Financial Services Management

Faster U.S. Payments

Cite

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Impact Assessment

- Faster retail payments are very likely to benefit households and small businesses through improved cash management, reduced fees, and less reliance on costly financing.
- Banks will see a significant reduction in overdraft fees that may be offset for earnings purposes by increased efficiency, the ability to compete better against nonbank payment services, reduced credit risk, and business-model changes.
- Interchange-fee revenue will be challenged if nonbank payment models advance while the FedNow build-out proceeds.
- Fed owner/operator status appears assured absent so long a delay that private services supersede it. At least some of these could be nonbank systems with demonstrated capacity to innovate quickly due to regulatory exemptions. Regulatory asymmetries, arbitrage, and structural risk could result if the U.S. payment system moves increasingly outside the interbank one dependent on the Fed and subject to its rules.
- Although the Fed has made the structural decision about its role, considerable uncertainty remains about FedNow functionality, changes to other Fed payment services, liquidity supports, and intraday/overnight risk to the central bank. Even the FedNow 2023/2024 start date is tentative and preliminary (full national roll-out is likely years off).
- Due in part to delay, crypto payment systems, especially in closed networks, may well advance despite Libra's set-back. Regulated banks could be further disintermediated if the payment system evolves asymmetrically. More ILCs and "rent-a-charter" banks are also likely as nonbanks seek a connection to the Fed's system to enhance the value of their own customer bases and payment products. Innovation would advance more quickly, but stability and inclusion could be adversely affected.

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- New Fed liquidity facilities and/or an always-open discount window would reduce payment-system and Fed risk, but adversely affect the interbank credit market. Nonbanks with direct or indirect access would presumably not be able to draw from Fed liquidity facilities, but the request does not make this clear. If not, new liquidity-support facilities from banks for nonbanks might be offered, providing business opportunities but posing additional risks to these banks and to the Fed.
- Since the Fed's RTGS system would operate through bank reserves, banks would likely hold more reserves, transferring those now used for private payment services due to the ability to earn interest on excess reserves. The Fed's portfolio would expand, perhaps suddenly during stress scenarios. Reserve volatility could further complicate monetary-policy transmission.

Overview

Following its 2015 request for comments on ways to speed a U.S. real-time gross settlement (RTGS) service with integrated clearing for retail payments[1] and a 2018 update, the Federal Reserve has decided that it will indeed take an owner/operator role in this critical arena. Citing a Treasury recommendation to do so[2] and overwhelming support in prior comment letters, the FRB does not expressly solicit views on this vital policy question, instead seeking views on the implications of entry, the importance of an additional liquidity-support facility, competitive implications, and whether also to update FedACH, its existing retail-payment batch system. Although the FRB says its new "FedNow" service will be at least preliminarily operational by 2023 or 2024, this seems unlikely given the slow path laid out for its decision-making and the challenges then to building a national, final, resilient, and ubiquitous RTGS system. This may lead to statutory change putting more pressure on the Fed to modernize as much of its system as quickly as possible and to requirements that banks provide real-time payments no matter the status of the Fed's efforts, leading to greater reliance on the sole private-sector real-time payment (RTP) provider and/or development of alternative payment channels along the lines pioneered, albeit with considerable controversy, by Facebook's Libra.[3] Community banks and tech-platform companies strongly support Fed entry, but large banks believe that their private-sector system can accomplish all of the Fed's goals under appropriate regulation ensuring that the central bank's RTGS goals are met. Since this system is already operational, opponents also believe that the public benefits cited by the Board will be met far more quickly with a regulated system that might preclude transformation of retail payments into a network in which nonbank providers control so much of the end-user relationship as to disintermediate regulated banks large and small. In addition to these critical competitive and structural questions, differences remain about the impact of a Fed-owned RTGS system on Federal Reserve liquidity facilities (including the discount window) and the central bank's own risks related to bank daylight or overnight overdrafts. Monetary policy might also be affected if banks retain larger reserve balances to ensure finality, especially in stress scenarios.

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[1] See **PAYMENT15**, *Financial Services Management*, February 3, 2015.
[2] See *Client Report* **FINTECH21**, August 7, 2018.
[3] See *Client Report* **CRYPTO11**, July 30, 2019.

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Impact

Despite the delays since the Fed first began its faster-payment work in 2013, there is little dispute over the benefits of a faster U.S. retail-payment system – almost everyone agrees with the Federal Reserve that RTGS in this sector would increase economic efficiency and be of significant benefit to individuals and small businesses that would no longer need to await delayed payment, possibly incurring overdraft fees, taking out costly short-term financing, or assuming other burdens that undermine efficiency and thus at least to some degree slow economic growth. Given the importance of rapid payments to low-and-moderate-income households, the costs incurred in funds-availability delays are particularly onerous; faster payments thus also have clear economic-equality benefits.

