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Fed Rate Policies Aid Foreign Banks

Lenders Pocket a Spread by Borrowing Cheaply, Parking Funds at Central Bank

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The Federal Reserve is changing the way it controls interest rates.

Banks headquartered outside the U.S. have been unlikely beneficiaries of the Federal Reserve's interest-rate policies, and they are likely to keep profiting as the Fed changes the way it controls borrowing costs.

Foreign firms have received nearly half of both the $4.7 billion in interest the Fed paid banks so far this year for the money, called reserves, they deposit at the U.S. central bank, and the $5.1 billion it paid last year, according to an analysis of Fed data by The Wall Street Journal. Those lenders control only about 17% of all bank assets in the U.S.

Moreover, the Fed's plans for raising interest rates make it likely banks will see those payments grow in coming years.

Though small in relation to their overall revenues, interest payments from the Fed have been a source of virtually risk-free returns for banks including Deutsche Bank AG , UBS AG , Bank of China Ltd. and Bank of Tokyo-Mitsubishi UFJ, according to bank regulatory filings. U.S. banks including J.P. Morgan Chase & Co., Well Fargo & Co. and Bank of America Corp. are also big recipients of Fed interest payments, according to the filings.

"It is a small transfer from U.S. taxpayers to foreign taxpayers," said Joseph Gagnon, a former Fed economist at the Peterson Institute for International Economics. The transfer, he added, was a side effect of Fed policy, not a goal.

Behind the payments is a complex interplay between new government regulatory policies and new methods the Fed has developed to control short-term interest rates.

The Fed has pumped nearly $3 trillion into the banking system since the 2008 financial crisis, increasing banks' reserves, in efforts to stabilize markets and boost economic growth.

Since 2008, it has paid banks interest of 0.25% on those reserves. The Fed affirmed this month that the rate it pays on reserves will be the primary tool it uses to raise short-term borrowing costs from near zero when the time comes, likely next year.

In part because regulatory requirements discourage domestic banks from holding more cash reserves than they need, many of the reserves created by the Fed are held by foreign banks.

In the past, the Fed influenced interest rates by increasing or reducing money in the banking system through small amounts of short-term bond trades with banks. This caused the Fed's benchmark federal funds rate to rise or fall, influencing other borrowing costs across the economy, such as those on mortgages, credit cards and business loans. Because there is so much money in the financial system now, that old method won't work and the Fed plans to rely primarily on adjusting the interest rate on reserves to change the fed funds rate and other borrowing costs.

The interest payments will increase over time as the Fed raises rates. The Fed remits most of its profits to the U.S. Treasury, and the rising cost of the interest payments could put downward pressure on the amount the central bank sends to taxpayers each year, the Fed has said.

Some observers say this could become a political challenge for the Fed, especially the payments it makes to foreign banks.

"The fact is that the Fed is going to be paying very large amounts of interest to banks," said William Poole, a senior fellow at the Cato Institute and former president of the Federal Reserve Bank of St. Louis. "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."

Some Fed officials also have expressed concern about how these payments will look. "I think the optics are very difficult to defend and might get us into trouble," James Bullard, president of the Federal Reserve Bank of St. Louis, said in an August interview with MarketWatch.

Wall Street Journal calculations show foreign bank holdings of U.S. reserves held at the Fed have increased from less than 20% of the total before the financial crisis to nearly 50% today.

Since 2009, they have earned roughly $5 billion by borrowing dollars cheaply, often at less than 0.10%, in short-term funding markets and depositing those funds at the Fed for 0.25%, according to the Journal analysis. That estimate doesn't take into account the costs of raising money through other means, overhead and taxes, which affect net income.

A spokeswoman for one bank engaged in the trade, Bank of Tokyo Mitsubishi, said that the growth of excess reserves parked at the central banks is a natural consequence of the Fed's policy. "The share of excess reserve balances held by BTMU has been in alignment with its business footprint in the U.S.," she said.

The foreign banks with the largest reserve balances at the Fed as of June 30, Deutsche Bank and UBS, didn't respond to requests for comment. A Chinese official close to Bank of China said it has been parking funds at the Fed in order to help it comply with liquidity requirements in its home market.

The foreign banks' activity is "entirely legitimate because they are providing a financial service and they are taking a spread," said Lou Crandall, chief economist at research firm Wrightson ICAP.

Big U.S. banks say the trade looks unattractive to them, largely because of U.S. capital requirements.

All big banks must fund their assets, including cash, with a minimum percentage of investor equity, or capital. Outside the U.S., banks are generally required to maintain a ratio of equity to assets of at least 3%.

Big U.S. banks must maintain equity of at least 6%, so they are less inclined to hold extra cash simply to park it at the Fed for a tiny spread.

In addition, the biggest foreign banks can generally report capital levels at the end of every quarter, rather than calculate them every day as the largest U.S. banks do. That means that on most days, foreign banks can park huge amounts of money at the Fed without worrying about its impact on their capital requirements.

Foreign banks have other reasons for being active in short-term U.S. dollar funding markets, beyond gains from Fed deposits. Many were caught short of dollars during the financial crisis, making it appealing for them to have increased their dollar holdings to avoid a repeat.

The Fed has experimented with an alternative, known as reverse repo trades, that would allow it to control interest rates via payments mainly to U.S. money-market mutual funds, rather than foreign banks. However, Fed officials are wary of this new tool and said this month they intended to limit its use.

U.S. bankers privately don't complain about missing out on the low-margin trade. There are "better uses of our time," one U.S. banker said, referring to activities that could generate a larger profit.

—Lingling Wei contributed to this article.