James McAndrews
TNB USA Inc.
25 Marshall St. Suite 2D
Norwalk, CT
06854

February 26, 2024

Attachments:
Armstrong Letter, TNB Letter

Chairman Jerome Powell
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave, N.W., Washington, DC 20551

President John Williams
Federal Reserve Bank of New York
33 Liberty Street, New York, NY 10045

Appeal Regarding TNB USA Inc. Account Application Denial

Dear Chairman Powell and President Williams,

I write to express my disappointment, shared by my colleagues, regarding the decision to reject TNB USA Inc.'s (TNB) account application and to request a reconsideration based on a factual assessment of our application.

TNB has patiently endured a six-and-a-half-year period during which the Federal Reserve analyzed its account application. The decision to deny TNB's application, announced in Chris Armstrong's letter (Armstrong letter) of December 19, 2023, is ill-founded, and should be reconsidered and reversed. It rests, in part, on false assertions about TNB's commitments, expressed in writing to the Federal Reserve in July 2023. The misinterpretation of those commitments by the Federal Reserve is egregious and should be corrected. Good public policy decision-making demands that, after a six-and-a-half-year period of consideration, the Federal Reserve be familiar with the facts of the application and provide analysis that is grounded in well-accepted theory and empirical analysis. The Armstrong letter contains neither of those features. In addition, we don't accept the view that the FRBNY has the legal authority to deny TNB's account application.[1]

In the following, we provide a brief response to issues raised in the three parts of the letter, correcting the factual record along the way. We include copies of both that letter and our letter (TNB letter) of July 5, 2023, addressed to Chris Armstrong and Joseph Torregrossa, outlining the commitments we made to overcome any reasoned policy concerns that might be advanced by the Federal Reserve.

[1] See Julie Hill, "Bank Access to Federal Reserve Accounts and Payment Systems," 40 453 YALE J. ON REG. (2023)

TNB's Purpose and Positive Impact

TNB is designed to provide a safe depository to U.S. institutions at competitive interest rates. This activity, especially with the constraints adopted by TNB, is wholly supportive of financial stability, monetary policy implementation, and the well-being of U.S. depositors.

Substantial Commitments Demonstrating Responsible Innovation

TNB made four commitments to the Federal Reserve in the TNB letter. Specifically, TNB:

1. **Surge Protector:** TNB established a surge protector, limiting the growth rate at which deposits could flow into TNB.
2. **Deposit Cap:** Set an upper limit on the issuance of deposits, equaling $160 billion, the same upper limit that applies to each of the more than 100 participants in the overnight reverse repurchase agreement facility (ON RRP).
3. **Federal Reserve Bank of New York Control:** Granted the Federal Reserve Bank of New York the exclusive right to set the limit at a higher level at the end of one and two years of operation, and to expand it or set it to $0, by closing TNB's account, at the end of its third year of operation.[2] This extraordinary commitment recognizes that TNB is a novel type of financial intermediary, and offers to the Federal Reserve the option of observing its activity for a short period, during which its effects can be judged.
4. **Deposit Drawdown Rule:** Established a deposit drawdown rule, under which TNB would shrink to $0 deposits over any three-month period after a trigger condition were met.[3] Notably, even if there were a proliferation of entrants copying TNB's business model, their combined balances would be $0 after the trigger event had occurred.

Addressing Specific Concerns:

Most of the assertions made in the Armstrong letter show either a lack of familiarity with, or a complete misreading of these commitments; furthermore, the concerns raised by the Armstrong letter are met by understanding the constraints imposed on TNB by its commitments.

Undue Risk to Financial Stability

In part A of Armstrong's letter several assertions about the nature of TNB's business model creating undue risk to the stability of the U.S. financial system are wholly unsupported by any analysis; they are conclusory. Furthermore, the assertions that future Federal Reserve approvals of other depository institution applications would create magnified risks to financial stability are addressed by future Federal Reserve policies and TNB's commitments.

In section 1 of part A of the letter, the concern is raised that a run on TNB could occur. TNB has designed its operations to be highly safe. The operations of the bank largely consist of calculating simple interest and applying it to account balances and sending account balances via Fedwire Funds Transfer to account

[2] Clearly, the Federal Reserve Bank of New York has the authority, under the TNB letter and its commitment to have it remain at $160 billion (by expanding the limit by a miniscule amount, if one insists on a literal reading) thereafter.

