

TNB USA Inc.

June 11, 2021



*Via Electronic Mail*

Ann E. Misback, Secretary  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue NW  
Washington, DC 20551  
Docket No. OP-1747

Re: Proposed Guidelines for Evaluating Account and Services Requests

Ladies and Gentlemen:

TNB USA Inc.<sup>1</sup> (“**TNB**”) is pleased to comment on the proposed guidelines for evaluating account and services requests (“**Guidelines**”)<sup>2</sup> issued by the Board of Governors of the Federal Reserve System (the “**Board**”) on the processes Federal Reserve Banks (“**Reserve Banks**”) should follow in addressing requests for accounts and payment services by certain eligible institutions operating under validly granted state charters.

## **1. Introduction**

That the Board proposed the Guidelines reflects the disparities in account provision that have emerged in recent years. It is not tenable that unequal and inefficient access to the services of Reserve Banks is allowed to persist by the Board and Reserve Banks. A nondiscriminatory application of a uniform policy is necessary for the efficiency and fairness of the nation’s financial system.

In responding to the request for comments by the Board on the Guidelines, we will point out some of the disparities in account provision by Reserve Banks in recent years. We will then address the specific questions posed by the Board, noting that the Guidelines could be

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<sup>1</sup> TNB is “The Narrow Bank.” As a Connecticut-based depository institution, TNB seeks to serve institutional customers by offering safe depository services at attractive interest rates. TNB was issued a Temporary Certificate of Authority by the Commissioner of the Connecticut Department of Banking as an uninsured bank in August 2017, which has since been renewed.

<sup>2</sup> Docket No. OP-1747 (May 5, 2021).

strengthened considerably by focusing on the equal application of nondiscriminatory policies on a nationwide basis, on the urgency of resolving account requests with dispatch, and on the importance of prioritizing innovation within the chartered banking sector. Next, we will discuss the demands for safe, competitive, deposit facilities for non-insured deposits, and address the concern the Board has expressed that narrow banks<sup>3</sup> could facilitate disruptive inflows in times of financial stress; TNB has adopted a policy that disallows it from receiving such disruptive flows. We conclude with an urgent plea to the Board that, after almost four years of delay, it allows the establishment of an account at the Federal Reserve Bank of New York for TNB, which will lead to a significantly safer and more efficient financial system in the U.S. and is consistent with the responsibilities of the Board and Reserve Banks under the Federal Reserve Act.

## 2. Disparities in account provision by Reserve Banks

Here we will outline two disparities in recent account provision by Reserve Banks. First, the Reserve Trust Company (the “Reserve Trust”), received a master account from the Federal Reserve Bank of Kansas City in 2017, the same year that TNB applied for an account from the Federal Reserve Bank of New York. Like TNB, the Reserve Trust, which is neither FDIC-insured nor federally regulated, does not make loans or otherwise leverage client funds.<sup>4</sup> The Reserve Trust has been operating for more than four years, while presumably earning IOER, without incident.<sup>5</sup>

The Reserve Trust company is chartered as a nondepository trust.<sup>6</sup> Under Colorado law, this alleviates the company from the necessity to obtain insurance from the Federal Deposit Insurance Corporation (the “FDIC”). However, under the Federal Reserve Act and the Federal Deposit Insurance Corporation Act, The Reserve Trust qualifies as a depository institution, so the company is a “nondepository depository.” This oxymoronic conflict between state and federal law is not present in the case of TNB, which is a depository institution under both the state and federal law. We are unaware of whether The Reserve Trust serves retail depositors and takes credit and liquidity risk, but TNB is restricted by its charter not to take credit or liquidity risks, and not to serve retail customers, as is appropriate for a depository institution without FDIC insurance. It is a disparity that The Reserve Trust has an account at a Reserve Bank and TNB does not.

Another disparity is revealed when one examines the International Financial Entities (“IFEs”) authorized under the International Financial Center Regulatory Act, passed by the Puerto Rican legislature in 2012. IFEs chartered under the Act enjoy a wide variety of

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<sup>3</sup> We defined and discussed narrow banks in our comments on the Board’s March 2019 Advanced Notice of Proposed Rulemaking (84 Fed. Reg. 8829 (Mar. 12, 2019)). The comments can be accessed at <https://www.tnbusa.com/wp-content/uploads/2019/05/2019.05.13-TNB-Response-to-ANPR-re-Reg-D.pdf>

<sup>4</sup> See Reserve Trust Company, <https://www.reservetrust.com/> (all websites listed in this document last accessed May 19, 2021).

