FEDERAL RESERVE SYSTEM

12 CFR Part 204

Docket No. R- 1652; RIN 7100-AF-40

Regulation D: Reserve Requirements of Depository Institutions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is requesting comment on whether it should propose amendments to its Regulation D (Reserve Requirements of Depository Institutions, to lower the rate of interest paid on excess balances ("IOER") maintained at Federal Reserve Banks (Reserve Banks) by eligible institutions that hold a very large proportion of their assets in the form of balances at Reserve Banks.

DATES: Comments must be received no later than **[INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: You may submit comments, identified by Docket Number R-1652; RIN 7100-AF-40, by any of the following methods:

- Agency Web site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.

- E-mail: regs.comments@federalreserve.gov. Include the docket number and RIN in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments are available from the Board's website at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons or to remove personally identifiable information at the commenter's request. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room 146, 1709 New York Avenue, NW, Washington, DC 20006, between 9:00 a.m. and 5:00 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Sophia H. Allison, Senior Special Counsel, (202-452-3565), or Gavin Smith, Senior Counsel, (202-452-3474), Legal Division, or Marnie Gillis DeBoer, Associate Director (202-452-3139), or Mary-Frances Styczynski, Senior Financial Analyst (202-452-3303), Division of Monetary Affairs; for users of Telecommunications Device for the Deaf (TDD) only, contact

202-263-4869; Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

I. Statutory and Regulatory Background

Section 19 of the Federal Reserve Act ("Act") provides that Reserve Banks may pay interest on balances maintained by or on behalf of certain institutions in an account at a Reserve Bank at a rate or rates not to exceed the general level of short-term interest rates ("IOR" authority). Institutions that are eligible to receive interest on their balances held at Reserve Banks ("eligible institutions") include "depository institutions" and certain other institutions.[1] This authority to pay interest does not extend to all balances maintained at Reserve Banks, such as balances of the Federal Home Loan Banks and of certain other non-depository institutions.[2] There is no requirement in the statute that interest be paid to any eligible institution, nor is there any requirement that the same interest rate or rates be paid to all eligible institutions or on all balances of eligible institutions.

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[1] *See* 12 U.S.C. 461(b)(1)(A) & (b)(12)(C); *see also* 12 CFR 204.2(y) (definition of "eligible institution").

[2] 12 U.S.C. 1435 (Federal Home Loan Banks); *see, e.g.*, 12 U.S.C. 1452(d) (Freddie Mac), 22 U.S.C. 285d (Asian Development Bank).

Section 19 of the Act also provides that the Board may prescribe regulations concerning the payment of interest on balances at a Reserve Bank.[3] The Board first authorized IOR in an October 2008 interim final rule amending its Regulation D.[4] Specifically, section 204.10 of Regulation D specifies the types of balances on which interest may be paid, the interest rates applicable to those balances, and the method for calculating interest. Reserve Banks may pay interest on balances that are maintained to satisfy an institution's reserve balance requirement (sometimes called "required reserve balances"), and also may pay interest on balances that are in excess of required reserves (excess reserves). Section 204.10 specifies an "IORR" (interest on required reserve balances) rate and an IOER (interest on excess reserves) rate. Regulation D currently provides that the IORR rate is 2.40 percent and that the IOER rate is 2.40 percent.[5]

II. Discussion

A. Recent Developments in Chartering Activity

Some financial firms recently have sought to establish special state charters for depository institutions with narrowly focused business models

[3] See 12 U.S.C. 461(b)(12).

[4] Regulation D Interim Final Rule, 73 Fed. Reg. 59482 (Oct. 9, 2008).

[5] See 12 CFR 204.10(b)(5) (setting forth IORR and IOER rates).

that involve taking deposits from institutional investors and investing all or substantially all of the proceeds in balances at Reserve Banks. These narrowly focused depository institutions would not be subject to federal prudential regulation and would not be subject to the same set of capital and other prudential requirements as other federally regulated banks.

