Consumer Finance Monitor (Season 7, Episode 46): Should Congress Create a New Federal Charter for Non-Bank Payment Companies?

Speakers: Alan Kaplinsky and Dan Awrey

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm. And I'm your host, Alan Kaplinski, the Foreign Practice Group leader for 25 years, and now senior counsel of the Consumer Financial Services Group at Ballard Spahr. And I'm pleased to be moderating today's program. For those of you who want even more information, don't forget about our blog, which also goes by the name of Consumer Finance Monitor. We've hosted our blog since 2011 when the CFPB became operational, so there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog, or to get on the list for our webinars, please visit us at ballardspahr.com.

And if you like our podcast, let us know about it. You can leave us a review on whatever platform you are using, Apple Podcasts, YouTube, Spotify, et cetera. Also, please let us know if you have any ideas for other topics that we should consider covering, or speakers that we should consider inviting as guests on our show. So, let me first introduce our guest who is a repeat guest. The podcast show got released on January 5th, 2023, so a little more than a year and a half ago. And then I'm going to tell you what we talked about then, and what we're going to talk about today. Our guest is Professor Dan Awrey. He is a professor of law at Cornell Law School, is teaching in research interests reside in the area of financial regulation, and more specifically the regulation of banks, investment funds, derivatives markets, payment systems, and financial market infrastructure.

Dan has undertaken research and provided advice at the request of organizations, including the Bank for International Settlements, the US Treasury Department, the Federal Reserve Board, the President's Working Group on Financial Markets. HM Treasury, UK Financial Conduct Authority, the Commonwealth Secretariat, and European Securities and Markets Authority. His research has been featured, I would say, in practically every major law review of the major law schools in the country. He's the co-author of one of the leading textbooks on financial regulation called Principles of Financial Regulation, published by Oxford University Press. He's also the founding co-managing editor of the Journal of Financial Regulation. So Dan, very warm, welcome to you. Delighted to have you back.

Dan Awrey:

Thank you so much, Alan. It's great to be back.

Alan Kaplinsky:

So before we get started on the topic we're going to delve into today, which I'm very excited about, want to just reflect back on the podcast that you were on, on January 5th, or at least it got released on January 5th, 2023. The title of the podcast was, Is the US Payment System Failing Business and Consumers? And at that time, we talked about a payment system, a new system, that the Federal Reserve Board was developing that was in the pipeline called FedNow. And at that time it had not yet been made available to the public. It hadn't been formally released. But we knew the contours of what this system was going to be all about, and I can recall very vividly during our discussion, we first talked about how the existing payment systems in the US are not really very effective and not efficient, and they pale when viewed alongside some of the payment systems in foreign countries.

And then I asked you about FedNow and I remember you saying you were pretty negative on it and you gave a pretty, I'd say, I don't know if skeptical is the right word, but you thought it probably was not going to be very successful. So I know that our audience, that a lot of them focus on payment systems is going to want to know what you think now a year after FedNow has been launched.

Dan Awrey:

Great. Yeah, this is still something that I try to keep a fairly close eye on. The key challenge for everybody interested in assessing the impact of FedNow is that we really don't have any data on whether and how much it's being used by the institutions that have signed up to participate in it. All the information that we get from the Fed is occasional updates in terms of the number of institutions that have signed on to the system, but that information really isn't that important relative to the number of transactions processed through that system. It's the number of transactions that ultimately are going to determine the success or failure of the system itself, but also of the technological ecosystem that at least in theory, the Fed hopes to build on top of these new real-time payment rails. And the reason that the number of banks signing up doesn't really matter, it's sort of like the number of people who indicate an interest in attending a particular seminar.

You get an email, you sign up three months in advance thinking you'll have the time and interest, but when the moment comes, the number of people in the room is a lot less than the number of people who indicated their interest. And so it goes with payment systems. The number of institutions who have notionally said, "Yes, sure, I'm happy to be part of FedNow," is pretty irrelevant if those institutions don't show up on the day. They have other options, whether it be in the form of existing payment rails or the private real-time alternative in the form of RTP. So it's not like they're required to use FedNow. And the reason that myself and others are skeptical is that the existing design features and pricing structure of FedNow don't really give participants much of an incentive to start using it. And since we don't have any data on whether it is being used sort of, I remain in the same state of skepticism that I was when we spoke a year and a half ago.