The heart of the controversy thus is not if there should be RTGS retail payments, but rather if the Fed through the Reserve Banks should take on an owner/operator role in yet another facet of the U.S. payment system.

The Monetary Control Act of 1980 and subsequent 1984 guidance stipulate the terms and conditions under which the Fed would make use of its authority to provide what would otherwise be private-sector payment services,[4] an approach ratified in the 2015 statement noted above. In this latest request, the Board provides preliminary details on pricing but makes it clear that it will not recover initial investment for at least ten years nor price initially to reflect lower volumes than a mature service is likely to enjoy. The Board has also reserved the right to set pricing permanently below a full private-sector adjustment factor (PSAF) even after final implementation if it decides that this is necessary to secure the public benefits anticipated from FedNow. The Fed's service could thus enjoy a significant advantage despite statutory restrictions and the Fed's own pricing principles.

However, the Fed's initial competitive-impact analysis concludes that at least the current private-sector competitor, The Clearing House's (TCH) RTP, should be able to compete because commercial banks will develop alternative liquidity and similar services even though the Fed has considerable advantages as a central bank at which mandated, interest-bearing reserves must be held. The analysis also suggests that contemplated changes to other Fed services (see below) will facilitate private-sector competition. The analysis does not consider the extent to which nonbank systems may disintermediate at least some of the role banks have traditionally played in the payment system due to their ability to innovate while many banks decide not to make use of the private sector alternative to avoid duplicative set-up costs and subsequent inter-operability problems.

One reason the Fed believes that it must become an RTGS owner/operator is that it lacks "plenary authority" over third-party payment-system providers. The Expedited Funds Availability Act (EFAA) gives the Fed far-reaching power over the payment system, but the Board reads this as inadequate because, while it may be able to supervise nonbank providers, it and the other federal banking agencies have no enforcement authority over them. However, the Board and federal banking agencies have the power to restrict or even ban banks from doing business with a problematic payment-service provider. This would at the least undermine the provider's franchise value, if not put it out of business. As a result, the Fed may well

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

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have *de facto* enforcement power – indeed, it is the expectation that this exists that leads nonbank vendors even to accept bank supervision.

Very large payment providers might be immune to this franchise-value risk. However, the Dodd-Frank Act gave the Financial Stability Oversight Council the authority to designate payment, settlement, and clearing providers as financial market utilities (FMUs).[5] Payment-service FMUs are then subject to the full force of Federal Reserve standards[6] that may be tailored specifically for each FMU with regard not only to safety and soundness, but also to pricing, resilience, and the benefits the Fed believes can only be achieved via its own entry into the faster-payment arena.

Although the request does not mention this FMU power or discuss any possible concerns, the Board does state that it also lacks authority over third parties with regard to "public benefit, competitive equity, effectiveness, or scope." This is, it says, critical given the payment-systems' public-good implications. However, the Board arguably also has no authority on these matters over banks, BHCs, or other regulated entities within its purview. For example, the FRB cannot ensure that banks serve the public except to the limited degree this is required in the Community Reinvestment Act. Longstanding policy has left these matters to individual banks or, when private companies do not satisfactorily serve the public good, to Congress. Why the Fed believes it needs this authority over the payment system but not the rest of the banking system is not made clear.

As noted, the FedNow system will take at least a decade to operationalize even in only initial fashion. As a result, the public goods espoused by the Fed and widely understood to result from faster payments will be long delayed if private-sector competitors defer entry and banks postpone decisions while they await arrival of a central-bank option with many benefits and perhaps even a moral-hazard edge. Although the Fed is subject to many of the same operational risks confronting a private faster-payment provider, its ability to withstand them is unique due to its unimpeachable status as a too-big-to-fail financial institution.

Perhaps due to this, the Fed has now said it will provide services only to banks and certain other regulated financial institutions. This could lead alternative payment-service providers to develop outside the reach of the Federal Reserve to serve at least some market segments seeking instantaneous payments. These services would likely not provide ubiquity and some may even bypass banks altogether. They are also likely only to offer payment services to customers of other services or to end-users willing to abandon traditional payment methods, leaving lower-income, older, disabled, and other individuals in the slower Fed-dominated system for an indefinite period of time.

Nonbank payment providers are already a formidable market force, especially outside the U.S. In its most recent assessment of this transformation,[7] the Financial Stability Board concluded that what it calls "decentralized" providers – i.e., those that do not intermediate but instead deal simultaneously with many customers or counterparties – pose financial-stability risk due to new forms of concentration risk, increased procyclicality, poor governance, heightened operational risk, increased misconduct risk, and uncertain resilience and recovery capability. Systemic risk due to regulatory arbitrage is also cited. The Fed's request does not address the role of nonbanks except by inference given the decision to provide services only for interbank settlement. When the request was released, FRB Gov. Brainard indicated

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[5] See **PAYMENT11**, *Financial Services Management*, July 23, 2010.