As explained in greater detail below, these narrowly focused depository institutions (Pass-Through Investment Entities or PTIEs) could theoretically attract a very large quantity of deposits from institutional investors by paying a rate that is nearly identical to the IOER rate. In effect, these PTIEs would pass through the interest obtained at the IOER rate from a Reserve Bank to their depositors, less a small spread.

The Board has not yet determined whether any or all PTIEs would meet the definition of "eligible institution" in Regulation D.[6] Assuming a PTIE were determined to be an "eligible institution," and assuming that a Reserve Bank were to exercise its discretion to grant that PTIE a master account, the PTIE could earn interest on balances that it maintains at a Reserve Bank.[7] Under the current provisions of Regulation D, this would

[6] 12 CFR 204.2(y) (definition of "eligible institution").

[7] Section 13 of the Federal Reserve Act, 12 U.S.C. 342. All subsequent references to "eligible institutions" in this advance notice of proposed rulemaking assume that such institutions have been granted master accounts at the discretion of a Reserve Bank.

enable PTIEs to earn interest on their balances at a Reserve Bank at the IORR and IOER rate, yet at the same time avoid the costs borne by other eligible institutions, such as the costs of capital requirements and the other elements of federal regulation and supervision, because of the limited scope of their product offerings and asset types.

Avoiding regulatory costs borne by other eligible institutions and unconstrained by meaningful capital requirements, PTIEs could effectively extend the IOER rate to their depositors that are not themselves "eligible institutions," and would be able to do so on a potentially very large scale. A proliferation of similar PTIEs could magnify these effects across the financial system.

The Board is concerned that PTIEs, by maintaining all or substantially all of their assets in the form of balances at Reserve Banks and having the ability to attract very large quantities of deposits at a near-IOER rate, have the potential to complicate the implementation of monetary policy.[8] In addition, the Board is concerned that PTIEs could disrupt financial

[8] Depository institution balances at Reserve Banks as a share of assets varies widely across individual depository institutions, reflecting differences in their business needs for liquidity and differences in overall asset-liability management strategies. However, in aggregate, reserve balances currently amount to roughly 10 percent of the assets of depository institutions and very few depository institutions maintain reserve balances that exceed 50 percent of their assets.

intermediation in ways that are hard to anticipate, and could also have a negative effect on financial stability, as described in greater detail below.

B. Monetary Policy Implementation

Although the Board is concerned that PTIEs could complicate the implementation of monetary policy, some market participants have argued that the presence of PTIEs could help the implementation of monetary policy. Under this view, the presence of PTIEs, by essentially expanding the counterparties to which IOER is paid, could strengthen IOER as a tool for managing the level of short-term interest rates. Specifically, under this view, the activities of PTIEs could narrow the spread between short-term rates and the IOER rate, potentially strengthening the ability of the Federal Reserve to manage the level of short-term interest rates.

The Board believes that monetary policy implementation has been very successful in maintaining the federal funds rate within the target range established by the Federal Open Market Committee (FOMC). The movements of other short-term money market interest rates have also tracked closely the changes in the target range for the federal funds rate. Accordingly, the potential benefits of PTIEs in enhancing monetary policy implementation appear to be quite modest. Moreover, the Board believes that PTIEs could present significant challenges for monetary policy implementation along a number of lines, as described below.

The viability of the PTIE business model relies on the IOER rate being slightly above the level of certain other key overnight money market rates. Under these circumstances, as outlined above, PTIEs could potentially attract a large quantity of deposits and maintain very large balances at Reserve Banks. The ability of PTIEs to attract a very large amount of deposits at a rate above other key overnight money market rates could affect the FOMC's plans to reduce its balance sheet to the smallest level consistent with efficient and effective implementation of monetary policy. Specifically, if deposits at PTIEs were to become an especially attractive asset for cash investors, the demand for reserve balances by PTIEs could become quite large. In order to maintain the desired stance of monetary policy, the Federal Reserve would likely need to accommodate this demand by expanding its balance sheet and the supply of reserves.

