Financial Stability and Monetary Policy Risks Associated with Granting Accounts to Institutions with Novel Charters

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On May 5, the Federal Reserve published proposed guidelines to be used to evaluate requests for accounts by institutions with novel charters, including uninsured deposit-taking institutions like narrow banks and the new Wyoming special purpose depository institution charter for crypto banks. The proposal is available here and a BPI primer on the issues is available here.

Among other criteria, the proposed guidelines state that the provision of an account should not "create undue risk to the stability of the U.S. financial system," or "adversely affect the Federal Reserve's ability to implement monetary policy." This note discusses the ways the Fed may be concerned that granting accounts to uninsured deposit-taking institutions with novel charters (UDIs) can create risks to financial stability or interfere with monetary policy implementation.

In short, because they are not federally insured, some UDIs can be subject to destabilizing and contagious depositor *outflows*. And because some UDIs would only maintain reserve balances as assets and reserve balances are attractive in periods of financial stress, they can be subject to destabilizing deposit *inflows*.

FINANCIAL STABILITY

The proposed guidelines state that a Reserve Bank should determine whether access to an account by a UDI by itself or by a group of similar UDIs could "introduce financial stability risk to the U.S. financial system." In particular, the Reserve Bank is instructed to consider

> "…the extent to which, especially in times of financial or economic stress, liquidity or other strains at the institution may be transmitted to other segments of the financial system."

For example, if a FinTech-affiliated UDI advertised its uninsured deposits as essentially riskless because they were backed by "reserves" but it turns out that they weren't riskless (more on that below), then depositors in the UDI, knowing that the first one out the door was most likely to get paid and later ones might not, could all simultaneously seek to withdraw their deposits (they'd certainly have strong incentive to do so). If the UDI had made losses that were not covered by its capital, or if it did not hold a sufficient quantity of highly liquid assets to pay depositors, it would have to close its doors, with any remaining depositors likely receiving only partial returns.

A run on one UDI is not a systemic risk, but when granting a charter, the Fed has to

consider the implications of granting charters to similar institutions as well. If there were other, similar UDIs, depositors at those UDIs would probably also rapidly withdraw their funds to protect themselves from possible similar trouble. Even if those UDIs were solvent, if they did not have enough cash on hand to meet the runs, they too would have to close their doors. Before halting depositor withdrawals, the UDIs may try to sell their assets at firesale prices, which could put pressure on unrelated institutions that held the same or similar assets.

Essentially the same dynamic could apply to stablecoins issued by UDIs that were advertised as being riskless but proved to be risky. If holders of any one stablecoin were unable to redeem their investments for 100 percent of the face value of the coin, all similar stablecoins would likely experience elevated demand to convert the stablecoin to dollars.

The deposits at a UDI could appear riskless but end up being risky for several reasons. Perhaps the most important reason is that the public has come to expect deposits to be riskless because the deposits they are familiar with are insured and UDI deposits would not be insured. In addition, some UDIs have played on the ambiguity of the word "reserves" to suggest that they are only allowed to invest in deposits at the Federal Reserve when they are actually allowed to invest in risky assets. Case in point: a Wyoming SPDI (crypto bank) can invest not only in central bank reserves, which are riskless and perfectly liquid, but also in certain municipal securities, agency securities, and any assets "determined by the Commissioner to be…permissible under safe and sound banking practices." [1 2]

These institutions also are permitted to use the word "bank" in their names, even though they are not insured depository institutions, contrary to the public's general understanding of what a bank is. The public may expect an institution that is called a bank to be subject to the same rigorous capital and liquidity standards as federally insured banks. Capital insulates depositors from losses and liquidity ensures the institution can meet deposit withdrawals. For example, federally insured banks are required to hold substantial capital to cover the potential for operational losses but the UDIs known to be seeking charters are not, despite also being subject to operational risk.

Moreover, even if deposits are backed 100 percent by reserve balances, they need not be riskless. Consider, for example, a bank funded 20 percent with deposits, 79.5 percent with debt, and 0.5 percent with equity whose assets are 20 percent reserve balances and 80 percent subprime mortgages. It would satisfy a 100 percent reserve requirement, but the deposits are far from riskless. Reserve requirements help ensure that an institution is *liquid* but not that it is *safe*. Deposits are not collateralized by the reserves. If an UDI defaults, depositors are treated as general creditors and so share in the losses equally with others, like debt holders, vendors and landlords of the institution, in contrast to depositors in FDIC-insured institutions.

The other financial stability worry the Fed describes concerns narrow banks or "pass-through investment entities" (PTIEs), another type of UDI seeking Fed account access. PTIEs invest only in reserve balances and are funded only with uninsured deposits and a tiny sliver of capital. The business model is to earn interest on the reserve balances and pass that interest on to

depositors minus a small amount to cover costs and provide a return on equity.

