Financial Services Management

Federal Reserve Payment-System Rewrite

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Overview

Although payment system innovation has historically been driven by the private sector, the Federal Reserve System is exploring whether it should operate more of the system and/or more forcefully direct the industry going forward. It would do so on grounds that central direction is essential to ensure prudent product innovation and to protect a vital underpinning of the U.S. economy. Were it to proceed, the system could be both safer and more ubiquitous, but new initiatives could also force reduced use of paper checks instead of awaiting gradual market transition, mandate cross-border payment standards dictated by the Federal Reserve, and perhaps give the central bank a new, over-arching role offering services and governing practice in both retail and wholesale payments.

Impact

As described in this paper, the payment system is becoming ever more complex and intertwined with a growing number of new products and non-bank providers. As a result, the Federal Reserve Banks (FRBs) have decided to revisit their 2002 policy[1] and contemplate a far more hands-on role shaping the payment system's future. The current vision focuses on the end-to-end

[1] See Client Reports in the **PAYMENT** series.

payment process, in contrast to past Fed strategies addressed to interbank issues. The expanded mission could well mean a new "utility" role for the Federal Reserve Banks that would enhance their role as centralization of large-bank supervision in Washington continues, perhaps promoting innovation and protecting payment-system integrity. However, a greater role for the central bank could also crowd out private institutions, especially those outside the banking industry. Pricing may be a particularly acute concern for providers that believe a greater Reserve Bank role would crowd them out. When Congress authorized the Federal Reserve to offer broader payment-system services in 1980, it required these to be priced to reflect private-sector costs. This adjustment is a longstanding dispute between the industry and FRBs, one not resolved as the Banks revised their pricing methodology almost ten years ago.[2]

The FRBs stipulate that the next-generation payment system must accommodate evolving end-user payment preferences evident as customers, especially retail ones, switch to mobile and other non-traditional technologies. New electronic networks are proliferating, including networks for person-to-person transfers, online merchants, business trade payments, and others. However, many of these networks do not have a broad base of members, which makes it inconvenient or impossible for in-network end users to make or receive payments to or from out-of-network end users. By contrast, legacy payment systems are nearly ubiquitous and allow end users to send payments to almost any receiver, without requiring the receiver to enroll in the system to retrieve the payment. Balancing inequity with protection is a major goal of the new initiative, the FRBs indicate, although doing so in practice is likely to prove a complex undertaking, especially given the limited regulatory reach of even the Federal Reserve.

A major goal of this project is achieving near real-time payment systems. Its benefits would include economic efficiency, improved cash management, and reduced fraud, with this perhaps also increasing innovation and U.S. economic competitiveness. However, achieving this goal will take considerable funding, likely difficult to obtain given all the regulatory pressures and economic constraints on the largest banks that would need to participate to make a near real-time system possible. The FRBs believe the industry has indicated that the Federal Reserve would need to take a major, direct role in the payment system to achieve this goal, and questions on it are thus requested along with views on how any such system could be established. Options include new front-end mechanisms and/or a variety of rules the FRB could require although the FRBs also contemplate establishing an entirely new payment system. This would of course have dramatic implications for all current payment-system participants.

Another major FRB goal is reduced reliance on paper checks. However, some have argued that focusing on this will divert effort from achieving a principal outcome objective: ubiquitous near real-time payment. To the extent energy and funds are diverted to a goal still resisted by users, fraud might

[2] See **PAYMENT5**, *Financial Services Management*, December 16, 2004.

increase and other risks increase. The FRBs are considering establishing a target for elimination of paper checks, suggesting for example that by 2018 ninety-five percent of non-cash payments would be made electronically. Any such goal would be ambitious and likely require a strong regulatory role from the Federal Reserve Banks, possibly disrupting payments, especially business-to-business ones. Incentives might encourage migration from paper checks, but the FRBs apparently expect the industry to provide these incentives even though who would in fact do so is unclear absent a mandate from the Reserve Banks.

Another key outcome sought is improved cross-border payment. The CFPB has recently finalized new remittance standards, as required by the Dodd-Frank Act.[3] The Banks are considering requiring or pressing for broader adoption of the XML-based ISO 20022 payment-method standard. This might well standardize cross-border payments, but perhaps at the risk of eliminating customized or even better templates.

What's Next

This paper was released on September 10, with comments due by December 13.

Analysis

A. Desired Outcomes

Those outcomes hopefully to be achieved within ten years would be:

- meaningful progress on key improvements;
- creation of ubiquitous electronic solution for retail payments that does not require the sender to know the recipient's bank-account number, with good funds mail available in near real time;
- greater electrification and process improvement over the "long-term;"
- better choices when making business or consumer cross-border payments; and
- better FRB/industry collaboration to promote payment-system security and continued public confidence.

B. Request for Comment

Questions are posed on:

[3] See Client Reports in the **WIRETRANS** series.

- the Banks' overall view of the payment system;
- tactics to shape the payment system's future;
- the appropriate Federal Reserve role here;
- the FRBs' analysis of gaps and opportunities in the payment system;
- the FRB's desired outcomes;
- the role of the Federal Reserve as "operator, leader or catalyst";
- ways to achieve ubiquitous near real-time payment;
- the benefits of achieving near real-time authorization/confirmation versus actual payment;
- the risk of increased fraud as systems evolve;
- impact on mobile payments;
- the impact of new FRB action;
- industry timeframe for modernization;
- the value of a centralized directory for account numbers and routing information for businesses and/or consumers;
- key threats to payment-system security;
- useful information on threat awareness and incident response; and
- future payment standards that improve security.