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Unpacking Recent Changes At The NY Federal Reserve

By **Matthew Bisanz, Leslie Cruz and Jeffrey Taft** (May 31, 2023, 4:12 PM EDT)


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On April 25, the Federal Reserve Bank of New York announced changes to its eligibility criteria for access to the Overnight Reverse Repo Facility, or RRP.[1]

These changes may prevent certain money market mutual funds from placing funds with FRBNY and force them to deploy funds directly in investment securities or a traditional bank account.

Use of the RRP has continued to surge since mid-2021, and interest rates paid through it have risen to over 5%. The changes appear to address policy concerns with how the RRP has been and may be used, and help support the transition to a new normal in terms of monetary policy.

The changes are effective immediately. In this article, we provide background on the RRP and discuss the FRBNY's recent changes.

Background

In 2013, the Federal Open Market Committee, or FOMC, first authorized the FRBNY to conduct a series of fixed-rate overnight reverse repurchase operations involving U.S. government securities, including agency securities.

This authorization became a permanent operation when the FRBNY established the RRP in October 2014. In transactions through the RRP, the FRBNY sells a U.S. government security and agrees to repurchase it later.

The four types of financial institutions eligible to serve as counterparties are primary dealers, banks (domestic and foreign banking offices in the United States), government-sponsored enterprises, and money market mutual funds.

Insured depository institutions can maintain reserve balances of cash in an account at their local Federal Reserve banks, and so the primary users of the RRP have been money market mutual funds.

For the Federal Reserve, these transactions help the FOMC control the federal funds rate and generate additional deposits at the Federal Reserve. In effect, the RRP represents a short-term loan to the Federal

Reserve that is secured by U.S. government securities.

For participants, the benefit of the RRP is that it provides a means to deposit cash with the Fed and receive interest instead of depositing it with a commercial bank. Because the Fed is a nearly risk-free counterparty, money market funds, which otherwise do not have access to Fed accounts, have become very active participants in the RRP.

In effect, certain money market funds are moving deposits from commercial banks to the Fed, reducing deposit funding for the banking system. This problem appears to have grown as some money market funds may have been established for the purpose of placing cash at the FRBNY.

April 2023 Change

Due to concerns about the increased use of the RRP and the use of the RRP by some money market mutual funds in a way contrary to the FOMC's intent, the FRBNY announced new changes to the program.

The changes are intended to restrict the program to only money market funds that seek to deposit excess cash in connection with the fund's normal investment operations. The changes seek to prevent the use of the RRP as a means for a person to obtain a de facto Fed account.

Under the FRBNY's proposed changes, eligibility for the RRP will require a money market fund to represent whether it is organized for the purpose — in whole or in part — of accessing the RRP. The fund also must disclose whether it is organized for a single beneficial owner or exhibits similarities to such a fund.

The FRBNY states that this change is intended to clarify that accessing the RRP should be a natural extension of an existing business model, and the counterparty should not be organized for the purpose of accessing the RRP.

Therefore, money market mutual funds that are organized for a single beneficial owner, or exhibit sufficient similarities to a fund organized to do so, generally will be deemed ineligible to access the RRP.

However, this should not disqualify a fund that serves as the cash management vehicle for multiple funds or investment entities in an investment fund complex from accessing the RRP.

Given the lack of explanation in its statement on how the FRBNY will determine the structure and purpose of a fund, it is unclear how or when it will make the disqualification determinations.

Takeaways

The Federal Reserve Board has been concerned for many years with banks with certain business models obtaining access to its services. This is because the Federal Reserve Board is concerned that inappropriate access to government-provided financial services may displace the role of traditional commercial banks, impair the liquidity transformation process and reduce private sector lending.

Additionally, the increased use of the RRP raises policy concerns with how it supports the normalization of monetary policy and whether there are broader issues associated with ever-increasing usage and interest rates.

Therefore, it is not surprising that the FRBNY would move to tighten the eligibility criteria for money market mutual funds to access the RRP.

Going forward, certain money market mutual funds that previously relied on the RRP will be expected to place cash with a commercial bank — which may use the deposits to make loans in the real economy — or invest directly in assets, which supports the functioning of the real economy.[2]

Accordingly, the expected end result is that the change is likely to remove a desirable cash holding option for money market mutual funds and entities that might seek to set up captive funds to access the RRP.

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[1] FRBNY, Statement Regarding the Policy on Counterparties for Market Operations and Reverse Repurchase Counterparties (Apr. 25, 2023), https://www.newyorkfed.org/markets/opolicy/operating_policy_230425.

[2] FRBNY publishes a list of counterparties that have access to the RRP. FRBNY, List of Reserve Repo Counterparties (Apr. 25, 2023), https://www.newyorkfed.org/markets/rrp_counterparties. It is unclear whether any existing counterparties were affected by the FRBNY statement because all of the funds listed were traditional money market mutual funds. Further, the list had not changed since November 14, 2022, implying that there was not a recent rush of new funds seeking to establish access.