Alan Kaplinsky:

And from what I understand, the Fed's been very reluctant to share the data pertaining to usage.

Dan Awrey:

They certainly haven't publicly disclosed this data, and that's something that myself and others have been agitating for some time. Public money and resources went to establishing this system. The only way to determine the effectiveness of this system and whether those resources were well spent is understanding usage. And so, I really do think the Fed should be disclosing usage figures, even if it turns out in the short term that it's an embarrassment to them.

Alan Kaplinsky:

Right. Right. Okay. Enough said about FedNow. Let's get into a very recent working paper, I would call it, that you've written called Money and Federalism, not yet published in any law review, but I'm sure will be in the future. Just to give everybody a grounding for what we're going to talk about, let read the abstract that's in your article and then we'll go from there. I have a lot of questions for you.

"The United States is the only country in the world in which both federal and state governments possess independent and yet overlapping authority for bank chartering, regulation and supervision. The roots of this unique dual banking system can be traced back to the Constitution, written almost a century before banks rose to the apex of the financial system and became the dominant source of money. Beginning with the landmark Supreme Court decision in Maryland v. McCulloch, the system has been a wellspring of jurisdictional conflict. Yet over time, this highly contested and highly fragmented system has also produced strong federal oversight and a financial safety net that protects bank depositors, prevents destabilizing runs, and promotes monetary stability.

"This system is now under stress. The source of the stress is a new breed of technology-driven financial institutions licensed and regulated almost entirely at the state level that provide money and payments outside the perimeter of both conventional

bank regulation and the financial safety net. This article examines the rise of these new monetary institutions, the state-level regulatory frameworks that govern them and the nature of the threats they may one day pose to monetary stability.

"It also examines the legal and policy cases for federal supremacy over the regulation of these new institutions and advances to potential models, one based on complete federal preemption, the other more tailored to reflect the narrow yet critical objective of promoting public confidence and trust in our monetary system."

What was your motivation for delving into this, I guess thicket, I would call it, of constitutional law? I mean, I must say I learned a heck of a lot, even aside from the theme of your article, just having all that history at my fingertips, it was really quite interesting. But anyway, how did you decide to get into this?

Dan Awrey:

Yeah, so it's a great question. Over the last couple of years I've been working with various actors in the administration, in Congress and in the banking agencies on some of the bills that have been put forward for things like federal regulatory frameworks for stablecoins. Not directly in the area of money and payments, not yet at least, but certainly adjacent to that. And I've long been an advocate for a federal payments charter. But one of the things that I came across in a lot of these conversations in DC was antagonism between the federal government and state's attorneys general around the constitutional authority to do what the federal government was proposing to do. There weren't a lot of explicit legal analyses of the constitutional authority to do so. Some of the threats were pretty veiled. And so initially, just as a curiosity, I wanted to understand better than I did, the footing on which the federal government stood in attempting to create regulatory frameworks for non-bank monetary institutions.

So the history that you enjoyed in the paper is mostly history that I was unfamiliar with as well. And once I started to delve into the jurisprudence, what quickly became apparent to me was that what we teach, what I teach in law school about the dual banking system and its constitutional origins is really unsatisfactory, is that most of the jurisprudence from Maryland v. McCulloch through the legal tender cases, the National Banking Act cases and the monetary clause cases of the 1930s is mostly about the federal government's authority over tax and fiscal affairs and has very little to do with either bank regulation per se, and absolutely nothing to do with the regulation of monetary institutions other than banks. And so, really then the article was first an attempt to then articulate the inadequacies of the constitutional jurisprudence on this particular set of issues. But then two, to start to think about how I would frame a constitutional story that supported some level of federal regulatory intervention into non-bank monetary institutions.

Alan Kaplinsky:

Well, let's start with a basic topic, and that is why do we have the dual banking system? As I understand it, and as you chronicled it in your working paper, there may not be any other countries that have anything like a dual banking system. How did it develop in the United States?

