Bankers Acceptances as a Nontraditional Monetary Policy: Some FAQs

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In a previous *Economic Synopses* essay, I suggested that bankers' acceptances might be a useful tool during the current period of nontraditional monetary policy. ("Nontraditional policy" is identified by the Federal Reserve purchasing, as its assets, securities other than U.S. Treasury debt, and by policymakers' concerns regarding the mix of assets held on the Federal Reserve's balance sheet, rather than only the total amount.) A drawback of nontraditional policy is that asset purchases increase the Federal Reserve's liabilities dollar-for-dollar because the Federal Reserve pays for the assets with checks (or the electronic equivalent) drawn on itself. Unless an extraordinary event intervenes (such as the Treasury selling a special debt issue and holding the proceeds as a deposit at the Federal Reserve, or banks repaying borrowings from the Federal Reserve), nontraditional policy can cause extraordinary increased in the monetary base, that is, in those liabilities of the Reserve Banks that are used by banks both for settling interbank debts and for additional lending. Large increases in the monetary base fuel fears among the public of future increased inflation. Federal Reserve policymakers argue that the increases are unimportant because they can, if and when conditions require, be quickly reversed (Bernanke, 2009). Not all analysts are so confident, and suggest that it would be desirable to invent a scheme wherein the same credit market support could be furnished by the Federal Reserve without large increases in the monetary base. I suggest bankers' acceptances might be such a scheme.

Since my earlier *Synopses* essay, a number of callers have asked similar questions. Here, I share my replies.

1) *Would a BA program at the Fed require any new/additional legislation?*

This issue requires more investigation. So far as I am aware, there are no provisions in the Federal Reserve Act that would prohibit such activity. In its earlier history, before the Great Depression, the Federal Reserve Banks *purchased* bankers' acceptances, that is, debts of private firms that had been "accepted" [guaranteed} by banks or acceptance corporations and were secured to the satisfaction of the Reserve Bank. My current proposal is quite different—a Reserve Bank (or a special purpose corporation chartered a Reserve Bank) would accept the debt and then sell it to private investors. Section 14 of the Federal Reserve Act allows the Board of Governors to authorize "any institution" to accept debts that, if secured to the satisfaction of the Reserve Bank, are eligible for purchase by the Reserve Bank or as collateral for loans from the Reserve Bank ("discounted" by the Reserve Bank). Whether this applies to my proposal will require a ruling from Federal Reserve legal counsel. There is a more important part: the essential ingredient is that any acceptances created by the Federal Reserve must be eligible for purchase or discount by a Reserve Bank. This assures that the holder of the acceptance, at maturity, will be paid. Section 13(3) of the Federal Act, recently invoked by the Board of Governors, permits "in exigent circumstances" the Reserve Banks to discount (that is, lend against) securities without adherence to the regulations, applicable in regular times, that determine the eligibility of assets for discount.

2) *Do we have any idea what the operating cost of a BA program at the Fed might be?*

This is a new idea, and I have no cost estimates. Yet, consider the Federal Reserve's new program to purchase agency debt and mortgage-backed securities. The operation of that program has been outsourced to a private firm (the Federal Reserve has not publically

named the firm). Perhaps an acceptance program similarly could be outsourced. The essential element, that requires market experience, is valuing the assets and creating the acceptance contracts. Should a fixed price be charged for the acceptance guarantee? Or a variable price that is adjusted based on whether the contract pays on time? Answers to such issues are yet to be developed.

3) *What would be the ultimate cost, assuming widespread use?*

It is essential that we exercise care re the extent of what is being proposed. There are two separate issues floating around Washington. One issue is the Federal Reserve's actions to improve the functioning of credit markets, specifically, non-traditional monetary policy as defined above. Such transactions include short-term business finance (commercial paper), mortgage finance, home-improvement loans, student loans, small business loans, etc.—that is, most assets that are securitized. The usual purchasers of such loans are scared, unable to develop usable measures of future credit risk. Acceptances promise to re-start these markets, drawing private capital (now, aggressively seeking Treasury securities or federally insured bank deposits) back into private finance. The acceptance program proposed for the Federal Reserve would guarantee only good-quality assets, albeit ones that may be foreclosed from today's market due to heightened uncertainty regarding future risk.

