FinTech Access to Fed Accounts and the Nation's Payments Systems: A Primer

BPI Staff | May 11, 2021

A lot of FinTechs are trying to act like banks while avoiding the supervisory and regulatory framework that applies to actual banks.[1] For these FinTechs, the duties and responsibilities – and costs – that come along with a real bank license are simply too great. So, FinTechs have been lobbying federal and state banking authorities to give them special "novel" bank charters that authorize them to do certain banking activities, while subjecting them to just a fraction of the regulatory and supervisory framework that would apply to an ordinary bank. Their lobbying efforts have paid off, and a number of these novel charters are now available.

The FinTechs' next goal is to get access to an account at a Federal Reserve Bank. Among other things, a Fed account will give them unfettered access to the nation's payments rails and potentially parts of the federal safety net.

Smelling a foul fish and a lot of unchecked risks, the Federal Reserve recently issued a set of proposed guidelines setting forth detailed considerations for evaluating account applications from FinTechs with novel charters. The proposed guidelines are a good first step, but they are just guidelines that *may* be considered rather than requirements that *must* be. Thus, and at a minimum, they would need to be strengthened to ensure enforceability and accountability before being finalized.

Below is a brief primer on these issues.

WHAT IS A "NOVEL" CHARTER?

- The easiest way to understand a novel charter is to contrast it with a regular bank charter.
- A regular charter allows an institution to engage in the "business of banking" in the U.S., which is comprised of three core activities: deposit-taking, lending and payments. As a general rule, you can't do these activities without a bank license.[2,3] Moreover, the deposits accepted by regular banks are FDIC-insured and the banks are eligible to borrow from the Fed as the lender of last resort. They are subject to a robust supervisory and regulatory framework to ensure their safety and soundness and compliance with the law.
- By contrast, a novel charter authorizes an institution to engage in some, but typically not all, of these core banking activities. So, the institution might be able to engage in lending or payments, but not deposit-taking; or the institution might be able to engage in deposit-taking, but the deposits might only be wholesale (not

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[1] This isn't true in all cases. Some FinTechs are getting a regular bank license, and conscientiously shouldering the duties and responsibilities that come along with it. Varo, Sofi, and Jiko are just a few examples. In the world of FinTech, they are proving to be the exception to the rule, however.

[2] There are some exceptions: if you only want to make loans, you can simply get a state lending license; if you only want to engage in payments activities, you can get a state money transmitter license. But if you want to do both payments and lending, and certainly if you want to take deposits, then you likely want a bank charter.

[3] A number of other so-called "incidental" activities are also authorized, like trust services, fiduciary powers, asset management, etc.

retail) and the institution would not be FDIC-insured. For more information on the full range of novel charters, see these BPI notes:

- FinTech and Big Tech Companies Want the Benefits of Banking Without the Responsibilities. Loopholes Could Let Them Succeed.
- Payments Charter Without Strong Safeguards Poses Risks to the Financial System

- Permissible activities aside, in all cases the novel charter is very intentionally crafted to allow the institution to be exempt from the vast majority of the existing bank regulatory and supervisory framework. This is important because that framework has been carefully crafted by Congress and regulators over the past 100+ years to ensure the U.S. banking system remains safe and sound, resilient to shock and that it functions to support American consumers and the real economy. Because the existing framework applies only to regular banks, the novel charters are a pure regulatory arbitrage play. For more information, see this BPI note

    - Is It OK for FinTechs To Use Regulatory Arbitrage To Avoid Consolidated Supervision?

WHO IS SEEKING A NOVEL CHARTER AND WHY?

- FinTechs are actively seeking novel charters. The best current examples are Kraken and Avanti, which are cryptocurrency exchanges that have received approval for a new so-called "special purpose depository institution" charter issued in Wyoming;[4] and Figure Bank, which has an application pending for an uninsured, deposit-taking bank charter issued by the OCC. Other examples include crypto firms that are obtaining novel versions of the OCC's limited-purpose trust company license. For more information on these charters, see these BPI notes:

    - Beware the Kraken
    - Why a Wyoming Charter Is No Hail Mary for the Anti-Fractional Banking Team
    - BPI and Joint Trades Coalition Submit Comment Letter in Response to Figure Application
    - BPI and Joint Trades Coalition Caution Fed Against Granting Kraken Financial Access to Payments System

- FinTechs seek these charters to maximize the scope of activities they are permitted to engage in at the lowest cost, which means skirting to the greatest extent possible the tangible and intangible costs associated with complying with the regulatory and supervisory framework that applies to regular banks.

WHY DO FINTECHS WANT A FED ACCOUNT?[5]

- In short, it allows them to conduct their banking business in a more cost-efficient way because they can bypass a regular bank as an intermediary to Fed services and thereby avoid the costs associated with that relationship, as well as also bypass the cost of being regulated and supervised like a regular bank.

- A Fed account has many benefits, including the ability to:[6]

    - Deposit funds into the account and draw checks against it.

