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Why Is the Fed Paying So Much Interest to Banks?

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> *"If you invest your tuppence wisely in the bank, safe and sound,*
> *Soon that tuppence safely invested in the bank will compound,*
>
> *"And you'll achieve that sense of conquest as your affluence expands*
> *In the hands of the directors who invest as propriety demands."*
>
> — *Mary Poppins*, 1964

When *Mary Poppins* was made into a movie in 1964, Mr. Banks' advice to his son was sound. Banks were then paying more than 5% interest on deposits, enough to double young Michael's investment every 14 years.

Now, however, the average savings account pays only 0.10% annually – that's 1/10th of 1% – and many of the country's biggest banks pay less than that. If you were to put $5,000 in a regular Bank of America savings account (paying 0.01%) today, in a year you would have collected only 50 cents in interest.

That's true for most of us, but banks themselves are earning 2.4% on their deposits at the Federal Reserve. These deposits, called "excess reserves," include the reserves the banks got from our deposits, on which they are paying almost nothing; and unlike with our deposits, there is no $250,000 cap on the sums banks can stash at the Fed amassing interest. A whopping $1.5 trillion in reserves are now sitting in Fed reserve accounts. The Fed rebates its profits to the government after deducting its costs, and interest paid to banks is one of those costs. That means we the taxpayers are paying $36 billion annually to private banks for the privilege of parking their excess reserves at one of the most secure banks in the world – parking their reserves rather than lending them out.

The banks are getting these outsized returns while taking absolutely no risk, since the Fed as "lender of last resort" cannot go bankrupt. This is not true for other depositors, including large institutions such as the pension funds that hold our retirement money. As Matt Levine notes in a March 8 article on *Bloomberg*:

> [I]f you are a large institutional cash investor—a money-market fund, a foreign central bank, things like that—then in some sense you have no way to keep your money perfectly safe…. The closest that big non-banks normally get is "overnight general collateral repo": You give your money to a bank, and the bank gives you back a Treasury security as collateral, and you can get your money back the next day.

This arrangement is reasonably safe for the institutional investor, which can withdraw its money on a day's notice; and it gets interest that is close to 2.4%. But the bank is using the investor's money to run its business, and the bank is leveraged. The money it gets from repoing Treasuries is used to buy other things and to trade in stocks, bonds, derivatives and the like. This makes the repo business highly risky for the market as a whole, as was seen when a run on the repo market triggered the credit crisis of 2008-09. As Jennifer Taub explained the problem in a 2014 article in *The New York Times*titled "Time to Reduce Repo Run Risk":

> An overnight repo would be like you having a car loan that is due in full every morning and if the lender does not renew your loan that day, you need to find a new one, each and every day or they take your car away.
>
> When trust is strong and cash plentiful, repos are rolled over. When trust reasonably erodes, or there is a panic, cash is demanded from the repo borrowers who might have to sell the collateral or relinquish it.… Indeed, the Federal Reserve Bank of New York has repeatedly warned of the repo "fire sale" risk.

Taub cited FDIC officials Thomas Hoenig and Sheila Bair, who warned that the banks remain dangerously interconnected and vulnerable to sudden runs due to their dependence on short-term, often overnight borrowing through the multitrillion-dollar repo market.

For large institutional investors, one proposed alternative is something called "The Narrow Bank" (TNB). TNB would take large-depositor money and park it at the Fed, and that's all the bank would do. The Fed would pay 2.4%, TNB would take a small cut, and the rest would be passed to the depositors. But the Fed has refused to open this sort of pass-through account, and in a recent notice of proposed rulemaking it explained why. As Matt Levine summarized its concerns:

> [T]he Fed worries that having too safe a bank would be bad for financial stability: In times of stress, everyone will flee from the regular banks to the super-safe narrow banks, which will have the effect of bringing down the regular banks.

Besides impairing its ability to target interest rates, the Fed is worried that narrow banks will take funding away from regular banks, making it harder for those banks to trade stocks and bonds (a business largely funded by repo) as well as jeopardizing their lending business. All of which shows, says Levine, that the Fed is not a neutral arbiter. It is working for the banks:

The Fed just gets to decide who gets to compete in the banking business, and how that competition will work, and what their business models can be, by virtue of its control of access to reserve accounts.… There is no modern banking that is independent of the sovereign's power to control money, and the question is just who the sovereign shares that power with.

The European Approach: Negative Interest Rates

While US banks are being paid an unprecedented 2.4% for leaving their reserves at the Fed, the European Central Bank is taking the opposite tack: it is *charging* banks a negative interest rate of 0.4% for holding their reserves. The goal is to get banks to move the reserves off their books by making new loans. If they lend money on to the real economy, and particularly to companies, this interest payment may be rebated to the banks under a facility called “targeted longer-term refinancing operations” or TLTROs. In 2016 and 2017, the ECB returned a total of 739 billion euros to banks through TLTROs, and it is expected to renew that program, in an effort to avoid an even greater economic downturn than Europe is suffering now.

Negative interest rates were supposed to be a temporary emergency measure, but in comments on March 27, ECB President Mario Draghi hinted that they could be around for a long time if not permanently. The “new normal” is evidently a chronically abnormal state of emergency in which central banks can experiment with the formerly unthinkable and get away with it.

A Public Option for the Rest of Us

Even if large depositors were allowed to participate in the perks of Fed accounts through TNB, small depositors and small businesses would still be left with a meager 1/10th of 1% annually on their deposits. But some interesting proposals are on the table for opening the Fed’s deposit window to everyone, allowing us all to collect 2.4% on our deposits.

One such plan was presented in a June 2018 policy paper titled “Central Banking for All: A Public Option for Bank Accounts” by a trio of law professors and former Treasury advisors headed by Morgan Ricks. They suggested that for the physical infrastructure to handle so many accounts, the Fed could use the post offices peppered across the country. Postal banking has been popular for two centuries in Europe and was offered in US post offices from 1911 to 1967. Postal banks were in their heyday in the 1930s, when private banks were going bankrupt and were vulnerable to crushing bank runs. The postal banks were government-backed, paid 2% interest on deposits, and were very safe. Congress could have expanded that system into a national public utility that safely and efficiently served the banking needs of local communities. But instead it chose to back the private banking system with federal deposit insurance, guaranteeing private bank deposits with taxpayer funds – again showing how the winners and losers are picked by government officials, depending on whose lobbyists have the most clout.

To prevent public banks from competing with private banks, Congress capped the amount of interest postal banks could pay and strictly limited their lending. As a result, in 1967 the postal banking system was shut down as being no longer competitive or necessary. But efforts are now underway to revive it. In April 2018, US Sen. Kirsten Gillibrand introduced legislation that would require every US post office to provide basic banking services.

A movement is also afoot to establish state- and city-owned banks that would have the ability to lend for infrastructure and other local needs. Local governments cannot get a risk-free 2.4% from the Fed for their demand deposits, but city- or state-owned banks could. Combining postal banks with a network of local public banks having affordable access to the Fed’s deep pocket could provide a safe and efficient public banking option for individuals, businesses and local governments.

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