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Tiering Introduced for US Payments System Access

As the gatekeepers of the Federal Reserve payments system, the twelve regional Federal Reserve Banks (Reserve Banks) are tasked with the analysis of requests for Federal Reserve accounts and services at their respective Reserve Bank, with oversight from the Federal Reserve Board. Questions and focus on payment system access has gained significant attention in the context of business model developments in the banking sector involving fintech companies and crypto natives seeking access to the US payment system. On March 2, 2022, the Federal Reserve issued updated guidance (2022 Guidelines)[I] regarding payment system access, introducing a three-tiered system for Reserve Banks to use in analyzing requests for that access, while reiterating the six principles for account access evaluation contained in its 2021 guidance (2021 Guidelines)[II]. On the heels of recent congressional inquiry, related to the merits of the payment system access process, the 2022 Guidelines signal the Federal Reserve's intent to further stratify and tier payment system access requests.

The 2022 Guidelines will likely have significant impacts to legal entity structure and capabilities required to obtain Federal Reserve account access. The Federal Reserve has established a 45-day public comment period, which closes on April 22, 2022.

<u>Overview and Comparison of Principles</u>

The 2021 Guidelines established six principles to promote uniformity of request evaluation and decision-making considerations across Reserve Banks. The 2022 Guidelines leveraged these six principles making only minor cosmetic or no changes to principles 1, 2, 3, and 6. In contrast, principles 4 and 5 were adjusted as follows:

Six Principles for Considering FRB Account Services Requests	
Principle 1	**Summary:** "Each institution requesting an account or services must be eligible under the Federal Reserve Act or other federal statute to maintain an account at a Federal Reserve Bank (Reserve Bank) and receive Federal Reserve services and should have a well-founded, clear, transparent, and enforceable legal basis for its operations." **Key Revisions – 2022 Guidelines:** None
Principle 2	**Summary:** "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." **Key Revisions – 2022 Guidelines:** None
Principle 3	**Summary:** "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." **Key Revisions – 2022 Guidelines:** None

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Six Principles for Considering FRB Account Services Requests *(Continued)*[iii]	
Principle 4	Summary: "Provision of an account and services to an institution should not create undue risk to the stability of the U.S. financial system." Key Revisions – 2022 Guidelines: Clarifying clause regarding capital requirements was added.
Principle 5	Summary: "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, economic or trade sanctions violations, or other illicit activity." Key Revisions – 2022 Guidelines: Reference to the BSA/AML compliance framework was added as opposed to "anti-money laundering and Office of Foreign Assets Control (OFAC)." The BSA/AML compliance program requirements are driven by the Federal Financial Institutions Examination Council (FFIEC) BSA/AML Manual, and the Federal Reserve acknowledges that guidelines may be updated and subject to change. The OFAC program requirements are still included but have been separated into their own sub-principle 5.c
Principle 6	Summary: "Provision of an account and services to an institution should not adversely affect the Federal Reserve's ability to implement monetary policy." Key Revisions – 2022 Guidelines: None

Tiering Structure

Previously, the 2021 Guidelines set forth a bifurcated approach, bucketing requests based on the presence of federal insurance (federally insured or non-federally insured) and setting the expectation that reviews of requests for non-federally insured firms would be more in-depth. To increase transparency of the review process, the recently issued 2022 Guidelines set forth three tiers into which each applicant would be placed. These tiers would influence the nature and extent of the review process.

Summary of Tiering Structure – 2022 Guidelines			
	Tier 1	*Tier 2*	*Tier 3*
Eligible Institutions	Institutions are: • Federally insured.	Institutions are: • Not federally insured but subject to prudential supervision at the institution level by a federal banking agency (by statute), and • Subject to prudential supervision by a federal banking agency and, if applicable, at the holding company level (by statute or commitments).	Institutions are: • Not federally insured and • Not subject to prudential supervision by a federal banking agency at the institution or holding company level.
Level of Regulatory Supervision	Subject to a standard, strict, and comprehensive set of federal banking regulations.	Subject to similar but not identical regulations as federally insured institutions (Tier 1) i.e., they may comply with similar requirements as holding companies subject to the Bank Holding Company Act.	Subject to a supervisory or regulatory framework that is substantially different from, and less rigorous than, the supervisory and regulatory framework that applies to federally insured institutions.
Risk Level	Poses less risk; however, if the application identifies potentially higher risk profiles, the institutions will receive additional attention.	Though subject to similar regulatory supervision like Tier 1 institutions, they may still present greater risks.	May pose the highest level of risk.
Stringency of Review	Access requests will generally be subject to a less intensive and more streamlined review.	Access requests will generally receive an intermediate level of review.	Access requests will generally receive the strictest level of review.
Availability of Supporting Documentation	Detailed regulatory and financial information will be readily and publicly available.	Detailed regulatory and financial information may be less available or may not be available in public form.	Detailed regulatory and financial information may not exist or may be unavailable.

