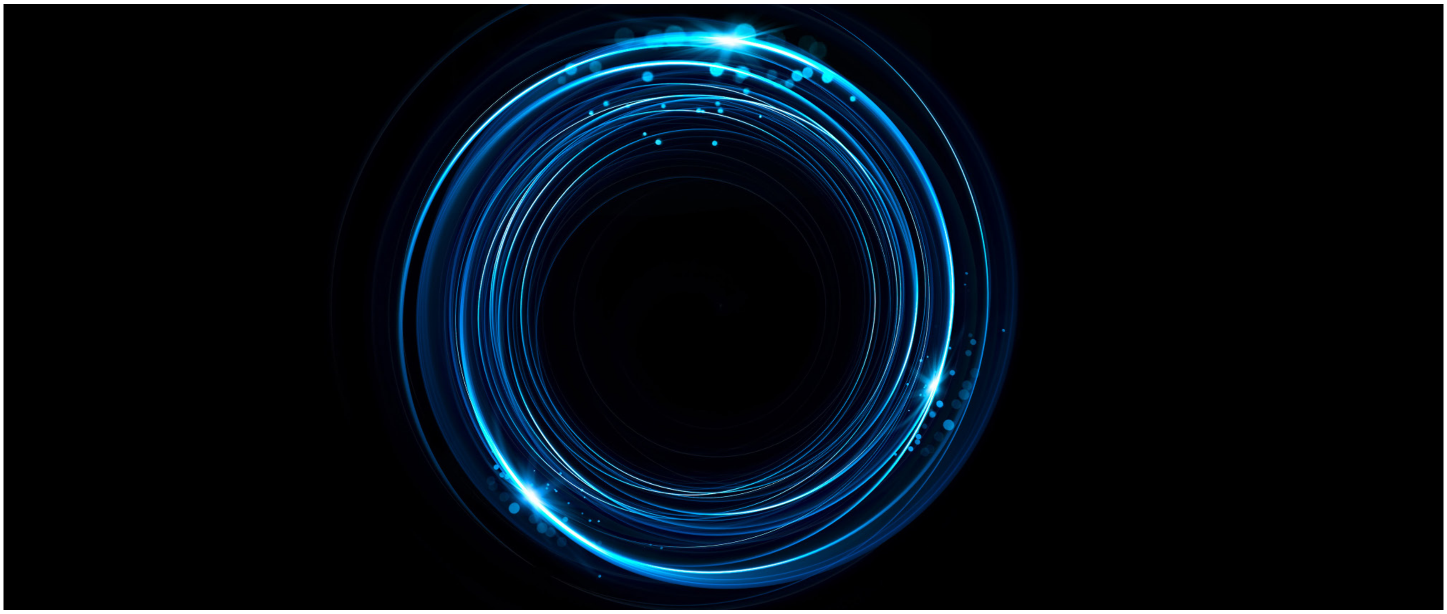

Federal Reserve Board (FRB) clarifies guidance for novel institutions seeking access to US payment system

New technologies have emerged in recent years that are transforming the financial system at a rapid pace. Emergent and incumbent financial services firms that leverage these technologies are changing entire sections of the ecosystem by identifying new ways to utilize existing US financial services infrastructure. In parallel, regulators are working to understand the intersection of traditional and novel institutions to incorporate a comprehensive framework on the sector.

Recent regulatory guidance, including by the FRB, the Basel Committee on Banking Supervision (BCBS) and individually and jointly by the Federal Financial Institutions Examination Council (FFIEC) members, have focused on emerging risks and risk management expectations around new technologies and platforms (e.g., digital assets, fintech, cloud computing), financial and operational resilience, anti-money laundering, consumer protection, and board and management governance. Increased digitization of payments infrastructure and mobile technologies are also raising questions around the providers of services and their connectivity to the traditional banking system. In a recent speech, Federal Reserve Board (FRB) Chair Jerome H. Powell said the FRB has been "carefully monitoring and adapting to the technological innovations now transforming the world of payments, finance, and banking."[1]

On May 5, 2021, the FRB released a notice requesting comment on proposed guidelines for Reserve Banks to establishing accounts at the Federal Reserve including with respect to novel institutions with non-traditional bank charter types that are looking to access accounts and services provided by Federal Reserve Banks.[2] This includes access to the payments system offered by the Federal Reserve Banks, which reduces institutions' reliance on third parties and brings cost efficiencies. The proposed guidelines are designed to provide a consistent framework across the Reserve Banks to evaluate requests to establish accounts at, and obtain other financial services provided by, the Federal Reserve System. The guidelines are also intended to ensure that each of the Reserve Banks evaluate a transparent and consistent set of factors when reviewing requests for access to Federal Reserve Bank accounts and services.[3]

The FRB's proposal comes at a broader industry crossroads. Over the last couple of years, there has been a wave of new entrants in the US banking system, including neo-banks and fintechs[4] and new crypto service providers.[5] This is coupled with a wave of technological advancements enabling modernization and digitization of banking services.[6] These new entrants increasingly want access to the Federal Reserve payment system for various reasons, including building a bridge between blockchain-enabled payments and existing payment rails and processing payments without relying on partnerships with correspondent banks.

