Proposal: 1652 (7100-AF40) Reg D - Reserve Requirements of Depository Institutions

Description:

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From: American Enterprise Institute, Paul Kupiec

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Comments:

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Proposal:Regulation D: Reserve Requirements of Depository Institutions [R-1652]
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Your comment: Public comment on proposal Federal Reserve System Proposal: Regulation D: Reserve Requirements of Depository Institutions Docket Number R-1652; RIN 7100-AF-40 Attention: Ms. Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System Thank you for the opportunity to comment on this Federal Reserve announcement of proposed rulemaking. Small, seemingly innocuous changes in law can have enormous unanticipated impacts years later. History shows that this is especially true when the law concerns congressional powers granted to the Federal Reserve System. For example, a few short sentences in an uncontroversial law passed by Congress in 2006 has unintentionally (without public debate or any explicit congressional authorization) given rise to massive changes in the way the Federal Reserve conducts monetary policy. The Financial Services Regulatory Relief Act of 2006, among other things, gave the Federal Reserve the authority to pay interest on bank reserve balances and power to write rules that govern the exercise of this authority. At the time the law was passed, this new authority was presented to Congress as a "technical adjustment" of little practical consequence. And yet this new power, passed by Congress on "voice vote" without objection, has been used to orchestrate massive changes in way the Federal Reserve conducts monetary policy--changes that were never explicitly discussed with or authorized by Congress. And now the Federal Reserve Board of Governors seeks to further stretch the interpretation of the poorly drafted Financial Services Regulatory Relief Act to discriminate against legally-chartered banking institutions that seek to utilize Federal Reserve banking services that are routinely provided to all member and non-member banks. Historically, the Federal Reserve requirement for banks to hold non-remunerated reserve balances has been criticized as an implicit "tax" on banks--a tax that disadvantaged banks relative to competing financial services institutions like money market mutual funds, institutions that are not required to hold reserves. As a practical matter, by 2006, the burden of an "unfair" bank required reserve tax had largely been minimized. The Fed had abolished reserve requirements on most types of savings account products and lowered the rate on remaining accounts that still required reserves. Moreover, banks devised ways to reduce required reserves further by sweeping customer balances intraday between accounts that required reserves and accounts with no reserve requirement. By 2006, the bank reserve tax was, in practice, no longer a significant drag on