Potential Impact and Implications of Tiering

The 2022 Guidelines are likely to have significant implications for fintechs, crypto natives, banks, and other firms depending on their respective legal entity structure and existing licensing. It is unclear if the approach outlined in the 2022 Guidelines would modify the duration and nature of the Reserve Banks' review processes, particularly for Tier 3 firms. However, several important nuances within the tiering framework may have an influence on tier designation and the intensity of the request review process.

With Tier 1 firms being the most straightforward group of firms, it is important to look further into the criteria for firms that fall in Tiers 2 and 3. The distinction between Tiers 2 and 3 is the presence of federal banking agency supervision at both the institution and its holding company. Regarding the "if applicable" language in the description of eligible institutions in Tier 2 and relating to holding company supervision, we understand that market participants are reading this clause to mean "if the institution has a holding company." That interpretation may be confirmed by the Federal Reserve over time. In the meantime, significant additional questions remain unanswered such as:

Key Focus Areas

1. What are the benefits and costs of being considered a Tier 2 firm – are Tier 2 firms more likely to be approved for account access vs a Tier 3 firm? Will the ongoing supervisory process provide consistent benefits for Tier 2 firms? Will the Tier 2 review process be quicker than the Tier 3 process?
2. Do firms that are applying to the Office of the Comptroller of the Currency (OCC) for a non-depository limited purpose national trust company (LPNT) charter, now need to commit to the Federal Reserve's consolidated supervisory program for bank holding companies in order to gain Federal Reserve membership and account access?
3. What actual commitment requirements would apply to any such holding company?
4. Why would Tier 2 be limited to institutions that are subject to federal banking agency supervision by statute, while their parent companies can satisfy this "federal" requirement by making commitments rather than having a statutory mandate?

The answers to these questions, and others likely to be raised by those who chose to comment, might have important impacts on the license choice for many firms looking for direct payments system access (e.g., is it worth just pursuing a full national or FDIC-insured state banking license – which would clearly place the resultant firm in Tier 1?). It is clear that firms will need to communicate their concerns during the public comment period and to the extent possible, engage in the rulemaking process to further tailor and clarify the range of potential impacts and ensure that the finalized 2022 Guidelines meet their needs.

Some key foundational areas may impact the requesting firm's choice between Tier 2 and Tier 3 [i]:

- What is the desired strategy and long-term vision?
- What is the existing legal entity structure and set-up of the firm?
- What are the potential impacts of holding company supervision?

For Tier 3 firms, enhanced coordination between the Reserve Banks and the Federal Reserve Board may be necessary given the diverse types of state licensed or chartered entities that are not also supervised by a federal banking regulator, with varying and non-uniform regulatory requirements, that are now requesting or may in the future request access. The 2022 Guidelines clearly communicate that requests from Tier 3 firms will receive the most scrutiny. This would be consistent with the Federal Reserve's statement that these firms may not have existing or readily available financials or regulatory information, which could also contribute to an extended review timeframe. Tier 3 firms are clearly viewed by the Federal Reserve as presenting a greater amount of risk compared to the holding companies in the first and second tiers, prompting what could be an extremely rigorous and time-consuming review process.

Key Considerations

The 2022 Guidelines provide clarification on the consistent use of an increasingly transparent principles-based review process. However, each request is reviewed individually, with final approval or denial made by the reviewing Reserve Bank. The 2022 Guidelines further suggest that Reserve Banks would follow a collaborative approach to processing incoming requests, possibly including centralized consultation with the Federal Reserve Board, and push for the need to have consolidated supervision at the parent level. Ultimately, Reserve Banks are responsible for managing the review process with regards to existing policy goals covering safety and soundness, monetary policy, financial stability, consumer protection, and the protection of the payment system, all of which imply severely risk-averse decision-making.

While the 2022 Guidelines clarify the Reserve Banks' core considerations, several questions are raised about how licensing, structuring, and forward-looking strategy may affect the outcome of requests. Firms that have pursued chartering LPNTs may need to consider alternative means to gain payment system access.

How should firms show-up or level-up to better position themselves prior to starting the access request process? Should firms map out an alternative route to obtain payment system access, preferably through an entity that is already federally insured and supervised? As the 2022 Guidelines are finalized, understanding the tiering criteria and the extent of the corresponding review will be critical for firms in advance of preparing requests.[v]

Endnotes

i. Federal Reserve Board (FRB), "Federal Reserve Board - Federal Reserve Board invites public comment on supplement to its May 2021 proposal" March 1, 2022.
ii. FRB, "Federal Reserve Board - Federal Reserve Board invites public comment on proposed guidelines to evaluate requests for accounts and payment services at Federal Reserve Banks" May 5, 2021.
iii. FRB, "Federal Reserve Board - Federal Reserve Board invites public comment on supplement to its May 2021 proposal" March 1, 2022.
iv. Ibid.
v. For a more comprehensive outline of banking charters and the corresponding permissibility of activities see our previous publication, "So, you want to be a bank...now what?" Also, for details on how banks and FinTech companies can participate in crypto "banking" and other activities tied to cryptocurrencies see our previous publication, "So You Want to be a Crypto Bank.";

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