Dan Awrey:

Yeah, the short answer to that question is that it's hard to overstate the extent to which Jefferson hated Hamilton, and Hamilton hated Jefferson. The slightly longer version of the story, and this is really a pervasive story in U.S banking regulation that goes beyond the mere structure of the dual banking system was the enduring skepticism of concentrations of both public and private power. And so, before the Constitutional Convention, you get both individual states and the Congress issuing charters for banks. After Confederation, you get Hamilton supporting the creation of the first Bank of the United States, and you get states as well that don't see any reason why they cannot also issue bank charters.

The system that comes out of this is one that is in many respects kind of famous as a constitutional story, but in other respects just sort of ducks and dodges, the fundamental question of can everybody issue a bank charter in the United States? After the fall of the second bank of the United States in 1936, we get this period where the only charters are state charters. After the Civil War, we get the national banking acts, one of the purposes of which is to try to eliminate through taxation and other means the state charters and make national banks the dominant source of money.

But that experiment ultimately fails. State banks and bankers experiment with things like checking accounts that avoid the tax. And none of this jurisprudence deals with the fact that we are now developing a competing federal state system of bank charters. So we've never fully dealt with the question is the answer to why we ended up with the dual banking system implicitly at the heart of Maryland and McCullough is the idea that the power to charter banks as an implied power of the federal government. A few years later in Briscoe, you get the Supreme Court saying that it's okay for states to charter banks, even if the state is the only shareholder of that bank. And really from that moment forward, the jurisprudence does very little to even acknowledge the conflicts and paradoxes associated with multiple governments, all exerting sovereignty over bank chartering regulation and supervision.

Alan Kaplinsky:

Yeah. Do you think, Dan, that one of the reasons we have so many banks in this country per capita, I guess, compared to other foreign countries, I think of Canada is a good example where there are really only I think a handful of banks. Is it because of the dual banking system?

Dan Awrey:

Yeah. So first of all, I believe there are currently 88 chartered banks in Canada. There are resting four. On some days, I'm willing to give it five banks dominate across almost all segments of banking markets in Canada. We have 88 chartered banking institutions for a population of just over 40 million. United has over 9,000 insured depository institutions for, let's make the math easy, a population of about 400 million. So by measures of GDP, by measures of banks per population, the United States is absolutely a global outlier. The dual banking system, as I said, is sort of an outgrowth of a politics that is really skeptical of concentrations of power. So is the unit banking system and restrictions on branch banking that were really the defining feature of the US banking system a lot of the 19th and 20th centuries. That's where I tend to put the primary explanatory force behind how many banks we've had historically. And similarly, I think we're still in the process of, and forgive me for using normative language, correcting from that high number to this day.

Alan Kaplinsky:

But isn't it ironic that the federal regulators are throwing up numerous obstacles against bank mergers? They just yesterday came out with their position or policy statement on how they're going to look at bank mergers. And they're making it more difficult and they have been making it more difficult, and particularly for larger banks.

Dan Awrey:

Yeah, I was going to say a happy bank merger Policy Change Day to those that celebrate, obviously we get DOJ's announcement yesterday, admittedly sometime in coming, they signaled they were going to do this a couple of years ago, and over the last couple of years. I think they've dropped us breadcrumbs in terms of which direction this was going to go in. I am of two minds on the bank merger issue. On the one hand, there are a lot of smaller banks in the United States that aren't necessarily economically viable in the longer term in the context of an environment where technology is playing more and more of a role in financial services. And for those banks, merger control is not going to do very much at all. And what I would like to see then is an attempt. I know we talk a lot about my forthcoming working papers when we chat, but I also have another working paper called The Big Problem of Small Banks, where if we're going to keep smaller banks small as a political priority, which I don't necessarily disagree with, we should be helping them in other ways.

One of the ways we're not helping them right now to segue back to our initial conversation is through things like FedNow. It would be entirely possible to build public infrastructure upon which smaller banks could build their businesses. And if we think that that would then help alleviate some of the longer term competitive pressures that come from relatively rapid technological change, if you like small banks, if you like the services that they provide, it would seem to that that's a direction that we should spend more time talking about. We shouldn't doing things like FedNow that are done in the name of small banks, but for the life of me, I can't figure out how they're actually going to help small banks. And there's a number of things that we can do and we don't talk about.

