



Banking Regulation, Monetary Policy and the Role of the Central Bank

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During the financial crisis, the Federal Reserve and other government agencies took extraordinary actions to support the financial sector. Those actions were an appropriate response to unprecedented events, but vastly increased government's role in financial markets. Ten years post-crisis, however, the Federal Reserve's role in financial markets has not returned to its pre-crisis norm and only continues to grow.

The Fed's expanding role owes much to interactions between its regulatory and monetary policies. Several post-crisis regulations and examination mandates encourage banks to prefer the Fed (or other government entities) as counterparties rather than other banks or financial institutions, and more generally to retreat from financial market intermediation critical for monetary transmission. Meanwhile, the Fed has been conducting monetary policy with a massive balance sheet and an expanded set of counterparties—actions that not only respond to but also further encourage the regulatory-induced retreat from intermediation by the banking sector.

The central irony of the Federal Reserve's current path is that its regulations were designed to prevent banks from ever having to rely on any type of governmental support, because such support represented a risk to the taxpayer and a moral hazard; such support was defined to include not just capital injection but also traditional discount window lending. Instead, though, the taxpayer now supports—directly and daily—a massive, unprecedented, and growing Federal Reserve role in U.S. financial markets. Taxpayer funds are also paid directly to money funds and other non-banks through a reverse-repurchase facility that has become necessary for the Fed to effectuate monetary policy. Thus, rather than playing a supporting role in markets once in a generation, the Fed has become the star of the show.

RELEVANT COMPONENTS OF THE SUPERVISORY AND REGULATORY RESPONSE

Post-crisis banking regulation included first-ever liquidity requirements and significant increases in the quantity and quality of required capital. In the United States, those reforms included capital stress tests designed to ensure that banks could withstand severe financial crises and economic contractions to come.

While those regulations have many virtues, they have instilled in law a preference for banks to transact with the central bank or government-sponsored agencies rather than other banks or financial institutions. For example, the regulatory Liquidity Coverage Ratio (appropriately) treats government securities more favorably — that is, as more liquid — than private securities, and it treats (questionably) loans from government agencies as more reliable than loans from banks or other financial institutions.

Post-crisis capital requirements have also weakened the interconnectedness of money markets critical for the transmission of monetary policy to the real economy. The Basel III capital accord included a 3-percent leverage ratio requirement, which the Federal Reserve raised to 5 percent for the largest banks; the Fed also included post-stress leverage requirement in its annual stress tests. Leverage requirements create a disincentive for banks to invest in low-risk assets such as repo lending. Similarly, multiple components of the systemic risk score used to calculate the capital surcharge applied to Global Systemically Important Banks (GSIBs) increase when banks participate in the repo or FX-swap market, effectively overtaxing that activity from a capital standpoint; here again, the Fed effectively doubled the tax for U.S. banks compared to those subject to the Basel accord as drafted.

As noted, each of these rules has significant virtues, which are obvious and widely touted. Collectively, though, they come with costs that are subtle and have been under-studied, particularly as some of them come from a complex interrelationship with monetary policy.

Relevant components of the monetary policy response

As part of its response to the Great Recession, the Federal Reserve purchased longer-term government securities to put downward pressure on longer-term rates. By October 2014, the Federal Reserve had accumulated \$4.5 trillion in assets. The asset purchases were funded with a commensurate increase in deposits of banks at the Fed, a/k/a “reserves,” which rose from less than \$50 billion before the financial crisis to a peak of \$2.8 trillion. With banks oversupplied with reserves, the federal funds market—where banks short on reserves previously had gone to borrow for account management purposes—withered.

The superabundance of reserves necessitated a different approach to policy. In particular, rather than raising rates by reducing the supply of reserves, in 2015 the Fed began to raise the interest rate it paid banks on excess reserves, a/k/a the IOER rate. But to ensure that market rates would increase along with the IOER rate, the Fed also offered a standing reverse repurchase facility that paid nonbanks a certain return on overnight investments in the Fed. Essentially, rather than just paying interest on deposits from banks, the Fed also started paying interest on deposits from GSEs, broker-dealers, and money funds.

As a crude summary of the increased role of the Federal Reserve in the financial system, we calculated the sum of all assets and liabilities that were transactions between the Fed and a private institution or a foreign official institution (as opposed to Treasury or currency). At the eve of the crisis, in June 2007, the items added up to \$66 billion; in January 2020, they totaled \$2,188 billion.

