



**Should Community Banks Borrow Under the Federal Reserve's
Term Auction Facility?
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January 29, 2009**

Toward the end of 2007 the Federal Reserve System established the Term Auction Facility (TAF) to help provide liquidity for qualifying depository institutions. Banks that are eligible borrowers under the Fed's primary credit program are eligible for TAF funds. To date, large institutions have been the primary users of the auction facility. This note documents the terms of recent auctions and argues that community banks that are not capital constrained should consider incorporating TAF funds in their liquidity planning and overall funding mix.

Why should community banks care about the TAF? In short, recent auctions have carried borrowing rates of just 20 and 25 basis points for loans (advances) of almost 3 months maturity. At these rates, banks can sharply reduce overall funding costs and/or invest the funds in low risk instruments to add to aggregate earnings.

General Terms of TAF Participation

In order to qualify for TAF funds, banks must have a CAMELS rating of 1, 2 or 3.¹ The auction process consists of the Board of Governors announcing auction terms, including among other items the offering amount, minimum bid, minimum bid rate and bid submission date. Each bank can submit a bid to include the amount requested and the interest rate that the bank is willing to pay. After closing of the bid period, the Federal Reserve accepts qualifying bids, beginning with bids at the highest interest rate and accepting bids with successively lower interest rates, until the last bid accepted makes the total amount of accepted bids equal to the pre-determined offering amount. If the amount of bids is less than the amount offered, all bids are accepted. All banks

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¹ Terms of the TAF are summarized on the Federal Reserve's web site at www.federalreserve.gov/monetarypolicy/taf.htm. For the January 26, 2009 auction, the minimum bid amount was \$5 million, the maximum bid was \$15 billion, and the minimum bid rate was 0.25%. Bidders requested \$136 billion out of the \$150 billion offered, for an average of \$1.3 billion borrowed per institution, with all bids accepted.

with accepted bids are awarded advances and pay the same interest rate, referred to as the stop-out rate, which equals the lowest rate at which the last bid was accepted. Importantly, advances under TAF cannot be prepaid and must be collateralized.

The first TAF offering was in December 2007 with subsequent offerings approximately every two weeks. Exhibit 1 compares the amounts offered over time with the bid/cover ratio, which equals the total amount of bids received by the Fed divided by the offering amount. Initially the Fed offered funds of \$50 billion or less every two weeks, alternating between one month and three month maturities. Through May 2008, the bids far exceeded the amounts offered by the Fed. As a result of the relatively strong demand for these funds, the Fed increased its bi-weekly offerings to \$75 billion and then \$150 billion beginning in October 2008. At this higher offering amount, the total amount of bids has been less than the allotment, such that the bid/cover ratio is below one. For example, on January 26, 2009 the Fed offered \$150 billion in TAF funds and 102 firms bid for just over \$136 billion, or 91% of that available.

The TAF Borrowing Rate

TAF borrowing rates have ranged from a high of 4.67% in December 2007 to a recent low of 0.20%. The stop-out rates have generally declined over time, and have effectively tracked movements in the Fed's target federal funds rate, indicating that the Fed sees the TAF as an auxiliary tool to discount window lending. Exhibit 2 shows the relationship between the stop-out rates on both the shorter-term TAF advances and 3-month TAF advances and the target federal funds rate.² As the Federal Reserve lowered the targeted federal funds rate from 4.25% at the end of 2007 to a range of 0 – 0.25% today, TAF advance rates fell coincidentally. Furthermore, as the offering amount increased to \$150 billion and bid/cover ratio fell below one, advance rates fell systematically. The bid/cover ratio and advance rates have remained low since October 2008. While TAF funding has been available for just a short period of time, it appears that a principal objective of Federal Reserve policy in recent periods is to lower bank borrowing rates to near zero, close to the target Federal funds rate.

Strategic Implications

TAF funding appears to be more attractive now than it has ever been. While there are risks associated with this funding source, banks that are well capitalized and with adequate collateral to pledge against the advances can use the proceeds to enhance earnings. Qualifying collateral is the same as that for discount window borrowings. With the U.S. in recession and the prime rate at 3.25%, banks have limited opportunities to make loans at rates that offer high risk-adjusted returns. The prime rate will likely remain low for much of 2009 such that loans priced at prime +

² Shorter-term advances are those with maturities of 35 days or less while longer-term advances are those with maturities of 83-85 days.

2% offer the same pre-tax and pre-expense yield as GNMA securities. Banks that grow earnings and net interest margin are likely to do so by lowering funding costs.

Well-capitalized banks can potentially use the TAF advances to help achieve one or more of the following strategic objectives.

