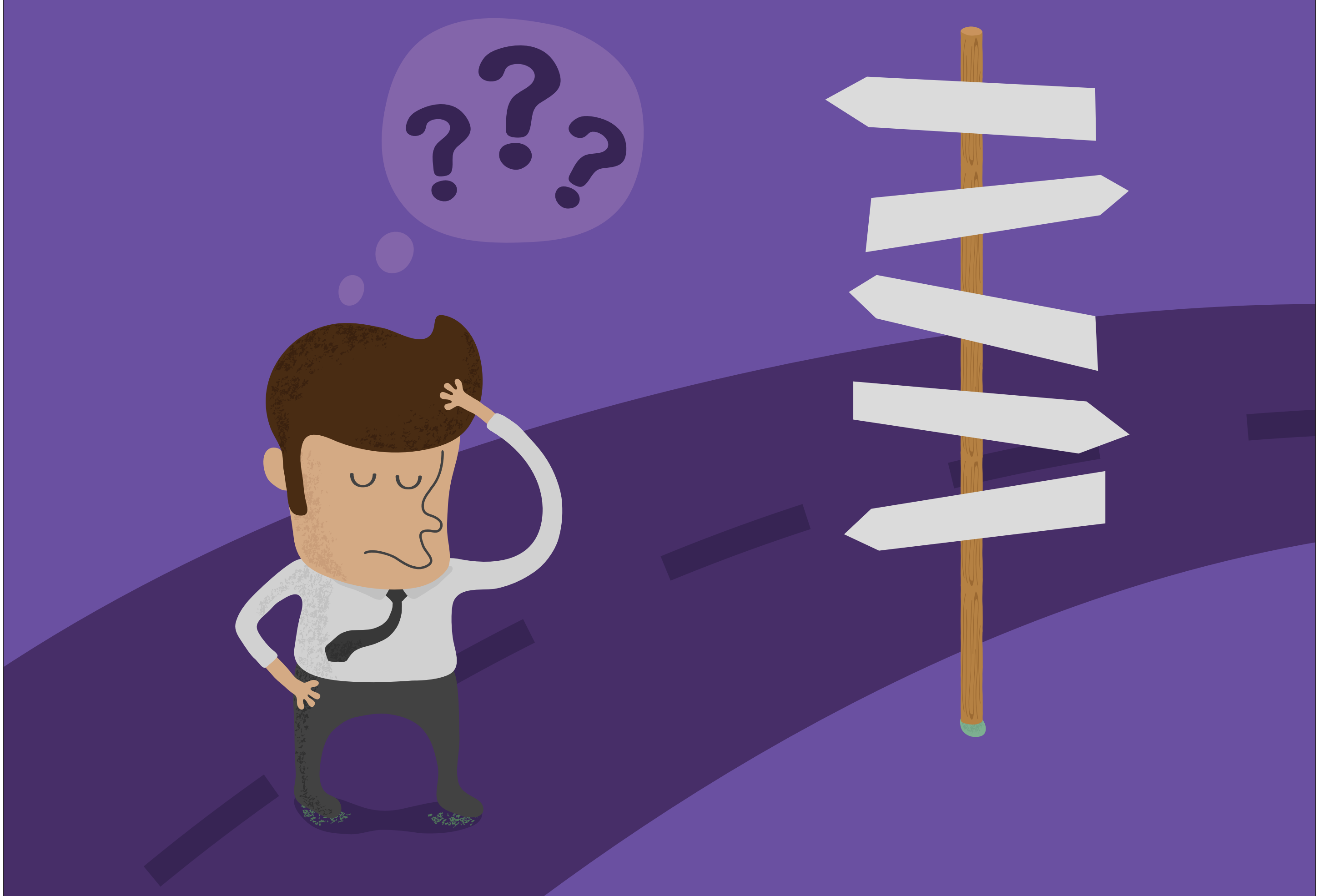

The SOMA dilemma

Oscar Huettner of BondLend looks at the effect of the Federal Reserve's lending programmes on securities finance

In reaction to the financial crisis of 2008, the US Federal Reserve created a series of emergency financing programmes aimed at ensuring the orderly functioning of the US financial markets. The TSLF, CPFF, PDCF, AMLF, MMIFF and TALF each provided liquidity to specific sectors of the banking system. As the market stabilised, each of these programmes was wound down and the Federal Reserve reverted to its traditional limited arsenal of tools for supplying emergency liquidity to the financial markets.

