Financial Services Management

"Pass-Through Investment" Charters

Cite

FRB, Advance Notice of Proposed Rulemaking (ANPR)

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Impact Assessment

- An IOER-focused bank would capture post-crisis monetary policy for strategic advantage, heightening political concern about IOER and the overall thrust of Fed policy.
- The new charter, if followed by others, might redefine custody banking, money-market funds, and the overall construct of wholesale funding, raising costs for any bank unwilling to pass IOER straight through to institutional investors.
- If the business model expands to retail deposits, then a still more fundamental challenge to traditional financial intermediation would result. However, as with institutional investors, retail depositors would receive higher rates of return.
- Any Fed decision to deny an otherwise-legal charter could have adverse implications for future innovation as traditional financial intermediation faces significant challenges from new entrants and the Fed distrusts the new business model.
- Action against this special-purpose bank might give the Fed additional authority also to sanction FBOs with large excess-reserve holdings or raise questions about why this has not been done.
- A key Fed concern is that the proposed charter is not under federal prudential regulation. It does, though, have a state charter. Punitive action in this case may create precedent for future constraints on state charters without FDIC insurance that are not housed within BHCs.

Overview

In addition to a court challenge against a special-purpose bank chartered by the state of Connecticut, the Federal Reserve is considering broader policy that would block any state bank charters seeking to hold large balances of reserves at the

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central bank for the purpose of providing a risk-free, relatively high-return deposit product. The Board believes this special "narrow bank" poses monetary and financial-stability challenges that warrant rejection of the charter application, but the bank counters that it is legal in all respects and offers an essential new service. The grounds for Board opposition thus pose fundamental strategic questions about the future of innovative bank charters and the resilience of monetary policy premised on a Fed portfolio funded by excess reserves from diversified banks and, via a different facility, certain money-market funds and nonbanks.

Impact

Charter determinations are in many respects a subjective judgment, based as they are on factors such as "managerial capacity." Further, chartering authorities have long been cautious of innovative charters such as those owned by non-traditional companies or designed for specialized markets. However, the bank involved in this case believes itself to be the essence of a "narrow bank," calling itself TNB to emphasize the point, the bank proposes to use the state charter granted to it to take wholesale funds for no other purpose than to hold them at the Federal Reserve principally in the form of excess reserves. The business proposition is that interest on excess reserves (IOER) is a rate at or above those otherwise available to institutional investors or similar entities for housing funds with which they wish to take no risk and for which they seek maximum liquidity. TNB Bank believes its more simple business model ensures a reasonable return to its shareholders without any risk that the Federal Reserve has reason to sanction.

The Board discounts the interest of retail depositors in obtaining higher return on deposits now held at banks for reasons not entirely made clear in the ANPR. However, it clearly believes that TNB could be only one charter among many that could quickly offer IOER-based rates to institutional investors. It also notes that one or another domestic or foreign firm might establish a state-chartered bank solely for its own cash-management services, thereby earning more than it could by bank deposit or investing in a conventional wholesale-funding vehicle. As a result, this ANPR raises issues with implications not only for TNB, but also for the broader construct of U.S. banking.

The ANPR's description of relevant statutory authority stresses that current law does not require the Fed to pay interest on reserves to all eligible institutions or to pay the same rate to all entities receiving it. However, it does not clarify what a new policy would be if a few legal charters are denied the master accounts that make them eligible to hold reserves at the central bank. The ANPR says only that banks with disproportionately large reserve positions pose all the risks on which comment is solicited, noting that banks now generally hold about ten percent of their assets at the Fed even though some hold up to fifty percent. How much is too much is not made clear in the ANPR, although various definitions are floated for comment along with approaches to how interest on reserves might vary for at least some of these options. The ANPR does not differentiate TNB or like-kind banks from foreign-bank branches that often hold very large excess-reserve balances at the Fed and use IOER to arbitrage very low home-country interest rates and or exchange rates. However, these branches have raised considerable Fed concern related to leverage-ratio "window-dressing"[1] which, should the Fed advance its TNB-related rules, might

[1] See **LEVERAGE17**, *Financial Services Management*, December 18, 2018.

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come into play with regard to sanctions also for foreign branches with large excess-reserve positions.

A major premise of the ANPR is that TNB and state banks that could come to be like it are exempt from costly capital and prudential regulation. However, state regulatory systems often define capital by reference to federal standards. These now do not impose a risk-based capital charge on deposits held at central banks, but do impose the leverage ratio on all but the custody banks exempted from leverage requirements on these assets under a 2018 law yet to be implemented by the Federal Reserve.[2] Special-purpose charters might nonetheless enable TNB or other banks to escape certain federal capital rules, but the Fed might then be able to require *de facto* compliance with key rules as an eligibility requirement for opening master accounts. Although the Fed states that it has broad authority to define eligibility, it does not discuss the extent to which regulatory adherence might be considered.

The Fed also fears that narrow banks such as TNB would disrupt financial intermediation due in part to the fact that bank funding costs could increase as competition from narrow banks forces traditional banks to compete harder for large-dollar or even retail deposits. This reasoning would lead one to conclude that IOER now reduces bank funding costs in ways that spur more lending, but empirical data on bank lending are problematic given slow real growth in bank lending in comparison with private-sector GDP. Some have also read this Fed concern as a concession to critics who believe that IOER subsidizes bank funding costs. However, as noted in a 2016 FedFin paper,[3] regulatory and other factors play an important role in the decision by domestic banks to hold large Federal Reserve deposits.

