April 22, 2022

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Request for Comment on Proposed Account Access Guidelines for Federal Reserve Banks to Utilize in Evaluating Requests for Access to Federal Reserve Bank Master Accounts and Services, Docket No. OP-1747

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the notice and request for comment captioned above,[2] issued by the Board of Governors of the Federal Reserve System ("Board"), regarding its proposed Account Access Guidelines ("guidelines") for Federal Reserve Banks ("Reserve Banks") to utilize in evaluating requests for access to Reserve Bank master accounts and services ("accounts and services").

While the guidelines represent a positive step in bringing transparency and consistency among Reserve Banks in their evaluation of requests for access to accounts and services, they fail to ensure an appropriate level of rigor that is transparent and consistent for so-called "Tier 2" and "Tier 3" institutions. These institutions do not have deposit insurance, are not subject to the supervisory and regulatory framework that applies to federally insured institutions, and therefore are deemed to be riskier or at least to require more scrutiny than "Tier 1" institutions, as outlined in the proposed guidelines (Tier 2 and Tier 3 institutions hereafter collectively referred to as "riskier institutions").

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies— including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] 87 FR 12957

First, although the proposed guidelines state that such institutions will receive "intermediate" and "the strictest" levels of review, respectively, no indication is given of what such heightened scrutiny means. This leaves these terms open to broad interpretation by Reserve Bank staff, undermining for riskier institutions the Board's intention to achieve greater transparency and consistency in the assessment process.

Second, standard assessment criteria and processes historically used by the Reserve Banks would not directly apply to institutions that do not have traditional banking models, and so it is unclear how scrutiny of any level should be executed for such institutions. For example, an appropriate level of capital for an institution with a novel bank charter and business model has never been defined. This gap would likely lead to under-assessed or even missed risks.

Additionally, the risks to the payment system posed by the riskier institutions likely would be exacerbated by last year's Board proposal to weaken the requirements to be able to request access to so-called collateralized daylight overdrafts. Considering that the changes proposed essentially allow any institution access, it seems likely that riskier institutions would also have access to collateralized daylight overdrafts. Such institutions likely would pose a higher risk to the Reserve Banks and the payment system even if the daylight overdraft capacity is collateralized.

Considering there is inherent uncertainty and increased complexity around the risks posed by riskier institutions and that robust standards for risk management and federal supervisory oversight are yet to be established for them, the guidelines should have a presumption of rejection of access (indeed, regardless of legal eligibility) until robust standards and oversight frameworks have been established for each institution type.

At the very least, applications by riskier institutions should be required to be reviewed by the Board, if not subject to Board approval. Additionally, a minimum assessment period should be in place. The ways in which the risks from such institutions manifest are as novel and unconventional as their business models, and so a sufficiently lengthy observation period is necessary, especially so since examiners currently do not have the training or experience in examining such institutions.

Finally, to better protect the payment system and Reserve Banks from increased risk, the Board should reconsider its proposal to modify its Payment System Risk ("PSR") policy and adopt the recommendations Better Markets put forth in its comment letter[3] to the proposal.

The Proposed Guidelines Fail to Address Multiple Risks and Issues Associated with Higher-Risk Institutions

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[3] See Better Markets Comment Letter on Proposed Changes to Part II of the Federal Reserve Policy on Payment System Risk (August 2, 2021), https://bettermarkets.org/wp-content/uploads/2021/09/Better_Markets_Comment_Letter_Payment_System_Risk1_0.pdf, incorporated by reference herein as if fully set forth.

A. Despite the Stated Goal of Transparency and Consistency in Assessment by the Reserve Banks, Standards for Institutions that Require More Tailored Guidelines Are Left Ambiguous and Open to Widely Varied Interpretations

In response to comments on the original proposed guidelines for evaluating requests for access to accounts and services,[4] the Board modified the proposed guidelines in the current proposal to "tailor" standards and expectations for the assessment process by institution type. The current proposal identifies three tiers of institutions, based on perceived level of riskiness or level of necessity of scrutiny. Tier 1 institutions are defined as federally insured depository institutions that are subject to robust regulation and supervision by the federal banking agencies. Tier 2 institutions are defined as not federally insured but are subject to prudential supervision at the institution level by a federal banking agency. Tier 3 institutions are defined as not federally insured and that are not subject to federal prudential supervision at the institution and holding company level.

