Risk sharing in the Federal Reserve System and in the Eurosystem

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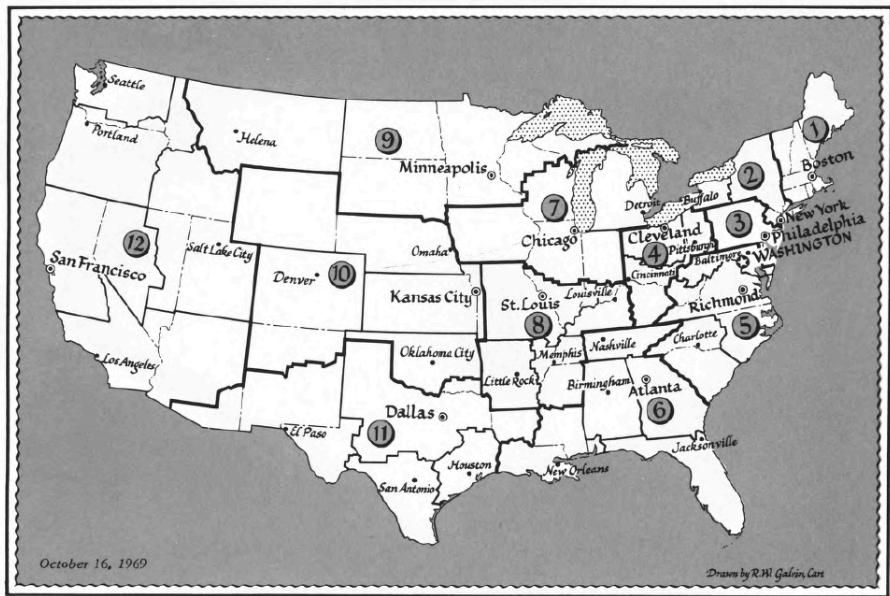
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October 16, 1969
Drawn by R.W. Galvin, Cart

Reserve ratios and par clearing

Federal Reserve Act, Section 16

“Every Federal Reserve bank shall maintain reserves in gold [...] of no less than 35% against its deposits"

- A Reserve Bank whose gold ratio fell below 35% would be unable to settle with other Reserve Banks
- Commercial banks in this district could no longer maintain business relations with other districts
- Payments from the district with inadequate gold might trade at discount violating the "par clearing" clause of the FR Act

Disruptive and cooperative adjustments

Disruptive adjustment

- Reduce Reserve bank liabilities to restore reserve ratio

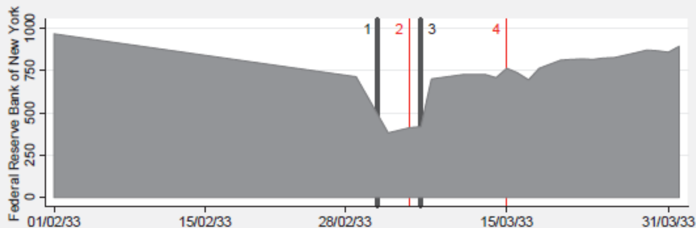
Cooperative adjustment: Reserve pooling

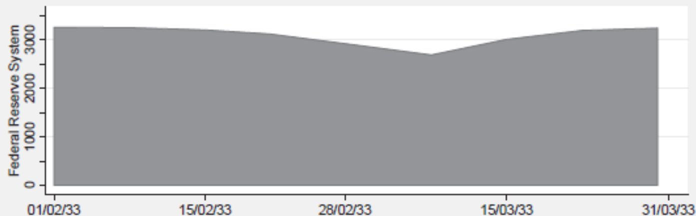
- Interdistrict rediscounts of bills
- Interdistrict purchases of bankers' acceptances

How did it work?

- Spirit of collaboration most of the time
- Tensions in 1920, Atlanta vs. Cleveland / Board
- Breakdown in March 1933

Figure 8: Interdistrict cooperation breakdown – February-March 1933
(Gold reserves, USD million)





Emergency measures

March 9, 1933: Emergency Banking Act

Title IV gave the Federal Reserve flexibility to issue emergency currency not backed by gold

March 11, 1933: telegram of Treasury Secretary Woodin to FRBNY Governor Harrison

"I do not hesitate to assure you that I shall ask the Congress to indemnify any of the 12 Federal Reserve banks for such losses"

Lessons and Reforms

Lessons

1. In a system composed of multiple legal entities, there is always a risk that some focus on their own positions with inadequate regard to national conditions
2. Autonomy fuels irritation and conflicts (disagreement over discount rate changes in the 1920s, non-authorized purchases by FRBNY in immediate aftermath of the crash, ...)

1930s Reforms

1. Made mutualization of reserves more automatic and direct
2. Reduced autonomy of decision-making

Medium term: More mutualization

Regulation M, July 4, 1933 introduces reallocation

"[The allocation] of government securities [...] shall be made with the view primarily of (a) enabling each Federal Reserve Bank to maintain a suitable reserve position"

FOMC directive, May 25, 1936

"The executive committee shall make [...] readjustments in the allotments as shall be necessary to raise the reserve ratio of [a bank] to 50%"

Medium term: Less autonomy

Open market operation, Banking Act 1933

Federal Reserve Banks are now prohibited from purchasing or selling securities at their own initiatives. FOMC replaces OMPC and is empowered to instruct Reserve Banks to sell or transfer any securities held or purchased to a joint System account

Discount rates, Banking Act of 1935

Section 14 (d): Each such bank shall establish [discount] rates every fourteen days, or oftener if deemed necessary by the Board

Growing restrictions on risk sharing

Asset purchases

- SMP (2010): full risk sharing
- OMT (2012): full risk sharing
- PSPP (2015):
  - Partial risk sharing: 20% full risk sharing; 80% no risk sharing
  - Each NCB buys the debt issued in its own jurisdiction

Growing restrictions on risk sharing

Collateral policy

- Before 2007:
  - Tier-1 list (uniform eligibility criteria): full risk sharing
  - Tier-2 list (eligibility criteria set at NCBs): no risk sharing
- After 2007: Convergence to Single List with full risk sharing
- December 2011 (Additional Credit Claims): eligibility criteria set at NCBs and no risk sharing

Growing restrictions on risk sharing

Emergency Liquidity Assistance

- When banks need liquidity beyond the amount of eligible collateral that they can pledge under normal refinancing operations, they turn to ELA
- Importance of ELA has increased during the crisis
- Responsibility lies with the NCB concerned. No risk sharing
- With SSM taking over as supervisor, no rationale for keeping ELA decentralized

Conclusion: does it all matter?

Growing differentiation in credit risk between NCBs doesn't matter because

1. The sovereign can recap the NCB
2. Another entity (e.g. other sovereign) can recap the NCB
3. A central bank can operate with negative equity

As long as Target balances remain unrestricted, this need not translate into a redenomination nightmare

But...