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Rodney Garratt
Antoine Martin
James McAndrews
Ed Nosal

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Abstract

This paper describes segregated balance accounts (SBAs), a concept for a new type of account that could provide increased competition for deposits, reduce system-wide balance sheet costs, and improve the transmission of monetary policy by facilitating greater pass-through of interest on excess reserves (IOER). SBAs are designed to remove credit risk by creating narrow accounts that could allow any bank to compete for money market funds. Because of increased competition, the rates paid on borrowings secured by SBAs, along with other money market rates, would likely be pushed up closer to the IOER rate and would be more tightly linked to that rate. SBAs could promote a more efficient allocation of reserves within the banking sector by shifting reserves from banks with high balance sheet costs to banks with low balance sheet costs. SBAs would not require setting an additional administered rate; IOER would be paid on the balances held in an SBA and the rate paid on the loan secured by the balances in the SBA would be competitively determined. We discuss a number of potential risks that SBAs could pose as well as further steps that would be required before SBAs could be implemented.

Key words: central bank, interest rate

Garratt, Martin, McAndrews: Federal Reserve Bank of New York (e-mail: rodney.garratt@ny.frb.org, antoine.martin@ny.frb.org, jamie.mcandrews@ny.frb.org). Nosal: Federal Reserve Bank of Chicago (e-mail: ed.nosal@chi.frb.org). The authors thank colleagues at the Federal Reserve Bank of New York and the Federal Reserve Bank of Chicago, and the staff of the Board of Governors of the Federal Reserve System. The views expressed in this paper are those of the authors and do not necessarily reflect the position of the Federal Reserve Banks of New York or Chicago or the Federal Reserve System.

1 Introduction

This paper introduces the concept for a new monetary policy tool, segregated balance accounts (SBAs), that could improve competition in money markets and strengthen the floor on overnight interest rates created by the payment of interest on excess reserves (IOER). In what follows, we explain how SBAs work, their advantages and potential risks.

SBAs are accounts that a bank or depository institution (DI) could establish at its Federal Reserve Bank using funds borrowed from a lender.¹ What distinguishes an SBA from the bank’s Master Account at its Federal Reserve Bank is that the funds deposited in an SBA would be fully segregated from the other assets of the bank and, in particular, from the bank’s Master Account. In addition, only the lender of the funds could initiate a transfer out of an SBA. Consequently, the borrowing bank could not use the reserves that fund an SBA for any purpose other than paying back the lender. Because of these (and other) conditions, the loan made by the lender to the bank would be collateralized by the reserve balances in the SBA account. The bank receives the IOER rate for all balances held in an SBA. The interest rate that the bank pays the lender of the funds deposited in an SBA would be negotiated between the bank and the lender.²

Since funds deposited in SBAs are set aside as collateral and cannot be used by the account holder—which is a DI—for its own purposes, the funds would be available to the lender in the event that the account holder goes bankrupt, subject to a stay that would be imposed by the Federal Deposit Insurance Act (FDI Act).³ Thus, SBAs could provide banks with a vehicle to borrow funds that is almost free of credit risk.⁴ The near elimination of credit risk, which is the hallmark of SBAs, would level

¹While SBA accounts could in principle be used in any jurisdiction, we focus on their potential application in the U.S. context. Appendix A provides a detailed description of the mechanics of SBAs as applied in this context. For purposes of this paper, a DI that establishes SBAs is assumed to be insured by the Federal Deposit Insurance Corporation (FDIC).

²SBA accounts are very similar to the notion of “Deposited Currency” proposed in Tobin (1985, Section IV). He also refers to the notion of segregated funds in Section V.

³Under the FDI Act, and subject to certain exceptions that are not applicable here, creditors of a DI that is in FDIC receivership are prohibited from exercising their right or power to terminate, accelerate, or declare a default under any contract with the DI, or to obtain possession or control of any property of the DI, without the consent of the receiver during the 90-day period beginning on the date of the appointment of the receiver. For purposes of this paper, it is assumed that the FDIC would act quickly to permit lenders to gain access to SBAs that collateralize their loans. However, this treatment has not been approved by the FDIC, and the decision by the FDIC on treatment of an SBA account in resolution could affect the willingness of firms to participate in these accounts. There are a number of other legal and regulatory issues that would have to be resolved to make SBAs a viable tool.

⁴Since the IOER paid on SBAs by the Federal Reserve would likely be deposited in the bank’s Master Account, the bank’s interest payment obligation on funds borrowed through SBAs would be subject to credit risk, but not the principal of the loan. For that reason, we consider SBAs as being almost free of credit risk.

the playing field so that all banks could borrow in the overnight money market on equal footing. This would increase competition in the market for unsecured funds, and bank deposits in general, and would lower the current discount that large banks apply to funds borrowed in the federal funds market. Our analysis suggests that SBAs could result in a more favorable distribution of reserves across the banking system, which would reduce aggregate balance sheet costs. As we discuss below, competitive frictions in overnight money markets and banks' balance sheet costs are the two key impediments to arbitrage that prevent the IOER rate from being fully passed on to the non-bank sector and, thus, from forming a floor for overnight rates. SBAs could facilitate a more complete pass through of the IOER rate to the non-bank sector and, as a result, overnight unsecured money market rates would be closer to or even above the IOER rate.

The problem of the imperfect pass through of the IOER rate to other overnight rates can be addressed by other policy tools. The Federal Reserve has used a daily overnight reverse repo (ON RRP) operation and, most recently, a term reverse repo (term RRP) operation to address this problem.⁵ Experience to date suggests that RRP operations have been effective in helping to eliminate low-rate transactions in many overnight money markets. SBAs and ON RRP operations could be complementary tools to help firm the floor on money market rates. Nevertheless, there are important differences between the two approaches. SBAs would almost completely eliminate the credit risk that prevents lenders from interacting with some borrowers and, hence, directly address the issue of competitive frictions. ON RRP operations, on the other hand, affect the competitive frictions in the deposit market only indirectly, by improving the bargaining power of some lenders, as the central bank enters the market as a potential borrower.

As is the case with any policy tool, there are a number of uncertainties and concerns surrounding usage of SBAs. One concern is that SBA take-up could be too large. During normal (non-stress) times, market rates will adjust to determine an equilibrium level for SBA balances. However, in times of intense stress, which may be characterized by a flight to quality, flows into SBAs could produce a scarcity of reserves that banks use to meet reserve requirements and could also cause (temporary) dislocations in funding markets for nonbank entities. The scarcity of reserves, however, would trigger an increase in the federal funds rate. As a result, the spread between the federal funds rate and the competitively determined SBA rate—which is tightly linked to the fixed IOER rate through competitive forces—would increase and would help arrest the surge.⁶ In addition, the negotiated terms of SBAs could specify upper limits on balances and, hence, the size of the surge in SBAs would be

⁵The term RRP has used at quarter-end dates since December 31 2014 to address distortions in the overnight market caused by banks' desire to reduce balance sheet space allocated to short-term borrowing on those dates.

⁶The mechanism is similar to what we observed during a flight into Treasury securities during the crisis. Their yields were depressed, thus reducing the incentives to buy them.

limited by the amount of capacity banks had in existing SBAs.

SBAs do not have the same moral hazard problems that are associated with deposit insurance because banks cannot use or access the funds in SBAs. The protection afforded funds in SBAs could not be transferred to other bank operations and, as a result, would not induce excessive risk taking by banks. SBAs can be interpreted as narrow bank accounts that deliver the main advantages associated with narrow banks with few, if any, of the disadvantages.

Our discussion of how SBAs could be used to help control money market rates fits broadly into the existing literature on monetary policy implementation, IOER, and reserves. The literature on monetary policy implementation began with Poole (1968). More recently, the Poole model has been used to think about monetary policy implementation with IOER and a large supply of reserves. Ennis and Keister (2008) provide a general framework for understanding monetary policy implementation with IOER. They show that IOER can help implement a floor on market rates and allows the Federal Reserve to manage interest rates when markets are competitive. Bech and Klee (2011) analyze the federal funds market in the presence of excess reserves in a noncompetitive environment. They argue that since government-sponsored enterprises (GSEs) do not have access to IOER, they have lower bargaining power and trade at rates lower than IOER, thus resulting in the observed IOER-federal funds effective rate spread. Martin, McAndrews, Palida, and Skeie (2014) develop a general equilibrium model to study how the Federal Reserve can use its tools to manage short-term interest rates and the large level of reserves on its balance sheet. That model extends Martin, McAndrews, and Skeie (2013) and considers how different monetary policy tools, such as a term deposit facility (TDF) and RRP, can help control interest rates in the face of balance sheet costs. Clouse, Ihrig, Klee and Chen (2014) study a similar question in a “preferred habitat” model. Kashyap and Stein (2012) show that, with both IOER and reserve quantity control, the central bank can simultaneously maintain price stability and address externalities resulting from excessive bank short-term debt issuance. Our model has a similar market structure to Bech and Klee (2011). We have bank to bank and GSE to bank market interactions, but the assumptions on how actors interact within these markets are different. In our model, the former market is competitive while the latter is noncompetitive.

