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May 13, 2019

Ms. Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

BY ELECTRONIC MAIL

Re: Regulation D: Reserve Requirements of Depository Institutions (Docket Number R-1652, RIN 7100-AF-40)

Ladies and Gentlemen:

We appreciate the opportunity to comment on the Advance Notice of Proposed Rulemaking (ANPR) issued by the Federal Reserve Board of Governors on March 6, 2019, regarding proposed amendments to Regulation D to lower the rate of interest paid on excess reserve balances (IOER) to eligible institutions that hold a very large proportion of their assets in the form of balances at Reserve Banks. These entities, referred to as Pass-Through Investment Entities (PTIEs), could be designed to efficiently pass on the interest earned on their reserves to institutional investors. The proposed amendments would authorize the Federal Reserve Board to lower the IOER rate to be paid to such institutions compared to the IOER rate applicable to all other eligible institutions that hold excess reserves at Reserve Banks.

Our view is that PTIEs would benefit the financial system by offering a safe, liquid means of investing cash balances that is not currently available to a broad range of financial market participants. Currently, traditional banks appear reluctant to accept large non-operating cash deposits. Other similar investment options outside the banking system are associated with counterparty, operational, and maturity risks, all of which are undesirable for the investment of cash reserves that specifically seek safety and liquidity. Deposits at PTIEs, as an alternative to other overnight investment options, would meet an existing need of market participants and increase the efficiency of their cash management. This increased efficiency may also support the resilience of institutional investors in periods of financial stress by facilitating the use of cash as a liquidity buffer.

The ANPR outlines a number of concerns about the effect of PTIEs on the implementation of monetary policy, financial intermediation, and financial stability. As we explain in this comment, we believe that PTIEs are unlikely to interfere with the Federal Reserve's implementation of monetary policy. We also would not expect PTIEs to have meaningful detrimental effects on commercial banks and funding markets. We believe concerns regarding a potential "flight to safety" as described in the ANPR can be effectively addressed by establishing dynamic limits on the size of PTIEs that would restrain their expansion in periods of severe market stress. Overall, in our view, these concerns do not present a compelling reason to pay a differential rate on the reserve balances of PTIEs than on balances of other eligible institutions.

Our Background

The D. E. Shaw group is a global investment and technology development firm with over $50 billion in assets under management across alternative and long-oriented investment vehicles. Our views on PTIEs are informed by three distinct perspectives. First, a number of investment funds managed by our firm hold a substantial portion of their assets as cash balances for risk and liquidity management purposes. We devote considerable resources to managing these cash reserves, seeking to minimize liquidity, counterparty, and operational risks, and we believe that we would place a sizeable portion of our funds' cash reserves with PTIEs were they to be established. Second, we have given considerable thought to the role PTIEs could play in the financial system because our firm has explored the possibility of launching a PTIE. As part of that exploration, which began in 2016, we have discussed the potential benefits of PTIEs with regulators and financial and nonfinancial firms, and our research in this area informs our comments on the ANPR. Third, our views on the likely effects of PTIEs on monetary policy are informed by the expertise of our investment professionals and treasury staff, including the firm's Director of Global Economics, who was head of the Markets Group at the Federal Reserve Bank of New York and manager of the System Open Market Account (SOMA) from 2009 to 2012.

The Key Benefits of PTIEs

PTIEs would allow for the efficient investment of cash balances held by nonfinancial corporations, investment managers, and other institutions as part of their prudent risk management. The key characteristic of these cash balances is that their holders generally seek to minimize risks, including investment, maturity and operational risks, and to maximize liquidity. We believe that these demands are not being effectively met by the current banking system.

In our experience, holding large non-operating cash balances as deposits in traditional banks has not been viable for two primary reasons. First, the business activities of traditional banks introduce counterparty risk that, even at modest levels, is deeply undesirable with respect to the investment of large cash reserves. Second, in our experience, traditional banks appear reluctant to hold deposits of sufficient size to serve as liquidity buffers for large institutions, which we attribute to regulatory costs, including the cost of expanding those banks' balance sheets. Reflecting this reluctance, banks have routinely offered us interest rates on deposits that are more than 100 basis points below the IOER rate. In effect, the current banking system does not incentivize traditional banks to efficiently accommodate large, liquid deposits that seek no risk.

As an alternative to traditional bank deposits, institutions seeking to hold large, liquid cash balances may also invest in money market funds or Treasury securities. However, investing in money market funds requires the assumption of some degree of counterparty risk and operational risk. These risks are remote, but they are particularly likely to manifest during periods of financial stress, when it is most important for institutions to be able to rely on their cash reserves. Investing cash balances in Treasury securities requires substantial trading operations and the assumption of maturity risk that is undesirable for purposes of a liquidity buffer. Treasury securities also do not offer same-day liquidity under standard settlement procedures.

In short, PTIEs could offer a risk-free, liquid asset in a form that meets the needs of a wide range of institutions with large non-operating cash balances more directly and more effectively than any alternative currently offered by the financial sector.

The Concerns Raised about PTIEs

The ANPR expressed the Federal Reserve's concerns regarding PTIEs in three general areas: (1) monetary policy implementation, (2) financial intermediation, and (3) financial stability. We comment on each in turn.

1. Monetary policy implementation

We agree with the Federal Reserve's views expressed in the ANPR that the implementation of monetary policy in the United States over the past several years has been successful, and we would not take the view that permitting the establishment of PTIEs is necessary for achieving successful implementation. However, we also do not believe that PTIEs would disrupt the Federal Reserve's ability to continue to successfully implement monetary policy.

