More Repo ructions: The Fed reinvents bailouts

Just when you thought bankers couldn't come up with any new mechanisms to get between the wallpaper and the wall …[1]

The "repo" crisis that began 16 September, brought on by too-big-to-fail financial institutions' refusal to lend to each other, is bringing a new permanent bailout facility into being. According to the minutes of its 29-30 October meeting, the Fed is considering establishing "a standing fixed-rate facility that could serve as an automatic money market stabiliser". First a recap of the Fed's bailout capabilities.

The US Federal Reserve's Discount Window, a lender of last resort facility as old as the Fed itself, by which eligible banks seek short-term liquidity often on an overnight basis, was put through its paces during the global financial crisis, beginning on 17 August 2007. The Fed cut the discount rate by half a per cent and extended the terms of its overnight loans by up to 30 days. Not two weeks earlier, on 4 August, financial commentator Jim Cramer had had his infamous "they know nothing!" meltdown on CNBC, demanding that the Fed "Open the discount window! Cut the rate! Relieve the pressure!" All the while, investment bank Bear Stearns was insisting it was not in trouble. Just over six months later it collapsed.

Primary Dealers

- Amherst Pierpont Securities LLC
- Bank of Nova Scotia, New York Agency
- BMO Capital Markets Corp.
- BNP Paribas Securities Corp.
- Barclays Capital Inc.
- BofA Securities, Inc.
- Cantor Fitzgerald & Co.
- Citigroup Global Markets Inc.
- Credit Suisse AG, New York Branch
- Daiwa Capital Markets America Inc.
- Deutsche Bank Securities Inc.
- Goldman Sachs & Co. LLC
- HSBC Securities (USA) Inc.
- Jefferies LLC
- J.P. Morgan Securities LLC
- Mizuho Securities USA LLC
- Morgan Stanley & Co. LLC
- NatWest Markets Securities Inc.
- Nomura Securities International, Inc.
- RBC Capital Markets, LLC
- Societe Generale, New York Branch
- TD Securities (USA) LLC
- UBS Securities LLC.
- Wells Fargo Securities, LLC

Primary dealers. Image: wallstreetonparade.com

Use of the Discount Window preceded the Fed's quantitative easing (QE) intervention. The true extent of that program—that is, Fed injections of emergency liquidity by buying assets from banks—was only discovered recently when the Fed lost a court battle and was forced to reveal its data, which showed that US$29 trillion was funneled into the banks in 2007-10.

The "repo" (repurchase agreement) market, made famous by today's crisis, provides quick liquidity to investment banks in a similar way that the Discount Window does for deposit-taking banks. It is known as the plumbing of Wall Street. Financial institutions can borrow cash in exchange for collateral, usually in an overnight exchange, at a short-term interest rate known as the repo rate.

The difference is that the Discount Window can only lend to deposit-taking banks, which tend to direct credit into commercial activity. So during the global financial crisis, in March 2008, the Primary Dealer Credit Facility (PDCF) was created. It was established "in response to the severe strains in the triparty repurchase agreement market and the resulting liquidity pressures faced by primary dealers", according to the Fed. Primary dealers are authorised to trade directly with the Fed, in order to buy and resell government securities such as Treasury bonds. The 24 primary dealers are all securities dealers, investment banks and trading houses. They are not, therefore, generally lending into the real economy. According to wallstreetonparade.com, the New York Fed pumped out US$8.9 trillion in loans via the PDCF during the last crisis, the majority going to the securities branches of Citigroup, Morgan Stanley and Merrill Lynch, with junk stocks and bonds accepted as collateral. The PDCF was closed in 2010.

It is these same primary dealers, however, that have been accepting daily and fortnightly "repo" loans from the Fed since 16 September, as normal interbank lending dried up. Despite the fact, by its own figures, that this has not increased excess reserves held at the Fed, which pool is used for repo market liquidity, the Fed on 25 November commenced offering a new type of repo loan—in the form of new 28-day and 42-day term loans. Some US$3 trillion dollars has been turned over by the Fed already, in total, over the three-month crisis.

By establishing a new permanent facility, the Fed would be "effectively standing ready to provide a form of liquidity on an as-needed basis", according to its meeting minutes. This had been suggested by JPMorgan Chase in an October client note which proposed a "standing repurchase-agreement facility" as the daily source of liquidity, freeing it and other trading houses to use its excess reserves for speculation. The Fed admits that "such a facility could increase the risk that some institutions may take on an undesirably high amount of liquidity risk", but the new facility is perhaps motivated by post-GFC restrictions on Fed bailout capabilities, as lamented by 2008 crisis managers, Fed Chair Ben

Bernanke, Treasury Secretary Hank Paulson, and NY Fed President and Treasury Secretary Timothy Geithner in *Firefighting: The financial crisis and its lessons* (2019).

Claims that the Fed's fix has worked are undermined by its continuing and growing interventions, but what does ring true are the claims of financial insiders who have declared its intervention is what is boosting the stock market, as well as helping to reinvert the bond yield curve.

The Glass-Steagall divide

Using the primary dealer market to inject funds protects the new bailout scheme, because unlike with the Discount Window, the Fed does not divulge who it is providing money to. The Discount Window cannot be used by primary lenders, but the new repo facility is morphing into an equivalent operation. As wallstreetonparade.com protested on 14 November: "There is nothing in the legislation that created the Fed, the Federal Reserve Act, that allows it to be the lenderof-last-resort to the trading houses on Wall Street. The Fed's Discount Window, which is legally allowed to make emergency or seasonal loans, is restricted by law to just deposit-taking banks—not Wall Street trading houses."

Referring to the PDCF, the Fed says its primary lender market was created "under the authority of Section 13(3) of the Federal Reserve Act, which permitted the Board, *in unusual and exigent circumstances*, to authorise Reserve Banks to extend credit to individuals, partnerships, and corporations." (Emphasis added.) This would exclude a permanent facility.

Legal or not, the gulf between the functions of the two mechanisms is notable. The Discount Window puts money into commercial banks, while the primary lender repo facility directs it into speculation by liquefying trading houses and securities dealers. The Fed's intention to turn the emergency PDCF system into a permanent liquidity spigot bridges this divide at a moment when the US government should be reinstating Glass-Steagall in order to reinforce it.

Footnote:

1. During a 2013 UK parliamentary debate on Glass-Steagall bank separation versus ring-fencing, former banker Lord Forsyth of Drumlean warned that ring-fencing, which merely separates commercial and investment units under the same roof, wouldn't protect depositors from predatory bankers, as "investment bankers are extremely adept at getting between the wallpaper and the wall".

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