Perceived level of riskiness or level of necessity of scrutiny of the institutions increases with each subsequent tier – Tier 3 necessitating the highest – with the distinction being determined by (1) whether an institution has deposit insurance and (2) the level of federal prudential supervision an institution is subject to. Accordingly, the proposal states that account access requests by Tier 2 institutions will receive an "intermediate" level of review, and that the "strictest" level of review will be applied to requests by Tier 3 institutions.

However, the proposed guidelines stop there and provide no additional detail as to what those terms mean on their own or in the context of the six evaluation principles laid out in the proposal. This ambiguity goes against the stated purpose of the proposal to bring more transparency and consistency to the assessment processes by the Reserve Banks. Assuming the Board is looking to achieve this stated purpose, the lack of further explanation of these terms seems to imply that the Reserve Bank staff are already aware or will be made aware of what these terms mean in the context of the account access evaluation process.

If that is the case, the Board should make public and reference any materials that define the distinction in this context for Reserve Bank staff. If not, the Board should provide additional guidance around these terms for each of the six evaluation principles. Without this, staff at each of the Reserve Banks will interpret the meaning of the terms differently, apply an inconsistent level of review, and perhaps utilize inconsistent metrics and standards. This could even occur among staff within a Reserve Bank. Also, this would result in a serious lack of transparency in the process and for the riskiest types of institutions. Such a disjointed and subjective process likely would lead to under-assessed or even missed risks.

B. Institutions Other Than Federally Insured Depository Institutions Have Unique Risk Profiles for Which Traditional Supervisory Standards Are Not Fully Appropriate

[4] 86 FR 25865

The six risk assessment principles in the proposed guidelines generally follow the risk management framework that has been established and refined over many years for federal insured depository institutions. It is a robust framework that – if executed with strong oversight and meaningful consequences – can serve to mitigate serious risks to the banking system. This framework applies appropriately to Tier 1 institutions since those are the institutions for which the framework was designed and is intended.

That is, the framework has been designed around risks that are posed by depository institutions that have federal deposit insurance, generally follow the historically typical business model of a depository institution or a holding company of a depository institution, and are subject to the regulations that have been put in place by the federal banking agencies. Therefore, this framework does not entirely apply for institutions that do not fit these criteria, at least not in the traditional way in which it has been applied. For example, consider two institutions with the same exact business model, but one has deposit insurance and the other does not. The institution without deposit insurance would face a higher likelihood of run risk by depositors and therefore would need a greater emphasis on different risk factors and risk mitigation efforts.

There especially would be risk management and mitigation differences for institutions with novel charters that might only participate in one aspect of banking and perhaps also rely on financial technology platforms or engage in or facilitate cryptocurrency activities. The focus on payments and the facilitation of stablecoins or cryptocurrency custody services would have significant implications for liquidity requirements as well as alternative implications for capital requirements and would necessitate a greater emphasis on anti-money laundering and consumer protection. Although, for example, the "crypto bank" charter granted by the Office of the Comptroller of the Currency ("OCC")[5] for Anchorage Digital Bank specifies capital, liquidity, and other requirements, the complete lack of historical experience and reference for such institutions calls into question the sufficiency and appropriateness of those requirements. Additionally, even newer and more complex business models are likely to request charters, leaving the OCC constantly a step behind in determining appropriate requirements.

Therefore, while the principles of the risk management framework are generally applicable to riskier institutions, their actual application for riskier institutions would necessarily have to differ from the application for Tier 1 institutions. Exactly how the application should differ has been left entirely to the discretion of the Reserve Bank staff performing the assessments. Not only would this lead to inconsistent and non-transparent assessments for riskier institutions, but it likely would also lead to under-assessed or even missed risks. Importantly, even if sufficient requirements were in place, Reserve Bank staff would not have the experience in performing supervisory assessments on novel business models and may not have the training or expertise to assess new and emerging technologies and digital assets.

[5] Announcement of and link to conditional charter approval for Anchorage Digital Bank (January 13, 2021) available at https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-6.html

C. Non-Tier 1 Institutions Would Increase Risk to the Payments System, Especially if the Proposal to Modify the Payment System Risk Policy is Finalized

In June of last year, the Board issued a proposal to modify its PSR policy.[6] Notably, the proposal seeks to significantly expand access to its so-called collateralized daylight overdraft capacity ("collateralized capacity"), which allows institutions with access to its payment system to overdraft their Reserve Bank account as long as the overdraft is collateralized. This capacity is above and beyond an institution's approved net debit cap, which is a pre-approved amount by which an account can be overdrawn, with or without collateral.