[3] TNB offered two such triggers, either of which we would abide by, that indicated a desire by the Federal Reserve to reduce the quantity of reserves in the banking system. Details are best described in the TNB letter.

holders. The bank would not be linked to the internet through online banking services, and maintains high standards for cybersecurity, know your customer, and anti-money-laundering programs. It maintains capital to meet operational risk regulatory requirements. Consequently, TNB's operational risk profile is safer than any private bank of which we are aware. Further, its constrained size limits the transmission of any disturbance at TNB to other institutions. Finally, TNB forestalls runs at other institutions, such as shadow banks, by attracting depositors from institutions that are risky and uninsured.

Section 2 of part A of the letter focuses on runs into TNB. TNB's size limit and its surge protector clearly address these concerns. The suggestion that TNB would allow institutions that have not signed a deposit agreement with it to simply deposit funds with TNB, or that TNB could not return such unaffiliated funds because of the failure of the bank from which the funds were sent, is highly unlikely and tendentious.

Monetary Policy Implementation

Part B asserts that monetary policy implementation would be adversely affected by TNB, even though TNB would have less than 1 percent of the capacity of the ON RRP, which is designed to accomplish the same end as is TNB, but only to a narrow base of institutions.

Section 1 focuses on TNB's acts causing reserve scarcity for broad banks through massive scale of operations, especially in stress conditions, and making it difficult for the Federal Reserve to estimate reserve demands. The size limit and drawdown rules directly address those concerns. Footnote 2, which suggests that TNB would have unconstrained size after three years of operation, is a complete misreading of the TNB letter and undermines all the assertions of this section.

Furthermore, TNB specifically requested that the Federal Reserve offer reasonable suggestions to improve the drawdown rule. Finally, both addressing this concern and the concern about a proliferation of entrants into TNB's business model, the Federal Reserve has the authority, given to it by TNB, to shut TNB down after three years of operation if it so chooses. The difference between preemptively disallowing TNB to operate and allowing it to operate for three years is that the decision after three years of operation would be based on facts learned during the limited period of operation, and not on fears and suppositions.

Section 2 suggests that TNB's activities could create interest rate volatility, especially during stress periods. This possibility is addressed by TNB's size limit, the surge protector, and the drawdown rule.

Section 3 focuses on TNB's possible effects on the federal funds market. If desired, TNB has been willing to restrict its depositor base to institutions not eligible for participation in the ON RRP, which would eliminate this concern.

Section 4 suggests that TNB and a group of like institutions could significantly affect the Federal Reserve's overall balance sheet size and composition. TNB's size limit addresses this concern. Further, after a three-year period, if there are many like institutions and the public, including the Federal Reserve, has learned through observation that there are inefficient outcomes associated with the operation of such institutions, the Federal Reserve can shut them down. Again, that decision would be based on observations and learning.

TNB is a positive contribution to the financial system:

We believe that TNB would work to support the monetary policy implementation of the Federal Reserve, in much the same way that the ON RRP has done. It would do so by offering safe deposits at competitive rates to institutions who are not eligible to participate in the ON RRP. TNB's activities contribute to financial stability by forestalling runs by investors who would otherwise place funds in risky and lower-yielding investments. TNB's commitments to limit its size, refrain from possibly excessive growth, go dormant under conditions of reserve restraint, and allow the Federal Reserve Bank of New York to both limit its size and to shut it down after three years provides an example of responsible innovation in the chartered, regulated, supervised, and examined sector of the financial system. It should be a welcome and healthy addition to it.

We look forward to your reconsideration of TNB's account application.

Sincerely,

James McAndrews

CEO, TNB USA Inc.

