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Fed looks to buy time in legal battle with Custodia

By Kyle Campbell

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The Federal Reserve's battle with the crypto bank Custodia largely boils down to one thing: timing. The Fed wants more time to build out its policies for granting financial technology firms access to its payment systems. Custodia Bank says it has already taken too long to process its application for a so-called master account.

In June, the Cheyenne, Wyoming-based digital asset payment and custody provider brought suit against the Federal Reserve Bank of Kansas City to compel it to either grant or reject its master account application after waiting for nearly two years.

Last week, the Fed motioned for the U.S. District Court of Wyoming to dismiss Custodia's lawsuit, a tactic it has already employed twice to fend off master account-based litigation — first from a Colorado cannabis bank Fourth Corner Credit Union in 2017 and again in 2020 from The Narrow Bank in Connecticut, which sought to hold all of its customers' deposits in risk-free reserves at the Fed.

If the strategy fails this time around and the Fed has to render a decision one way or the other, the consequences will ripple far beyond Custodia, said Julie Hill, a University of Alabama law professor whose research focuses on Fed master accounts. The grounds on which it would grant or deny Custodia's bid for a master account would set the precedent for the host of other fintechs that have cropped up around the country under various state chartering regimes, she said.

"It might be in the back of the Fed's mind that, 'Look, we've got to be ready when that wave of applications comes in, so if we're going to grant Custodia's application, we shouldn't grant it until we have all of our ducks in a row,' " Hill said.

Dennis Kelleher, president and chief executive of the nonprofit Better Markets, cautioned the court against rushing the Fed to decide whether crypto banks should be granted access to the Fed's payments system and under what conditions. He said those are critical questions that should be answered by the Fed in due time.

"These are complex, novel issues with grave implications for financial stability, and the law gives the Fed the responsibility and discretion for evaluating and balancing the many competing and often conflicting public and private interests," Kelleher said. "Moreover, if the court does inject itself into such decisions — or worse, substitute its judgment for the Fed's — it'll open the floodgates to unending lawsuits dragging the courts deeper and deeper into policymaking where they have no expertise or experience."

Even if the Fed succeeds in having the Custodia suit thrown out, the mere filing of the lawsuit — combined with pressure from Sen. Cynthia Lummis, R-Wyo., and other members of Congress — has already forced it to move quicker than it likely would have otherwise, said Kaleb Nygaard, an economic historian and researcher.

"Regardless of whether the lawsuit is formally successful or not in getting Custodia an account, they have almost certainly been successful in speeding up the nationalization or the equalization of the policy across the Fed system," he said.

Nygaard pointed to the Board of Governor's new guidelines for granting master accounts, which were finalized one day before the motion to dismiss, as proof that the Fed is hastening its efforts to craft policy for nontraditional master account applicants.

The guidelines, which have been in the works for more than a year, create a three-tiered system for applicants, with federally insured and supervised institutions receiving the least scrutiny and non-insured entities that are not monitored by bank regulators getting the most.

The impetus for the guidelines is to create a process for firms that hold so-called novel charters that some states are granting to nonbank fintechs. This includes firms such as Custodia and Kraken, which are chartered as Wyoming special-purpose depository institutions. Established by a 2019 statute, the classification allows companies to participate in some banking activities.

Both Custodia and Kraken applied for master accounts with the Kansas City Fed, which oversees payment system access for banks in the Fed's 10th district, in 2020 and are awaiting responses. Without access to the Fed's payment rails, both firms have yet to get off the ground.

In introducing the guidelines, Fed Vice Chair Lael Brainard said they created a "consistent and transparent process" for evaluating master account applications. Kelleher said the framework is an "appropriate, deliberative process."

Others view the guidelines less favorably. Norbert Michel, director of the Center for Monetary and Financial Alternatives at the libertarian think tank Cato Institute, said the framework is light on specifics and gives the Fed broad cover to deny the application of fintechs that would threaten traditional banks. He said the guidelines primarily serve as a legal document to which it can refer in instances of future litigation.

"They want something so that if they do keep getting sued, they have, like, an APA-style fallback to say, 'No, we have this process. We put this process out. This is systematic. We think about this risk, this risk, this risk and that other risk,' " Michel said, referring to the Administrative Procedure Act. "That's all that document is."

Hill said the risks considered by the guidelines are so wide-ranging that, in their current form, they provide little insight into how novel charters can best position themselves to mitigate those risks. However, she said the guidelines will not be the end of the conversation within the Fed system for how to handle master accounts, but rather the foundation for a more fleshed-out process as the 12 regional reserve banks come together around the issue.

"I'm expecting the Federal Reserve to have some updated processes that come out of their collaboration among the reserve banks," she said. "You can't take non-law and turn it into law, but you can take guidance and turn it into an application form to follow and a list of people to contact for specific types of banks."