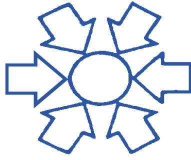

Financial Services Management

Payment-System Access

Cite

FRB, Proposed Guidelines for Evaluating Account and Services Requests

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Impact Assessment

- Although the Board does not directly say so, its eligibility construct appears clearly open to non-traditional charters, providing a benefit long limited to insured depositories and certain other tightly-regulated entities.
- Legacy banks could face far-reaching strategic challenges if non-traditional companies, perhaps including powerful tech platforms or their affiliates, gained Fed payment-system access. This might well enhance innovation but still raises finality concerns unless the Fed's risk-management eligibility criteria suffice.
- Opening payment-system eligibility could preempt alternative payment systems and cement the Fed's control over existing ones because its competitors could be crowded out.
- Forum shopping for payment-system access would be constrained, if not eliminated, stifling options for novel payors and perhaps limiting payment access for all but a few selected entities or charters that would then enjoy significant strategic advantage.
- IDIs and other firms with access to the payment system could not count on automatic continuation of such access and thus could face additional franchise risk.
- Monetary-policy transmission could change course, especially if the Fed takes reserve-like assets from nonbanks and pays interest on them.

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Overview

When the Fed announced its new instant payment system in 2020,[1] it made it clear that access would be limited to traditional insured depository institutions (IDIs) and ever since has shown no public inclination to open the system. Now, however, it is seeking views on precisely that, a move surely reflecting the OCC's decision to authorize a special-purpose fintech charter[2] and new cryptocurrency national trust banks[3] along with plans for a national payment charter and demands from tech-platform companies for payment system access either directly or via industrial loan company (ILC) and similar charters. Payment-system access is of extraordinary strategic value to financial and commercial firms because it eliminates the need for sometimes-costly intermediaries and creates a platform for additional services. However, the rationale for restricting access to IDIs has long been that less-regulated entities pose risks not only to the finality and certainty essential to payees, but also to financial stability if significant volumes of transactions are mishandled in ways that create systemic risk. The extent to which the Fed administers its new access system and the resilience of those granted access will determine safety-and-soundness results, but these could be particularly problematic if IDIs are so adversely affected by the changed competitive landscape that they cease to be a source of systemic resilience. The future of financial intermediation and thus of monetary-policy transmission are also uncertain if payment-system participants are not deposit-taking and lending institutions. The Fed is seeking views on how such a transformation would affect monetary-policy transmission but does not appear concerned with the prospect for broader structural change.

Impact

As the Board readily acknowledges in this request for comment, new technologies have combined with novel charters to raise questions about the extent to which the FRB should continue to reserve its powerful payment system for IDIs. As the Fed does not also make clear, the future of the U.S. central bank as the arbiter of payment-system governance and operation could falter if the lengthy amount of time it will take before instant payments are fully operational[4] collides with fast-paced technology that opens alternative payment-system options.

The Fed does face one private real-time payment provider, but it is limited to banking organizations and thus under its direct and indirect regulatory thumb. New payors on a new system might not be as easily governed nor as amenable to payment-system activities compatible with the Fed's monetary-policy transmission needs. This question is so compelling that, as detailed below, monetary-policy compatibility is proposed as one element for Fed access. The Fed may be able now to ensure new entrants operate as desired to gain essential access; if alternative channels develop, this is less likely and monetary-policy

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1 See **PAYMENT20**, *Financial Services Management*, August 13, 2020.

2 See **FINTECH20**, *Financial Services Management*, March 20, 2017.

3 See **CRYPTO17**, *Financial Services Management*, January 13, 2021.

4 See **PAYMENT20**, *Financial Services Management*, August 13, 2020.

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transmission could thus prove still more challenging. If the Fed alters access also to reserve accounts and interest on them, structural realignment would be still more pronounced.

The Fed's proposal would, however, give it new control over the payment system as the Fed's own services evolve. Currently, Reserve Banks have considerable discretion as to whom they grant access. Although this discretion would to some degree continue, the guidance proposes that it would be constrained within new boundaries. This may prevent one or another Reserve Bank from opening the system in ways not favored by the Board, stifling innovation but also enhancing uniformity and reducing the risk of regulatory arbitrage.

However, new entrants might go beyond the non-traditional charters noted above that currently benefit from regulatory-arbitrage advantages over legacy IDIs and holding companies. The Fed has, for example, been deeply troubled by an application in 2017 from "The Narrow Bank," a charter that would be regulated by both the State of Connecticut and FDIC.[5] The Fed feared that this bank's business threatened both monetary policy and financial stability and likely now seeks to ensure it can prevent any future proposals more quickly and certainly.

Further, the Fed has little to no control over novel charters that do not elect to be state member banks. An increasing number of these are seeking IDI charters via the FDIC through the ILC window for which payment-system membership in the past has been essentially automatic. Although the FDIC recently issued a final rule applying what it says are parent-company standards akin to the Fed's source-of-strength requirement for BHCs,[6] the Fed disagrees about the extent to which standards for these firms compare to those it demands. When a parent company is a firm with the market power of Google, this gives the Fed particular pause, making its control over payment-system access a still more compelling concern.

As noted below, the first eligibility principle is that the firm be legally eligible to access the Fed's payment system. The proposal states that the Board is considering whether these legal standards should be elucidated, but does not now ask for views on this question. It is sure to receive them given that the proposal expressly states that additional eligibility criteria would apply to non-IDIs, implicitly countenancing approval based on a Reserve Bank's risk assessment under these new criteria. The Board does state that member banks are generally clearly eligible, but current law goes on to confer eligibility also to state nonmember banks such as the nontraditional charters described above, to credit unions, and certain other charters without also making clear that these authorizations are exclusive.

