

Tiering introduced for US payment system access

Financial system stakeholders express concerns and provide recommendations via public comments.

Direct access to Federal Reserve's payment systems, through a master account established with one of the 12 Federal Reserve Banks, is a valuable thing. So, who gets a master account? Will future access continue to be limited to state and Federal Deposit Insurance Corporation (FDIC)-insured depository institutions (IDIs), non-IDI national "banks," and US branches and agencies of foreign banks? If others will potentially have access, who sets the approval criteria and decides who is "in" and who is "out"—the Federal Reserve Banks, the Board of Governors of the Federal Reserve System (FRB), or some combination of those bodies?

Recent high-profile applications for Federal Reserve accounts access by non-IDIs, including several new “special purpose” state-chartered, non-insured depository institutions with digital asset-focused business strategies, have brought these questions to the forefront.

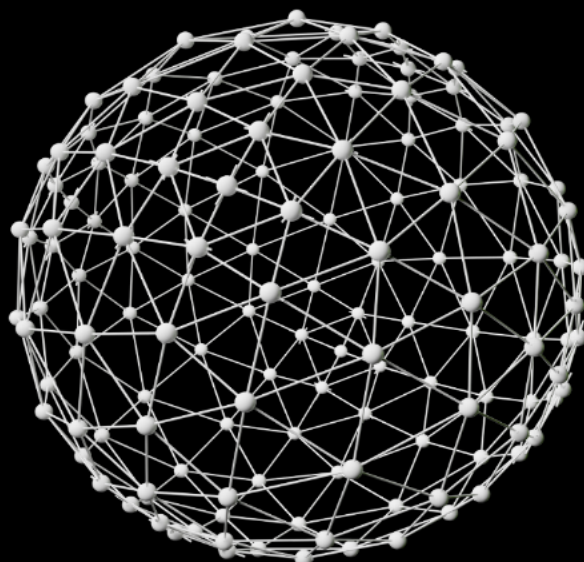
Without agreed-upon guidelines and consistent application of those guidelines across Reserve Banks, the process may continue to attract significant delay, scrutiny, and tension. While the Federal Reserve account application processes, largely a procedural formality for eligible institutions, and operations historically have been the role of the Federal Reserve Banks without significant public attention or scrutiny, those days now appear to be over.

In the context of these recent events, and in a business environment where decisions over who will or will not get direct payment system access could significantly impact future business models in the United States, the FRB issued “Proposed Guidelines to Evaluate Requests for Accounts and Services at Federal Reserve Banks” on March 1, 2022 (the “2022 Guidelines”)¹ with the intent of increasing transparency and consistency of the review process across the Federal Reserve Banks.

An expansion of who can establish accounts could open the door to new benefits and capabilities for a number of entities that may have otherwise previously been ineligible for access.

That expansion could, however, pose risk to the payment system if applicants are not effectively managed. For example, once the Reserve Banks provide final settlement for transactions (e.g., over the Fedwire Funds Service, Fedwire Securities Service, National Settlement Service, and on Automated Clearing House (ACH) credit originations), they face direct and potentially significant risk of loss if depository institutions—or other potential accountholders—are unable to settle their daylight overdrafts before the end of the day.²

In February, our *2022 banking regulatory outlook* outlined the tensions in the Federal Reserve account application process and the potential business model value that access to the US payment system has in the marketplace.³ In May, we provided an initial take on the 2022 Guidelines and related request for comment, outlining the potential impact and implications of the proposed tiering system and key considerations.⁴ With the April 22, 2022, closure of the public comment period regarding the 2022 Guidelines, this publication will provide our summary of key themes taken from the comments, including commenter observations and recommendations that the Federal Reserve will consider as the 2022 Guidelines are finalized.



Proposed Guidelines

As proposed, the 2022 Guidelines reflect six evaluation principles to be applied across all applicants:⁵

- **Principle 1** – 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.
- **Principle 2** – 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.
- **Principle 3** – 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.
- **Principle 4** – Provision of an account and services to an institution should not create undue risk to the stability of the US financial system.
- **Principle 5** – 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.
- **Principle 6** – Provision of an account and services to an institution should not adversely affect the Federal Reserve's ability to implement monetary policy.

Proposed tiering system

The 2022 Guidelines also introduce a tiering system that divides applicants into one of three tiers based on five factors used to determine the intensity of the application review process. As it stands, the tiering system would place the most scrutiny on Tier 3 applicants, with the least amount of scrutiny placed on Tier 1 applicants and Tier 2 applicants being left somewhere in between. The proposal implies that the higher the applicant tier, the harder—and possibly longer—the application process.

Tiering structure summary⁶

	Tier 1	Tier 2	Tier 3
Eligibility	Federally insured.	<u>Not</u> 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).	<u>Not</u> federally insured, and <u>Not</u> 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, these institutions will receive additional attention.	Though subject to similar regulatory supervision, like Tier 1 institutions, 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 .

