CHANGES IN THE TREASURY'S CASH MANAGEMENT PROCEDURES

by William N. Cox

Under new legislation signed by President Carter in October 1977, the Treasury is now arranging to make substantial changes in its cash management procedures in early summer. The details are complicated and will not be treated here, but the changes are substantial enough that a brief description of them is of general interest.

The basic changes are four: (1) Many nonbank financial institutions—savings and loan associations, mutual savings banks, and credit unions—will gain the opportunity to hold Treasury funds; (2) all depositary institutions will have to pay the Treasury interest on balances held longer than one day; (3) the Treasury will reimburse them directly, on a per item basis, for the various transactions services provided; and (4) the Treasury will also be able to invest its cash balances in its own securities or those of Federal Government agencies.

Technicians at the Treasury, at the Federal Reserve, at commercial banks, and at other financial institutions are now in the process of understanding and reacting to these new arrangements. While they do, our purpose here is to outline the old arrangements and the context within which they operated, then turn to the new arrangements with an explanation of how they came to be introduced.

The Present Procedures. Currently, commercial banks which meet certain well-defined standards may handle certain financial transactions on behalf of the Treasury. As a depositary, a bank may receive tax payments from employers, sell and redeem savings bonds and some other Treasury securities, and cash Treasury checks.

Why would a bank want to be a Treasury depositary? There is some prestige involved, and many banks feel that their depositary status enables them to offer additional services to their customers. By far, the most important reason, however, is that the Treasury has traditionally held its deposits at the bank for several days before withdrawing them into the Federal Reserve System. Commercial banks holding these so-called tax and loan account balances for several days have been able to invest them at a profit while paying no interest to the Treasury.[1] The implicit agreement has been that the interest a depositary can earn by investing the deposits compensates for the costs of handling tax deposits and performing other services for the Treasury.[2]

From the establishment of the tax and loan account system in 1917 until 1974, the Treasury held most of its cash balances in these accounts, maintaining a much smaller working balance with the Federal Reserve Banks.[3] These arrangements worked very well in the Sixties, but as interest rates continued to climb in the Seventies, the Treasury began to reexamine the situation. More and more states and municipalities began to demand and get interest on their deposits, prompting some members of the public to ask why the Treasury didn't do the same thing. The

[1]Tax and loan accounts have carried reserve requirements, however, ranging from 7 to 16¼ percent at member banks, depending on the size of the bank.

[2]Such as redeeming maturing Treasury securities, selling new issues of securities, and cashing Treasury checks. Some nonbank institutions have also provided such services but without compensation.

[3]Occasionally, the Treasury has moved funds the other way on a prorated basis, redepositing balances *from* the Federal Reserve Banks back into the tax and loan accounts, but such redeposits in accounts were a small proportion of tax and loan deposits received by depositaries; almost all of the flow has run the other way.

answer had been, as we have seen, that the interest-free deposits gave rough compensation for services provided to the Treasury by depositary banks. But as interest rates went up, the Treasury began to suspect that the compensation was rising faster than the depositaries' costs. Studying the problem, the Treasury concluded in 1974 that the depositaries were indeed being overcompensated for their services.[4] Since then, the Treasury has kept most of its balances at the Federal Reserve rather than in the tax and loan accounts at commercial banks.

Treasury Cash Management and the Fed. Pulling these balances out of the banks and into the Federal Reserve has been an interim and somewhat unsatisfactory solution, however, because it has caused some day-to-day difficulties for the conduct of Federal Reserve open market policy. When the Treasury's balance at the Federal Reserve moves up or down, the aggregate amount of bank reserves changes equally and oppositely. The Fed usually tries to offset these changes by open market operations. A stable Treasury balance at the Fed, therefore, reduces an important source of instability in bank reserves and thereby reduces the complications of open market operations—the principal tool of monetary policy. For this reason, the Treasury tried to maintain a steady working balance until 1974. It did this by calling in funds from the tax and loan accounts to replenish payments out of the working balance at the Fed and by redepositing funds into the tax and loan accounts when the balance at the Fed increased.

