May 13, 2019

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. R–1652; RIN 7100–AF–40

Re: Potential Revisions to Regulation D (Reserve Requirements of Depository Institutions) to lower the rate of interest paid to certain state-chartered depository institutions on excess balances maintained at Federal Reserve Banks

Ladies and Gentlemen:

TNB USA Inc.[1] ("**TNB**") is pleased to comment on the advance notice of proposed rulemaking (the "**ANPR**")[2] issued by the Board of Governors of the Federal Reserve System (the "**Board**") on whether it should propose amendments to its Regulation D (Reserve Requirements of Depository Institutions) to lower the rate of interest paid on excess balances (the "**IOER**") maintained at Federal Reserve Banks ("**Reserve Banks**") by certain eligible institutions operating under validly granted state charters.

1. Introduction

"Narrow banks" can be conceived of as any private sector depository institution, public sector facility or other entity whose main purpose is to offer nonbanks overnight investments that are, directly or indirectly, fully backed by central bank liabilities. A private sector narrow bank, such as TNB, that has been granted a lawful state charter to operate would provide to its depositors a service that is economically equivalent to the overnight investment facilities that the Federal Reserve currently makes available to nonbanks. The present set of Fed-operated narrow banking facilities includes the overnight reverse repurchase ("**ON RRP**") facility and the foreign

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1 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.

2 84 Fed. Reg. 8829 (Mar. 12, 2019).

repurchase agreement pool (the "**FRP**"). As a private-sector start-up entity, our aim is to exercise our lawfully-granted state-chartered banking powers to broaden the availability of safe, high-yielding liquid deposits.

Whether publicly or privately operated, we believe narrow banks provide significant benefits to the health of the financial system by passing on more interest to depositors, reducing the subsidization of incumbent banks, and offering safe investment facilities to institutional investors. Our goal is not to interfere with the functioning of existing Federal Reserve programs or monetary policy objectives, but rather to enhance the efficacy of both by adding a much-needed element of private sector competition to the market for deposits in the United States.

The ANPR contemplates defining TNB and any other state-chartered private-sector narrow banks that may arise in the future as Pass Through Investment Entities ("**PTIEs**")—"depository institutions with narrowly focused business models that involve taking deposits from institutional investors and investing all or substantially all of the proceeds in balances at Reserve Banks."[3] The ANPR further contemplates that PTIEs should be singled out from all other depository institutions eligible to receive IOER and specifically designated to earn an IOER rate lower than the generally prevailing rate—possibly zero.[4]

Under its current framing, the ANPR appears to regard a lawfully operating bank that actually passes through the bulk of its income as interest paid to its depositors as a presumptively harmful anomaly. In contrast, the ANPR appears much more comfortable with the low-competition status quo in which the huge sums of IOER paid to incumbent banks constitute "pass-to" payments to bank shareholders and management as opposed to "pass-through" interest payments that benefit savers and depositors as a whole.

The ANPR goes on to justify its proposed discrimination against narrow banks on the asserted ground that it would be contrary to congressional intent for depository institutions to pass on the interest they earn to their depositors, where such pass-through occurs as a result of the competitive pressure exerted by start-up firms that adopt the low-risk narrow banking business model. Contrary to this framing, we believe it was plainly intended by Congress when it authorized Federal Reserve Banks to pay interest on reserves that the Federal Reserve should encourage the "pass-through" of IOER to depositors.[5] Instead, the ANPR proposes extraordinary steps to preserve the "pass-to" of IOER straight to the bottom line of incumbent banks that pay their own demand depositors virtually nothing in interest.

Like the Fed's existing public sector narrow banking facilities, private sector state-chartered narrow banks would offer significant benefits to society. They would increase deposit market competition, improve the transmission of monetary policy and strengthen financial

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[3] ANPR at 8829.

[4] ANPR at 8831.

[5] *See generally* Testimony of Governor Laurence H. Meyer before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Banking and Financial Services, U.S. House of Representatives, "Comments on H.R. 1585 and regulatory streamlining," (May 12, 1999) *available at* https://www.federalreserve.gov/boarddocs/testimony/1999/19990512.htm.

stability. The speculative concerns expressed in the ANPR about the as-yet unobserved undesirable effects of narrow banks on monetary policy implementation and financial stability are not well founded, and run contrary to the evidence from the operating history of the Fed's own narrow banking facilities. Indeed, sound theory and evidence point to further beneficial effects that private sector narrow bank competition will offer for the implementation of monetary policy and the stability of the financial system. Such benefits depend on private-sector narrow banks being treated in a nondiscriminatory fashion under Regulation D.

In this comment letter, we offer an alternative policy for the payment of interest to all banks that would preserve the competitive benefits of state-chartered narrow bank entry into our nation's dual banking system, while addressing any possible concerns of future undesirable surges of deposits into such institutions.

This letter is organized as follows:

- Section 2 outlines the reasons we believe the Board lacks the legal authority to override or suppress the State of Connecticut's legally valid decision to authorize TNB to operate as a private sector narrow bank:

  - In short, the Fed is not a chartering authority. The clear impetus of the ANPR in contemplating discriminatory IOER treatment for PTIEs is to use the Fed's technical power to set IOER as a means of eliminating the practical availability of an entire category of bank charter under validly enacted state law.

  - Fundamentally, the Federal Reserve cannot use its technical regulatory authority to set IOER rates in a manner that disregards and contravenes the overarching legislative framework within our federal system.

  - To do so would constitute, in the words of the recent decision by the U.S. District Court for the Southern District of New York ("**S.D.N.Y.**") in favor of a state financial regulator that is challenging the actions of a federal banking regulator as exceeding its legal authority, "essentially the exercise of a legislative function by administrative agency fiat."[6]

- Section 3 discusses the significant benefits of allowing state chartering of private sector narrow banks to proceed on a non-discriminatory basis. Under a regime of equal IOER treatment, private sector narrow banks would:

  - Pass through interest earned on reserves to depositors;

[6] *Vullo* v. *Office of Comptroller of Currency*, No. 18 CIV. 8377 (VM), 2019 WL 2057691, at *16 (S.D.N.Y. May 2, 2019).

- Improve rate competition in deposit markets, which in turn would:
  - reduce the subsidization of incumbent banks;
  - improve the transmission of monetary policy;
  - reduce dispersion in money-market rates;
  - raise deposit rates paid to depositors generally; and
- Generate tangible financial stability benefits rather than the speculative detriments described in the ANPR.

➢ Section 4 examines certain fundamental banking principles in the context of narrow banking:

- The Federal Reserve's creation and expansion of its own narrow bank operations addresses a critical need throughout financial cycles;
- The safety from financial risks that is characteristic of private sector narrow banks arises as an inherent consequence of adopting the extreme constraint of operating with 100 percent reserve backing for deposits, and is not reliant on, or enhanced by, substituting equity for deposit funding beyond the degree specified by applicable state capital rules;
- Contrary to the apparent presumption of the ANPR, it is indeed consistent with congressional intent to allow start-up state-chartered banks to operate in a way that will enable depositors to earn appreciably positive interest rates on their deposits with banks receiving IOER;
- Narrow banks reduce costly inefficiencies that arise from imperfect competition in deposit markets; and
- Contrary to congressional intent, the *status quo* in which the Fed impedes private sector narrow banks from competing for depositor funds allows incumbent banks to capture economic rents and inappropriately subsidizes their costs of compliance with prudential regulation.

➢ Section 5 responds to the specific questions posed by the ANPR.

2. The legal question presented by the ANPR

2.1 The discriminatory IOER regime contemplated by the ANPR is an attempt to legislatively re-write the statutorily established division of chartering authority to effectively preclude states from exercising a legally valid form of chartering authority.

Under the Constitution and the Tenth Amendment, legislative power that is not explicitly granted to Congress is reserved to the states. This federal system of government has been reflected throughout our nation's history by the existence of the dual banking system. Under the dual banking system, the federal government has statutorily defined authority (in the National Bank Act, Federal Reserve Act, Federal Deposit Insurance Act and elsewhere) to charter and regulate banks in specified circumstances set forth within these statutes. The practical result of this in today's world is that most banks, *because they conduct their banking activities in a way that triggers federal regulation under a relevant federal statute*, have a primary federal regulator.

Within this lattice of federal statutes prescribing federal regulation in almost all practical circumstances (but in each case based on the specific attributes of the bank in question—*e.g.*, having deposit insurance, being a national bank, being a Fed member), a small amount of residual space has remained for states to enact statutes allowing state-chartered, uninsured banks to be licensed by the state's department of banking subject to prudential regulation only by state, and not federal, authorities.

In 1999, the legislature of the State of Connecticut, exercising its power as a sovereign in our federal system, enacted a law to enable just that.[7] There is, and can be, no dispute as to the validity and propriety of that statute. The ability of the State of Connecticut to enact such a statute to permit chartering of a class of banking institution that is not subject to federal prudential regulation is a deliberate architectural feature of the dual banking framework, a natural consequence of our federal system of government. This is not, as the ANPR appears to imply, a loophole.

To view the fact that the State of Connecticut retains, and has exercised, this power as a "loophole" represents a profound misunderstanding of our federal system that gets its functioning precisely backwards—states retain power <u>except</u> where a valid federal law has preempted or otherwise placed conditions on the exercise of that power. Under our system of laws, the Federal Reserve has no power to grant or deny bank charters.[8] For the Board to use its Regulation D authority, as the ANPR contemplates, to deny in practical terms the ability of a

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[7] *See* Conn. Gen. Stat. Ann. § 36a-70(t).

