Overview

On March 11, 2008, the Board of Governors of the Federal Reserve System (Board) by the unanimous vote of its five members approved under section 13(3) of the Federal Reserve Act (12 U.S.C. § 343) the establishment of the Term Securities Lending Facility (TSLF) and authorized the Federal Reserve Bank of New York (the Reserve Bank) to lend under that program. The TSLF is intended to promote liquidity in the financing markets for Treasury and other collateral and thus to foster the functioning of financial markets more generally.

Background and Details on the TSLF

For many years, the Federal Reserve has lent U.S. Treasury securities overnight from its System Open Market Account (SOMA) to primary dealers (designated banks and securities broker-dealers with which the Reserve Bank trades U.S. government and select other securities).¹

In early March 2008, liquidity strains escalated in a variety of collateralized funding markets. Widespread collateral scarcity in the repurchase agreement (RP) market for Treasury securities intensified due to strong demand for Treasuries as a safe haven. In addition, uncertainty over the value of other securities led to a precipitous decline in their prices, leading to sharply reduced liquidity in the funding markets for these assets. The dislocations caused by this systemic reduction in liquidity posed severe risks to financial stability and hampered Federal Reserve efforts to reduce the cost and increase the availability of credit.

These circumstances suggested that additional lending of U.S. Treasury securities by the Federal Reserve would reduce systemic risks and facilitate the effective implementation of open market operations and monetary policy. The Federal Reserve recognized that expanding the types of collateral accepted in connection with securities lending and extending the term of these transactions would meaningfully expand the availability of U.S. Treasury securities and help alleviate the sharply increased pressures in the market for U.S. Treasury securities,

¹ These loans are collateralized by other U.S. Treasury securities and as such do not require authorization under section 13(3) of the Federal Reserve Act.
a key market for private investment and hedging transactions and for the implementation of U.S. monetary policy. In addition, such lending was expected to help to ease pressures in the funding markets for the other securities that are accepted as collateral. As a result, the Board determined that unusual and exigent circumstances existed and approved the establishment of the TSLF.²

On July 30, 2008, the Federal Reserve announced an extension of the TSLF, the Term Securities Lending Facility Options Program (TOP), in which options to draw shorter-term TSLF loans at future dates are auctioned to the primary dealers. The TOP-related loans are targeted to span periods of expected heightened collateral market pressures, such as quarter-end, and do not generally coincide with the terms of regularly scheduled TSLF loans. Establishment of the TOP program required only an administrative change to some TSLF terms and did not require a separate Board authorization under section 13(3) of the Federal Reserve Act.

**Structure and Basic Terms**

Under the TSLF, the Federal Reserve auctions term loans of U.S. Treasury securities to primary dealers.³ These loans must be collateralized by a pledge of other securities. The TSLF is authorized under section 13(3) of the Federal Reserve Act, which permits the Board, in unusual and exigent circumstances, to authorize Reserve Banks to extend credit to individuals, partnerships, and corporations that are unable to obtain adequate credit accommodations from other banking institutions. TSLF auctions commenced on March 26, 2008, and will continue through January 30, 2009, or longer if conditions warrant.

The following provides an overview of the terms and conditions that govern the TSLF. The Board and Reserve Bank continue to work to monitor the affected financial markets and to consult with market participants and, accordingly, the terms and conditions governing the facility may be modified in the future if appropriate.

*TSLF Auctions.* TSLF loans are awarded to primary dealers based on competitive bidding, subject to a minimum fee requirement. The Open Market Trading Desk of the Reserve Bank auctions general Treasury collateral (Treasury bills, notes, bonds and inflation-indexed securities) held by SOMA for loan against eligible collateral as defined below. The Reserve Bank announces in advance the

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² Because the TSLF affects the SOMA, approval of the Federal Open Market Committee (FOMC) was also obtained.
³ A list of primary dealers can be found at http://www.newyorkfed.org/markets/pridealers_current.html
specific breakdown of general Treasury collateral to be allocated in a TSLF auction. The allocation of these general Treasury securities is done on a pro rata basis.

The Reserve Bank reviews and accepts bids at the highest rate through successively lower rates. As the TSLF is a single-price auction, all accepted bids are awarded at the same fee rate, which is the lowest rate at which any bid was accepted. The aggregate amount of all accepted bids does not exceed the lesser of (i) the offering amount, and (ii) the aggregate amount of all bids submitted at or above the minimum bid rate. When necessary, bids at the lowest accepted interest rate are prorated. Auction awards are rounded to the nearest $1 million.

Dealers are allowed to submit two propositions in each auction. Each bid may not exceed 20 percent of the offering amount. Dealer awards are limited to no more than 20 percent of the amount of SOMA collateral offered during each auction. The Reserve Bank reserves the right to further restrict dealer bids at its sole discretion.

*Eligible Collateral*. In order to prevent securities lending from affecting overnight bank reserves, loans are collateralized with eligible collateral rather than cash. Eligible collateral is determined by the Reserve Bank and includes:

**Schedule 1 Collateral:**
- All collateral eligible for tri-party repurchase agreements arranged by the Open Market Trading Desk (open market operations): Treasury securities, agency securities, and mortgage-backed securities issued or fully guaranteed by federal agencies; and

**Schedule 2 Collateral:**
- All Schedule 1 collateral;
- Investment grade corporate securities;
- Investment grade municipal securities;
- Investment grade mortgage-backed securities; and
- Investment grade asset-backed securities.

*Collateral Custody and Valuation*. Dealers receiving awards at auction are required to pledge auction-eligible collateral from their clearing bank custodial accounts. Collateral is valued daily by the clearing bank and adjustments to collateral levels may be required to maintain the designated margin amounts. Margin requirements are determined by the Reserve Bank.
Lending Fees. The minimum fee rate is 10 basis points for Schedule 1 collateral and 25 basis points for Schedule 2 collateral. The lending fee can be thought of as approximately equivalent to the spread between the Treasury general collateral rate and the general collateral rate for the pledged collateral over the term of the loan.

Use of Loan Proceeds. All transfers of securities are made through the borrower’s clearing bank account. General Treasury collateral lent by SOMA cannot be transferred out of a dealer’s clearing bank, but may be used to settle certain types of repurchase agreement contracts.

Amount Outstanding. As of October 29, 2008, the value of Treasury securities lent under the TSLF was $197.5 billion. The value of the collateral pledged to the TSLF was $236.0 billion.

Expected Costs. The Board does not expect that securities lending under the TSLF will result in any losses to the Federal Reserve or the taxpayer. While losses could occur in the event of a primary dealer bankruptcy, the risk of loss is mitigated by haircuts on collateral value, daily revaluation of the collateral, and limits on the participation of individual dealers.