Currently, collateralized capacity is only allowed if an institution already has been approved for a positive net debit cap, conducts a point-in-time self-assessment to support supervisory findings, and provides a business case for the need for collateralized capacity. A positive net debit cap is only granted to institutions that are "financially healthy" and have regular access to the discount window, so only the most credit-worthy institutions could apply for the additional collateralized capacity.

The proposal seeks to "expand access" to collateralized capacity and to "reduce the administrative steps" that are required to obtain access to collateralized capacity. The proposed changes would expand access by allowing institutions that meet the following criteria to request access to collateralized capacity:

1. Institutions with net debit cap categories of "zero," "exempt," or "de minimis." It is important to note the "zero" net debit cap category is either because the bank has chosen to have no debit cap or has not been allowed to have one based on the Reserve Bank's determination.
2. Domestic institutions with a Prompt Corrective Action designation of "undercapitalized," "adequately capitalized," or "well-capitalized"
3. Institutions with any supervisory rating, including "unsatisfactory".

Essentially, the proposal seeks to remove any minimum requirement for an institution to be able to obtain collateralized capacity. This seems to open accessibility to all sorts of institution types that are not federally insured depository institutions. For example, considering the proposed policy allows institutions with any level of capitalization to request access to collateralized capacity, it seems supervisors would not even need to bother determining an appropriate capital level for institutions with novel charters since that no longer matters. The proposal also effectively removes the consideration of supervisory assessments as a factor in being able to request collateralized capacity, so it seems an institution that is not directly supervised by a federal banking agency (Tier 3 institutions) would be able to request collateralized capacity.

[6] 86 FR 29776

As we stated in our comment letter[7] in response to the proposal, expansion of access to collateralized daylight overdrafts, particularly to institutions that currently are prohibited from having either collateralized capacity or even a positive net debit cap, would increase risk to the system by encouraging adverse selection. Institutions that are weak or poorly-run and represent a higher level of risk to the Fed – a level that has traditionally been seen as disqualifying – would be more likely to utilize the intraday credit if they are allowed access. Considering collateralized daylight overdrafts are essentially interest-free intraday loans, this could promote a higher reliance by such institutions on this capacity for intraday funding, increasing risk to the Reserve Banks as well as to the institution itself if the Reserve Banks recognize its weak financial condition and reduce or remove the collateralized capacity.

The Board Must Consider Modifying the Guidelines to Protect Against Risks from Tier 2 and Tier 3 Institutions

A. The Board Must Outline a Much Stricter Process for Tier 2 and Tier 3 Institutions

Assuming access to Federal Reserve accounts and services is indeed legally available to Tier 2 and Tier 3 institutions, the Federal Reserve must consider putting in place a process that appropriately protects the Federal Reserve System, the financial system, and the economy from the risks posed by such institutions. As discussed above, the Board has failed to define or even provide guidance around what is meant by "intermediate" and "the strictest" levels of review for these institutions.

Indeed, riskier institutions require a significantly higher level of scrutiny when considering access to Federal Reserve accounts and services, but what that means must be made more explicit. This, of course, would be a difficult exercise, especially for Tier 3 institutions that may have novel charters and business models. That is, expanding on what is meant by these stricter levels of review and even tailoring the application of the risk management framework to unique and different business models would take time to be appropriately thoughtful and effective.

Therefore, until robust risk management frameworks and supervisory oversight processes are in place and until it is clearer what is meant by the stricter levels of review for riskier institutions, the Board should instead include a guideline of a presumption of rejection of applications by Tier 2 and Tier 3 institutions to obtain Federal Reserve accounts and services. The Board itself recognizes in its proposal the distinction between legal eligibility and what is reasonable eligibility to protect against risks – "legal eligibility does not bestow a right to obtain an account and services." The riskier institutions, and indeed the Federal Reserve, must demonstrate that effective risk management standards and practices can be established prior to their applications even being considered. General effectiveness of risk management standards

[7] Better Markets Comment Letter on Proposed Changes to Part II of the Federal Reserve Policy on Payment System Risk (August 2, 2021), https://bettermarkets.org/wp-content/uploads/2021/09/Better_Markets_Comment_Letter_Payment_System_Risk1_0.pdf

and practices (combined with assertive oversight) have been demonstrated over time for Tier 1 institutions, hence the "more streamlined review" process that has been proposed for them.

