

## First Quarter 2008 Knowledge College

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### The Federal Reserve and The Credit Crisis

The Federal Reserve has taken an unprecedented role during the current credit crisis. The following is a summary of The Fed's role in the past and how it has changed.

#### The Fed's Stated Mission

- **The Federal Reserve's primary duties fall into four general categories**
  - 1) Conducting the nation's monetary policy in **pursuit of maximum employment, stable prices, and moderate long-term interest rates**
  - 2) **Supervising and regulating banking institutions** to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
  - 3) **Maintaining the stability of the financial system and containing systemic risk** that may arise in financial markets
  - 4) Providing financial services to depository institutions, the U.S. government, and foreign official institutions, including **playing a major role in operating the nation's payments system**

#### The Fed's Response to Credit Crisis

- **The credit crisis deepens in August of 2007**

The Fed supplied large quantities of reserves through traditional means. Interbank lending tightened significantly as bond investors shunned even Government Agency securities in favor of U.S. Treasuries.

The Fed took the following actions:

  - 1) Reduced Fed Funds rate.
  - 2) Conducted Open Market operations to purchase securities to inject liquidity
- **Traditional Fed tools prove ineffective** as the benefits didn't necessarily reach institutions that needed help the most.

- **The Fed responds by creating new lending procedures**

**August 2007**

Term Securities Lending Facility - allowing investment banks to borrow Treasury bills, notes and bonds using mortgage-backed securities as collateral.

**December 2007**

Term Auction Facility - offering commercial banks funds through an anonymous auction facility to avoid the stigma associated with having to borrow at the discount window.

**March 2008**

*Bear Stearns sale to JP Morgan is announced on 3/16, next day the Fed creates...*

Primary Dealer Credit Facility - extending lending rights to investment banks under terms normally reserved for regulated banks.

## **Bear Stearns Collapse**

Bear Stearns clients and counterparties lost confidence in the investment bank and pulled out assets at a stunning pace as rumors and panic surrounding Bear Stearns' liquidity position spread. Despite having \$17 billion in cash 5 days earlier, on March 14<sup>th</sup> Bear Stearns found themselves unable to meet client requests to cash out positions. Bear Stearns' asset positions were highly leveraged and illiquid.

**March 14<sup>th</sup>**

**The Fed agreed to provide a \$30 billion 28-day loan** to JP Morgan Chase, who then loaned the money to Bear Stearns.

**March 16<sup>th</sup>**

Facing bankruptcy and with Fed approval, Bear Stearns agrees to a takeover by JP Morgan Chase for \$2 share (later raised to \$10). **The Fed provided special financing in the transaction, agreeing to take on up to \$30 billion of Bear Stearns' "less-liquid" assets.**

## Summary

Federal Reserve Chairman Ben Bernanke and his Fed colleagues have taken unprecedented steps to try to maintain order and stability in the banking system. Critics question if the Fed has gone too far with their role in the Bear Stearns' sale (including assuming risk on Bear Stearns debt) and by lending to investment banks, who are largely unregulated. As a scholar of the Great Depression when bank runs were too common, Bernanke seems determined to avoid the significant mistakes he believes the Fed made then by failing to take adequate action.

The long-term consequences of these changes remain to be seen. If the Fed is willing to loan to investment banks, it is reasonable to expect that regulation of those banks will follow. Any form of regulation would likely include limits on leverage that would limit the availability of capital to the entire economy. The Fed's willingness to bail out what was the 5<sup>th</sup> largest Wall Street bank could create a moral hazard in the future, incentivizing market participants to discount or ignore counterparty risk under the presumption that the Fed is implicitly guaranteeing the counterparty. Finally, by taking on the less liquid assets in the market, The Fed has reduced the quality of its balance sheet, which could adversely affect their ability to perform their core duties, especially fighting inflation, and respond to future crises.

*For more information, please contact any of the professionals at DiMeo Schneider & Associates L.L.C.*