Comments overview

As of June 10, 2022, the FRB's website reflected a total of 24 comment letters from a combination of 32 commenters.⁷ Two comment letters reflect the perspectives of multiple organizations, with one of those comment letters submitted by a group of six trade associations and the other submitted by a group of three nonprofit organizations.⁸ The comment letters identified several areas of concern and potential solutions for consideration, which we have summarized below, including those reflected under the following eight themes:⁹

Theme	Observations from comment letters	Recommendations from comment letters
Clarification of processes	<ul style="list-style-type: none"> • The guidelines require additional detail and explanation. • What is the nature of the review process for each tier, and what is the potential for additional requirements and commitments? • Will processes be adopted to facilitate a standardized review or response timeline to better support consistency efforts? • How will ongoing monitoring be implemented post-approval, with emphasis on otherwise unregulated entities? • What are the expectations concerning account usage? • Are there any presumptions concerning the maintenance of reserve balances, and if so, to what extent would those presumptions be rebuttable? 	<ul style="list-style-type: none"> • The guidelines should clarify: <ul style="list-style-type: none"> ○ Legal eligibility of applicants; ○ The tiering process and related designation criteria; and, ○ Application review considerations. • Commenters recommended that the FRB provides insight into how applicants will be assessed based on: <ul style="list-style-type: none"> ○ Their respective tier designations; ○ The nature of required commitments; and, ○ The extent of post-approval monitoring activities. • The guidelines should clarify if approval for Tier 2 and 3 firms would be delegated to the FRB.
Disparate treatment	<ul style="list-style-type: none"> • The proposal suggests that federal supervision is superior to state supervision, which undermines the intent of the dual banking system. • Institutions that are not federally regulated or supervised are at a competitive disadvantage given that they are automatically assigned a higher tier and are subject to increased scrutiny during the review process. 	<ul style="list-style-type: none"> • State supervised institutions should receive the same treatment as federally supervised institutions given that federal and state supervisory regimes are comparable and, in many cases, identical. • The FRB should base the stringency of its review on how applicable regulatory requirements tie to the six evaluation principles.
Legal eligibility	<ul style="list-style-type: none"> • Clarification is needed to determine which entity types are eligible to apply for account access. • The Federal Reserve Act's definition of "depository institution" is seen as the basis for determining legal eligibility. <ul style="list-style-type: none"> ○ Eligibility does not guarantee account approval. • Applicants that are not federal or state supervised insured banking organizations should not be deemed eligible, as they are not subject to the full range of risk management and consumer protection regulations as banks. 	<ul style="list-style-type: none"> • The definition of a nonbank should be confirmed under the Federal Reserve Act for the purposes of determining legal eligibility. • Applications submitted by "novel" charters should be denied. • There should be a recommended presumption of rejection for Tier 2 and 3 firms, or there should be a recommended presumption of rejection for all firms, until a supervisory program and related expectations are in place. • Access should be denied for specific entity types (e.g., pass-through investment entities).

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Innovation	<ul style="list-style-type: none"> The proposed guidelines have the potential to restrict innovation and competition in the banking sector. Novel charters can offer new financial products and services that could result in increased inclusion for the unbanked or underbanked. Fintech companies and other novel charters could reduce costs and reduce barriers to entry for consumers, contributing to economic development. 	<ul style="list-style-type: none"> A new payments access option should be created for innovative companies interested in activities outside of deposit-taking and lending. The FRB should issue risk mitigation guidance on new risks presented by innovative companies rather than denying applications or increasing review scrutiny. Fintech firms may have a narrow business focus, the scope of review for these firms should align with the amount of risk presented by their business.
Board involvement and consistent application of guidelines	<ul style="list-style-type: none"> The 2022 Guidelines do not address equitable treatment for all applications or Reserve Bank accountability in decision-making. Lack of clarity in review and assessment processes could lead to differing outcomes across Reserve Banks and possibly overlooked or understated risk. There is a potential for an abuse of power regarding the Reserve Bank decision-making process. FRB involvement in decision-making would reduce the ability for applicants to game the system. 	<ul style="list-style-type: none"> Reserve Banks should be required to follow a formalized set of steps to ensure consistent processing of requests. Additional guidance should be developed to differentiate between the review stringency for each evaluation principle. Applications for institutions with higher risk profiles should be reviewed by the FRB. Reserve Bank application review processes should be reviewed for consistency.
Supervisory oversight	<ul style="list-style-type: none"> Ongoing supervision, and if needed, enforcement, will better protect the integrity of the payments system. Nonbanks were criticized for being subject to less oversight than banks and being seen as more inherently risky. Allowing entities access to the payments system without the need to meet regulatory requirements could have a negative impact. 	<ul style="list-style-type: none"> Ongoing monitoring at firms that gain access to the payments system should be clearly explained. Oversight requirements for firms that gain access to the payments system should be on par with those of banks and credit unions, regardless of charter type of business model. Cybersecurity, capital, and liquidity risks should be assessed. Reserve Banks should consider compliance with consumer protection requirements, the Bank Secrecy Act (BSA), and Anti-Money Laundering (AML) regulations.