A second issue is the banks themselves. Many hold large amounts of non-performing assets. Dealing with "toxic" legacy assets should be discussed as a separate issue, recently addressed by the Treasury's Financial Stability Plan.

The cost of the first (the Fed's actions to improve current credit-market functions) likely are modest. Appropriate fees will, at least in part, defray the costs of defaults on the underlying assets and perhaps also defray operating expenses. Yet, fees should not be so high as to discourage worthwhile participation since the purpose of the program is to re-start credit markets during a time of heightened uncertainty (setting fees very high tends to disproportionately attract poorer-quality borrowers who have no alternative, while also discouraging better-quality borrowers that are shut out of financial markets due to recent heightened uncertainty). One option, perhaps, is set a modestly high initial acceptance fee that is combined with an experience-linked rebate if actual defaults and losses are smaller than initially anticipated – rather like your auto insurance company sending a rebate. It must not be forgotten, however, that losses do occur when there is risk; taxpayers' money will be at risk. The public purpose in re-starting credit markets must be balanced against possible losses.

Costs of a widespread intervention in the banking industry that might include acceptance financing of "egacy" or "toxic" assets are difficult to predict with any precision. Guidance might come from the American RTC of 20 years ago, the Nordic countries experience circa 1992 (Anderson, 2009), and the Japanese experience of 2001-3.

4) *How quickly could an acceptance program begin? Would the financial crisis be over before the program starts?*

I suspect an acceptance program could be implemented relatively soon, especially if all or parts were out-sourced to knowledgeable banking organizations. The Federal Reserve and private-sector financial institutions have considerable experience valuing collateral—within the Federal Reserve, both the discount window and recently created special purpose vehicles are actively doing so. Further, the use of risk-based fees, as mentioned above, might speed implementation by easing the burden of precisely valuing heterogeneous assets.

5) *Could a bankers' acceptance program assist weak banking organizations, those holding large amounts of "toxic" or "legacy" assets that*

are reluctant to lend because of uncertainty whether they can obtain funds in the future?

It is important to separate the use of an acceptance program by the Federal Reserve to improve the functioning of credit markets from the use of an acceptance program to resolve the banking crisis.

The Treasury recently proposed a Financial Stability Program that includes a public-private partnership both to value and fund acquiring such assets. While the details have not been released, acceptance are an ideal instrument. Contingencies built into the acceptance contract assist in sharing risk between private investors and public guarantors, plus both the acceptance fees and the market price paid by private investors for the underlying contract have potential to be useful components of a private-public partnership. I am not aware that acceptances are being considered by the Treasury, however.

For "bad" assets, the Congress's creation of the RTC to handle the bad assets from savings and loans is a model that has been emulated worldwide. Although the RTC is best-known for closing many savings and loans, it also acted as a "bad bank" in some respects—it would, at times, remove "bad" assets from an institution's balance sheet, infuse cash, and auction the institution. In the process, equity holders suffered losses (as was appropriate) but taxpayer costs likely were minimized. Bad assets were transferred to and re-marketed by the RTC's workout division. Although, in principle, these assets could have been "packaged" into securities and the securities sold as acceptances, it is difficult to argue that the taxpayers' eventual losses would have been smaller.

6) *Could the Federal Reserve achieve the benefits of an acceptance program in a more familiar manner by use of reverse repurchase agreements, that is, matched sale-purchases? In such transactions, the Federal Reserve sells an asset to a private investor with an attached agreement to buy back the asset at a specified future price on a specific date. Isn't this simpler?*

One advantage of an acceptance is that the purchaser of the acceptance has a marketable money-market asset: the acceptance contract, which is payable on maturity to the holder. Typically, reverse repurchase agreements (RRPs) do not have such a feature—the commitment to repurchase the asset is with a specific investor. The investor in a RRP, essentially, has made a loan to the Federal Reserve—and the secondary market for loans may be thin. Also, it may be more difficult to write contingent contracts for RRPs than for acceptances, that is, contracts that specifically address the default risk. An acceptance, when the acceptance fee is set correctly and/or a contingent contract is used, provides a flexible mechanism for creating risk sharing between private and public-sector investors.

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