2 IOER and Alternative Policy Tools

The Federal Reserve responded to the 2007-09 financial crisis and its aftermath with a variety of monetary policy measures that dramatically increased the supply of reserves. Compared to the past, this contributed to a substantially lower federal funds rate, as well as other overnight money market interest rates. In October 2008, the Federal Reserve began paying IOER to banks. It was expected that the IOER rate would create a floor for overnight (unsecured) rates since banks would not be willing to lend at a rate below IOER. This did not happen and overnight rates remained

significantly below the IOER rate. One reason for this outcome might be that many money market lenders do not have direct access to IOER. However, absent frictions, banks would be expected to compete for funds and bid up rates until those rates become very close to the IOER rate.

Balance sheet costs and imperfect competition are potential frictions that have been suggested to explain the large spread between money market rates and the IOER rate. The friction we emphasize in this paper is that the set of bank counterparties which key lenders are comfortable lending to is too small to absorb their funds. In particular, money market lenders are concerned about the default of their counterparties.⁷ Since lenders restrict the number of borrowing counterparties they are willing to deal with, and because balance sheet considerations prevent institutions they do trust from engaging in unlimited IOER arbitrage, borrowers end-up having some bargaining power. Consequently, borrowers are able to impose low borrowing rates on the lenders while earning the IOER rate on the reserves associated with the amount they borrow.

In June of 2011, the FOMC announced the creation of two new tools—term RRP and a TDF—aimed at managing short-term market interest rates and keeping them close to the IOER rate. These tools could provide support for overnight rates by draining reserves from the balance sheets of banks. However, to be effective the amount of reserves drained from the banking system would need to be rather significant.

In August 2013, the FOMC announced that an overnight ON RRP facility could be used as another potential tool. The ON RRP facility addresses the competitive frictions that limit the pass through of the IOER rate to other overnight market rates by allowing a set of non-banks to lend directly to the Federal Reserve at a fixed rate on an overnight basis.⁸ The ON RRP facility has been effective in creating a soft floor for money market interest rates. That said, if the spread between the IOER rate and the ON RRP rate is kept wide, then the spread between many overnight market rates and the IOER rate will remain wide.

SBAs could complement the set of tools already available and help make these tools more effective.

3 Federal Funds Market

To understand the channels through which SBAs could improve the pass through of the IOER rate to other overnight rates, we focus our discussion and analysis on a particular overnight rate, the federal funds rate. Nevertheless, many of our results

⁷Money market lenders may also be concerned about the willingness or ability of their counterparties to borrow on a consistent basis. Since monitoring borrowers is costly, lenders are likely to only undertake such costs if they expect to be able to lend on a regular basis.

⁸Strictly speaking, the ON RRP is an auction and the resulting interest rate from the auction could be lower than the offering rate if the quantity of bids exceeded the ON RRP cap. In practice, the cap did bind only once, on a quarter-end date, and is generally not expected to bind.

can be interpreted broadly and apply to money markets more generally. The federal funds market is a market for (typically) overnight loans between banks and other institutions, such as GSEs, that maintain reserves at the Federal Reserve.

One can think of the federal funds market as consisting of two sub-markets: an interbank market, in which DIs trade with one another, and an IOER arbitrage market, in which GSEs lend to DIs. Following the naming convention of Bech and Klee (2011), we refer to the first market as b2b and the second market as g2b. Because the g2b market consists of non-banks—that are ineligible for IOER—lending to banks overnight, it can be thought of more generally as a market for large overnight deposits.

Participants in the b2b market are DIs that have reserve requirements and earn IOER. Participants in the g2b market are the DIs (or a subset of them) and GSEs. Since the biggest current lenders in the federal funds market are Federal Home Loan Banks (FHLBs), we model lending behavior in the g2b market after FHLBs.⁹ FHLBs are not subject to reserve requirements and do not earn IOER on their deposits at the Federal Reserve. The demand for reserves by DIs stems from their need to meet reserve requirements and their ability to earn IOER on any excess reserves they acquire. Although FHLBs do not have reserve requirements, they do need to maintain a non-negative balance at the Federal Reserve for business purposes. FHLBs can also lend to the ON RRP facility (up to their counterparty cap).

The supply of total reserves—reserves held by DIs and GSEs—is determined by the size of the Federal Reserve’s balance sheet. However, not all reserves are necessarily available in the b2b market. Reserves that lenders in the g2b market hold on to (i.e., do not lend to DIs) are not part of the supply of reserves in the b2b market.

In the model, the g2b market meets first. Each lender in the g2b market lends to a select group of banks that it is able to monitor and this market is noncompetitive, (details are provided below). The outcome of trade in the g2b market determines the aggregate supply of bank reserves in the b2b market. That is, the amount of reserves that lenders lend to DIs in the g2b market becomes part of the DIs’ aggregate reserve holdings, and this determines the relevant aggregate supply of reserves for the b2b market.

The federal funds rate is a weighted average of rates negotiated in the g2b market and the b2b market. Currently, most federal funds trades occur in the former market.¹⁰

3.1 The b2b Market

We adapt the simple model of the market for reserves found in Ennis and Keister (2008) to understand interest rate determination in the b2b market. In the model,

⁹More broadly, they could represent any set of large money market lenders, noting that these other money market lenders do not have Federal Reserve accounts and, therefore, do not have access to IOER.

¹⁰See Afonso, Entz and LeSueur (2013).

the Federal Reserve determines the supply of reserves by undertaking open market operations. If the Federal Reserve purchases assets on the open market, then the supply of reserves will increase; if they sell assets from their portfolio, then reserves will decrease. Banks are required to hold reserves and this generates the demand for reserves. Banks with too many reserves supply them in the federal funds market and banks with too few demand them in the federal funds market.

We start by considering n “creditworthy” banks. The real world counterparts of these creditworthy banks are those (large) banks that have the ability to raise large deposits in the unsecured fed funds (or Eurodollar) markets.¹¹ As in Ennis and Keister we will assume all of the creditworthy banks are identical and hence we will present the analysis in terms of a typical or representative bank. The reserve requirement for a bank is denoted by RR and it can borrow and lend reserves in the b2b market at the rate, r_{b2b} . After the b2b market winds down, a bank receives a payments shock, ε , that can either increase or decrease its reserve holdings. Suppose, for simplicity, that a bank’s payment shock is distributed uniformly over the interval $[-P, P]$ and that $RR > P$.¹² If a bank’s reserve holdings are below the required amount after the payment shock, then it must borrow reserves from the Federal Reserve’s discount window at the primary credit rate, r_{PCR} , to make up the difference.

Reserves deposited at the Federal Reserve receive an interest payment of r_{IOER} per dollar. Holding reserves, however, can be costly. A bank face various costs when, for example, an increase in the supply of reserves leads it to expand or modify the composition of its balance sheets. The costs associated with expanding a bank’s balance sheet may include an FDIC assessment fee, as well as the cost of raising additional capital. Indeed, a bank may need additional capital if the size of its balance sheet increases, but it does not want to increase its leverage ratio.¹³ While the cost of the FDIC assessment fee appears to be approximately linear, the cost of capital is likely to be increasing in the amount of capital being raised. As an alternative to adding capital when the size of its balance sheet increases, a bank that wants to keep its leverage ratio constant could modify the composition of its balance sheet by replacing other assets with reserves. The cost of this adjustment is likely to be increasing with the amount of reserves since the composition of the bank’s

¹¹Later, when we introduce SBAs, there will be a role for m less creditworthy banks. Less credit worthy banks are those that are unable to borrow in the unsecured money market.

¹²Relaxing the uniformity assumption changes the shape of the demand curve we will discuss below in ways outlined in the working paper version Ennis and Keister, but does not change the qualitative implications of the analysis.

¹³While actions that increase bank reserves do not necessarily increase bank assets, as banks could take compensating actions, such as reducing their holdings of other assets, evidence from LSAPs conducted through 2012:Q3, suggests that, first, assets purchased by the Federal Reserve were ultimately sourced primarily from non-banks, such as households (including hedge funds), broker-dealers, and insurance companies, and thereby, all else equal, increased bank reserves and total bank assets immediately after each purchase. Second, commercial bank assets remained elevated after LSAPs; in other words, banks did not reduce their holdings of other assets as bank reserves were increased via LSAPs. See Carpenter *et al.* (2013).

balance sheet will move further away from its desired composition.¹⁴ It is reasonable to assume that this cost does not kick in until reserve levels are high. We will assume for convenience that they kick in precisely at the reserve level $R = RR + P$. If we assume that the linear cost coefficient is $a > 0$ and the convex cost coefficient is $b/2 > 0$, then the balance sheet costs for an individual bank with reserve holdings R are given by

$$\begin{aligned} aR & \text{ if } R < RR + P \\ aR + \frac{b(R-RR-P)^2}{2} & \text{ if } R \geq RR + P \end{aligned} .$$

A federal funds loan is an unsecured loan to a DI. Consequently, when considering the costs and benefits of such a loan, the lender should account for the possibility that the borrower will default.

