SPEECH

Desk Operations: The New Normal

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Lorie K. Logan, Executive Vice President

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Welcome to the 2021 Annual Primary Dealer Meeting.

Primary dealers play an important role as counterparties in open market operations, providing a key link in the implementation of monetary policy—a core responsibility of the New York Fed as the Reserve Bank selected to operate in financial markets on behalf of the Federal Open Market Committee (FOMC). In addition, primary dealers serve as important participants in U.S. Treasury auctions. I'm glad that we're back together—even if only virtually—to participate in this annual forum. These meetings provide an opportunity to strengthen our relationship and communicate our expectations.

It was just over a year ago that the global economy and financial markets were upended by the COVID-19 pandemic, and the Federal Reserve undertook extraordinary actions to respond to the crisis. Today, I'd like to reflect on the operational approach of the New York Fed's Open Market Trading Desk (the Desk) during the past year, and some of the lessons I take away from this experience. Moreover, I'd like to highlight how our operations have transitioned since the onset of the pandemic, and some of the ways they will continue to evolve to ensure that we implement the FOMC's directives for open market operations in an effective and efficient manner.

Before proceeding, let me note that the views presented here are my own and do not necessarily reflect those of the New York Fed or the Federal Reserve System.[1]

The Pandemic Response: Flexible and Adaptive

In my remarks to this group at the end of 2019, I focused on the FOMC's approach to implementing an ample reserves regime.[2] We had set a course to gradually reduce repurchase operations and eventually maintain an ample level of reserves with regular Treasury purchase operations.

Events overtook those plans. Our focus shifted abruptly when the onset of the pandemic triggered extraordinary economic stresses and dislocations in the global financial system.[3] The Federal Reserve responded with swift and integrated action to support smooth market functioning and ensure the flow of credit to U.S. households, businesses, and state and local governments. In addition to conducting large repo operations and purchasing substantial amounts of Treasuries and agency mortgage-backed securities (MBS), the Federal Reserve expanded FX swap lines and Discount Window lending, and extended liquidity to critical parts of financial markets and the economy through special lending and credit facilities. Also, regulations were temporarily adjusted to encourage bank lending.

On the Desk, responding to the crisis required an exceptionally high degree of adaptability and flexibility. For open market operations—both repo operations and outright purchases—the Desk was broadly directed by the FOMC to support smooth market functioning.[4] For Treasuries, agency MBS and agency commercial mortgage-backed securities (CMBS), the FOMC directed us to purchase securities in the amounts needed for this purpose. To comply with these directives, we responded to fast-moving market developments and adjusted operations as conditions evolved. In reflecting on the crisis, I believe that both the FOMC's full commitment to market functioning and the speed, scale and flexibility of our operations were essential components to a successful response.

Over time, market functioning has improved markedly, and we have gradually returned to more normal operations: asset purchases now proceed at a steady pace, regularly-scheduled term repo operations and agency CMBS operations are no longer being conducted, and the lending authority for all but one of the 13(3) facilities has expired. Of course, even as some of the extraordinary measures have been wound down, the FOMC remains committed to using its full range of tools to support the U.S. economy.

On the Desk, we continue to adapt our operations to ensure the effective implementation of the FOMC's directive. Today, I would like to share some thoughts on how we have returned to more normal operations and how they will continue to evolve.

Asset Purchases: Ongoing Adjustments to Ensure Efficient and Effective Implementation

The FOMC's objective for asset purchases has evolved since the beginning of the pandemic; whereas purchases were initiated to support smooth functioning in the markets for Treasuries and agency MBS, over time the Committee has expanded the objective of purchases to include helping to foster accommodative financial conditions. Since its meeting in December of last year, the FOMC has directed the Desk to increase the Federal Reserve's holdings of Treasury securities by at least $80 billion per month and of agency MBS by at least $40 billion per month and has stated that it will continue to increase these holdings until