The Fed appears to believe the law now gives it wide latitude both within enunciated cases in current law and beyond. The proposal also states that the

[5] See **CHARTER25**, *Financial Services Management*, March 18, 2019.

[6] See **ILC15**, *Financial Services Management*, December 21, 2020.

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Fed determines eligibility not only by the law, but also by its goals (e.g., innovation, inclusion, safety, finality, monetary policy); legal eligibility alone does not grant access – a statement that gives Reserve Banks more grounds on which to condition access but that also provides for approval even if certain criteria are not expressly met.

The Fed also states that the risks detailed in the principles are similar to those governing banks but does not expressly stipulate that risk measurement and mitigation would need to be done as required of banks nor could the Fed examine nonbanks to ensure conditions remain satisfactory as is done routinely with IDIs and other entities that currently enjoy payment-system access. The proposal also says that other federal and state regulatory views of an institution will be considered "where possible" but does not condition access on any such regulator, saying only that access decisions for non-IDIs may take more time.

The proposal also notes that an institution's access might pose risks, but its access might still have "net benefits" to the financial system that are "not a focus" of the risk-management framework. It is unclear when or how this might occur. Depending on how this latitude is granted, entities might gain access on an array of policy criteria that further cloud the benefits of IDI status as a key to payment-system access. However, the system might become more inclusive, more efficient, or otherwise enhanced as a result.

Although the guidance is designed for new entrants, the Board specifies that it should also be used by Reserve Banks to assess risk for all participating payors. It seems unlikely that a newly-risky participant would be barred access outside extraordinary circumstances as this is essentially a charter's death sentence with significant market and prudential implications. However, the Board stipulates that Reserve Banks could mandate risk-mitigation measures that could have significant cost and strategy impact for affected firms as well as reduce the Federal Reserve System's own risk exposure. Reserve Banks have long had most of these powers but rarely used them; with this restatement of these sanctions and new emphasis on them, payment-system access could become more conditional.

Finally, this proposal is significant not only in its own right, but also in conjunction with an array of pending central-bank digital-currency (CBDC) initiatives. The combined force of a CBDC and still broader Fed control over a payment system with even greater reach could make the U.S. central bank not only the regulatory arbiter of financial market utilities, but also the most important one there is. Were this power further combined with the "FedAccount" proposal advanced by Senate Banking Committee Chairman Brown,[7] the Fed would control most of the funding and virtually all of the payment-system channels essential to financial intermediation. The implications of so sweeping a structural change would be profound not only with respect to economic growth, credit allocation, privacy, systemic integrity, and monetary-policy transmission, but also of economic equality, privacy, and tenets of U.S. assumptions about the economic role of the federal government.

[7] See **CBDC**, *Financial Services Management*, April 16, 2020.

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What's Next

The Federal Reserve Board voted unanimously to approve the proposal, which was released on May 5. Comment is due sixty days after *Federal Register* publication.

Analysis

A. Framework

As noted, these criteria would cover new requests for payment-system access as well as ongoing Reserve Bank evaluation of existing payors.

B. Eligibility Criteria

In addition to the criteria describe below, Reserve Banks would also need to determine if access approval sets precedent, presumably consulting with the Board in such cases. Reserve Banks are free upon granting access or thereafter to do so conditionally (i.e., with real-time monitoring, paying a different rate of interest, payment caps). The Board also states that a Reserve Bank access decision does not constitute a Board endorsement – an issue that may come into play as approved companies begin to market their services.

Although not categorized as the Fed does in the proposal, conditions Reserve Banks would need to consider include:

- Legal Eligibility: This will be judged by reference to the Federal Reserve Act, "other" federal statutes, and the extent to which a payor has a clear legal framework governing its own operations and abides by applicable law. It is not clear if an eligible entity must meet all these conditions, but drafting suggests Reserve Banks are also to assess the extent to which a payor's activities endanger AML/CFT, sanctions, or consumer-protection compliance.
- Risk: The proposal details the risks Reserve Banks are to consider in terms of both those a payor poses to the Fed and the system as well as those inherent in the payor's own operations with regard to its risk-management and -mitigation strategies. These requirements echo much mandated for IDIs in terms of risk management, audit, and controls. Reserve Banks are also to determine compliance with applicable state and federal regulation but being subject to a specific regulator does not appear to be a criterion for eligibility.
- Financial Condition: Reserve Banks must find a payor to be sound by criteria detailed in the proposal.
- Settlement Processes: The payor must also demonstrate capabilities in this area on standards also detailed by the Board.
- Systemic Risk: The eligibility criteria also require Reserve Bank assessment of a payor's impact across the payment and financial system and its recovery and resolvability capabilities. Reflecting the Fed's desire that Reserve Banks not create precedent, this systemic-risk assessment must consider not only the

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systemic risk a payor itself might pose if granted access, but also that of like-kind entities. The Board also notes here that entities without capital requirements akin to those for banks could disintermediate the financial system under stress due to sudden funding inflows, amplifying stress.

- Monetary-Policy Transmission: As noted, access should not endanger this, with Reserve Banks again told not only to look at the payor seeking or retaining access, but also like-kind institutions. Factors to be considered include reserve-balance impact, short-term funding market implications, and changes to Reserve Bank balance sheets. Review should go through the cycle and not be limited to current monetary policy.

C. Request for Comment

The Board seeks views on matters including:

- whether all risks are appropriately addressed;
- clarity and specificity;
- the extent to which the guidelines support responsible financial innovation; and
- if there are other ways to address access requests equitably and consistently.

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