We now describe the typical bank's demand for reserves. For convenience we define it relative to the demand curve in a world with no balance sheet costs and no credit risk, as described in Ennis and Keister (2008). The demand curve for this benchmark case is shown in Figure 1. In the absence of balance sheet costs or credit risk and for any given level of reserves, R , there is a unique market interest rate $r(R)$ such that for $r_{b2b} > r(R)$ the bank would strictly prefer to lend some of its reserves in the b2b market and for $r_{b2b} < r(R)$ the bank would strictly prefer to borrow additional reserves in the b2b market. There are three distinct cases to consider: (i) When $R \in [0, RR - P]$, the bank has to borrow reserves from the Federal Reserve after its payment shock with probability one. In this situation, the bank prefers to lend reserves when $r_{b2b} > r_{PCR}$ and borrow reserves when $r_{b2b} < r_{PCR}$. When $r_{b2b} = r_{PCR}$, the bank is indifferent between borrowing and lending. Therefore, the demand curve is perfectly elastic at the rate r_{PCR} when $R \in [0, RR - P]$. (ii) When $R \in (RR - P, RR + P)$, the bank has a precautionary demand for reserves. A bank may find it advantageous to borrow in the b2b market to avoid having to borrow from the Federal Reserve at the penalty rate. A bank borrows from the Federal Reserve whenever $R + \varepsilon < RR$. Since the payment shock is uniformly distributed on $[-P, P]$, we have that

$$\Pr[R + \varepsilon < RR] = \Pr[\varepsilon < RR - R] = \frac{RR - R + P}{2P}.$$

The market *b2b* rate for which a bank is willing to hold onto a given level of reserves is determined by an indifference condition that equates the expected net cost associated with having to borrow at the discount window,

$$\frac{RR - R + P}{2P}(r_{PCR} - r_{IOER}),$$

with the (net) gain associated with lending in the federal funds market, $r_{b2b} - r_{IOER}$.

¹⁴This type of effect is discussed in the preferred habitat model outlined in Clouse *et al.* (2014).

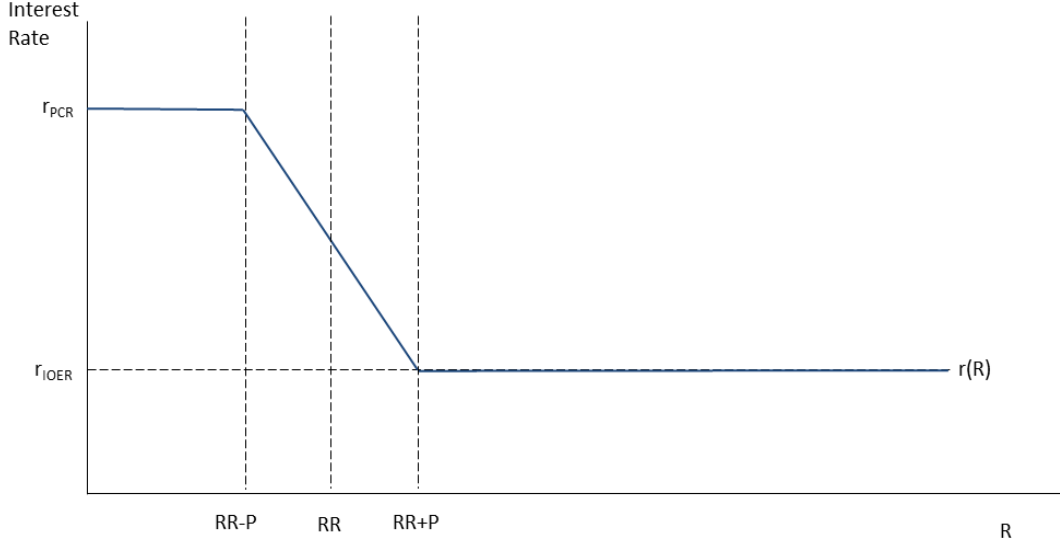


Figure 1: Individual Bank's Demand for Reserves: No balance sheet costs or credit risk

Hence, when $R \in [RR - P, RR + P]$, the demand curve is given by

$$r(R) = \frac{RR - R + P}{2P}(r_{PCR} - r_{IOER}) + r_{IOER}.$$

(iii) Finally, when $R > RR + P$, the bank prefers to lend reserves when $r_{b2b} > r_{IOER}$, demands an infinite amount of reserves when $r_{b2b} < r_{IOER}$ and is indifferent between borrowing and lending when $r_{b2b} = r_{IOER}$. The demand curve is perfectly elastic at rate r_{IOER} when $R > RR + P$. Hence, the bank's demand curve for reserves is

$$r(R) = \begin{cases} \in [r_{PCR}, \infty) & \text{if } R = 0 \\ r_{PCR} & \text{if } 0 \leq R \leq RR - P \\ \frac{RR - R + P}{2P}(r_{PCR} - r_{IOER}) + r_{IOER} & \text{if } RR - P \leq R \leq RR + P \\ r_{IOER} & \text{if } R \geq RR + P \end{cases} \quad (1)$$

We now introduce balance sheet costs and credit risk into the analysis. First, notice that, *borrowing* additional reserves will increase the size of the bank's balance sheet and, hence, balance sheet costs if the bank's post-payments shock reserve holdings exceed required reserves. Second, if initial reserve holdings are less than $RR + P$, then *lending* reserves may increase balance sheet costs because there exist payments shocks that would require the bank to obtain a discount window loan from the Federal Reserve. In particular, a discount window loan would be required for sure when $R \in [0, RR - P)$ and may be required when $R \in [RR - P, RR + P]$. Third, a lender

needs to be compensated for credit risk; obviously a borrower does not. All of this implies that lenders and borrowers face different balance sheet costs and credit risk concerns and, as a result, the interest rate at which a bank would be willing to lend a unit of reserves is different from the interest rate at which it would be willing to borrow an additional unit. Therefore, when credit risk and balance sheet costs are introduced, the demand “curve” for a bank is a correspondence. As we show below, the upper bound of the correspondence is determined by a lending bank’s indifference condition and the lower bound is determined by a borrowing bank’s indifference condition.

We start with the lending bank’s upper bound, $r^U(R)$, and describe it relative to the “no cost/no credit risk” demand curve $r(R)$, where $r^U(R) = r(R) + c(R)$ and $c(R)$ can be thought of as the additional (marginal) compensation that is required to make a loan. In words, the upper bound $r^U(R)$ is the lowest interest rate at which a bank does not strictly prefer to lend. There are a number of cases to consider and we start with the easier cases. When $R \in [0, RR + P)$, the lending bank does not face any additional balance sheet costs. In this situation, the upper bound exceeds $r(R) = r_{IOER}$ by a constant mark-up c , where c represents the additional compensation required for credit risk. Suppose that the borrowing bank defaults on a b2b loan with probability q . Then, compensation c is given by the solution to $r_{IOER} = (1 - q)(r_{IOER} + c) - q$ (i.e., if the bank does not extend a dollar loan it receives r_{IOER} and if it does it receives $r_{IOER} + c$ with probability $1 - q$ and loses a dollar with probability q) or

$$c = \frac{q(1 + r_{IOER})}{1 - q},$$

which implies that

$$r^U(R) = r(R) + \frac{a + q(1 + r_{IOER})}{1 - q}.$$

When $R \in [0, RR - P)$, a bank will, with probability one, borrow from the Federal Reserve after its payment shock. If a bank chooses to lend a unit of reserves in the b2b market, it will have to borrow it back at the discount window at the Federal Reserve at rate r_{PCR} and will, in addition, incur a balance sheet cost equal to a .¹⁵ In this case, the upper bound exceeds $r(R) = r_{PCR}$ by the constant mark-up c' , where c' equates the expected marginal cost of the loan (giving up r_{IOER} and having to borrowing from the Federal Reserve) with the expected benefit, i.e., c' solves $(a + r_{PCR} - r_{IOER}) + r_{IOER} = (1 - q)(r_{PCR} + c') - q$ or

$$c' = \frac{a + q(1 + r_{PCR})}{1 - q},$$

¹⁵Lending itself does not change the size of the balance sheet of a bank since the reduction in reserves is replaced with a new asset, the loan. But here the bank has to borrow from the discount window to replace the reserves that were lent out and this increases the balance sheet.