Theme	Observations from comment letters	Recommendations from comment letters
Competition	<ul style="list-style-type: none"> • Nonbanks have a competitive advantage over traditional banks, as they could have access to the payment system without being subject to the rules and regulations applicable to banks. • The proposed Guidelines afford nonbanks similar benefits as traditional banks without incurring the costs of comparable regulation. • Access to the US payment system would allow ongoing competition between banks and nonbanks. • Competition exists within the subsets of nonbanks and uninsured banks given that some of these entity types may gain access while others may not. 	<ul style="list-style-type: none"> • Nonbanks should not be eligible for access. • Tier 3 firms and uninsured banks should be denied access.
Timing	<ul style="list-style-type: none"> • Commenters voiced concerns about the length of time it takes for nonbanks to receive both routing numbers and master accounts from the Federal Reserve. • The proposal did not include procedures governing a timely response process or requirements for transparency when communicating acceptance or denial to the applicant. • The initial proposal was issued in 2021; the process to develop and revise the guidelines is ongoing; pending applications remain in queue, with no clear finalization date. • Delayed finalization has a negative impact on applicants and the financial services industry alike. 	<ul style="list-style-type: none"> • The FRB should act quickly to finalize the guidelines and process any pending requests. • The Reserve Banks should make application decisions within a reasonable time frame, providing rationale for denials and allowing firms to reapply, if they can address stated concerns. • There should be a minimum review period for applications to provide sufficient time for the Federal Reserve to assess a firm's condition and adequacy of risk management processes.

Of particular note is that the criteria for Tier 2 includes non-IDI entities subject to federal supervision but excludes those non-IDIs subject only to state supervision, at the entity level. Some commenters expressed concerns that this implication may undermine the stature of state supervision and the US dual banking system (federal and state charters). Given the close supervisory relationships that the Federal Reserve Banks share with state bank supervisors, the Federal Reserve's resolution of this disparity will be of great interest to state bank supervisors and entities subject to state but not federal supervision.

Also of note are comments related to the timing around Federal Reserve Bank responses to access requests.

These comments focus on the need to finalize the 2022 Guidelines quickly, address pending requests, and commit to formalized review time frames going forward. Two comment letters specifically addressed elongated wait times for routing numbers and master accounts. Protracted access could materially impact institutions' business models, possibly leading to firms taking legal action.

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Summary takeaways

The Federal Reserve is in the process of considering the comments it has received. While comments and recommendations provide insight into concerns and potential solutions from a range of financial sector stakeholders, it remains to be seen which observations and recommendations will have a significant impact on the final version of the 2022 Guidelines. The final guidelines should provide clearer guideposts and more transparency about the Federal Reserve Bank processes than has been available to date. That said, the final guidelines are not likely to reach the level of granularity and “certainty” that some are seeking, if not demanding, in the current marketplace. The final guidelines are also likely to reflect a greater public role of the FRB, and knock-on centralization of decision-making, than has been the case to date.

Going forward, entities planning to request access to master accounts will need to carefully consider their charter, legal entity structure, and business model as drivers for determining the nature and extent of the access request review process.¹⁰ The proposed tiering system would impose enhanced scrutiny on those entities that are not federally insured or supervised under the current legal and regulatory framework.

For those entities that are not currently supervised by a federal banking agency, there is a high likelihood that any approval for access will be accompanied by potentially significant “supervisory” conditions. These entities would need to think about their preparedness for bank-like safety and soundness oversight, which may include aspects of addressing:

- Enterprisewide risk management
- Settlement risk
- Governance from a board and senior management oversight perspective
- Audit and internal controls
- Compliance
- Cybersecurity
- Liquidity risk management
- Capital planning
- BSA/AML

Endnotes

1. Board of Governors of the Federal Reserve System (FRB), [“Federal Reserve Board invites public comment on supplement to its May 2021 proposal.”](#) March 1, 2022.
2. FRB, [“Federal Reserve Policy on Payment System Risk,”](#) policy document, amended effective March 19, 2021.
3. See our [2022 banking regulatory outlook](#), February 2022.
4. For additional insight into the Federal Reserve’s 2022 proposed guidelines please see our publication, [“Tiering introduced for US payments system access,”](#) March 2022.
5. FRB, [“Federal Reserve Board invites public comment on supplement to its May 2021 proposal”](#) March 1, 2022.
6. Ibid.
7. FRB, [FOIA Comments](#), accessed June 6, 2022.
8. The trade association group letter was authored by American Bankers Association, Bank Policy Institute, Consumer Bankers Association, Independent Community Bankers of America, Mid-Size Bank Coalition of America, and The Clearing House. The nonprofit organization group letter was authored by Center for Responsible Lending, National Community Reinvestment Coalition, and National Consumer Law Center.
9. FRB, [FOIA Comments](#), accessed June 6, 2022.
10. 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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