As the Desk considers how to approach operations, we first and foremost seek to carry out the FOMC directive in an efficient and effective manner. In doing so, there are important operational choices to be made. The Desk's approach to these choices is guided by key principles, a few of which I would like to highlight today. First, we aim to be transparent, providing information to market participants and the public to ensure fairness and promote understanding of our purchase operations. We also seek to obtain securities at competitive and appropriate prices for the Federal Reserve, as this will ultimately benefit the U.S. taxpayer. In addition, unless otherwise appropriate for efficient and effective implementation under the directive, we endeavor to operate in a manner that is relatively neutral to the securities available for purchase and in a way that limits the potential for our operations to affect normal market functioning. In practice, we follow this principle by purchasing Treasury securities across sectors in approximate proportion to the universe of Treasury securities outstanding and by concentrating our purchases of agency MBS in recently produced securities. I would like to discuss a few changes that we have made or are planning in the Desk's Treasury, agency MBS, and agency CMBS operations that help us adhere to these guiding principles.

Treasury Purchase Operations

Last March, when conditions were highly disrupted in the U.S. Treasury market, we purchased a wide range of securities to address broad market dysfunction—and, at times, we weighted purchases more heavily toward sectors in which conditions were especially strained. Adjustments made to the size and composition of purchases were announced in the Desk's purchase calendars, often released multiple times a week.

As market conditions stabilized, we adjusted purchase allocations to be roughly proportional to the amounts outstanding across the nominal Treasury coupon and TIPS coupon curves, and we lengthened the purchase calendars to provide more predictability in our planned operations.

As our Treasury purchases transitioned to a more proportional allocation, there were still sectors of the curve that we refrained from purchasing. For example, the Desk generally has avoided purchasing bills, both to avoid increasing scarcity value in these securities arising from strong investor demand and because bill purchases have relatively little impact on financial conditions.[5]

Even in this steadier operating regime, we continue to adjust our purchase approach consistent with our principles. For example, we conduct periodic reviews of our allocations across purchase sectors and make modest changes in response to the evolving market environment. During the past year, issuance of Treasury securities has increased markedly as the U.S. Treasury has sought to fund pandemic-related fiscal stimulus expenditures. Even with this new issuance, the distribution of Treasury coupons outstanding has been fairly stable given the large outstanding stock of Treasury debt. However, modest shifts have occurred. In particular, the introduction of the 20-year Treasury bond has increased amounts outstanding around the 20-year maturity point. In addition, the pace of increase in TIPS issuance has been slower relative to nominal coupon securities. With net issuance expected to remain high in the near term, we anticipate that the composition of outstanding supply will continue to evolve. As a result, we plan to make minor technical adjustments to our purchase sectors and increase the frequency at which we update purchase allocations to remain roughly proportional to the outstanding supply of nominal coupon securities and TIPS. We expect to announce these as a part of a normal purchase calendar release in coming months.

Agency MBS

Our agency MBS operations starting last March were also initially driven by the need to support smooth market functioning. Purchases focused at first on a broad range of coupon securities in the outstanding universe of agency MBS that came under intense selling pressure. Our operations also included purchases for near-term settlement to help ease pressures on dealer balance sheets, which is different than the Desk's usual practice of purchasing in the forward-settling market.

As conditions normalized, agency MBS purchases returned to a more neutral allocation roughly in line with recently produced agency MBS coupons in the to-be-announced (TBA) market. These agency MBS coupons represent the most liquid and readily available supply and their purchase is least likely to cause settlement frictions in the agency MBS market. Their yields are also most closely tied to primary mortgage rates. The recent rise in longer-term Treasury yields and primary mortgage rates has shifted origination into agency MBS with relatively higher coupons, and our purchases have followed suit.

The recent increase in interest rates will also have implications for the timing of purchases and the amounts of securities purchased relative to supply. We reinvest our monthly agency MBS proceeds after paydowns are received, and in the near term these purchases may continue at a robust pace. In contrast, agency MBS origination volumes are expected to decline because of the recent increase in mortgage rates. This temporary difference between the amount of our reinvestments and origination volumes will diminish as the prepayments in our portfolio also slow down because of higher mortgage interest rates. However, in the meantime, we will be closely monitoring for possible signs that market participants are experiencing difficulty delivering enough agency MBS pools into forward TBA contracts and will adjust the forward settlement date of our purchases accordingly.

