Two Important Fed Programs that Should Be Mutually Reinforcing Are in Conflict. Why?

Bill Nelson | Oct. 13, 2022

Introduction

The Federal Reserve both requires banks to be able to demonstrate that they can convert Treasuries and agency mortgage-backed securities that they hold for liquidity contingencies into cash and offers banks a new permanent standing repo facility (SRF) that functions to convert those same securities into cash. You'd think that these two programs would be fantastic complements. Banks could sign up for the SRF, making that facility more effective in accomplishing the Fed's objectives for it, and also making the banks even more reliably liquid. Banks, in turn, could point to that access as how they would monetize their portfolio of government securities in a liquidity stress event. Nevertheless, as far as we can determine, the Fed is not allowing any banks in their internal liquidity stress tests to point to the SRF as the way that they would monetize their assets. The result is especially impactful for smaller regional banks, many of which do not have regular access to the repo market, which is costly to establish and not needed for their normal business, and so would be particularly helped if they could point to the SRF as their access point. The SRF has become essentially a facility exclusively for primary dealers, U.S. GSIBs, and U.S. branches of foreign banks. Luckily, as explained below, the fix is easy.

Internal Liquidity Stress Tests

As part of the post-GFC reforms established by the Dodd-Frank Act, regional and larger banks are required to perform internal liquidity stress tests (ILSTs) periodically and report the result to their examiners. Banks with more than $250 billion in assets must conduct the tests once a month; those with more than $100 billion in assets report once a quarter. The tests are designed to evaluate the impact of a variety of stressful scenarios on a bank's liquidity, profitability, and solvency situations. The tests must include scenarios covering liquidity troubles at the bank and liquidity troubles in the market, and must be conducted at the overnight, 30-day, 90-day, and one-year horizons, along with any other planning horizon relevant to their liquidity profile.

As part of the ILSTs, banks must demonstrate that they can monetize the assets they are holding in their liquidity buffer in time to meet potential outflows. Specifically, the regulation states:

> (iv) Operational requirements. With respect to the liquidity buffer, the bank holding company must:
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> …(B) Demonstrate the capability to monetize a highly liquid asset under each scenario…

For example, a bank that holds a large book of agency mortgage-backed securities can only point to the securities as a source of liquidity at the overnight horizon if it can convert the securities to cash in one day. We understand that ILSTs are more binding for many banks than the more familiar, and transparent, standardized liquidity requirement, the liquidity coverage ratio (LCR). Notably, the LCR treats Treasury securities and reserve balances identically, and agency MBS as the second-most liquid type of asset.

Standing Repo Facility

In July 2021, the Federal Reserve opened a new lending facility, the Standing Repo Facility. Each day the SRF offers to conduct overnight repos against Treasury securities and agency MBS with primary dealers and commercial banks at a fixed rate, currently equal to the top of the FOMC's range for the federal funds rate. The operations are conducted on the tri-party repo platform, where primary dealers fund their positions, so SRF participants must have or get access to that platform. Because Treasuries and agency MBS are the securities in which the Federal Reserve Bank conducts open-market operations, the securities are often referred to as "OMO securities." As stated by Federal Reserve System Economists Andolfatto and Ihrig in April 2019:

> The motivation for establishing a standing repo facility is twofold:
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> - First, the facility could be used to support interest rate control by establishing a ceiling on repo rates, thereby guarding against unwanted spikes in money market rates. The use of a ceiling tool for this purpose would be seen as enhancing the monetary policy operating regime of the FOMC.
> - Second, the facility could be used to reduce the demand for reserves for any given rate of interest on excess reserves."

The SRF is intended to accomplish the first objective primarily by lending to primary dealers, who are automatically enrolled in the facility. By providing primary dealers confidence that they will be able to finance any of their own repos at a reasonable price at the SRF, the facility should encourage each dealer to provide funding into the repo market if repo rates spike again as they did in September 2019 as long as the dealer is not balance-sheet constrained.

