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How the Federal Reserve Will Rescue U.S. Credit Markets

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The Federal Reserve has expanded the amount of money it will lend to banks: for the first time the Fed is making loans to investment banks, lowered the spread between the discount and fed funds rate (lowered the penalty), broadened the range of collateral to secure Treasury bill swaps, and coordinated these efforts with other central banks. The Fed began lowering both the federal funds rates and the discount rate in August 2007. The U.S. is experiencing the largest banking system bailout in history. Fed Chairman Bernanke is widely regarded as an academic authority on the financial conditions that led up to the Great Depression and how the economy was brought back to prosperity.

Credit markets need buyers and sellers. Buyers avoid buying debt instruments that are dropping in value. In June 2007, collateral and the underlying asset valuations entered a period of decline (re-pricing). The first hint that a problem existed was the collapse of a hedge fund managed by Bear Stearns (leveraged 30:1). At the same time, bankers noticed a systemic rise in the number of loan payments falling 60 to 90 days behind and rising foreclosures; an environment similar to past recessions. Recently, mortgage companies have been unable to pay margin calls from their lenders, as collateral values have fallen and assets have become illiquid. The largest money center banks have been forced to recognize losses never seen before, related to asset backed securities. Institutional investors that include insurance companies, banks, pension funds, and hedge funds have been adversely affected by a stalling credit market system. The disruption of the short-term commercial debt (commercial paper) market backed by the credit of the issuers or asset backed commercial paper (secured by a depressed real estate market) has forced investors to flock to treasuries. The near collapse of Bear Stearns forced the Fed, for the first time, to make a direct loan to an investment bank. Previously, the Fed exclusively made loans to member banks.

The Fed has come to the rescue. Simply put, the Fed has agreed to swap treasury bills for asset-backed securities that no one wants to own and to make favorable loans to banks and Wall Street firms. Without this support, the largest financial institutions would not be able to operate. The Fed has bought time, but may end up holding most if not all of the asset backed securities until maturity. The market benefits since the securities were not sold at a large discount and the banks have raised their liquid assets; a means to make new loans to future borrowers.