Attachments: Armstrong Letter, TNB Letter

CC: Christopher Armstrong
Joseph Torregrossa
Mark Van Der Weide
Trevor Reese
Matthew Eichner
Andreas Lehnert
Stacey Tevlin
James Clouse
David Bowman
Jane Ihrig
Margaret DeBoer
Laura Lipscomb
Elizabeth Klee
Elizabeth Kiser
David Mills
Marco Cipriani
Jacob Gramlich
Suzanne Benvenuto
Richard Ostrander
Roberto Perli
Kartik Athreya
The Honorable James Himes
Nicholas Larson
Julie Remache

FEDERAL RESERVE BANK *of* NEW YORK

33 LIBERTY STREET, NEW YORK, NY 10045-0001

Christopher D. Armstrong
EXECUTIVE VICE PRESIDENT &
HEAD OF OPERATIONS & RESILIENCY

December 13, 2023

James McAndrews, Chairman & CEO
Gene Park, President & COO
TNB USA Inc.
25 Marshall St. Suite 2D
Norwalk, CT 06854

Re: Final Determination for Master Account Request – TNB USA Inc.

Dear Mr. McAndrews and Mr. Park:

I write in response to the application by TNB USA Inc. ("TNB") for a master account. As TNB requested on November 3, 2022, the Federal Reserve Bank of New York ("FRBNY") prioritized its review of TNB's master account application under Principles 4 and 6 of the Board of Governors of the Federal Reserve System's Guidelines for Evaluating Account and Services Requests (the "Guidelines"), which state that the provision of an account should not present undue risk to the stability of the U.S. financial system or adversely impact the Federal Reserve's ability to implement monetary policy.

Under the Guidelines, TNB is a Tier 3 institution because it is neither federally insured nor subject to prudential supervision by a federal banking agency. The Guidelines recognize that access requests from such institutions "may pose the highest level of risk" and so are subject to "the strictest level of review." The FRBNY's review of TNB's account access request incorporated all the information TNB provided throughout the application process, including the amendments to TNB's business plan submitted on November 14, 2022, February 20, 2023, and July 5, 2023, and the substance of our July 14, 2023 call. Under Principles 4 and 6 of the Guidelines, the FRBNY has determined that providing TNB a master account would pose undue risk to the stability of the U.S. financial system and would adversely affect the Federal Reserve's ability to implement monetary policy, and thus denies TNB's request.

A. Principle 4 Determination: Provision of a Federal Reserve master account and services to TNB would create undue risk to the stability of the U.S. financial system.

TNB describes its business model as collecting institutional investor deposits and making corresponding deposits in a master account at the FRBNY, to collect interest that it will pass on to its depositors, less a service fee. TNB does not plan to make loans, facilitate payments, or offer additional products or services. Due to the nature of TNB's business model, providing master account access to TNB would create undue risk to the stability of the U.S. financial system, particularly during times of financial or economic stress. In addition, granting account access to TNB could lead to account requests from like institutions and to a proliferation of such entities. The risk to financial stability would be magnified by the likely emergence of such institutions if account access were granted to TNB.

T 201.531.3077 | **E** Christopher.Armstrong@ny.frb.org | **W** www.newyorkfed.org

1. **Liquidity or other strains at TNB or a group of like institutions may be transmitted to other segments of the financial system.**

Granting FRBNY master account access to TNB could have a deleterious effect on U.S. financial stability, as it is very plausible that deposit flight or other strains at TNB could transmit to other depository institutions with significant shares of uninsured deposits.

TNB would be subject to non-financial and liability-side risks, which create the potential for strains. TNB's non-financial risks would include the risk of operational outages or failures (e.g., cybersecurity attack, systems failure). Such events can cause losses of confidence that trigger large-scale withdrawals of deposits or other liabilities. A key liability risk at TNB would be the potential for deposit withdrawals that reach sufficient size to create runs, wherein remaining depositors withdraw out of fear. TNB's business model also makes the risk of deposit flight higher than for traditional banks. Because TNB would not provide depositors with traditional banking services such as lending, its depositors would have fewer financial linkages to TNB than with a traditional bank. This further reduces the incentives for depositors to stay at TNB should the institution face significant adverse developments.

TNB's lack of deposit insurance would make it more likely to transmit strains to other financial institutions through contagion effects. Given the lack of any deposit insurance at TNB, the risk would be higher that its own strains could transmit to uninsured depositors at other institutions, as those depositors fear that the strains at TNB could also materialize at their own institutions, and they lack the guarantee of FDIC deposit insurance to protect them in such adverse states.