which implies that

$$r^U(R) = r(R) + \frac{a + q(1 + r_{PCR})}{1 - q}.$$

When $R \in [RR - P, RR + P]$, a bank will, with positive probability, have to borrow from the Federal Reserve following its payments shock. Similar to above, the mark-up over $r(R)$, which we denote by $c''(R)$, equates the expected marginal cost of the loan with the expected marginal benefit, i.e.,

$$\frac{RR - R + P}{2P} [r_{PCR} + a - r_{IOER}] + r_{IOER} = (1 - q)[r(R) + c''(R)] - q, \quad (2)$$

Since, from (1),

$$r(R) = \frac{RR - R + P}{2P} (r_{PCR} - r_{IOER}) + r_{IOER} \quad (3)$$

when $R \in [RR - P, RR + P]$, plugging (3) into (2), we get

$$(1 - q)(r(R) + c''(R)) - q = r(R) + \frac{RR - R + P}{2P} a,$$

and thus

$$c''(R) = \frac{\frac{RR - R + P}{2P} a + q(1 + r(R))}{1 - q},$$

which implies that

$$r^U(R) = r(R) + \frac{\frac{RR - R + P}{2P} a + q(1 + r(R))}{1 - q}.$$

We now examine the borrowing bank's lower bound of the demand correspondence, $r^L(R)$, which represents the highest rate at which a bank would not strictly prefer to borrow. Credit risk plays no role in defining this lower bound. When $R \in [0, RR - P)$, the bank, with probability one, borrows from the Federal Reserve following the payments shock. Since the bank incurs the same increase in balance sheet costs, a , whether it borrows a dollar on the b2b market or from the Federal Reserve, the highest borrowing rate in the b2b market, $r^L(R)$, is equal to the Federal Reserve's lending rate, r_{PCR} . When $R > RR + P$, the bank never has a need to borrow from the Federal Reserve following a payments shock in order to meet its required reserve obligations. Balance sheet costs will increase for certain but the actual marginal increase will depend on both the level of reserves, R , and the size of the payments shock, ε . Suppose that $R \in (RR + P, RR + 2P)$. In this region, the bank will incur the linear cost, a , for certain and the convex cost (associated with the parameter b) with positive probability less than one. The expected increase in marginal balance sheet costs associated with borrowing a dollar is

$$\begin{aligned} & a + \int_{RR - R + P}^P b(R + \varepsilon - RR - P) \frac{1}{2P} d\varepsilon \\ &= a + \frac{b}{4P} (R - RR)^2. \end{aligned}$$

Since $r(R) = r_{IOER}$ in this region, we have that

$$r^L(R) = r_{IOER} - [a + \frac{b}{4P}(R - RR)^2].$$

If $R \in (RR + 2P, \infty)$, then the bank incurs the convex cost for sure. The increase in marginal balance sheet costs is given by

$$a + \int_{-P}^P b(R + \varepsilon - RR - P) \frac{1}{2P} d\varepsilon = a + b(R - RR - P),$$

and we have that

$$r^L(R) = r_{IOER} - [a + b(R - RR - P)].$$

Finally, when $R \in (RR - P, RR + P)$, the expected benefit of borrowing is associated with the lower borrowing costs that are available in the b2b market compared to borrowing at the Federal Reserve. In this situation, the expected marginal benefit associated with borrowing is

$$\frac{RR - R + P}{2P} [r_{PCR} - r_{b2b}].$$

As above, the expected cost of borrowing depends on the level of bank reserves, R , and the magnitude of the payments shock, ε . There are two cases to consider. Suppose first that $R \in (RR, RR + P)$. If $\varepsilon > RR - R$, then a dollar loan will incur a balance sheet cost of a and an opportunity cost for the loan equal to $r_{b2b} - r_{IOER}$. As well, if $\varepsilon > RR - R + P$, then the dollar loan incurs an additional balance sheet cost equal to $b(R + \varepsilon - RR - P)$. Hence, when $R \in (RR, RR + P)$, the expected cost of a dollar loan in the b2b market is

$$\begin{aligned} & (1 - \frac{RR - R + P}{2P})(a + r_{b2b} - r_{IOER}) + \int_{RR - R + P}^P b(R + \varepsilon - RR - P) \frac{1}{2P} d\varepsilon \\ = & (1 - \frac{RR - R + P}{2P})(a + r_{b2b} - r_{IOER}) + \frac{b}{4P}(R - RR)^2. \end{aligned}$$

The interest rate that equates the marginal benefit and the marginal cost is

$$r^L(R) = \frac{RR - R + P}{2P} r_{PCR} + (1 - \frac{RR - R + P}{2P})(r_{IOER} - a) - \frac{b}{4P}(R - RR)^2,$$

which can be rewritten as

$$r^L(R) = r(R) - (1 - \frac{RR - R + P}{2P})a - \frac{b}{4P}(R - RR)^2.$$

Now suppose that $R \in (RR - P, RR)$. In this case the payments shock always leaves the bank with reserves that are less than $RR + P$ which implies that the bank avoids

the convex part of the balance sheet costs function. Therefore, the expected margin cost associated with a dollar loan is simply

$$\left(1 - \frac{RR - R + P}{2P}\right)(a + r - r_{IOER}).$$

The interest rate that equates marginal benefit and marginal cost is

$$r^L(R) = \frac{RR - R + P}{2P}r_{PCR} + \left(1 - \frac{RR - R + P}{2P}\right)(r_{IOER} - a),$$

which can be rewritten as

$$r^L(R) = r(R) - \left(1 - \frac{RR - R + P}{2P}\right)a$$

Combining the above functions, the demand correspondence of a typical credit-worthy bank can be expressed in terms of the non cost/no credit risk demand curve,

$$r^U(R) = r(R) + \begin{cases} \in \left[\frac{a+q(1+r_{PCR})}{1-q}, \infty\right) & \text{if } R = 0 \\ \frac{a+q(1+r_{PCR})}{1-q} & \text{if } 0 < R < RR - P \\ \frac{\frac{RR-R+P}{2P}a+q[1+r(R)]}{1-q} & \text{if } RR - P \leq R < RR + P \\ \frac{q(1+r_{IOER})}{1-q} & \text{if } R \geq RR + P \end{cases}$$

$$r^L(R) = r(R) + \begin{cases} \in [0, \infty) & \text{if } R = 0 \\ 0 & \text{if } 0 < R < RR - P \\ -\left(1 - \frac{RR-R+P}{2P}\right)a & \text{if } RR - P \leq R < RR \\ -\left(1 - \frac{RR-R+P}{2P}\right)a - \frac{b}{4P}(R - RR)^2 & \text{if } RR \leq R < RR + P \\ -a - \frac{b}{4P}(R - RR)^2 & \text{if } RR + P \leq R < RR + 2P \\ -a - b(R - RR - P) & \text{if } R \geq RR + 2P \end{cases}$$

Each of the segments for both $r^U(R)$ and $r^L(R)$ “connect” to one another to form the upper and lower bounds of the demand correspondence for bank, see Figure 2.¹⁶

Let nS denote the aggregate supply of reserves.¹⁷ The corresponding range of equilibrium rates lie between the lower and upper bound curves as illustrated in Figure 2. These are equilibrium rates in the sense that at any interest rate in the range $[r^L(S), r^U(S)]$ no bank wishes to change its reserve holdings by either borrowing or lending additional reserves in the b2b market. Notice that the total reserves in Figure 2 are “very large” to reflect the current state of policy. The very large supply of reserves results in a wide range of equilibrium rates in the b2b market.

¹⁶Note that there is some curvature associated with convex costs for the lower bound of the correspondence, $r^L(R)$, when $R \in (RR, RR + 2P)$. To keep the diagrams simple, we have suppressed the curvature associated with these non-linear portions.

¹⁷Part of a bank’s reserve holdings comes from borrowing in the g2b market. As we shall see, each of the n bank creditworthy banks borrow the same amount in the g2b market.