The ANPR states: "The ability of PTIEs to attract a very large amount of deposits at a rate above other key overnight money market rates could affect the [Federal Open Market Committee's] plans to reduce its balance sheet to the smallest level consistent with efficient and effective implementation of monetary policy." It should be noted that the size of the Federal Reserve's balance sheet is governed entirely by its decisions about reinvestments, purchases, and sales from the SOMA portfolio, all of which will remain under the control of the Federal Reserve. The underlying concern may be that, if PTIEs held large balances and the rest of the banking system had a particular demand for reserves, then the Federal Reserve would ultimately need to meet that demand by holding a larger balance sheet. However, we believe that the market pricing mechanism would mitigate the need for Federal Reserve action in that case. If traditional banks have large demand for reserves for their fundamental activities and found themselves short because of the presence of PTIEs, then overnight interest rates generally would rise. Such a rise in rates would make PTIEs less profitable, allowing reserves to shift from PTIEs to traditional banks as needed.

The ANPR also raises the concern that PTIEs could reduce activity in various funding markets, including the federal funds market, and leave the rates in those instruments more volatile. Financial market participants currently allocate funds across these markets, with relative interest rates adjusting to efficiently distribute activity across them. Bank deposits should be included among the set of funding markets. In that context, it strikes us as inefficient to take action intended to reduce the return (and hence limit activity) in that one market, in order to boost activity in the others. Moreover, in light of the Federal Reserve's use of the IOER rate to influence the full set of short-term interest rates that affect economic activity, the capacity for PTIEs to pass through the IOER rate to a wider set of depositors would likely bolster the effectiveness of the Federal Reserve's policy framework.

2. Financial intermediation

The ANPR raises concerns about the effects of PTIEs on financial intermediation and ultimately on the cost of credit provided to firms and households in the economy. We address this topic in two steps.

First, the ANPR states that "PTIEs could also diminish the availability of funding for commercial banks generally." It is true that traditional banks would face more competition for deposits, thereby putting some upward pressure on deposit rates and wholesale funding rates. However, these activities will only shrink if traditional banks choose not to fund at those more competitive rates. Moreover, as noted above, in our experience, traditional banks generally have not seemed inclined to compete for large non-operating deposits.

Second, the ANPR states that these developments could "raise the cost of credit provided by banks to households and businesses." When considering this issue, it is important to take into account the ability of the Federal Reserve to make adjustments to the IOER rate and other policy instruments. The Federal Reserve generally sets monetary policy (including the IOER rate) to influence private borrowing costs to levels consistent with its dual mandate. If it was determined that the establishment of PTIEs was increasing borrowing costs for private firms and households to inappropriate levels, the Federal Reserve could lower the IOER rate (either through technical adjustments to the IOER rate within the federal funds rate target range, or in conjunction with a decline in the target range).

The concerns regarding the effects of PTIEs on financial intermediation in the ANPR appear to imply that limiting competition from PTIEs would allow traditional banks to pay lower deposit rates than they otherwise would in the presence of PTIEs, and that part of this difference might be passed through to their customers. Instead, we submit that it likely would be more beneficial to allow greater competition on deposit rates and to have the Federal Reserve adjust the IOER rate as appropriate to ensure that private borrowing rates are at the right level for economic conditions.

3. Financial stability

The ANPR discusses the possibility that PTIEs would improve financial stability, outlining an argument (with which we agree) that deposits held at PTIEs "could reduce the creation of private money-like assets that have proven to be highly vulnerable to runs and to pose serious risks to financial stability." In addition, we believe that PTIEs, by offering a more attractive means of investing cash reserves, will at the margin make holding such reserves more attractive to market participants, which could increase liquidity buffers held by a range of institutions. However, the ANPR also raises some financial stability concerns that have to do with the provision of an asset that is too safe. Specifically, the ANPR expresses concern that PTIEs could play a destabilizing role during periods of financial stress by offering an unlimited supply of "very attractive safe-haven assets" that would exacerbate a flight from bank funding.

We believe that some of these concerns are well-founded. However, in our view these concerns could be effectively addressed by placing a dynamic cap on the size of PTIEs—one that prevents them from expanding rapidly (*e.g.*, during times of stress) but does not prevent their organic growth over time. This mechanism would limit the ability of market participants to reallocate assets into PTIEs in an abrupt manner. We note that similar concerns regarding financial stability were raised about the overnight reverse repo facility offered by the Federal Reserve as it was being developed, and one of the ways in which this concern was addressed was through a cap mechanism.

Conclusion

We believe that PTIEs could offer a valuable instrument to firms that seek to hold large liquidity buffers as part of their prudent risk management. Lowering the IOER rate applicable only to PTIEs compared to all other eligible institutions would effectively prohibit the establishment of PTIEs as economically viable options for such firms to deposit their cash balances, discouraging them from holding the appropriate level of cash balances or forcing them into inferior instruments. We believe that such an outcome would be inefficient for such firms and the financial system generally for the reasons stated above.

We appreciate the need to carefully consider the concerns raised in the ANPR regarding the effect of PTIEs on the implementation of monetary policy and on financial intermediation, but we do not believe those concerns present a compelling reason to pay a differential rate on the reserve balances of PTIEs than on balances of other eligible institutions. In our view, the most legitimate concern about PTIEs is that the relative safety they offer could exacerbate flight-to-quality dynamics, which we believe can be addressed in a narrowly-tailored way by applying a dynamic cap on assets (or assets earning IOER) of PTIEs.

Given the benefits PTIEs could offer to the wide range of firms that have cash management needs as described in this letter, we believe that the Federal Reserve should allow PTIEs to develop, prudently and subject to supervision, rather than effectively preventing their establishment from the outset through the amendments proposed in the ANPR.

Sincerely,

The D. E. Shaw Group