Depending on the constellation of interest rates, PTIEs could be an attractive investment for lenders in short-term funding markets such as the federal funds market. If the current lenders in the federal funds market shifted much of their overnight investment to deposits at PTIEs, the federal funds rate could become volatile. Such a development could require the

FOMC to change its policy target on relatively short notice. Moreover, a marked change in the volatility of the federal funds rate could have spillover effects in many other markets that are linked to the federal funds rate such as federal funds futures, overnight index swaps, and floating-rate bank loans.

More generally, a large-scale migration of institutional cash investors to deposits at PTIEs and away from other depository institutions, money market mutual funds, or repo markets could result in smaller trading volumes across a range of unsecured and secured overnight money markets. If this shift were large enough, or if cash shifted into or out of PTIEs rapidly, the reference rates derived from reported transactions in those markets, such as the overnight bank funding rate (OBFR), could also become volatile. This volatility could make it difficult for the Federal Reserve to control short-term rates more broadly as a means of implementing monetary policy.

C. Financial intermediation

The Board is also concerned that the presence of PTIEs could have unpredictable effects on financial intermediation broadly, potentially reshaping the financial industry in various ways that could raise the costs of private financial intermediation.

Deposits at PTIEs, as noted above, could become attractive investments for many lenders in overnight funding markets. Lenders in the overnight general collateral ("GC") repo market could find PTIE deposits more attractive than continued activity in the overnight GC repo market. If the rise of PTIEs were to reduce demand for GC repo lending, securities dealers could find it more costly to finance their inventories of Treasury securities. Such a development could impair the liquidity of the repo market, making it harder for banks to monetize Treasury securities in times of stress and raising the overall cost of Treasury borrowing. A decline in the robustness of the repo market could also have implications for the success of the decision of the Alternative Reference Rates Committee to base LIBOR's replacement on the U.S. Treasury repo market.[9]

PTIEs could also diminish the availability of funding for commercial banks generally. To the extent that deposits at PTIEs are seen as a more attractive investment for cash investors that currently hold bank deposits, these investors could shift some of their investments from deposits issued by banks to deposits with PTIEs. This shift in investment, in turn, could raise bank funding costs and ultimately raise the cost of credit provided by banks to households and businesses.

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[9] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Sept-20-2018-FAQ

Some have argued that the presence of PTIEs could play an important role in raising deposit rates offered by banks to their retail depositors. The potential for rates offered by PTIEs to have a meaningful impact on retail deposit rates, however, seems very low. To the extent that the deposits of PTIEs would be marketed largely to institutional investors, it seems very unlikely that the expansion of PTIEs would result in meaningfully higher rates on retail deposit accounts. Such retail deposit accounts have long paid rates of interest far below those offered on money market investments, reflecting factors such as bank costs in managing such retail accounts and the willingness of retail customers to forgo some interest on deposits for the perceived convenience or safety of maintaining balances at a bank rather than in a money market investment. Accordingly, the Board believes that PTIEs would play a limited, or no, role in raising overall retail deposit interest rates.

D. Financial stability

The Board also is concerned about the uncertainty that PTIEs may present for financial stability. Some have argued that deposits at PTIEs could improve financial stability because deposits at PTIEs, which would be viewed as virtually free of credit and liquidity risk, would help satisfy investors' demand for safe money-like instruments. According to this line of argument, the growth of PTIEs could reduce the creation of private money-like assets that have proven to be highly vulnerable to runs and to pose serious risks to financial stability. Some might also argue that PTIE deposits could reduce the systemic footprint of large banks by reducing the relative attractiveness to cash investors of deposits placed at these large banks.