This stability vanished, however, when the Treasury decided to reduce the proportion of its funds held in the tax and loan accounts. Subsequently, most of the Treasury's overall cash holdings have been held at the Fed and most of the swings in the Treasury's cash have been reflected in that account. Accordingly, the Fed has had to conduct a much larger volume of offsetting open market operations under the interim arrangements. Under the new arrangements, the Treasury balance at the Fed should regain much of its previous stability, particularly now that the Treasury can also buy its own securities in the market.

Since an increase (decrease) in the Treasury's balance at the Fed generally prompts the Fed to use open market purchases (sales) to offset the effect on bank reserves, a movement of Treasury funds from tax and loan accounts into the Fed reduces the Treasury's net interest expense. The Fed reacts to an increase in the Treasury's balance, for instance, with an equivalent purchase of Treasury securities from private holders. The interest on these additional securities is consequently paid to the Fed rather than to private investors. The Fed returns the entire additional interest payment to the Treasury, whereas private investors return only a small proportion in the form of income taxes.[5]

The New Procedures. The procedures now being implemented reflect an attempt by the Treasury to retain and improve the advantages of the interim arrangements while eliminating the interference with the Fed's open market operations. As before, a bank may qualify with the Treasury to accept tax and loan deposits from the public. Collateral requirements are unchanged. Unlike the earlier situation, however, other financial institutions may also qualify. Each depositary—bank or nonbank—will have to choose one of two new ways to handle the Treasury's money. Under the "remittance option," the depositary agrees to transfer to the Treasury account at the Federal Reserve all tax and loan deposits one day after receipt. In effect, an institution choosing this option will have no use of the Treasury's money, will be unable to earn interest by investing Treasury balances, and will not have to pay any net reserve requirements against them.[6]

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[4]Report of a Study on Tax and Loan Accounts, Department of the Treasury, June 1974

[5]At the end of each year, the Fed adds up the Treasury interest and other receipts, deducts the Fed's operating expenses, and returns the difference through the legal device of a tax on Federal Reserve notes. On average, more than 90 percent of interest paid to the Fed is returned in this way. In the example above, however, *all* the additional interest would be repaid, since the Fed's operating expenses are not affected by the additional holdings of Treasury securities

[6]These one-day deposits actually do carry reserve requirements. Technically, however, the deposits will be offset by an increase in "cash items in process of collection," which will be deducted in the calculation of reserve-bearing deposits. So there will be no *net* reserve requirements against the one-day deposits. Similarly, because checks deposited for the Treasury's account cannot be collected in one day, the deposits are not investable

Alternatively, the depositary may choose to sell the Treasury interest-bearing notes on the day after the deposits are received, with the rate of interest tied to a yet-to-be-established rate on national repurchase agreements. The Treasury will call in the balances, with interest, whenever it wants to bring the money into its account at the Federal Reserve. These notes will not be considered deposits, and member banks will not have to hold required reserves against them. The Treasury expects such notes to have an average maturity of about ten days, whereas the current tax and loan deposits are usually called in about two days.

Since under the new arrangements a depositary will either be unable to invest Treasury funds (the remittance option) or will have to pay the Treasury interest on such funds (the note option), the depositary will no longer be receiving the use of interest-free funds as an implicit compensation for services provided to the Treasury. Instead, the depositaries—bank or nonbank—will be compensated directly and explicitly on a per item basis.[7] Thus, the use of funds and the provision of services will be "unbundled"; depositaries will be able to evaluate each function separately.

Two Choices. Each prospective depositary, therefore, has two choices to make in response to these new procedures: (1) whether or not to be a Treasury depositary, and if the answer is "yes," then (2) whether to operate under the remittance or the note option. Neither decision is irrevocable. Each institution would probably first decide whether it would be better off under the note option or the remittance option: Can the institution earn enough from reinvesting the Treasury funds to more than offset the interest paid to the Treasury and the costs of handling the reinvestment? Then, to decide whether to participate at all, the institution would combine the potential earnings from the preferable option with the other relevant considerations—the Treasury's new reimbursements relative to the internal costs of handling Treasury transactions, the value of additional customer services it can offer as a depositary, and the speed with which Treasury funds received can be collected as investable or transferable balances. ■

[7]Reimbursement, for example, will include 50 cents for each Federal tax deposit received. Reimbursement levels have been set by the Treasury from its own cost figures.