Alan Kaplinsky:

So let's turn now to the emergence of this relatively new monetary institution. And we're talking about non-banks. There are entities that aren't chartered as a bank, either a national bank or a state-chartered bank. But many of them are now very heavily engaged in the payments systems like banking institutions do. So tell me first, how have the state legislatures, and state regulators responded to the emergence of this non-bank financial institution?

Dan Awrey:

Yeah, I guess the first thing I would say is that non-bank financial institutions issuing monetary liabilities have been around since banks. What's changed is that the new entrants are largely technology-driven institutions that, as you say, are actually more focused on providing fast, convenient cost-effective retail payments. And so the people who might be impacted by, for example, the failure of these new non-bank institutions are a different category than the sophisticated institutions that might otherwise participate in wholesale money markets. The backdrop from a regulatory perspective is that really for quite a long time, states have had domestic money transmitter laws that were designed for the age of Western Union that were the primary regulatory and chartering framework for these vehicles. So these new monetary institutions, but for a few exceptions, tend to be licensed money transmitters in each of the states of the United States in which they carry on a business.

Some states and the conference of state banking Supervisors has coordinated this process, has started to update their domestic statutes for the purposes of contemplating some of these new institutions. In the last couple of years, in particular, the CSBS's model laws have been updated to contemplate crypto payment platforms, just to give one example, but there's another class of states, and here I think New York and Wyoming are probably the best examples that have created entirely new chartering authorities and regulatory frameworks for at least some of these new institutions.

Now, paradoxically, in both New York and Wyoming, they're chartering frameworks focus on crypto, but actually it's the business models of more conventional non-bank financial institutions that tend to be the things that keep me up at where a lot of the new payments activity, and you can see this in the Atlanta Fed's survey of payment choices are conventional non-bank intermediaries like PayPal, like Cash App that are not banks, but also for the most part, don't really go anywhere near crypto as well.

Alan Kaplinsky:

So you talked about the state money transmitter laws that been on the books for long, long time and were initially enacted in order to deal with Western Union and companies of that sort that would use telegraphs or telexes to transmit money. Why has the federal government not followed suit?

Dan Awrey:

Gosh, that is a great question. I think it's fair to say that the idea of federal payments chartering legislation has kicked around DC for at least 20 years. And as you know, the chances of any particular idea being picked up and run with outside some sort of external impetus are quite low. I myself have written several model federal payment chartering laws, none of which I'm sad to say have ever really gotten any traction whatsoever. And so part of the story is certainly I think that up until relatively recently, and specifically up until crypto for various reasons, got on the radar of Congress, there wasn't really that much interest in this sort of move. Bolstering that is that we really haven't seen the failure of a large non-bank monetary institution that is regulated as a money transmitter until relatively recently. We had MoneyGram almost fail during the global financial crisis.

FTX was really the first big failure that we saw, but people think of FTX as a crypto play, even though its primary regulatory vector in the United States was through state money transmission laws. And so we haven't really seen the type of large high-profile failures where people who aren't gambling on crypto lose their money that would spur Congress to action. Where some traction has gotten though is that for all sorts of reasons, stablecoin legislation has now gotten two and likely three before the end of this term kicks at the can at passing Congress. And folks like myself are at great pains to point out that if you're going to adopt a stablecoin charter at the federal level, with a few tweaks, you could also adopt just a general purpose payments charter at the federal level.

And in fact, simply privileging one specific set of technologies, the blockchain and distributed ledger technologies used in stablecoins is really bad policy. Why not just adopt a federal payments charter, and then within that chartering framework allow stablecoin issuers to build their businesses?

Alan Kaplinsky:

So let's talk focus next, and we're going to get very soon to what you're going to be proposing. But what are the problems? What are the principle risks that are associated with the emergence of these non-bank monetary institutions? Why is there a problem?

Dan Awrey:

So the problems are latent but growing. We have several hundred years of history and experience in regulating banks. As that regulation unfolds and we become more comfortable with it, we see banks take root at the heart of the American monetary system, and then we build this safety net around them and a regulatory apparatus in connection with that safety net. That means that Americans are very comfortable with bank deposits as the primary source of money. The problem arises from the fact that that comfort level means that most people are just not used to asking questions about whether the deposit or quasi-deposit liabilities that they hold with PayPal, or a cash app or Venmo are as good a type of money as an insured bank deposit.

