FedFin Client Report

Wednesday, February 10, 2016

Bipartisan IOER Concerns Hijack Yellen Hearing

Client Report: **IOER2**

Executive Summary

FRB Chair Janet Yellen today testified before the House FinServ Committee, providing an update on monetary policy that contained a newly-pessimistic outlook. In this report, we focus on her comments addressing financial-services policy. In her testimony, Chair Yellen went out of her way to defend the FRB's policy on interest on excess reserves (IOER), attacked as a big-bank subsidy by members of both parties throughout the hearing. She defended IOER by arguing that the FRB contributes more to the Treasury, and thus taxpayers, through the interest the FRB earns on its expanded balance sheet than it pays in IOER. Chair Yellen also received a number of inquiries regarding the possibility, legality, and potential impacts of negative rates in response to this year's round of stress tests (see Client Report **STRESS25**). She was quick to assure the committee that this is meant as a fact-finding exercise and is not a sign of things to come, although she also noted that market forces could push rates negative and/or the FRB might resort to this tool if warranted by economic circumstances. Confirming FedFin's read of a newly-released 2010 memorandum, Ms. Yellen said she did not believe there are legal impediments to reaching negative nominal rates by setting one for IOER. This report addresses these issues.

Analysis

Opening Statements

Chairman Hensarling (R-TX) noted that, despite the President's positive tone during his State of the Union address, economic conditions continue to be dire by many measures. Calling the FRB the financier and facilitator of national debt, he called for quick action on the FORM Act (see FSM Report **FEDERALRESERVE26**) and urged the FRB to unwind its balance sheet, which he called a source of systemic risk.

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

Ranking Member Waters (D-CA) questioned whether it was prudent to raise the federal funds rate while inflation is below target and weakness remains in the labor market. She also questioned whether the Fed has a coherent exit strategy, commenting that an exit strategy that does not involve a massive transfer of wealth from the FRB to banks is needed and could be achieved through using FRB assets for social-impact financing. She also criticized the FRB for not sanctioning big-bank living wills.

Rep. Mulvaney (R-SC) confined his remarks to the FRB's regulatory role, arguing that the central bank has grown way beyond its intended scope. Rep. Moore (D-WI) supports the December FOMC decision to raise the federal funds rate, but commented on the idiosyncratic nature of doing so while other central banks are lowering rates.

Testimony

Chair Yellen detailed the economic conditions the United States faces before addressing the economic outlook and monetary-policy considerations. She noted that the economy has made progress towards the goal of full employment and that, while inflation will remain low in the short term, she sees encouraging signs that it will return to normal in the medium term. The Chair said that the FOMC expects to continue with its plans to slowly begin to tighten monetary policy, but that as always, the Committee is carefully monitoring the data and that monetary policy decisions will be based on these data and not a predetermined course.

Q&A

Rep. Hensarling questioned the approach the Fed is currently taking with regards to ending its accommodative policy, arguing that the FRB is subsidizing deposit rates for the biggest banks by paying an above-market rate for excess reserves. Chair Yellen noted that IOER is widely used by other central banks and that excess reserves finance holdings of longer-term Treasury securities and other assets which earn substantially greater interest than the FRB pays out.

Rep. Waters also asked Chair Yellen about IOER, questioning if IOER is the most prudent way to set policy and asking if the FOMC has alternatives. Chair Yellen argued that the pre-crisis approach to adjusting interest rates through variations in the amount of required reserves is no longer feasible and that shrinking the balance sheet at this time would be a challenge due to the potential negative impact it could have on the economic recovery. Ms. Yellen also pointed out that, because the FRB has been telling the public that it plans to move through reducing its balance sheet gradually and executing policy in the interim through IOER, market expectations now demand that it

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do so. She again defended paying IOER by saying that the FRB's large balance sheet pays more interest to taxpayers than IOER pays to banks.

Rep. Mulvaney, continuing the IOER discussion, asked the Chair if market rates have ever been below IOER. The chair responded that, when IOER was set at 25bps, the Fed funds rate traded below it. This continued when the Fed funds rate was increased in December. Rep. Mulvaney then questioned the Chair on whether the Fed would consider transitioning to a rules-based system, and under what conditions this would be feasible. Chair Yellen, while supportive a rules-based system in theory, argued that it would be irresponsible to mechanically follow rules without taking into account a large set of economic indicators.

Rep. Moore pressed on why more bankers have not been criminally prosecuted, leading Ms. Yellen to reiterate that this is a Justice Department call, not one the FRB may make.

Rep. McHenry (R-NC) asked whether the FRB has the legal authority to implement negative rates, leading Ms. Yellen to say that she is unsure on this point because the issue has never been fully researched. When the issue was briefly considered in 2010, no in-depth investigative efforts were made because the FRB decided negative rates would not have been the prudent course at that time.

Rep. Garrett (R-NJ) criticized the new 13(3) emergency-lending rule (see FSM Report **RESCUE70**) saying it is full of loopholes that undermine its goals and is unduly opaque. Chair Yellen countered that the FRB is now prohibited from lending to an insolvent borrower and that emergency lending must be broadly based.

Rep. Neugebauer (R-TX) asked whether Fed policies are reducing liquidity, citing European Commission efforts to assess the cumulative impact of its requirements (see FSM Report **COMPLEXITY2**) and urging a similar FRB effort. Chair Yellen said that the FRB is still in the process of finalizing Dodd-Frank rules and that a full analysis could not be done until these rules are implemented.

Rep. Royce (R-CA) questioned the Chair on the decision to include negative rates in the latest round of stress testing. While he does not believe this predicts future action, he is concerned about the timing of this release due to the negative-rate policies in Japan and Europe. He asked if, provided the FRB had the legal authority, negative rates are an FRB tool. Chair Yellen said that the scenario was not motivated by plans to implement negative rates, but driven by a desire to be prepared in the event market stress naturally pushes rates negative, as has happened before.

Rep. Rothfus (R-PA) asked the Chair whether the FRB considered the treatment of custody deposit when crafting the supplementary leverage ratio (SLR) (see FSM Report **LEVERAGE5**), noting it does not recognize the essentially riskless nature of these assets. Ms. Yellen said the FRB did consider this when crafting the rule, but because the SLR is not intended to be the binding capital constraint, it is appropriate.

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