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# Why The 'Narrow Bank' Regulatory Discussion Signals Upcoming Disruption

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The global financial crisis reminded banks that, while bad credit can be a cancer-like slow killer, a liquidity crunch can be a sudden executioner. The result was new regulations that set funding levels to help banks better ride out the kind of evaporating funding that brought down Lehman Brothers. One reaction to these new rules has been for some banks, such as Goldman Sachs, to enthusiastically embrace their new role as retail deposit gatherers. Indeed, Goldman has made the growth of Marcus, the company's digital retail bank, a key plank of their strategy.

Most banks in the U.S. still have a traditional balance sheet structure of assets and liabilities. Up to this point, challenges to that model have been on the asset side, where we've seen the rise of specialist lenders who are not dependent on deposit funding. Instead, they pass the assets they originate through to investors in the form of either whole-loan sales or bundled securities.

This business model is taking a toll on traditional banks. Federal Reserve data suggests that of all net new commercial credit extended in the U.S. in 2017, FDIC banks accounted for only 3%. It's a startling indictment that in a booming economy many regional banks in the U.S. are struggling to grow the asset side of their balance sheet and instead are replacing loans with investment assets to earn an interest-rate spread.

This process of separating traditional bank assets and liabilities has recently reached a natural endpoint with the formation of TNB USA (it stands for "The Narrow Bank"), a new Connecticut-licensed bank that simply does away with the asset side of the balance sheet and instead focuses on just taking deposits. At the heart of its business model is privileged access to a Master Account at the New York Federal Reserve, which pays a rate materially above that offered by most commercial banks. Therefore, with a low-cost infrastructure, TNB can make a spread between what it is paid by the Fed and what it pays to its end customers. It is then up to the Fed to invest those deposits in U.S. Treasuries and other debt instruments.

The Narrow Bank won't take deposits from individual consumers, but instead from high-quality non-bank financial institutions, such as pension funds and money market funds that don't have direct access to the Fed. Essentially, TNB is a pass-through entity, offering non-deposit financial institutions a chance to store their cash at a better rate than they could elsewhere, while at the same time offering the security of a safe and liquid Federal Reserve deposit account.

Philosophically, this simple idea amounts to a profound challenge to the traditional bank balance sheet model in that it questions why risky assets like credit card loans and middle market credit lines need to be funded by risk-free insured consumer deposits. Why are those assets not funded purely by risk capital (equity or debt), as we see in pass-through credit models? If you have risk on one side of the balance sheet, why not on the other?



Maybe because of this business model challenge, the New York Fed has rejected TNB's application for a Master Account, and in turn, TNB has filed a federal lawsuit claiming that the Fed has violated established regulations against preferential treatment among similarly structured banks. Indeed, a 1980 act of Congress explicitly states that access to Fed Master Accounts should be provided on “an equal and non-discriminatory basis” for suitably licensed banks. The Fed's response was expected by the end of October, but thus far, there has been no rationale offered, but there is plenty of speculation that the Fed is worried about growth in its own balance sheet if it enables this business model.

Regardless of the outcome of this specific court case, it's a harbinger of further change to come in a rapidly evolving banking industry. The traditional model exemplified by small-town banker Jimmy Stewart in “It's a Wonderful Life,” where Bob's and Charlie's savings went to fund Mack's and Buddy's houses, is now woefully out of date and we are entering a far more fragmented era.

Customer management and distribution could move to either specialized fintech companies such as Betterment in wealth management, or to big tech such as Amazon. We're already seeing these changes in places like China, where many retail financial services are now intermediated through lifestyle apps such as WeChat, and Europe where regulations such as PSD2 are intended to actively sever the link between underlying deposit accounts and ancillary services such as payments initiation.

TNB's request for a Master Service Account at the Fed may be just the beginning of challenges to the traditional banks' intermediation role. This summer, the progressive-minded Great Democracy Institute published a paper by three academics, including a former Obama administration Treasury official, proposing that the Federal Reserve offer deposit accounts directly to individual consumers. This would be narrow banking for the masses, connecting depositors to the Fed without the banking middleman or the need for deposit insurance, as those deposits would be guaranteed by the federal government.

One benefit of this approach would be to eliminate the lag between when the government raises interest rates and when that rise is reflected in consumer accounts, estimated to cost U.S. depositors $100 billion annually in missed interest earnings. If the Fed is your banker, the interest rate transmission mechanism is immediate. To bring this idea to life, the Fed would need to build a customer service layer to allow depositors to transact, but in the world of digital apps, that is becoming less of a challenge than when branch networks were the dominant method of accessing those deposits.

It's worth noting that Norway already has a version of this system. While in the U.S., narrow banking for the masses would face tremendous resistance from bank lobbyists, it nonetheless signifies the type of creative thinking happening in the banking world.

Individual banks can try to hunker down and ride out these changes by protecting their traditional business model, but time is clearly running out. While the largest banks in the U.S. have shown that investing in a better digital customer experience can mean happier customers who stick around longer, the typical U.S. small regional or community bank is in a very different situation. Struggling to compete with digitally enabled competitors on both sides of the balance sheet, many smaller banks may need to take radical steps to renovate their business models.

With nearly 20% of competitors in the U.S. banking and payments industry new since 2005, and nearly 15% of new revenue growth going to these new entrants, we are moving into a period of disruption in U.S. banking. Some of that will result in consolidation within a still-fragmented industry — but it seems inevitable that banking outsiders, such as Walmart or Amazon, will also end up playing a major role. Whatever happens to TNB, there will be no shortage of ideas about how to remake the U.S. banking industry over the next decade.

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