

NEW YORK CLEARING HOUSE

100 Broad Street, New York, N.Y. 10004

October 1, 1999

NORMAN R. NELSON
ACTING PRESIDENT

TEL: (212) 612-9205
FAX: (212) 612-9253

Ms. Cynthia L. Johnson
Director
Cash Management Policy
and Planning Division
Financial Management Service
U.S. Department of the Treasury
Room 420
401 14th Street, S.W.
Washington, D.C. 20227

Re: Proposed Change to Interest Rate on
TT&L Note Balances (RIN 1510-AA79)

Dear Ms. Johnson:

The New York Clearing House Association L.L.C.
("Clearing House")¹ is pleased to comment on the Treasury
Department's proposal to change the interest rate it charges
depositories that participate in the Treasury Tax and Loan
("TT&L") investment program.²

¹ The members of The New York Clearing House Association L.L.C. are The Bank of New York, The Chase Manhattan Bank, Citibank, N.A., Morgan Guaranty Trust Company of New York, Bankers Trust Company, HSBC Bank USA, Fleet Bank National Association, European American Bank, and Republic National Bank of New York. This letter has also been reviewed and endorsed by the following banks that are members of the Clearing House's affiliate, The Clearing House Interbank Payments Company L.L.C.: ABN AMRO Bank N.V.; Bank of America, National Association; The Bank of Tokyo-Mitubishi, Ltd.; Deutsche Bank Aktiengesellschaft; and UBS AG.

² Proposed changes to 31 C.F.R. § 203.2, 64 Fed. Reg. 41,748 (Jul. 30, 1999).

Under this program, banks and other financial institutions borrow from the Treasury short-term operating funds Treasury does not need immediately. For the past 20 years, Treasury has charged the borrowers an interest rate equal to the federal funds rate minus 25 basis points. This rate was originally set to approximate the rate charged for overnight repurchase agreements involving U.S. Treasury and agency securities. According to the background information provided in the *Federal Register* notice on this proposal, at the time this rate was put into place, "the overnight repurchase agreement market was not mature and a published rate was not available . . . ," and it was generally believed that the overnight repo rate was about 25 basis points below the fed funds rate.

Treasury believes that overnight repo market has now matured to the point where Treasury can ascertain the prevailing rate and obtain this "true rate" rather than a "proxy rate" for its TT&L investments. Accordingly, Treasury has proposed to have the Federal Reserve Bank of New York ("FRBNY"), as its fiscal agent, survey its primary dealers each week regarding the "volume-weighted average overnight rate that primary dealers paid to finance general collateral securities."

Treasury states that the fed funds rate and the overnight repo rate have moved "broadly in tandem," but that since 1990, the average difference between the two rates has been about 2 basis points. In other words, participants in the TT&L note program can expect the interest rate that they pay on these borrowings to increase from the fed funds rate minus 25 basis points to the fed funds rate minus 2 basis points.

A 23 basis-point increase in an interest rate is a substantial one by any measure. Before taking such a significant step, Treasury should ask some fundamental questions: What benefits will accrue to the borrowers to justify the rate increase? What market responses are likely to occur as a result of the increase? Is the increase warranted?

Treasury points to two benefits of the new rate. First, Treasury will get the benefit of an "explicit" overnight repo rate rather than a "proxy" rate. As the explicit rate is substantially higher than the proxy rate, this can be a substantial benefit to the Treasury — if participation in the note program remains constant. For the depositaries, Treasury counts as a benefit "an easily understandable rate which will be publicly available." But the current TT&L rate is also easily understandable and publicly available. The Federal Reserve Banks have published the fed funds rate for over 40 years, and anyone wanting to know the TT&L rate merely has to subtract 25 basis points from the fed funds rate. Moreover, there is nothing preventing the Treasury or FRBNY as its fiscal agent from calculating the TT&L rate in accordance with the current formula and publishing it as a separate rate. The benefit to bankers of an explicit rate is at best a modest one that does not justify such a substantial rate increase.

Market responses to the program may include a sharp decrease in the number of banks willing to participate in the TT&L note program. Treasury invests in this program only those balances that are not needed for immediate cash outlays. As this amount can vary from day to day, all balances held by participants are subject to immediate call, which usually occurs around 11:00 A.M. eastern time. Participants therefore never know what their balances will

be until that time. If balances that a bank is counting on to be part of its end-of-day position are called by Treasury, the bank must go to the market in the afternoon to make up the difference, usually at a higher interest rate. This is a primary reason why banks believe that the TT&L program involves interest rate risk. This risk is exacerbated because the TT&L rate is calculated weekly and applied to balances held in arrears. Bankers have therefore come to regard the current low rate they pay on TT&L balances as reasonable compensation for the exposure to the program's interest rate risk; they do not regard the balances they obtain through the program to be in any way comparable to balances obtained in the overnight repo market, especially in view of Treasury's proposal to set the rate on the basis of a survey of primary dealers, which normally have a higher cost of funds than banks.

If the Treasury adopts the proposal, there will be virtually no difference between the fed funds rate and the TT&L rate. For banks, the fed funds market has a number of advantages over the TT&L note program as a source of funds. Fed funds can be purchased as needed each day, they are not subject to same-day call by the seller, and the rate is determined by the market each day. Perhaps most important, fed funds purchases are unsecured while TT&L borrowings must be fully collateralized. This has a number of important implications, not least of which is the effect upon a bank's liquidity ratio. Secured lending, like the TT&L program, *should* carry a significantly lower interest rate than unsecured lending, like fed funds purchases, because secured lending is inherently less risky. Less liquidity and a higher cost of funds may also result in less funds being available for banks to lend.

If the rates paid by banks for fed funds purchases and for TT&L borrowings are virtually identical, banks will have no incentive to participate in the TT&L note program, and given the other disadvantages of relying on TT&L balances Treasury can expect many banks to withdraw from the program.

With fewer participants in the TT&L program, Treasury's balances at the Federal Reserve Banks will increase and may become more volatile, perhaps complicating the Federal Reserve's implementation of its monetary policy.

Because of these factors, we urge Treasury to withdraw its proposal to change the interest rate it charges participants in its TT&L note program.

If you have any questions about this letter, please call Joseph R. Alexander, Counsel, at (212) 612-9334.

Very truly yours,

A handwritten signature in cursive script, reading "Norman R. Nelson". The signature is written in dark ink and is positioned to the right of the typed name.

NRN:mlr