If needed, the Desk can also conduct dollar roll transactions to facilitate the orderly settlement of securities purchases. These operations help limit the potential for the Desk's purchases to disrupt normal market functioning by rolling forward the settlement month of securities that may be showing signs of short-term scarcity.[6] We recently enhanced the transparency of dollar roll operations by releasing the results on the New York Fed's website on the same day that the operations occur, rather than weekly. This change provides more timely information to all market participants.

Finally, it is fitting to conclude the discussion of our asset purchases by noting the end of regularly scheduled agency CMBS

dislocations in that market. Given the ongoing stabilization in this market, we recently ceased regularly scheduled operations in agency CMBS.

Even as the crisis has receded and our operations have normalized, we remain ready to adjust our operations as needed to sustain smooth market functioning, as directed by the FOMC. This could include changing the size or composition of our Treasury and agency MBS purchases or even recommencing purchases of agency CMBS, if needed. As I noted earlier, fulfilling the directive from the FOMC is our first priority.

Money Markets: The New Normal

I'd like to turn now to money markets. Many of the extraordinary measures taken to address dysfunction in dollar funding markets associated with the pandemic have also gradually wound down. The Desk's remaining term repo operations were phased out in February, the frequency of some central bank swap line operations was reduced last summer, and the lending authority of the 13(3) funding facilities related to money markets has expired.

Nonetheless, the FOMC's ongoing asset purchases continue to lift bank reserves to new highs, and an environment of elevated reserves is likely to be the new normal for an extended period.[7] Fortunately, the Federal Reserve's ample reserves framework is well-suited for managing short-term interest rates in environments associated with a wide range of reserve levels. In fact, the rapid increase in assets and the resulting expansion of reserves that have occurred during the pandemic are the types of actions the FOMC contemplated when choosing an ample reserves regime. While this shift to operating at much higher reserve levels has been smooth, the Federal Reserve is always prepared to make adjustments to ensure effective policy implementation.

Most recently, the growth in reserves has contributed to a decline in overnight rates relative to interest on excess reserves (IOER). The effective federal funds rate and other overnight unsecured rates have softened modestly, while we have observed more pronounced downward pressure on overnight repo rates. The large size of secured market investors, such as government money market funds (MMFs) and government sponsored enterprises, combined with recent reductions in the investments available for these investors, such as Treasury bills, have put particular downward pressure on repo and bill rates.

In this environment, the overnight reverse repo (ON RRP) facility is likely to become an increasingly important element of our operating framework. The ON RRP facility helps place a floor on overnight rates by offering a broad range of money market investors an alternative risk-free investment option. The availability of this facility is especially important because nonbanks represent a substantial proportion of the U.S. financial system and money markets, but do not have access to interest-bearing reserves at the Federal Reserve. Additionally, the facility can alleviate downward pressure on money market rates associated with reserve growth by broadening the liabilities that support balance sheet expansion. The ON RRP has historically been an effective floor for the federal funds rate and has also supported other short-term interest rates, and we expect it will continue to do so in the future.

As a measure of prudent planning, the Desk recently conducted a review of key design features of the ON RRP to ensure that the facility supports effective policy implementation. Notably, assets under management at government MMFs—a major group of money market investors—have increased significantly and become more concentrated at the largest funds since the facility's $30 billion per-counterparty limit was set in 2014. In light of these changes, the FOMC recently increased the per-counterparty limit on ON RRP usage to $80 billion which restores the capacity of the facility relative to the assets under management at our MMF counterparties to roughly the level that existed when the $30 billion limit was established.