Payment Channels Volume and Market Share[7]

Counts And Values Of Transactions Processed By Different Channels In 2020			
Payment Channels		**Payments Processed**	
		Count	Total value
Large Dollar Wholesale Payments	Fedwire	180 M +	$840 T +
	CHIPS	120 M +	$530 T
Automated Clearing House		~ 26 B	NA

Key Highlights

The FRB's proposed guidelines contain six principles that aim to support consistency in approach and decision-making across all twelve Reserve Banks. Although these principles are not new to the US banking industry and "depository institutions," they provide a roadmap for novel institutions that could have challenges meeting these hurdles:

- The principles re-enforce the underpinnings of what current access means and criteria for a Federal Reserve "master account". The impact is likely to add additional emphasis on evaluating applicants' risk management and mitigation capability.
- The benefits of federal payments account and federal services comes at the cost of added regulatory compliance burden that includes potential enhancements to customary risk management concepts issued by bank regulators.
- New-age fintechs with modern technologies would have to demonstrate regulatory compliance, risk management readiness, and operational resilience to gain access to the federal payment system, presumably utilizing the same standards required for size, complexity, and business activities of traditional banks/ depository institutions.
- Applicants would need to establish or enhance existing risk management framework and governance arrangements, including compliance risk program (with emphasis on Bank Secrecy Act [(BSA)/ant-money laundering (AML)], operational risk (with emphasis on resiliency, cybersecurity risk controls, and IT infrastructure/ business continuity) policies, and internal controls (based upon operational payment systems).
- Applicants' size/market share and resultant potential to impact the broader financial system at a macro-economic level through financial stability would also come under the regulatory lens with interest in US and cross-border payments.
- The approach would be "fairly straightforward in most cases" for federally insured depository institutions; however, it may require "more extensive due diligence" for non-federally insured institutions.[8]
- Principles would ensure consistency across the Federal Reserve System.[9]

The FRB approach to access is driven by an application process, where the access applicant is viewed as a "counterparty" and evaluated based on an independent analysis of their risk profile. So, applicants need to understand that over and above the principles, the respective account-holding Reserve Bank retains the discretion to place additional risk management controls on the account and services, as it may deem necessary to mitigate risks. It may impose further obligations during the access approval process and thereafter, relating to operational, credit, legal, or other risks posed to the Reserve Banks, the payment system, or broader financial stability. The impact to an institution will depend on the capabilities built and developed during the various state and federal application processes.

Proposed Principles and their potential impact...

Principle 1: Eligibility

Each institution requesting an account or services must be eligible under the Federal Reserve Act or other federal statutes to maintain an account at a Federal Reserve Bank and receive Federal Reserve services and should have a well-founded, clear, transparent, and enforceable legal basis for its operations.

- Only those entities that are member banks or meet the definition of a depository institution under the Federal Reserve Act are legally eligible to apply for account access.
- The Reserve Bank would assess the consistency of the applicant's activities and services and compliance with key banking laws such as BSA/AML requirements, or consumer protection laws.
- Definitions of "member bank", "depository institution" as defined by the Federal Reserve Act's Section 19(b) is foundational for the application of these principles.[10]

Principle 2: Safety and soundness

Provision of an account and services to an institution should not present or create undue credit, operational, settlement, cyber, or other risks to the Reserve Bank

- Impacts will be focused on "to the Reserve Bank," but rely on the below capabilities:
  - Applicant's institution needs to have an effective risk management framework and governance arrangements to ensure it is compliant:

  - This includes having policies, procedures, systems, and controls to manage applicable risks and effective implementation across three lines-of-defense.
  - Risk types of emphasis would consist of credit risk, compliance risk, operational risk, liquidity risk, and broader approach to operational resiliency.
  - Risk management capabilities should cover typical risk lifecycle, identify, measure, mitigate, monitor and report.
  - Should demonstrate connectivity to existing regulatory expectations and guidance.
- The institution must maintain adequate levels of capital and sufficient liquid resources to meet its obligations to the Reserve Bank.
- Effectiveness of the risk management framework must be supported by internal testing and internal audit reviews.
- There must be appropriate oversight by board of directors (and other types of relevant governance forums) and senior management in place.
- There must be an operational risk framework to ensure operational resiliency, a business continuity plan, and policies and procedures for identifying risks:

Principle 3: Payment system stability

Provision of an account and services to an institution should not present or create undue credit, liquidity, operational, settlement, cyber, or other risks to the overall payment system

- Capabilities as noted in Principle 2 should be developed and relied upon with a focus on the overall payment system.