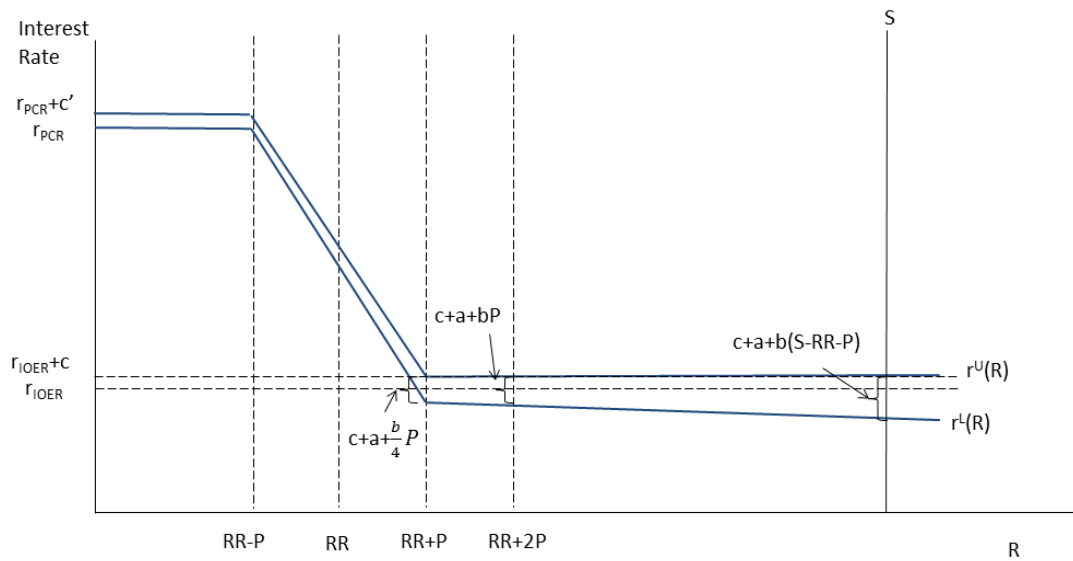


Figure 2: Supply and Demand for Reserves with Balance Sheet Costs and Credit Risk

3.2 The g2b Market

The participants in the g2b market are DIs and GSEs, most notably the FHLBs. FHLBs primarily provide funding for home mortgage loans to member institutions by issuing debt in financial markets. As a result, at any particular time FHLBs typically have large amounts of cash on hand. FHLBs have reserve accounts at the Federal Reserve, so they can always deposit cash that is not currently needed for its member institutions overnight at the Federal Reserve. However, unlike banks, GSEs do *not* receive IOER on their deposits at the Federal Reserve. To obtain interest on their cash balances, FHLBs can and do make overnight loans in the federal funds market and at the Federal Reserve’s ON RRP facility.

We assume that the lenders in the g2b market are identical and that each one initially holds R_g reserves at the Federal Reserve. They are willing to lend these reserves to DIs at sufficiently high rates. A practical consideration is that in reality FHLBs and other large money market lenders, such as money market funds, deal only with a limited set of highly creditworthy counterparties and place concentration limits on the amounts they are willing to lend to any particular counterparty. Taking into account these considerations, we model the g2b market in a manner that is consistent with the following stylized facts: (1) lenders in the g2b market deal only with a small number of borrowers, (2) lenders in the g2b market are only willing to lend to individual banks up to pre-specified concentration limits, (3) borrowing banks make take-it-or-leave-it offers to lenders in the g2b market, meaning that g2b lenders

are essentially price takers, and (4) rates offered to lenders in the g2b market must exceed their threat point, which is the overnight secured rate (we use the ON RRP rate as a proxy for rates in the secured overnight market).

To incorporate noncompetitive frictions we assume that the n creditworthy banks and the many identical FHLB-type lenders are distributed around a circle. For convenience we can assume there are equal numbers of creditworthy banks and lenders in the g2b market and that they are distributed so that each lender has a creditworthy DI to the left and to the right. We assume it is costless for a lender to monitor creditworthy banks to its immediate left and right and infinitely costly to monitor other creditworthy banks. A lender will not give a loan to a bank that it cannot monitor. As a result, a lender will provide loans to at most two creditworthy banks.¹⁸ We assume lenders set concentration limits for each of their potential borrowers equal to half of the amount they are willing to lend.

The interaction between lenders and borrowers in the g2b market is as follows. First, each borrower announces the rate it is willing to pay to its two potential lenders. These are take-it-or-leave offers on the borrowing rate. Next, lenders either accept or reject posted offers; if they accept, then they submit loan amounts up to their concentration limits. Any lender that rejects the posted offers, invests at the ON RRP facility at the ON RRP rate, r_{ONRRP} .

In equilibrium, the lender will offer the same loan size to each bank and each bank offers the interest rate

$$r_{g2b}^* = r_{ONRRP} + k,$$

where k is the credit risk premium on g2b loans. The equilibrium risk adjusted interest rate in the g2b market equals the lender's outside option, which is the Federal Reserve's ON RRP rate, r_{ONRRP} .¹⁹ Since the lender is indifferent between accepting and rejecting the interest rate offer, it accepts it and offers half of its reserves to each bank that it deals with; banks borrow the entire loan supply from each of its lenders.²⁰

The above equilibrium condition relies on the fact that each lender's threat to lend at the ON RRP facility is credible. While each lender faces a cap that limits the amount it can lend to the ON RRP facility, the level the cap is currently set at \$30

¹⁸The assumption that there are the same number of borrowers and lenders is not crucial. We could assume, for example that there were half as many lenders so that there were two potential borrowers to the left and right of every lender. None of the following analysis would be substantially changed.

¹⁹We assume that the spread banks earn, $r_{IOER} - r_{ONRRP} - k$, is greater than their marginal balance sheet costs.

²⁰The model described here is a special case of a more general model of the g2b market found in Garratt, Nosal and McAndrews (2015). Here we assume that the sum of each lender's concentration limits do not exceed the amount they are willing to loan. So borrowers have no incentive to bid up the price. The same equilibrium result can be achieved in this framework if the sum of each lender's concentration limits exceeds the amount they are willing to lend and the amount lenders are willing to lend exceeds the amount borrowers are willing to borrow.

billion, which is far in excess of any FHLBs unsecured overnight activity.

3.3 Equilibrium Federal Funds Rate

In practice, the effective federal funds rate is a weighted mean of rates that are observed in the overnight, unsecured interbank market.²¹ Our theory decomposes the interbank market into two sectors: the b2b market and the g2b market. In the current situation, with excess reserves in the vicinity of \$3 trillion, rates in the b2b market are predicted to lie in an interval surrounding r_{IOER} , as shown in Figure 2 and activity in the b2b market is predicted to be small. As such, the model predicts that the effective federal funds rate will be close to the rate obtained in the g2b market. This result seems to reflect what we actually observe, as shown in Figure 2.

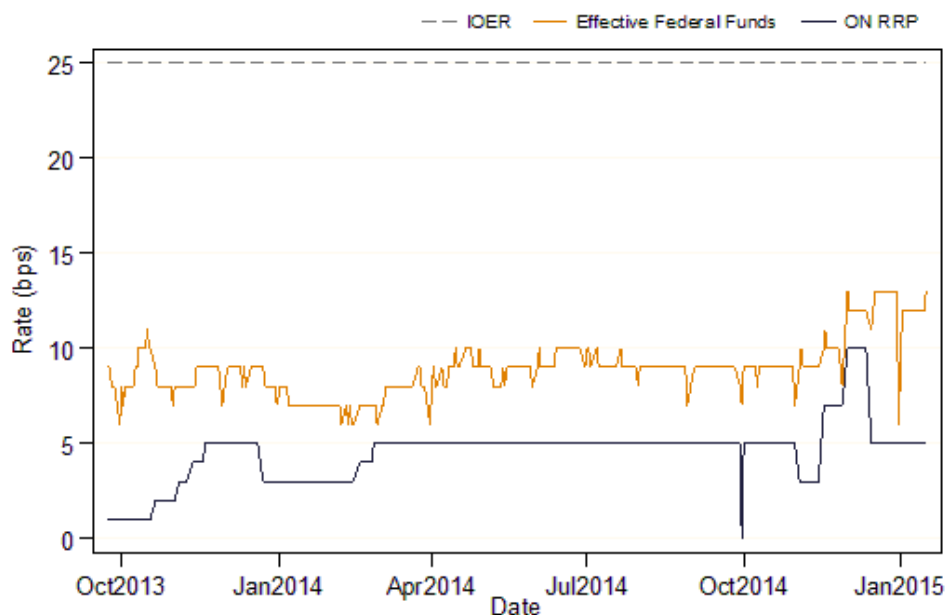


Figure 3: The sample is 9/23/2013-1/16/15.

4 Segregated Balance Accounts

Competitive frictions in the g2b market arise because the credit risk concerns that lenders have regarding banks lead them to restrict their interactions to a small set of

²¹The Federal Reserve has announced plans to replace the weighted mean calculation with a weighted median. See <http://www.newyorkfed.org/markets/EFFR-technical-note-070815.pdf>.

counterparties that have fixed loan limits. Since, by design, SBAs would eliminate counterparty credit risk—they would be nearly safe assets—there are two possible channels by which SBAs can eliminate noncompetitive frictions in our model. First, since any bank can offer an SBA, the number of eligible bank counterparties increases. This means that cash investors can shop around for the best rates that are available, where all offered rates effectively carry zero counterparty credit risk. Second, there is no need to impose a concentration limit or caps on funds placed in an SBA with a particular bank.

We now introduce m “less-creditworthy” banks, where m is large relative to n . One can think of these banks as being smaller regional banks. Our designation of the banks as less-creditworthy may mean that they are deemed by the market to be risky or simply that they are too small and infrequent participants in overnight markets to warrant monitoring efforts by lenders. Consistent with this interpretation, we also assume that these banks do not face meaningful payment shocks and, hence, hold reserves exactly equal to their reserve requirements. We denote the reserve holdings of each of these banks by \hat{S} . These banks are too small to have leverage ratio problems. Therefore, we model them as having constant marginal balance sheet costs equal to a , the FDIC assessment fee.