[8] "The Fed is not a chartering authority and should not contort itself to become one. The kinds of existential banking concerns that the Fed makes about Fourth Corner and TNB are for chartering authorities to evaluate. Connecticut and Colorado have already done this work." Peter Conti-Brown, "The Fed wants to veto state banking authorities. But is that legal?," *Brookings Institution* (Nov. 14, 2018), *available at* https://www.brookings.edu/research/the-fed-wants-to-veto-state-banking-authorities-but-is-that-legal/.

state banking authority to grant a state uninsured banking charter under validly enacted state law would exceed the bounds of its proper authority.

In the case of TNB, there is no federal statute that imposes federal prudential regulation on its activities as a state-chartered uninsured bank. In the case of state-chartered PTIEs more broadly, the Federal Reserve does not contend that there is any such basis for federal regulation, and the ANPR casts this fact as a central problem that the punitive and discriminatory IOER treatment of PTIEs is intended to fix.

But to impose such discrimination on an entire class of state-chartered institutions would not be a proper use of the Board's power to set IOER rates. The discriminatory treatment contemplated by the ANPR would close off the Constitutionally-founded ability of the State of Connecticut (and any other state) to charter institutions whose activities are limited to those that don't legally trigger federal regulation.

In addition to being an improper interference with the role of state governments, such preclusive action would intrude on the congressional legislative function as well—if Congress had wanted to pass a law to subject all banks that issue deposits to federal regulation, it arguably could have done so. It has not. The statutes Congress has enacted all base the imposition of federal prudential regulation on the specific character of a given institution and its activities, leaving the possibility—in keeping with the constitutionally founded dual banking system—for states to charter institutions that are narrowly confined to activities that do not statutorily warrant the imposition of federal regulation.

As a practical matter, organizing a bank under the Connecticut uninsured bank statute has historically been difficult—because, as an economic and business matter, it is difficult to convince customers—or, in the first instance, the state chartering authority—that an uninsured bank is adequately safe to conduct the business of banking. We are all familiar with the problem of bank runs and the difficulties of uninsured banks during the period before federal deposit insurance existed in this country.

For the state uninsured bank charter to have any practical usefulness to the State of Connecticut or its citizens, organizers of such a bank need to come up with a business model capable of delivering—on its own merits and without any governmental backing of its liabilities (in contrast to FDIC-insured U.S. banks foreign banks that are regarded by the marketplace as benefiting from foreign governmental support), the necessary measure of safety.

The founders of TNB have brought forward such a business model, which has undergone thorough vetting by the Connecticut Department of Banking (the "**CTDOB**") and has been found by the CTDOB to be worthy of a state charter.

Now, by its unlawful actions to deny a master account to TNB—buttressed by the content of the ANPR—the Federal Reserve is proposing to supplant laws enacted by Congress with regulations that do something they acknowledge that Congress itself has not done: shut down the practical ability of the CTDOB to charter a safe, uninsured institution.

If adopted, the discriminatory IOER regime advanced by the ANPR would force the state chartering authority, if it is to make any use at all of a validly enacted state uninsured bank statute, to charter institutions that are markedly less safe than narrow banks—institutions that engage in behavior sufficiently risky to avoid classification as a PTIE. The result of such a mandatory PTIE-inspired push toward unsafe business models for uninsured institutions would likely result in the reasoned judgment by relevant state authorities that such non-PTIE uninsured banks would not be fit recipients of such a charter. The discriminatory payment of IOER contemplated by the ANPR would thus effectively obstruct, preclude and preempt the exercise of a valid state statute.

If it is proper public policy to prohibit or otherwise federally regulate the activities of a state-chartered uninsured bank, our Constitution provides a means to achieve that result—Congress can pass a law that does so. It has not, and the Board would potentially be vulnerable to the charge that it has exceeded its powers if it attempts to pursue such a result in the context of this rulemaking.

In short, the Board cannot use its technical regulatory authority to set IOER rates in a manner that disregards and contravenes the overarching legislative framework within our federal system. To do so would constitute, in the words of the recent S.D.N.Y. decision in favor of a state financial regulator that is challenging the actions of a federal banking regulator as exceeding its legal authority, "essentially the exercise of a legislative function by administrative agency fiat."[9] Whether the Board may use its authority under Regulation D to effectively deny states the use of their validly enacted chartering statutes would likewise appear to be "a question of deep economic and political significance that is central to this statutory scheme," such that a future reviewing court could infer that, because of its fundamental regulatory, legislative, and constitutional implications, "had Congress wished to assign that question to an agency, it surely would have done so expressly."[10]

3. The significant social benefits of narrow banks

3.1 Narrow banks would improve competition in deposit markets, which in turn would reduce the current subsidization of incumbent banks, improve the transmission of monetary policy, raise deposit rates at other banks, and reduce dispersion in money-market rates.

The most widely held form of financial assets—bank deposits—are earning a miserly average interest rate, far below what a competitive market for deposits would offer. Incumbent banks are getting a much higher rate for their own deposits at Reserve Banks than what they pay on their customers' deposits. As Jeb Hensarling, then-Chairman of the House Financial Services Committee put it to Federal Reserve Chairman Powell during his February 2018 monetary policy

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[9] *Vullo*, 2019 WL 2057691 at *16.

[10] *Vullo*, 2019 WL 2057691 at *16 (quoting *King* v. *Burwell*, 135 S. Ct. 2480, 2489 (June 25, 2015)).

testimony, "[b]ut you are paying 150 basis points, our constituents are getting 10 basis points."[11] Even though the interest rate offered by the Federal Reserve to banks on their excess reserves has subsequently been increased to 235 basis points, according to the FDIC the national average interest rate paid by banks on jumbo savings accounts is still only 10 basis points.[12]

From the perspective of the average depositor, the main problem with this stagnant dynamic is that incumbent banks are not forced to compete aggressively for deposits by raising rates paid to depositors when the Federal Reserve raises the IOER rate. 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 own 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.[13] However, when the Federal Reserve raises wholesale rates, banks take months to increase the rates they offer depositors. As Chairman Powell elaborated to Chairman Hensarling, "[r]etail deposits are sticky on the way up. They generally come up with a lag."[14] Driscoll and Judson found that if well-functioning competition had in fact been present 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.[15]

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11 Hearing before the Committee on Financial Services, U.S. House of Representatives, "Monetary Policy and the State of the Economy," p. 29 (Feb. 27, 2018), *available at* https://www.govinfo.gov/content/pkg/CHRG-115hhrg31349/pdf/CHRG-115hhrg31349.pdf.

12 FDIC, "Weekly National Rates and Rate Caps – Weekly Update," *available at* https://www.fdic.gov/regulations/resources/rates/.

13 John C. Driscoll and Ruth A. Judson, "Sticky Deposit Rates," *Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs*, Federal Reserve Board, Washington, D.C. (Oct. 1, 2013), *available at* https://www.federalreserve.gov/pubs/feds/2013/201380/201380pap.pdf.

14 Hearing before the Committee on Financial Services, U.S. House of Representatives, "Monetary Policy and the State of the Economy," p. 29 (Feb. 27, 2018), *available at* https://www.govinfo.gov/content/pkg/CHRG-115hhrg31349/pdf/CHRG-115hhrg31349.pdf.

15 *See, e.g.*, Pablo Kurlat, "Deposit Spreads and the Welfare Cost of Inflation," Stanford University (Dec. 2018), *available at* http://web.stanford.edu/~pkurlat/papers/Inflation%20December%202018.pdf; Itamar Drechsler, Alexi Savov and Philipp Schnabl, "The Deposits Channel of Monetary Policy," *The Quarterly Journal of Economics* (May 29, 2017), *available at* https://academic.oup.com/qje/article/132/4/1819/3857743; Vladimir Yankov, "In Search of a Risk-Free Asset," *Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs*, Federal Reserve Board, Washington, D.C. (Aug. 2, 2014), *available at* https://www.federalreserve.gov/econresdata/feds/2014/files/2014108pap.pdf; Ben R. Craig and Valeriya Dinger, "Deposit market competition, wholesale funding, and bank risk," *Journal of Banking & Finance*, Elsevier, Vol. 37(9), pp. 3605-3622 (2014), *available at* https://ideas.repec.org/; David Neumark and Steven A. Sharpe, "Market Structure and the Nature of Price Rigidity: Evidence from the Market for Consumer Deposits," *The Quarterly Journal of Economics*, Vol. 107:2, pp. 657-680 (May 1992); Timothy

The $12.5 trillion[16] now on deposit at U.S. banks represents a huge opportunity for savers to get a better deal. A major public benefit of the Federal Reserve treating state-chartered narrow banks in a non-discriminatory way (as opposed to the highly prejudicial treatment envisioned by the ANPR) would be the new set of competitive forces that state-chartered narrow banks would unleash within the market for customer deposits. Higher rates offered to large depositors by narrow banks would put pressure on incumbent banks to raise the rates of interest they pay to their own depositors. American savers would benefit significantly as the aggregate amount of savings by depositors would be more efficiently determined and allocated.

With improved pass-through of its rates into money markets, the Federal Reserve could raise its policy rates less in order to get average money market rates up to its desired level, removing the need to pay a significant deposit subsidy to incumbent banks. This subsidy creates a perception problem for the Federal Reserve that could eventually erode its political independence in relation to monetary policy.

In the ANPR, the Federal Reserve correctly raises the possibility that "the activities of PTIEs could narrow the spread between short-term rates and the IOER rate, potentially strengthening the ability of the Federal Reserve to manage the level of short-term interest rates."[17] However, the ANPR then goes on to state that "monetary policy implementation has been very successful in maintaining the federal funds rate within the target range established by the Federal Open Market Committee" (the "**FOMC**") and that therefore, the "potential benefits of PTIEs in enhancing monetary policy implementation appear to be quite modest."[18] But the ability of the Federal Reserve to maintain the federal funds rate generally within its target range is not evidence that IOER is being effectively passed through to depositors. The federal funds market (at about $75 billion)[19] is tiny in comparison with the bank deposit market (at about $12.5 trillion)[20] and is therefore not representative of wholesale market rates. Further, research by Board economists Ayelen Banegas and Manjola Tase explains that the federal funds market is dominated by foreign banks that engage in "IOER rate arbitrage" by exploiting the fact that government sponsored enterprises do not receive interest on their deposits at Reserve Banks.[21]

H. Hannan and Allen N. Berger, "The Rigidity of Prices: Evidence from the Banking Industry," *American Economic Review*, Vol. 81(4), pp. 938-945 (Sept. 1991), *available at* https://ideas.repec.org.