Alan Kaplinsky:

When you say as good, you mean as safe?

Dan Awrey:

That's right. So there's two things that can happen to the promises that a corporation issues me that I don't like if that promise is something that I use as money. The first thing is they don't fulfill their promise. They don't let me take my money out when I request it. They don't let me transfer it to when I want to pay somebody. And importantly, both of those things are prohibited by federal bankruptcy law if that firm that made that promise to me enters bankruptcy. The automatic standard bankruptcy law basically kills the ability of a customer to withdraw money like they can in insured bank deposits or transfer it to make a payment to cover their rent, their tuition, what have you. And we exempt banks from bankruptcy law and build the safety net around them for precisely this reason. Just because my bank failed doesn't mean that my landlord doesn't need my rent check anymore.

And that's a pretty fundamental problem that you encounter when you start using contractual liabilities as a source of money. The problem then is effectively that PayPal, Venmo, Cash App are all subject to basic corporate bankruptcy law. And that if people understandably don't understand or don't care about that difference and these platforms, non-Bank financial institutions provide money that is more convenient or faster or cheaper, is that we should simultaneously expect a lot of activity to shift into that system. And empirically that's what we see. And that system is now operating without the same safety net as banks. And in the event that one of these institutions, a large one where multiple institutions were to get into trouble, the application of bankruptcy law would mean fundamentally different outcomes for those consumers relative to banks. They're not going to be able to take their money out. They're not going to be able to take their money out potentially for quite some time.

And when they do ultimately get repaid, it may be the case if they're general unsecured creditors in the bankruptcy process that they get paid a lot less than the 100 cents on the dollar that they're used to from an FDIC-insured bank account. So the first problem is the consumer protection problem of bankruptcy changes everything in terms of consumers exposure to risk when dealing with these non-bank monetary institutions. The second issue is then one of microprudential safety and soundness for the banking system, and its connections to this non-bank monetary system.

We saw with the failure of Silicon Valley Bank that a large stablecoin issuer circle was holding about $3 billion in customer funds at SVB, and it had not been for the fact that SVB received extraordinary support, those funds for the most part would've been uninsured. And that leaves the government with two choices. One is to insure uninsured deposits, which it unfortunately is now in quite the habit of doing, or two, letting the customers of Circle pay the price for Circle's decision, put

customer funds in the wrong FDIC-insured bank. And so there you can start to see the vectors of contagion between non-bank monetary institutions and banks, that then if left unchecked, pose not only problems for the consumers of non-banks, but also feeds into the existing moral hazard problems associated with rescuing the banks in which many of these institutions hold customer funds.

Alan Kaplinsky:

Okay. So you mentioned the Circle problem, but that, as I understand it, and correct me if I'm wrong, was a result of a lot of consumers thinking that they were going to be protected in the event of failure, and they weren't actually protected. But as I understand it, the new kind of institution that you would like the federal government to charter for non-banks won't deal with that particular issue. It's going to deal with other problems. And what I'm wondering is are there examples that you can provide of non-banks that are just in the payments area, where there have been failures and that that's created a problem?

Dan Awrey:

So the first thing I would say is that my proposals actually do directly deal with this problem. A federal payments charter in my view, has to come with access to a Federal Reserve master account, which then means that circle never has to do business with SVB. It's only putting its money in SVB because it needs a safe place to park it and conveniently access to the payment system. If we give Circle access to a Federal Reserve master account, we solve both problems and eliminate the potential contagion effects between non-banks and banks. So I would say that my proposal absolutely deals with this particular problem by cutting out the middle man, which in this particular case was the source of the instability.

Alan Kaplinsky:

So the only risk that people would have would be if somehow the Federal Reserve system failed.

Dan Awrey:

Yeah, in which case we have much bigger problems on our hands.

Alan Kaplinsky:

Which is interesting because since September 2022, the combined earnings of the Federal Reserve system is about $195 billion. They haven't made money. A couple of Federal Reserve banks have made a little bit of money since then, but because of the interest rate mismatch, the negative gap that brought down the savings and loan industry a few decades ago, the Federal Reserve system's doing the same thing. And they brought it on themselves. That's the irony. But they're never going to fail. I mean, if you look at the balance sheets of the different Federal Reserve banks, they don't show the deficit that they're operating under now.