[6] See **FMU4**, *Financial Services Management*, August 7, 2012.

[7] See *Client Report* **FINTECH24**, June 17, 2019.

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that the central bank is concerned about Libra and similar nonbank providers and appeared to assume that FedNow would ensure continued national reliance on banks. This is, however, uncertain especially given the lengthy period of time before FedNow is likely to be fully operational and market changes along the way.

In addition to these payment- and financial-system implications, the Fed's decision to expand its payment-system role has liquidity and monetary-policy impact. Faster final payments pose increased liquidity risk for disbursing banks, risks now addressed by intraday and overnight overdrafts and, if necessary under acute stress, the discount window. These facilities are now open only on business days, meaning that faster-payment liquidity risk on weekends and holidays could not be addressed through these channels unless the Fed expands and extends them. The Board has not yet decided how to do so, although it does seem intent that, just as it has taken on a new payment system role, it should also provide a new set of liquidity supports. Doing so would pose additional risk to the central bank and undermine the competitiveness of interbank liquidity facilities.

Monetary-policy implications are not addressed in this request for comment, but faster payments through bank reserves is likely to increase reserve volatility along with larger holdings at the central bank. The interplay between these changes to reserving and the Fed's ability to conduct quantitative easing or tightening is uncertain, but likely to be problematic once FedNow becomes a large-volume provider. It is also possible that reserve volatility leads to difficulties calculating reserve totals and thus to short-term rate volatility with problematic policy implications.

What's Next

The Board voted 4-1 to approve this policy on August 2. Vice Chairman for Supervision Quarles was the sole dissenter, doing so on grounds that the private sector has sufficient capacity to provide RTGS and meet the Fed's policy objectives. Comments on the request are due by November 7. The Board will then move cautiously, conducting its competitive analysis upon conclusion of its consideration of comments. Thus, although the Fed says it will have at least a preliminary 24x7x365 system in place by 2023 or 2024, it does not seem likely that it will decide finally to do so and how operationally to proceed until at least mid-2020. The Fed may also issue another public notice on its decisions regarding outstanding functionality issues; it has not made clear if this will also be a request for views and, if so, if other deadlines would move forward.

As noted, the Fed's 2023-2024 schedule for FedNow is also tentative and carefully phrased to make it clear that, even then, FedNow may not be truly nationwide or include all planned functionality. The Board does not expect any private service at that point to have achieved this goal, but that remains to be seen – at least one now considers itself ubiquitous in 2019 and others offer nationwide service to consumers, if not necessarily to banks. Reflecting all the challenges confronting FedNow's final design, the Board notes now that it will issue a *Federal Register* notice describing its system with sufficient clarity to enhance bank participation. No deadline for doing so is provided nor does comment on it appear to be planned.

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Further, although this request makes it clear that the Fed intends to make its FedWire service faster, it will separately seek comment on expanded hours for FedWire and the National Settlement Service. No schedule for doing so is indicated.

Reacting to these delays, Democrats have as noted introduced legislation not only to push the Fed to move faster, but also to require banks to provide real-time payments even in the absence of a completed RTGS system.[8] The House Financial Services Committee plans a hearing on these issues in late September; House legislation might proceed to floor passage thereafter, but prospects in the Senate are at best uncertain. Reflecting the controversy sparked by Libra, the House Financial Services Committee is also considering legislation to bar tech-platform companies from financial-services and crypto-asset activities.[9] Passage of this legislation is also most uncertain but it would directly ban at least some very large nonbanks from providing RTGS services.

Analysis

A. FRB Conclusions

Key to the Fed's decision is its assessment of other service providers and of public benefits. The Fed's methodology focuses on long-term effects, with the request making clear that this does not necessarily address present circumstances or suggest that the risk assessment on which entry is premised is necessarily probable. The Fed will not defer action unless or until negative consequences of having done so are apparent. It is not sufficient only to find that there may be no other provider to justify Fed entry; the Fed may determine that there are other providers but that these nonetheless do not ensure scope, effectiveness, and equity. The public-benefits criterion is met if a payment system is accessible, safe, and efficient. The Board concludes that:

