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PUBLIC INTEREST COMMENT

PROPOSED FED GUIDELINES SHOULD BE REFINED TO ENSURE ACCESS AND COMPETITION IN PAYMENTS SERVICES

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Proposed Guidelines for Evaluating Account and Services Requests
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We appreciate the opportunity to submit a comment to the Federal Reserve (Fed) on its proposed guidelines for evaluating requests for access to its accounts and services. The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group. Rather, it is designed to help the Fed as it considers how to modernize its payments system.

The Fed's publication of the proposed guidelines is timely and important because technology and innovations in the use thereof are changing how payments are made and are affecting the very infrastructure of the US payment system. There are any number of nondepository fintech firms that are attempting to offer new services to the public and are willing to follow Fed protocols as they seek to compete and broaden the market for their payment services. Setting specific guidelines and criteria is a welcome milestone to the extent those guidelines and criteria clarify the conditions of entry and expected performance standards that apply to firms seeking access to a Fed Master Account.

In the Fed's introduction to the proposed guidelines, it emphasizes five policy goals: "(1) ensuring the safety and soundness of the banking system, (2) effectively implementing monetary policy, (3) promoting financial stability, (4) protecting consumers, and (5) promoting a safe, efficient, inclusive, and innovative payment system."[1] These goals are a tall order in the context of a

1. Proposed Guidelines for Evaluating Account and Services Requests, 86 Fed. Reg. 25865, 25866 (May 11, 2021).

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widening and innovative payments system, which is developing at a fast pace with new and complex technologies. If the Fed is to allow for innovation, it should expect greater uncertainty of outcomes and risk, both from changes within the established banking and payments infrastructure and from new entrants as they implement innovative payment products and services.

The Fed lays out six principles it will use to guide its review of request for access to its accounts and services. The proposed guidelines outline expectations for parties making a request and assure that potential risks are recognized and managed, including risk to operational safety and soundness, risk of illegal transactions, and overall risk to Fed banks and the payments system. As important as these considerations are, the Fed should acknowledge that it cannot—and should not—attempt to eliminate all risk if innovative products and services are to be successfully introduced to the public. In fact, in seeking to eliminate all risk the Fed may ironically subject the public to greater risk than is necessary by frustrating beneficial innovation and competition. The following comments, therefore, are intended to identify instances where the proposed principles might benefit from further detail or clarification as they seek to achieve the Fed's listed policy goals.

DISCUSSION

As a preliminary matter, in determining which firms get access to the Fed's payments system, the Fed should be motivated by the original, underlying purpose of its involvement: providing the public with a higher-quality and more reliable payments system than could be provided solely by private industry.[2] Although the validity of this purpose might be debated, at minimum the Fed should be motivated by the public interest, not any particular interest group or market incumbent.

Although traditional concerns such as the stability of payments and compliance with essential criminal laws are certainly legitimate, the Fed should not fall into the trap of believing that any change or entry of firms with new business models presents undue risk. Instead, the Fed should adopt a general bias in favor of entry, innovation, and competition, while retaining the right to exclude firms that, owing to their own deficiencies, present an unacceptable risk to the Fed's legitimate and clearly articulated interests. However, those legitimate risks do not include the risk that market incumbents may lose market share or even fail. A competitive economy must allow for firms to fail and be replaced with new firms that better meet customer needs. Even if the Fed believes that it cannot let certain firms fail, it should not limit access to its payments system on those grounds.

Principle 1 indicates that the applicant must provide a legal basis justifying its right to apply. However, the Fed should provide more detail on how it will apply the Federal Reserve Act, the Federal Deposit Insurance Act, and the Bank Holding Company Act in determining eligibility to seek access to a Fed Master Account. For example, the Fed refers to section 19(b) of the Federal Reserve Act or other statutes as grounds for eligibility for such an account. The Federal Reserve Act refers to sections 3 and 5 of the Federal Deposit Insurance Act.[3] A new fintech company with

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2. Brian Knight and Trace Mitchell, *Private Policies and Public Power: When Banks Act as Regulators within a Regime of Privilege*, 13 N.Y.U. J. of L. and Liberty 66, 125 (2020) (discussing policy justifications for the Federal Reserve providing payments services to banks).

3. "The term 'depository institution' means— (i) any insured bank as defined in section 3 of the Federal Deposit Insurance Act or any bank which is eligible to make application to become an insured bank under section 5 of such Act. . . . The term 'bank' means any insured or noninsured bank, as defined in section 3 of the Federal Deposit Insurance Act." Federal Reserve Act, 12 U.S.C. § 461. Permissible and nonpermissible bank activities are defined broadly within the Bank Holding Company Act.

limited activities outside of payments might be eligible for deposit insurance and, therefore, might meet the conditions of eligibility for a Fed account. However, the proposed guidelines give no indication of whether eligibility is sufficient for such access.

Also, in the instance of a company issuing stablecoins or other cryptocurrencies some further interpretation by the Fed or the Federal Deposit Insurance Corporation of eligibility for account access may be needed. Also, companies such as PayPal that are involved in other nonbank activities may face requirements under the Bank Holding Company Act if they or their affiliates request access to Fed accounts. The Fed should provide greater detail on what is required from applicants making the case for such access. The clearer the requirements, the better able firms will be to structure their applications to meet the statutory and regulatory requirements. Also, if firms choose to go outside such guidelines, they would do so knowing that the Fed's review would be more extensive and the outcome less certain.

Without some greater degree of clarity provided within principle 1, the Fed's evaluation for account access could easily lead to an endless loop of discussion and argument about what is permitted. The Fed has an obligation to clarify as much as possible which statues and related regulations apply when firms seek access to accounts or services, and it should clarify exactly how those statutes and regulations apply.

