From: Bert Ely
To: "regs.comments@federalreserve.gov"
Subject: Comment on ANPR re Regulation D: Reserve Requirements of Depository Institutions -- Docket No. R-1652; RIN 7100-AF-40
Date: Friday, May 10, 2019 3:10:39 PM
Attachments: AEI -- The Fed and ensuring financial stability -- 5-6-19 -- handout version.ppt

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To whom it may concern:

Please find attached a set of PowerPoint slides which represent my comment on the ANPR re Regulation D: Reserve Requirements of Depository Institutions.

I clicked through these slides during a presentation at a May 6, 2019, conference at the American Enterprise Institute devoted to the subject matter of this ANPR. You will find the link to a video of the conference on this webpage:
https://www.aei.org/events/must-the-federal-reserverestrict-entry-and-innovation-to-ensure-financial-stability/?mkt_tok=eyJpIjoiTmpjM01qVTRZemxtT1dJNCIsInQiOiJiNGthUVhSXC9rOENKMVRGMjdkUjBCYmJ2NEQxcDhaaDN1YmpBbTArRjlSQXN2WUswWXBpU2lxa2JPUTUwWU1jNWZOZGprWER0UENvWUM1cDB4cTdXWkJNMnZmRU5lY3RUZFlkdjlOY3JKelwvRWdOVWZPREFsQmNDWjBhdlVrUFBPIn0%3D

Please do not hesitate to contact me if anyone at the Fed has any questions for me regarding my comment.

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Must the Federal Reserve restrict entry and innovation to ensure financial stability?