<sup>5</sup> Colo. Div. Banking, 107th Annual Report (2017), <https://spl.cde.state.co.us/artemis/regserials/reg21internet/reg212017internet.pdf>.

<sup>6</sup> Ibid.

permissible risky activities, including taking deposits from individuals and holding risky assets.<sup>7</sup> The IFEs enjoy special low-tax treatment. The deposits of the IFEs are not insured by the Federal Deposit Insurance Corporation, nor are the IFEs regulated by a federal authority. Several IFEs have established accounts at the Federal Reserve Bank of New York, a disparity with respect to the lack of establishment of an account for TNB at the same Reserve Bank.<sup>8</sup>

### 3. Discussion of specific questions posed in the request for comments

We have several specific comments on the specific questions raised by the Board in its request for comments on the guidelines. To be clear, the following questions are posed in the request for comments on the proposed guidelines:

1. Do the proposed account access guidelines address all the risks that would be relevant to the Federal Reserve’s policy goals?
2. Does the level of specificity in each principle provide sufficient clarity and transparency about how the Reserve Banks will evaluate requests?
3. Do the proposed account access guidelines support responsible financial innovation?

As we discussed, the proposed guidelines could advance the nondiscriminatory application of the Reserve Bank’s authority to establish accounts for eligible depository institutions. However, no guideline specifically states that goal, a lacuna that should be addressed. Furthermore, no time limit is suggested for the Reserve Bank to determine its decision on the establishment of an account; a 90-day period should be sufficient for Reserve Banks to conclude their evaluations.

Our next two comments consider the risk that the Reserve Banks, in making a determination not to provide accounts for applicants, deter innovation in the chartered depository institution sector. This is a risk because innovation, some of it quite risky and inefficient, is occurring in the nonbank sector. First, the “shadow bank” sector of finance has grown significantly in recent decades, including the most recent decade in the wake of the global financial crisis in 2007-09.<sup>9</sup> Second, much of the innovation we have seen in recent years has been in fast growing deposit-like products at Money Services Businesses and “stable coins.”<sup>10</sup> Those developments in particular risk run-like outcomes for society, which could be forestalled

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<sup>7</sup> <https://www.the2022actsociety.org/tax-incentives/act-273/>.

<sup>8</sup> See <https://www.dlapiper.com/en/us/insights/publications/2017/01/international-financial-entities-in-puerto-rico/> (accessed on May 29, 2021). Here again, TNB is chartered under laws that have been in existence for decades and enjoys no special tax treatment of its activities.

<sup>9</sup> Financial Stability Board, “Global Monitoring Report on Non-Bank Financial Intermediation 2019,” January 19, 2020, see Table 2-5, documenting the growth, between 2012-2017 in other financial institution size in the U.S. <https://www.fsb.org/2020/01/global-monitoring-report-on-non-bank-financial-intermediation-2019/>

<sup>10</sup> See McAndrews, James and Menand, Lev, Shadow Digital Money (March 13, 2020). Available at SSRN: <https://ssrn.com/abstract=3554006> or <http://dx.doi.org/10.2139/ssrn.3554006> and Barry Eichengreen, “From Commodity to Fiat and Now to Crypto: What Does History Tell Us?” NBER Working Paper No. 25426, January 2019. [https://www.nber.org/system/files/working\\_papers/w25426/w25426.pdf](https://www.nber.org/system/files/working_papers/w25426/w25426.pdf)

if the sponsoring institutions were supervised and regulated as banks.<sup>11</sup> Most recently, prime money market mutual funds in the U.S. suffered a run on their deposit substitutes in the third week of March 2020, with the funds losing over \$77 billion that week in their fully demandable “shares.”<sup>12</sup>

By denying an account to an eligible chartered depository institution, on the grounds that it might increase risks to the U.S. financial system, the Reserve Bank may perversely increase risks overall. What is crucial is that the baseline against which the Reserve Bank is estimating risk effects specifies that the activity may otherwise take place in a less-regulated, less-supervised environment, were the account not to be established for the applicant.