MARKET INTERACTIONS

In January 2019, the FOMC decided to continue conducting monetary policy with an oversupply of reserves, in part because of an increase in the level and volatility in demand for them. That demand for reserves was significantly owed to the preference federal banking agencies had for banks to hold reserves over other types of liquid assets.

In September 2019, the repo market broke down because banks and broker-dealers did not step in to equilibrate a supply-demand imbalance caused by corporate tax payments and Treasury securities settlement. Banks were unwilling to use their reserve balances to lend into the repo market, in part because of a supervisor preference that banks hold reserves rather than Treasuries. Banks also were unwilling to raise funds to lend into the repo market for two reasons: leverage requirements and GSIB surcharges generally made the resulting balance sheet expansion too expensive, and banks were reluctant to upend their capital and liquidity allocations to respond to a temporary event.

The Fed responded to the breakdown by further expanding its balance sheet and actively considering creating a standing repo facility that would mirror its standing reverse repo facility. Reportedly, the standing facility might not just lend funds to commercial banks (which already borrow through the discount window) and primary dealers (which already participate in Fed open market operations) but also hedge funds and other participants in the FICC sponsored repo program. In short, the Fed stepped in to solve a problem caused by its increased role in financial markets by further expanding its role in those markets and by planning to increase its role in them still further.

MORE TO COME?

The volatility in repo markets in September 2019—and the massive Federal Reserve response—occurred in part because banks are disincentivized by regulation and supervision to exercise their core function: offering liquidity where it is needed. If the next dislocation happens when the economy is weak rather than strong, the turmoil could cascade into capital markets and the broader economy. If so, especially with the federal funds rate already near zero, the Federal Reserve would necessarily ramp up its balance sheet and intervene more aggressively in financial markets.

More immediately, there is a chance that the FOMC will indicate that it is officially targeting the repo rate rather than, or in addition to, the federal funds rate. If so, because the FOMC controls neither supply nor demand in the repo market (unlike the federal funds market), it will have to effect control by standing ready to lend or borrow into the market in unlimited quantities at fixed interest rates just above and below its target rate. If this were to happen, the Federal Reserve would become the “market maker of first resort” in the world’s most important financial market. Again, all of this is due to regulations designed to reduce the likelihood of the Fed supplying indirect liquidity support to banks, because that Fed role is seen as too much governmental involvement in finance.

BREAKING THE FEEDBACK LOOP

To some extent, the Federal Reserve appears to have heard these concerns. In response to the turmoil in September 2019, it is reportedly attempting to convince examiners to stop encouraging banks to favor reserves over Treasuries. The Fed has also proposed reducing the U.S. leverage ratio requirement toward international norms (see Fed proposal [here](#)) and raised the possibility of eliminating the leverage-ratio hurdle rates from stress tests (see Fed speech [here](#)).

Moreover, beginning in October 2017 the Fed had been shrinking its portfolio of government securities by reducing its reinvestments of principle. Reserve balances had declined from a high of \$2.8 trillion to about \$1.4 trillion in early September 2019. Market rates had risen from below the IOER rate to at or a bit above the rate, providing banks an incentive to economize on their holdings of reserve balances.

Unfortunately, the Fed reversed course following the September turmoil and as of mid-January 2020 had reinflated its portfolio by over \$400 billion. The jury is out as to whether the Fed will continue the gradual decline once having addressed the volatility in reserves that contributed to the turmoil.

In November 2018 the FOMC indicated that it would reconsider its decision to implement monetary policy using a large-balance sheet approach if it turns out the necessary balance sheet is much larger than it anticipated. While the precise level it anticipated is secret, available information suggests the FOMC then judged that \$1 trillion in reserves would be needed. The Fed's current estimate appears to be about \$1½ trillion.

We encourage the Fed to keep to its word, reconsider its decision, and decide to conduct policy in a manner similar to how it did before the crisis, with a level of excess reserves about one thousandth of its current level. It should combine that change in monetary policy with the changes in regulatory policy it is already considering, strengthening forces of arbitrage between money markets and therefore the monetary transmission mechanism.

Before the crisis the Fed implemented monetary policy by engaging in small and comparably unimportant repo transactions with primary dealers to adjust the size of its balance sheet. Given the tight linkages between financial markets, changes in the fed funds rate were well transmitted to other interest rates. As a result, the Fed once had a small footprint and good monetary control. In the current environment, the Fed's footprint is huge and growing and its monetary control questionable.

If the Fed continues on its current course, when the next crisis occurs, we worry that its independence will be at risk. The star of the show always takes the blame when the ratings are poor.

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