2. **Access to a Federal Reserve master account and services by TNB or a group of like institutions could affect deposit balances across U.S. financial institutions more broadly and have a deleterious effect on U.S. financial stability, especially during times of financial or economic stress.**

Granting master account access to TNB or like institutions could incentivize flight to such institutions in times of economic or financial stress, which, in sufficient size, would interrupt critical funding markets and/or credit to the U.S. real economy. As demonstrated in 2008 and in 2020, such stress outflows can impair critical funding markets and require emergency official sector interventions. As demonstrated in 2023, these outflows can quickly accelerate into runs that spread across banking institutions and threaten the credit and financial intermediation they provide.

Granting access to TNB would provide it with assets that are free of the risks inherent to financial institutions that provide credit to the real economy and intermediate critical financial markets. In events where stress is occurring outside of TNB, rather than within it, account access would make TNB the economically incentivized "safe haven" destination for qualifying institutional depositors. In this case, institutional assets would plausibly shift to TNB out of banking institutions, money market funds, and/or similar entities that fund the real economy and critical markets.

T 201.531.3077 | **E** Christopher.Armstrong@ny.frb.org | **W** www.newyorkfed.org

TNB's proposed mitigant to this risk, its pledged "surge protector" for deposits,[1] would not adequately mitigate the identified risk to financial stability. First, if granted master account access, TNB could become one of many institutions that use the same business model; even if all were to bound deposit growth in the way that TNB proposes, bounded deposit surges across multiple institutions could easily constitute a material drain on financial institutions that provide credit and critical market funding. Second, additional operational limitations would render the proposed mitigant less than effective: FRBNY and TNB would need to monitor the account ex post to impose caps because transfers over the Fedwire system are final when processed and are monitored for available balances on the sending side (i.e., not caps on the receiving side, in this case, TNB). As such, TNB would have no visibility into final transfers coming into its account because those would be initiated outside of TNB's purview by account holders at the other institutions. This would render any caps proposed by TNB or FRBNY as possibly illusory in times of stress—funding would flow in and TNB would need to comply with agreements by sending wires back out, possibly into a bank that just failed because of the outgoing activity. Finally, the external enforcement of a deposit limit is not practicable in financial system stress: external enforcement by the public sector—that is, to suddenly restrict the movement of deposits—would very likely exacerbate the uncertainty and/or panic that is causing the flight to safety in the first instance.

B. Principle 6 Determination: Provision of a Federal Reserve master account and services to TNB would materially adversely affect the Federal Reserve's ability to implement monetary policy.

There is a material risk that TNB depositors will view TNB deposits as substitutes for other money market investments and that their demand for TNB deposits will be driven by non-price factors, such as perceived safety and liquidity. This risk would materially adversely affect the Federal Reserve's ability to implement monetary policy. In addition, any related adverse impact on monetary policy implementation would be magnified by the likely emergence of like institutions if account access were granted to TNB. Such impacts would be amplified should TNB or a group of like institutions achieve significant scale in their deposit bases.

1. Access to a Federal Reserve master account and services by TNB or a group of like institutions would affect the level and variability of the demand for and supply of reserves.

Access to an account by TNB or like institutions would affect the level and variability of the demand for reserves when there is significant investor demand for deposits at TNB or like institutions. Importantly, TNB is not subject to certain prudential capital requirements such as leverage ratios; moreover, TNB would not pay FDIC deposit insurance premiums. As a result, TNB would not have significant balance sheet constraints or costs based on regulatory requirements that would otherwise limit its size and growth.[2] Hence, over time TNB or a group of like institutions could achieve significant scale in their deposit base, which would be fully backed by reserves.

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[1] In a 2022 addendum to its business plan and a 2023 communication, TNB proposed that "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 period." The addendum asserts that "[t]his policy rules out any amplification of stress via the actions of TNB during a period of financial stress in which investors seek safe deposit facilities in large quantities."

[2] TNB proposed an upper limit on its deposit growth for the first three years of operation but not beyond.