16 Board of Governors of the Federal Reserve System, "Assets and Liabilities of Commercial Banks in the United States," *available at* https://www.federalreserve.gov/releases/h8/current/default.htm.

17 ANPR at 8830.

18 ANPR at 8830.

19 Federal Reserve Bank of St. Louis, "Effective Federal Funds Volume," *available at* https://fred.stlouisfed.org/series/EFFRVOL.

20 Board of Governors of the Federal Reserve System, "Assets and Liabilities of Commercial Banks in the United States," *available at* https://www.federalreserve.gov/releases/h8/current/default.htm.

21 Ayelen Banegas and Manjola Tase, "Reserve Balances, the Federal Funds Market and Arbitrage in the New Regulatory Framework," *Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs*, Federal Reserve Board, Washington, D.C. (Sept. 1, 2016), *available at* https://www.federalreserve.gov/econresdata/feds/2016/files/2016079pap.pdf.

That the federal funds rate has been within its target range is not evidence that narrow banking would only moderately enhance monetary policy implementation.

As further asserted justification for the hastily-reached conclusion that narrow banks would only moderately enhance monetary policy implementation, the ANPR asserts that "[t]he movements of other short-term money market interest rates have also tracked closely the changes in the target range for the federal funds rate."[22] This is also inaccurate. In fact, there is significant dispersion across the spectrum of short-term money market rates.[23] In addition to deposit rates, other major wholesale money market rates, including various repurchase ("**repo**") rates, are only weakly tied to the federal funds rate. If that were not the case, the Federal Reserve's ON RRP facility, which offers rates below the IOER rate, would never have been introduced in the first place.

Finally, the ANPR's suggestion that narrow banks would not improve interest rate pass-through to depositors is inconsistent with its assertion that narrow banks have the potential to attract large deposit balances away from incumbent banks. As a matter of basic competition, if incumbent banks were to experience significant deposit outflows in favor of narrow banks, incumbent banks would react in a competitive fashion by offering higher deposit rates in order to retain most of those deposits. The view that entry by private-sector narrow banks would not affect deposit rates offered by incumbent banks is contradicted by the findings of controlled experiments conducted by the Federal Reserve itself which showed that the primary effect of narrow banks' activity on the money market would be to increase deposit rates. As explained by Simon Potter, head of the Markets Group at the Federal Reserve Bank of New York ("**FRBNY**"), the Federal Reserve conducted experiments by changing the rate offered in its ON RRP facility:

> During the six-week test, the offering rate was temporarily lowered from 5 basis points to 3 basis points, then raised to 7 basis points and 10 basis points. The Fed's FR 2420 data on bank borrowing activity show that after each increase in the ON RRP offering rate, the distribution of fed funds trades shifted toward higher rates, with the vast majority of trades being executed at rates at or above the offering rate. The same patterns were observed in detailed data on brokered fed funds and Eurodollar trades, the latter of which encompasses a larger volume and wider set of lenders than fed funds, and also in secured markets. Examining in particular individual repo trades where money market funds and GSEs supply cash to counterparties over the tri-party platform, we saw repo rates shift higher and nearly all trading volume occur at or above the ON RRP rate.[24]

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22 ANPR at 8830.

23 *See* Darrell Duffie and Arvind Krishnamurthy, "Passthrough Efficiency in the Fed's New Monetary Policy Setting," presented at *Designing Resilient Monetary Policy Frameworks for the Future: A Symposium Sponsored by the Federal Reserve Bank of Kansas City*, Jackson Hole, Wyoming (Aug. 25-27, 2016), *available at* https://www.darrellduffie.com/uploads/policy/DuffieKrishnamurthyAugust2016.pdf.

24 Simon Potter, "Money Markets and Monetary Policy Normalization," Federal Reserve Bank of New York (Apr. 15, 2015), *available at* https://www.newyorkfed.org/newsevents/speeches/2015/pot150415.html.

These ON RRP experiments by the Federal Reserve suggest that the posting by narrow banks of higher-than-existing deposit rates *would* lead incumbent banks to respond with higher deposit rates. Those higher rates at incumbent banks would, in turn, act as a brake on deposit growth at narrow banks. Moreover, narrow banks, with a broader class of potential depositors than the ON RRP facility, would affect deposit market competition to an even greater extent than the Fed's experiments suggested. Narrow banks would likely attract deposits from states, municipalities and corporations. Those depositors would then behave like the counterparties of the ON RRP facility, in that they would demand that incumbent banks offer deposit rates equal to or above the rate offered by narrow banks. By maintaining restrictive participation requirements with respect to the ON RRP facility, the Federal Reserve has been able to contain the competitive impact of its own narrow bank to a relatively slim set of money market participants—mainly money market funds and Federal Home Loan Banks. The ANPR's proposal to quash narrow banking removes a large potential for deposit competition, to the detriment of savers and to the benefit of incumbent banks.

3.2 Narrow banks generate financial stability benefits that significantly outweigh the concerns described in the ANPR.

Two prerequisites for the ability of narrow banks to improve financial stability are that (1) the narrow bank must be safe and (2) it must offer a competitive deposit rate. The policy favored by the ANPR would reduce the deposit rate that narrow banks could offer, thereby reducing the contributions of narrow banks to financial stability.

Ideally, narrow banks would be allowed to provide safe deposit facilities at competitive interest rates, reducing the tendency of lenders to seek out systemically risky "pseudo-safe" alternatives. The lack of safe deposit facilities was an important exacerbating factor in the financial crisis of 2007-09 (the "**Crisis**").[25] An excessive reliance by financial intermediaries on seemingly safe, but systemically risky, short-term wholesale funding caused runs and threats of runs that undermined the entire financial system.[26] Reducing the demand for systemically risky short-term funding is accomplished most effectively through competition. If safe alternative deposit facilities are available at competitive rates, those facilities can out-compete systemically risky alternatives, thus reducing the threat of runs on short-term wholesale borrowing.[27]

The ANPR also overlooks the positive effect that narrow banks have on financial stability when they act as shock absorbers. As Simon Potter explained, the Federal Reserve's ON RRP

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[25] *See* Tobias Adrian, Daniel Covitz and Nellie Liang, "Financial Stability Monitoring," *Annual Review of Financial Economics*, Vol. 7, pp. 357-395 (2015); Darrell Duffie, "Prone to Fail: The Pre-Crisis Financial System," *Journal of Economic Perspectives*, Vol. 33 (2019), *available at* https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.33.1.81; Robin Greenwood, Samuel G. Hanson and Jeremy C. Stein, "A Comparative-Advantage Approach to Government Debt Maturity," *Journal of Finance*, Vol. 70, No. 4 (2015).

[26] *See* Markus K. Brunnermeier and Martin Oehmke, "The Maturity Rat Race," *Journal of Finance*, Vol. 68, No. 2 (2013), *available at* https://scholar.princeton.edu/markus/publications/maturity-rat-race.

[27] Robin Greenwood, Samuel G. Hanson and Jeremy C. Stein, "A Comparative-Advantage Approach to Government Debt Maturity," *Journal of Finance*, Vol. 70, No. 4 (2015).

facility played this role in connection with the exogenous shock produced when the SEC implemented new rules for money market mutual funds in 2016:

> The good news is that the ON RRP facility served as a shock absorber for overnight rates . . . money market funds, particularly government funds, increased their use of ON RRP during the transition. Because of the availability of ON RRP, government funds knew they would be able to temporarily place some of the new funding they received at the ON RRP facility while they were looking for new investment opportunities. . . . As a result of this elastic provision of a risk-free investment opportunity, overnight secured and unsecured rates were only modestly affected by these large flows, and overnight markets continued to move as intended following changes in the FOMC's target for the federal funds rate.[28]

Narrow banks are distinctive in being able to serve as shock absorbers. By accommodating large deposit inflows or outflows with little impact on market rates, narrow banks allow the financial system to more quickly accommodate significant shocks.

The ANPR raises the concern that in times of financial stress, narrow banks may receive inflows that would lead to a sudden withdrawal of funding from borrowers in sound financial condition, amplifying financial stress. This concern is misplaced.

First, narrow banks must acquire new depositors to receive very large inflows. The acquisition of new customers involves a process that would require days or weeks to complete. During that interim period, the Federal Reserve, acting as lender of last resort, could accommodate extraordinary liquidity needs as they arise. Second, runs were widespread during the Crisis notwithstanding the absence of narrow banks. Investors ran into too-big-to-fail institutions and government-only money market mutual funds.[29] Finally, the government moved to guarantee trillions of dollars of transaction accounts at banks and the shares of money market mutual funds, making safe repositories widely available at the height of the Crisis.[30] The entry into the market by narrow banks, far from exacerbating the financial system's vulnerability to runs, would significantly reduce it.

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28 Simon Potter, "Money Markets at a Crossroads: Policy Implementation at a Time of Structural Change," Federal Reserve Bank of New York (Apr. 5, 2017), *available at* https://www.newyorkfed.org/newsevents/speeches/2017/pot170405.

29 *See* Joao Santos, "Do Markets 'Discipline' All Banks Equally?" *Journal of Financial Economic Policy*, Vol. 1, No. 1, pp. 107-123, 2009; Jonathan D. Rose, "Old-Fashioned Deposit Runs," pp. 2015-111, Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C.; Lawrence Schmidt, Allan Timmerman, and Russ Wermers, "Runs on Money Market Mutual Funds," *American Economic Review* 2016, 106(9): pp. 2625-2657.