The Fed's proposal notes that reserve balances are attractive investments during times of financial stress. Only banks are able to invest in reserve balances, but PTIEs essentially allow other institutions to invest in reserve balances as well. As a result, these UDIs can be magnets for flights to quality out of investments in "nonfinancial firms, financial firms, and state and local governments." The massive "dash for cash" that occurred in March 2020 provides a good illustration of how such outflows can be destabilizing. In the event last year, the dash was into (among other things) bank deposits, which rose by nearly $2 trillion and funded banks' $700 billion increase in lending. Had those funds flowed into PTIEs, they would have only funded increased holdings of reserve balances.

MONETARY POLICY

The Fed's monetary policy concerns about granting accounts to UDIs appear to be focused on the implications of PTIEs for reserve balances. On May 13, 2019, the Fed issued an ANPR in which it proposed paying PTIEs a lower interest rate on reserve balances than other account holders (available here). In that proposal, the Board described its specific monetary policy concerns in detail.

The proposal last month states that a Reserve Bank should consider whether granting an account to a UDI or a group of similar UDIs

> "…could affect the level and variability of the demand for and supply of reserves, the level and volatility of key policy interest rates, the structure of key short-term funding markets, and on the overall size of the consolidated balance sheet of the Reserve Bank."

These concerns correspond to those described in the Fed's PTIE proposal from 2019.

First, the Board is concerned that PTIEs may make it difficult for the Fed to shrink its balance sheet if it decided to do so. Investors in other assets such as Treasury bills, commercial paper or certificates of deposit could shift their investments to PTIEs, and the PTIEs would, in turn, deposit those investments at the Federal Reserve as reserve balances. In order to control interest rates, the Fed would need to supply the reserves that are demanded and doing so requires the Fed to maintain a correspondingly large securities portfolio.
Second, currently, the only lenders in the fed funds market are GSEs. GSEs have deposits at the Fed but do not receive interest. Rather than receive zero interest, GSEs lend their extra cash in the fed funds market to banks. The Fed is concerned that if GSEs can invest in PTIEs, they will

stop lending in the fed funds market. Trading volume in the market would fall and volatility in the fed funds rate would increase.

The Fed also indicated that if PTIEs attracted investors away from depository institutions and money market mutual funds, trading volumes in repo markets and the Eurodollar market could also decline, increasing volatility in those markets as well.

ENFORCEMENT

The proposal states that Reserve Banks would need to determine if granting an account to the UDI or to a group of similar UDIs would increase financial stability risks or interfere with monetary policy implementation before granting the account. The Reserve Banks are encouraged to make use of assessments of the financial condition of the institution by state and/or federal supervisors. Notably, the proposal states that the flight-to-quality risk is greater if an institution is not required to meet capital requirements similar to those of a similar institution that receives federal deposit insurance.

If a Reserve Bank concludes that granting an account would create financial stability or monetary policy problems, the Reserve Bank would presumably not grant the account. The Reserve Bank also could determine that financial stability or monetary policy problems could be mitigated by placing restrictions on the UDI's account. In particular, the Reserve Bank could pay a different interest rate, limit the amount in the account on which interest is paid, or put a cap on the amounts in the account.

To avoid the financial stability risk associated with destabilizing and contagious runs out of the accounts, Reserve Banks could seek assurance that the deposits were, in fact, riskless and that the UDI had liquidity needed to meet any outflows. Such assurance could come, for example, from the UDI being required by its charter to only invest in reserve balances and to be subject to capital requirements like normal banks.

To avoid the financial stability and monetary policy risks associated with attracting investors either in normal times or during stress, the Reserve Bank could pay PTIEs a lower interest rate or it could require the PTIEs to maintain the same capital levels as a similar bank that has federal insurance; either change would cause the interest rate a PTIE was able to pay its depositors to fall below other money market rates. The Reserve Bank could also put a cap on the size of each PTIE's account.

[1] Wyoming Administrative Rules, Audit, Dept. of Banking Division, Chapter 20: Special Purpose Depository Institutions. https://docs.google.com/viewer?a=v&pid=sites&srcid=d3lvLmdvdnxiYW5raW5nfGd4OmZlMTYzNDY1NmM3ZjQ2Ng

[2] The list of allowable investments in the Wyoming regulation is ambiguous. As noted, it permits SPDIs to invest in agency and municipal securities but requires the SPDIs to invest only in Level I High Quality Liquid Assets (HQLA). Level 1 HQLA includes only reserve balances and Treasury securities.