Staff also reviewed access to the facility and concluded that the existing counterparty types are still representative of the universe of repo market investors. However, the review also presented an opportunity to consider potential adjustments in line with the New York Fed's broader efforts to ensure that our counterparty policies promote a fair and competitive marketplace—a topic that we'll be exploring further in today's panel discussion. Expanding counterparty eligibility can reduce barriers to entry and foster inclusivity by potentially making our operations accessible to smaller firms. A more vibrant and diverse marketplace could, in turn, strengthen the effectiveness of monetary policy implementation tools. In this regard, we expect in coming months to reduce the size and activity thresholds for ON RRP counterparty eligibility, which will help achieve these goals.

This is part of the Federal Reserve's ongoing commitment to support diversity, inclusion, and opportunity, following the expanded counterparty access for certain 13(3) facilities and agency CMBS operations. Relaxing eligibility criteria helps bring a diverse set of firms by size, business model, and ownership into our counterparty base, and we look forward to leveraging these new business relationships to also broaden our market intelligence efforts.

As a final note on money markets, in addition to ensuring that the ON RRP's terms continue to support effective policy implementation, the Federal Reserve may consider adjusting administered rates if undue downward pressure on overnight rates emerges, as noted in the minutes of the March FOMC meeting released yesterday. The Federal Reserve has adjusted administered rates within the target range on numerous occasions in recent years as conditions in overnight markets have changed. Such adjustments are purely technical steps to support effective policy implementation and to maintain the federal funds rate well within the target range.

Conclusion

In sum, we have gradually returned to more normal operations amid greatly improved financial market conditions. The Desk has continued to adapt its operations to ensure that it meets the FOMC's directive. In addition, we have sought to adjust the way open

As will be discussed in a panel later today, the New York Fed also remains engaged with efforts to advance the important goal of enhancing market resiliency through both our sponsorship of the Treasury Market Practices Group (TMPG) and our support of the LIBOR transition as co-convener of the Alternative Reference Rates Committee (ARRC) and producer of the Secured Overnight Financing Rate (SOFR). Our partnership with each of your institutions remains an important part of the effective and efficient implementation of policy and of ensuring financial market stability and resiliency.

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[1] I would like to thank Linsey Molloy, Matt Raskin, Nate Wuerffel, and Patricia Zobel for their assistance in preparing these remarks and colleagues in the Federal Reserve System for valuable comments and suggestions.

[2] This “ample reserves regime” is a version of a “floor” system in which reserves are supplied in sufficient quantity to ensure that control over the federal funds rate and other short-term interest rates is exercised primarily through the setting of the Federal Reserve's administered rates.

[3] For additional details about the Federal Reserve's response during the COVID-19 pandemic and associated lessons, see Governor Lael Brainard (2021), “Some Preliminary Financial Stability Lessons from the COVID-19 Shock,” speech delivered at the 2021 Annual Washington Conference, Institute of International Bankers, held via webcast, March 1, and Lorie Logan (2020), "Treasury Market Liquidity and Early Lessons from the Pandemic Shock," speech delivered at the Brookings-Chicago Booth Task Force on Financial Stability (TFFS) meeting, held via videoconference, October 23.

[4] For additional details about the Federal Reserve's response during the COVID-19 pandemic to support and sustain market functioning, see Lorie Logan (2020), “The Federal Reserve’s Market Functioning Purchases: From Supporting to Sustaining,” speech delivered at the SIFMA Webinar, held via videoconference, July 15.

[5] Floating rate notes (FRNs) have also not been purchased in operations since March 2020 due to the limited impact these purchases would have on financial conditions.

[6] The Desk may roll the settlement month forward by selling the dollar roll. A dollar roll sale is a transaction that involves the sale of agency MBS for delivery in one month and the simultaneous agreement to purchase substantially similar securities in a later month, thus effectively postponing delivery when there is a dislocation in available supply. The Fed can also use a coupon swap to settle some agency MBS purchases; a coupon swap is the simultaneous sale of one agency MBS and purchase of another agency MBS, which has a different coupon, issuer, or both.

[7] Over the last month, reserve growth accelerated and reached a new peak of nearly $4.0 trillion, reflecting asset purchases conducted over the last year and the recent decline in the Treasury General Account (TGA).