Payment System Access

Cite
Federal Reserve Board, Guidelines for Evaluating Account and Services Requests

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Impact Assessment

- Despite the Fed's effort to clarify payment-system access, its criteria and process remain opaque.
- Structural reform may thus come via idiosyncratic Reserve Bank decisions, not express and transparent federal-policy action.
- Payment-system access for major nonbanks or even commercial companies is possible under the new definition of eligible charters.
- Significant competitive disparities could result along with heightened regulatory arbitrage, although innovation might advance in concert with renewed balance between state and federal regulators.

Overview

Following considerable controversy surrounding how Federal Reserve Banks grant master accounts,[1] it has finalized a somewhat more explicit set of guidelines along lines proposed the second time the Fed attempted to set guidelines via a "supplemental" proposal earlier this year[2] amending its 2021 effort.[3] Doubtless expecting the controversy which followed these final guidelines, the Fed was at pains in both the preamble and release to emphasize that the new standards are "transparent and equitable." However, as noted below, some changes to the supplemental in fact increase Fed and/or Reserve-Bank discretion to grant or deny payment-system accounts on a case-by-case basis above and beyond the specifics again provided related to different charters and risks. Thus, as in other versions, the final guidelines likely give expedited and certain access to traditional banking organizations with Fed-

1 See *Client Report* **FEDERALRESERVE70**, June 22, 2022.

2 See **PAYMENT24**, *Financial Services Management*, March 9, 2022.

3 See **PAYMENT22**, *Financial Services Management*, May 10, 2021.

supervised BHCs, but what otherwise constitutes an eligible BHC and the extent to which even very non-traditional charters would gain access is still uncertain. Still, it seems likely that at least some non-traditional banking organizations will gain payment-system access providing them a major competitive boost, especially if Reserve Bank approvals do not insist on the costly standards applicable to insured depositories and Fed-regulated BHCs.

Impact

The initial proposal, which was substantively repeated in the supplemental and now in these final guidelines, laid out factors Reserve Banks are to consider in granting access to master accounts and related services. This perhaps better described the Fed's process, but it did not significantly constrain Reserve-Bank discretion or provide procedural certainty given the broad nature (e.g., safety and soundness) of its goals and the often-subjective nature of judgments related to them. For example, the opinions of other regulators about the extent to which an applicant company meets the Board's principles must be considered by Reserve Banks, but "only to the extent possible," further preserving Reserve Bank discretion and perhaps even increasing the odds of inter-agency disputes. As discussed below, the Board also decided against making its decisions transparent or setting firm timelines or appeals processes.

The final three-tier process for Reserve Bank deliberations sets out a process for streamlined, "intermediate," and additional scrutiny based on an applicant's charter. However, there is broad discretion for Reserve Banks to approve or deny applicants regardless of their tier or the views of other agencies or Reserve Banks. The final standards also seem to allow the FRB and/or Reserve Banks (this is not made clear) additional discretion to consider nonbank holding companies to be the equivalent of BHCs if a parent company commits to abide by Fed standards. When this would occur and under what terms or transparency is also not made clear, perhaps allowing companies that own entities seeking payment-system access to satisfy one or more Reserve Banks regarding regulation even if the activities the parent company conducts (e.g., commerce) differ markedly from those allowed to a BHC.

The final guidelines also do not address other ways in which payment-system determinations could vary widely across the country with significant implications for the entire U.S., in which payment-system access is not limited to any individual Reserve Bank district. There are twelve Reserve Banks, thus allowing for many different approaches and a patchwork of standards. This will likely lead to clusters of charters in favorable Reserve Bank districts competing with like-kind companies hoping to set up shop elsewhere in the U.S. not granted this franchise-critical privilege. Significant structural change to the payment system might thus occur without the clear approval of the Federal Reserve or the policy transparency necessary to inform Congressional judgment about the extent to which non-traditional or riskier banks warrant payment-system access.

The final guidelines also reiterate that all entities granted payment-system access must comply with all existing rules judged by reference to its operations. What this means in practice for non-traditional companies, especially those outside the reach of federal and often also state regulation remains unclear, with the final statement suggesting that entities without rules might still qualify for access and/or that small companies unable yet to meet certain standards or otherwise exempt from them might gain access even though larger unregulated companies do not. The extent to which each Reserve Bank does or does not impose risk-mitigation conditions or deny certain

applications that may appear qualified will drive the extent to which the Board's transparency and equity objectives are met in practice. It may prove particularly difficult to judge this because the Board denied requests to make public the list of entities granted payment-system access on grounds that this is confidential business information. The Board has also decided against creating a list of eligible charters or setting any other specific legal-eligibility standards beyond those broadly mandated in law. There are also no procedural standards, allowing each Reserve Bank to take as much or as little time as desired without either the applicant or public having insight into these decisions.

