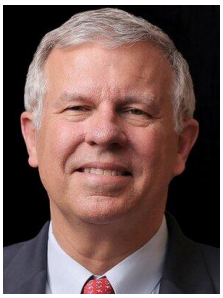
Novel Applications May Fizzle After Fed Master Account Wins

By **Randall Guynn, Daniel Newman and Justin Levine** (May 16, 2024)



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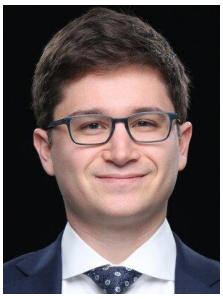

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Two federal district courts recently upheld decisions by the Federal Reserve Bank of Kansas City, or FRBKC, and the Federal Reserve Bank of San Francisco to deny master account applications from Custodia Bank Inc. and PayServices Bank.

The U.S. District Court for the District of Wyoming ruled in the Custodia matter on March 29, and the U.S. District Court for the District of Idaho ruled in the PayServices case on March 30.

The two decisions mark the second and third times a federal district court has held that a Federal Reserve bank has the discretion to deny master accounts to legally eligible depository institutions. Both Custodia[1] and PayServices have filed notices to appeal the decisions.

The decisions are significant for depository institutions with so-called novel charters that wish to have direct access to the payment systems of the Federal Reserve System and settle transactions in central bank money. A depository institution cannot obtain this type of direct access unless it has a master account at a Federal Reserve bank.

A master account is also a necessary, but not sufficient, condition for an institution to have access to the Federal Reserve's discount window, to incur intraday or overnight overdrafts in any of the Federal Reserve's payment systems, or to obtain direct membership in the major clearing networks that connect the U.S. payment system.

The decisions allow Federal Reserve banks to continue to implement the master account access guidelines[2] issued by the Board of Governors of the Federal Reserve. The guidelines effectively call for Fed banks to apply strict scrutiny to master account applications from "Tier 3" banks, a category that includes uninsured state-chartered depository institutions that are not subject to federal prudential regulation and do not have a holding company subject to Federal Reserve oversight.

Given the protracted and high-profile nature of Custodia's lawsuit, this article focuses on the Custodia court's decision that Fed banks have discretion to reject master account applications.

We also discuss the implications of the Custodia and PayServices cases for the future ability of depository institutions with novel charters to obtain master accounts, as well as for the future of the dual banking system more generally.

Legal Analysis of the Ruling

On March 29, the Wyoming federal court held that the FRBKC was not required to grant Custodia's request for a master account even though Custodia was legally eligible for one, citing seven reasons in support of its decision.[3] Here, we focus on the parts of the court's analysis that we think are most likely to be disputed as part of Custodia's appeal to the U.S. Court of Appeals for the Tenth Circuit.

Plain Text and Statutory Scheme

Much of the court's reasoning focused on the plain text of Title 12 of the U.S. Code, Section 248a,[4] which was added by the Depository Institutions Deregulation and Monetary Control Act of 1980.[5] Custodia had argued that Section 248a required the Federal Reserve banks to open a master account for all legally eligible depository institutions upon request.

Several prominent academics, including professors Peter Conti-Brown[6] and Julie Andersen Hill,[7] have supported Custodia's position.

Express Requirement

The court rejected Custodia's argument that Section 248a expressly requires Federal Reserve banks to grant legally eligible depository institutions a master account so that they can access Fed bank services.

- Court's reasoning: Section 248a merely directs the Federal Reserve Board to "publish for public comment a set of pricing principles in accordance with this section and a proposed schedule of fees based upon these principles." The statute then provides that the "schedule of fees prescribed pursuant to this section shall be based on the following principles." It lists, among several principles, that "[a]ll Federal Reserve bank services covered by the fee schedule shall be available to nonmember depository institutions and such services shall be priced at the same fee schedule applicable to member banks [with certain exceptions]." The district court read the language on which Custodia relied as being merely a "pricing principle" and not a mandate to grant all legally eligible depository institutions a master account.

- Custodia's possible response: The language in Section 248a is not a mere pricing principle but rather an express mandate to grant master accounts to all legally eligible nonmember depository institutions. Because the services described in Section 248a cannot be made available to a depository institution unless it has a master account, the most reasonable interpretation of this mandate is that it requires the Fed banks to open master accounts for all legally eligible depository institutions that request one.