bank profits as required reserves were mostly satisfied by the "vault cash" held by banks. Still, the intent behind Congress's grant of authority to the Federal Reserve Board to pay interest on bank reserves was intended to remove the "unfair" reserve tax and thereby reduce the incentive for banks to expend resources to artificially lower the required reserves they held at the Fed. It was never the intent of Congress that the Fed would use its power to pay interest on bank reserves to create a riskless interest-earning asset with an interest rate rich enough to attract a significant share of the banking system's assets, nor was it the intent of Congress to allow the Fed to discriminate among banks by paying different banks different interest rates on their respective reserve balances. The Federal Reserve Board's grant of authority to pay interest on bank reserves was not scheduled to take effect until 2011, but with the onset of the financial crisis, Congress accelerated implementation and allowed the Fed to begin paying interest in the fall of 2008. The push to accelerate the Fed's authority was triggered by the Fed's aggressive asset purchases which ballooned bank excess reserve balances during a period of severe dysfunction in the federal funds market. While the congressional intent behind the authority to pay interest on reserves granted in the 2006 act was to provide banks with interest remuneration on their required reserves, by late December 2008, the Fed had ceased to make any distinction between required reserves and excess reserves and began paying banks the same rate on all reserve balances at the so-called IOER rate, a rate set by the Board of Governors of the Federal Reserve System. Notice I said the IOER rate is set by Federal Reserve Board and not the Federal Open Market Committee (FOMC). While the FOMC is the body that has official authority over Federal Reserve monetary policy, the 2006 act places the authority over setting the interest rate on reserve balances with the Federal Reserve Board, not the FOMC. While this may seem like an unimportant detail, it actually could create significant issues at a future date. Interest on excess bank reserves is the primary tool the Federal Reserve uses to implement monetary policy. Conflicts could arise, for example, should an administration pack the Federal Reserve Board with governors that hold monetary policy views different from those of the FOMC. The Federal Reserve Board could vote to implement a monetary policy that deviates from the policy specified by the full FOMC. At a minimum, the power granted in the 2006 legislation further centralizes central bank power in the politically appointed Board of Governors in Washington DC, and diminishes the influence of the non-political (in theory at least) reserve bank presidents from the 12 Federal Reserve districts. For many technical reasons, paying interest on bank reserves did not accomplish what the Fed had set out to accomplish (to put a floor on the federal funds rate) and so the Fed had to introduce additional policy tools to enable it to hit its federal funds rate target. But whether or not paying interest on bank reserves allows the Fed to hit its federal funds rate target is of minor consequence compared to the changes that paying interest on bank reserves has had on the monetary policy transmission mechanism. When the Fed started paying interest on reserves, the percentage of banking system deposits held in reserve balances at the Fed jumped from under 7 percent of banking system deposits to more than 16 percent of bank deposits. The increase in bank reserve holdings came at the expense of fewer bank loans. Before the crisis, more than 93 percent of bank deposits were used to fund bank loans. After the Fed began paying interest on reserves, the loan-to-deposit ratio fell to less than 70 percent, as banks choose to hold reserves at the Fed and earn the generous IOER interest rate instead of using deposits to fund consumer and business loans. Another unanticipated consequence of paying interest on bank reserves is that new specialized start-up banks have sought to join "club Fed" so they too can earn the generous IOER rate. Among these start-ups are new state-charted limited purpose banks. Approved to operate a simple business model where they collect large uninsured deposits from money market mutual funds and similar institutions, these banks plan to invest their deposits exclusively in a Fed master account and earn the IOER rate. Because their costs will be low, the new institutions can keep a small spread and pass most of the IOER onto mutual fund shareholders. These institutions will create a new source of competition for consumer and business deposits that will help to boost the meager interest rates businesses and consumers earn on their bank savings and transactions balances. On average, banks have passed very little of their IOER earnings on to their business and retail depositors. After more than 10 years of earning near zero interest earnings on their bank deposits, my guess is that most consumers and businesses would welcome the higher rates generated by additional competition for their deposits. But the Fed, not so much. The Fed's proposed changes to Regulation D would allow it to pay different banks different interest rates on their reserves--including a rate of zero to institutions of the Fed's choosing. Under its proposal, the Fed chooses which banks qualify for a high rate, which quality for a low rate, and which earn nothing. The Fed's proposed rule conflicts with the congressional intent behind the 2006 grant of authority and with legal precedents that require the Fed to provide banks equal access to Fed services. If enacted, these proposed rule changes give the Fed a new dangerous power--the power to use interest on reserves to choose bank winners and losers, including blocking new bank entrants the Fed deems "undesirable". In 2006, when Congress gave the Federal Reserve Board authority to pay banks interest on reserves, it never imagined the Fed would use that authority to pay Fed-favored banks higher interest rates on their reserves--but in this ANPR, this is exactly what the Fed is proposing to do. The Federal Reserve's argument that these new institutions, so-called PTIEs, could make its job of controlling interest rates more difficult by ruining liquidity in the Federal funds and repo markets is disingenuous. The Fed itself impaired these markets when it started paying IOER on all bank reserve balances. The data show that the share of bank deposits allocated to Federal funds and repo market activity declined by more than 50 percent following the introduction of the IOER. Besides, today the Fed sets interest rates by fixing the IOER rate. The Federal funds rate is no longer as informative of conditions in money markets as it was pre-crisis. The Fed's argument that PTIEs could create systemic risk is also dubious. These institutions are super safe without any regulation. Their only investments are deposits in a reserve account at the Fed. But the Fed argues, should something lead depositors to question the safety of the regulated banking system, depositors might run banks and move their saving to these new institutions. The Feds solution of paying PTIE's a lower or zero interest rate as a form of "systemic risk insurance" is a perverse policy solution. It is unconscionable that the Federal Reserve would propose preventing businesses and consumers from earning fairer rates of interest on their deposits at these new institutions in order to prevent bank runs the next time consumers panic because Federal bank regulators failed to anticipate a brewing financial crisis. If the Fed truly was concerned about the entrance of PTIEs, it could prevent them from forming by using existing Regulation D rules without a need to discriminate among banks by paying different interest rates. If the Federal Reserve Board only paid interest on bank required reserves--as Congress had originally intended--and it reverted to paying zero interest on banks' excess reserves, PTIE's would no longer be economically viable. But such a change would require the Fed to shrink its balance sheet, restart a fully functioning federal funds market, and return to using open market operations to control the scarcity of bank excess reserve balances. For today at least, the Fed has decided against returning to the pre-crisis approach for implementing monetary policy. It has instead chosen to continue to set interest rates by paying banks above-market interest rates on their excess reserve balances. It should be no surprise that above market interest rates on bank excess reserves will attract innovation and new entrants. This Federal Reserve ANPR on proposed changes to Regulation D highlight significant weaknesses in the 2006 legislative language authorizing the Board of Governors of the Federal Reserve to pay interest on bank reserves. Congress should convene hearings to discuss the implications of the enormous changes in Federal Reserve monetary policy operations that have been enabled under the existing congressional grant of authority to pay interest on bank reserves and to review prudent limitations that should be enacted in new legislation to limit the Fed's Regulation D powers and rule-making authority. Sincerely, Paul H. Kupiec Resident Scholar, The American Enterprise Institute 1789 Massachusetts Ave NW, Washington DC, 20036