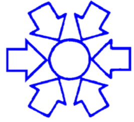
Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: September 18, 2020

When I wrote last week on the OCC's shift to "activity" from "entity" regulation, the memo and the subsequent op-ed in the *American Banker* elicited a lot of questions about just what I meant by structural transformation. I said last week that intermediation, not arbitrage, stokes growth. Many of you agreed with that, but still more ask what this means in practice. The answer, as I'll explain now, is that disassembled banks are only updates of old-school "narrow" banks that house deposits in depositor-selected assets, not those a bank selects via loans or investments in the macroeconomy. These narrow charters usually rely on 100 percent, sterile reserves to back the funds entrusted to them, a model harkening back to Renaissance goldsmiths once deemed doomed by the development of "fractional banking" in the 17th century and the economic growth it powered – structural transformation and then some.

The modernist vision of narrow banking arose in the late 1980s after the S&L crisis, with a Brookings scholar and a McKinsey consultant urging it as the way to ensure financial stability. Although policy-makers flirted with the idea, no one bought into narrow banking because no one could figure out how to make money in it. Stiff capital regulation was thus developed as a way to mandate shareholder buffers to align reasonable profitability with sufficient reserves. After the great financial crisis (GFC) of 2008, capital was of course the prime directive, but profitability remains problematic. Technology instead makes the profit impediment to narrow banking far more porous. Acting Comptroller Brooks and others thus see new-style narrow banks as one solution to GFC 2.0, the COVID crisis now wreaking so much havoc.

In just the last two weeks, we've seen two new-age, narrow charters that exemplify the disassembled banking model. The first is Jiko bank. It is a clever reinvention of an old, traditional charter that decided to go beyond being rented to being owned outright by a fintech venture that plans to invest deposits only in Treasury obligations to give, the sponsors say, both higher returns and greater safety for funds over the FDIC's $250,000 insurance ceiling. Access to the payment system is wrought by sweeping funds from Treasuries into bank money and from there to and fro' across the globe – or so it's supposed to go.

The other new-age charter born just a few days ago is Wyoming's first "special-purpose depository institution" for Kraken, a digital asset firm. Although described as a custody bank like any other, it's in fact far different because it plans to use custody digital and fiat-currency assets for services such as debit cards and wire transfers. Sterile reserves are said to offset all this risk.

Lest one think these narrow charters are confined only to the retail arena, remember TNB, literally The Narrow Bank. Its long-pending charter to take funds and house them only in excess

reserves remains on hold in part because the Fed fears its systemic and even macroeconomic impact.

The Fed has, however, given approval to Jiko to become a bank holding company. Whether this means it's fine with narrow banking as long as the Fed is in charge of it remains to be seen, but it does provide at least some scope for activity-based banking in concert with payment-system access. How much, is though, very much to be determined.

The OCC under Acting Comptroller Brooks has no such qualms. The OCC readily gave Jiko's bank the national charter it craved for an efficient nationwide presence and the OCC has also announced open season for digital custody banks. Like Mr. Brooks' planned payments banks, these charters will be granted on a case-by-case basis allowing innovation and arbitrage to stride hand-in-glove into an uncertain future for fractional banking.

The end of fractional banking also looms in the payment system even if Mr. Brooks stands down. Officials at the International Monetary Fund have proposed that tech companies engaging in digital-currency activities with access to the payment system would have to post holdings of high-quality securities or cash equal to the amount of their currency liabilities. This takes the idea of stable coin and might well make it truly stable because the new-money provider can't use the reserves or fudge their value. While it's an expensive proposition, it would make new money if not altogether good, then at least a lot better, especially if a regulator or central bank has the power to ensure and enforce not just these reserve requirements, but also other consumer and financial-market protections.

Indeed, that's the rub – disassembled banking is dangerous even if it's fully reserved because no one may be able to find the reserves when they're most needed. It's for this reason that deposit insurance came to be. Pre-Depression banks were fractional and thus run-prone by design, but they were also run-prone because the reserves they held – gold and the like – were often long gone. Treasury obligations are risk-free (one hopes), but matching maturities to fund outflows would be right tricky even if true sterile reserving banned rehypothecation or trading. Sterilizing reserves won't ensure they're there. Without an over-arching regulator with the authority and expertise needed to look under a complex firm's hood, narrow banking will still be risky banking. It will, though, be quite profitable, threatening fractional banking and, with it, the intermediation on which economic growth still relies.