30 *See* "Temporary Liquidity Guarantee Program," *available at* https://www.fdic.gov/regulations/resources/TLGP/index.html and "Treasury Announces Temporary Guarantee Program for Money Market Funds," (Sept. 29, 2008) *available at* https://www.treasury.gov/press-center/press-releases/pages/hp1161.aspx.

The fact that the government had to provide safe deposit facilities for large deposits in the midst of the Crisis by deploying large-scale *ad hoc* government guarantees suggests that it is even more important to provide safe deposit facilities for large deposits *prior* to a crisis.[31] The solution that would reduce the size and likelihood of runs is to provide safe depository services to such depositors at all times. That is precisely the point of creating narrow banks. Such a solution to the problem of runs is much less costly to society than offering unlimited guarantees of deposits in risky banks, as occurred in the last crisis and is expected to occur in the next crisis.

4. Correctly Applying Prudential Banking Principles

The ANPR bases its strongly signaled intention to disrupt or eliminate the narrow bank business model on certain core premises that we believe are mistaken and contrary to fundamental principles of sound banking and prudential regulation.

First, the ANPR's focus on the application of the U.S. leverage capital rule to an institution that naturally does not attract this capital requirement is misplaced. Leverage-based capital requirements are not relevant for the safety of narrow banks or to the benefits that the availability of safe deposits can provide to the financial system as a whole. In a revealing facet of this argument, the ANPR hints that certain prudential standards such as the leverage-based capital requirement should be used to impose taxes on innovative and safe narrow banks, rather than as tools to enhance financial safety and stability associated with capital and other prudential requirements.

Second, the ANPR overlooks the efficiency benefits of narrow banks. The ANPR implies that the spread between the IOER rate and deposit rates serves a useful role in offsetting regulatory compliance costs, which, as we will explain, creates an effective subsidy to large domestic and foreign banks currently incumbent in the market. This is an inefficient arrangement and plainly contrary to congressional intent.

4.1 The Federal Reserve's creation and expansion of its own narrow banks has been beneficial because narrow banking fulfills a critical need throughout financial cycles.

Among the most notable features of the Crisis were the widespread runs on financial instruments issued by nonbanks, including auction-rate and variable-rate securities, asset-backed commercial paper, prime money market mutual funds, and some types of repos. Outstanding amounts of runnable instruments have remained high as a share of total private-sector debt in the

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[31] This was precisely the reason that James Tobin advocated for the creation of narrow banks to operate alongside broad banks: to constrain the moral hazard and other costs of deposit insurance by providing safe deposits in an alternative way. *See* James Tobin, "The Case for Preserving Regulatory Distinctions," presented at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, (Aug. 20-22, 1987), and "Financial Innovation and Deregulation in Perspective," Keynote address, the Second International Conference of the Institute of Monetary Studies and the Bank of Japan (May 29-31, 1985).

years since the Crisis.[32] The lack of alternative safe investment facilities has been identified by many analysts as the proximate cause of the growth of such runnable securities, resulting in a financial system vulnerable to runs.[33]

Runnable securities fill a need for short-term liquid investment facilities. Short-term Treasury bills already enjoy a liquidity premium, especially when the supply of Treasury bills is relatively low.[34] If the U.S. Treasury issues relatively smaller amounts of Treasury bills, funding itself with relatively more long-term debt, the private-sector issuance of runnable securities increases, taking advantage of the liquidity premium that large institutions are willing to pay for their seeming safety and convenience.[35] Many types of private sector short-term debts are runnable liabilities,[36] as demonstrated by the Crisis.

State-chartered narrow banks could provide rate- and risk-sensitive wholesale investors a safe depository facility. Such facilities must offer a competitive return to attract those investors who are both rate-sensitive and "flighty." The concern that deposit runs from incumbent traditional banks might serve as a precipitating event to a financial crisis can be alleviated significantly if narrow banks accommodate the demands of rate-sensitive flighty cash investors

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32 *See* Jack Bao, Josh David and Song Han, "The Runnables," *Fednotes*, Federal Reserve Board of Governors (Sept. 3, 2015), *available at* https://www.federalreserve.gov/econresdata/notes/feds-notes/2015/the-runnables-20150903.html; Daniel Covitz, Nellie Liang and Gustavo A. Suarez, "The Evolution of a Financial Crisis: Collapse of the Asset-Backed Commercial Paper Market," *Journal of Finance*, Vol. 68, pp. 815-848 (June 2013); Patrick McCabe, "The Cross Section of Money Market Fund Risks and Financial Crisis," *Finance and Economics Discussion Series*, Board of Governors of the Federal Reserve System (U.S.) pp. 2010-2051 (Sept. 12, 2010), *available at* https://www.federalreserve.gov/Pubs/FEDS/2010/201051/201051pap.pdf; Marcin Kacperczyk and Philipp Schnabl, "When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007-2009," *Journal of Economic Perspectives*, Vol. 24, Winter 2010, pp. 29-50 (2010), *available at* https://www.aeaweb.org/articles?id=10.1257/jep.24.1.29; Gary B. Gorton and Andrew Metrick, "Securitized Banking and the Run on Repo," *Journal of Financial Economics*, Vol. 103, pp. 425-451 (June 2012).

33 Robin Greenwood, Samuel G. Hanson and Jeremy C. Stein, "A Comparative-Advantage Approach to Government Debt Maturity," *Journal of Finance*, Vol. 70, No. 4 (2015).

34 *See* Robin Greenwood, Samuel G. Hanson and Jeremy C. Stein, "A Comparative-Advantage Approach to Government Debt Maturity," *Journal of Finance*, Vol. 70, No. 4 (2015); Arvind Krishnamurthy and Annette Vissing-Jorgensen, "The Aggregate Demand for Treasury Debt," *Journal of Political Economy*, Vol. 120, No. 2, pp. 233-267 (2012); Mark Carlson et al., "The Demand for Short-Term, Safe Assets and Financial Stability: Some Evidence and Implications for Central Bank Policies," *Finance and Economics Discussion Series*, Board of Governors of the Federal Reserve System (Nov. 2014).

35 *See* Gary B. Gorton, Stefan Lewellen and Andrew Metrick, "The Safe-Asset Share," *American Economic Review: Papers and Proceedings*, Vol. 102, pp. 101-06 (May 2012); Robin Greenwood, Samuel Hanson and Jeremy C. Stein, "A Gap-Filling Theory of Corporate Debt Maturity Choice," *Journal of Finance*, Vol. 65, No. 3, pp. 993-1028 (June 2010); Arvind Krishnamurthy and Annette Vissing-Jorgensen, "The Impact of Treasury Supply on Financial Sector Lending and Stability," *Journal of Financial Economics*, Issue 118, No. 3 (Dec. 2015).

36 Jeremy C. Stein, "Monetary Policy as Financial-Stability Regulation," *Quarterly Journal of Economics*, pp. 57-95 (Feb. 2012).

prior to the occurrence of stressful financial conditions. The presence of narrow banks as business-as-usual participants in the banking ecosystem would allow narrow banks to play a beneficial role as a safe and superior alternative to late-in-cycle systemically risky short-term liabilities that might otherwise attract significant runnable funding.

The validity of these observations is clearly reflected in the Federal Reserve's own actions. Since the Crisis, the Federal Reserve has significantly expanded its provision of safe "deposit" facilities through its creation of the ON RRP facility and its greatly expanded FRP[37]. These existing facilities satisfy our definition of narrow banks: depository institutions, entities, or facilities whose principal customer service is to offer to nonbanks overnight investments that are, directly or indirectly, fully backed by central bank liabilities. These facilities have both supported the implementation of monetary policy through their competitive impact on money markets and have promoted system stability more generally by expanding the availability of safe overnight investments available to selected nonbank market participants.

The ON RRP facility is, in economic substance, a narrow bank that was purposefully designed to improve pass-through by offering non-bank institutional depositors a way to invest cash perfectly safely at a higher rate than they might otherwise receive. The FOMC, during its meeting on September 18, 2013, described the purpose of the ON RRP facility: "the facility could be an effective additional tool for managing money market interest rates and helping to support a floor on those rates."[38]

Operating costs and restrictions on potential counterparties limit the ability of the Federal Reserve's own narrow banking facilities to satisfy the demand for safe deposit facilities and add competition in deposit markets. The Fed has a limited set of addressable counterparties because it is not authorized to provide accounts to non-depository institutions, with limited exceptions.[39] The ON RRP facility is therefore specifically structured to meet a legal definition of an open market operation as opposed to constituting an account. This structural form is more costly to operate than a private-sector narrow bank, because private-sector clearing banks must be paid to operate the facility and the FRBNY must provide collateral to private sector participants in the ON RRP facility.

4.2 Narrow bank safety is provided by 100 percent reserves, not by substituting equity for deposit funding.

Traditional depository institutions can provide safety from runs and the corresponding fire sales in three ways, absent reliance on the lender of last resort: substitute equity for the

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37 The H.4.1 statistical report of the Federal Reserve Board of Governors reported that the balances in the FRP were $106 million for the week ending on April 30, 2008, and $262 billion for the week ending on May 1, 2019. *See* Board of Governors of the Federal Reserve System, "Factors Affecting Reserve Balances – H.4.1," (May 9, 2019), *available at* https://www.federalreserve.gov/releases/h41/.

38 Minutes of the Federal Open Market Committee (Sept. 17-18, 2013), *available at* https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20130918.pdf.