To this end, the Fed should engage in rulemaking to formally and concretely define the kind(s) of entities that are eligible for Fed Master Accounts. If in the course of its analysis it finds that firms and business models are excluded owing to technical legal requirements even as those firms serve the widest public interest, it should promptly work with Congress to reform the law to allow greater entry and competition. Likewise, Congress should amend the law, if necessary, to grant the Fed surgical policy tools to safeguard the payments system while not placing undue burdens on participating firms.

Principles 2 and 3 address risks posed by firms seeking entry to the payment system to the Fed member banks and to the overall payments system, respectively. These are legitimate concerns, and the Fed should take steps to ensure that firms gaining access to its payments system do not present inordinate risk. However, the Fed should also be mindful that innovative firms may be able to address risks in different ways than traditional banks.

Therefore, the Fed should continually update its guidance and requirements to allow these new firms to address risk without being bound to outdated or irrelevant requirements. If the Fed is going to require firms comply with its orders and policies, those orders and policies must be updated to reflect current reality rather than just forcing innovative pegs into legacy holes.

Principles 4 and 6 are related in that they both address the importance of the Fed's role in assuring financial stability through its supervisory and monetary policy roles. Principle 4 requires that access to a Fed account not create undue risk to financial stability whereas principle 6 requires that such access not adversely affect the Fed's ability to implement stable monetary policy. Each principle is reasonable. To the extent that an applicant meets the statutory and regulatory requirements for access to a Fed account, and to the extent that its operations are monitored and supervised by the Fed or another appropriate regulatory body, its access to an account poses no greater threat to financial stability or monetary policy than does that of any traditional bank or payments provider. The Fed's responsibility should be to assure that the applicant's proposal

complies with the payment statutes and regulations and that, as a going concern, it operates in a safe manner.

Under principle 4, the Fed acknowledges a concern that nonbank payments providers, such as fintech firms, would be subject to more favorable capital requirements and less regulatory oversight, introducing greater risk into the financial system. Such circumstances also might give nonbank payments providers a cost and competitive advantage over traditional banks, which could cause significant disintermediation of transaction deposits from banks to fintech firms, reducing funds available for lending. The result might be a less stable banking and financial industry. However, this outcome is by no means assured, and under certain circumstances the disintermediation of banks may in fact be desirable.

The Fed should remember that the purpose of capital and capital requirements is to provide funding and mitigate external risk to a firm's customers, counterparties, and the broader economy, *not* to provide competitive equity among firms. As such, firms should not be subjected to excessive requirements or regulations in the name of creating a level playing field that is not in fact level. The Fed's responsibility is to protect the payments and financial systems, not play the role of the Handicapper General in Kurt Vonnegut's *Harrison Bergeron*. Therefore, any framework used by the Fed should avoid conflating mere disintermediation or competitive pressure on incumbents with a legitimate threat to the financial system.

Furthermore, in the case of capital, fintech firms are unlikely to have any significant advantage over banks, given the already high leverage of banks, ranging from a 5 percent leverage ratio for the largest banks to an 8 percent ratio for smaller banks.[4] Also, if the Fed places minimum capital levels as a condition for access to its account services on the basis of sound risk analysis, any capital advantage would be normalized. In the latter case, to the extent that new entrants confine their activities to payments services, those firms would be subject to applicable payments laws and regulations and should have no regulatory advantage over traditional banks with regard to the provision of payments services.[5] Should they seek to broaden their activities to, for example, lending, then their risk profile would change, and they would need to adhere to the additional appropriate laws and regulations governing such an activity.

On the matter of monetary policy, principle 6 requires that any firm gaining access to a master account not adversely affect the Fed's ability to implement monetary policy. Though this is an understandable goal, it is difficult and unreasonable to anticipate how entry of new payments providers would affect this goal. The Fed should adapt its monetary policy practices to match the economic reality created by a competitive market, not resist entry and innovation out of fear that competition will hamper monetary policy.

The banking and financial industry is already changing at an extraordinary pace, which affects the Fed's methods and ability to implement policy. For example, over the past two decades the number of bank depository institutions has declined by more than half while the share of industry deposits held by the largest five banks has doubled from 20 percent to 40 percent. These

4. For current ratios and requirements, see FEDERAL RESERVE BANK OF KANSAS CITY, BANK CAPITAL ANALYSIS, https://www.kansascityfed.org/research/bank-capital-analysis/ (December 31, 2020).
5. For example, such an applicant might be a fintech firm structured as a narrow bank for which every deposit is backed by a short-term US Treasury security and for which firm revenues are derived from transaction fees. The firm's capital would be required to fund ongoing payments operations, but there would be no capital or borrowed money to fund loans or other investments. If the firm were to expand its business model to that of commercial banking, it would need to seek a bank charter.

changes represent a sizeable shift in the intermediation process from small to large banks. Also, over the past 14 years the Fed has dramatically changed how it conducts monetary policy, relying on quantitative easing and interest rate targeting for repurchase agreements rather than on only the fed funds rate.

Few people anticipated these changes. It will be equally difficult to anticipate the effects on the implementation of monetary policy from the entrance of new payments providers. Thus, the Fed should modify principle 6 to more accurately reflect the limits of its capacity to anticipate monetary policy effects—or it should drop the principle entirely and focus on those principles that will serve to assure that new entrants comply with applicable laws and regulations and that they operate in a safe and sound manner. Under these conditions the Fed can be expected to successfully carry out its monetary policy mandate.

CONCLUSION

The Fed should be commended for seeking to modernize access to its payments system. This system was established in the public interest, and it will remain true to that mission if it allows innovation and competition within the financial system. Therefore, the Fed should seek to adopt a bias in favor of access while maintaining appropriate safeguards. The proposed guidelines, with appropriate changes, present a good opportunity to start that process.