- RTGS is the best approach to a faster interbank payment system since there is unlikely to be more than the one provider now in the business to meet the Fed's goals in the absence of FedNow due to the massive infrastructure needed for sound and nationwide RTGS, potential incentive misalignment between a privately-owned provider and payment-system participants, and risk concentrations. Fed entry thus is needed to ensure public benefit. The Board is particularly concerned about the "long tail" of thousands of very small banks and credit unions it thinks a private RTP provider will not serve.
- Inter-operability is a desirable public benefit that is not likely to be quickly achieved. Nationwide reach is thus the most important objective. The Fed will continue to explore this issue. Even though direct payment exchange may not be an initial FedNow element, it is desirable and the Board will pursue it.
- The Fed is uniquely positioned to set standards and thus ensure payment-system safety. FedNow enhances redundancy, thus increasing resilience.
- FedNow efficiency derives from the improved ability of all banks to reach all of each other's customers, with FedNow competition also increasing overall efficiency in part due to greater competition for end-user services. However, there will be societal costs in the short run due to how long the Federal Reserve would need to subsidize FedNow and increased bank connection costs in the presence of multiple services. FedNow's benefits outweigh these costs in the

[8] See **PAYMENT16**, *Financial Services Management*, August 7, 2019.

[9] See **FINTECH26**, *Financial Services Management*, August 13, 2019.

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Board's estimation.

B. Pricing

As noted, the Fed is also governed by the PSAF, with current law also mandating that development costs be recovered over the long term. With regard to faster payments, the Fed expects this to happen no sooner than ten years after FedNow begins operation. The Board's pricing principles also permit it to adjust pricing if needed to achieve public benefits, with the Board seeking comment if this is planned.

C. Liquidity Management

The Fed has concluded that expanding the operating hours of the Fedwire service and NSS is the best way to provide liquidity-management functionality. With this backstop, participants in private RTGS will be able to manage liquidity on a "just-in-time" basis, reducing liquidity cost and risk. Deferred-payment and other faster systems that are not RTGS would also benefit; indeed, the Fed thinks these changes will advantage wholesale and cross-border payments. However, the Fed may as noted move forward on this decision in a separate notice-and-comment process, looking at options such as limited availability on weekends and holidays or full 24x7x365 operation.

D. FedNow Description

Although the request includes extensive detail on specific aspects of FedNow, it also states that some or all of the functional details may differ before FedNow is launched or thereafter and/or be completely revised. In addition, the Fed is considering whether to extend discount-window operations to holidays and weekends, although it does not plan to do so initially. Tools to handle intraday and overnight balances are also being considered, with revisions possible to existing FRB standards. Alternate messaging networks might also be allowed at some future point.

1. Systemic Functionality

Based on the conclusions above, the request details how FedNow might work in an end-to-end fashion on a 24x7x365 basis through the interbank settlement system. In short, the FedNow Service would process individual payments within seconds, 24 hours a day, seven days a week, 365 days a year, to support credit transfers for a variety of uses such as person-to-person payments, bill payments, and smaller-value business-to-business payments. The service would settle interbank obligations through debit and credit entries to balances in bank master Reserve Bank accounts. A seven-day accounting cycle (revised from the current five-day one) would apply. All settlements would be final, with banks required to make funds available instantaneously to end-user customers after receiving settlement notification.

The FedNow Service may also incorporate clearing functionality with messages containing information required to complete end-to-end payments in addition to interbank settlement information. The service could also support the inclusion of additional descriptive information related to a payment and might allow for nonvalue

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message types. Formatting will be based on ISO 20022 standards. The request for comment also details the steps in RTGS payments.

2. *Eligible Users*

As noted, FedNow will be available only to banks and the other insured depositories now eligible to access Fed services, with master accounts calculated at the close of each calendar day. The Fed is "exploring" inter-operability regardless of weekends and holidays.

E. Competitive-Impact Analysis

The request reiterates that the Board conducts an analysis of competitive impact prior to deciding to offer a new payment service. Among the factors it considers is whether the Fed's dominant market position or legal issues have adverse competitive effect. FedNow is said to be significantly different than the TCH service in ways that affect its conclusions that FedNow would not unfairly compete.

For example, the Fed has determined that its status as a central bank does not clearly convey benefits even though funds held at it may earn interest and are otherwise useful as required reserves. Comment is sought on this analysis.

The request also details how the Board conducts these analyses and how it may then modify a proposed service or decide not to offer it at all.

As noted, the initial competitive-impact analysis has led to the above FedNow plan; additional analysis will be conducted after comments are received on issues such as:

- the extent to which commercial banks could pay interest, provide liquidity support, and otherwise compete with the Federal Reserve;
- the risk-free nature of central-bank money versus funds held at a commercial bank;
- whether expanded Fedwire hours and NSS would reduce competitive impact; and
- ways to modify FedNow to reduce adverse competitive impact.

F. Request for Comment

In addition to comment on all of the details summarized above and the Board's competitive-impact analysis, views are solicited on:

- the Fed's pricing plan, which is detailed;
- the non-value messaging aspect of payment functionality, with views specifically sought on its timing;
- ways to access a directory; and
- whether FedNow should also include fraud-prevention services.

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