Non-price factors (i.e., perceived safety and liquidity that TNB deposits offer over alternative money market investments) can be a significant contributor to demand for deposits at TNB or a group of like institutions and such demand can occur at almost any constellation of money market interest rates, including at levels of the federal funds rate above the IORB (the maximum rate TNB can pay), thereby potentially contributing to reserve scarcity among all other banks. In stress conditions, cash investors could likely redirect a significant portion of their investments away from secured and unsecured markets in favor of the safety and liquidity offered by deposits at TNB or a group of like institutions. The investments in deposits at TNB or a group of like institutions would also reduce the supply of reserves available to other banks, prompting an increase in the banking system's overall demand for reserves. Such increase could result in the need for the Federal Reserve to provide additional reserves in uncertain and hard or impossible to predict amounts. The impact of these shifts would be greater to the extent that TNB and a group of like institutions achieve significant scale.

Additionally, the weight investors place on non-price factors could shift over time and possibly change rapidly during periods of financial sector stress, making it more difficult for the Federal Reserve to estimate the demand for reserves and interpret price signals from money markets, which are key inputs for effective monetary policy implementation. An account restriction that would require TNB to rundown deposits to zero when reserves are not ample, as proposed by TNB, could ensure that the account would not significantly contribute to reserve scarcity, at least over a medium-run horizon. However, such a drawdown rule would not adequately mitigate the identified risks to monetary policy implementation posed by TNB given existing uncertainty in the appropriate level of reserves and the potential for funding pressures to emerge unexpectedly. Moreover, the implementation of the rule would be complex, especially if it were to be applied across TNB and a group of like institutions. A drawdown rule would also likely be challenging in practice to administer effectively.

2. **Access to a Federal Reserve master account and services by TNB or group of like institutions would affect the level and volatility of key policy interest rates.**

Providing account access to TNB or a group of like institutions would likely affect the level and volatility of key money market rates during periods of financial market stress, where demand for deposits is driven by investors' preferences for safety and liquidity over return. In principle, if depositors were driven purely by rate considerations, providing account access to TNB or a group of like institutions could affect funding markets by narrowing the spread between the federal funds rate and other money market rates and IORB. TNB or like institutions would effectively create a new reservation rate for a range of money market investors that is likely to be higher than the current reservation rate set by the ON RRP and closer to IORB. As a result, TNB or group of like institutions could help mitigate volatility in short-term interest rates, by firming the floor on money-market rates set by IORB.

However, investors' views on the value of non-price factors could shift rapidly during periods of financial market stress. At such times, material increases in demand for deposits at TNB or a group of like institutions driven by investors' preferences for safety and liquidity over return could exacerbate secured and unsecured funding market pressures, driving up rates and creating interest rate volatility, potentially increasing the need for the Federal Reserve to provide liquidity through open market operations or lending operations to maintain rate control. In addition, less robust funding market activity could have implications for other money market reference rates.

3. Access to a Federal Reserve master account and services by TNB or group of like institutions would affect the structure of key short-term fundings markets.

Providing account access to TNB or a group of like institutions would affect the structure of key short-term funding markets by drawing funding away from traditional money market instruments, both secured and unsecured, especially when the demand for TNB or a group of like institutions' deposits is driven by non-price factors. These markets and the financial institutions active in these markets are central to the current framework for the implementation of monetary policy. Such structural changes would create uncertainty both during the transition to a new market structure and in the potential new steady state.

Importantly, providing account access to TNB or a group of like institutions could lead to a reduction in federal funds trading activity. If the reduction were to be sufficiently large, the effective federal funds rate, as currently constructed, may no longer be a robust reference rate. TNB's initial business plan and July 2023 amended business plan list GSEs as target clients, which are the major lenders in the federal funds market. In stress conditions, pressures could also emerge in secured funding markets should cash investors such as money market funds opt to reduce their participation in the repo market and shift their funds to deposits in TNB or like institutions. Such changes would put pressure on dealers' abilities to fund themselves and provide funding to their clients.

4. Access to a Federal Reserve master account and services by TNB or group of like institutions would significantly affect the overall size of the consolidated balance sheet of the Reserve Banks.

To the extent that demand for TNB or a group of like institutions' deposits is driven by non-price factors, the Federal Reserve might need to grow its balance sheet via open market operations or discount window lending to accommodate increased reserve demand. The increase in demand from TNB or like institutions and the related effect on the balance sheet of Federal Reserve Banks would likely be more pronounced in stress conditions as cash investors shift funds away from other money market investments. This impact could be greater to the extent that TNB and like institutions achieve significant scale. Furthermore, the additional uncertainty and volatility of reserve demand introduced by TNB or group of like institutions could require the Federal Reserve to maintain a larger balance sheet to provide an additional "buffer" to the reserve supply.

