The information recently released by the Fed also enables a quantitative understanding of the risks assumed by the Fed during the recent financial crisis.

I find it interesting that opinions differ on the significance of the quality of a central bank's balance sheet. Some insist that the quality of the central bank's balance sheet is critical, while others argue that any response to the financial crisis is bound to impair the quality of the Fed's balance sheet, but that this will not affect confidence in the institution or the US dollar because the US is not a developing economy. I cannot concur with the insistence

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on maintaining balance sheet quality if it places heavy constraints on the central bank's ability to respond to the crisis. But at the same time, I think it is important for the central bank's stakeholders to know, even if after the fact, what kinds of risks the central bank assumed during the crisis. This kind of accountability is particularly important when the measures have the potential to influence the allocation of economic resources and therefore fall into the realm of conventional fiscal policy.

In short, I believe that a policy measure should not be discontinued simply because a central bank's risk exposure consistently exceeds a given level. Instead, I think it would be more constructive to review the bank's capital or the way in which its profits are transferred to the government. Inasmuch as greater risk-taking is a phenomenon characterizing not only the Fed but also the central banks in other developed economies, I see a growing global need for the kind of detailed risk disclosure provided by the Fed.

Author's Profile

Tetsuya Inoue

Chief Researcher
Financial Technology and Market Research Department

E-mail : kyara@nri.co.jp

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Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara

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