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Federal Reserve's Expansion of Repurchase Market Is a Bad Idea

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The Federal Reserve has been expanding a new "test" program it calls the Overnight Reverse Repurchase Facility (ON RRP). This program is a drastic departure from its regular open-market operations and potentially expands the federal financial safety net to the entire money market.

Such an expansion increases systemic risk and increases the likelihood of unintended consequences creating turmoil in financial markets, problems that the Fed has already acknowledged.[1] The Fed should decrease its footprint in financial markets and stop testing new ways to assist financial firms.

What Are Reverse REPO Agreements?

The repurchase market, commonly referred to as the repo market, deals with the buying and selling of short-term securities. In general, a repo agreement is a contract where one party agrees to sell securities for cash and repurchase the same securities later at a higher price (frequently the next day). Thus, a repo is basically a short-term loan: One party borrows cash from another and provides securities for collateral. If the borrower fails to repurchase the securities as promised, the lender simply keeps the securities.

A *reverse* repo is exactly the same contract, but it describes the lender's perspective instead of the borrower's. Viewed in this manner, a lender provides cash, purchases the securities for collateral, and then sells them back to receive cash in the future. The borrower views the transaction as a repo, while the lender views the transaction as a reverse repo. The Fed has engaged in repo transactions for decades but mainly as a lender of cash to its primary dealers in the conduct of its normal open-market operations.[2]

What Is the Fed's Role in the ON RRP?

Historically, the Fed has typically lent cash to primary dealers and accepted Treasuries as collateral in repo transactions. There are two major differences under the new ON RRP. First, the Fed is now borrowing cash and using its own securities as collateral. Second, the Fed is now trading with many firms instead of with only its primary dealers.

In particular, the Fed is now engaged in these transactions with large money market mutual funds and Fannie Mae and Freddie Mac. As former Federal Deposit Insurance Corporation chairwoman Sheila Bair recently noted, this arrangement means that, in effect, "the Fed's counterparties are giving a secured loan to the most creditworthy borrower on the planet."[3] Put differently, the Fed is giving these firms a new risk-free opportunity to earn money.

According to Bair, the ON RRP "hit an overnight high of $242 billion at the end of the first quarter of 2014," and the Fed has now "raised the overnight allotment cap for individual buyers from $500 million in September to $10 billion."[4] In other words, on any given day private firms (and Fannie and Freddie) can lend the Fed up to $10 billion and collect interest the next day. This arrangement essentially provides these lenders with free money at the expense of pri-

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vate markets—there is absolutely no risk the Fed will fail to uphold its end of the contract.

These transactions are only indirectly backed by taxpayers, but the larger problem is that these contracts expand the federal financial safety net to additional segments of the financial industry. If made permanent, money market firms would have a ready-made place to park their cash for a risk-free return. In the event of market turmoil, money market funds would have absolutely no reason to buy, for example, the commercial paper of the non-financial firms (such as PepsiCo and Home Depot) they normally buy.[5] One unintended consequence of the ON RRP, therefore, would be to divert funds away from non-financial firms.

Why Is the Fed Engaging in These Transactions?

The Fed typically conducts monetary policy by trying to influence the federal funds market, the inter-bank lending market where banks lend each other excess reserves. However, the Fed has expanded these excess reserves—through "quantitative easing" (QE)—so aggressively since 2008 that many participants have no reason to borrow excess reserves. Thus the Fed's own aggressive actions have minimized the impact of its normal operations. Rather than reverse its QE policies and shrink the level of excess reserves, the Fed has decided to test ways that it can influence *other* short-term lending markets.

The Fed also seems to be responding to a fundamental shift in the composition of lending markets: The share of total lending that traditional banks account for has been steadily falling since the 1970s. According to the Federal Reserve's Flow of Funds data, total credit-market debt went from $1.6 trillion in 1970 to almost $60 trillion in 2013, and the share of that debt flowing through depository institutions fell from 42 percent to 17 percent.[6] (See chart.) Thus, for decades, an increasing amount of financial intermediation has been taking place outside the traditional banking sector, where the Fed's operations have always been focused.

This fact alone makes it more difficult for the Fed to implement traditional monetary policy, and the Fed has compounded the problem by aggressively growing its balance sheet since the 2008 financial crisis. In one sense, the only way the Fed can maintain its relevance is to expand its reach into financial markets.[7]

Why Expanding the ON RRP Is a Dangerous Idea

The ON RRP program potentially expands the federal financial safety net to the entire money market. An expanded ON RRP program would increase systemic risk because:

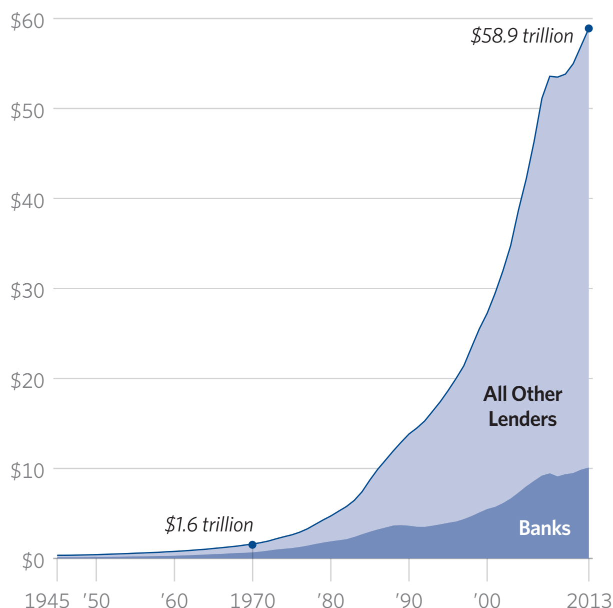
- It would allow even more firms to "run" straight to the Fed during market instability, and
- Investors would be less likely to monitor their own risk if they know they have an expanded government backstop.