*   *   *

C. Conclusion.

For the foregoing reasons, the FRBNY hereby denies TNB's request for an account.

Sincerely,

Christopher D. Armstrong
Executive Vice President &
Head of Operations & Resiliency
Federal Reserve Bank of New York

cc: Sushmita Shukla

Attachment 2: TNB Letter

James McAndrews
TNB USA Inc.
25 Marshall St. Suite 2D
Norwalk, CT
06854

Chris Armstrong and Joe Torregrossa
Federal Reserve Bank of New York
33 Liberty Street, New York, NY 10045

July 5, 2023

Dear Chris and Joe,

We appreciate the work and attention you have devoted to evaluating our request for an account at the Federal Reserve Bank of New York. As you are aware, TNB USA Inc. applied to the FRBNY in August 2017 for a master account. We ask that the FRBNY establish an account as soon as is practicable.

TNB has made important concessions since 2021 to address any concerns that policymakers might have regarding TNB's operations including, for example, those expressed in the Board of Governor's ANPR of March 2019. In this letter, we offer significant additional guardrails on our operating model that we hope will further address any concerns of the Federal Reserve for the operation of TNB.

First, in 2021 TNB established a <u>Surge Protector</u>:

TNB pledges to abide by a "Surge-Protector" in receiving deposits. Specifically, after a two-year period of becoming established, TNB will not receive deposits in excess of three times its current balance over any subsequent three-month period. Such a restriction on inflows strikes a balance between the competitive provision of safe deposit facilities and avoiding any massive increase in deposits in a short period of time. This policy rules out any amplification of stress via TNB deposit taking during a period of financial stress in which investors seek safe deposit facilities in large quantities.

Second, earlier this year TNB established an <u>upper limit on its issuance of deposits</u>:

As a condition of the establishment of its account, TNB agrees to submit its operations to an initiation period of 3 years. Conditional on its account being established, TNB would agree to limit its issuance of deposits so that its account balance at the Federal Reserve Bank of New York would not exceed an upper limit of $160 billion during the first year of operation. The Federal Reserve Bank of New York would have the option to set the upper limit on TNB's account balance for each of the following two years, with a minimum of $160 billion. After 3 years of operation, the Federal Reserve Bank of New York could remove the upper limit on account balances, expand it, or close TNB's account at its sole discretion.

The upper-limit-on-deposits pledge is, of course, even stronger than the surge protector in limiting inflows to TNB if it reaches levels of deposits close to its upper limit.

To further address any possible concerns held by the Federal Reserve, TNB is willing to change its mission from intermediating the safety and earnings on reserve balances to U.S. institutional investors to intermediating the safety and earnings on reserve balances to U.S. institutional investors only when

reserves are ample. The possible concern this commitment is intended to address is that, for reasons of a structural demand for narrow bank account deposits, or for some other reason, reserves may become "locked up" in narrow banks. Such a result might frustrate the Federal Reserve in achieving its objectives for the size of its balance sheet.

TNB is willing to incorporate a deposit drawdown rule into its business plan. It is also willing to commit to this via contract and will commit to the rule with its supervisor, the Department of Banking of Connecticut.

Below we review two possible restrictions, to either of which we agree to submit; we want to be clear that in either case, TNB would maintain the cap on its size of $160 billion and follow the terms of its initiation period. We are committing to the rule for a term of three years, consistent with the initiation period, after which TNB would renew the commitment at the option of the Federal Reserve Bank of New York.

One version of such a contractual restriction or agreement would be:

Price-mediated drawdown of TNB:

> Whenever the Effective Federal Funds Rate minus 5 basis points exceeds the Interest Rate on Reserve Balances every day for one month, and the ON RRP rate remains no less than 10 basis points below the Interest Rate on Reserve Balances, TNB will reduce its deposit balances at the Federal Reserve Bank of New York to zero over a three-month period.
>
> If, during the course of the drawdown of TNB, the Effective Federal Funds Rate falls below the Interest Rate on Reserve Balances every day for a week, the drawdown will be stopped, and TNB will return to normal operations.

