I offer these comments as a private citizen, retired after a 35-year career at the Kansas City Fed. I led its check services and electronic access network support businesses and headed the Financial Services Division, which included Cash services for the region, Fedwire operations and FedLine customer support and inside sales responsibilities for the country. In addition, I oversaw the payment system research group, studying emerging and legacy payments systems and markets, pricing, safety and security issues and trends, and coordinated the payments advisory council comprised of executives from financial institutions in its 7-state region. Most recently, I supported the Financial Services Policy Committee that oversees the Federal Reserve System's payments product offices and provides leadership for payment system improvements. I supported KC Fed President and CEO Esther George, executive sponsor for the Federal Reserve's Strategies for Improving the US Payment System from 2014, until my retirement last year.

Why Faster Payments Services and Should the Federal Reserve Banks Provide Them?

"Faster payments," specifically the electronic, real time and credit transfer aspects, will improve convenience, reduce risk in retail payments compared to check and ACH debit payments and serve as an electronic version of cash for a variety of use cases. This new method of payment will deliver substantial benefits to US citizens and businesses once fully adopted. Increasingly popular in other countries, faster payments have garnered broad support from stakeholders in the US -- payment system providers and end users – documented in the Faster Payments Task Force final report and evidenced by millions of dollars of private capital invested by the largest banks in the country.

The Board's request for comment considers the role that the Federal Reserve Banks should play going forward to ensure the benefits of this new payment method are realized timely and broadly. Ubiquitous access to send and receive faster payments from insured bank accounts is the most critical success factor for faster payments to be adopted and to maximize public benefits. The vast majority of households (93% in 2015) in the US have a bank account.[1] To gain ubiquity, it is crucial that the 10,000 or so US financial institutions have the ability to receive and post a faster payment in real time to its customer accounts. **I believe ubiquitous access to faster payments and its benefits cannot be achieved with reasonable effectiveness, scope and equity without the Federal Reserve Banks offering these services to US financial institutions.**

As a foundational question, the Board asks whether a real time gross (RTGS) or a deferred net (DNS) settlement model should form the foundation for faster payments in the US. It notes that most countries implementing faster payments recently have favored RTGS for its counterparty credit risk benefits. As a significant exception, the UK's Faster Payments Service (UK FPS) implemented in 2008 relies on a DNS approach. However, at the 2012 Kansas City Fed payments conference, then director of major projects for UK FPS, Richard Mabbot explained that this decision was based on pressure from regulators to implement

[1] Who are the Unbanked? Characteristics Beyond Income, Hayashi and Minhas, 2018. The national unbanked rate, measured as the share of U.S. households that do not have a checking or savings account, steadily declined from 8.2 percent in 2011 to 7.0 percent in 2015 (Burhouse and others 2016).

the system quickly and the fact that DNS settlement was used for the UK's retail payment systems at that time.[2]

I favor the RTGS model given global trends, elimination of counterparty credit risk (and the corresponding cost of loss sharing agreements) and the substantial benefits of simplicity resulting from combining information for posting and settlement into one message and process. Technology has advanced considerably in the last ten years to support this straightforward and efficient real time clearing and settlement model. One should expect technical capabilities to continue to advance, as volume is likely to ramp up slowly. I also support development of a Fed-provided liquidity management tool to provide private arrangements an opportunity to leverage settlement in central bank funds and reduce liquidity costs. A market where robust private arrangements compete vigorously with the Federal Reserve Banks for clearing and settlement of financial institutions' payments transactions has served the nation well for four decades.

My remaining comments provide rationale for my view that **the Fed should indicate its intention to enter the market now for faster payments with a 24x7x365 RTGS service** that is consistent with its mission (efficiency, integrity/safety and equitable access) and with its responsibilities and constraints outlined in the Depository Institutions Deregulation and Monetary Control Act of 1980 (MCA).

1. **Like other payments markets, the market for faster payment services to financial institutions is likely to result in a dominant provider, leading to adverse effects on efficiency, innovation, resiliency/safety over the long term.**

The market for payments services displays network effects.[3] One outcome of this type of market is that the incentives of payment network providers are very strong to maximize the number of financial institution members so payments can be completed within their network. As a result, a payment network will naturally seek membership from banks with high transaction volume to become the dominant player and structure pricing and services attractive to smaller banks to gain critical mass. Once a dominant network emerges, it will exhibit monopolistic behavior with respect to pricing and proprietary technical approaches which may interfere with overall efficiency. In addition, economic theory leaves open the possibility of adverse effects on innovation (e.g., safety and reliability advancements).