Since SBAs eliminate credit risk and remove the need for monitoring, any of the m less-creditworthy banks can borrow from any lender using SBAs. We anticipate that banks seeking to attract funds will be able to post their SBA borrowing rates for all to see. The posting of rates implies that Bertrand competition will lead to an equilibrium SBA rate, r_{SBA}^* , that is the same across all providers of SBAs and equal the IOER rate minus the marginal balance sheet cost, i.e.,

$$r_{SBA}^* = r_{IOER} - a.$$

This competitive outcome reflects the type of price competition contemplated by Tobin (1985, Section IV), which can only occur after other differentiating features of banks are eliminated. Since the less-creditworthy banks have lower balance sheet costs than current federal funds participants and because there are a large number of these banks, they will likely be able to attract all of the funds that go into SBAs

The willingness of the lenders to supply funds secured by SBAs will, of course, depend on alternative investment opportunities, including unsecured lending. Banks that undertake unsecured (federal funds) borrowing, either for the purposes of IOER arbitrage or for their own use—e.g., to meet reserve requirements—will have to pay a rate above the SBA market rate by an amount that just is sufficient to compensate lenders for credit risk. We now demonstrate that the resulting market equilibrium will have the vast majority of excess reserves in the system residing in SBAs, while levels of reserves needed to meet reserve requirements would remain in banks’ own master accounts.

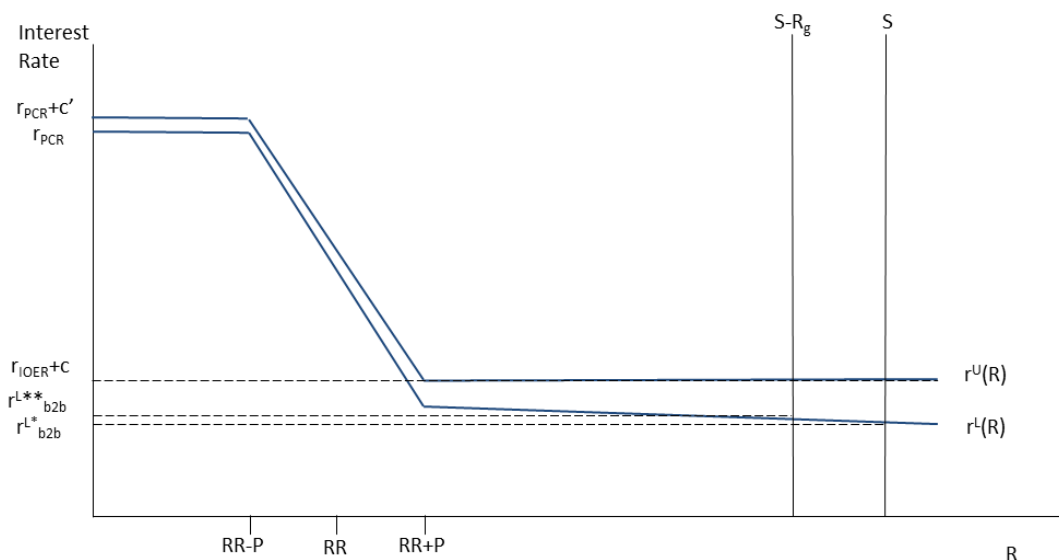


Figure 4: Equilibrium with SBAs: First step.

4.1 Federal Funds Market Equilibrium With SBAs

We will describe the market equilibrium in two steps. Owing to higher balance sheet costs, (large) creditworthy banks are unable to compete with the less-creditworthy banks that borrow using SBAs at a borrowing rate equal to $r_{IOER} - a$. As a result, in the first step, lenders in the g2b market will lend all of their reserves, R_g , to less creditworthy banks, who invest the reserves in SBAs. This effectively eliminates the noncompetitive g2b market discussed above. Since loans from GSEs are uniformly distributed across the creditworthy banks before the introduction of SBAs, the immediate result would be a decrease in the reserve holdings of a typical creditworthy bank from S to $S - R_g$ and the range of interest rates in the b2b market would decrease from $[r_{b2b}^*, r_{IOER} + c]$ to $[r_{b2b}^{**}, r_{IOER} + c]$, as illustrated in Figure 4. The increase in the lowest equilibrium b2b interest rate r_{b2b}^{**} reflects the decline in balance sheet costs incurred by the creditworthy banks because the reserves they each hold declines.

But this is not the end of the story; something else happens. The remaining reserves held by the creditworthy banks have offsetting liabilities, the vast majority of which are in the form of bank deposits. Notice that the maximum deposit rate that a creditworthy bank can pay is equal to the IOER rate minus the marginal balance sheet costs. (In practice, banks likely pay considerably less than this.) However, the competitive interest rate on SBAs exceeds the IOER rate minus the creditworthy bank's marginal balance sheet costs since creditworthy banks incur the additional non-linear balance sheet cost. Deposit holders will therefore have an incentive to liquidate

some of their deposit holdings and convert them into loans secured by SBAs. This movement should put competitive pressure on the deposit rate.

We now describe the second step. Reserves in SBAs that collateralize the loan cannot be used by the bank to meet another depositor's payment request and these reserves cannot be counted toward the balances a bank maintains in order to satisfy its reserve requirements. The introduction of SBAs, therefore reduces the supply of (usable) reserves available to the creditworthy banks from S to $S - q_{SBA}$, where q_{SBA} denotes the per-bank quantity of outstanding SBA balances. The first step, above, described the situation where $q_{SBA} = R_g$. But there may be additional demand for SBAs associated with depositors of creditworthy banks who convert some of their (low interest rate) deposits into loans secured by SBAs. It should be emphasized that we do not restrict lenders whose loans are secured by SBAs to be GSEs. In principle, a broad set of individuals and institutions could have their loans to a DI secured by an SBA. Therefore, we expect equilibrium levels of SBAs to be greater than the reserve holdings of FHLBs, i.e., $q_{SBA}^* > R_g$.

It is difficult to determine exactly how many depositors will convert funds into SBAs. Uninsured deposits should be the first to migrate to SBAs because the rate on these deposits must be below the equilibrium rate offered by SBAs and these deposits entail some credit risk. If, after the migration of uninsured deposits, the marginal balance sheet costs of the creditworthy banks are still above that of the less creditworthy banks that are offering SBAs, then we could see an additional migration of insured deposits. In what follows, we will generally assume that the migration of uninsured deposits does not reduce the supply of usable reserves below $RR + P$. Then the equilibrium level of SBAs is determined by the incentives of insured depositors to move into SBAs. Since insured deposits have (roughly) the same risk characteristics as SBAs we should expect insured deposits to flow into SBAs until marginal balance sheet costs of the creditworthy banks are reduced to $r_{IOER} - a$. At this point the maximum possible rate that can be earned on deposits at the creditworthy banks (which we assume is achieved) is equal to the rate earned on SBA balances.

Define \tilde{R} such that $r^L(\tilde{R}) = r_{IOER} - a$. Then, the equilibrium level of *aggregate* SBA balances is given by nq_{SBA}^* , where $q_{SBA}^* = S - \tilde{R}$, as illustrated in Figure 5. The equilibrium federal funds rate r_{FF}^* is now determined solely in the b2b market (loans secured by SBAs are not included in this rate). Hence,

$$r_{FF}^* \in [r_{IOER} - a, r^U(\tilde{R})]. \quad (4)$$

4.2 Distribution of Reserves

SBAs result in a more favorable distribution of reserves across the banking system, which results in a reduction in aggregate balance sheet costs. We can explicitly compute this savings in the model. After the introduction of SBAs, aggregate balance

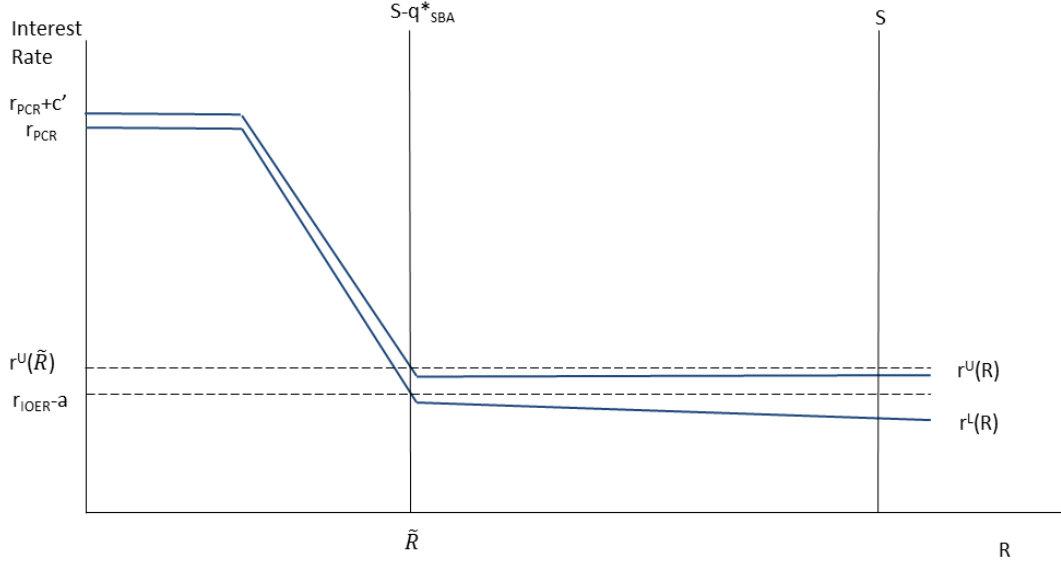


Figure 5: Equilibrium with SBAs: Second step.

