BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

November 8, 2019

The Honorable Patrick McHenry
Ranking Member
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Ranking Member:

Thank you for your letter dated October 17, 2019, in which you raised a number of important questions regarding the Federal Reserve's balance sheet and our decision to purchase Treasury securities and conduct overnight and term repurchase agreement (repo) operations. In summary, we want to assure you that these are purely technical operations aimed at maintaining reserves at or above levels that prevailed in early September. Once reserves have reached this level on a sustained basis, we anticipate that purchases of securities will moderate to a trend pace necessary to maintain an ample level of reserves over time. Our open market operations conducted for reserve management do not imply a change in the stance of monetary policy or the economic outlook.

The following are responses to the enumerated questions in your letter.

1. **The Federal Reserve System holds approximately $1.4 trillion in excess reserves. Is this level inadequate to provide the banking system with a sufficient buffer in times of financial stress? If not, what level of reserves is needed?**

As noted in its statement on October 11, 2019, the Federal Open Market Committee (FOMC) is currently seeking to maintain reserve balances in the banking system at or above levels that prevailed in early September or about $1.5 trillion. Ultimately, the level of reserves will be determined by banks' underlying demand for reserves along with the Federal Reserve's assessment of an appropriate additional buffer of reserves to serve as a shock absorber during periods when reserve demand and supply change, sometimes unexpectedly. Both of these components—bank demand for reserves and the buffer—could change over time, and we are carefully monitoring a wide range of information in assessing the appropriate level of reserves to maintain on an ongoing basis.

2. Is there insufficient liquidity in the financial system?
a. If so, to what do you attribute this perceived lack of liquidity?

The strains in money markets that developed in mid-September likely reflected a range of factors that resulted in a temporary but significant imbalance of demand and supply in overnight funding markets. A sizable net settlement of Treasury auctions contributed to heightened demand for dealer financing of new securities. At the same time, payment flows associated with corporate taxes resulted in a reduction in the supply of repo financing available to dealers from their usual lenders in the repo market, including money market mutual funds, banks and government-sponsored enterprises (GSEs). While these Treasury settlements and payment flows were of typical size, all of this occurred in an environment in which the total amount of reserves had fallen to multi-year lows, and amidst growing issuance of Treasury securities. Together these factors left some borrowers searching for funds and bidding up repo rates significantly in the process. The pressures in repo markets spilled over to money markets more broadly, including the federal funds market. Consistent with the FOMC's directive to maintain the federal funds rate in the target range, the Open Market Desk (Desk), which carries out trading activities pursuant to the FOMC's direction, conducted repo operations to address pressures in money markets that could adversely affect monetary policy implementation and help maintain an ample level of reserves. In October, the FOMC also directed the Desk to purchase Treasury bills at least into the second quarter of next year in order to maintain ample reserve balances at or above the level that prevailed in early September 2019. In our view, our actions have been effective at maintaining sufficient liquidity in the financial system.

b. If not, are your recent activities indicative of issues related to capital and regulatory policies?

From a safety and soundness perspective, banks generally have sufficient liquidity.[1] This means that banks have liquidity buffers sufficient to meet outflows in case they encounter stress. A broader question is whether large financial institutions face restraints or other incentives that discourage them from providing liquidity to borrowers facing liquidity shortfalls during periods of market stress. A number of observers, for example, have suggested that supervisory and regulatory factors related to liquidity risk management played a role in amplifying the market strains in September. In particular, some banks appeared to limit the amount they were willing to lend in repo markets, despite very elevated rates. We are currently assessing the potential role of regulatory and supervisory policies in recent money market developments. It is worth noting, however, that many other types of lenders in repo markets—such as money funds, GSEs, and pension funds—that are not subject to the same regulations, also appeared to limit their lending in repo markets as rates moved sharply higher in mid-September. The nature and causes of recent strains in repo markets are topics that the Federal Reserve will continue to analyze over coming months.

[1] Domestic banks over $100 billion in assets currently hold $2.7 trillion in high quality liquid assets. The U.S. GSIBs have an average Liquidity Coverage Ratio of 120 percent, well above the requirement of 100 percent.

3. What role does the existing bank regulatory regime play in the need for the recent open market operations? Was the existing bank regulatory regime a factor in the decision to restart open market operations? If so, please explain.

As discussed in the response to question 2 above, the Federal Reserve announced that it would purchase Treasury bills into the second quarter of next year to maintain reserves in the banking system at or above levels that prevailed in early September. In addition, the Federal Reserve indicated that it would conduct overnight and term repo operations as necessary to help maintain an appropriate level of reserves in the banking system and to address money market pressures that could adversely affect the implementation of monetary policy. The Federal Reserve's announcement that it would seek to maintain reserves in the banking system at or above the level that prevailed in early September reflects its current assessment that reserves at or above that level would provide banks with an ample level of reserves.

