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Interest on Fed reserves is the wrong market policy to criticize

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There is a considerable debate in the world of economics and finance about the efficacy of the Federal Reserve's payments of "interest on excess reserves" held at the central bank. Norbert Michel at the Heritage Foundation and George Selgin at the Cato Institute, vociferous critics of the practice, [claim](#) that the 1% now paid in [interest on excess reserves](#) (IOER) is constraining bank lending. In fact, there is nothing that supports this thesis.

Properly viewed, the Federal Reserve System is the alter ego of the U.S. Treasury. The Fed does not earn "profits" from its holdings of Treasury debt, but simply forgives part of the obligations of the United States, subtracts its operating expenses, and remits the balance back to the Treasury.

In 2008, when Congress gave the Fed the power to pay IOER deposited with the Fed, it was simply creating a new short-duration, risk-free asset class. Excess reserves compete with Treasury obligations and other short-duration investment assets with low or zero risk weighting for bank capital purposes. The 1% that the Fed now pays on IOER is a bit higher than the 0.8% available on T-bills maturing in the next four weeks, but does this constrain bank lending? Absolutely not.

A better approach than ending interest on excess reserves is for Congress and the White House to make clear to Federal Reserve Chair Janet Yellen that the central bank should reduce its portfolio of Treasury and agency securities in a deliberate and orderly fashion. **Bloomberg News**

In the theoretical realm of economics, the Fed's 1% payment of IOER may seem significant. But, especially since it is a true risk-free asset, the relevant comparison for this rate is against other short-term investments with similar risk profiles. Excess reserves on deposit with the Fed are cash, so if the bank finds a better use for the funds, there is nothing to prevent a change in asset allocation.

When considering the asset-liability management of a bank, there are basically three buckets: lending, investing and trading. The fact that the bank can earn 1% on excess reserves with the Fed — with a zero capital weight — is certainly relevant to the investment function of the institution, but the lending side of the house is unlikely to even consider it. More important to lending are the internal exposure risk limits for different asset classes, the overall leverage of the institution versus regulatory limits, and the net runoff of existing loans.

This is not to say that Fed monetary policy has no effect on lending. In fact, the vast expansion of the Fed's \$4.7 trillion portfolio of Treasury debt and mortgage-backed securities has a significant impact, resulting in a distortion of the credit markets. These purchases of securities by the Fed were funded with excess reserves essentially created by the Fed as part of its radical policy of "quantitative easing," or QE. The result has been a sharp contraction in credit spreads that has effectively suppressed the true cost of credit.

Far from constraining bank lending, the Fed's QE has encouraged a great deal of lending and, most important, securities issuance to inferior borrowers at investment-grade credit spreads. Investment grade debt issuance is at record levels. The fact that the Fed pays banks 1% on IOER balances in return for longer-duration Treasury debt and even Ginnie Mae MBS acquired via QE is hardly a good trade-off. Indeed, one might well ask why the Fed does not pay banks more than 1% in IOER!

Some foreign banks seem to find this situation attractive, which explains why offshore institutions hold the majority of excess reserves on deposit with the Fed. Yet virtually every domestic banker I have asked about the attractiveness of IOER versus commercial loans, or other long-duration risk assets, has indicated that the latter is far more attractive. But more fundamentally, the lending officer of the bank would not even consider increasing its reserves on deposit at the Fed. That is an investment decision that is part of the larger asset-liability management equation.

Ultimately, most of the growth of excess reserves at the Federal Reserve is driven more by QE than the relative rate paid. When the Fed belatedly declares success and winds down its massive portfolio, credit markets will start to normalize and the considerable credit risk created by QE will also start to subside, though this process will take many years. Although some view the Fed's payment of IOER as a subsidy to banks and an inflationary threat, others maintain it keeps interest rates and inflation in check.

"In the wake of the Great Recession, interest on excess reserves has become an essential tool for the Fed to influence short-term interest rates and inflation," Robert Eisenbeis of Cumberland Advisors told Congress last year. "For most of the history of the Federal Reserve, no interest was paid on reserves. But requiring banks to hold a portion of their assets in the form of a non-interest-bearing reserve against their deposits effectively reduced bank earnings and functioned as a tax."

Prior to 2008, banks tried to minimize excess reserves, typically by lending. This converted excess reserves into required reserves. "For the banking system as a whole, this practice creates a money multiplier and expands the money supply, and during periods of rapid expansion it leads to inflation," Eisenbeis said.

"Today, for example, one dollar of reserves could theoretically support a tenfold increase in the money supply and potentially trigger an explosion in inflation. This unwelcome prospect explains why economists and some members of the Federal Open Market Committee are concerned that the Fed needs to wind down its portfolio, decrease the amount of excess reserves and return interest rates to normal."

Unfortunately, the Fed is several years behind the curve when it comes to normalizing monetary policy, which is one reason the level of excess reserves has not fallen significantly. Some observers such as Michel and Selgin have called upon the Fed to end payment of IOER as a means of reducing excess reserves, which is a decidedly [neo-Keynesian](#) perspective on managing the flow of funds in the banking system.

A better approach is for Congress and the White House to make clear to Fed Chair Janet Yellen that the time for radical policy experiments such as QE has ended and that the central bank's portfolio of Treasury and agency securities needs to be reduced in a deliberate and orderly fashion. The real threat posed by the trillions in excess reserves is not that it stymies lending, but that it enables the manipulation of the credit markets and may lead to higher credit losses for banks down the road.