North America Equity Research
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Large Cap Banks

Major Moves By Fed Should Help Markets & Credit Creation - ALERT

Banks

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The Fed announced on Sunday night moves to provide further liquidity to the markets, one of which is a major change. The Fed exercised a power not used for 75 years to provide broker dealers access to the discount window and importantly broadened its window to cover a much larger group of assets. These moves are the latest in a series of steps by the Fed to prevent the financial markets from getting into further tailspin on worries about broker dealers and the economy from spiraling into a major recession. The problems at entities like Carlyle Capital are still unresolved. By itself, no one step is a panacea, but this should help the fixed income markets reduce the panic and ultimately maintain and improve credit creation, esp. mortgage originations (and other debt too) by further reducing spreads and the cost of mortgage and other debt. The Fed also meets Tuesday, with potential for a further rate cut.

- **The Fed made 3 announcements last night.** 1) The Fed provided access to the discount window to broker dealers and 2) is expanding the collateral it would accept much more broadly to include mortgage backed securities (MBS), asset backed securities (ABS), munis, & investment grade corporate debt. (3) The Fed also reduced the cost of accessing this financing by reducing the discount rate (not Fed Funds rate) by 25 bp. Furthermore this facility is to be in place for at least 6 mths and for a longer period if required.
- **Providing a lifeline to other broker dealers that may have been under stress is also a plus to large banks** that interact with these broker dealers in many ways – as lenders and counterparties in several ways in trading, derivatives and other areas.
- **We understand broker dealers' net MBS inventories are at close to record levels** and there is potential for more to come from players such as Carlyle Capital. Counterparties were recently much more nervous and requiring greater capital allocation, which would further pressure firms holding these assets. This would have also further pressured mortgage origination volumes and mortgage costs. The Fed's move provides the ability for broker dealers to be able to fund this through the Fed and continue their role as market makers.
- **Accepting a much broader array of collateral should help the securitization markets** for a broad array of products beyond just mortgages. We understand the Fed has structured these to limit credit risk.
- **MBS and ABS spreads had widened a lot over the past few weeks.** Last week's Fed moves to accept MBS collateral helped improve MBS spreads.
- **The discount rate was reduced to 3.25% yesterday night.** The discount rate gap now has shrunk to only 25 bp above the Fed Funds target rate so to make it not punitive for broker dealers and banks who need access to the Fed window. The discount rate used to be below the Fed Funds rate until 2003 but has been above thereafter to deter its usage by making it more expensive.

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