The facility is intended to accomplish the second objective by providing banks comfort that if they need cash that day, they can get it by repoing their OMO securities; as a result, they do not need to hold such high levels of reserve balances. Note that the second objective can only be accomplished by changing the views of commercial banks, not primary dealers, because only commercial banks (and thrifts and credit unions) have accounts at the Fed and hence only commercial banks have reserve balances.

Complementarity

The two programs ought to be complementary. Smaller regional banks do not have ready access to repo markets and so cannot convert their Treasury securities or agency MBS into cash quickly enough for the securities to count toward the ILST at the overnight horizon, even though the securities are highly liquid and safe. For such banks, signing up for the SRF would provide them with a way to monetize the assets reliably.

For the SRF to encourage banks to hold OMO securities rather than reserve balances it needs to provide regional banks a useful service so that they will sign up. Some regional banks do not have business models that require normal access to repo market funding, so the SRF serves no purpose for them apart from contingency planning. Indeed, to use the SRF the banks need to gain access to the tri-party repo platform, which is costly.

Thus, it would seem to be in the spirit of both programs to encourage regional banks to sign up for the SRF and plan on using the facility to monetize their OMO securities in their ILSTs. Moreover, it would help each program accomplish its objective. By signing up for the SRF, regional banks would improve their liquidity situation, furthering the objective of the ILSTs. By allowing banks to count SRF access as the method by which regional banks would monetize their assets in their ILSTs, participating in the SRF would expand, and examiner endorsement of the SRF would help reduce any stigma associated with the facility. Broader participation in the SRF would also help avoid strains on the U.S. Treasury market that would occur if banks simultaneously sought to monetize their Treasuries by selling them.

Conflict

Nevertheless, our understanding is that banks have not been allowed to point to the SRF as their means to monetize their holdings of Treasury securities and agency MBS in their ILSTs. In part reflecting this significant reduction in the usefulness of the facility for regional banks, no regional banks have signed up. Only 14 banks have signed up, all are GSIBs or U.S. branches of large foreign banks.

What can explain this counterintuitive policy? The Fed has made no official announcement about the SRF and ILSTs, so it is necessary to guess. In 2013, Jeremy Stein, when he was on the Federal Reserve Board, gave a thoughtful speech on why liquidity regulations should not allow banks to assume use of central bank credit, arguing instead that the banks should self-insure against liquidity risk. It is worth quoting from his speech at length, because he conveys a fairly widely held view in regulatory circles:

> It follows that if one is going to make an argument in favor of adding preventative liquidity regulation such as the LCR on top of capital regulation, a central premise must be that the use of [Lender of Last Resort] capacity in a crisis scenario is socially costly, so that it is an explicit objective of policy to economize on its use in such circumstances. I think this premise is a sensible one. A key point in this regard--and one that has been reinforced by the experience of the past several years--is that the line between illiquidity and insolvency is far blurrier in real life than it is sometimes assumed to be in theory. Indeed, one might argue that a bank or broker-dealer that experiences a liquidity crunch must have some probability of having solvency problems as well; otherwise, it is hard to see why it could not attract short-term funding from the private market.
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> This reasoning implies that when the central bank acts as an LOLR in a crisis, it necessarily takes on some amount of credit risk. And if it experiences losses, these losses ultimately fall on the shoulders of taxpayers. Moreover, the use of an LOLR to support banks when they get into trouble can lead to moral hazard problems, in the sense that banks may be less prudent ex ante. If it were not for these costs of using LOLR capacity, the problem would be trivial, and there would be no need for liquidity regulation: Assuming a well-functioning capital-regulation regime, the central bank could always avert all fire sales and bank failures ex post, simply by acting as an LOLR.

Consistent with Stein's reasoning, for the Fed's policy to make sense, there must be some social cost associated with allowing banks to make use of the SRF, so ILSTs should be designed to minimize use. It is unclear, however, what that social cost could be. Use of the SRF by a regional bank that does not have normal access to the repo market does not indicate its counterparties in the repo market have concerns about its solvency; the bank doesn't normally borrow in the repo market, so it is not the case that its access has dried up. Moreover, there is no scenario in which the Federal Reserve is taking on credit risk when providing overnight repo funding against Treasury securities or agency MBS as long as the Fed is applying an appropriate haircut.