Dan Awrey:

Yeah, that's right. The legal engineering at the heart of the Fed basically means that it's never going to fail for financial reasons. The reason that the Fed fails is an apocalypse. And not to say that apocalypses don't happen, but my bank money is not the thing I'm going to be worried about during an apocalypse. I'm not going to call the Federal Reserve. I'm going to call the joint chiefs of staff. Because that's where the problem resides at that point. And so I agree that there's really no realistic possibility that the monetary apparatus of the Fed, and even I would go far as saying global US dollar treasury markets are going to fail. Now, you did ask a question about whether we've had any failures though, right?

Alan Kaplinsky:

Yeah. Yeah.

Dan Awrey:

Yeah, and this goes back to some work that I did many, many years ago. The short answer is that what we have are some near misses like MoneyGram, which given the permissive nature of state money transmitter laws, was actually permitted to invest in everybody's favorite investment of 2008 mortgage-backed securities. And so in that world where you have these very permissive state regimes, the question isn't if they can fail, but when and under what circumstances. The other shoe on the other foot, to torture several metaphors simultaneously, is that because these state charters are sort of catch-all charters for a whole manner of different types of financial institutions, is that what we're seeing with crypto is that that permissive nature is something that actors who want to maintain maximum flexibility to invest customer funds in whatever they like, will also gravitate towards these frameworks.

So if you think of the crypto winter in 2022, the crypto winter in 2022, which obviously was largely the summer, but I'll put that aside for the moment, was almost all state money transmitter failures in effect. That's what we have in the United States to regulate these institutions that don't qualify as banks or broker dealers or any other federal regulatory category. And part of that is an indictment of the framework itself, the state level frameworks themselves, but part of that also falls of course to the type of decisions that crypto entrepreneurs were making. And so I want to keep those two separate if only because I look at a firm like PayPal that's a licensed money transmitter. And up until its recent foray into crypto seemed to take a relatively conservative approach towards the investments that it was going to make with the 40 billion or so in customer funds that it currently has on its balance sheet.

And so I don't want to say that it's all the regulatory framework, although I think the regulatory framework facilitates risk taking that could lead to failure. But a lot of it comes down to the decisions that management makes about how if it's issuing monetary liabilities, it wants to match those liabilities with the credit maturity and liquidity risks of its investments. Good actors will do that well, which is why we haven't seen a lot of failures. But bad actors may do that very poorly, and at present state money transmission laws don't really have much to say about that.

Alan Kaplinsky:

Right. So you're trying to get ahead of this problem. It's like we've got a runaway train here and it's headed toward a major collision at some point. And you know from your experience and your research that the state laws are inadequate. So tell me, let's get to your proposals. I know you have alternative A and alternative B. Alternative A is in your mind, far better than B, but you recognize the political reality that it may be difficult or not impossible to get the first alternative enacted.

Dan Awrey:

Yes. So A is make the United States like the rest of the world. Let's just call it what it is. The United States is a global outlier with having the states actually regulate this now. It would be a global outlier if you added a federal regulatory layer that still contemplated state chartering regulation and supervision. But you're absolutely right. That basic dynamic is of course the dynamic at the heart of the existing dual banking system. That system has lasted through all sorts of political environments going on to centuries, and I really don't think that payments are going to be the thing that take down the dual banking system.

So the second proposal really is to have a set of common rules at the federal level that on a targeted basis, preempt state laws. And we were just talking about the basic issue here, which is one of the types of investments that these institutions can make with customer funds. And then two, and I think this is also important and we've only touched on it briefly, is that we need to find a way to lessen or eliminate the impact of bankruptcy, specifically Chapter 11 bankruptcy on the customers of these institutions. We can do this in a variety of ways. The paper talks about some of them, but the most straightforward way is to add these charter holders to the list of firms that are exempt from bankruptcy under section 109 of the bankruptcy code, and to then use federal regulation to craft a bespoke resolution framework for these institutions. And that should be relatively easy if in my model all of these institutions are depositing their customer funds in reserve accounts.

This simply becomes an administrative resolution regime where we find out who's owed what and the government cuts them a check. So when the firm fails, many things may happen to the firm, but the customers can effectively walk away with their nominal balances fully intact at relatively low cost in terms of an administrative lift from federal banking agencies in the Fed.

