RBC Capital Markets

Subject: Regulation D - Reserve Requirements of Depository Institutions- Policy on Payment System Risk [R-1381] - Proposed amendments to Regulation D (Reserve Requirements of Depository Institutions) that would enable the establishment of a term deposit facility

Ladies and Gentlemen:

The RBC Capital Markets US Interest Rate Strategy team appreciates the opportunity to comment on proposed amendment of Regulation D to allow for term deposits at the Federal Reserve by eligible institutions for use in monetary policy.

Introduction

The extraordinary measures the Federal Reserve has undertaken to support the economy over the past two years has left open questions as to the Federal Reserve's "exit strategies." We believe it is appropriate for the Federal Reserve to increase the number of reserve management tools available and that the flexibility provided by these tools will be paramount, given the size of excess reserves.

Our research suggests that bank lending will be constrained for some time as capital will likely be the governor of growth in monetary aggregates as opposed to the size of the Monetary Base (especially excess reserves) for at least the next several quarters. Our work on the banking system suggests that in aggregate it will likely take banks another year before their capital position will support broad based lending.

We believe transforming components of the monetary base into other forms of liabilities (e.g. reverse repos, term deposits, etc.) would be the least disruptive means of removal of policy accommodation. We suggest selling assets should be used as a last resort as it would be most disruptive to markets. The effective sale of assets will occur anyway through rolloff of the SOMA portfolio at a pace of about $20bn a month, after the Fed ends their security purchase programs.

Further, we believe the Federal Reserve could perform such actions prior to increasing the Federal Funds target rate. Using reverse repos and/or the Term Deposit Facility, while least disruptive strategy to markets, would likely cause money market yield curves to steepen. This steepening would likely slow economic growth and inflation expectations as money market funds and other short term investments would attract savers, creating a de facto rate hike.

There has been some confusion among market participants and the public as to the creation of money, and a belief that the overall size of the Fed's balance sheet could be a source of inflation – as opposed to only those liabilities that are inputs into the money supply. Given these circumstances, we suggest public education of how monetary policy is transmitted into the real economy would help the Federal Reserve in containing inflation expectations.

Comments on Term Deposit Facility (TDF) Operations

We believe the proposed amendments to Regulation D are appropriate for the creation of such a facility. We also believe that auctions with terms of 14, 28, 84 and 182-days could all be utilized. Depending on the size to be auctioned, we suggest that 28 and 84-day facilities could be offered regularly, with monthly or bi-monthly 182-day auctions.

We support the proposal to allow flexibility as to the benchmark instruments to use in determining maximum term deposit rates. Upon implementation, we suggest initially utilizing only one instrument to ensure clarity of the rate used. Although most of the rates suggested in the proposed amendment would be appropriate, we suggest OIS as the most appropriate measure.

Utilizing OIS would allow market participants to hedge their interest rate risk with a liquid instrument. As OIS can be customized to terms that match the maturity to be offered at scheduled TDF auctions, the market should be able to more easily absorb the supply. We believe other instruments would provide for less effective hedges as they are either collateralized, illiquid, or difficult to short. Therefore, using OIS should limit the market impact of hedging activities, although we do expect money market curves will steepen as the TDF is utilized.

Please do not hesitate to contact us if you have questions, comments or concerns regarding our suggestions.

Sincerely,

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