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[4] According to the Wyoming Division of Banking, "Wyoming-chartered special purpose depository institutions ("SPDIs") are banks that receive deposits and conduct other activity incidental to the business of banking, including custody, asset servicing, fiduciary asset management, and related activities. SPDIs will likely focus on digital assets, such as virtual currencies, digital securities and digital consumer assets." *Available at*: http://wyomingbankingdivision.wyo.gov/home/areas-of-regulation/laws-and-regulation/special-purpose-depository-institution

[5] By Fed account, we mean a "master account" at one of the 12 Federal Reserve Banks.

[6] Although not discussed in the proposal, depository institutions that are eligible to have accounts are also eligible to borrow from the discount window.

- Earn interest on reserve bank balances held in those accounts.
- Have direct access to the Federal Reserve's Payment System Services without needing to partner with a regulated bank. [7] More information about what it means to have a Fed account is available here.

ARE FINTECHS WITH NOVEL CHARTERS LEGALLY ELIGIBLE TO APPLY FOR FED ACCOUNTS?

- Maybe. It's not entirely clear. The statute governing Fed account access, the Federal Reserve Act, is over 100 years old and the provisions governing access have been updated only intermittently over time, and not in any sort of comprehensive or modern way.
- As a general matter, Reserve Banks may, but are not required to, provide master accounts to Federal Reserve member banks, nonmember banks or trust companies, and "other depository institutions," which is defined to include insured banks and institutions that are eligible to make an application to become insured. There is a lack of clarity around what it means to be eligible to make an application to become insured.
- The Fed's proposed policy statement does not provide clarity on which institutions are legally eligible for accounts, though it notes it may provide clarity in the future. In other words, the Fed is punting for now. At some point soon, the Fed should seek to provide clarity on the question of legal eligibility through a transparent, *ex-ante* process, rather than continue to wait and make nontransparent *ad hoc* decisions along the way.
- Of course, nothing prevents Congress from weighing in to provide clarity.

IF THEY ARE ELIGIBLE TO APPLY FOR FED ACCOUNTS, WILL THE FED APPROVE THE APPLICATIONS?

- It's unclear, although this is precisely why the Fed has issued its proposed guidelines: to provide a clear and transparent framework by which the applications would be ***considered***.
- The guidelines recognize that applications for Fed accounts by regular banks are pretty easy to evaluate. Given that these banks are subject to an extensive and well-known regulatory and supervisory framework, including regular examinations, the Fed can be confident that they are in safe and sound condition and comply with a range of important laws and regulations, such as those related to anti-money laundering, sanctions and capital.
- Conversely, the Fed rightly maintains that it lacks this same confidence when it comes to FinTechs with novel charters because they are not subject to the same framework. Under the Fed's proposed guidelines, the Fed would consider the same factors for FinTech applicants that it considers under their existing regulatory and supervisory framework for banks. These include the institution's capital and liquidity positions and its ability to manage credit, liquidity, operational, settlement, BSA/AML, cyber and other risks.

[7] Access to the payment system allows an institution to serve its customers more efficiently and to benefit from participation in a nationwide network. These services include: electronic transfer of funds, including through the Automated Clearing House system and Fedwire Funds Service; FedCash Services, which ensures depository institutions have sufficient supplies of currency and coin; Check Services, which offer electronic and paper check processing; National Settlement Services, which is offered to master account holders that settle for participants in clearinghouses, financial exchanges and other clearing and settlement arrangements; and Fedwire Securities Service, which provides issuance, maintenance, transfer and settlement services for all marketable U.S. Treasury securities, and securities issued by other federal government agencies, government-sponsored enterprises and international organizations.

- The Fed's proposed guidelines have no enforcement mechanism whatsoever for ensuring (i) that the Reserve Banks abide by the guidance or (ii) that novel charter applicants in fact actually meet the standards laid out in the guidance at the time of the application or, if approved, thereafter.

- At a minimum, the Federal Reserve should **strengthen** the guidelines by making it mandatory that the Reserve Banks adhere to them via a formal and documented process that promotes accountability and consistency. The guidelines should also require each Reserve Bank to conduct a thorough pre-approval exam to ensure an applicant's compliance with the bank-like standards set forth in the guidelines, as well as to conduct regular exams thereafter to ensure ongoing compliance.

WHY IS THE EXTRA SCRUTINY OF NOVEL CHARTERS AND FINTECHS NEEDED?

- Letting FinTechs have access to the payments system without sufficiently evaluating their safety and soundness and ability to manage their risks could harm the banking, payments and broader financial systems.

- As recognized in the Fed's proposal, the novel charter institutions' business models pose risks for financial stability and monetary policy implementation. As we discovered last year when prime money funds yet again needed to be bailed out, institutions that take uninsured deposits, even ones that claim only to be investing riskless assets, are subject to runs that are destabilizing for the financial system. And institutions that invest only in reserve balances encourage flights to quality out of the real economy that amplify periods of stress and increase the volatility of the Federal Reserve's balance sheet.

- Businesses with novel charters are susceptible to cyber risks, threats to the privacy of consumer data and money laundering and sanctions risks. It is critical to protect the nation's financial and payments systems from this type of harm.