Omission of the Word "All"

The court also reasoned that Section 248a does not require all Federal Bank services to be made available to all nonmember depository institutions.

- Court's reasoning: Congress appears to have deliberately omitted the adjective "all" before "nonmember depository institutions" because it had inserted the word "all" before "Federal Reserve bank services."

- Custodia's possible response: The use of the adjective "all" before "Federal Reserve bank services" and the failure to repeat that adjective before nonmember depository institutions are not sufficient to fairly imply that Congress intended for the Fed banks to have the discretion to grant master accounts only to a subset of all nonmember depository institutions.

Title and Heading of Section 248a

The court also pointed to the titles and headings used to describe the parts of the U.S. Code where Section 248a resides in further support of its ruling.

- Court's reasoning: Section 248a only applies to the Federal Reserve Board, and not the Fed banks, since it was codified in a subchapter of the U.S. Code titled "Board of Governors of the Federal Reserve System." The court cited a book written by Bryan Garner and the late U.S. Supreme Court Justice Antonin Scalia for the proposition that the title and headings of legal texts are permissible indicators of meaning.[8]

- Custodia's possible response: The book by Justice Scalia and Garner that is cited by the court also provides that although statutory titles and headings are permissible indicators of meaning, they cannot override contradictory language in the body of the statute.[9]

The Toomey Amendment

While the Custodia case was pending, then-Sen. Pat Toomey, R-Pa., proposed an amendment to the Federal Reserve Act that was enacted into law as part of the 2023 National Defense Authorization Act[10] and later codified as Title 12 of the U.S. Code, Section 248c.[11]

Section 248c requires the Federal Reserve Board to "create and maintain a public, online, and searchable database that contains ... a list of every entity that submits an access request for a reserve bank master account and services," including whether the request was "approved, rejected, pending, or withdrawn."

- Court's reasoning: The Toomey amendment implies that Congress believes Fed banks have the discretion to grant or deny applications for master accounts. Judge Robert E. Bacharach of the Tenth Circuit did not have the Toomey amendment available for his consideration when he reasoned in Fourth Corner Credit Union v. Federal Reserve Bank of Kansas City in 2017[12] that all legally eligible depository institutions are entitled to master accounts as a matter of law.

- Custodia's possible responses: Toomey submitted an amicus brief,[13] which stated that the purpose of the amendment was clearly not to suggest that Federal Reserve banks had any discretion to deny master account applications from any legally eligible depository institutions. The amendment was specifically intended to increase the transparency and public accountability of the Fed banks' master account approval

process, which otherwise had been conducted in secret. Moreover, as others[14] have noted,[15] the court initially cast doubt on this same argument in its June 2023 order.[16] Had the court interpreted the purpose of the Toomey amendment consistent with Toomey's stated intent, the court would have followed Judge Bacharach's opinion, as it seemed primed to do in its June 2023 order.

Policy Arguments

The court wrote that certain policy arguments supported its decision to construe the statute to give Federal Reserve banks discretion to deny master accounts to some legally eligible depository institutions.

- Court's reasoning: If the Fed banks did not have the discretion to deny applications for master accounts from at least some legally eligible depository institutions, they could be forced to grant master accounts to state-chartered depository institutions that are not "soundly crafted." Making state chartering laws "the only layer of insulation for the U.S. financial system" could cause a "race to the bottom" where states reduce state chartering burdens and allow "minimally regulated institutions to gain ready access to the central bank's balance sheet and Federal Reserve services."

- Custodia's possible responses:

    - First, if Section 248a expressly requires the Federal Reserve banks to open master accounts for all legally eligible depository institutions, it does not matter whether that was a good idea or not. A federal court cannot override a law duly enacted by Congress solely because the court believes it is bad policy.

    - Second, the view reflects a level of distrust of state banking regulators that the Tenth Circuit may not consider to be justified.

    - Third, the FRBKC and the Federal Reserve's payment system would not be exposed to any material risk merely by opening a master account for Custodia and providing Custodia access to the services listed in Section 248a(b) because the FRBKC could (1) require Custodia to preposition any funds to be transferred instead of allowing Custodia's master account to go into overdraft and (2) choose not to give Custodia access to the Federal Reserve's discount window or any other lender of last resort facility, which are not included in the list of covered services in Section 248a(b).