39 *See* 12 U.S.C.A. § 342.

quantity of deposits issued, guarantee deposits, or invest the proceeds of deposits in safe and liquid assets.[40] A main source of bank fragility is the demandable or short-term nature of deposits. By funding itself without issuing deposits and other very short-term liabilities, a bank that funds risky assets can avoid runs. Hence, the greater is the proportion of equity used to fund a bank, holding fixed its (risky) assets, the safer are the liabilities issued by the bank.

Secondly, the safety of a depository institution that funds risky assets can be increased with deposit insurance, which reduces run incentives.[41] Deposit insurance requires activity limitations, supervision, and regulatory capital requirements to offset the reduced incentives for depositors to monitor the credit and liquidity qualities of the bank. With deposit insurance, equity acts as a deductible that is complementary to deposit insurance. The equity is a first-loss, "skin-in-the-game" tranche of the capital structure that reduces expected losses to the deposit insurer from the failure of a depository institution, to other creditors, and eventually to taxpayers in the event of a bailout.

The third way to assure bank safety is by limiting a bank's investments to perfectly safe assets. A narrow bank is safe because it invests solely in non-risky central bank reserves.[42] In practice, a narrow bank must have some equity as a buffer against operational risk. But the safety of a narrow bank comes essentially from the stringent contractual and regulatory restrictions of its investments to central bank deposits, and not primarily from equity.

By organizing as a 100-percent reserve bank under a state's bank chartering authority, a narrow bank can provide far greater safety than any current federally regulated bank. TNB is subject to the minimum capital requirements imposed by the CTDOB on an uninsured bank (including the imposition of operational risk capital standards based on Basel III guidelines), which provide appropriate, ample, and meaningful equity requirements.

On a comparative basis, TNB's capital regime sets minimum capital in excess of the requirements that apply to the custodial bank business line of many of the nation's largest banks. The custodial business line consists of banks holding assets in custody on behalf of customers. The custodial assets have zero-risk weight and do not count toward leverage-based capital standards as they are not treated as being "on-balance sheet." Custodial banks are subject to the Basel III operational risk capital guidelines. It would not be prudent or appropriate to apply federal leverage-based capital requirements to narrow-bank assets or the custodial assets of custody banks, neither of which pose credit or liquidity risk to the bank. For the same reason,

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40 *See* Gary B. Gorton and Andrew Metrick, "Securitized Banking and the Run on Repo," *Journal of Financial Economics*, Vol. 104, pp. 425-451 (June 2012); Gary B. Gorton, "The History and Economics of Safe Assets," *Annual Review of Economics*, Vol. 9(1), pp. 547-586 (2017), *available at* http://doi.org/10.1146/annurev-economics-033017-125810.

41 Douglas Diamond and Phillip Dybvig, "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy*, Vol. 91, pp. 401-419 (1983).

42 George Pennacchi, "Narrow Banking," *Annual Review of Financial Economics*, Vol. 4, (2012).

the application of federal leverage-based capital requirements to narrow banks would serve no prudential purpose.

Narrow banks incur a substantial contractual and regulatory cost to achieve such a high level of inherent safety—the opportunity cost of restricting their current and future investments to central bank reserves. The ANPR is incorrect to assert that the narrow bank is "avoiding regulatory costs borne by other eligible institutions."[43] Narrow banks are appropriately subject to capital requirements based on the actual extent of their operational risks. There are consequently no gaps in the current state and federal regulatory capital framework with respect to its application to narrow banks.

The correct comparison of the operational costs of broad and narrow banks can be looked at through the concept of "envy-free" allocations.[44] Suppose broad banks were given the choice to either (1) limit all of their current and future investments to reserves alone, and thereby not be subject to federal leverage capital requirements, or (2) maintain their current broad-banking business model, with its high net interest margins, profits from other banking activities, and capital requirements. Given this choice, no broad bank would choose (or, at least, has chosen) to become a narrow bank.

The coexistence of broad and narrow banks as an "envy-free allocation" is further evidenced by the long-run equilibrium of narrow bank competition. Narrow banks, by offering 100-percent reserve-backed deposits, offer a single homogeneous service to their customers. In contrast, broad banks are multi-product firms with a high degree of service differentiation. Single-service firms with homogeneous services engender transparent and direct price competition. Broad banks, however, have cross-business service and product linkages that tend to bind customer relationships and create search and switching costs. Comparison shopping is difficult across broad banks as the services that they offer are differentiated. The resulting net interest margins that can be earned by narrow banks are more than an order of magnitude smaller than those of broad banks. Broad banks would therefore not choose to become narrow banks simply to avoid regulatory costs.

4.3 Depositors earning an interest rate on their bank deposits is consistent with congressional intent.

The ANPR posits that narrow banks "could effectively extend the IOER rate to their depositors that are not themselves 'eligible institutions'",[45] and that "[t]he Board is concerned that paying IOER to PTIEs would effectively amount to paying IOER to entities (for example, institutional investors that in many instances are not authorized to maintain balances at Reserve Banks) that Congress did not intend to receive it."[46] This concern overlooks the fact that, as with

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43 ANPR at 8830.

44 Hal R. Varian, "Equity, Envy, and Efficiency," *The Journal of Economic Theory*, Vol. 9, Issue 1, pp. 63-91 (Sept. 1974).

45 ANPR at 8830.

46 ANPR at 8831.

any bank that currently receives IOER on reserves at the Federal Reserve, a depositor at a narrow bank would have no direct claim on the Federal Reserve account or balance sheet. The category of private sector banking entities entitled to maintain IOER-earning accounts at the Federal Reserve—depository institutions—would remain the same, which is the precise category of institutions prescribed by Congress to have such access. As with any depository institution, depositors in narrow banks would earn a rate of interest on their deposits that would be set by competitive dynamics, including depositor perceptions related to the safety of narrow banks and the attractiveness of the rates they offer. Such competition for deposits—and the nature of the deposits themselves as claims on depository institutions—would be identical to the form of competition that takes place every day among the thousands of depository institutions that receive IOER in their accounts at Reserve Banks. Applying the same IOER rate to narrow banks as currently applies to every other form of depository institution under the framework of laws that Congress itself prescribed is not a violation of congressional intent.

Ironically, a more worrisome extension of interest to "noneligible institutions" is the Federal Reserve's own ON RRP facility. The Federal Reserve is not authorized to create interest-earning accounts for nonbank money market participants—Federal Home Loan Banks, money market mutual funds, and other non-depository institutions. Accordingly, the Federal Reserve created a facility that it classified as an open market operation, but whose characteristics mirror those of a deposit account at the FRBNY.[47] Participants in the ON RRP facility receive interest directly from the FRBNY and have the option to invest up to $30 billion at a fixed interest rate and receive securities of equal value to their investment. This accommodation is highly unusual in similar repo transactions among other counterparties. While ON RRP participants must bid a second (lower) interest rate, applied only if the facility reaches its capacity, the Federal Reserve has not set an upper limit on the aggregate size of the facility. The facility's size is limited only by the Federal Reserve's holdings of pledgeable securities, which is far larger than the highest actual level of usage. To conduct these transactions, the Federal Reserve has relied on the costly services of two of the nation's largest clearing banks, JP Morgan Chase and The Bank of New York Mellon.

4.4 Narrow banks reduce inefficiencies stemming from imperfect competition in deposit markets and reduce rents earned by broad banks from interest on reserves.

The ANPR posits that permitting narrow banks to earn IOER at the generally applicable rate would shift deposits away from traditional incumbent banks toward narrow banks and that "[t]his shift in investment, in turn, could raise bank funding costs and ultimately raise the cost of credit provided by banks to households and businesses."[48] This reasoning is incorrect. Were

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47 *See* "Domestic Open Market Operations During 2013," Federal Reserve Bank of New York ("Reverse repos are an operation in which eligible counterparties place cash temporarily at the Federal Reserve in exchange for securities from the SOMA portfolio, economically the same as a collateralized deposit."). Further, the collateral does not reduce the counterparties' credit exposure to the Federal Reserve Bank of New York, nor is it used by counterparties to rehypothecate for other purposes. Consequently, the ON RRP facility offers investments that are economically the same as a deposit.

48 ANPR at 8830.

narrow banks' activity actually to result in the payment of higher deposit rates by incumbent banks, the resulting increase in bank funding costs would cause a gain in market efficiency, leading to a higher overall social benefit for intermediating savings and credit.

Narrow banks would not necessarily shift a significant amount of deposits away from broad banks. In fact, the more likely source of deposits in narrow banks would be from investors that have been holding, directly or indirectly, government securities. The ON RRP facility is again instructive here. The primary users of the ON RRP facility have been government-only money market mutual funds. As noted by Simon Potter of the FRBNY, "lending volumes in secured and unsecured money markets have been stable, suggesting that the Federal Reserve's facilities have not displaced activity in the private sector."[49] For context, the size of ON RRP facility has at times exceeded $400 billion, yet the ON RRP facility has had a *de minimis* impact on the total quantities of bank liabilities. Prime funds, an important class of investors in wholesale broad-bank deposits, were smaller investors in the ON RRP facility, even prior to the 2016 money-market fund reform. Based on this example, the primary demand for narrow bank deposits is likely to arise from investors currently holding government securities rather than from broad bank depositors.

At the same time, the ON RRP facility did have the desired effect of creating, to some extent, additional rate competition for bank deposits, despite the small eventual impact on the amount of deposit funding. As pointed out by Potter, "[w]e have now seen in practice that changes in administered rates can effectively move market rates—both because effective competition helps bring administered and market rates closer together and because the mere existence of administered-rate facilities . . . can affect competition between private borrowers and investors even when these facilities see little usage."[50]

But why did the rate competition created by the ON RRP facility not also contract the quantity of bank liabilities? This is likely because of the low degree of competition for bank deposits. In the extreme (but illustrative) case, a monopolist can avoid a loss of market share to an entrant merely by reducing its profit margin. Hence, imperfectly competitive banks can raise deposit rates in competition with the ON RRP or narrow banks, and retain depositors. Incumbent banks would earn lower rates of profit, while depositor welfare would improve.

