In order to incentivize a shift in banks demand for reserves, a fixed-rate repo facility would need to be available in large size to large banks, and be available during both episodes of broad-based funding market strains and firm-specific liquidity events. Such availability could result in a Federal Reserve balance sheet expansion during these events driven by one or a few large firms. Supplying a higher level of reserves under normal conditions would reduce the need for this episodic expansion by providing the banking system with an ongoing access to assets of the highest level of liquidity.

That said, the facility could likely provide some financial stability benefit by reducing the risk of widespread funding market strains. For example in a scenario where money funds pulled back from their financing relationships with dealers, dealers could face liquidity strains. In this scenario, it is possible that money funds may seek to place cash with the ON RRP as a safe-haven investment. In turn, the repo facility could see increased usage by dealers and other counterparties. The result might be that the Federal Reserve balance sheet could serve to intermediate a sizeable share of typical private sector money market activity. To the extent that this role was consistent with calming market conditions and supporting a return to normal funding relationships, such a function might be beneficial.[27]

Balance sheet expansion could also occur in more common periods of funding market pressures, depending on the rate of the facility. For example repo rates tend to increase when dealers face substantial security financing needs such as during periods of increased Treasury issuance. Take up at a standing fixed-rate repo facility could thus be quite large during periods with significant increases in Treasury issuance.

Policy Considerations Associated with Counterparty Access

We discussed above how counterparty choice would drive the different potential effects of the facility on market rates and reserve demand. Another component of counterparty selection is fairness. Repo operations that provide liquidity to non-bank entities, as in a facility that used primary dealers as counterparties, could become the subject of public criticism, particularly if take-up of the operations were very high in periods of stress. On the other hand, having a readily available tool to address funding market stress may support financial stability.

For a repo facility focused on banks, there would be different considerations, such as managing the number of counterparties. There are 24 primary dealers established by the Desk according to its counterparty policy. It is difficult to know ex-ante how many banks would be interested in a repo facility. While there are over 5000 reserve account holders, the 75 SFOS respondents capture about 75 percent of current reserve holdings and over 80 percent of the aggregate reserve demand. The largest banks have very significant securities holdings, and, as shown in the Appendix, a great deal of variation in securities portfolio structures. In terms of holdings of Treasury securities, larger banks hold more Treasuries in aggregate and as a proportion of their assets than smaller banks. That said, there is evidence that some small banks have significant Treasury security portfolios and thus could be interested in a repo facility as well (see Appendix). Also, smaller banks, and industry groups representing them, might voice concerns if smaller banks did not have a pathway to access. These considerations suggest that if policy makers were interested in pursuing a bank-focused repo facility, it would be important to identify the appropriate criteria for counterparty selection.

Changing market incentives for securities portfolio choices

[27] The rate on the facility could be adjusted up or down by the FOMC in response to the evolution of funding market conditions. The spread of the primary credit rate over the federal funds rate was narrowed during the crisis.