When Consistency is Not Foolish: A More Sensible Approach To Granting Fed Accounts and Paying Interest on Reserves

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Earlier this month, the Federal Reserve Board published proposed guidelines to be used by Federal Reserve Banks in evaluating requests for Federal Reserve accounts by institutions with novel charters, including uninsured deposit-taking institutions (UDIs) like narrow banks and non-deposit-taking FinTech payments companies. The proposal is available here, and a BPI primer on the issue is available here.

The proposal aims to ensure a consistent approach across the System for reviewing account applications. Indeed, one of the Board's primary functions is to establish regulations governing Reserve Bank behavior, and the Board and Reserve Banks have longstanding processes to ensure that the Banks implement the Board's regulations and policies in a uniform manner.[1] However, somewhat curiously, the proposal makes no mention of any of those processes; nor does it contemplate any other process for ensuring that its guidelines would be uniformly applied in practice. Further, some parts of the proposal actually seem to undercut the goal of consistency. In this post, we recommend that the Board clearly articulate mechanisms to ensure consistent outcomes around account access, as the proposal seems to intend.

A MORE COHERENT FRAMEWORK TO ENSURE CONSISTENT OUTCOMES

As noted, one of the Board's key statutory functions is to oversee Reserve Bank operations.[2] Section 13(1) of the Federal Reserve Act provides that "Any Federal reserve bank ***may*** receive from any of its member banks, or other depository institutions . . . deposits of current funds in lawful money," leaving open the question of the conditions for such receipt.[3] The Board's proposal seeks to ensure that "Reserve Banks apply a consistent set of guidelines when reviewing . . . access requests to promote consistent outcomes across Reserve Banks and to facilitate equitable treatment across institutions."[4] Further, the proposal provides that "the evaluation of an institution's access request should also consider whether the request has the potential to set a precedent that could affect the Federal Reserve's ability to achieve its policy goals now or in the future."[5] The Board explains further that the uniform applicability of "the proposed guidelines would reduce the potential for forum shopping across Reserve Banks and mitigate the risk that individual decisions by Reserve Banks could create de facto System policy for a particular business model or risk profile."[6] However, the proposal contains no mechanism to ensure the uniform applicability sought.

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[1] Section 11(j) of the Federal Reserve Act authorizes the Board to "exercise general supervision over said Federal reserve banks." 12 USC § 248(j).

[2] *Id.*[3] 12 USC U.S.C. § 342 (emphasis added).

[3] 12 USC U.S.C. § 342 (emphasis added).

[4] 86 Fed. Reg. 25,865, 25,866 (May 11, 2021).

[5] 86 Fed. Reg. at 25,867.

[6] 86 Fed. Reg. at 25,866.

Historically, the Board, working with the Reserve Banks, has established consistent rules for actions taken by Reserve Banks and numerous procedures for ensuring compliance with those rules. In certain instances, the Board has delegated oversight responsibility to the Director of The Division of Reserve Bank Operations and Payment Systems (RBOPS) (or the Director's designee).[7] RBOPS generally "oversees the policies and operations of the Federal Reserve Banks as providers of financial services to depository institutions and as providers of fiscal agency services to the U.S. Treasury and other government agencies."[8] For example, RBOPS conducts audits of Reserve Bank operations, including compliance with Board regulations concerning payment, accounts and services, and the Federal Reserve's Policy on Payment System Risk.[9] Presumably, the granting of accounts would fall under those audits, although no such audits are mentioned in the proposal.

The Federal Reserve uses a similar mechanism to ensure consistency in discount window lending. In that context, the Federal Reserve Banks make three different types of discount window loans – primary credit, secondary credit and seasonal credit loans.[10] Every two weeks, pursuant to its authority under the Federal Reserve Act, the Board establishes the interest rates that will be charged on the three types of loans based on proposals from the Reserve Banks.[11]

The Board also establishes, under this same authority, the rules governing who qualifies for which type of loan.[12]

[7] *See* Board of Governors of the Federal Reserve, Office of Inspector General: "Opportunities Exist to Enhance the Onsite Reviews of the Reserve Banks' Wholesale Financial Services," Audit Report 2014-FMIC-B-014 (September 30, 2014) at 4, available at: Opportunities Exist to Enhance the Onsite Reviews of the Reserve Banks' Wholesale Financial Services (federalreserve.gov).