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49 Simon Potter, "Money Markets after Liftoff: Assessment to Date and the Road Ahead," Federal Reserve Bank of New York (Feb. 22, 2016), *available at* https://www.newyorkfed.org/newsevents/speeches/2016/pot160222.

50 Simon Potter, "Implementing Monetary Policy Post-Crisis: What Have We Learned? What Do We Need to Know?" Federal Reserve Bank of New York (May 4, 2016), *available at* https://www.newyorkfed.org/newsevents/speeches/2016/pot160504.

In fact, private-sector narrow banks could actually *increase* the quantity of total banking deposits, as rate competition fostered by narrow banks leads households to shift their cash investments from government securities to deposits in broad banks.[51]

Importantly, this competitive dynamic need not raise Treasury borrowing costs on net, and in fact would likely lower them. Why? This is so because competition from narrow banks would reduce the cross-sectional dispersion of money market interest rates and increase the sensitivity and responsiveness of money market conditions to the IOER rate set by the Fed. With this enhanced correspondence between the IOER rate and overall money market conditions, the Fed would be able to set a *lower* IOER rate (with consequent lower Treasury rates in the broader money market) to achieve given desired targets.

Finally, given the imperfect nature of competition in deposit markets, we do not think that bank lending activities would shrink if banks were forced to compete more aggressively for deposits. Banks invest their deposit funding in both Reserve Bank deposits that earn IOER and in loans that earn higher yields but also generate higher costs and risks. Suppose, for instance, that a specific loan is a loss-making investment before considering the subsidy to its funding costs that is generated by the spread between the IOER rate and deposit funding rates. The bank would then strictly prefer to invest the associated deposit funding in Reserve Bank deposits, thus earning the full IOER-to-deposit-rate spread, rather than investing in a loan whose losses are more than offset by the same spread. That is, with or without below-market-rate deposit funding, a profit-maximizing bank would not invest in a loan that is unprofitable at market-based funding costs, given that it can always invest in reserves and earn a market return of IOER.[52]

4.5 The payment of interest on reserves improperly subsidizes banks' cost of compliance with prudential regulation.

In Section 4.4, we pointed to extensive evidence that the deposit market is not highly competitive. In this section, we examine the theoretical, yet unrealistic, case of a more competitive deposit market. We do so because we understand that the ANPR adopts a

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51 *See* Darrell Duffie and Arvind Krishnamurthy, "Passthrough Efficiency in the Fed's New Monetary Policy Setting," presented at *Designing Resilient Monetary Policy Frameworks for the Future: A Symposium Sponsored by the Federal Reserve Bank of Kansas City*, Jackson Hole, Wyoming (Aug. 25-27, 2016), *available at* https://www.darrellduffie.com/uploads/policy/DuffieKrishnamurthyAugust2016.pdf; James McAndrews, Rodney Garratt, Antoine Martin and Ed Nosal, "Segregated Balance Accounts," Federal Reserve Bank of New York, *Staff Report*, No. 730, (May 2015, Revised Aug. 2015), *available at* https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr730.pdf; David Andolfatto, "Assessing the Impact of Central Bank Digital Currency on Private Banks," Federal Reserve Bank of St. Louis Working Paper 2018-026B (Oct. 2018).

52 Suppose that deposit funding is available at the rate r, that IOER is R, and that a particular bank loan cannot be made profitably if the deposit funding rate r were to be reset to R. Then the loan is break-even (zero profit) with funding at some hypothetical deposit rate y between r and R. The total actual profit on the loan is then equal to the profit associated with obtaining a subsidy of y-r on the deposit funding. But, instead of making the loan, the bank could earn a higher profit by investing the same deposit funding in central bank deposits at the higher arbitrage spread of R-r > y-r.

competitive model to assert that narrow bank entry will cause an increase of costs to broad banks.

In the ANPR, the Federal Reserve asserts that:

> [u]nder the current provisions of Regulation D . . . PTIEs [could] earn interest on their balances at a Reserve Bank at the IORR and IOER rate, yet at the same time avoid the costs borne by other eligible institutions, such as the costs of capital requirements and the other elements of federal regulation and supervision, because of the limited scope of their product offerings and asset types.
>
> Avoiding regulatory costs borne by other eligible institutions and unconstrained by meaningful capital requirements, PTIEs could effectively extend the IOER rate to their depositors that are not themselves "eligible institutions," and would be able to do so on a potentially very large scale. A proliferation of similar PTIEs could magnify these effects across the financial system.
>
> The Board is concerned that PTIEs, by maintaining all or substantially all of their assets in the form of balances at Reserve Banks and having the ability to attract very large quantities of deposits at a near-IOER rate, have the potential to complicate the implementation of monetary policy.[53]

This passage suggests that the Board believes (1) that broad 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, and (2) that competition from narrow banks would attract large quantities of deposits from broad banks—that is, that the banking deposit market in fact has a significant degree of competition. Together, these points imply that the payment of interest on reserves confers a subsidy to banks that, in the Board's view, plays an important role in offsetting the costs of meeting capital requirements and other elements of federal regulation and supervision.

Assuming the competitive case for the sake of refuting the ANPR's argument, the spread between IOER and the interest rate paid on broad-bank deposits is a Federal Reserve subsidy to broad banks. The difference between the deposit rates of broad banks and narrow banks must be caused by the costs of capital requirements and other elements of federal regulation and supervision. Only in this theoretical competitive case would narrow banks be able to attract deposits from broad banks. But if this were to come to fruition, a migration of deposits to narrow banks would be efficient and welfare improving.

Prior to 2008, reserves did not pay interest. Holding reserves was costly to banks.[54] The cost of reserves was conventionally thought to be the federal funds rate—the rate at which a bank

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53 ANPR at 8830.

54 The cost of holding required reserves was often referred to as the reserve tax. There has been a persistent gap between the effective federal funds rate and banks' average deposit rate for decades. As discussed, we

could lend out its reserves. By setting a low deposit rate to recoup costs of compliance with regulation, the banking industry—banks, depositors, and bank borrowers—were paying the costs of those regulations.

After the payment of interest on reserves, the value of reserves to banks is the direct interest revenue banks earn from them. Holding reserves is now potentially profitable to banks. A bank earns profits on its reserve holdings if the costs of deposits supporting the reserve holdings and any other costs of holding reserves is less than the IOER rate. Earlier in this letter, we have considered the realistic case of imperfect competition, in which the sum of banks' deposit rates and other costs associated with investing in reserves is strictly below the IOER rate.

In the ANPR, the Board presents a competitive environment in which narrow banks would be able to attract deposits, and "could raise the costs of private financial intermediation."[55] This logic is only valid in a competitive deposit market, where banks are not earning profits on their reserve holdings. In that case, if a narrow bank enters, a narrow bank that "would not be subject to federal prudential regulation and would not be subject to the same set of capital and other prudential requirements as other federally regulated banks" could post deposit rates that would be higher than those of broad banks.[56] The difference between the IOER-deposit rate spreads of broad and narrow banks would represent the costs of capital and other federal prudential requirements, as other costs of banking between broad and narrow banks would be similar.

By entering the market, narrow banks would dissipate that portion of the subsidy provided to broad banks that covers the costs of capital and other federal prudential requirements. In this case, what is threatened by the entry of narrow banks is a subsidy that is directly attributable to those costs of prudential regulation.[57] Were the Federal Reserve to pay a lower rate of interest on reserves to narrow banks, it would be subsidizing banks' compliance

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ascribe most of that shortfall, including rates for deposits in excess of $100,000, to imperfect competition. In the Federal Reserve's view, however, the shortfall in deposit rates is accounted for by costs. Those costs include the costs of capital requirements and other elements of federal regulation and supervision, as deposit rates are presumably bid up to that level by competition. Theoretical models that address the case of price-taking banks confirm the Federal Reserve's logic on this point. *See* Antoine Martin, James McAndrews and David Skeie, "A Note on Bank Lending in Times of Large Bank Reserves," *International Journal of Central Banking* (Dec. 2016), *available at* https://www.ijcb.org/journal/ijcb16q4a5.pdf.

55 ANPR at 8830. Note that in the present case of imperfect competition, the entry of narrow banks need not raise the costs of other financial intermediaries. Instead, the profits or rents earned by broad banks could be squeezed by narrow bank entry, with no effect on bank costs. Only in the competitive case will the dissipation of the subsidy result in higher costs being borne by broad banks. Again, we argue that it is appropriate for broad banks, rather than the Federal Reserve Banks, to bear those costs of capital regulation and other elements of federal regulation and supervision.

56 ANPR at 8829.

57 A. Kahn, "The Economics of Regulation: Principles and Institutions," Vol. 1, New York: Wiley and Sons (1970).

with capital requirements and other elements of federal regulation and supervision by shielding those banks from the competition of narrow banks.

This is a troubling and doubly inefficient result. First, it is inefficient as a matter of public finance. Taxpayers should not subsidize one industry relative to another without due consideration and appropriation by Congress. Second, the subsidy offsets the intended effect of the regulation, which is to reduce the negative externalities of excessively risky banking. To the extent that incumbent banks hold interest-earning reserves, those costs are no longer borne by banks, but by taxpayers. Such subsidization undermines the very purpose of those prudential regulations.

It is only in the unrealistic competitive case that the entry of narrow banks would attract deposits from broad banks. The banking deposit market is far from competitive. In practice, banks engage in nonlinear rate setting in which the most mobile depositors receive the highest bids on their deposits, while depositors who are less mobile receive lower rates. Less mobile depositors include many states and municipalities, corporations, and other entities important to the economy. The average level of bank deposit rates on jumbo checking and savings accounts reported by the FDIC Weekly National Rate report is far below the IOER.[58] This is despite the fact that the narrowly circumscribed wholesale federal funds rate is currently relatively close to the IOER rate.

