Avila Rodriguez Hernandez Mena & Garro LLP

Puerto Rico
Financial Services Forum
Federal Reserve Guidelines for Master Accounts

Alcides Avila

October 17-18, 2022

Guidelines for Evaluating Account and Service Requests

- On August 15, 02022 the Federal Reserve Board adopted final guidelines for the establishment of Master Accounts and access to payment services.
- The guidelines arose from the recognition that FinTech's and other novel charters offering a host of new types of financial products and services needed access to Fed accounts and payment systems.
- The guidelines seek to promote a risk based and consistent set of factors to review and approve applications for master accounts and services.
- Will Impact IFE's in application process

Guidelines for Evaluating Account and Service Requests

- The guidelines adopt a set of 6 underlying principles and include a tiered structure to provide “clarity on the level of due diligence and scrutiny that Reserve Banks will apply to different types of institutions” presenting different levels of risk.
- The 6 “principles” are based on the Fed’s policy goals of:
  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

Guidelines for Evaluating Account and Service Requests

Of the 6 principles

- The first makes clear that only legally eligible institutions need apply
- The remaining five principles addressed specific risks, ranging from narrow risks (such as risk to an individual Reserve Bank) to broader risks (such as risk to the U.S. financial system)

For these five principles the guidelines list factors for the Reserve Banks to consider.

Guidelines for Evaluating Account and Service Requests

Guidelines are not a substitute for the “Handbook” required by the Federal Reserve Bank of NY:

- The Handbook sets out the minimum factors and steps that an institution must meet and take to open an account, and the documents required
- The guidelines establish the factors and criteria that the Reserve Banks must use to evaluate such information in order to approve an account and payment services
- IFE’s will need to address “Principles” in Handbook and applications

Guidelines for Evaluating Account and Service Requests

The Handbook applies to institutions that are not subject to supervision by a Federal regulatory authority and are generally viewed as higher risk. These factors are considered in the guidelines.

The Six Principles

The Six Principles

Principle 1 - Eligibility

- **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 and should have a well-founded, clear, transparent, and enforceable legal basis for its operations**
    - Generally, only institutions that are member banks or meet the definition of a depository institution under section 19(b) of the Federal Reserve Act are legally eligible
    - The Reserve Bank should assess the consistency of the institution's activities and services with applicable laws and regulations and consider whether the activities and services would impede compliance with U.S. sanctions programs, BSA and AML requirements or consumer protection laws and regulations.

The Six Principles

Principle 2 – Safety and Soundness

- **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.**
- Factors
  - Effective risk management framework and governance to ensure that the institution operates in a safe and sound manner during both normal conditions and periods of idiosyncratic and market stress:
  - Be in substantial compliance with its primary supervisor's regulatory and supervisory requirements;
  - Be able to demonstrate:

The Six Principles

Principle 2 – Safety and Soundness

- an ability to comply with Board orders and policies, and other applicable agreements, operating circulars and requirements of the Federal Reserve;
- sound financial condition, including adequate capital to continue as a going concern and to meet its current and projected operating expenses under a range of scenarios;
- its ability, on an ongoing basis, including during periods of idiosyncratic or market stress, to meet all of its obligations and comply with its agreement for a master account, including by maintaining:
  - sufficient liquid resources to meet its obligations to the Federal Reserve Bank;
  - operational capacity to ensure that such liquid resources are available to satisfy all such obligations to the Federal Reserve Bank on a timely basis; and
  - settlement processes designed to appropriately monitor balances in its master account on an intraday basis, to process transactions through its account in an orderly manner and maintain/achieve a positive account balance before the end of the business day.

The Six Principles

Principle 2 – Safety and Soundness

- An operational risk framework designed to ensure operational resiliency against events associated with processes, people, and systems, which should:
  - identify the range of operational risks presented by the institution's business model;
  - establish sound operational risk management objectives to address such risks;
  - establish sound corporate governance arrangements;
  - establish rules and procedures to carry out risk management objectives;
  - employ the resources necessary to achieve risk management objectives and effectively implement rules and procedures; and
  - support compliance with electronic access requirements, including security measures, outlined in the Federal Reserve Banks' Operating Circular No. 5.

