Narrow banking and its role in the financial system

TNB USA Inc.
James McAndrews
CEO
July 24, 2019

Narrow banks are depository institutions, entities, or facilities whose main purpose is to offer nonbanks overnight investments that are, directly or indirectly, fully backed by central bank liabilities.

Introduction

Narrow banks can increase rates of interest on deposits at banks, save taxpayers' money, and reduce the nation's vulnerability to runs. It is surprising, then, that the Federal Reserve Board in March of this year issued an advanced notice of proposed rulemaking (ANPR)[1] that would have the effect of ruling out narrow banks, even as Chairman Powell recently said that a banking system with diverse institutions with different business models, is "the banking system we want and need."[2]

Ten years after the financial crisis, when the Federal Reserve lowered the policy rate close to zero, and almost four years after the Fed started raising the interest rate paid to banks, average depositors still earn little or nothing at banks, even with deposit accounts being the most widely held financial asset of U.S. households. The FDIC's weekly national average interest rate for deposits the week of July 15, 2019 was 0.06 percent for Jumbo Deposits, those in excess of $100,000; in contrast, the Federal Reserve is paying banks 2.35 percent on their reserves. The spread between the interest rate paid to banks on reserves and the average interest rate paid to jumbo deposits at banks has increased by more than two percentage points in the years during which the FOMC has been raising the policy target rate, painfully illustrating the worsening deal depositors, even large depositors, receive from incumbent banks.[3]

Paying interest on reserves

Why does the Fed pay interest to banks? Congress authorized the Federal Reserve Banks to pay interest on reserves in The Financial Services Regulatory Relief Act of 2006. That action was well before, and therefore unrelated to, the financial crisis of 2007-09. Paying interest on required reserves was a long-desired goal of the banking industry and financial economists. The lack of interest payments on required reserves led to costly and wasteful efforts by banks to avoid holding reserves. One tactic was to create "sweep" accounts, that moved deposits into money market funds overnight, allowing them to avoid holding required reserves and incurring the "reserve tax." Those actions were inefficient, and tended to favor large banks and large depositors, so the allowance to pay interest on required reserves overcame that long-standing inefficiency in our financial system.

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[1]Regulation D: Reserve Requirements of Depository Institutions, A Proposed Rule by the Federal Reserve System on 03/12/2019, available at https://www.federalregister.gov/documents/2019/03/12/2019-04348/regulation-d-reserve-requirements-of-depository-institutions

[2] Jerome H. Powell, *Welcoming Remarks* At "Stress Testing: A Discussion and Review," a research conference at the Federal Reserve Bank of Boston, Boston, Massachusetts, July 9, 2019.

[3] On November 23, 2015, the spread between the rate of interest paid to banks on reserves and the FDIC's national average jumbo demand deposit rate was 0.21 percent, and it has risen to 2.29 percent on July 15, 2019.

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James Tobin, the great monetary economist, recommended in 1960 that paying interest on excess reserves, while allowing banks to pay interest on deposits, would improve the efficiency of monetary policy, Treasury issuance practices, and bank competition. In the 1960s, banks were not allowed to pay interest on deposits, a prohibition whose last vestiges were finally repealed in 2010 in the Dodd-Frank Act. Tobin had great hopes for the price competition that would occur with the repeal of the prohibition on banks' paying interest on deposits. He said that allowing banks to pay interest would "replace with price competition some of the existing wasteful and imperfect non-price competition for deposits . . . the allocative efficiency of the banking system would be improved." He also pointed out that "[t]here may be some banks that are able to remain in business only because present federal legislation enables them to capture rents that would otherwise go to their depositors. Should they remain in business? Needless to say, the proper role of government is to oppose rather than to compel collusive price conventions."