An additional aspect of this issue, again relating to the first question, is whether all depository institutions that serve retail customers should have their deposits insured by the FDIC. While we agree that the FDIC coverage is, and has been, a centerpiece of the stability of the U.S. financial system, we believe that it is the role of Congress to mandate such coverage. We are concerned that the Board’s proposed guidelines interpose Reserve Banks, and their judgments, for the role of Congress. While we support Congress mandating deposit insurance coverage for all depository institutions that receive deposits from retail customers, we are concerned that these guidelines seek that outcome without the mandate provided by legislation.<sup>13</sup>

A related concern is the sixth proposed guideline, considering effects on monetary policy implementation. Monetary policy implementation is affected strongly by the shadow banking sector. One needs only consider the Federal Reserve’s massive and successful interventions assisting the financing of bond funds and money market mutual funds in March 2020 to realize that monetary policy implementation responds to developments outside the banking sector. In late May 2021, for example, the Federal Reserve issued more than \$450 billion in overnight reverse repurchase agreement liabilities to money market mutual funds (balances akin to overnight accounts).<sup>14</sup> The FOMC has stated that the overnight reverse repurchase facility will play an “important part” of its implementation of monetary policy.<sup>15</sup>

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<sup>11</sup> See Gary Gorton, “Recent Changes and the Future of the U.S. Financial System,” at Markus Academy, April 15, 2021, <https://bcf.princeton.edu/events/gary-gorton-on-recent-changes-and-the-future-of-the-us-financial-system/>; also see Lev Menand, “Why Supervise Banks? The Foundations of the American Monetary Settlement, Vanderbilt Law Review, volume 74 number 4, 951 May 28, 2021.

<sup>12</sup> See Financial Stability Oversight Council, “2020 Annual Report,” December 3, 2020, at page 100. <https://home.treasury.gov/system/files/261/FSOC2020AnnualReport.pdf>

<sup>13</sup> We view the costs of allowing non-FDIC-insured risky depository institutions to serve retail customers to include consumer confusion over whether their accounts are insured, and a lesser degree of precaution if the depository institutions do not provide risk-based capital for the risks of their ventures in like amounts to insured depositories.

<sup>14</sup> See Board of Governors of the Federal Reserve System, “H.4.1” for May 27, 2021, <https://www.federalreserve.gov/releases/h41/current/>

<sup>15</sup> See Federal Open Market Committee, “Minutes of the Federal Open Market Committee,” March 216-17, 2021, pg. 3, “In their discussion following the Desk briefings, participants noted that the ON RRP facility had been very effective in establishing a firm floor for the federal funds rate and supporting monetary policy implementation. Participants commented that the facility would continue to be an important part of the monetary policy implementation framework going forward, particularly in coming months with reserve

An emphasis on the sixth proposed guideline is misplaced because nonbank financial sectors influence monetary policy implementation and the demand for Federal Reserve liabilities. The judgment by a Reserve Bank that the Federal Reserve's ability to conduct monetary policy would be adversely affected by its provision of an account could well overlook countervailing effects. As we will discuss in the next section, there are large, currently unmet, demands for safe, competitive deposits by money market mutual funds, bond funds, corporations, money services businesses and other nonbank financial intermediaries whose balances far exceed the limits of federal deposit insurance. As TNB and other potential narrow banks of its type would seek to accommodate such demands, their actions would significantly lessen the potential and repeated demands these sources of instability would place on the Federal Reserve.

In addition to potential effects an account opening might have on the nonbank sector, the Federal Reserve is well equipped with tools to control the demand for its liabilities by account holders. While the Board should act in a nondiscriminatory fashion, its policies for the remuneration of reserves gives it wide discretion over the demand for reserves by depository institutions, and, as a result, it can offset structural demands for reserves by its remuneration policies. Finally, Reserve Banks do not have the monetary policy authorities of either the Board or the FOMC and should not dictate solutions for those entities. There is a clear separation in the Federal Reserve Act of monetary policy responsibilities governed by the Board and the FOMC, and financial service responsibilities of the Reserve Banks. For these reasons, the sixth guideline is fraught with difficulties.

