A Better Deal for American Depositors: The Promise of Narrow Banks
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The financial asset most widely held by U.S. households – bank deposits – is earning a miserly interest rate, far below competitive market rates. Banks take in deposits from the public and then deposit the money at Federal Reserve Banks at a much higher rate. As Jeb Hensarling, the Chairman of the House Financial Services Committee put it to Fed Chairman Powell during his February 2018 monetary policy testimony, “But you’re paying 150 basis points, our constituents are getting 10 basis points.” The 12 trillion dollars now on deposit at U.S. banks represent a huge opportunity for savers to get a better deal.

Why don’t banks pay more to their depositors? Because banks simply don’t need to compete very hard for deposits. Most of their customers find it cumbersome to switch their deposits from one bank to another. Banks take advantage of that. For example, research done at the Fed shows that when the Fed lowers wholesale money market rates, banks are quick to reduce the rates they pay to depositors. But when the Fed raises wholesale rates, banks take months to increase the rates they offer depositors. As Jerome Powell, the Chairman of the Federal Reserve Board, pointed out in response to Jeb Hensarling, “Retail deposits…are sticky on the way up. And they’re – they generally come up with a lag.”

It is true that the divergence between the rate that the Fed pays to banks and the rate that banks pay to their depositors has gotten even bigger as the Fed has tightened monetary policy. For example, the difference between the rate that the Fed pays banks and the national average jumbo checking deposit rate, for deposits more than $100,000, as reported by the FDIC, increased from 0.2 percent in March 2015 to 2.14 percent in February 2019. The bad deal that American households are now getting from banks is therefore going to get even worse, unless something is done to disrupt the low state of competition in the deposit market.

A new form of competition for deposits could improve this situation. Suppose an ultra-safe, low-cost, and focused competitor were to enter the deposit market and offer a rate close to that offered by the Fed to banks. Eventually, incumbent banks would be forced to react by giving their own depositors a better deal. Is such an entrant feasible? Let's examine the requirements.

In conventional banking, safety is difficult to achieve because depositors can always "run." Were all depositors to run at the same time, conventional banks would have difficulty satisfying the surge of withdrawal demands. However, a different kind of bank, called a "narrow bank," could quickly and safely satisfy all potential withdrawal demands by always investing *all* customer deposits in reserve balances at the Federal Reserve.

The safety associated with investing all customer funds in Federal Reserve Bank deposits also implies ultra-low operating costs. Because the assets of a narrow bank—reserves at Federal Reserve Banks—carry no financial risk, costly insurance from the FDIC is not needed. For the same reason, investment exclusively in perfectly safe assets, a narrow bank has low capital requirements relative to a conventional bank.

In 2008, Federal Reserve Banks began to pay interest on bank reserves, creating a new reason for the existence of narrow banks, the ability to pay interest to their own depositors. This is distinct from the basis of historical proposals for narrow banking, which was purely to make banking perfectly safe. A famous example is the "Chicago Plan," proposed in the wake of the banking crisis of 1933. Today, new-style narrow banks could complement conventional banks by restricting themselves to offering high interest rates on perfectly safe deposits. To this day, however, no narrow banks operate in the U.S. We are members of the board of TNB USA Inc, a narrow bank that hopes to open for business soon.

Because new-style narrow banks would provide safety by limiting their investments to Federal Reserve Bank deposits, deposit insurance would not be needed. Depositors would be limited to large financial firms. such as large money market mutual funds and other asset managers, that manage savings for Americans by investing inflows from pension funds, 401(k) savings accounts, and other sources. If narrow banks are successful in raising the rates received by these large wholesale depositors, the benefits will be shared widely with U.S. households.

A beneficial side effect of narrow banks is the new set of competitive forces that will be unleashed in the broader banking market. The higher deposit rates offered to large depositors by, and possibly by follow-on narrow banks, will put pressure on incumbent banks to raise the rates of interest they pay to their own depositors. American savers will benefit significantly.

In addition to getting American depositors more interest on their bank deposits, narrow banks can satisfy the desires of those depositors who seek ultimate safety for their savings, once again because they will keep all their funds in Federal Reserve Banks. For the same reason, narrow banks will never need to rely on government bailouts. Overall, we believe that narrow banks will trigger a significant improvement in the benefits offered to Americans by the U.S. banking system.