Tobin clearly overestimated the strength of the price competition that resulted from allowing banks to pay interest on deposits. Most normal bank customers find it cumbersome to switch their deposits from one bank to another, a behavior that incumbent banks exploit. Research done by the Federal Reserve Board's economists John Driscoll and Ruth Judson shows that when the Federal Reserve lowers wholesale money market rates, banks are quick to reduce the rates they pay to depositors.[4] However, when the Federal Reserve raises wholesale rates, as it has since late 2015, banks are slow to increase the rates they offer depositors. Driscoll and Judson found that if well-functioning competition had in fact been active to cause banks to pass through wholesale money-market rate increases, then "depositors would have received as much as $100 billion more in interest per year during periods when market rates were rising." The anemic actual pass-through of the Federal Reserve's monetary policy into deposit interest rates is well documented in other research.

<u>Narrow banks can improve rate competition for deposits</u>

Narrow banks, which are banks that invest solely in Federal Reserve deposits, and pass on most of the interest they receive to their depositors, would offer significant deposit rate competition to incumbent banks. As narrow banks would have very little operational risk, and no credit or liquidity risks, their services would be highly substitutable for one another. Under those conditions, price, or interest rate, competition will be the primary way narrow banks can attract depositors. Consequently, narrow banks will bid up deposit rates to levels very close to the rate of interest paid on reserves by Federal Reserve Banks.

As narrow banks have no need to, and almost certainly will choose not to, offer deposit insurance, they are restricted from offering deposits to retail depositors. Rate competition will likely be the most intense for the deposits of institutional investors. Nonetheless, ordinary Americans can benefit when large asset managers, who manage pension funds, retirement savings, and other assets of people, can

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[4] John C. Driscoll and Ruth Judson, "Sticky Deposit Rates," *FEDS Working Paper No. 2013-80*
Federal Reserve Board, November 23, 2013.

earn higher deposit rates at narrow banks. Furthermore, the competition from narrow banks would encourage other banks to raise their deposit rates, so the benefits of narrow banks would be widespread.

Narrow banks would save taxpayers money

Narrow banks would save taxpayers money. First, as the Federal Reserve Board pointed out in its ANPR, banks pay deposit rates below the rate of interest on excess reserves partly to recover the costs of capital requirements and other elements of federal supervision and regulation. This has been a long-term feature of banks' behavior.

Banks typically make the marginal lending decisions based on earning at least the same risk-adjusted rate on loans as the Federal Reserve's policy rate, the federal funds rate.[5] They then pay a lower rate on deposits. The spread between the rate banks earn on their loans and reserves and the rate they pay on their deposits is called the *net interest margin*. In general, the bank sets the net interest margin to recover its costs and to provide a return on investment.[6]

In the decades before the payment of interest on reserves by Federal Reserve Banks, banks would set deposit rates below the federal funds rate to recover costs, including the costs of capital requirements and other elements of federal supervision and regulation. After the payment of interest on reserves, and the expansion of the quantity of reserves, banks now receive interest from the government in excess of what they pay their depositors. What this implies is that, to the extent a bank has interest-earning reserves on its books, the federal government's payment of interest at or near the federal funds rate is providing compensation to banks for their costs of the banks' compliance with rules the federal government put in place to constrain banks' risk-taking.

This subsidization of banks' costs is wasteful and perverse, as well as permanent. It is wasteful as it costs the Federal Reserve more to achieve its desired objectives—a level of "financial conditions," often summarized as the federal funds rate, but encompassing broader conditions that include deposit interest rates. The more closely deposit interest rates follow the rate of interest paid on reserves, the less it would cost the government, and taxpayers, to achieve the appropriate level of financial conditions.[7] It is perverse as well, as the costs of compliance with capital requirements and other elements of federal supervision and regulation that are being subsidized by the payment of interest on