Advocates for sound public policy should be troubled by the Board's suggestion that the interest rate that it pays on reserves should be above the rate that bank depositors receive in order to subsidize banks' costs of prudential regulation. By reducing the competitive effect that private-sector narrow banks would have on wholesale deposit rates, the ANPR's proposal seeks to perpetuate this inefficient subsidy.

5. Responses to questions posed by the ANPR

5.1 Has the Board identified all of the relevant public policy concerns associated with PTIEs? Are there additional public policy concerns that the Board should consider?

We have addressed the Board's asserted policy concerns related to narrow banks, focusing on the increased competition and financial stability offered by narrow banks. We have also pointed out the inefficiency caused by the current spread between IOER and interest rates offered by broad banks to their customers. The subsidization of banks represented by this spread contravenes a fundamental purpose behind the prudential regulation of banks. The ANPR does not address these points, which are highly relevant to the public policy interest in narrow banks.

As an additional concern, we point to the implementation of monetary policy and the size of the Federal Reserve's balance sheet. The authorization by Congress for Reserve Banks to pay interest on reserves was a significant change in the U.S. financial system. Narrow banks, such as

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[58] FDIC, "Weekly National Rates and Rate Caps – Weekly Update," *available at* https://www.fdic.gov/regulations/resources/rates/.

the ON RRP facility and TNB, have naturally arisen from the deployment of that authority. As discussed by many experts, the ability to pay interest on reserves gave the central bank the ability to implement its interest rate policy and its balance sheet policy separately, with each of these key policy components maintaining a significant degree of independence from the other.[59] This independence greatly improved the effectiveness of monetary policy. In particular, the Federal Reserve's ability to control market interest rates following the Crisis would have been markedly constrained if the Federal Reserve did not have the authority to pay interest on reserves.

Another potential use of this independence between a central bank's interest rate and balance sheet policies was recommended by Greenwood, Hanson and Stein (2016).[60] In that paper, Greenwood, Hanson, and Stein recommend that the Federal Reserve, via the ON RRP facility, maintain a permanently large balance sheet:

> By expanding the overall supply of safe short-term claims, the Fed can weaken the market-based incentives for private sector intermediaries to issue too many of their own short-term liabilities. And, crucially, we argue that the Fed can crowd out private sector maturity transformation in this way *without compromising the ability of conventional monetary policy to focus on its traditional dual mandate of promoting maximum employment and stable prices*. (emphasis in original).

Greenwood, Hanson, and Stein recommend that the Federal Reserve invest in relatively short-term government securities as it expands its balance sheet in order to fulfill this financial stabilization objective. In that way, the Federal Reserve's balance sheet expansion is not risky and does not compromise its other mandates.

Since it was authorized to pay interest on reserves, the Federal Reserve has innovated its policy setting, greatly expanding the FRP and creating the ON RRP facility "to intensify competition in money markets."[61] The ON RRP facility was described for many years as necessary to the implementation of monetary policy by the FOMC. As mentioned above, the upper bound to the potential size of the ON RRP facility has been the securities available to the Federal Reserve to proffer as collateral in the facility. The size of the facility has been controlled

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59 Michael Woodford, "Monetary Policy in a World Without Money," *International Finance* (Dec. 2002); Marvin Goodfriend, "Interest on Reserves and Monetary Policy," in proceedings of the Conference on Financial Innovation and Monetary Transmission, Federal Reserve Bank of New York, Economic Policy Review, pp. 77-84 (May 2002); Todd Keister, Antoine Martin and James McAndrews, "Divorcing Money from Monetary Policy," *Economic Policy Review*, Federal Reserve Bank of New York, Vol. 14, Issue 2, pp. 41-56 (Sept. 2008), *available at* https://www.newyorkfed.org/medialibrary/media/research/epr/08v14n2/0809keis.pdf.

60 Robin Greenwood, Samuel Hanson and Jeremy C. Stein, "The Federal Reserve's Balance Sheet as a Financial-Stability Tool," *Economic Policy Symposium Proceedings*, Federal Reserve Bank of Kansas City (2016).

61 Simon Potter, "Money Markets at a Crossroads: Policy Implementation at a Time of Structural Change," Federal Reserve Bank of New York (Apr. 5, 2017), *available at* https://www.newyorkfed.org/newsevents/speeches/2017/pot170405.

practically by offering those narrow bank investments at a discount to IOER. That discount allows banks to still recoup their balance sheet costs of compliance with prudential regulations by paying deposit rates below the rate paid on IOER, perpetuating the subsidization of the nation's largest domestic banks as well as foreign banking organizations.

The size of the FRP, at around $250 billion, has been significant for years without apparent adverse effects on financial markets. Far from threatening the Federal Reserve's monetary policy innovations, the FRP has supported the Federal Reserve's monetary policy implementation and has not posed risks to the Federal Reserve's income. In the minutes to its meeting of December 2, 2018, the FOMC pointed to the social benefits of these balances, as a convenience to foreign central banks. Narrow banks would provide similar conveniences to U.S. depositors, and would not pose a risk to the Federal Reserve's income, even if narrow banks were to lead to modest expansion of the Federal Reserve's balance sheet.

The evidence we have from these innovations by the Federal Reserve suggests that there are small, if any, costs to the balance sheet expansion that has occurred under the payment of interest on reserves, relative to the Federal Reserve's mandates. This history suggests that private-sector narrow banks would pose little or no risk to the Federal Reserve's balance sheet preferences. Further, were the Federal Reserve to unduly restrict the size of its balance sheet, that could lead to excessive and unhealthy private-sector maturity transformation, imperiling both the nation's and Federal Reserve's financial objectives.

The potential anticompetitive effects of the ANPR proposal are also worth considering. The ON RRP facility expanded the market for narrow banking quite significantly, but to date the Federal Reserve holds a monopsony in that market. The ON RRP facility and the FRP are the only two narrow banking facilities in operation in the United States, with both being publicly provided by the FRBNY. Were the Federal Reserve to put in place a rule that substantially deprived private-sector narrow banks revenue from interest on reserves, the exclusion from the narrow banking market would be nakedly anticompetitive. As the Federal Reserve's own participation in the market demonstrates, the net social benefits of narrow banks are significant, which in turn would make the exclusion of private providers from the narrow banking market highly inefficient and counterproductive.

5.2 Are there public policy benefits of PTIEs that could outweigh identified concerns?

All of our comments apply to this question and overwhelmingly demonstrate that the public benefits of private-sector narrow banks outweigh the identified concerns.

5.3 If the Board were to determine to pay a lower IOER rate to PTIEs, how should the Board define those eligible institutions to which a lower IOER rate should be paid?

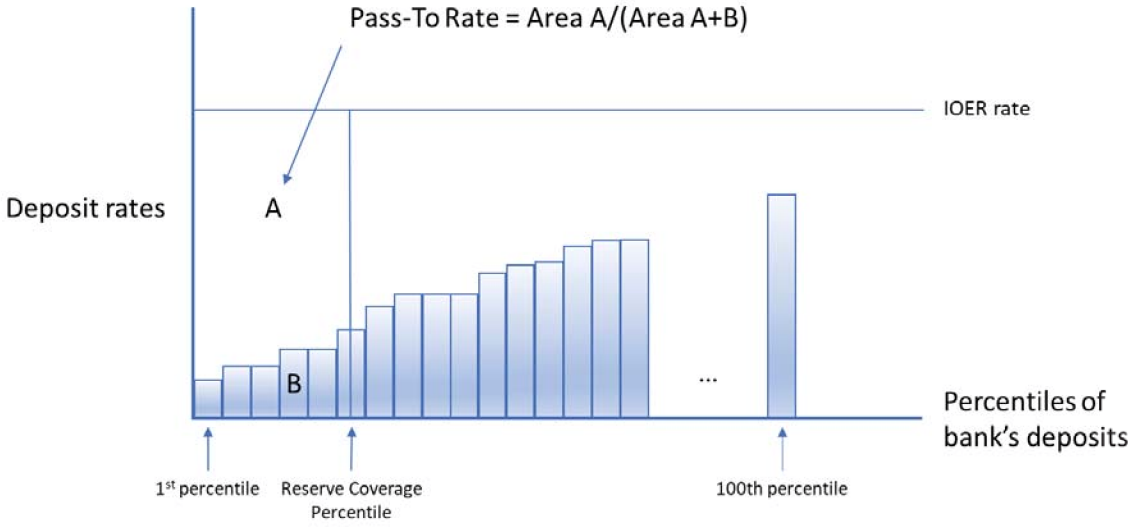
First, the term "Pass-Through Investment Entities" is not useful in identifying depository institutions that are 100 percent reserve banks. The term should be re-framed to focus instead on the extent to which depository institutions are being subsidized by retaining net interest paid to

them via the federal program of interest on reserves, what we have called "pass-to," as opposed to paying depositors, or "pass-through."

As an assistance to the public and to economists in understanding the functioning of the market for deposits, the Board might consider publishing, periodically, a histogram showing the cross section of deposit rates offered by banks, by percentile of deposit amounts. For example, the median deposit rate is the interest rate with the property that half of the deposits issued by U.S. banks receive a deposit rate that is lower than this rate, and the other half of deposits receive a rate that is higher than this rate.

To measure an individual bank's "pass-through rate," given that banks pay different deposit rates to different depositors, a similar histogram is useful at the individual bank level. Consider a histogram, shown below, that indicates the interest rate (on the vertical axis) paid on each percentile of a bank's deposits (shown on the horizontal axis). The bank also earns interest on the reserves it holds. Suppose it holds less in reserves than it issues in deposits; call the amount of reserves the "reserve coverage percentile." Then the revenue from the interest it earns on reserves can be displayed on the bank's deposit rate histogram, as shown below. Such information would not be intended for publication, but could be useful to the Federal Reserve to calculate and publish industry average rates of "pass-to".