The Six Principles

Principle 3 – Risks to Payment System

The 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.

Factors:

- The Reserve Bank should incorporate, to the extent possible, the assessments of an institution by state and/or federal supervisors into its independent assessment of the institution's risk profile.

- The Reserve Bank should confirm that the institution has an effective risk management framework and governance arrangements to limit the impact that idiosyncratic stress, disruptions, outages, cyber incidents, or other incidents at the institution might have on other institutions and the payment system broadly. The framework should include:

The Six Principles

Principle 3 – Risks to Payment System

- Clearly defined operational reliability objectives and policies and procedures to achieve those objectives.
- A business continuity plan that addresses events that have the potential to disrupt operations and a resiliency objective to ensure the institution can resume services in a reasonable timeframe.
- Policies and procedures for identifying risks that external parties may pose to sound operations, including interdependencies with affiliates, service providers, and others.

The Six Principles

Principle 3 – Risks to Payment System

- The Reserve Bank should identify actual and potential interactions between the institution's use of a Reserve Bank account and services and (other parts of) the payment system.

- The extent to which the institution's use of a Reserve Bank account and services might restrict funds from being available to support the liquidity needs of other institutions should also be considered.

d. Meet the safety and soundness factors of Principle 2

The Six Principles

Principle 4 – Financial Stability

Provision of an account and services to an institution should not create undue risk to the stability of the U.S. financial system.

Factors:

- The Reserve Bank should incorporate, to the extent possible, the assessments of an institution by state and/or federal supervisors into its independent assessment of the institution's risk profile.

- The Reserve Bank should determine, in consultation with the other Reserve Banks and Board as appropriate, whether the access to an account and services by an institution itself *or a group of like institutions* could introduce financial stability risk to the U.S. financial system.

The Six Principles

Principle 4 – Financial Stability

- The Reserve Bank should confirm that the institution has an effective risk management framework and governance arrangements for managing liquidity, credit, and other risks that may arise in times of financial or economic stress.
- The Reserve Bank should consider the extent to which, especially in times of financial or economic stress, liquidity or other strains at the institution may be transmitted to other segments of the financial system.
- The Reserve Bank should consider the extent to which, especially during times of financial or economic stress, access to an account and services by an institution (or a group of like institutions) could affect deposit balances across other institutions and whether any resulting movements could have a negative effect on U.S. financial stability.

The Six Principles

Principle 4 – Financial Stability

This policy recognizes that balances held in master accounts are very high quality making them very attractive in times of financial or economic stress. As a result, in times of stress, investors that would otherwise provide short- term funding to nonfinancial firms, financial firms, and state and local governments could rapidly withdraw that funding and instead deposit their funds with an institution holding mostly central bank balances. If the institution is not subject to capital requirements similar to a federally insured institution, it can more easily expand its balance sheet during times of stress; as a result, the potential for sudden and significant deposit inflows into that institution is particularly large, *which could disintermediate other parts of the financial system, greatly amplifying stress.*

The Six Principles

Principle 5 - Prevention of Financial Crimes

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, or other illicit activity.

Factors:

- The Reserve Bank should incorporate, to the extent possible, the assessments of an institution by state and/or federal supervisors into its independent assessment of the institution's risk profile

The Six Principles

Principle 5 - Prevention of Financial Crimes

- The Reserve Bank should confirm that the institution has a BSA/AML compliance program consisting of the components set out below and in relevant regulations.
  - A system of internal controls, including policies and procedures, to ensure ongoing BSA/AML compliance;
  - Independent audit and testing of BSA/AML compliance to be conducted by bank personnel or by an outside party;
  - Designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance (BSA compliance officer);
  - Ongoing training for appropriate personnel, tailored to each individual's specific responsibilities, as appropriate;
  - Appropriate risk-based procedures for conducting ongoing customer due diligence to include, but not limited to, understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile and conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.