[5] A "marginal" decision is one that concerns the very last loan made; the average loan rate would typically be above the rate charged on the bank's last, or marginal, loan.
[6] Although the rising spread between the rate paid to banks by the Federal Reserve and the rate banks pay on average to depositors in a short time makes it unlikely that most of that increased spread reflects increased costs.
[7] Darrell Duffie and Arvind Krishnamurthy discuss the desirability of reducing the dispersion on short-term interest rates in their paper "Passthrough Efficiency in the Fed's New Monetary Policy Setting," in Richard A. Babson, editor, *Designing Resilient Monetary Policy Frameworks for the Future, A Symposium Sponsored by the Federal Reserve Bank of Kansas City*, Jackson Hole, Wyoming, August 25-27, 2016, Federal Reserve Bank of Kansas City, pages 21-102.

reserves are intended to be paid for (internalized) by banks and their customers. Having taxpayers pay these costs undoes the good that they are intended to do.

Narrow banks reduce the nation's vulnerability to financial crises

Narrow banks reduce the nation's vulnerability to runs and financial crisis. Over the last half century many large asset managers and others have tended to amass occasionally large pools of cash that must be safely invested for short periods. The size of those pools exceeds the limits on federal deposit insurance, so those investors have often turned to shadow banks, that offer seemingly safe, but systemically risky, short-term wholesale funding liabilities. These left our nation vulnerable to the runs that were the proximate cause of the global financial crisis in 2007-09—runs on ARS, VRDO, ABCP, Repo, Prime MMMF, and others.[8] Narrow banks can safely accommodate these funds, and, unlike the case with shadow banks, narrow banks are systemically safe—no deposits in narrow banks need ever run. Consequently, narrow banks can fill a much-needed role in our financial system for those large depositors that leave our nation vulnerable to runs even today.

A simple interest rate rule can control the activity of narrow banks

The Federal Reserve expressed several concerns about the operation of narrow banks in its March ANPR. In particular, it expressed the concern that narrow banks could lead to a larger balance sheet for the Federal Reserve, and that individuals and institutions might seek to shift deposits into a narrow bank in times of stress in the financial system. While both events described may be desirable to society, nonetheless, a question to ask is whether there is any way to capture the benefits of narrow banks while precluding any undesirable outcomes, including those expressed by the Fed.

Indeed, there is such a policy.[9] Importantly, the policy would apply to all banks, including narrow banks. First, the Federal Reserve would pay all banks the same rate of interest up to a specified "surge-protector" level. For banks whose balances exceed the surge-protector level, the rate paid on those excess balances would be a lower rate, perhaps one percentage point below the level of the rate paid on smaller balances, or zero, whichever is higher.

The surge-protector level of reserves would be bank-specific and time-varying; it could, for example, be based on some multiple of the most recent quarterly-average level of reserves held by the bank. Allowing inflows up to the surge-protector level would allow a trade-off between the need to provide safe deposit facilities at a competitive rate, thereby promoting competition for deposits and financial stability, and the unlikely possibility that narrow banks would receive destabilizing inflows in times of financial stress, or cause an excessively large balance sheet for the Federal Reserve.

[8] See Zoltan Pozsar, "Shadow Banks: The Money View," Office of Financial Research, 14-04, July 2, 2014 for a discussion of these trends and events.

[9] A more extensive discussion of the policy is provided in TNB USA Inc.'s comment letter on the Fed's ANPR, and can be found here: https://www.tnbusa.com/2019/05/tnbs-response-to-the-federal-reserves-anpr-regarding-reg-d/

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Conclusion

Narrow banks offer many potential advantages for the U.S. The Federal Reserve should both allow them to begin operation by offering accounts to them, and continue its policy of offering the payment of interest on nondiscriminatory terms to all banks, including narrow banks. A non-discriminatory interest rate rule can control any undesirable effects of excessive growth of narrow banks. The competition fostered by narrow banks will be a benefit to depositors at all banks; the reduction in the wasteful and perverse subsidization of banks' costs of compliance with prudential regulations will be a gain to taxpayers; the greater availability of safe deposit facilities will make the U.S. less vulnerable to the modern runs from shadow banks.