A presentation by

Bert Ely

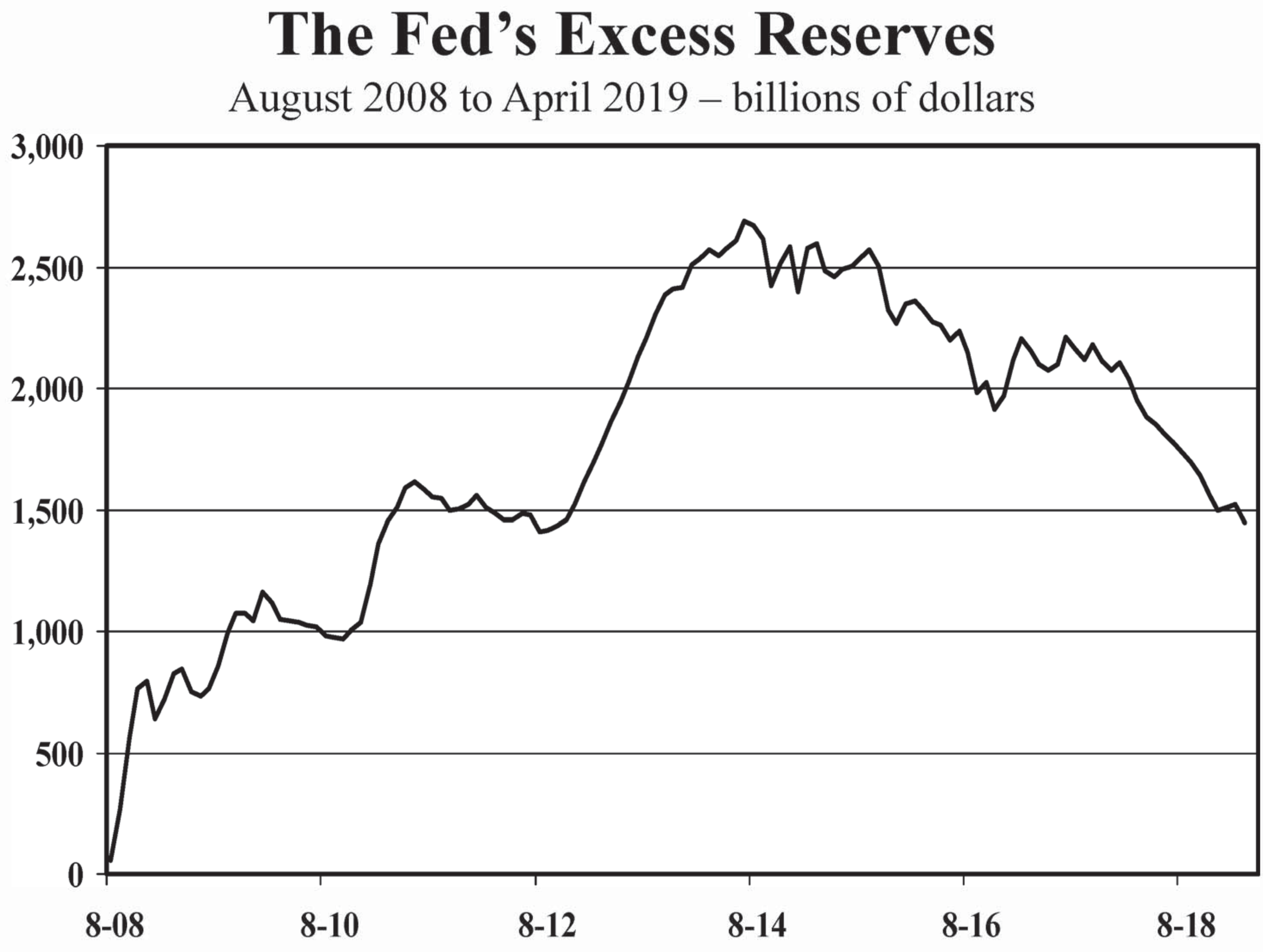
American Enterprise Institute

May 6, 2019

Why the “narrow bank” concept is an active proposal today – some history

- The Fed balance sheet ballooned after it began purchasing longer maturity securities in 2008 to push down the long end of yield curve – chart
- The Fed paid for those securities by borrowing from the banking system through the creation of excess reserves, as shown in the accompanying chart
  - Excess reserves are now in a long-term decline
- In effect, a substantial portion of the federal debt is financed by excess reserves sitting on bank balance sheets as an asset funded by customer deposits
  - The Fed pays interest on excess reserves (IOER), which essentially are a riskless (taxpayer-backed) asset

3-year, 5-year, 10-year Treasury yields
July 1, 2003 to May 2, 2019
Rate peak – 6-12-07
Lehman bankruptcy Filing – 9-15-08
Rate peak – 11-8-18
10-year
3-year
5-year
Percent
0
1
2
3
4
5
6
7/1/2003
3/23/2005
12/14/2006
9/5/2008
5/29/2010
2/19/2012
11/11/2013
8/4/2015
4/26/2017
1/17/2019


The Fed's Excess Reserves
August 2008 to April 2019 – billions of dollars
3,000
2,500
2,000
1,500
1,000
500
0
8-08
8-10
8-12
8-14
8-16
8-18

Why the Fed pays interest on excess reserves (IOER)

- Excess reserves about 8.5% of total bank assets
- The Fed has to pay interest on excess reserves to cover the banks' cost of holding excess reserves as an asset on their balance sheets, including
  - Interest paid on the deposits and borrowings funding the excess reserves
  - FDIC premiums on those deposits
  - Operating expenses/bank overhead/regulatory costs
  - Return on equity capital needed to maintain capital ratios on bank balance sheets swollen by excess reserves

Today's version of a narrow bank essentially would be a <u>regulatory arbitrage</u>

- Today's narrow bank – a "pass-through investment entity" (PTIE) – would avoid many costs FDIC-insured banks bear
  - No deposit insurance premiums
  - Reduced operating expenses due to no retail activities
  - Substantially lower regulatory costs – no CRA
  - Ability to operate with much more leverage due to the essentially riskless nature of its assets
- Cost savings would be shared with the PTIE's depositors, which will be large institutions
- PTIEs will be more like a money market mutual fund investing in Treasuries than a commercial bank

Potential risks to the PTIE business model

- The existential risk – excess reserves shrink back to pre-2008 levels
- PTIEs are paid a sufficiently lower interest rate on their Fed balances than FDIC-insured banks earn such that PTIEs cannot attract sufficient deposits
  - The Fed apparently believes it can pay a lower interest rate on PTIE balances
  - The banking industry will push for that rate differential
- Regulatory costs imposed on PTIEs, notably capital requirements, wipe out any PTIE rate advantage

Political issues/risks posed by PTIEs

- PTIEs will draw intense political opposition from established banks, especially those doing substantial business with institutional investors
  - This will be especially true for the custodial banks
- Impact of PTIE's on the FDIC – reduced premium income versus reduced risk posed by large banks
- Uncertainties about impact of next crisis on PTIEs
- Congress may weigh in if PTIEs become so large as to distort financial intermediation and competition
  - Capital requirements could be imposed on PTIEs that would severely weaken the PTIE business model

I look forward to the panel's discussion and questions from the audience