A recent paper by several Federal Reserve economists describes the implications of the dominant provider market structure outcome for faster payments.[4]

> *"In the dominant-operator environment, provision of faster payments by a large operator that serves the vast majority of the market may result in productive efficiencies due to scale and scope economies. However, the dominant operator may lack competitive discipline on prices and service quality. Difficulties with market fragmentation would not arise in this environment, but high fees may reduce adoption, posing challenges to ubiquity. Additionally, a dominant operator may be well positioned in certain ways to promote safety but may concentrate operational or other risks. Moreover, a lack of competitive pressure leads to mixed effects on innovation."*

[2] Richard Mabbot Commentary, Consumer Payment Innovation in the Connected Age, 2012 Federal Reserve Bank of Kansas City payments conference.
[3] See Nicholas Economides, Competition policy in network industries: an introduction
[4] Faster Payment: Market Structure and Policy Considerations, November 2017, Rosenbaum, Aaron, Garth Baughman, Mark Manuszak, Kylie Stewart, Fumiko Hayashi, and Joanna Stavins.

In the US, retail payments are made by cash (face to face), ACH, check, cards, and a subset of wire transfers. The Clearing House (TCH) is the dominant private sector provider of electronic payment services to financial institutions in the US. The Fed competes with TCH for electronic check, ACH and wire transfer services in a way that serves to mitigate the potential for TCH to exhibit monopolistic behavior in the market. The Fed's products are available to all and by law, its pricing is transparent and cost-based, including a factor to replicate cost of capital and taxes paid by private organizations.

The Fed does not offer clearing services for payment card transactions. Examining the history of payment cards provides insight to the question of how the market for faster payments might evolve without the Fed as a participant. Early in the development of the first point of sale (POS) payment networks in the 1970s, a national commission looked at whether the Fed should handle POS payments in addition to ACH payments and concluded that it should not, expecting that private regional networks would provide efficient nationwide access. At the same time, it recognized the possibility that at some point in the future, market imbalances or inefficiencies might occur that could be addressed by the Fed's participation.[5] In the 2000s, the market did indeed become imbalanced as regional networks consolidated and market power concentrated in a few firms. Merchants, bearing the costs of payment card transactions, filed lawsuits and lobbied Congress to intervene, which it did via the Durbin Amendment to the Dodd Frank Act. Congress mandated that the Federal Reserve regulate pricing and market practices, an admittedly suboptimal solution. It was too late for the Fed to enter the market as the EFT Commission contemplated 35 years prior.

Considering economic theory and actual payments market evolution, I expect that the largest banks in the country will argue that the faster payments market can be adequately served by the companies they've funded (Early Warning Systems' (EWS) Zelle and TCH's real time payments service) and that the Fed should wait for a market failure before it decides to enter. This is a risky strategy in my view. TCH and EWS are actively positioning themselves as dominant providers of faster payments services to financial institutions. It is likely they will exercise their market power over the longer term, in the form of pricing that will limit equitable access by thousands of smaller banks and credit unions and, potentially, by underinvesting in security and resiliency. Like the payment card example, it will be difficult for the Fed to enter as a competitive force once market failure is identified; more likely are lawsuits, legislation and regulation.

While a single provider of faster payments infrastructure is common in other countries, those governments are active in the governance, regulation and supervision of the private sector. The US has no such regulatory system and no authority from Congress to establish one. The potential cost, timeframe for implementation and ultimate effectiveness to establish and execute a regulatory regime are highly uncertain, but likely to be significant.

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[5] Report of the National Commission on Electronic Funds Transfers February 1977, pp. xvii-xviii and p. 78. "The Commission recommends that the Federal Government should not be involved operationally at present… except for the provision of net settlement among depository institutions. The Commission, however, does not wish at this time to foreclose completely the possibility that, at some future point, it may become appropriate to have a Government operational role in POS switching and clearing facilities, either to correct market imbalances that might develop or to ensure an efficient and effective national payments system."

2. **The Federal Reserve has decades of experience developing payments technology to provide innovative, efficient and secure payment services to the US Treasury and thousands of banks and credit unions of all sizes across the US.**

The Federal Reserve Banks can develop and deliver new faster payment services, timely and effectively. They were pioneers in designing and implementing check image capture and processing technology that revolutionized the paper-intensive check collection industry in the US. They have extensive experience developing systems internally and acquiring and integrating third party software into their payments platforms. They developed a system for secure and reliable electronic access to payment services and continuously enhance it to address diverse and growing security threats. And, the Reserve Banks are already expanding the operating hours for its Fedwire Funds service. The service described in the request for public comment is very similar to the Fed's existing services and capabilities. I expect significant economies of scope to enhance the Fed's overall cost effectiveness in developing and running a 24x7x365 RTGS service.