Perhaps the most significant change in the final guidelines from the second proposal is more comparable treatment for state and federal charters. Although commenters likely hoped that comparability would liberalize treatment of non-traditional state charters, the final standards instead narrow the scope of national banks without deposit insurance that are eligible for second-tier expedited consideration only to those with a Fed-supervised parent holding company or one that has made "commitments" to adhere to like-kind standards which as noted may mean with regard to prudential standards, activities or whatever a Reserve Bank thinks suffice. This second tier now also makes it still more clear these companies will be considered on a case-by-case, risk-based basis regardless of which tier they seem nominally suited.

Comments on the earlier proposals urged the Board to also expressly monitor non-traditional companies and/or to make public the results of its reviews or subsequent continued-eligibility decisions. This was not done, making it possible that Reserve Banks could lose sight of companies outside the effective, ongoing supervision of federal or state regulators and allow continued payment-system access at risk to industry competitiveness and stability. The Board has also decided against conditional approvals for nontraditional companies, meaning that even the riskiest firms allowed entry would be allowed to operate nationwide even if another Reserve Bank came to disagree with its access unless this dispute is resolved in favor of the host Reserve Bank or the Board successfully intervenes.

What's Next

These final guidelines were released on August 15, the same date the Fed faced a deadline to respond to litigation from a digital-asset company protesting the Fed's longstanding refusal to rule on its master-account application. The standards are effective upon publication in the *Federal Register*, leading to speculation that the Fed will quickly act on this and other stalled requests. However, in voting to approve the guidance, Gov. Michelle Bowman cautioned not to expect expedited treatment, noting significant issues remained unresolved. Whether the Board and Reserve Banks agree with her is unclear, but the final standards do stipulate an implementation phase-in during which the Board and Reserve Banks will "expeditiously" develop a plan to promote consistency. Rejecting comments, the final standards do not include any timeline during which Reserve Banks must notify applicants and/or decide on access requests.

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Analysis

I. Principles

With the exception of payment-system access related to fiscal agents, financial-market utilities, and certain other cases, the principles governing Board and Reserve-Bank review of access requests are:

- Each institution receiving a master account must be eligible under federal law to do so and have a well-founded, clear, and enforceable legal basis. Reserve Banks are to access activities in light of relevant law and determine if access could adversely affect sanction compliance, AML requirements, and consumer protection.
- Account services should not pose undue risks (including cyber-risk), taking into account possible views of other federal and state regulators, and ensure the institution has an effective risk-management program, with criteria for evaluating this detailed in the guidelines. The company should be in substantial compliance with all regulatory and supervisory requirements and demonstrate the ability to comply with all standards associated with AML, sanctions enforcement, and payment-system access under stress conditions.
- The institution should not present risk to the payment or financial system determined by criteria also spelled out in the guidance. Again, there are many details here and, combined with those in the other principles, lay out a set of findings intended to form a safety-and-soundness construct.

Payment-system access by the institution in question or a group of like-kind institutions should not undermine the Fed's ability to transmit monetary policy under benign and stress conditions evidenced by factors detailed in the guidance. A Reserve Bank could make this decision on its own or consult with other Banks and/or the Board.

II. Review Criteria

As noted above, it is not sufficient for an institution simply to fall within one of these tiers to be assured that, if it believes that it meets these criteria, then it will gain payment-system access. Conversely, falling into the third tier does not mean access will be denied. Reserve Banks are to make these calls in consultation with each other and on a case-by-case basis, when possible taking views of state and federal regulators into account. Any request that sets a precedent which might affect the Fed's overall ability to achieve its policy goals in areas such as financial stability and monetary policy may also receive additional review or experience requests for additional risk mitigation or even rejection. Payment-system access may be revoked if an institution's risk profile rises to levels deemed unacceptable by a Reserve Bank.

A. Tier 1

This governs insured depositories and would generally lead to relatively simple approval unless an IDI is identified as posing higher risk.

B. Tier 2

This governs institutions that are not insured but are covered under a federal or state statutory set of prudential standards or fall under BHCs under FRB supervision under law or "commitment." Holding companies not under statutory FRB control would thus

be eligible if the company involved agreed to comply with Fed-comparable standards for prudential rules, activities, or whatever criteria satisfies the Fed and/or a Reserve Bank. Edge and Agreement Act Corporations and branches of and agencies of foreign banks fall into this tier.

These entities would receive an "intermediate" level of review. This is said to be similar to that for Tier 1 but more intensive; in what way or how long this might take compared to Tier 1 is not prescribed.

C. Tier 3

This covers institutions eligible for payment-system access that do not fall under either Tier 1 or 2, although there appears to be some contradiction with Tier 2 in that entities under a state set of prudential standards without a holding company do not appear to be within this tier unless they are also under federal supervision or have an approved BHC. State regulation alone does not appear to suffice even though federal supervision does even in the absence of an approved form of BHC. These review standards would be the strictest, but again how Reserve Banks would proceed, the extent to which different Reserve Banks would view standards in the same light, or how long this might take is not spelled out.

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