sheet costs are simply $(nS + m\hat{S})a$. This is because reserve holdings of each of the creditworthy banks are less than $RR + P$ when SBAs are introduced and, as a result, the only balance sheet costs that these banks face is the FDIC assessment fee. A creditworthy bank's balance sheet costs before the introduction of SBAs is given by

$$aS + b \frac{(S - RR - P)^2}{2}.$$

Therefore, the aggregate savings in balance sheet costs is

$$nb \frac{(S - RR - P)^2}{2}.$$

In other words, all of the (convex) costs associated with the leverage ratio compliance is eliminated with the introduction of SBAs.

5 Monetary Policy With SBAs

5.1 Complete Pass Through of Changes in IOER

The competition that SBAs generate improves the transmission of monetary policy in the sense that any increase in the Federal Reserve's IOER policy rate should be matched by a similar increase in money market rates. Consider an increase in the IOER rate by an amount δ and assume that this is accompanied by a same-sized

increase in the PCR rate, maintaining the spread between the PCR rate and the upper limit of the federal funds target range at 50 basis points, which it has been since September 2007. After the increase in these rates, we would expect the equilibrium SBA rate to increase by δ as well. Moreover, the level of usable reserves at which the lower bound of the demand correspondence equals $r_{IOER} - a$ will still be \tilde{R} . Therefore, in order to determine the effect of the rate changes on the upper bound (and hence the range of equilibrium federal funds rates) we need to compute the change in the upper bound at \tilde{R} when r_{IOER} and r_{PCR} are both increased by δ . From our specification of $r^U(R)$ in Section 3.1, the upper bound increases by $\delta/(1-q)$. Since we expect q to be close to 0, the increase should be close to δ . In short, we expect that both the lower and upper bounds of the range of equilibrium federal funds rates will shift up by an amount approximately equal to δ . Provided that the composition of trades within this range does not change much, pass through will be approximately complete.

Complete (or near complete) pass-through of changes in the IOER rate into changes of the federal funds rate does not occur in the model in the absence of SBAs. This is because the creditworthy borrowing banks have little incentive to bid up rates since they have all of the bargaining power. In this situation, our model suggests that the federal funds rate is determined by the floor created by ON RRP, and that raising the IOER “ceiling” will have little impact on the federal funds rate.

5.2 Automatic Reserve Management

Historically, when the size of the Federal Reserve’s balance sheet was much smaller and reserves were scarce, variations in autonomous factors—such as currency demanded by the public—led to potential fluctuations in the federal funds rate that were offset by repo and open market operations. Even though excess reserve balances are now in the trillions, the above analysis indicates that SBAs could reduce usable reserves to the point of scarcity where, once again, fluctuations in autonomous factors are relevant. The equilibrium described in Figure 5, however, has nice stability properties that automatically offset fluctuations in autonomous factors and, as such, costly actions by the Federal Reserve to counteract them would not be necessary.

When SBAs exist, fluctuations in currency demand by the public are offset by flows into and out of SBAs. If currency demand increases by, say, ΔC in Figure 6, usable reserves become more scarce; they decrease from $S - q_{SBA}^*$ to $S - q_{SBA}^* - \Delta C$. If aggregate SBAs remain fixed, this implies that the deposit rate is likely to rise above the rate paid on SBAs, which should result in the liquidation of some SBAs back into deposits. The decrease in SBA holdings increases the level of usable reserves and this puts downward pressure on federal funds rates. Ultimately, the range of equilibrium rates should be restored to levels at or near the original levels. In Figure 6, the situation is illustrated by an initial shift to the left of the of the usable reserves supply curve, followed by a return its original position: i.e., we assume the equilibrium is restored at $R^d = S - q_{SBA}^* - \Delta C - \Delta q_{SBA}$, where $-\Delta q_{SBA} = \Delta C$. In short, the

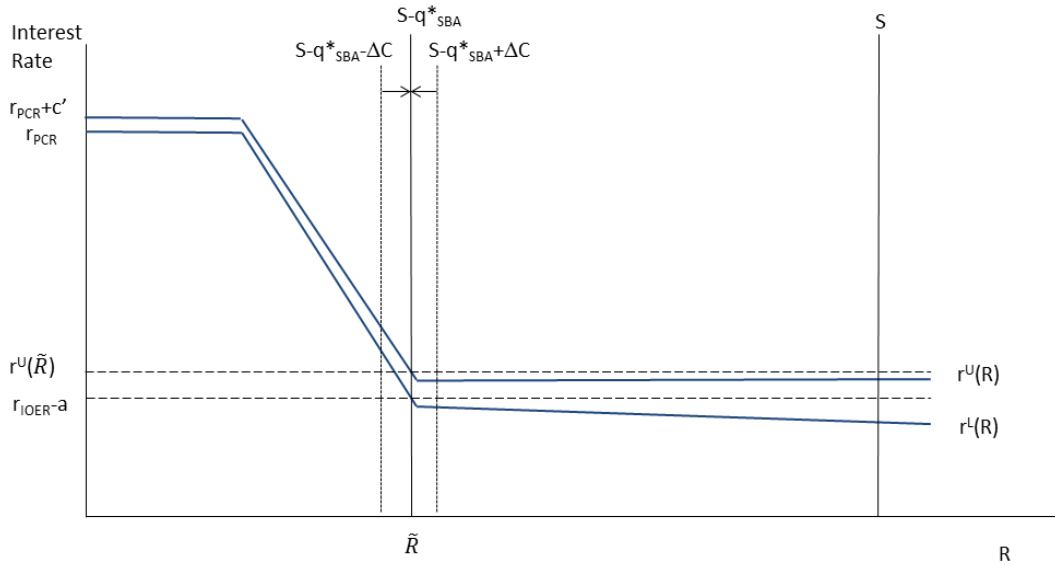


Figure 6: Changes in Currency Demand

increase in currency demand is matched by an equivalent decrease in SBAs.

If, on the other hand, currency demand decreases, so that the supply of usable reserves increases to $S - q_{SBA}^* + \Delta C$ in Figure 6, then the argument we used to pin down the equilibrium level of SBA balances in Section 4.1 applies. The decrease in currency demand should be matched by an equivalent increase in SBAs, which leaves both the federal funds rate and usable reserves unchanged.

5.3 SBAs in a World With Low Excess Reserves

Over time, the amount of excess reserves in the banking system will likely decline as the size of the Federal Reserve’s portfolio is reduced. As usable reserves shrink, the aggregate level of SBAs would also be expected to shrink, just as in the case where currency demand increases. The reduction in reserves (induced by the reduction in the size of the Federal Reserve’s portfolio) will be matched by a reduction in SBAs, leaving the amount of usable reserves and the federal funds rate unchanged.

If reserves become sufficiently scarce, then SBA balances should fall to zero and we would be back in a corridor system, where the federal funds rate can be “significantly” higher than the IOER rate.²² Even though SBA usage would be *de minimis* in a corridor system, their existence would still contribute to supporting the IOER rate

²²An appealing feature of SBAs is that they are a new technology and not a facility. If market participants no longer demand SBAs, then their use simply ends. There would be no need to impose an end to their use. Similarly, if they were to become desirable again, at some point in the future, the market could reemerge without requiring official intervention.

as the lower bound. For example, should overnight market rates drop close to the IOER rate, we would expect that investment in SBAs would resume, which would prevent overnight rates from dropping below floor set by the IOER rate (net of any balance sheet costs).

6 Potential Risks

6.1 Flight to Quality

In recent crises, there has been a flight to quality in financial markets.²³ In 2008, while substantial funds attempted to shift into Treasury securities, especially bills,²⁴ there was also a huge flow of funds into U.S. commercial bank deposits, most notably into custody banks. While such a brisk removal of liquidity from key markets is problematic, economists have argued that there is a silver lining because big banks become flush with deposits, which allows their customers to draw down lines of credit.²⁵

Recently, market observers and policy makers have expressed concerns that uncapped ON RRP could exacerbate flight-to-quality flows, by providing a risk-free alternative to bank deposits, thereby causing a removal of much needed liquidity from the financial system.²⁶ For these reasons, an aggregate cap on the amount that can be invested at the ON RRP facility has been imposed and an auction pricing mechanism has been introduced to ration ON RRPs in the event that bids exceed the aggregate cap.