In fact, the moral hazard cost could be greater if the Fed ended up having to buy the Treasury securities or agency MBS in a situation where the markets for the securities were overwhelmed, such as happened in March and April 2020. If the Fed provides overnight repo financing against the securities, it is taking on neither credit nor interest rate risk. But if the Fed purchases the securities, there is a substantial transfer of interest rate risk from the financial market participant to the Federal Reserve, as illustrated by the extraordinary losses the Federal Reserve has incurred on its portfolio of securities this year (Levin, Lu and Nelson, 2022). As a result, the potential moral hazard consequences from asset purchases may be greater than for overnight repos against OMO collateral.

Indeed, if a bank signs up for the SRF and uses the SRF to monetize its Treasuries and agency MBS, it is not clear what liquidity risk the bank is supposed to self-insure against. Without the SRF, agency MBS and even Treasuries entail some liquidity risk for a regional bank without regular access to the repo market because it could take a few days to convert the assets into cash. But if the bank signs up for the SRF, it can convert the Treasuries or MBS into cash immediately, so the securities have no liquidity risk.

Synthesis

The Federal Reserve can further both its monetary policy and bank safety and soundness objectives, and strengthen the resilience of Treasury markets, by allowing banks to assume in their ILSTs that they will make use of the SRF if they have arranged access. Doing so will encourage more regional banks to sign up for the SRF and make the facility better able to encourage banks to reduce their holdings of reserve balances, which, in turn, will allow the Federal Reserve System to get smaller. The FOMC has consistently said that it intends to implement monetary policy at minimum efficient size. For instance, in a speech on March 8, 2019, Chair Powell stated:

> "The Committee has long said that the size of the balance sheet will be considered normalized when the balance sheet is once again at the smallest level consistent with conducting monetary policy efficiently and effectively. Just how large that will be is uncertain, because we do not yet have a clear sense of the normal level of demand for our liabilities".

Moreover, amid increasing signs of illiquidity in Treasury markets, as QT continues, the effective functioning of the SRF becomes ever more important as a way to avoid another episode of repo market volatility like September 2019 or Treasury market disfunction like March 2020. For the SRF to accomplish that objective, primary dealers and GSIBs need to be willing to use the facility and that requires the facility to be essentially stigma free. A public message from the Fed that it sees use of the SRF as a normal business decision, not an indication of liquidity stress will help minimize any stigma associated with the facility. The Bank of England, for example, has also created a new repo facility (the "Short-term Repo Facility or "STR") as part of its QT plan and stated:

> "The Bank intends that the STR should be used freely from the point of introduction, as a way for counterparties to access reserves as necessary. The [Prudential Regulation Authority] would judge use of the STR as routine participation in sterling money markets and intends that it should be seen as such by bank boards and overseas regulators".

The Fed should make a nearly identical announcement. And if using the SRF is a normal business decision, it would be counterintuitive if a bank could not plan on using the facility as part of its liquidity contingency planning.

Indeed, encouraging more regional banks to sign up for the SRF would further enhance the liquidity of the banking system. For example, when the Fed revamped the discount window in 2003, creating the primary credit program, it issued an supervisory letter, SR 03-15 that states "By enhancing the availability of discount window credit, the new primary credit program offers depository institutions an additional tool for managing short-term liquidity risks." The Fed should issue a similar SR letter now about the SRF and its use in contingency planning and internal liquidity stress tests.

At present the SRF appears to be a facility intended only for primary dealers, GSIB, and U.S. branches of foreign banks. The Fed is missing an opportunity to strengthen further the liquidity profile of regional banks while simultaneously enhancing the ability of the SRF to accomplish its objectives of supporting Treasury market and repo market functioning and reducing banks' demand for reserve balances. In other words, it's a win-win.

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