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Bank Suit Could Complicate the Fed's Rate Policy

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A lawsuit against the Federal Reserve Bank of New York could complicate the central bank's effort to control short-term interest rates at a time when investor scrutiny of those markets is intensifying.

TNB USA Inc. contends in a federal suit filed in late August that it has been wrongly blocked in its pursuit of a "master account" at the Fed that would allow it to earn interest on deposits placed on the Fed's books.

Analysts say that if TNB won approval to offer deposit accounts to clients and other banks copied its model, the development could pose a threat to how the Fed has controlled short-term rates since the 2008 crisis.

Instead of targeting a specific short-term rate, as it did before the financial meltdown, the Fed now sets a firm range between the rate it will pay deposit-taking banks at the high end, and the overnight reverse repurchase rate that is available to an approved roster of money managers and other institutions at the low end. The fed-funds rate floats in between.

TNB and other banks like it could thwart this system, analysts said, by collecting interest at the higher rate and offering that rate, minus a spread to cover costs and profits, to institutions that deposit money with them.

"I applaud the cleverness of this," said Tim Duy, an economics professor at the University of Oregon. "That spread was sitting out there and somebody found a way to take advantage of that."

The Fed's range for the funds rate now stands at between 1.75% and 2%, with the interest on excess reserves rate at 1.95%. The Fed is widely expected to boost that range when officials meet this week.

TNB and banks like it would allow the sort of firms that would otherwise earn the lower reverse repo rate a way to get a higher return. That could render the rate floor moot. The Fed would still have a lot of control over short-term rates, but the lower end floor could cease to be a meaningful rate.

Some Fed watchers say the threat to the rate control regime may not prove that big a deal. For some time now, there has been little actual interest from eligible firms to earn the reverse repo rate, as those firms have put their money to work in other places, with better returns.

George Selgin, a Cato Institute senior fellow, attributes this situation in a blog post to "the tendency of the Fed's policy rate settings to lag further and further behind increases in market-determined interest rates" in a time of expanding budget deficits.

Regardless of market conditions, TNB says it isn't trying to break the system, and it is explained to the Fed how it will limit its activities to accomplish that. The Fed "has a clear statutory obligation" to grant the official account, said James McAndrews, a former Fed research official who is leading TNB. He also believes the TNB model is entirely complementary of the Fed's monetary policy goals and reinforces what's now in place.

The Fed hasn't said why it hasn't approved TNB's application beyond unspecified "policy concerns," TNB's lawsuit says. Central bank watchers say the denial is essentially without precedent. TNB is operating under a temporary charter that Connecticut banking regulators granted in August 2017 that expires next year.

The New York Fed has thus far not responded to the suit, and it and the Fed's Board of Governors declined to address the claims.

Peter Conti-Brown, a legal studies and business ethics professor at the Wharton School of the University of Pennsylvania, said he's "not convinced that the Fed has the legal authority to deny TNB its master account." The Fed "will have to show why it has the statutory authority to use discretion to deny" an application like TNB's, Mr. Conti-Brown said.

There are longer-term implications of the TNB model. If it proved popular -- and there is no way to know yet whether it would -- it could serve as the first step on a longer march to connect the public to the central bank more directly. Some academics have argued monetary policy could be made more potent if people and companies were allowed to bank directly with the Fed, via interest-bearing accounts.

Fed policy changes could then bypass fickle financial markets and make themselves felt at the consumer level, which would in theory make rate changes more powerful. TNB may not be seeking such an outcome, but a successful performance of its model could start the wheels turning for such a world.

TNB is "another manifestation of how innovation runs ahead of regulation," said David Beckworth, of George Mason University's Mercatus Center. "The Fed's fear is not only destroying the floor system, but moving their balance sheet one step closer to more and more entities and ultimately the public."