The Board believes, however, that the emergence of PTIEs likely would have negative financial stability effects on net. Deposits at PTIEs could significantly reduce financial stability by providing a nearly unlimited supply of very attractive safe-haven assets during periods of financial market stress. PTIE deposits could be seen as more attractive than Treasury bills, because they would provide instantaneous liquidity, could be available in very large quantities, and would earn interest at an administered rate that would not necessarily fall as demand surges. As a result, in times of stress, investors that would otherwise provide short-term funding to nonfinancial firms, financial institutions, and state and local governments could rapidly withdraw that funding from those borrowers and instead deposit those funds at PTIEs. The sudden withdrawal of funding from these borrowers could greatly amplify systemic stress.

E. Congressional Intent Considerations

When Congress amended the Act to authorize Reserve Banks to pay interest on balances of depository institutions, it specifically restricted the receipt of such interest to a limited class of institutions. The Board is concerned that paying IOER to PTIEs would effectively amount to paying IOER to entities (for example, institutional investors that in many instances are not authorized to maintain balances at Reserve Banks) that Congress did not intend to receive it.[10] As such, the payment of IOER in such cases could be viewed as inconsistent with the intent of Congress in providing the Federal Reserve with the authority to pay interest on balances maintained by the institutions specified in the Act.

III. Request for comment

A. General Proposals

As discussed above, the Board recognizes that there are both potential benefits and potential costs associated with the presence of PTIEs in the U.S. financial system. The Board believes that the potential negative impact of PTIEs on monetary policy implementation, financial intermediation, and

[10] The extension of IOER to non-eligible entities could be spread to numerous non-eligible entities through a PTIE, or it could be extended to one non-eligible entity if, for example, a PTIE were established by a single large domestic or foreign financial or commercial firm for its own cash management purposes.

financial stability would outweigh the potential benefits if the Reserve Banks paid IOER to PTIEs.

In response to these concerns, the Board is requesting comment on whether it should amend Regulation D to provide for a lower IOER rate for PTIEs.[11] PTIEs could be identified as any eligible institution that holds a very large share of its assets in the form of balances at a Reserve Bank. Alternatively, PTIEs could be identified as any eligible institution that holds a very low level of capital relative to its assets. A PTIE also could be defined more narrowly as an eligible institution that (i) has a very high reserves/assets ratio or very low capital/assets ratio; and (ii) is not subject to supervision by a federal banking agency (e.g., the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the National Credit Union Administration). In all of these alternatives, the Board expects that it would define PTIE such that the vast majority of existing eligible institutions would continue to be paid the current IOER rate on all of their excess balances.

In terms of a lower IOER rate, Reserve Banks could pay a rate of zero on all the excess balances of such institutions. Alternatively, Reserve Banks

[11] Central banks in other countries, for example New Zealand and Norway, have found it necessary to limit the amount of central bank balances that individual institutions may maintain for various reasons related to the implementation of monetary policy.

could pay such institutions IOER up to a certain level of balances held at a Reserve Bank (as a percentage of the institution's total assets or total capital) and a lower or zero rate on balances above this level.

The Board seeks comment on all aspects of this advance notice of proposed rulemaking, including the potential public policy costs and benefits of PTIEs discussed in the previous section, the general regulatory proposals to change the IOER framework in this section, and the more specific questions presented below.

B. Specific Questions

In addition to the foregoing, the Board is also seeking comment on the following questions:

1. Has the Board identified all of the relevant public policy concerns associated with PTIEs? Are there additional public policy concerns that the Board should consider?
2. Are there public policy benefits of PTIEs that could outweigh identified concerns?
3. If the Board were to determine to pay a lower IOER rate to PTIEs, how should the Board define those eligible institutions to which a lower IOER rate should be paid?

4. If the Board were to determine to pay a lower IOER rate to PTIEs, what approach should the Board adopt for setting the lower rate?
5. Are there any other limitations that could be applied to PTIEs that might increase the likelihood that such institutions could benefit the public while mitigating the public policy concerns outlined above?

By order of the Board of Governors of the Federal Reserve System, March 6, 2019.

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Margaret McCloskey Shanks,
Deputy Secretary of the Board.