In other words, if the effective federal funds rate rises to at least 5 bps above the interest rate on reserve balances, and stays that way every day for a month, TNB will draw down its deposits at the Federal Reserve Bank of New York over a three-month period. The three-month period would prevent a major inconvenience for TNB's depositors. If rates fall, so that the federal funds rate falls below the interest rate on reserve balances every day for a week, TNB's operations will return to normal.

Another version of the rule would be:

Quantity-mediated drawdown of TNB:

> Whenever, in the normal course of operation of the ON RRP, and in the context of the Federal Reserve reducing the size of its balance sheet, the balances in the ON RRP facility fall to zero every day for a month, TNB will reduce its deposit balances to zero over a three-month period. If, during such a drawdown of TNB, the ON RRP receives balances of at least $160 billion every day for a week, the drawdown will be stopped, and TNB will return to normal operations.

In other words, if, while reducing the size of its balance sheet, investment in the ON RRP decreases sufficiently and is sustained, TNB will draw down its deposits at the Federal Reserve Bank of New York over a three-month period. If investment in the ON RRP picks up, to a level of at least $160 billion of balances every day for a week, TNB will return to normal operations.

TNB is committing to abide by either of these rules. These two rules could be considered options for the Federal Reserve, and TNB is open to its suggestions for the appropriate parameters or form for the rules. The principle here is what is most important: TNB will intermediate the safety and earnings on reserve balances to U.S. institutional investors in times of ample reserves and will not frustrate the Federal Reserve's implementation of monetary policy and its objectives for the size of its balance sheet, but rather will complement it.

We offer some brief notes below on why we think that these policies greatly attenuate any concerns that policymakers might have about TNB's operation.

- First, as explained in many documents, TNB's operations seek to provide safety to institutional depositors at competitive rates, and now we add the condition that reserves must be ample (as evidenced by a sustained slight elevation in the effective federal funds rate relative to the interest rate on reserve balances, or by a sustained reduction in investment in the ON RRP). These operations work to support the implementation of monetary policy and financial stability. For example, due to the resulting improvement in deposit market competition when tightening monetary policy, the Fed would not need to increase its policy rates as much to get average deposit rates to increase by a given amount.
    - TNB's operations would extend to more U.S. institutions benefits that are similar to those enjoyed currently only by institutions eligible for the Federal Reserve's ON RRP facility. The authorization by Congress for the Federal Reserve Banks to pay interest on reserves to depository institutions makes possible the business strategy of TNB and is a foreseeable and efficient innovation in competition. It should be allowed to provide more investors with the benefits of safe and remunerated deposits. This is consistent with the testimony in Congress of several Vice Chairmen of the Board of Governors during the years 1999-2006. The size restriction and drawdown rules we propose limit the competitive effects of TNB to be consistent with the Federal Reserve's monetary policy and to assure the Federal Reserve that TNB's operations will be fully in support of financial stability.
- Concerns have been expressed over the possibility that excessive amounts of deposits could flow into TNB under various circumstances. Both the surge protector and the limit on deposits directly address this concern. The drawdown rule will result in narrow banks holding no reserve balances if the rule's condition for drawdowns occur.
- Some might be concerned about the precedent that could be set by establishing an account for TNB. However, the 3-year initiation period directly addresses the precedential concern. During that period, the Federal Reserve and society in general will be able to learn about how TNB operates, and its effects in financial markets. After that period, the Fed would have the authority to shut TNB down, so establishing the account for TNB confers no precedent on other potential applicants for accounts, even if organized in the same way as TNB.
    - In addition, either of the drawdown rules would assure the Federal Reserve that no matter how many narrow banks were to enter the market, they would have a combined balance of $0 if both the drawdown rule were imposed on them, and the conditions that would trigger the rule were operative.

