Box 1

Lending during a Credit Crisis

The Federal Reserve has three potential advantages over traditional banks when making loans during adverse liquidity conditions: access to a large amount of collateral, confidential information on banks' creditworthiness, and exposure to less liquidity risk.

First, the Fed holds a large pool of collateral in the form of banks' pledged assets at the discount window. Most of these assets—consisting mainly of bank loans—are difficult for banks to borrow against in private markets because of the absence of supporting market conventions and pricing services, making the collateral difficult to use as security for private loans.[a]

Second, the Federal Reserve systematically monitors banks' financial health as part of its normal supervisory duties.[b] The Fed is informed of the "CAMELS" rating of all depository institutions, even the ones for which it is not the primary supervisor.[c] By limiting term lending to banks with CAMELS ratings of 1 to 3—the highest credit quality and the fewest supervisory concerns—the Fed can be reasonably confident of a borrower's ability to repay.[d] In fact, recently issued CAMELS ratings have been shown to be a useful predictor of defaults.[e] Under normal conditions, the supervisory information obtained by the Federal Reserve may be a less reliable signal of a firm's financial health than the information possessed by the firm's private counterparties, since banks monitor one another when engaged in a lending relationship.[f] However, in crisis conditions, knowledge of a bank's supervisory rating may be more informative about basic creditworthiness than market insight because activity is typically reduced to very low levels and prices are often extremely volatile.

The Federal Reserve has a third potential advantage when lending during a crisis. In distressed funding markets, banks are reluctant to lend because they may not be aware of either their future liquidity needs or their future borrowing ability, given the unsettled conditions. These conditions have much less of an effect on the Fed, in part because it holds a portfolio of (very liquid) Treasury securities that can be sold or redeemed to fund loans and in part because it can expand its holdings of the securities. The central bank is therefore exposed to less liquidity risk.

---

[a] Using these assets to make collateralized loans shifts risk away from the loans and toward the bank's remaining uncollateralized creditors (or its residual claimants—including the Federal Deposit Insurance Corporation, a public sector entity); there is no overall reduction in risk. If it is moderately expensive to collateralize lending (owing to the need for legal services, supporting infrastructure to manage the collateral, and pricing services), then as a practical matter it might be more economical for private parties to lend on an unsecured basis.

[b] For information on the examination of federally supervised financial institutions, see Federal Financial Institutions Examinations Council (<http://www.ffiec.gov/>).

[c] CAMELS refers to the six assessed components of a bank's financial condition: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk; the sixth component was added in 1997. A bank's CAMELS rating is highly confidential and known only by its senior management and the appropriate supervisory staff. For foreign banking organizations, the Reserve Banks rely on SOSA (strength of support) ratings.

[d] Examiners assign a rating of 1 to 5 for each component of CAMELS, with 1 representing the highest rating, as well as a composite rating for the bank's overall condition and performance. Banks with composite CAMELS ratings of 1 or 2 are considered to present few supervisory concerns, while those with ratings of 3 or higher present moderate to extreme degrees of supervisory concern. The Federal Reserve lends to borrowers with a 1, 2, or 3 rating through the primary credit program of the discount window and to banks with a rating of 4 or 5 through the secondary credit program. The Fed also has a third window for seasonal borrowing—for example, by agricultural banks. When a bank borrows from the discount window, the Federal Reserve does not reveal whether it has borrowed as a primary or secondary credit.

[e] The largest financial institutions are monitored continuously by the Federal Reserve. For the smallest banks, a CAMELS score might be updated as infrequently as every eighteen months. The older a score the less reliable a predictor it is of a bank's likelihood of repayment. See Cole and Gunther (1998).

[f] Holmstrom and Tirole (1998) argue that the private provision of liquidity is preferable unless private market information becomes unreliable.