While these emergency programmes have slipped into financial history, one rarely noted measure that the Federal Reserve undertook in 2008 has not been reversed. That is, the easing of the terms of the Federal Reserve SOMA lending programme and the dramatic increase in availability that it has provided to the securities lending market.

Traditionally, the Federal Reserve allowed dealers to borrow limited amounts of treasuries and agencies from its SOMA holdings on an overnight basis. It capped availability to 45 percent of its holdings in each CUSIP and charged a minimum fee of 100 basis points. Dealers could borrow a maximum of 100 million per issue and were restricted to bidding for no more than 500 million of securities in total.

In response to the severe market conditions in 2008, the Federal Reserve dramatically eased these terms. Ninety percent of each CUSIP was made available. Dealers could bid for up to 25 percent of the available supply and had their overall cap raised to 5 billion. More importantly, the minimum borrow fee was lowered to 1 basis point in December 2008. It was increased nominally in April 2009 to 5 basis points but still remains extraordinarily generous by historical standards.

Given the relative stability of the US treasury market at the current time, it is worth asking the question should the Federal Reserve alter its extremely accommodative stance towards lending its SOMA portfolio and revert back to its traditional role as lender of last resort? An examination of the Federal Reserve's SOMA holdings versus the market-wide statistics available in DataLend illustrates the dilemma the Federal Reserve faces in making this decision.

As of the end of March, the Federal Reserve held approximately 2.95 trillion securities; about four times its pre-crisis holdings. Of these, 1.875 trillion were notes, bonds, TIPS and agency securities. Most commentaries on the effects of Quantitative Easing (QE) have concerned themselves with the difficulties involved in unwinding these positions in the future. What they generally have not examined is how these positions affect the current securities finance market. The Federal Reserve's holdings now dramatically exceed the combined inventories of the major agent lenders. DataLend reported a total inventory of 809 billion treasuries and agencies as of March month end and a total nominal on loan of 297 billion. This represents the vast majority of US treasuries available to the market from traditional providers. The Federal Reserve is now in a position where it is the largest single source of US treasury lending liquidity.

Pre-crisis, the Federal Reserve's daily securities lending balances rarely exceeded 2 billion. Since easing the terms of its SOMA lending programme, the Federal Reserve's outstanding loans have increased dramatically. The high water mark was June 29 2011 when Wall Street borrowed more than 37 billion of securities. Although daily levels decreased during 2012, we have seen a spike in 2013 with 28 March reaching almost 26 billion. If the terms of the Federal Reserve's SOMA lending programme were to revert back to pre-crisis levels would we expect to see an increase in agent lenders' balances of approximately 23 to 24 billion? The answer to this question is not as simple as you would expect.

More important to this discussion than QE1, 2 or 3 is Operation Twist. As a result of its targeting of specific maturities, the Federal Reserve now finds itself holding almost 71 percent of its portfolio in the 2016 to 2021 area of the curve. The Federal Reserve currently holds 245 individual treasury issues. For 105 of these, their holdings exceed 30 percent of each issue. For 77, their holdings exceed 40 percent and in 44 cases they hold more than 50 percent. The majority of these large holdings are concentrated in this 2016 to 2021 segment of the curve.