Implications of These Rulings for Tier 3 Banks and the Dual Banking System

If the decisions are not successfully appealed, they would have important implications for the future ability of depository institutions with novel charters to obtain master accounts, as well as for the future of the dual banking system more generally.

Strict scrutiny of Tier 3 banks virtually precludes them from obtaining master accounts. These decisions would allow the Fed banks to continue to apply the guidelines' strict scrutiny standard of review for applications from Tier 3 banks.

While the guidelines do not expressly preclude Tier 3 banks from obtaining master accounts, the strict scrutiny standard of review that they call for would make it virtually impossible for Tier 3 banks to obtain a master account.

The decisions by the FRBKC and the Federal Reserve Bank of San Francisco to deny master accounts to Custodia and PayServices, respectively, as well as the Federal Reserve Bank of New York's February decision[17] to deny[18] a master account to TNB USA Inc., strongly support this prediction.

Fed banks have the power to increase the operating costs of uninsured depository institutions with novel business models.

Shortly after the Civil War, Congress attempted to drive state-chartered banks out of business because it considered them to be unsafe and unsound and a threat to the new national banking system. It attempted to do so by imposing a 10% excise tax on paper currency issued by state-chartered banks without imposing a tax on paper currency issued by the new national banks.[19]

The result was that many state-chartered banks converted into national banks. Other state banks managed to survive despite the tax by convincing their customers to use checking accounts instead of paper currency to pay for goods and services.

Here, it is not Congress but the Federal Reserve that is imposing costs on uninsured state-chartered depository institutions with novel business models.

The denial of master accounts to state-chartered banks with novel business models will increase these banks' operating costs by forcing them to pay intermediaries to give them indirect access to the Fed's payment services.

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[1]https://storage.courtlistener.com/recap/gov.uscourts.wyd.61107/gov.uscourts.wyd.61107.321.0_1.pdf.

[2] https://www.govinfo.gov/content/pkg/FR-2022-08-19/pdf/2022-17885.pdf.

[3] https://www.davispolk.com/insights/client-update/district-courts-refuse-order-federal-reserve-grant-master-accounts-custodia.

[4] https://www.govinfo.gov/content/pkg/USCODE-2022-title12/pdf/USCODE-2022-title12-

chap3-subchapII-sec248a.pdf.

[5] https://www.congress.gov/96/statute/STATUTE-94/STATUTE-94-Pg132.pdf.

[6] https://storage.courtlistener.com/recap/gov.uscourts.wyd.61107/gov.uscourts.wyd.61107.240.1.pdf.

[7] https://ilr.law.uiowa.edu/volume-109-issue-1/cannabis-crypto-federal-reserve-discretion-payments.

[8] Antonin Scalia & Bryan A. Garner, Reading Law: The Interpretation of Legal Texts, at 221 (2012).

[9] Id. at 174-176.

[10] https://www.congress.gov/117/plaws/publ263/PLAW-117publ263.pdf.

[11] https://www.govinfo.gov/content/pkg/USCODE-2022-title12/pdf/USCODE-2022-title12-chap3-subchapII-sec248c.pdf.

[12] https://www.ca10.uscourts.gov/sites/ca10/files/opinions/01019832098.pdf.

[13] https://storage.courtlistener.com/recap/gov.uscourts.wyd.61107/gov.uscourts.wyd.61107.151.0.pdf.

[14] https://twitter.com/EleanorTerrett/status/1774117195578016254.

[15] https://bankregblog.substack.com/p/clearing-the-docket?utm_source=post-email-title&publication_id=858886&post_id=143123653&utm_campaign=email-post-title&isFreemail=true&r=1gv5pa&triedRedirect=true&utm_medium=email.

[16] https://storage.courtlistener.com/recap/gov.uscourts.wyd.61107/gov.uscourts.wyd.61107.164.0.pdf?utm_source=substack&utm_medium=email.

[17] https://www.tnbusa.com/wp-content/uploads/2024/02/TNB-Letter-of-Appeal.pdf?source=email.

[18] https://www.americanbanker.com/news/federal-reserve-denies-the-narrow-banks-master-account-application.

[19] Act of July 13, 1886, ch. 173, 14 Stat. 98, 146.