A final point to make in response the questions posed in the proposed guidelines concerns footnote number 5 that devolves to Reserve Banks the setting of the rate of interest on reserve balances for account holders. This devolution by the Board of its responsibilities to determine the rate of interest on reserves is not warranted. Reserve Banks cannot easily ensure the nondiscriminatory application of interest on reserves, a principle to which the Board should adhere in its administration of the policy. Second, without monetary policy authority, Reserve Banks are poorly placed to determine the appropriate rate of interest, which, again, should be a nondiscriminatory rate set by the Board in any case. Finally, if the Board or Reserve Banks have reservations about the business plan of a potential account holder, they could conceivably limit the size of activity of the account holder, but they should not change the nature of the business unilaterally. Temporary size restrictions could allow the Board to test the effects of the new business plan on the U.S. financial system, while lowering the rate of interest on reserves would,

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levels projected to rise rapidly. Participants broadly supported the proposed increase in the counterparty limit, and a few participants also noted that they would support removing the limit altogether. A few participants suggested that some type of dynamic or differential limit could be considered in the future to enable the ON RRP facility to adapt more readily to market developments. A few participants noted that the concerns at the time the facility was established about possible adverse effects of the ON RRP facility on financial stability and the structure of money markets had not materialized. Indeed, over the spring of 2020, the facility played an important role in helping stabilize money market conditions. In light of the potential for greater use of the ON RRP facility going forward in connection with the expansion of the Federal Reserve's balance sheet and associated downward pressure on overnight rates, a couple of participants noted that it might be useful to review lessons learned regarding the ON RRP facility since its inception." <https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20210317.pdf>

in contrast, make some business models uneconomic, and would not generate socially useful information.

#### 4. The unmet demand for safe and competitive deposits

The shadow banking system has substituted for banks in meeting the demands for safe, money-like instruments in recent decades.<sup>16</sup> This trend is likely related to the rise of large “asset-pools” whose size vastly exceeds the limits on insured deposits, making bank deposits less able to fulfill the demands of institutional savers.<sup>17</sup>

The crisis events in 2007-09 and again in March 2020, in which runs occurred on several of the money-like instruments, show that the shadow banking system’s substitutes for safe bank deposits are imperfect, and, in fact, systemically risky. Furthermore, evidence suggests that the structure of the U.S. shadow banking system, in which intermediaries that are runnable, such as prime money market mutual funds and others, are major depositors in banks, who, in turn, are subject to runs, is destabilizing to the whole financial system.<sup>18</sup>

During the market events in the second quarter of 2020, there was a significant flow of funds into bank deposits and Treasury-only money market mutual funds, of, respectively, approximately \$2 trillion and \$1 trillion.<sup>19</sup> This shows that in times of stress, savers tend to deposit into banks and Treasury-only money market mutual funds. One may conclude from this pattern that *in times of stress, bank deposits and other safe assets are in ample supply*.

We reconcile the apparent discord between the secular substitution of seemingly safe but systemically risky shadow banking liabilities and the retreat partially into bank deposits in crisis as follows. In normal times, bank deposits are dominated in return by the yield on shadow banking liabilities.<sup>20</sup> In crisis, policy interest rates are set at the effective lower bound, resulting in near equality of yields across short-term money market instruments. As a consequence, during and after severe financial stress, bank deposits relative yields rise, and are no longer dominated by the returns on alternative investments.

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<sup>16</sup> See Gorton, Gary, Stefan Lewellen, and Andrew Metrick, “The Safe-Asset Share,” *American Economic Review: Papers & Proceedings* 102 (May 2012), 101-106: “The classic form of safe financial debt is bank deposits. But while bank deposits constituted the vast majority of safe financial debt before 1980, the share of deposits has dropped by more than one half from its peak... ‘[M]oney-like debt’ refers to commercial paper, net repurchase agreements, federal funds, money market mutual fund assets, interbank transactions, broker-dealer payables, and broker-dealer security credits.” Pg. 104

<sup>17</sup> Poszer, Zolton, “Shadow Banking: the Money View,” Office of Financial Research, Working Paper 14-04, July 2, 2014.

<sup>18</sup> See Cipriani, Marco, Antoine Martin, and Bruno Parigi, “Money Market Funds Intermediation and Bank Instability,” Federal Reserve Bank of New York, Staff Report No. 599 February 2013, Revised May 2013.