- **Lower funding costs:** Many community banks currently operate with an average interest cost of funds between 2% and 3%. Rather than try to replace maturing CDs and time deposits from non-core customers by offering relatively high market rates on these deposits, why not bid for TAF funds offering a rate close to the target federal funds rate, which is well below the CD rates the bank would otherwise pay? For example, if a bank obtained \$10 million in TAF funds at 0.25%, the high end of the target fed funds rate range, and replaced \$10 million of time deposits paying 2.5%, the interest savings over 84 days would amount to approximately \$52,000. Because of the short maturities on the TAF funds, you are assuming the risk that rates will increase in the near term. However, the bank's aggregate interest rate risk is mitigated if the bank is currently asset sensitive. The bank is essentially using a lower cost liability to repay higher cost liabilities.³
- **Add spread income:** Community banks have several alternatives to invest TAF funds in low credit risk alternatives with minimal interest rate risk such that they can increase their net interest income. On January 26, 2009, TAF bid winners obtained 84-day funds (maturing on April 23, 2009) at a rate of 0.25%. At that time, a bank that was a member of IDC's Deposit Network, for example, could have invested up to \$12.5 million in the firm's Money Market Account Extra at a rate of 1.18%.⁴ IDC Deposits distributes the investment among its member institutions such that the full amount is FDIC-insured. At this investment rate, the bank could earn a spread of 93 basis points such that a \$10 million investment would add approximately \$21,500 in pre-tax income for the 3 months. While this investment offers minimal interest rate risk, banks could choose more aggressive alternatives with greater risk that offer higher earning yields.

³ The Federal Reserve has announced TAF dates extending every two weeks through March 23 rotating between 28-day and 84-day maturities.

⁴ The Pacific Coast Bankers' Bank is custodian for the program and warrants that the funds are placed only in well-capitalized banks. This rate can change over the 3-month interval described.

- **Reduce liquidity risk:** If your bank relies on any type of hot money that could be pulled immediately without notice, TAF funds represent a more stable source of funds. Banks that rely on brokered deposits offered by large correspondent banks that can be called are particularly at risk. TAF funds are a low cost alternative. The auctions are scheduled through March 2009 and will likely be extended given the current economic climate.

Summary

These are unconventional times for banks and bankers. Auctions under the Federal Reserve's Term Auction Facility currently appear to provide an opportunity for community banks to improve their operating performance by restructuring their funding sources and mix. Of late, the auctions have been undersubscribed, with the amount of bids submitted being less than the total amount of funds offered by the Federal Reserve, resulting in attractive borrowing rates. The TAF has the potential to lower a community bank's overall funding cost, add to net interest income via investment in low credit risk assets, and reduce liquidity risk. To take full advantage of the auctions, the banks must be well capitalized and willing to take a minimum \$5 million in TAF funds at the auction. There is no guarantee that the auctions will continue after March 2009, but the Federal Reserve has committed to keeping interest rates low throughout the year.

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Exhibit 1: Amount Offered and Bid/Cover Ratio

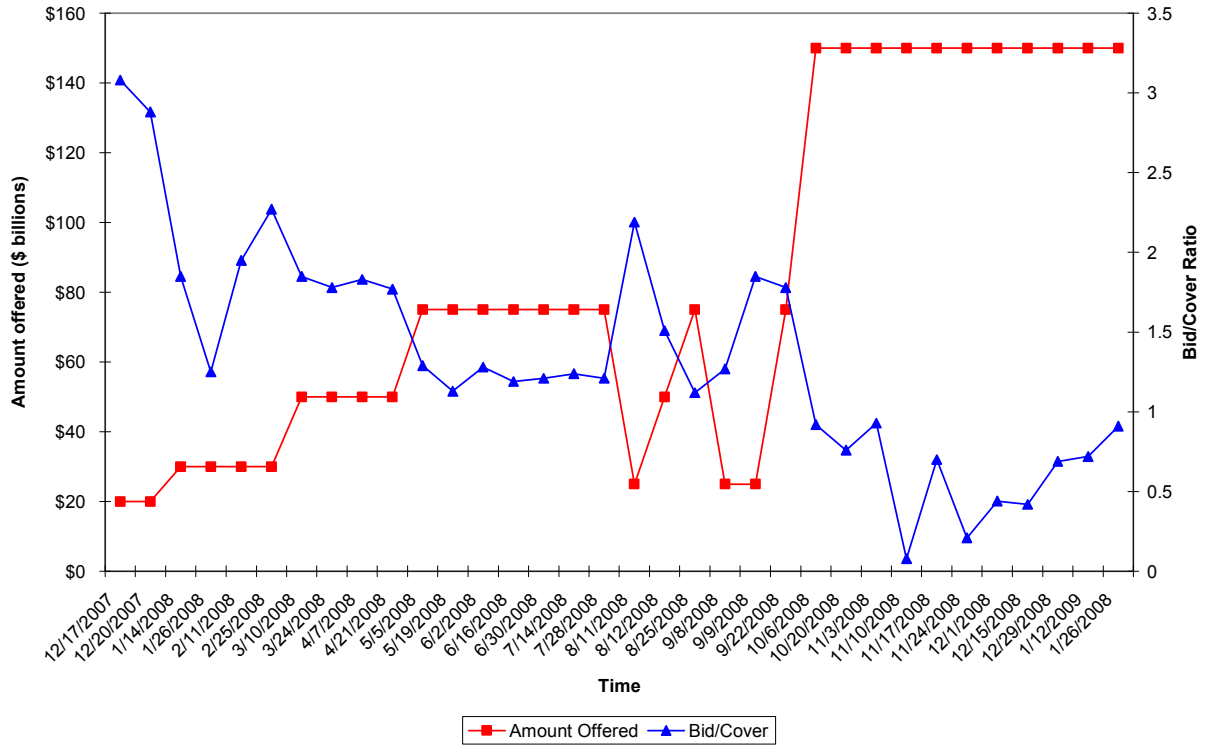


Exhibit 2: Comparison of TAF Advance Rates with the Federal Funds Rate