A similar concern could arise with SBAs. During a crisis, SBAs might be seen by lenders as an attractive near risk-free investment. However, a “surge” into SBAs—i.e., an increased supply of funds by lenders for SBA collateral arrangements—would be accompanied by counterbalancing price movements. Suppose that, in our model, take up in SBAs rises above equilibrium levels depicted in Figure 5. Then, as described in Section 5.2, this would result in an increase in federal funds rates and banks would have an incentive to raise the deposit rate as a cheaper alternative for attracting reserves. Further, because SBAs are supplied competitively, their rate would not adjust, since the rate is “competitively tied” to the IOER rate. The result would be an increase in the spread between the both the deposit and the federal funds rates and the rate paid on SBA balances, which should help to arrest the surge and mitigate potential dislocations in funding markets.

Additional factors could limit the ability of investors to suddenly place large sums of money into loans secured by SBAs. SBA collateral arrangements would likely

²³See Gatev and Strahan (2006).

²⁴This necessarily led to a rise in their price, since the supply of bills is fixed in the short run. The fixed supply of bills and consequently their yield in such situations may help to reduce the shift into safe assets and so limit the risk of disruptions in existing funding patterns

²⁵See Strahan and Gatev (2006).

²⁶See Frost, Logan, Martin, McCabe, Natalucci, and Remache (2015).

specify caps on balances at the insistence of the borrowing banks. Banks have a desired leverage ratio and typically want to stay below it. As a result, banks would only demand loans secured by SBA balances up to a point that keeps them below that target. It is difficult to predict whether usage in non-stress times would approach these caps, leaving little room for a surge in balances during times of stress, or whether caps would be far from binding on a daily basis. But this is something that the Federal Reserve would have influence over. As a party to the SBA agreement, it could impose caps.

6.2 Effect on the Federal Funds Market

The current situation, where the federal funds rate lies below the IOER rate and the federal funds market is dominated by FHLBs lending to foreign banks, is somewhat unusual and is strongly affected by frictions such as balance sheet costs and imperfect competition. SBAs could lead to a significant reduction in the FHLBs' federal funds lending to foreign banks. The likely result would be that federal funds arbitrage transactions would diminish and arbitrage would most likely take place in loans secured by SBAs. If SBAs attract FHLB funds from the federal funds market, then the federal funds volume could decline from its current (low) level and the federal funds rate could come to reflect only a few idiosyncratic trades. However, as more reserves move into SBAs, some banks could find themselves short of reserve balances. These banks would have incentives to borrow in the federal funds market and the share of interbank transactions could rise. Since the interest rate on interbank transactions is typically higher than the IOER rate—because reserves are typically “scarce”—the federal funds effective rate would be expected to increase as the share of these transactions increase, and could eventually lie above the IOER rate. Overall, SBAs could hasten the day when the federal funds trades occur above the IOER rate and are comprised primarily of interbank trades.

6.3 Effect on the FDIC

Reserves held in SBAs would not be available to the FDIC if the account holder becomes insolvent. Banks could end up substituting out of uninsured deposits and into borrowing secured by SBAs, and that would weaken the FDIC's position in resolution. From the perspective of the FDIC, this is similar to a situation where investors chose to transfer funds out of the bank and place the funds in repos, including those offered by the Federal Reserve Bank of New York in the form of ON RRP. In each case, the bank's uninsured deposits would decrease and we would see a corresponding decrease in assets available to the FDIC. To provide additional protection to the FDIC the ability to offer SBAs could be restricted to banks with a CAMELS rating of 1, 2, or 3.

An argument can be made that funds in SBAs should be exempt from the FDIC

assessment fee. Tobin (1985, Section V) advocates (p. 26) the creation of “funds which could not be impaired by difficulties elsewhere in the institution’s balance sheet.” He goes on to write (p.26-27) that such funds would “limit the scope of intermediaries’ liabilities that need to be protected by deposit insurance, and by the same token the scope of intermediaries’ assets that need to be continuously scrutinized and regulated.”

6.4 Legal and Regulatory Issues

Several legal and regulatory issues would need to be resolved before SBAs could be implemented. Three issues are essential. First, it would need to be determined that the Federal Reserve System has the authority under the Federal Reserve Act to maintain SBAs and recognize the security interest of the lender. Second, to function as near risk-free investments, the FDIC would need to act quickly to permit lenders to gain access to SBAs that collateralize their loans in the event the borrowing DI becomes insolvent and is placed into FDIC receivership. Third, since banks cannot secure deposits, a statement from the Office of the Comptroller of the Currency that the funds acquired from lenders and placed in SBAs would be classified as “money borrowed” would be required. Prior to operationalizing SBAs these and other operational issues would have to be addressed.

7 Concluding Remarks

SBAs are a new type of account that would allow any bank to credibly compete for overnight money market funding because they are almost completely free of credit risk. Since banks could compete more vigorously for funds by using SBAs, the rates paid on borrowed funds secured by SBAs, along with other money market rates, are likely to move closer to and to be more tightly linked to the IOER rate. The rate paid on borrowed funds secured by SBAs are market-determined and, therefore, will adjust to changing economic circumstances.

While SBAs would not reduce the aggregate supply of reserves in the system, they would reduce the amount of “usable” reserves that banks can use to meet reserve requirements or to make their own payments. In equilibrium, SBAs would be expected to endogenously reduce the amount of usable reserves to levels very close to the point of scarcity. As such, the introduction of SBAs would effectively identify the minimum level of reserves consistent with satiation. That is, any additional reserve balances above this minimum would not be valued by banks to either fulfill reserve requirements or use for payments. Since this minimum quantity of reserves is not observable in the absence SBAs, SBAs may be helpful in identifying an optimal target for reserve levels that may be difficult to achieve using conventional draining tools. Conveniently, if reserve levels are reduced to a point of scarcity through other means, market forces should cause SBA use to decline to zero. Since SBAs are a technology and not a

facility, this would not require any action by the central bank. Rather the accounts would simply be inactive unless conditions changed.

If some banks face higher marginal balance sheet costs than others, then the competition induced by SBAs would be expected to redistribute bank reserves in a way that equates the marginal balance sheet cost across all banks. Hence, SBAs also promote an efficient allocation of reserves within the banking sector.

Should SBAs be created, they could be discontinued at any time if the Federal Reserve judged it appropriate to do so. Indeed, since the Federal Reserve provides the technology that makes SBAs possible, it would be possible to discontinue their use simply by not signing any new SBA agreements. Existing agreements could be allowed to expire at the agreed term.

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Appendix: Detailed Description of SBA Mechanics

The SBAs proposal envisions that an account holder of a Federal Reserve Bank (FRB), which must be a type of entity that is eligible to earn interest on excess reserves, would, from time to time, borrow funds from one or more entities (each entity referred to as the "lender of funds") on a secured basis. To secure its borrowings from a lender of funds, the account holder would enter into an agreement to grant to the seller a security interest in funds deposited in the SBA that the account holder established at its FRB specifically for the purpose of securing borrowings from the seller. Each time the account holder borrows from the lender of funds, the account holder would deposit funds (or cause funds to be deposited) to the SBA in an amount equal to the amount borrowed.

An SBA would be an account established by an account holder that is separate from its Master Account. The SBA account holder would not be able to use the funds in the SBA account for any purpose (e.g., to satisfy reserve requirements) other than to secure its obligation to repay the lender of funds and to earn interest on the account balance. The interest earned on this balance would be at the same rate as IOER. The SBA account holder would not have the right to transfer funds out of the SBA. Instead, the SBA would be established so the funds can be sent into or transferred out of the account through either National Settlement Services or the Fedwire Funds

Service. The interest earned on the balance in the SBA would be credited to the SBA account holder master account. It is then anticipated that the SBA owner would transfer an agreed amount of interest earned on the funds in the SBA to their lender. A separate SBA would need to be established by the Administrative Reserve Bank for each relationship (i.e., borrower/lender pair).

It is anticipated that the majority of these funds would be held in the SBA on an overnight basis, but there would be no restrictions to term borrowing by the owner of the SBA. This would be part of the bilateral agreement between the borrower and lender of the funds. The interest rates paid to the lender by the borrower as part of the SBA agreement would be negotiated bilaterally at the time the contract is initiated and would last the duration of the contract. We anticipate that the interest rate would be tied to the IOER rate. At this point, there is no anticipated minimum or maximum usage levels needed to establish or maintain an SBA. However, if there is an overwhelming demand for account holders to establish these accounts, there could be an operational burden placed upon the Reserve Banks for their set up and maintenance.