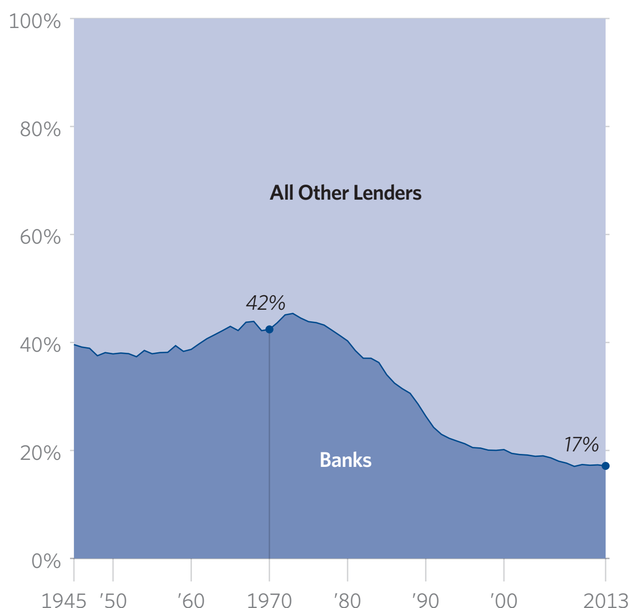
1. Minutes of the Federal Open Market Committee, June 17–18, 2014, p. 3, http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20140618.pdf (accessed August 7, 2014).
2. Open-market operations refer to the buying and selling of U.S. Treasury securities. The primary dealers buy and sell Treasuries on the Fed's behalf. See Norbert J. Michel, "The Fed at 100: A Primer on Monetary Policy," Heritage Foundation *Backgrounder* No. 2876, January 29, 2014, http://www.heritage.org/research/reports/2014/01/the-fed-at-100-a-primer-on-monetary-policy.
3. Sheila Bair, "The Federal Reserve's Risky Reverse Repurchase Scheme," *The Wall Street Journal*, July 24, 2014, http://online.wsj.com/articles/shelia-bair-the-federal-reserves-risky-reverse-repurchase-scheme-1406243228 (accessed August 7, 2014).
4. Ibid.
5. Money market funds normally use cash to invest in commercial paper, an *unsecured* short-term investment that many non-financial firms use to finance their operations.
6. Board of Governors of the Federal Reserve System, Financial Accounts of the United States, July 5, 2014, http://www.federalreserve.gov/releases/z1/current/data.htm (accessed August 12, 2014).
7. Reports have also surfaced of a lack of available Treasury securities for collateral in repo markets. The fact that the Fed now holds more than one quarter of all outstanding Treasuries could be contributing to this problem. See Ryan Tracy, "Banks Retreat From Market That Keeps Cash Flowing," *The Wall Street Journal*, August 12, 2014, http://online.wsj.com/news/article_email/banks-retreat-from-market-that-keeps-cash-flowing-1407890157-lMyQjAxMTA0MDEwMzExNDMyWj (accessed August 13, 2014).

CHART 1

Credit Markets Shifting Away from Banking Sector—and the Fed

The overall credit market has been rising rapidly for decades, but since the early 1970s a smaller share of loans has come from banks, where the Fed has historically focused its operations.





Note: "Banks" refers to U.S. chartered despository institutions.
Source: Board of Governors of the Federal Reserve System, Financial Accounts of the United States, July 5, 2014, http://www.federalreserve.gov/releases/z1/current/data.htm (accessed August 12, 2014).

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A larger ON RRP also makes it more likely that any sort of liquidity crisis will spread to the goods-and-services sector of the economy. Money market funds normally use cash to buy commercial paper—unsecured short-term debt—issued by non-financial firms such as John Deere and Target. An expanded ON RRP makes it more likely that money market funds would lend to the Fed rather than these firms at the first sign of market turmoil.

What Should Congress Do?

Several Members of Congress, such as Representative Mick Mulvaney (R–SC), have started questioning the Fed over the ON RRP,[8] and at least two Federal Reserve District Bank presidents—the New York Fed's William Dudley and the Boston Fed's Eric Rosengren—have publicly acknowledged some of the dangers the ON RRP creates for markets.[9]

ON RRP, still in the testing phase, would ultimately result in yet another expansion of the federal

8. Hearing, *Monetary Policy and the State of the Economy*, Committee on Financial Services, U.S. House of Representatives, Part 1, July 16, 2014, http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=387226 (accessed August 7, 2014), and hearing, *Legislation to Reform the Federal Reserve on Its 100-Year Anniversary*, Committee on Financial Services, U.S. House of Representatives, Part 1, July 10, 2014, http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=386842 (accessed August 7, 2014).

9. See William Dudley, "The Economic Outlook and Implications for Monetary Policy," remarks before the New York Association for Business Economics, New York Federal Reserve, May 20, 2014, http://www.newyorkfed.org/newsevents/speeches/2014/dud140520.html (accessed August 7, 2014), and Eric Rosengren, "New Monetary Policy Tools: What Have We Learned," Central Bank of Guatemala XXIII Cycle of Economic Lectures, Boston Federal Reserve, June 9, 2014, http://www.bostonfed.org/news/speeches/rosengren/2014/060914/060914text.pdf (accessed August 7, 2014).

financial safety net. The program marks a drastic departure from previous open-market operations and potentially increases systemic risk. The fact that the Fed is testing new ways to influence additional short-term credit markets only underscores that its aggressive QE policies have damaged markets and should be reversed sooner rather than later.

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