On 28 March 2013, Wall Street borrowed 112 different CUSIPs from the Federal Reserve. All but seven of these were borrowed at the minimum rate of 5 basis points. The highest average fee paid was 12.4 basis points. While it may be argued that the fact that most of these securities were lent at 5 basis points effectively put a floor under these issues and possibly the market as a whole, there is another factor to consider here. In reviewing these 112 securities against DataLend's inventory figures, 23 were not held in sufficient quantities by agent lenders to satisfy Wall Street's needs. Of the five issues with SOMA borrowings of 2.5 billion or more, none were held by agent lenders in sufficient quantity. All were within the 2016 to 2021 section of the curve

Looking closely at T 3.375 11/15/19, we can see the importance of the availability of the Federal Reserve's SOMA holdings to the overall liquidity of the US treasury market.

What becomes apparent from this analysis is how Operation Twist has led to a dislocation in the securities lending space. However unintentional, the Federal Reserve has created a situation where its holdings have dramatically limited the lending pool of certain securities. Further, it faces a dilemma that if it were to revert back to a 50 or 100 basis point minimum lending fee for its holdings, it would potentially be seen as punishing market participants for assisting with Operation Twist.

One possible solution to this dilemma might be for the Federal Reserve to vary its minimum fee based upon the proportionate size of its holdings. In the current environment, it is not difficult to envision the Federal Reserve moving its minimum fee to 25 or even 50 basis points for the majority of its holdings. This would not only aid agent lenders and beneficial owners, but it would also provide the Federal Reserve and the market with a means of price discovery in the securities lending space. For those issues where the Federal Reserve holds a disproportionate position it could set the minimum lending rate lower, eg, 10 or 20 basis points. If the programme were to be properly structured, it would serve as an important message to the market that the Federal Reserve sees the US treasury market moving towards a 'normal' structure.

Figure 1

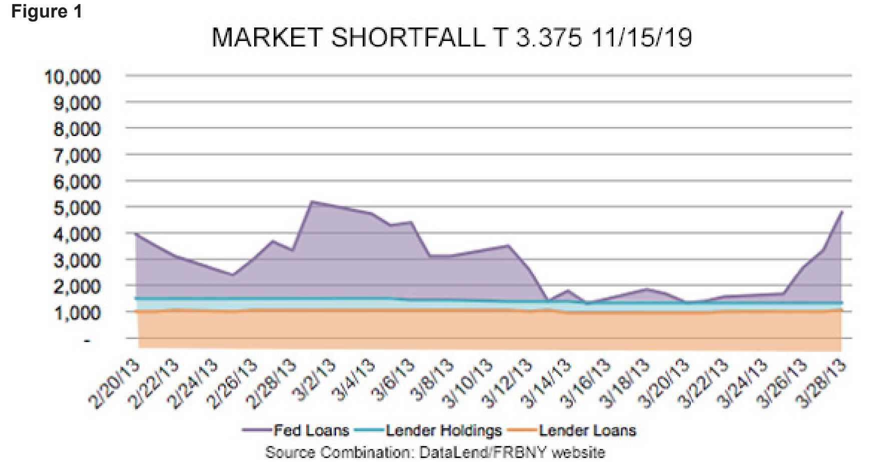

Figure 2

ISSUE	ISSUE SIZE	FED HOLDINGS*	LENDER HOLDINGS**	FED LOANS*	LENDER LOANS**	LENDER SHORT FALL
T 3.375 11/15/19	71,037	34,521	1,358	4,785	1,089	4,515
T 3.5 5/15/20	68,219	36,594	2,490	5,522	1,126	-4,158
T 1.25 10/31/19	29,000	14,519	1,012	2,987	678	-2,652
T 1.25 2/29/20	29,000	4,854	3,090	2,583	2,473	-1,966
T 3.626 2/15/20	71,595	27,744	2,405	2,785	1,489	-1,870

*Source: DataLend

All financial information in this article was sourced from FRBNY Website: http://www.newyorkfed.org/index.html* and DataLend**

Oscar Huettner
Director and global product manager
BondLend