Alan Kaplinsky:

Yeah, so let me make sure I understand it. These entities would not be able, or they'd be restricted in where they could deploy their assets or the funds that they're receiving from their customers. They could only put their funds with a Federal Reserve Bank. They couldn't go anywhere else.

Dan Awrey:

So in the purest form of the model, that's absolutely right, and I've made my argument to just about everybody in Washington about why I think that should be the case. The consensus in Washington is a little different though, I think, that in the event that we move forward with these types of regimes, they would likely be allowed to put their money in banks in the form of commercial deposits. They would likely be able to invest in US Treasury securities as well. My problem with both of those things first, is that once I get to put it in a bank. I have the circle problem writ large. Now I have a vector of contagion that I'm trying to get rid of. And second, with Treasury securities, I have the SVB problem, which is the problem of whether I get to count them at book or mark to market.

And as interest rate environments change, the fact that we're really not letting, or these proposals would not let institutions engage in a lot of intermediation mean that their balance sheets would be very exposed to these mark to market fluctuations, which on the one hand makes you want to not mark them to market. But of course, the problem with not marking them to market means that you can get these wide gaps, a la SVB between what their financial statements say the securities are worth and what they're actually worth when you need to sell them in order to redeem investor, or to honor investor withdrawal requests.

Alan Kaplinsky:

So under your preferred system where the monies are invested or are deposited at a Federal Reserve Bank, would they be demand obligations of the Federal Reserve Bank? Would they bear some nominal amount of interest? They wouldn't, I take it be longer term obligations because then it leads to the mismatch problem again, wouldn't you?

Dan Awrey:

So they would behave just like reserve balances in the conventional banking and payment system because they would be part of the conventional banking and payment system. That's one of the features of this system is that having a master account and the ability to hold reserve balances at the Fed is what enables these institutions to connect directly to the payment system. What I punt on in the paper, and to be honest I punt on in my forthcoming book as well, is the question of whether those reserve accounts should pay interest. And here's the debate, if I can have the debate myself, I'll take both sides of this argument really quickly. On one side, the reason why the Fed has sometimes resorted to paying interest on reserve accounts for banks largely stems from the role of banks in the real economy. The Fed is effectively using interest rates as a monetary policy lever to induce banks to expand or contract credit.

That's not something that is going to be a concern for these institutions because by definition, they won't be out in the market extending credit. So that's the argument against paying interest on the balances of these institutions. The argument for paying some level of nominal interest is a vaguer social policy argument that reflects the benefits of potentially diversifying the payment system away from banks. That is to say that... to call this unusual, I think is an understatement. I call it something that is amphenema to the current Fed leadership, I think is accurate, but insofar as things like the too big to fail problem have become entrenched and pernicious, one of the easiest structural solutions that we have available to us is to take substitutable activities that are performed by banks like payments. And we can both think back to 2008, 2009, and here, the number of bank executives and policy makers that said, "But it's the payment system. We can't stop the payment system from working. We've got to save the banks because of the payment system."

If you can unbundle banks from the payment system, those arguments should have a lot less force. And insofar as then nominal interest on reserve accounts helps affect that structural shift, then it may be worthwhile. That's a very difficult argument to make in the world that we live in today, where as you mentioned before, we don't have any large failures that we can point to, but the argument that I would say in response is that we've largely failed to address too big to fail. And in fact, it's

probably gotten worse as a result of the SVB failure. And we really do need to start looking to more structural solutions, because if anything, the Fed Treasury and the White House seemed quite willing to look at the 20th biggest bank in the United States that nobody designated as domestically, systemically important ex ante, and ex post bail out a whole bunch of banks because apparently this bank was too big to fail. We can either live in that world, or we have to start finding creative solutions to avoid it.

Alan Kaplinsky:

Right. Let me ask you, it's sort of a related subject, but why is it that the Fed has not been that open to granting master accounts to non-banks? What's their worry

Dan Awrey:

Gosh, I risk getting in trouble, I think answering this question. I get asked this question a lot and I get asked it by... Well, a lot of people who have a much more direct involvement in this particular battle than I do. The short answer to the question is that the Fed in its capacity as a prudential regulator that oversees anti-money laundering and terrorist financing programs for the institutions under its jurisdiction, is worried about things like cannabis banking and crypto as potential vectors for illicit finding. That's the official party line. And it's not an unreasonable line, but it is one that should be subject to scrutiny, both because the nature of the tools and systems that exist suggest that existing risk-based MLCF CTF programs can help mitigate these risks.

