

FEDERAL RESERVE SYSTEM

Date: May 18, 2011
To: Federal Open Market Committee
From: William English and Brian Sack
Subject: Draining Tools Update

This memo provides an update on the ongoing development of our two temporary reserve draining tools—reverse repurchase agreements and term deposits.¹

Reverse Repurchase Agreements

On February 1, 2011, the Trading Desk at the Federal Reserve Bank of New York (the Desk) posted eligibility criteria for a third wave of money market funds (those with assets greater than \$5 billion) to become counterparties for the reverse repurchase agreement program. After processing the applications, completing the counterparty reviews, and executing the necessary legal documentation, we intend to accept 32 new funds from 17 fund families as counterparties. A list of the funds accepted in this third wave is provided in Figure 1, and the Desk intends to publicly announce this list in a statement on Monday, May 23.

With these additions, the Desk will have enlisted a total of 90 money market funds as counterparties for reverse repurchase agreements. These 90 funds have nearly \$2.0 trillion in assets under management, with about a quarter

¹ We appreciate the significant contribution of Chris Burke and Jim Clouse to this memo.

of those assets currently in repurchase agreements. The Desk does not plan to expand its counterparty list to other money market funds at this time, as the additional draining capacity that could be gained is limited.

In addition to the money market funds, the Desk can conduct reverse repurchase agreement operations with the primary dealers as counterparties. While the primary dealers do not typically hold large amounts of cash balances, they can act as intermediaries by borrowing from other market participants that are looking to invest funds. Earlier surveys suggested that the primary dealer community would be able to conduct about \$150 billion of reverse repurchase operations in aggregate, though this estimate may be reduced if the Desk is also draining funds from sources (such as money market funds) that the dealers rely on for funding.

Beyond the primary dealers and the money market funds, the Desk intends to add two other types of counterparties—government-sponsored enterprises (GSEs) and depository institutions. With those two additional sets of firms, we may have reached the full set of counterparties for reverse repurchase agreements, as there are no additional types of firms that appear to be promising candidates.

For the GSEs, the Desk plans to post eligibility criteria on Tuesday, May 24, for those entities to become counterparties. The main threshold will be a minimum of \$15 billion in average daily outstanding investments in tri-party repurchase agreements. We expect only Fannie Mae and Freddie Mac to apply, as the Federal Home Loan Banks and other GSEs are not significant users of tri-party repo.

After the GSEs, the Desk expects to publish eligibility criteria for depository institutions to apply. The rationale for adding depository institutions as counterparties for reverse repurchase agreements is that they are the ultimate

holders of excess reserves. While they already have access to the term deposit facility, our view is that they should be allowed to participate in reverse repurchase agreements as well, so that they can choose the instrument that they find most appealing. Discussions with those institutions have suggested that they are interested in accessing the program, primarily because they can re-hypothecate the collateral from the reverse repurchase agreement to raise funds if needed, making those transactions more liquid than a term deposit.² The reverse repurchase agreement program would only be made available to the 50 to 100 depository institutions with the largest reserve holdings, given limitations on the number of counterparties that can be accepted in the FedTrade infrastructure.

As a final note on reverse repurchase agreements, given the challenges that we have faced in scheduling times with the clearing banks and counterparties to conduct small-scale exercises, the Desk intends to establish a regular schedule under which these operations would be conducted about every other month. The next set of small-scale operations, which will include the additional money market funds as counterparties, is expected to occur in mid-June.

Term Deposits

The term deposit facility (TDF) continues to receive a slow stream of additional applications from depository institutions. At this time, the TDF has 566 registered participants that, in aggregate, hold about \$860 billion in reserve balances.³

² Note that, when collateral from a reverse repurchase agreement is re-hypothecated in this manner, it does not affect the aggregate level of reserves in the banking system. In this manner, it differs importantly from breaking a term deposit (discussed below) or from liquidating a term deposit at the discount window, as those actions undo the reserve draining effects of the term deposit.

³ These data are as of May 6, 2011. Reserve balance figures are averages for the maintenance period ended April 20, 2011.

The Federal Reserve continues to conduct relatively small TDF auctions of 28-day deposits about every other month, in order to ensure the readiness of the tool. Auction demand has been solid, with auction stop-out rates generally about 1 basis point above the interest rate on excess reserves.

Over the past several months, the TDF automated system has been undergoing an upgrade that will allow for two new options: an early withdrawal feature and floating-rate deposits. The early withdrawal option would allow depository institutions to unwind their term deposits before maturity subject to an early withdrawal penalty, with the penalty presumably set to discourage frequent exercise of this option. Floating-rate deposits would pay interest based on a fixed, auction-determined spread relative to a specified reference rate (for example, the interest rate on excess reserves). Many depository institutions have indicated that they would find these features attractive, particularly for longer-term deposits. The upgraded application could be deployed before the end of the year.

Please let us know if you have any questions or concerns about these steps.

Figure 1
**Additional Counterparties for Reverse Repurchase Agreements
 To Be Announced on May 23**

Investment Advisor or Manager	Eligible Reverse Repo Counterparty
BlackRock Institutional Management Corp	BlackRock Liquidity Funds: T-Fund BlackRock Liquidity Funds: TempCash
BofA Advisors, LLC	BofA Treasury Reserves
The Dreyfus Corporation	Dreyfus Cash Management Plus Dreyfus Institutional Reserves Money Fund
Federated Investment Management Company	Federated Capital Reserves Fund Federated Prime Value Obligations Fund
Fidelity Management & Research Company	Fidelity Fixed Income Trust: Money Market Portfolio
Invesco Advisers, Inc.	STIT Government and Agency Portfolio
J. P. Morgan Investment Management, Inc.	JPMorgan Liquid Assets Money Market Fund
Morgan Stanley Investment Management, Inc.	Morgan Stanley Institutional Liquidity Fund Government Portfolio
Northern Trust Investments, Inc	Northern Institutional Funds - Diversified Assets Portfolio Northern Institutional Funds - Government Portfolio Northern Institutional Funds - Government Select Portfolio Northern Funds - Money Market Fund
Prudential Investments LLC	Prudential Investment Portfolios 2 - Prudential Core Taxable Money Market Fund
SSgA Funds Management, Inc.	Institutional Liquid Reserve Portfolio SSgA Money Market Fund SSgA Prime Money Market Fund State Street Navigator Securities Lending Trust
T. Rowe Price Associates, Inc.	T. Rowe Price Prime Reserve Fund T. Rowe Price Summit Cash Reserves Fund
TDAM USA, Inc.	TDAM Money Market Portfolio
UBS Global Asset Management (Americas), Inc.	Prime Master Fund Treasury Master Fund UBS RMA Money Market Portfolio
U.S. Bancorp Asset Management, Inc	First American Treasury Obligations Fund Mount Vernon Securities Lending Prime Portfolio
The Vanguard Group, Inc.	Vanguard Federal Money Market Fund
Wells Fargo Funds Management	Wells Fargo Advantage Money Market Fund Wells Fargo Advantage Prime Investment Money Market Fund Wells Fargo Advantage Treasury Plus Money Market Fund