Fed Extends Swap Lines at Discount

Yesterday the Fed and 5 other major central banks announced measures to shore up liquidity in the global banking system. In the past 6 months LIBOR OIS spreads, the TED spread, swap spreads and LIBOR had been rising steadily as money markets slowly seized up. Obviously the Fed felt that conditions had deteriorated to a level at which it had to act. The swap lines that the Fed would extend are due to expire Aug 2012. This has been extended a further 6 months to Feb 2013. So the announcement was regarding swap lines already in place and which are currently well under-utilized (about 2.5 billion USD) compared with the whole of 2008 and 2009 utilization (ranging between 100 – 600 billion USD). The cost of borrowing would also be reduced from 0IS + 100 bps to 0IS + 50 bps. This signals a possible reduction in the Fed primary discount rate from the current 75 bps. Absent such an adjustment, it would be cheaper for a European bank to borrow USD from the ECB than for a US bank to borrow at the Fed's discount window. But that's all academic. These swap lines are simply not being drawn down.

Since 2008, the knee jerk reaction has been for banks to sell down their loan books and to replace their balance sheets with sovereign debt. Why? Because sovereigns carry a zero risk weighting under Basel 2. Since corporates were at the same time shoring up their balance sheets just as sovereigns were bailing out private balance sheets by buying their toxic assets, risk was being transferred away from corporates to sovereigns just as banks were substituting away from corporates to sovereigns. A strong Tier 1 capital ratio has become a red flag lest the zero weighting was not due to cash and near cash assets. Now that banks are replete with sovereigns, very much eligible for repo with central banks, the cheaper source of funding has been to repo these assets at single digit basis points costs with the central banks and deposit the cash back with the same central banks for a thin but positive spread. Domestic banks, for example in the US, have to pay a small cost of insurance to the FDIC, pretty much destroying the arb spread, but foreign banks do not pay this cost. For them, it is entirely viable to repo their sovereign bonds and earn a spread on their reserves with the central bank.

So the Fed swap lines are currently not any where close to fully drawn and are not nearly as cheap as the repo market for which the banks have ample collateral. How interesting. At the same time, TED spreads and LIBOR OIS spreads have continued to widen even as equity markets have rallied. OK, so its been less than 24 hours and we are talking about the relative intelligence between fixed income and equity traders. No contest. My tendency is to go short the equity markets if the technicals even show a peep of weakness.

The cynic in me asks why the Fed is prepping the morphine when the patient is in a critical but stable condition.