And it's never been the case that these programs were supposed to be risk-free to begin with. There are reasonable risk-based programs under the Bank Secrecy Act. Financial institutions should be finding ways to combat illicit finance, but it's not a zero-tolerance policy and never has been. On that level, while I understand the Fed's concern, it is one that is not shared by a lot of people, myself included, as being definitively against issuing master accounts to these novel institutions.

Alan Kaplinsky:

I think, as I recall, somewhere in your paper, you mentioned that one of the companies that was denied a master account has sued the Fed and that there was litigation pending. Has there been any... Do you know where it stands, or?

Dan Awrey:

Well, so since last we spoke, the trial court held in favor of the Federal Reserve in the custodial litigation. That's now being appealed, but I don't think I have any updates on how that appeal is going. I don't think there's been a hearing on the merits at this point.

Alan Kaplinsky:

Right. Let me ask you one more question because drawing to the end of our show. The Synapse debacle that occurred over the summer months is very much in the news. And I'm wondering whether your proposal either alternative A or B, would solve that problem, or is that a different problem?

Dan Awrey:

It's a slightly different problem, but they're related. And let me tell you why. In a world where I have a federal payments charter, that enables policymakers to get the benefits of non-bank payment institutions while simultaneously cracking down on the type of regulatory arbitrage at the heart of the Synapse business model at the moment, because the alternative is to comply with 49 states money transmitter laws and/or get a banking license. What we're seeing in so-called Banking as a Service is really a regulatory arbitrage play where these businesses are everything but a bank. They focus on the technology and then outsource the one thing they can't do without a banking license, which is take deposits and facilitate payments.

That's a really big threat, in my view to the regulatory perimeter, but it's one that's perfectly understandable from a business perspective, because the United States has presented such terrible chartering options for these institutions. So to my mind, at the same day that you institute the Federal Payments Charter is also the day that I shut down our business models like the

Synapse business model, which are creating these very long intermediation chains, these very long data chains. Also, that customers can have the convenience of FinTech with the safety of a bank deposit. And my proposal is effectively a federal chartering option that's designed to do exactly that, and eliminate both the need for and potentially policy acquiescence to these type of workarounds in effect.

Alan Kaplinsky:

Okay. Dan, we've covered a lot in your working paper, but is there anything that we should cover that I just didn't ask you a question about?

Dan Awrey:

No, I think this is fantastic. I think that as your audience will know, this is really something of a golden age for both innovative policy-making and litigation in the areas that we've been talking about. In addition to some of the policy changes that may come down from the Synapse debacle, we've got the Court of Appeal hearing arguments in the PayPal CFPB case coming up, which will also go towards, I think, providing some regulatory clarity for non-bank payments. And we have the prospect of stablecoin legislation as well, all of which sort of feed into the issues that we've been discussing. So we talked about a lot, but to be frank, more than anytime I can remember, there's a lot more that we could be talking about in this vein as well.

Alan Kaplinsky:

And I know you're still writing other papers that are going to be dealing with some of these other issues that you haven't yet reduced to one order.

Dan Awrey:

It's true, and it reminds me, and my apologies to Joe Jackson and my publishers at Princeton University Press, but I should say I have a book coming out in four days called Beyond Banks: Technology, Regulation and the Future of Money that explores a lot of these issues, both from a legal perspective, but also from a financial infrastructure perspective.

Alan Kaplinsky:

Right, well, that's interesting. Is it going to be available online on Amazon?

Dan Awrey:

So physical copies go on sale in a couple of weeks at Barnes Noble, Target, Waterstones. There's going to be an audiobook available on iTunes and Audible. So I feel like people are going to get sick of me before the end of the year.

Alan Kaplinsky:

Well, we're never going to get sick of you on our podcast show. So really, first of all, thank you very much for sharing your wisdom that's reflected in this article.

Dan Awrey:

No, thank you so much. It's always a pleasure.

Alan Kaplinsky:

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