<sup>19</sup> See the “Assets and Liabilities of Commercial Banks in the United States-H.8” Table 2, Row 36, August 28, 2020, <https://www.federalreserve.gov/releases/h8/20200828/> and the “Financial Accounts of the U.S. Table L.121, Money Market Funds,” row 8: <https://www.federalreserve.gov/apps/fof/DisplayTable.aspx?t=l.121>

<sup>20</sup> See, for example, Itamar Drechsler, Phillip Schnabl and Alexi Savov, “The Deposit Channel of Monetary Policy,” *Quarterly Journal of Economics* 132(4), November 2017, 1819-1876.

This constellation of yields reveals an unmet demand in the U.S. financial system for a safe and competitive bank account for uninsured deposits in normal times. With the supply of such a service, uninsured depositors will have an alternative short-term investment which is free from run risk. That investment alternative can be used by money market mutual funds and other shadow banking institutions to accommodate their own shareholders' withdrawal demands, rather than engage in a disruptive fire sale of marketable securities. Such a service would greatly enhance the systemic safety of those institutions and the U.S. financial system more broadly.

It is important to note two points. Were a safe and competitive deposit service available to institutional investors, it is likely that funds would flow out of the safe deposit service in times of crisis, as institutional investors draw on such funds to meet withdrawal demands placed on them, and flow into other banks and Treasury-only money market funds as typically occurs. Second, the safety and stability of the U.S. financial system would be enhanced by having more short-term wholesale funding supplied by non-runnable deposits in normal times.

The second point must be emphasized: creating a safe and competitive deposit service for institutional investors does not *create* a risk of runs into such a service during a crisis, as runs into banks and money market mutual funds already occur. Instead, the creation of such a service will *forestall runs* from occurring, as a larger share of institutional investments will be held in a safe form in normal times.

## **5. TNB should have an account at the Federal Reserve Bank of New York soon.**

TNB applied for an account from the Federal Reserve Bank of New York in August 2017. It is imperative that an account be established for it as soon as possible. TNB has met the requirements for such an account after its review of credit and liquidity risks by the Federal Reserve Bank of New York in the fall of 2017, and TNB has robust systems to comply with Know Your Customer and Anti-Money-Laundering requirements. As we have explained in great detail in many documents, and pointed out in this note, TNB would add to the safety and efficiency of the U.S. financial system.<sup>21</sup>

In its proposed guidance, the Board expresses the concern that “If the institution is not subject to capital requirements similar to a federally-insured institution, the potential for sudden and significant deposit inflows into that institution is particularly large, which could disintermediate other parts of the financial system, greatly amplifying stress.” This concern, as we discussed above, is misplaced. But here we rule out any such significant deposit inflows into TNB.

TNB pledges to abide by a “surge-protector” in receiving deposits, similar in spirit to the surge-protector policy it suggested in its comments on the Board’s March 6, 2019 Advanced Notice of Proposed Rulemaking.<sup>22</sup> Specifically, after a two-year period of becoming established, TNB will not receive deposits in excess of three times its current balance over any three-month

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<sup>21</sup> See the documents section at <https://www.tnbusa.com/>.

<sup>22</sup> Op. cit. page 29.

period. Such a restriction on inflows strikes a balance between the provision of competitive safe deposit facilities, while avoiding any massive increase in deposits in a short period of time, avoiding any amplification of stress.

TNB is safe and adheres to appropriate and sound regulations imposed by its well-respected regulator, the Connecticut Department of Banking. It will add greatly to the safety and efficiency of the U.S. financial system and, unlike other similar situated eligible depository institutions, has endured a nearly four-year period during which it has not had an account provided by the Federal Reserve Bank of New York. This delay is not consistent with the equal applicability of law and regulation desired by the Board. We urge the Board to recommend the establishment of an account for TNB.

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TNB appreciates the opportunity to comment on the proposed guidelines. If you have any questions, please contact the undersigned by phone at (917) 609-0086 or by email at [jmcandrews@tmbusa.com](mailto:jmcandrews@tmbusa.com).

Respectfully submitted,

James McAndrews  
Chairman and Chief Executive Officer  
*TNB USA Inc.*

cc: Honorable Jerome H. Powell, Chairman  
(Board of Governors of the Federal Reserve System)