BankThink

Place a growth limit on the Fed's reverse-repo facility

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A growth limit on the Federal Reserve's reverse-repo facility would remove the destabilizing fear that a run into it — and away from banks — is a possibility, writes James McAndrews.

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Bank depositors are questioning the safety of their deposits following the sudden failures of Silicon Valley Bank, First Republic Bank and others. Those doubts have accelerated withdrawals of deposits from banks. However, bank deposits have been shrinking for the last year. It is usual for bank deposits to be withdrawn whenever the Fed raises interest rates. When the Fed raises rates, banks pay depositors far less than what they can earn at money market mutual funds and in similar investments, causing deposits to exit the banking system. It is a feature, not a bug, of the Fed's raising rates and has been characterized as "the deposits channel of monetary policy."

Is 2023 any different? In addition to the increased worry about bank safety, something else is different in 2023. The Fed built a new monetary policy tool: the overnight reverse-repurchase agreement facility (reverse-repo facility). That facility, begun in 2014, allows select money market mutual funds, broker-dealers and government-sponsored agencies to place funds directly with the Fed overnight and, in exchange, to receive Treasury securities as collateral. It pays a rate of interest equal to a tenth of a percent below the rate that Federal Reserve Banks pay commercial banks on their reserve balances.

Currently, this rate is 5.05 percent, far above the 0.06 percent rate the average depositor earns on interest checking accounts, according to Federal Deposit Insurance Corp. data for April 18, 2023. Not surprisingly, this facility has been quite popular. Balances rose from about $1 trillion in mid-2021 to more than $2 trillion in mid-2022. As of May 4, about $2.26 trillion was invested in reverse-repo facility balances.

One might suspect that the program is too much of a good thing. That is, its fixed-rate yield and safety features might have the potential to accelerate withdrawals from banks from a steady pace to a run into the Fed. To be clear, that destabilizing scenario has not occurred. The recent surge into money market mutual funds was invested primarily in government and government-guaranteed securities, and only a small share was invested in the reverse-repo facility.

Moreover, it is important to recognize that the reverse-repo facility works to stabilize the financial system. First, it supports the Federal Open Market Committee's interest rate objective by putting a floor on overnight interest rates. Second, it relieves constraints on bank lending capacity associated with required leverage ratios. When the Fed expands the amount of reserve balances, by purchasing securities or reducing the size of the reverse-repurchase facility, banks' assets tend to rise, which can push banks' leverage ratios down toward their required minimums, reducing lending. Finally, it has likely reduced the severity of the runs we have seen. By paying rates close to market rates, it has attracted more of the flighty erstwhile depositors from banks into money market mutual funds during the earlier period of financial calm, precluding runs that might otherwise have occurred during the more recent financial storm.

Crucially, though, the fear of a run into the reverse-repo facility is itself a risk. Depositors could run in anticipation that a sudden massive shift of other depositors from banks into the Fed could expose them to losses. That the Fed offers — to select private firms — a fixed-rate elastic investment into which depositors might flee creates uncertainty that weakens depositors' confidence in banks. This is crucial during the current period of bank failures and the federal debt ceiling uncertainty. As a result, at present the reverse-repo facility confounds the Fed's efforts to bolster the safety of the banking system.

Luckily, there is a straightforward fix to this conundrum regarding the potential for runs into the Fed, one that was reviewed in a 2015 paper by Federal Reserve staff: Cap the size of the facility. The Fed did impose a per-participant cap of $160 billion. In aggregate, though, those caps are ineffective; even with the per-participant caps, a destabilizing inflow into the reverse-repo facility remains a possibility. The paper went further and examined a second option, a growth limit.

A growth limit on the reverse-repo facility would remove the destabilizing fear that a run into it is a possibility. Part of a central bank's job is to remove, where possible, extreme financial risks from society. In that way it seeks to guide economic expectations into coherent and mutually supportive plans. A growth limit would allow participants to increase their investments in the reverse-repo facility, supporting financial stability and monetary policy as intended, while disallowing outsize jumps in investments into it that could be destabilizing now. The bank that I founded, TNB USA Inc., committed to just such a policy in 2021 in response to concerns expressed by the Federal Reserve about the possibility of destabilizing runs into TNB. The Federal Reserve should move to end this possibility for its reverse-repo facility now; to implement the policy after such a risk were to be manifested would be far too late.

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