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Foreign Banks Get Push From Fed Policies

The Fed's interest rate policies have been nothing but a source of income for banks inside and outside the US, and this is likely to continue if the Fed keeps tight control over borrowing costs

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Foreign banks have received $4.7 billion in interest payments this year, over reserves deposited at the US Central Bank. Last year, these interest payments amounted to $5.2 billion, totaling $9.8 billion in just two years. This is due to the 1500 basis points (bps) spread between the extremely cheap borrowing rates and Fed deposit rates. Analysts estimate these earnings to go up if the Fed decides to raise these rates. Since 2009, the percentage of reserves held by foreign banks has risen from 20% to nearly 50%. This lending amounts to only 17% of bank assets in the country.

These risk-free returns contribute a great deal to the banks' revenues. According to the Fed's regulatory filings, some of the foreign banks with the largest reserves at the Central Bank are Deutsche Bank AG (USA) (DB), UBS AG (UBS), Bank of China Ltd. (SHA:601988) and Bank of Tokyo-Mitsubishi. American banks include JPMorgan Chase & Co. (JPM), Wells Fargo & Co. (WFC), and Bank of America Corp (BAC).

A spokesperson for the Bank of Tokyo-Mitsubishi believes these excessive reserves are an inevitable consequence of the Fed policies: "The share of excess reserve balances held by BTMU has been in alignment with its business footprint in the US." Similarly, Lou Crandall, chief economist at Wrightson ICAP, terms this parking of funds to be "entirely legitimate because they [Fed] are providing a financial service and they [banks] are taking a spread." However, a representative of Bank of China disclosed to sources that these deposits are to meet the liquidity requirements in the home countries.

The Fed has injected around $3 trillion in the financial sector, and has been paying an interest of 0.25% on the Fed reserves. These payments are a way to formulate new government policies and regulate short-term interest rates. However, in a meeting this month, the Fed confirmed that the reserve rate will be used to boost the short-term borrowing rates, currently at near-zero level, after a "considerable time."

Previously, the Fed adjusted the interest rates by pumping or withdrawing the money supply in the economy, through short-term bond trading. That method is no longer feasible, as excessive money supply exists in the system. Hence, the Fed will alter the reserve rates to change the existing Fed funds and borrowing rate.

These abundant payments to foreign banks could set off political warning signals. William Poole, a senior fellow at the Cato Institute and former president of the Federal Reserve Bank of St. Louis, has said: “The fact is that the Fed is going to be paying very large amounts of interest to banks, it's highly likely that some politicians will notice that and given the proclivity of some politicians anyway to demagogue issues, the Fed is going to have some political explaining to do." James Bullard, president of the Federal Reserve Bank, agrees.

It must be noted that most of the reserves come from foreign banks, due to limits placed on US banks to keeps excessive cash reserves. Foreign banks require an equity-asset ratio of 3%, while US banks require an equity-asset ratio of 6%. This tempers their desire to secure their funds at the Fed. Additionally, foreign banks have to report their capital levels on a quarterly basis, as compared to US banks that require daily calculations. US banks also have to deal with higher levels of deposit insurance fees. They can bypass these fees by investing in transactions outside the Fed’s jurisdiction.