[8] The Fed - Reserve Bank Operations and Payment Systems (federalreserve.gov). *See also* Audit Report 2014-FMIC-B-014 at 4 (Stating that "RBOPS is responsible for the oversight of Reserve Bank operations, including overseeing and monitoring various aspects of wholesale financial services . . . The FMI Oversight group within RBOPS supports the Board in meeting its statutory responsibilities under [section 11(j) of] the Federal Reserve Act for oversight of the Reserve Banks' wholesale financial services, as well as under Title VIII of the Dodd-Frank Act for supervision of the private-sector FMUs designated as systemically important" (internal citations omitted).

[9] *See*, *e.g.*, Federal Reserve 2019 Annual Report, "Oversight of Federal Reserve Banks," available at: The Fed - Publications: Annual Report (federalreserve.gov). ("The Board's reviews of the Reserve Banks include a wide range of oversight activities, conducted primarily by its Division of Reserve Bank Operations and Payment Systems . . . The oversight program identifies the most strategically important Reserve Bank current and emerging risks and defines specific approaches to achieve a comprehensive evaluation of the Reserve Banks' controls, operations, and management effectiveness."). *See also* "Federal Reserve Policy on Payment System Risk," Amended as of March 19, 2021, *available at*: Federal Reserve Policy on Payment System Risk. This policy states that "Through this policy, the Board expects financial system participants, including private-sector FMIs and the Reserve Banks, to reduce and control settlement and other systemic risks arising in FMIs, consistent with the smooth operation of the financial system. This policy is also designed to govern the provision of intraday balances and credit while controlling the Reserve Banks' risk by (1) making financial system participants and FMIs aware of the types of basic risks that may arise in the payment, clearing, settlement, or recording process; (2) setting explicit risk-management expectations; (3) promoting appropriate transparency by FMIs to help inform participants and the public; and (4) establishing the policy conditions governing the provision of Federal Reserve intraday credit to eligible account holders." Policy on Payment System Risk at 4. *See also* Audit Report 2014-FMIC-B-014 for an example of the Reserve Bank oversight and monitoring RBOPS conducts.

[10] *See* 12 CFR 201.4. Primary credit is for financially sound banks, secondary credit is for other banks and seasonal credit is for community banks with seasonal funding needs.

[11] Section 13(8) of the Federal Reserve Act provides that "All such advances shall be made at rates to be established by such Federal reserve banks, such rates to be subject to the review and determination of the Board of Governors of the Federal Reserve System." *See*, *e.g.*, "Minutes of the Board of Governors discount rate meetings," February 8, 2021, *available at*: Minutes of the Board's discount rate meetings from February 8 through March 17, 2021 (federalreserve.gov) ("Subject to review and determination by the Board of Governors, the directors of the Federal Reserve Banks of Boston, New York, Cleveland, Chicago, St. Louis, Minneapolis, Kansas City, and San Francisco had voted on January 28, 2021, and the directors of the Federal Reserve Banks of Philadelphia, Richmond, Atlanta, and Dallas had voted on February 4, to establish the primary credit rate at the existing level of 0.25 percent").

[12] *See id*. The Board has promulgated Regulation A, entitled "Extensions of Credit by Federal Reserve Banks, pursuant to sections 10A, 10B, 11(i), 11(j), 13, 13A, 14(d), and 19 of the Federal Reserve Act (12 U.S.C. 248(i)-(j), 343 *et seq.*, 347a, 347b, 347c, 348 *et seq.,* 357, 374, 374a, and 461). *See* 12 CFR 201 et seq.

As noted, for example, a bank must be in "generally sound financial condition" to qualify for primary credit.[13] A bank can receive a seasonal credit loan if its seasonal need "will persist for at least four weeks."[14] And so on.