The ratio between the interest on reserve revenue minus the deposit expense paid by the bank between the 1st percentile out to the reserve coverage percentile to the bank's total IOER revenue is a measure of the "pass-to" rate for that bank, as shown below. The pass-through rate is (1 − pass-to rate). The Federal Reserve could, if it intended to base this rule on pass through, define "Pass-Through Investment Entities" as those depository institutions with a high pass-through rate. Conceptually, those institutions could be broad banks or narrow banks, as there is nothing preventing broad banks from passing interest on reserves on to depositors.



If the Board were to pay a lower IOER rate to PTIEs, this would have two potentially dangerous consequences. First, using federal prudential regulations as though they are taxes that

have the purpose of discriminating among depository institutions would undermine the role of prudential regulations. The ANPR suggests that if the Board paid PTIEs the regular IOER rate, "this would enable PTIEs to earn interest on their balances at a Reserve Bank at the IORR and IOER rate, yet at the same time avoid the costs borne by other eligible institutions."[62] If a prudential regulator such as the Board were to apply a prudential regulation to make it more difficult for one class of depository institution to compete with another, rather than for a prudential purpose, the prudential basis for the regulation and other potential regulations would be undermined.

In the specific application proposed by the ANPR, the regulation would become a tool for penalizing extremely safe state-chartered depository institutions. With the proposed precedent and practice, moreover, prudential standards and regulation could become a political football. For example, special interests might attempt to have a class of institutions exempted from some requirement without consideration of the risk those institutions pose to the banking system. The principles underlying prudential regulations could become obscured and more difficult to disentangle from other intentions, increasing risks to the banking system. Those applying the regulations could become jaded about their purposes.

Second, as noted previously, the Board is neither a chartering authority nor a competition authority. By subjecting a defined class of state-chartered depository institutions to discriminatory application of its IOER policy, the Board would be improperly interfering with states' sovereign rights to charter banks.

As previously discussed, our preferred definition of the institutions that have the economic characteristics described in the ANPR would be "depository institutions, entities, or facilities whose principal customer service is to offer to nonbanks overnight investments that are, directly or indirectly, fully backed by central bank liabilities." This definition would apply to TNB, the FRP, and the ON RRP facility. These all share the defining feature of investments that are 100-percent backed by central bank liabilities. That some of these entities are publicly provided and others are private is a feature, and not a failing, of the definition. Further, this definition, while it does apply to certain state-chartered depository institutions, does not do so exclusively. Rather, the key criterion is the complete backing of offered investments with central bank liabilities.

With this definition of a narrow bank, there is little risk of a slippery slope. Suppose that a bank were to seek a state charter while offering deposits, 90 percent of which are backed by reserves and 10 percent of which are backed by risky assets. Such a bank would have some risk, so would be suitable for application of federal capital requirements, among other federal regulations and supervision.

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[62] ANPR at 8830.

5.4 If the Board were to determine to pay a lower IOER rate to PTIEs, what approach should the Board adopt for setting the lower rate?

To the extent that the interest rate paid to narrow banks is lower than IOER, the inefficient subsidy that we have described would be perpetuated. To maximize the role of narrow banks of increasing competition in bank deposits, limiting the inefficient subsidy provided by IOER, and improving the pass-through of monetary policy, narrow banks should earn a rate of interest on their reserve holdings equal to the rate earned by other depository institutions.

The ANPR states that "[i]f the current lenders in the federal funds market shifted much of their overnight investment to deposits at PTIEs, the federal funds rate could become volatile."[63] The current lenders in the federal funds market are primarily Federal Home Loan Banks. As such, the federal funds market has not been an "interbank" market in the traditional sense for many years. Were narrow banks allowed to operate, it is predictable that the federal funds rate would rise to some extent, possibly to levels exceeding the rate of interest paid on reserves. That would not cause any difficulties for the Federal Reserve in its execution of monetary policy, and would return the federal funds market to one that reflects the fluctuations in the demands by banks for reserves.

As we have discussed, the size of the ON RRP facility was controlled by paying a rate on those investments that is below the rate of interest paid on reserves. Besides perpetuating the subsidy to banks' costs of compliance with prudential regulation, lack of competition in the market for deposits allowed the federal funds rate, for most of the period from 2014 to 2018, to settle at levels below the rate of interest on reserves. In recent weeks, however, the federal funds rate has often equaled or exceeded the rate of interest paid on reserves. This configuration of interest rates has not harmed the ability of the Federal Reserve to implement its preferred monetary policy. Nor has it impeded activity in repo markets, nor called into question the usefulness of the Federal Reserve's new reference interest rates. Likewise, providing the same rate to narrow banks that is paid to other banks on their reserves would not imperil the ability of the Federal Reserve to conduct monetary policy, interrupt repo market activity, or impede efforts to construct and adopt new reference interest rates.

5.5 Are there any other limitations that could be applied to PTIEs that might increase the likelihood that such institutions could benefit the public while mitigating the public policy concerns outlined above?

The ANPR focuses a great deal on the concern that narrow banks could receive inflows in times of financial stress, which could lead to a sudden withdrawal from other banks that could greatly amplify financial stress.

We have argued that this concern is not well placed. We have pointed out that the presence of narrow banks would reduce the vulnerability of the financial system to runs. Nonetheless, we consider a policy that could address the stated concern that narrow banks could

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[63] ANPR at 8830.

receive excessive inflows in times of financial stress. We mention two options, neither of which involves discriminatory treatment of narrow or broad banks, and which could preserve the benefit of providing safe deposit facilities at competitive rates.

First, in times of financial stress, the Federal Reserve could pay all banks the same rate of interest on reserves up to a specified "surge-protector" level. For balances beyond the surge-protector level, the rate paid to all banks could be decreased to 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 time-varying and could be based on the most recent quarterly-average level of reserves held by the bank. For instance, one could define the surge-protector level of reserves as three times[64] the prior quarterly-average of reserves held by a bank. Such a rule would discourage banks from receiving deposits in excess of three times their prior quarter's average level. That would allow a trade-off between the need to provide safe deposit facilities at a competitive rate, thereby promoting financial stability, and the unlikely possibility that narrow banks would receive excess inflows in times of financial stress.

A fairly large growth multiple should be used for the coefficient on last quarter's average level of reserves held for both a technical and a more fundamental reason. First, depository institutions are paid interest based on their daily holdings of reserves averaged across two-week maintenance periods. The surge-protector level would be applied each day to the bank's holding of reserves. Second, banks should be allowed to meet normal and perhaps extranormal demands and to provide shock absorption of dynamic demands, as this is one of the ways that all banks enhance financial stability, perhaps especially during times of financial stress.[65]

A second option would be to implement surge protection at all times. This alternative has the drawback of reducing the efficiency benefits of the deposit-rate competition but the benefits of having deposits available as financial system shock-absorbers.

6. Conclusion

While the ANPR concedes the potential benefits of narrow banks, it concludes that the potential negative impacts of narrow banks could outweigh the potential benefits. For all of the reasons that we have stated, we believe that this conclusion is unwarranted. We further believe that private-sector narrow banks would provide extraordinary safety to the financial system. The Board would harm the nation were it to adopt a highly restrictive policy on interest payments on

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64 The coefficient, three, is only used for purposes of illustration.

65 This point mirrors the "headroom" discussion of the ON RRP. *See* Simon Potter, "Money Markets and Monetary Policy Normalization," Federal Reserve Bank of New York (Apr. 15, 2015), *available at* https://www.newyorkfed.org/newsevents/speeches/2015/pot150415.html ("Additionally, having some excess capacity, also known as headroom, in ON RRP operations over expected usage is important for the facility's effectiveness in helping to control rates."). Further, sufficient headroom should be provided to avoid a perception among potential depositors that safe deposits are limited in amount in a time of stress.

narrow bank reserves. The Federal Reserve's creation and expansion of its own narrow banks demonstrates it does believe in the efficacy of narrow banks.

In authorizing Reserve Banks to pay interest on required reserves, Congress intended to remove the "reserve tax," an inefficient situation that caused wasteful efforts by banks to economize on reserves. Further, authorizing Reserve Banks to pay interest on excess reserves provided an additional tool for monetary policy implementation. The Federal Reserve, in creating the ON RRP facility, recognized that narrow banks were necessary to make the payment of interest on reserves an effective tool of monetary policy. However, Congress did not intend to provide subsidies to banks in the form of a large margin between IOER and average deposit rates offered to bank customers, offsetting the cost of compliance with prudential regulations and thereby decreasing their prudential effects.

It would be an historic missed opportunity if the Board were to prevent the entry of private-sector narrow banks by discriminatorily reducing the interest they are permitted to earn. Providing safe deposits via narrow, private sector, state-chartered banks was made possible through congressional authorization for Federal Reserve Banks to pay interest on reserves. Narrow banks represent an innovative approach to providing safety in a manner that is entirely appropriate for the large depositors whose funds vastly exceed the limits of deposit insurance. However, in the absence of functioning private-sector narrow banks, the lack of safety of those depositors' funds leaves the nation's financial system vulnerable to destabilizing runs. Narrow banks can address this vulnerability safely and efficiently.

Remunerating narrow banks' reserves in a nondiscriminatory fashion will increase competition in money markets, improve the welfare of depositors, increase the allocative efficiency of savings and investments, reduce an inefficient subsidy to banks, improve the transmission of monetary policy into money markets, and accord with the congressional intent for the payment of interest on reserves.

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TNB appreciates the opportunity to comment on the ANPR. If you have any questions, please contact the undersigned by phone at (917) 609-0086 or by email at jmcandrews@*tnbusa.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)