- Some might be concerned about the competitive effect that TNB might have on banks, particularly mid-sized banks. The upper limit on TNB's initial size of $160 billion addresses that concern.
    - The limit is the same limit that the nonbank participants in the Fed's ON RRP facility face in making investments directly at the Fed (rather than making deposits at banks). There are more than a hundred such participants facing the limit. TNB would have the effect, at most, of adding one additional such competitor to bank deposits.
    - Further, unlike the very largest banks, TNB would itself be of relatively small size, and would not have the capacity, or headroom, to be considered a potential repository of the approximately $5 trillion in uninsured deposits in U.S. banks.
    - It bears repeating that TNB would not engage in making payments, in providing custody services, lending, or competing with banks in any fashion beyond its mission of providing safe depository services to U.S.-based institutional investors at competitive deposit rates.
- Some might be concerned that TNB would simply "steal market share" from the Fed's own ON RRP facility, and thereby be privately profitable but socially useless. However, the size limit established by TNB eliminates that concern. The ON RRP has had roughly $2 trillion invested in it on average during the last year. TNB's limit of $160 billion is a small fraction of that amount. Further, were TNB to attempt to compete directly with the ON RRP by posting a very high deposit rate, in excess of the ON RRP rate, it would likely experience an excess supply of deposits. TNB would be forced to lower its deposit rate as a consequence. It is very likely, then, that TNB's deposit rate will lie below the ON RRP rate and would, as a result, be unattractive to ON RRP participants. TNB would most likely serve institutions that do not have access to the ON RRP, such as states and municipalities, asset managers smaller than those who participate in the ON RRP, and corporations. These activities of TNB would be socially useful in supporting financial stability and monetary policy implementation.
- Another concern is that, notwithstanding the size restriction on TNB's balances, an extreme rate-insensitivity on the part of some of TNB's depositors may lead to some deposits remaining in TNB even under a significant interest rate differential from what might be offered by broad banks. Such a situation might not be consistent with the Federal Reserve's objectives for the size of its balance sheet. The drawdown rule would address this concern. If the effective federal funds rate were to rise above the interest rate paid on reserve balances, then TNB will drawdown its balances at the Federal Reserve Bank of New York, accommodating the Federal Reserve's objectives. We note that this restriction is consistent with the effective federal funds rate rising within the FOMC's target range for the effective federal funds rate. The alternative rule would similarly address such a concern.
- The three-year initiation period provides all parties with the opportunity to learn how investors respond to the operation of TNB and its effects on financial markets. Further the commitments TNB makes here can be assessed, renewed, and improved if the Federal Reserve finds them useful in assuring the public that TNB's operations are in support of monetary policy implementation and financial stability. The principle by which TNB seeks to operate, to

intermediate the safety and earnings of reserve balances only if reserves are in ample supply, is the key commitment of TNB to acting in support of the Federal Reserve's objectives. Allowing innovation in the chartered, regulated, supervised, and examined depository institution sector of finance is important, and TNB's innovation warrants both the caution and the flexibility that the three-year initiation period provides. TNB's commitments to address any concerns about its effects on financial stability and monetary policy implementation are highly restrictive; the initiation period can provide information to all about their forms and effects.

Another issue we wish to bring to your attention is the conflict of interest to which the Federal Reserve is subject as both the public-sector operator of the ON RRP facility, and as the service provider to TNB USA Inc., which is a lawful private depository institution applying for an account. The ON RRP is sole provider of safe overnight investments to a strict subset of U.S. institutional investors, excluding from the facility the vast majority of such investors. We earlier explained that TNB's size restriction was likely to lead to TNB marketing its services to U.S. institutions currently not eligible for the ON RRP, including states and municipalities. Were the Federal Reserve Bank of New York to exclude TNB USA Inc. from entering this service, a clear allocative inefficiency would result, and with the assurances and commitments we offer in this letter, there is no offsetting risk that would be avoided. We ask that the Federal Reserve review its conflicted position as the public sole provider of safe overnight investments and as the service provider to TNB to make sure that that conflict plays no role in evaluating TNB's account application.

We look forward to discussing these issues with you, and to a swift and successful conclusion to our application for an account.

James McAndrews
CEO
TNB USA Inc.
June 23, 2023

Cc
Mark Van Der Weide
Trevor Reese
Andreas Lehnert
Stacey Tevlin
James Clouse
David Bowman
Jane Ihrig
Margaret DeBoar
Laura Lipscomb
Elizabeth Klee
Elizabeth Kiser
Jacob Gramlich
Suzanne Benvenuto
Richard Ostrander
Roberto Perli