Pursuant to these regulations established by the Board, each Reserve Bank must decide if an applicant qualifies for the type of credit for which it has applied, and the Reserve Bank then makes the lending decision.[15] There is a System committee – the Subcommittee on Credit Risk Management, or "SCRM" – where representatives from the Reserve Banks ensure that each Reserve Bank is applying the rules uniformly.[16] Board staff from RBOPS and the Monetary Affairs Divisions observe these meetings. In addition, the Board conducts regular audits of each Reserve Bank's lending rules and practices to ensure that the Bank is following Regulation A.[17]

Thus, it is somewhat of a mystery why the proposal does not mention any of these established and well-tested practices – or any other mechanism – to review or monitor application decisions throughout the system to ensure consistency of application. The Board should, at a minimum, make clear that it will leverage its existing tools – or create new ones – to review application decisions across the System. For example, the access decisions presumably would fall under RBOPS' authority to monitor the Reserve Banks' compliance with Board regulations and policies. The SCRM or another similar committee composed of representatives from each of the Reserve Banks and the Board could review account access decisions to ensure consistency in application of the Board's access rules across the System.

THE PROPOSAL'S DELEGATION OF DECISIONS ON THE IORB RATE UNDERCUTS THE PROPOSAL'S GOAL OF CONSISTENCY

Not only does the proposal fail to mention a mechanism to ensure consistency of application, it appears to cede to individual Reserve Banks the Board's statutory authority to establish the interest rate that Reserve Banks would pay to any particular accountholder.[18] The proposal states:

> "If the Reserve Bank decides to grant an access request, it may impose (at the time of account opening, granting access to service, or any time thereafter) obligations relating to, or conditions or limitations on, use of the account or services as necessary to limit operational, credit, legal, or other risks posed to the Reserve Banks, the payment system, financial stability or the implementation of monetary policy or to address other considerations.[5]"

[13] 12 CFR 201.4(a).

[14] 12 CFR 201.4(c)(2).

[15] 12 CFR 201.3, 201.4.

[16] *See*, *e.g.,* Amy Kytonen, Vice President, Supervision, Regulation, and Credit "Credit risk management update: Contributions from the Ninth," (September 18, 2019), available at: Credit risk management update Contributions from the Ninth | Federal Reserve Bank of Minneapolis (minneapolisfed.org) (The Subcommittee on Credit Risk Management "assists Reserve Bank presidents in developing and implementing policies for managing discount window credit, condition monitoring, and payment system risk . . . In a nutshell, SCRM ensures that all things related to managing credit risk are considered nationwide . . . ").

[17] The Board's Division of Monetary Affairs conducts audits of the Federal Reserve Banks for compliance with Regulation A.

[18] *See* 12 U.S.C. 461(b)(12). Specifically, section 19(12) states that: "(A) In General. Balances maintained at a Federal Reserve bank by or on behalf of a depository institution may receive earnings to be paid by the Federal Reserve bank at least once each calendar quarter, at a rate or rates not to exceed the general level of short-term interest rates. (B) Regulations Relating To Payments And Distributions. The Board may prescribe regulations concerning—(i) the payment of earnings in accordance with this paragraph; (ii) the distribution of such earnings to the depository institutions which maintain balances at such banks, or on whose behalf such balances are maintained; and (iii) the responsibilities of depository institutions, Federal Home Loan Banks, and the National Credit Union Administration Central Liquidity Facility with respect to the crediting and distribution of earnings attributable to balances maintained, in accordance with subsection (c)(l)(A), in a Federal Reserve bank by any such entity on behalf of depository institutions."

> "5. The conditions imposed could include, but are not limited to, paying a different rate of interest on balances held in the account, limiting the amount of balances on which interest is paid, or establishing a cap on the amount of balances held in the account."

Thus, under the proposed guidelines, if a Reserve Bank decides to provide an applicant an account, that individual Reserve Bank apparently could impose as a condition that it will pay a different interest rate – that the Reserve Bank itself would set – to the applicant than to other accountholders.

This is striking for a number of reasons. First, by statute, the Board sets the interest rate the Reserve Banks pay on reserve balances (the IORB rate). Section 19 of the Federal Reserve Act provides that the Board may prescribe regulations concerning the payment of interest on balances at a Reserve Bank.[19] There is no comparable authority provided to Reserve Banks under section 13 of the Federal Reserve Act, "Powers of Federal Reserve Banks."[20] Further, while the Board may delegate some functions to the Reserve Banks, it may not delegate those related to rulemaking or principally to monetary and credit policies.[21] Thus, it is not within the Board's authority to delegate this function, as it is related to (a) rulemaking, and (b) "principally to" monetary policy.[22] The Board has explained that the "The interest rate on required reserves (IORR rate) is determined by the Board and is intended to eliminate effectively the implicit tax that reserve requirements used to impose on depository institutions. The interest rate on excess reserves (IOER rate) is also determined by the Board ***and gives the Federal Reserve an additional tool for the conduct of monetary policy*** . . . ***the Federal Reserve intends to move the federal funds rate into the target range set by the FOMC primarily by adjusting the IOER rate***."[23]

