The REPO Bank:

A Narrow Bank Proposal

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COMMENTS WELCOME

The REPO bank is a type of narrow bank specializing in providing payment accounts which are backed by repurchase agreements. By "repurchase agreements" understand overnight loans collateralized (perhaps over-collateralized) by pledge of government securities or other high-grade securities such as mortgage-backed securities. With this asset structure, a REPO bank stands ready to provide a payments balance to anyone who can pledge adequate securities, <u>and</u> to provide securities to anyone who has a payments balance. Thus, both increases <u>and</u> decreases in the supply of payments balances are completely elastic.

Along with the REPO bank, it is to be anticipated that specialized mutual funds will arise offering accounts which could be pledged at the REPO bank. Such accounts would open the overnight loan market to smaller players and so reduce their need to hold large idle transactions balances. Since overnight REPO bank loans are essentially overdrafts, to the extent that REPO banks come to meet the transactions needs of the entire economy, aggregate transactions balances will be zero. In this respect, the REPO bank is an institutional embodiment of an ideal book entry payments mechanism.

Like other narrow bank proposals, the REPO bank proposal concerns only reform of the payments mechanism, and leaves open the question of how best to reform the system by which production and trade is financed, i.e. the credit system more generally. As it stands, the proposal takes as given a supply of high-quality marketable securities emerging from the credit system. The point of the REPO bank proposal is to use that existing credit structure in an efficient manner to support a safe and sound payments mechanism.

Some narrow bank proposals seek safety and soundness by separating the payments mechanism from the credit system (e.g. by requiring 100% reserves of Federal Reserve notes). By contrast the REPO bank proposal builds from the idea that such separation creates opportunities for arbitrage profits which tend to undermine the system over time. In order to avoid such flaws, the REPO bank proposal builds on the existing credit structure. Of course, this means that a REPO bank is vulnerable to credit market crises. It will be necessary therefore to give REPO banks access to the discount window. A general crisis in the credit market would leave REPO banks holding the collateral pledged for their overnight loans which should be more than adequate security for short-term discounts.

The REPO bank proposal differs from the money market narrow bank proposal in a number of important respects:

(1) Repurchase agreements are the nearest thing to the sight deposits of banks that we find among available open market credit instruments. By holding overnight assets, REPO narrow banks incur even less interest rate risk than money market narrow banks. Because overnight assets are fully collateralized by

liquid securities, the solvency of the REPO bank is assured. And most important, because REPOs are self-liquidating by construction, the liquidity of the REPO bank is assured. Alterations in payment flows which lead some agents to draw down their balances are easily met simply by reducing the number of REPO renewals. Since REPOs are derivative securities, fluctuations in payments balances do not disturb the underlying structure of primary credits but only affect the proportion of that structure which is pledged for repurchase.

(2) The collection of marketable securities which are eligible as collateral for a REPO is much larger than the collection of high-grade short-term securities which are the assets of money market narrow banks. Given the large amount of short-term government debt now available, this broadening of the set of eligible securities might not seem to be a compelling advantage. The point however is not to assure an adequate supply of narrow bank assets, but to minimize the distortion to the maturity structure of asset prices which arises from the financing of the payments mechanism. Proposals which would confine narrow banks to short assets have the effect of driving short rates down relative to long rates, a distortion which is absent from the REPO bank proposal.

(3) Because the assets of the REPO bank completely assure its ability to meet the payments needs of its customers, there is no reason why the REPO bank cannot affiliate with other credit

market institutions. Other narrow bank proposals founder on the observation that, given the state of existing banking institutions, separating the narrow deposit-taking bank from the broad credit-providing bank is tantamount to separating the good bank from the bad bank with a high likelihood that the bad bank will subsequently fail. Transition to a REPO bank payments system would be less traumatic since the purpose is not to separate the credit system from the payments system, but to ensure that the payments system is built on the most solid portion of the existing credit system.

(4) The market seems already to be giving us REPO banks as payments accounts, while the money market mutual funds (the nearest thing to a money market narrow bank) seem inherently limited to precautionary balances. For many years banks have held REPO positions as a secondary reserve against their demand liabilities. More recently, large banks have begun to provide sweep accounts for their corporate customers, by means of which idle payments balances are held directly as REPOs. The REPO bank proposal seeks to disentangle these market innovations from other trends in banking, and to generalize them to the payments system as a whole. The fact that the key mechanism of a REPO bank already exists in the marketplace is reassurance that the REPO bank is compatible with the existing structure of asset prices and the existing credit system.

(5) Other narrow bank plans envision little change in

current monetary control practice. To the extent that the REPO bank supports payment balances by collateralized overdrafts it eliminates transactions balances in the aggregate, and this elimination has potentially far-reaching consequences for the conduct of monetary policy. With the quantity of transactions balances fixed at zero by the REPO bank, monetary control will focus more on stabilizing the underlying credit market than controlling the quantity of money. Many narrow banking proposals (e.g. the 100% reserves plan) seek to regain control over the quantity of money. The REPO plan is built on the recognition that such control is incompatible with the existence of a sophisticated financial market. That is not of course to deny that the Federal Reserve will be able to influence market rates under the REPO plan. If narrow banks are required to hold reserves the supply of which is controlled by the Federal Reserve, then through open market operations the Federal Reserve can influence rates in the short term. It is clear however that too much dependence on this mechanism will lead to innovation which bypasses the REPO bank structure. It is in the spirit of the REPO bank proposal to limit such interventions and so to avoid presenting arbitrage opportunities which undermine the system and compromise the safety and soundness of the payments mechanism.