3. **The Reserve Banks have unique components and reach critical to establishing a 24x7x365 RTGS faster payments service.**

In addition to the Fedwire Funds, FedACH, and electronic check processing systems, the Fed's extensive settlement account system and its electronic access network that connects nearly all financial institutions in the country directly or through a correspondent (e.g., corporate credit union, bankers bank, etc.) are unmatched by the private sector's services. If the Fed did not offer faster payment RTGS settlement services, the Fed's network reach (and costs) would have to be replicated by the private sector to achieve ubiquitous access.

4. **The Federal Reserve Banks have been judged to compete fairly in the market for retail payments services for nearly 40 years.**

As noted in the Board's request for public comment, the GAO's recent study confirms that the Fed's payments activities have been beneficial, lowering prices for customers while its competitors market share has increased. When the GAO asked participants about the Fed's future role, understandably, competitors said the Federal Reserve should reduce its payment services role. However, many participants supported having the Federal Reserve continue to compete in the market for payments services.

5. **The Federal Reserve Banks have been critical to the resilience of the US payment system in times of stress.**

Because the payment system operates so consistently and reliably, the public takes it for granted. However, there are times when this is not the case and public confidence in electronic payments are threatened. Because the Reserve Banks operate the payment system's core infrastructure and have a public mission, they have been able to serve as a backstop to address countless disruptions swiftly and minimize their impact on financial institutions and the public's confidence. During the disruption of air transportation resulting from the 9/11 attacks, the Reserve Banks continued to accept paper checks for deposit, enabling banks to shield their customers from the impact of delayed processing. When hurricanes, tornados and other natural disasters hit financial institutions, the Reserve Banks extensive contingency arrangements enable its staff to work closely with banks to keep payments flowing. During the financial crisis, the Federal

Reserve expedited the process to establish direct connections and provide services to financial institutions whose correspondent bank failed or decided the credit risk was too high to serve them.

6. **<u>The Reserve Banks have broad support to continue to serve as a provider of payment services, including faster payments.</u>**

Over my career, I've interacted with hundreds of payments executives representing financial institutions and businesses. The vast majority have expressed their support for the Fed continuing its service provider role as the payment system evolves toward faster payments. These stakeholders value having a competitive choice in the market and the Fed's long history of improving the payments system's safety, resiliency and stability, especially in times of crisis. I expect this support will translate into a customer base for faster payments similar to that for checks and ACH that will enable the Reserve Banks to compete effectively and comply with the requirements of the MCA, including recovering all costs to provide the service over the long term.[6]

In closing, the Reserve Banks have a 105-year history of advancing developments as providers of services to banks that improve the US payments system for the public's benefit. The Federal Reserve's mission is focused on the efficiency, integrity and equitable access of the US payments system. And the Reserve Banks and the Board of Governors play several roles to pursue this mission. Specific to the Reserve Banks role as a payments service provider to financial institutions, the Board's policy statement in 1990 describes the impact going forward as follows:

> *"This participatory role has served the nation well, contributing directly and indirectly to widespread public confidence in a payments system that is quick, sure, and efficient. The Federal Reserve's participatory role is well suited to the structure of the United States' financial industry. This country has a highly fractionalized banking system spread over wide areas with different types of institutions having differing payments needs. As interstate banking spreads, the underlying public-policy rationale for the Federal Reserve's operational presence in the payments system will continue to be an important consideration. The Federal Reserve will continue to bring to payments markets an overall concern for safety and soundness, promotion of operating efficiency, and equitable access. Indeed, those considerations relating to integrity, efficiency, and access to the payments system will remain at the core of the Federal Reserve's role and responsibilities regarding the operation of the payments system."*[7]

Consistent with the Fed's mission and history, the public would be well served for the Reserve Banks to continue in their service provider role by delivering a 24x7x365 RTGS service to financial institutions that is competitive and innovative, provides broad access and choice in the market, high levels of resiliency and the safety and security needed to achieve ubiquitous adoption. If not, I expect faster payments could be limited to customers of the largest banks and, eventually, political pressure will result in regulation of the dominant provider. This outcome would not be in the public interest.

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[6] Board of Governors of the Federal Reserve System Pricing Principles. "Over the long run, fees shall be established on the basis of all direct and indirect costs actually incurred in providing the Federal Reserve services priced, including interest on items credited prior to actual collection, overhead, and an allocation of imputed costs that takes into account the taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private business firm, except that the pricing principles shall give due regard to competitive factors and the provision of an adequate level of such services nationwide."

[7] The Federal Reserve in the Payment System, 1990 Board of Governors policy statement.