

TO: Board of Governors of the Federal Reserve System

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PROPOSAL: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments [OP-1625]

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Response to Questions

The U.S. payment system is once again at a crossroads similar to the 1970s and the weight of paper checks. Accepting that technology can facilitate transformational change ultimately resulted in Check 21. The growing gap between the market's need for transaction capabilities and the expectations that come with a digital economy versus the current underlying settlement abilities all revolve around a piecemeal of systems that oftentimes result in inefficiencies and delays. In order to meet the growing expectation of a 24x7x365 economy, the demand for a broader and nationally accessible faster payment system is crucial.

RTGS would bring about a much-needed modernization of the Federal Reserve infrastructure to support interbank settlement of faster payments, resulting in a possible minimization of risk and a maximization of efficiency. It is known that the U.S. retail payment system is behind other countries: the Reserve Bank of Australia and the European Central Bank have implemented or are currently finalizing the implementation of RTGS systems to support private-sector faster payment services. Most existing real-time payment systems offer an instant, interbank electronic fund transfer that can be initiated through one of many channels: smart phones, tablets, digital wallets, and the web. This involves authorization, posting, settlement and notification. Improving the U.S. payment system through RTGS would bring about speed, security, and efficiency, while expanding domestic and international capabilities and bringing together much needed collaboration.

The Reserve Banks currently provide payment services to more than 11,000 banks across the country. As such, a 24x7x365 RTGS service provided by the Reserve Banks has the potential to significantly improve the prospects of banks of all sizes in obtaining equitable access to a real-time interbank settlement infrastructure for faster payments. Additionally, having the Reserve Banks develop a 24x7x365 RTGS settlement service would assist in seamlessly leveraging current payment architecture for the real time payment offering, rather than having to go through a brand new architecture. Faster payment networks require both sides of the transaction to be on the network—as most banks are signed up with the Federal Reserve in some capacity, acceptance from financial institutions should be more widespread. Additionally, Third Party Service Providers, (currently for WAFD, Fiserv Pep+) would be forced to implement and accommodate any changes rather than fulfillment being optional

with a separate vendor and product. It is important to note that time is of the essence in implementing a successful Federal Reserve RTGS settlement service: now that The Clearing House's "(TCH)" new real-time payment ("RTP") platform is live in the U.S., its executive management have the goal to reach ubiquity by 2020 with additional aims of utility and security.

Yet, an outstanding concern that has yet to be addressed is implementation and maintenance costs. The Federal Reserve has not provided insight into fee structure, any potential volume discounts, operational costs or a cost recovery model. An apprehension would be the pitting of financial institutions against one another, opposite to that of the TCH private sector proposed solution of a not-for-profit initiative. However, WAFD does acknowledge the healthy competition and potential for increase in resiliency in case of an emergency that the Federal Reserve acting as an operator could bring. Additionally, it is important to bear in mind that the RTGS adjustments to the financial service industry and its customers pose to be substantial both from an operational and potentially monetary standpoint. Nevertheless, any potential disruptions would not outweigh the benefits of creating a 24x7x365 system.

In a common infrastructure connecting banks to faster payment services, the potential for the overall safety of faster payments would increase, removing banks from a deferred "I.O.U." settlement mechanism. It would, in turn, also pressure the development of private-sector faster payment systems, increasing innovation and choice in the market, thus ensuring for banks the opportunity to develop new services or enhance existing services. No matter the size, financial institutions all could capitalize on the underlying interbank settlement infrastructure.

Payment speed is important to both consumers and businesses. Having that ubiquitous participation means RTGS faster payment settlement would be broadly available to everyone and allowed to be used in a variety of different circumstances. The faster payment demand would primarily be concentrated within Business to Business (B2B), Business to Consumer (B2C), Consumer to Business (C2B), Domestic Peer to Peer (P2P) and Cross Border Peer to Peer (P2P). It would also allow the financial services sector to draw more of the unbanked/underbanked population into the financial mainstream. For example, a majority of check cashing consumers currently are using check cashing services for the speed and convenience, rather than the traditional bank account. A faster RTGS settlement system built around a comprehensive, industry-wide foundation would increase banks' prospects for success. Yet the system would need to consider real-time authorization/clearing, intra-day availability of funds, intra-day interbank settlement and late-day interbank settlement.

At this time, the Federal Reserve has mentioned various design options, which would impact aspects of daily bank function, as alternative approaches for increasing the speed of payment system infrastructure. Four have been chosen for further study:

- Enhancement of the debit card networks;
- Leveraging of a distribute public internet protocol (IP) architecture;
- Building a new (near) real-time infrastructure to address use cases, leverage legacy infrastructure for settlement; or

- Building a new (near) real-time payments infrastructure that would also process transaction types handled by legacy ACH and check platforms and potentially wire platforms as well.

Efficiency is the crucial component for successful interoperability between RTGS services for faster payments. If the Federal Reserve becomes an operator, it is imperative that it interoperate with existing real time payment solutions found within the private sector, like those offered by TCH. This would ensure that financial institutions are not forced to choose between offering only one solution that would not be able to connect with the entire marketplace, or with the undesirable task and inefficiencies of operating two different systems.

With that being said, Washington Federal would like it acknowledged that while building new real-time payments infrastructure that would also process transaction types handled by legacy ACH and check platforms (with the potential for wire platforms) would be the most ideal solution, it recognizes that this transformation comes with a potentially high cost and would result in a burden of time and resources. However, it should remain as a possible longer-term objective. A possible alternative would be building a new real-time payments infrastructure to address targeted use cases while leveraging infrastructure for settlement.

A Liquidity Management Tools (“LMT”) would greatly assist the 24x7x365 funds transfers from a financial institution’s master account to a faster payments account. It is essential that this LMT work with any internal Federal Reserve solution and within the private sector solutions. This would ease concerns about funds sitting in faster payment accounts or low balances causing payments to be halted overnight or on weekends the Fedwire is closed. But without additional information, parameters and implementation procedures remain unknown. Ideally, WAFD would prefer the Reserve Banks develop a LMT that is either a tool that allows an automatic transfer of balances (or “sweep”) based on pre-established thresholds and limits, or a combination of a tool that requires the bank to originate transfers from one account to another and uses the sweep method. But whatever tool the Federal Reserve develops, it would need to find a balance between settlement risks, immediacy and liquidity requirements. The high liquidity needs associated with RTGS may require the exploration of liquidity-saving mechanisms and perhaps the development of hybrid systems.

The concept of “paying now” is not new: cash serves as an immediate payment transaction instrument. However, RTGS has begun to build a new standard among consumers, driving for changes to traditional payment types: checks, credit, debit, prepaid and the like. The key factors driving real-time payments include technology innovation, new players and business models (many non-financial), merchant and consumer expectations, globalization and most importantly regulatory pressures. The Federal Reserve needs to develop a comprehensive and effective roadmap to define the new operating model.