The Six Principles

Principle 5 - Prevention of Financial Crimes

- The Reserve Bank should confirm that the institution has a compliance program designed to support its compliance with the OFAC regulations
  - An OFAC compliance program should identify higher-risk areas and provide for appropriate internal controls for screening and reporting;
  - establish independent testing for compliance;
  - designate a bank employee or employees as responsible for OFAC compliance; and
  - create a training program for appropriate personnel in all relevant areas of the institution

The Six Principles

Principle 6 – Monetary Policy

Provision of an account and services to an institution should not adversely affect the Federal Reserve's ability to implement monetary policy

Factors:

- The Reserve Bank should incorporate, to the extent possible, the assessments of an institution by state and/or federal supervisors into its independent assessment of the institution's risk profile.

- The Reserve Bank should determine, in consultation with the other Reserve Banks and the Board as appropriate, whether access to an account and services by an institution itself or a group of like institutions could have an effect on the implementation of monetary policy.

The Six Principles

Principle 6 – Monetary Policy

- The Reserve Bank should consider, among other things, whether access to a Reserve Bank account and services by the institution or group of like institutions could affect:
  - the level and variability of the demand for and supply of reserves,
  - the level and volatility of key policy interest rates,
  - the structure of key short-term funding markets, and
  - the overall size of the consolidated balance sheet of the Reserve Banks.

- The Reserve Bank should consider the implications of providing an account to the institution in normal times as well as in times of stress. This consideration should occur regardless of the current monetary policy implementation framework in place.

Tiered Structure for Analysis

Tiered Structure for Analysis

Tier 1: **Eligible institutions that are federally insured.**

- Federally-insured depository institutions are already subject to a standard, strict, and comprehensive set of federal banking regulations.

- In addition, for most Tier 1 institutions, detailed regulatory and financial information would in most cases be readily available, often in public form.
- Tier 1 institutions will generally be subject to a less intensive and more streamlined review.

- If application of the Guidelines identifies potentially higher risk, the institutions will receive additional attention.

Tiered Structure for Analysis

Tier 2: **Eligible institutions that are not federally insured but are subject (by statute) to prudential supervision by a federal banking agency. In addition, (i) if such an institution is chartered under federal law, it has a holding company that is subject to Federal Reserve oversight (by statute or commitments); and (ii) if such an institution is chartered under state law and has a holding company, that holding company is subject to Federal Reserve oversight (by statute or commitments).**

Tiered Structure for Analysis

- Tier 2 institutions are subject to a similar, but not identical, set of regulations as Tier 1 and thus may present greater risks than Tier 1 institutions.
- Reserve Banks will have significant supervisory information about, as well as some level of regulatory authority over, Tier 2 institutions.
- Accordingly, account access requests by Tier 2 institutions will generally receive an intermediate level of review

Tiered Structure for Analysis

Tier 3: **Eligible institutions that are not federally insured and are not considered in Tier 2.**

- Non-federally-insured institutions that are chartered under federal law but do not have a holding company subject to Federal Reserve oversight would be considered in Tier 3.

- Non-federally-insured institutions that are chartered under state law and are not subject (by statute) to prudential supervision by a federal banking agency, or have a holding company that is not subject to Federal Reserve oversight.

Tiered Structure for Analysis

- Tier 3 institutions may be subject to a regulatory framework that is substantially different from the regulatory framework that applies to federally-insured institutions.

- Detailed regulatory and financial information regarding Tier 3 institutions may not exist or may be unavailable.

- Accordingly, Tier 3 institutions will generally receive the strictest level of review.

IFE – Action Points

- IFEs will be Tier 3 and subject to enhanced and strict review.
- Preparation for Applications:
  - Capital Stress Tests
  - Liquidity Stress Tests with view to meeting Fed Obligations
  - Independent Risk Assessment, including risk management and corporate governance
  - Independent AML/OFAC Review
  - Cyber Security and Recovery Plans – Tested
  - Review of Impact on Payment System

Q&A

PRESENTER

Alcides I. Avila
Partner

Avila Rodriguez Hernandez Mena & Garro LLP
2525 Ponce de Leon Blvd, Penthouse 12th Floor
Coral Gables, FL 33134
Tel: 305.779.3570 Fax: 305.779.3561
aavila@avilalaw.com