GSE Activity Report

Thursday, January 4, 2018

The Arbitrage Machine Revs Up

Summary

In April, we alerted you to a Cleveland Fed study arguing that the GSEs, especially the Home Loan Banks, fuel billions in profitable arbitrage trading by foreign banks. A new Fed staff study uses confidential data to reach a still more damning conclusion. The Fed can't do much about GSE lending, but it sure can do something about foreign-bank demand for it. If it does, the FHLBs will need a new gig.

Impact

The arbitrage play comes because the GSEs can borrow from the Fed but are not allowed to hold reserves, including interest-bearing ones, at the central bank. So, the GSEs borrow at rock-bottom prices and lend the money to banks – mostly foreign ones. The branches and agencies of these foreign banks do have reserving privileges at the Fed, so they plop the GSE loans into excess reserves and – voila – achieve a tidy arb spread on a riskless transaction. Banks used to borrow from money-market funds in this arena, but the SEC's restrictions on non-governmental assets has left the field open almost exclusively to the GSEs.

Why don't U.S. banks play this arbitrage game? The new Fed study shows that they do, but at sharply-lower volumes and also at lower spreads and for different purposes. Large U.S. banks have less of a spread between the cost of their GSE borrowing and interest on excess reserves (IOER) because they must pay FDIC premiums on these reserve assets and at the same time allocate leverage-ratio capital at a whopping rate double that governing most foreign banks. Foreign banks do have a leverage-ratio constraint. However, it's not only smaller than the like-kind U.S. rule but also judged only on a month- or quarter-end basis, making leverage capital a free ride for as long as 119 days every three months. U.S. banks are subject to daily-averaging for their leverage ratios precisely to bar this type of window-dressing.

Notably, the new Fed study also finds that foreign banks fund their excess-reserve holdings with borrowings from the GSEs; U.S. banks do it with deposits (which we would note are largely those received by custody banks that cannot be used in any other way as explained

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in a 2015 FedFin study).

The Fed cares about this arbitrage ploy not only because it doesn't want to see foreign banks flaunt the rules that bind big U.S. ones, but even more importantly because the ability of foreign banks to ride the IOER train under-cuts the Fed's ability to set the fed funds rate and thus drive U.S. monetary policy. Many IOER critics have argued that it is a subsidy because IOER is not in fact the risk-free floor the Fed intends as a lower bound to U.S. short-term rates. Lower rates from the GSEs are in fact the lower bound, meaning that the Fed's nominal floor is above-market and, for foreign banks, quite profitable given the risk-free nature of the trade and the very small risks, if any, taken by the GSEs in this daylight and overnight market.

In 2013, the Fed recognized that this arbitrage trade so threatened its lower bound that it created the over-night reverse-repo program (ONRRP) to curtail it. There are doubts about the ONRRP's floor but, even if it works, it also creates a Fed window for GSEs that, critics again assert, is almost as good as IOER for all but the taxpayer.

Outlook

What could the Fed do about all this? Former Fed Gov. Tarullo wanted to impose capital requirements on foreign branches and agencies, which would have put a sharp stop to the most arbitrage-advantaged of the GSE/IOER trade. The new Fed study reinforces Fed staff interest in such a standard, but its fate is uncertain due to the significant personnel transition under way at the central bank. Another way to curtail the trade is to eliminate IOER as Board-nominee Goodfriend has long advocated. Very gradual reductions in the Fed balance sheet also reduce excess reserves, at least to some extent, but the best way to end this gig is to give banks – foreign and domestic – something better to do with the money the GSEs will continue to lend to them.

Absent significant regulatory changes and far stronger loan demand, only Fed regulatory action directed at foreign banks will curtail an important source of FHLB earnings. Were this to happen, the Banks would have to subsidize advances for the biggest U.S. banks still more deeply or figure out how to go back to funding mortgage finance.

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