Without the clarity of what robust risk management frameworks and supervisory oversight looks like for riskier institutions and what is meant by the stricter levels of review for riskier institutions, not only would the Board fail to achieve its stated goal of greater transparency and consistency in the assessment process for riskier institutions, it would also insufficiently protect against the risks posed by these institutions. At the very least, until robust processes and frameworks are in place, applications for access to accounts and services should be directed to the Board for review if not outright approval. This would help to ensure the transparency and consistency that the Board seeks.

Additionally, the review process should be subject to a minimum review period that is sufficiently lengthy to determine the financial health of an institution and the efficacy of its risk management processes. For example, the OCC recently issued a consent order against Anchorage Digital Bank,[8] a so-called crypto bank, about fifteen months after it granted its special charter.[9] The OCC apparently found serious deficiencies in the Anchorage Digital Bank's Bank Secrecy Act/anti-money laundering program, citing "its engag[ement] in violations of law and regulation." This opens the question of why the OCC granted the charter in the first place and makes clear that sufficient time is necessary to perform a thorough review of novel business models. However, even for Tier 2 institutions, which are subject to some level of federal banking agency oversight, an appropriate minimum amount of review time should be in place in order to assess the risks their specific business models pose in consideration of their lack of deposit insurance.

B. The Payment System Risk Policy Proposal Must Not Be Finalized as Proposed

As we stated in our comment letter[10] to the proposal on modifications to the PSR policy from last year, while the encouragement of collateralization of daylight overdrafts is an important risk management effort, the proposal seeks to do so without sufficient consideration of the risks created by the proposed changes that would expand access to banks that may be undercapitalized and/or assessed by Federal Reserve supervisors as being badly managed. First, the effective removal of supervisory considerations from the eligibility criteria would undermine the supervisory process by weakening yet another incentive for banks to effectively manage their operations and their risks, and ignore the assessments of the Federal Reserve's supervisors.

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[8] Announcement of and link to consent order (April 21, 2022) available at https://www.occ.gov/news-issuances/news-releases/2022/nr-occ-2022-41.html

[9] Announcement of and link to conditional charter approval for Anchorage Digital Bank (January 13, 2021) available at https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-6.html

[10] See Better Markets Comment Letter on Proposed Changes to Part II of the Federal Reserve Policy on Payment System Risk (August 2, 2021), https://bettermarkets.org/wp-content/uploads/2021/09/Better_Markets_Comment_Letter_Payment_System_Risk1_0.pdf

These assessments should be used to inform the Fed about which banks are and are not appropriate counterparties for transactions with the central bank.

Second, expansion of access to collateralized daylight overdrafts, particularly to institutions that currently are prohibited from having either collateralized capacity or even a positive net debit cap, would increase risk to the system by encouraging adverse selection. Banks that are weak or poorly-run and represent a higher level of risk to the Fed – a level that has traditionally been seen as disqualifying – would be more likely to utilize the intraday credit if they are allowed access. This second point around adverse selection is especially concerning for Tier 3 institutions that may have novel business models with risk that is inherently higher or significantly more reliant on short-term funding.

As such, we repeat here that the Board should strongly consider the modifications to the proposal put forth by Better Markets in its comment letter. This would not only serve to protect the payment system and Reserve Banks from risks posed by riskier Tier 1 institutions but also for Tier 2 and Tier 3 institutions.

CONCLUSION

Better Markets appreciates the Board's effort to bring more transparency and consistency to the assessments of applications to access Federal Reserve accounts and services, including for institutions that are not federally insured or have non-traditional business models and charters. However, we feel strongly that a lack of clarity of standards for risk management and review for riskier, unconventional institutions necessitates guidelines that prevent approval for such institutions until the standards are clarified and are robust. At least, the Board should be involved in the assessment process for such institutions and a lengthy minimum review period should be established. Additionally, we reiterate our recommendations to modify last year's proposal regarding the PSR policy.

Sincerely,

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