Second, as noted, even if arguably it were within the Reserve Bank's authorities to set the IORB rate for certain types of accounts (for example, if the Board declined to establish regulations governing the payment of interest on reserves and the Reserve Banks interpreted silence as tacit authorization to set the rate of interest paid on reserves), or it were able to delegate this function, doing so would undermine one of the key goals of the proposal to ensure consistency across the System. Indeed, inconsistency would be likely, as the proposal includes no mechanism by which the Board and Reserve Banks would agree to common rates.

Third, delegation of interest rate setting would be inconsistent with the Board's 2019 Advance Notice of Proposed Rulemaking for evaluating master account requests from narrow banks or "pass-through investment entities" (or PTIEs, as the Board calls them) (available here). The Board requested comment on whether Reserve Banks should

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[19] *Id.*

[20] *See* sections 13(1)-(14) of the Federal Reserve Act.

[21] Section 11(k) of the Federal Reserve Act provides that the Board, by published order or rule, may delegate any of its functions, other than those related to rulemaking or principally to monetary and credit policies. 12 U.S.C. 248(k).

[22] *Id.*

[23] Federal Reserve Board, "Policy Tools: Interest on Required Reserve Balances and Excess Balances," available at: Federal Reserve Board - Interest on Required Reserve Balances and Excess Balances (emphasis added) (last updated May 18, 2021). The Board issued an interim final rule in 2008 implementing the authority it was provided by Congress in 2006 in the "Financial Services Regulatory Relief Act of 2006" (PL 109–351, Oct. 13, 2006) to pay interest on excess reserves. In adopting the IFR, the Board stated that "The ability to pay interest on balances held at Reserve Banks should help promote efficiency and stability in the banking sector. Paying interest on excess balances will permit the Federal Reserve to expand its balance sheet as necessary to provide sufficient liquidity to support financial stability while implementing the monetary policy that is appropriate in light of the System's macroeconomic objectives of maximum employment and price stability. Paying interest on excess balances should also help to establish a lower bound on the federal funds rate." 73 Fed. Reg. 59482 (Oct. 9, 2008).

pay PTIEs a different rate of interest on their excess reserves than they pay to other banks. That earlier proposal asks:

> If the Board were to determine to pay a lower IOER rate to PTIEs, how should the Board define those eligible institutions to which a lower IOER rate should be paid?

> If the Board were to determine to pay a lower IOER rate to PTIEs, what approach should the Board adopt for setting the lower rate?

Note that there was no ambiguity over the fact that the Board would set the interest rate.[24]

Why might the Board have chosen such open-ended language about interest rates in the account access proposal? It seems unlikely that the final arrangement the Board establishes to handle account requests by UDIs would leave Reserve Banks such discretion in practice. One explanation could be that there is disagreement across the System over how these cases should be handled, with some in the System objecting to the idea that UDIs might earn a different rate of interest, and the Board wanted to put a marker down covering the possibility. If that's the reason, it is all the more important that the Board establish—or use existing—mechanisms to ensure consistent implementation of the guidelines that it establishes.

In order to ensure consistent application of the guidelines—including with respect to interest rates—the Board would need to go further than it has in the proposal, which merely sets forth factors to be considered. The Board should establish guidelines that the Reserve Banks must consider and subject those decisions to centralized review and monitoring, at least for non-traditional applicants, including PTIEs. For example, the Board could establish in the guidelines at least three potential outcomes for applications for accounts: rejection, the granting of a "limited" account, and the granting of a "regular" account. A regular account would be the same as the accounts currently provided federally insured depository institutions. A limited account would receive a lower rate of interest, or no interest, as established by the Board for all such accounts, and perhaps a cap on use, also set by the Board. The Board also could define criteria that must be met in order to be granted either a limited or regular account. Reserve Banks could then decide whether to reject an application or grant a regular or limited account based on the Board's criteria. The Board could then ensure that its existing mechanisms are used, or new mechanisms created, to ensure consistency across the System.

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[24] The ANPR has not advanced since its initial publication.