THE FEDERAL RESERVE PUSHES BACK ON NARROW BANKING

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U.S. Depository Institutions Alert

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Innovation and rapid change are permeating financial services. But amidst those trends, the Board of Governors of the Federal Reserve System (the "Federal Reserve") recently took action aimed at maintaining the status quo.

On March 12, 2019, the Federal Reserve issued an advance notice of proposed rulemaking (the "ANPR") regarding its Regulation D, which governs reserve requirements for depository institutions. [1] Under Regulation D, the 12 Federal Reserve Banks are authorized to pay interest on reserve balances maintained by eligible depository institutions at the applicable Federal Reserve Bank. [2] Banks are required under Regulation D to maintain certain minimum reserve balances at their regional Federal Reserve Bank and are allowed to maintain balances in excess of these minimum reserves ("Excess Reserves"). [3] The interest rate currently paid by the Federal Reserve Banks on Excess Reserves is 2.4% (the "IOER Rate"). [4]

As the ANPR points out, some financial firms have recently sought to establish state-chartered, non-FDIC insured depository institutions ("Narrow Banks") with narrow business models premised on taking deposits from institutional investors, depositing the proceeds with the applicable Federal Reserve Bank, and passing through to the investor most of the interest earned by the institution on the corresponding reserve balances. The investor, in turn, earns a premium on its deposits at the Narrow Bank as compared to other low-risk, highly-liquid investments (e.g., U.S. Treasury securities). The Narrow Bank business model is viable so long as prevailing interest rates remain low as compared to the IOER Rate.

The ANPR comes on the heels of a lawsuit filed by one such financial firm against the Federal Reserve Bank of New York (the "FRBNY"). [5] In August 2017, the Connecticut Department of Banking issued TNB USA Inc. ("TNB"), a Connecticut state-chartered bank whose chairman and chief executive officer is a former FRBNY official, a temporary certificate of authority. The temporary certificate of authority would be exchanged for a permanent bank charter once, among other things, the FRBNY issues TNB a "master account." A master account is essentially an account that a bank holds at its regional Federal Reserve Bank that allows it to transact with that Federal Reserve Bank and access the national payment system operated by the Federal Reserve.

TNB's business plan is to offer "ultra-safe depository services for institutional money market investors." [6] Like the Narrow Bank model described in the ANPR, TNB planned to deposit these investors' funds with the FRBNY and pay the investors a slightly lower rate than the IOER Rate, thereby earning a spread on the difference. TNB does not plan to obtain FDIC deposit insurance, meaning that it would largely avoid federal banking regulation. The FRBNY has yet to issue a decision on TNB's application for a master account. Its delay in doing so resulted in the TNB lawsuit. [7] TNB contends that as a state-chartered depository institution, it is legally entitled to an FRBNY master account. [8] The Federal Reserve and the FRBNY, on the other hand, contend that whether to grant a master account to TNB is a matter of the FRBNY's discretion. [9]

The Federal Reserve expressed several concerns in the ANPR regarding Narrow Banks. It stated that Narrow Banks have the potential to attract very large quantities of deposits and, consequently, maintain very large balances at Federal Reserve Banks, which may complicate the Federal Reserve's implementation of monetary policy. [10] The Federal Reserve also expressed concerns about the effect that Narrow Banks could have on financial intermediation generally, for example, by sapping demand for bank deposits and other types of conventional liquid investment vehicles. Additionally, it raised concerns about Narrow Banks' potentially harmful effect on the stability of the U.S. financial system. Finally, the Federal Reserve observed that allowing Narrow Banks to act as conduits for nonbank investors to access the IOER Rate may undermine Congress' intent that only traditional depository institutions have access to this benefit. The questions included in the ANPR for public comment suggest that the Federal Reserve may be considering effectively putting an end to Narrow Bank models like TNB's by amending Regulation D to provide that a lower IOER Rate would apply to Narrow Banks as compared to the IOER Rate that would be available to traditional depository institutions.

In the current fintech era, when new and innovative business models are dominating the discussion on financial services, the Federal Reserve's issuance of the ANPR and stance in the TNB litigation are reminders that traditional banks continue to have certain meaningful advantages over the many unregulated or lightly regulated financial firms that seek to compete with them.

NOTES

[1] 84 Fed. Reg. 8,829 (Mar. 12, 2019) (to be codified at 12 C.F.R. Part 204).

[2] *See* 12 C.F.R. § 204.10.

[3] *See* 12 C.F.R. §§ 204.1(c), .10(b).

[4] *See* 12 C.F.R. § 204.10(b); https://www.federalreserve.gov/monetarypolicy/reqresbalances.htm.

[5] *See* Complaint, TNB USA Inc. v. Fed. Reserve Bank of N.Y., No. 18 Civ. 7978 (S.D.N.Y. Aug. 31, 2018).

[6] Opposition to Defendant's Motion to Dismiss at 8-9, TNB USA Inc. v. Fed. Reserve Bank of N.Y., No. 18 Civ. 7978 (S.D.N.Y. Mar. 26, 2019).

[7] TNB filed its application for a master account with the FRBNY in August 2017. TNB contents that Federal Reserve Banks usually grant approval to open a master account within a matter of days after an application is filed.

[8] TNB's position is based on its interpretation of Section 11A of the Federal Reserve Act, 12 U.S.C. § 248a ("Section 11A"), which concerns the pricing of certain services provided by the Federal Reserve. TNB argues that because Section 11A provides that such services "shall be available to nonmember depository institutions," the Federal Reserve must make each of the services specified in Section 11A available to nonmember depository institutions such as TNB. Even though a Federal Reserve master account is not among the specified services, TNB contends that, as a practical matter, a depository institution must have a master account in order to access the specified services, and therefore, the Federal Reserve must issue a master account to a nonmember depository institution that requests one.

[9] The Federal Reserve argues that Section 13 of the Federal Reserve Act, 12 U.S.C. § 342, which provides that any Federal Reserve Bank "may receive" deposits from its member banks or "other depository institutions," grants the FRBNY discretion to deny master account applications.

[10] For example, large inflows of Excess Reserves from Narrow Banks could force the Federal Reserve to expand its balance sheet at a time when it may wish to affect monetary policy by shrinking its balance sheet. *See* 84 Fed. Reg. 8,829 at 8,830.

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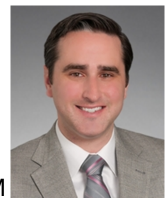

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