Box 2

Operation of TAF Auctions

The Federal Reserve has typically conducted Term Auction Facility (TAF) auctions of twenty-eight-day term funding. The interval between auctions has been biweekly, except for periods around holidays.

The TAF operates in a fashion similar to the discount window.[a] Depository institutions eligible for primary credit through the discount window—those determined to be in generally sound financial condition by their District Reserve Bank—can participate. Borrowing is fully collateralized; assets used as collateral are those eligible to be pledged at the discount window. The Federal Reserve uses standard discount window haircuts to value the collateral pledged.[b] In addition, the maximum TAF funding for which an institution can bid, including loans that would be outstanding concurrent with that auction's awards, cannot exceed 50 percent of available pledged collateral. Individual propositions per bidder at any auction are limited to a maximum of two. To promote a relatively large number of winning bids, the Fed limits the maximum auction award to any individual institution to 10 percent of the announced auction quantity. The minimum bid size was initially set at $10 million, but it was later reduced to $5 million to allow smaller institutions to participate. The TAF auction itself follows the single-price format used in Treasury auctions; the format is designed to encourage participation.

A typical TAF auction occurred on March 10, 2008. At 10 a.m. ET, the Federal Reserve announced bidding.[c] The announcement included information on when eligible banks could submit bids (11 a.m. to 1 p.m.), the amount of funds being auctioned ($50 billion), the minimum and maximum size of bids ($5 million and $5 billion—the latter representing 10 percent of the total amount), the minimum interest rate at which bids could be submitted (2.39 percent), the term of the loan (twenty-eight days), and other details. At 11 a.m., banks began submitting bids by telephone to their Reserve Bank.

On March 11 at 10 a.m., the Federal Reserve announced the results of the auction.[d] The interest rate on the loans allocated was determined to be 2.8 percent (41 basis points above the minimum bid rate), eighty-two banks had submitted bids, and the total amount of propositions was $92.6 billion, or 1.85 times the amount available at auction. Finally, the winning banks had funds credited to their accounts on March 13 and they repaid the loans on April 10.

[a] When the Federal Reserve lends to a bank through the discount window or through the TAF, it intends to *sterilize* the borrowing. In other words, it conducts open market operations to offset the injection of reserves that occurs when the loan is made. Banks in total will have the same amount of reserves in aggregate both before and after a TAF auction. However, after the auction, the financial sector typically will hold more government securities than before, and the Federal Reserve will hold more loans to banks on its balance sheet. Like the discount window, the TAF operates not by increasing the quantity of reserves held by banks, but by changing the composition of the Fed's asset holdings.

[b] A haircut is the percentage difference between the market value of the collateral and the amount that a lender can borrow. The margin is calculated as the haircut times the price of the collateral.

[c] See <http://www.federalreserve.gov/newsevents/press/monetary/20080310a.htm>.

[d] See <http://www.federalreserve.gov/newsevents/press/monetary/20080311b.htm>.