In assessing the causes of the strains in money markets in mid-September, the Federal Reserve is studying a full range of factors that may have played a role. This includes the role of bank regulation and supervision.

Preliminary analysis indicates that certain regulations cited by market participants, such as the liquidity coverage ratio (LCR), likely did not play a significant role in the strains in money markets in mid-September. The LCR requires large banking firms to maintain appropriate amounts of high quality liquid assets (HQLA)—a category that includes assets such as reserves, Treasury securities, and repurchase agreements on Treasury securities. Under the LCR, there is no penalty or disincentive for lending cash against Treasury securities. Whether a firm stepped in and utilized its reserves to lend against Treasuries or not, its LCR would have been the same.

It is also important to note that firms that are not subject to bank regulation, such as money market mutual funds, GSEs, and pension funds, also seemed reluctant to step in to take advantage of very high repo rates in mid-September. This suggests that factors other than bank regulation may have been important as well.

The Federal Reserve continues to review the role of a wide range of factors in the events of mid-September, including bank regulation, supervisory expectations regarding internal liquidity stress tests, and the technical requirements of intraday or overnight liquidity facilities provided by the Federal Reserve.

4. Do you intend to create a permanent repo facility?

Following its January 2019 meeting, the FOMC issued a statement indicating that it intends to continue to implement monetary policy in a regime with an ample supply of reserves. Under an ample reserves regime, control over the level of the federal funds rate and other short-term interest rates is exercised primarily through the setting of the Federal Reserve's administered rates and does not involve active management of the supply of reserves.

That said, there may be situations even in an ample reserves regime in which temporary open market operations can play a useful role. Indeed, the developments in repo markets in September highlight the potential role of temporary open market operations as a backstop in an ample reserves regime to temporarily increase reserves, when needed, and to help guard against money market pressures that could adversely affect the implementation of monetary policy.

The FOMC discussed the possible role of a standing repo facility at the June 2019 meeting. As summarized in the minutes of that meeting, policymakers discussed a range of issues associated with establishing such a facility and no decisions were reached. The FOMC continues to monitor monetary policy implementation and assess the tools most appropriate to foster efficient and effective implementation of monetary policy in a regime with an ample supply of reserves.

5. **Does there need to be greater participation in the repo marketplace from small financial institutions?**

The repo market in the United States is a deep, active market, which includes a wide range of participants.

- *Cash borrowers* include, but are not limited to, depository institutions, broker-dealers affiliated with a bank holding company, broker-dealers not affiliated with a bank holding company, and leveraged asset managers, such as hedge funds.

- *Cash lenders* include, but are not limited to, depository institutions, broker-dealers affiliated with a bank holding company, broker-dealers not affiliated with a bank holding company, GSEs, money market mutual funds, securities lenders, and pension funds.

The Federal Reserve Bank of New York (FRBNY) also is a participant in the repo market, when it conducts open market operations in order to implement monetary policy at the direction of the FOMC. The specific eligibility requirements for being an FRBNY repo counterparty for open market operations are available on the FRBNY's public website at https://www.newyorkfed.org/markets/counterparties. Outside of its own open market operations, the Federal Reserve does not dictate or determine the size, identity, or eligibility of private-sector firms that engage in the repo market or the terms upon which they transact with each other.

6. **The transition to the Secured Overnight Financing Rate, or SOFR, is based on the repo rate. What will the recent volatility in the repo market mean for SOFR's pricing? How could this volatility impact borrowers?**

The Alternative Reference Rates Committee (ARRC) has long been aware that any market-based overnight rate such as the Secured Overnight Financing Rate (SOFR) can exhibit times of heightened volatility, and the group discussed that possibility in its report when it laid out the case for its choice of SOFR. Notably, there have been days of temporary volatility in other markets, even in the federal funds market. Importantly, SOFR exhibits the characteristic of a robust reference rate because it is representative of the market it covers—the U.S. Treasury repurchase agreement market. Indeed, SOFR is determined by over $1 trillion in transactions in the repo market each day.

Additionally, the use of SOFR in most financial contracts will rely on averages of the rate over time, limiting the impact of any day-to-day volatility to borrowers. SOFR futures, swap contracts, and floating rate debt contracts all refer to these types of averages of the daily SOFR, and SOFR-based loans are expected to do so also. These averages of daily SOFR rates have historically been quite smooth. For example, a 3-month average of SOFR has been less volatile than 3-month U.S. dollar LIBOR, even during the period of volatility in repo markets in September.

We hope you find this information helpful. Please let us know if we may be of any further assistance.

Sincerely,

Jerome H. Powell
Chair
Board of Governors of the
Federal Reserve System

John C. Williams
President
Federal Reserve Bank of New York