What’s Next

The FRB released this ANPR on March 6; comments are due by May 13. This timing and the fact that the proposal is not only an advance one, but also lacking any specific actions, suggests it will be many months before the Fed establishes a formal policy on charters such as TNB. As noted, the case is also pending in the courts, with the Fed hoping that this resolves its dispute with this one bank and gives it time to address all of the policy questions without additional political risk.

IOER has become a contentious political issue as the Fed’s balance sheet grew to unprecedented proportions after 2009 and, more recently, as the central bank expects to “normalize” its portfolio to still-high levels – e.g., $3.5 trillion – as it crafts a new approach to U.S. monetary policy. Republicans have proposed either that the Fed sharply reduce its book and/or that IOER be paid to the taxpayer, not to banks.[4] Democrats have been more supportive of the Fed, although some and Sen. Sanders (I-VT) have also proposed that IOER be used to fund social welfare spending in areas such as affordable housing. To the extent a bank such as TNB “exploits”

[2] See **LEVERAGE14**, *Financial Services, Management*, June 8, 2018.

[3] FedFin Analysis: The Impact of IOER – Why the FRB Pays Interest on Excess Reserves.

[4] See *Client Reports* in the **IOER** Series.

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IOER solely as a pass-through vehicle, calls from Congress to eliminate or redirect IOER could gain additional force.

In addition the Fed's opposition to this special-purpose charter is likely to raise questions from conservatives about the reason the Fed believes it needs so large a portfolio, why it maintains other facilities that pay interest to nonbanks, and how it plans to normalize monetary policy without becoming a permanent presence in the global financial markets beyond the scope once considered conventional for a central bank.

Analysis

The Fed considers a TNB-style bank to be a pass-through investment entity (PTIE). The Board has yet to determine that PTIEs are eligible institutions for interest-on-reserve purposes. Key points about the PTIE charter asserted in the ANPR include:

- PTIEs would enjoy privileges via master accounts at a Reserve Bank without the cost of capital requirements or other federal prudential standards. The ANPR does not describe which state capital and prudential standards might apply and how these costs compare to federal requirements for like-kind charters beyond saying that PTIE capital requirements would not be "meaningful."
- PTIE charters could attract large quantities of deposits at a near-IOER rate. These deposits could grow beyond those contemplated by TNB gathered from institutional investors to retail customers and then be taken by numerous special-purpose banks in ways that challenge traditional banks and central-bank policy.

A. Monetary-Policy Implications

The ANPR notes that some believe that PTIEs would strengthen monetary policy by making IOER a more market-relevant interest rate. The Board counters that:

- Current policy has successfully kept rates in desired ranges. The ANPR does not note recent Fed efforts to alter IOER to make it better reflect FOMC goals. It also does not discuss the reverse-repo program or other facilities now under active FOMC consideration.
- If PTIEs succeed in holding large amounts of deposits, then the Fed will find it difficult to normalize its balance sheet to the smallest possible amount. However, if funding simply shifts between narrow banks and other banks, as the Fed suggests could occur in its assessment of financial intermediation and financial stability, then reserve balances would only shift, not change. Further, it is unclear that the Fed could not reduce its portfolio regardless of balances flooding into narrow banks if it were willing to adjust asset purchases and sales to keep its desired amount of assets.
- Large PTIE balances would exacerbate short-term rate volatility. The ANPR suggests also that smaller volumes in overnight money markets are likely, exacerbating market volatility and complicating monetary policy.

B. Financial Intermediation

Fed fears here include:

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- PTIE deposits could prove more attractive to overnight lenders in core repo markets, impairing repo-market liquidity, exacerbating stress, and raising Treasury borrowing costs.
- The transition to new benchmark rates could be imperiled.
- Overall funding for commercial banks could drop, raising the cost of credit provided by banks.

Despite the suggestions about retail deposit-taking, the detailed analysis argues that the potential for PTIEs to improve retail-deposit returns is said to be low due to TNB’s proposed business model and the cost of offering retail deposits versus accepting short-term wholesale funds. The ANPR also asserts that retail customers accept lower rates as a condition for the convenience of checking accounts versus money-market fund investments.

C. Financial Stability

The Board’s financial-stability concerns are:

- Despite assertions that PTIEs would increase the supply of “safe money,” this option would draw funds from banks or holdings of high-quality liquid assets and thus exacerbate volatility in stress scenarios. Although this is possible if funds flow out of diversified banks into narrow banks, banks under stringent liquidity rules might be able to withstand this, albeit possibly at higher cost if banking agencies adjust outflow assumptions for funding sources now assumed to be relatively “sticky.” However, to the extent that capital-market funds flow into narrow banks and thus into central-bank reserves, financial stability might arguably be enhanced versus flights of funds to other safe assets now subject to potential liquidity shortages and other constraints resulting from more limited bank capacity as market-makers.
- The Board also notes that some believe that narrow banks would enhance stability by moving funds from very large banks. The Fed refutes this by reiterating its concerns about a flight to narrow banks under stress that could imperil diversified banks and thus undermine financial stability. It also suggests that the fact that rates on excess reserves would not necessarily change as demand surges would adversely affect financial stability.

D. Congressional Intent

The Board fears that paying interest on reserves to PTIEs would be *de facto* payment of interest to institutional investors to whom Congress did not intend such payments.

E. Request for Comment

Views are specifically solicited on:

- the need to offer a lower interest rate to PTIEs, i.e., zero or, perhaps, a sliding rate based on the business model;
- the definition of PTIEs. These might be identified as entities that hold a “very large share” of assets at a Federal Reserve Bank. PTIEs could also be

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identified as banks with low capital relative to assets, or through a more narrow definition (e.g., a higher reserve-asset ratio, a low capital-to-asset ratio, and/or exemptions from federal supervision);

- any other limits that could be applied to PTIEs; and
- any other policy issues raised by this application.

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