Principle 4: Financial system stability

Provision of an account and services to an institution should not create undue risk to the stability of the US financial system

- In times of financial or economic stress, or liquidity or other strains, the applicant must demonstrate that the business activities and the resultant risks will not be transmitted to other segments of the financial system. There must be effective checks and controls in place to manage all risks appropriately.
- The institution and its activities must not adversely affect the deposit balances across the US financial institutions more broadly or have a deleterious effect on US financial stability.

Principle 5: Prevention of fraudulent and criminal activities

Provision of an account and services to an institution should not create undue risk to the overall economy by facilitating activities such as money laundering, terrorism financing, fraud, cybercrimes, or other illicit activity

- The applicant must ensure there is a well-established AML program consistent with the requirements in 31 CFR 1020.210 - Anti-money laundering program requirements for banks, and in compliance with the Office of Foreign Asset Control (OFAC) regulations.
- The AML program must include a system of internal controls, including policies and procedures, and independent audit and testing of BSA/AML and OFAC compliance.
- The institution must be able to demonstrate senior management commitment to BSA/AML and OFAC compliance and have ongoing training for appropriate personnel at every level.

Principle 6: Macro-economic stability

Provision of an account and services to an institution should not adversely affect the Federal Reserve's ability to implement monetary policy

- The applicant's business activities should be well-diversified and balanced to not affect the level and variability of the demand and supply of reserves.
- The institution must demonstrate the ability to maintain adequate capital and be in sound financial condition not to disrupt or warrant any volatility in key policy interest rates and the structure of the funding markets.
- Maintaining sufficient liquid resources to meet obligations is crucial to gain regulators' confidence.

Next steps

The proposed guidelines are expected to draw significant interest through this comment period that extends 60 days after the publication in the Federal Register (on May 5, 2021). These Federal Reserve Master Account Access Guidelines will require an integrated end-to-end risk management framework to analyze and the self-assess application of the guidelines at the novel institution. The proposal defines the requirements and expectations on how to gain access to the payments system. However, obtaining a charter will not automatically grant access. Institutions should consider having a sound risk and compliance framework across the three lines of defense and demonstrate operational resilience in business activities to win regulators' confidence. New applicants must take a cue and tailor their charter applications to specifically address the requirements and considerations presented in the proposed guidelines.

Key considerations…

- Analysis for banking charters and application process should consider these proposed guidelines in their business case and timelines to evaluate and implement risk and compliance systems.
- Applicants' business case and application should include detailed information on risk identification and assessment process, records, systems, controls, and overall risk governance.
- Evaluation of current state against requirements and future capabilities will also require thorough assessment and understanding of key FRB Operating Circulars (e.g., Operating Circular #5 that includes electronic access requirements, security measures).[11]

- Applicants should address within the context of not only initial design and build, but also for sustainability, when a federal master account is granted.
- While all institutions pose some risk, the key differentiator will likely be to demonstrate how the applicant's business model poses "acceptable risk" to FDIC deposit insurance fund and broader financial system, if applicable.
- Building a monitoring process to evaluate the regulatory landscape over the medium to long term, particularly for these guidelines and the evolution of central bank digital currencies including Central Bank Digital Currencies (CBDCs), and the FRB's approach on it, will be key.[12]

While access to the federal system may appear daunting at first, its many long-term strategic advantages may, for some applicants, outweigh the initial costs. As novel institutions and banking ecosystems further evolve and intertwine, time will tell how far novel institutions would go with federal account access relative to their nonbank peers.

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Contacts

John Graetz
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Joan Cheney
Managing Director | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Ken Lamar
Independent Senior Advisor to Deloitte & Touche LLP

Peter Phelan
Independent Senior Advisor to Deloitte & Touche LLP

Richard Rosenthal
Senior Manager | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Megan Jones
Consultant | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Sonali Singh
Senior Manager | Deloitte Risk & Financial Advisory
Deloitte & Touche Assurance & Enterprise Risk Services India Private Limited

Prateek Saha
Senior Consultant | Deloitte Risk & Financial Advisory
Deloitte & Touche Assurance & Enterprise Risk Services India Private Limited

Deloitte Center for Regulatory Strategy

Irena Gecas-McCarthy
FSI Director, Deloitte Center for Regulatory Strategy, Americas
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Austin Tuell
Manager| Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Kyle Cooke
Senior Consultant | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP

Deloitte.