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PUBLIC INTEREST COMMENT

FEDNOW PORTENDS A MORE COMPETITIVE AND RESILIENT PAYMENTS SYSTEM

THOMAS M. HOENIG[1]
Distinguished Senior Fellow, Mercatus Center at George Mason University

Federal Reserve Actions to Support Interbank Settlement of Faster Payments
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I appreciate the opportunity to respond to the request for comment by the Board of Governors of the Federal Reserve System (Board) regarding the competitive effects, operational considerations, and other policy issues related to its provision of a real-time gross settlement payments system (RTGS), identified as FedNow. The Mercatus Center at George Mason University has provided me the opportunity to prepare these comments as it is committed to bridging the gap between academic ideas and real-world policy issues and to advancing public understanding of the effects of government actions on society. Accordingly, these comments are intended to assist the Board as it considers how best to facilitate an effective payments system now and into the future.

In the comments that follow I address, first, the Board's request for comment regarding expected competitive effects and public benefits from developing its FedNow system; and second, I suggest that, as FedNow proceeds, the Board should anticipate the costs and benefits of expanding access to it by both banks and nonbank fintech firms.

COMPETITIVE EFFECTS AND PUBLIC BENEFITS

The Board outlined an analytical framework for judging the competitive effects or appropriate benefits that would justify the entry of the Federal Reserve Bank System (FRBS) into RTGS payments services. In summary, the framework includes the following:

1. The Board determines whether the proposal has an adverse effect on other service providers, which will compete with the FRBS in providing a similar service.

[1] Thomas M. Hoenig is a senior fellow at the Mercatus Center at George Mason University, former president at the Federal Reserve Bank of Kansas City, and former vice chairman of the Federal Deposit Insurance Corporation.

For more information, contact
Mercatus Outreach, 703-993-4930, mercatusoutreach@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Blvd., 4th Floor, Arlington, VA 22201

2. If so, the Board considers whether such effects are owing to legal differences and whether those differences grant the FRBS a dominant market position.
3. If the FRBS has a dominant market position, then the Board must evaluate whether the same public benefits could be achieved by other means with lesser or no adverse competitive impact.
4. Depending on these considerations, the Board either modifies the proposal to mitigate the adverse competitive impact or proceeds with the proposal as is. The latter may be warranted if mitigation is unlikely to be effective and the public-good objectives are sufficiently met by the current proposal.

Payments in the United States involve millions of transactions and trillions of dollars each day. As payment technologies have developed, any new settlement system will benefit from significant economies of scale as well as rapid efficiency gains and, as a result, will possess the attributes of a natural monopoly. This is reflected in the reality that the only entrant besides the FRBS willing to develop an RTGS system is The Clearing House (TCH), a consortium of the 25 largest global banks. Without the FRBS, it appears that this consortium would be the sole provider of a payment settlement system involving a quadrillion dollars of payments annually. Such a monopoly would have the opportunity and incentive to set price and service levels to its advantage.

The entry of the FRBS into RTGS provides a competitive alternative to TCH. The FRBS has the infrastructure and technical knowledge to develop such a system. Its entry provides for greater transparency into RTGS operations and pricing, as it is statutorily required to disclose its costs and methods of analysis; and it must achieve a return on equity for this service comparable to that historically achieved by the banking industry. It must provide access to its RTGS system to all eligible participants in the payments system. Thus, the entry of the FRBS into RTGS is procompetitive, offering choice of provider based on quality and price and providing for greater transparency through disclosure of its product and pricing decisions.

The FRBS does not have a dominant market position, since payments settled among TCH members account for a significant share (some estimates are as high as 50 percent) of payments completed within the United States. And since the FRBS must disclose its prices, methods of pricing, and service levels, it is unlikely that it could unfairly take market share from the consortium without it being quickly disclosed and addressed. The consortium has no comparable disclosure requirements.

The FRBS has one apparent advantage over other providers. Settlement funds held with it carry no risk of loss while funds held with the consortium could be subject to loss should it or a member fail. Also, while the FRBS pays interest on reserves, which includes settlement funds, it is not required to pay interest on the joint settlement account held on behalf of the other payment settlement provider.

Regarding the risk of loss if funds are held with the private payment settlement provider, it is important to put the likelihood that this would occur in perspective. History shows that those institutions providing real-time payments would not be allowed to fail or be liquidated should they fail. All resolution plans in place and accepted by the regulators are designed to keep the operating banks working through any reorganization of the consolidated institution should it fail.

Regarding the advantage of paying interest on reserves held with the FRBS, this can be addressed in one of two ways. The FRBS could specifically carve out settlement balances with banks using FedNow services and pay no interest on these balances. Alternatively, it could pay interest on the combined settlement account the consortium holds with the FRBS for distribution to its members.

Thus, while there is a legal difference between the consortium and the FRBS, this difference does not undermine the consortium's ability to successfully compete with it. As noted earlier, by offering the market a choice of providers, FedNow enhances competition, a clear benefit to the public. Also, because FRBS must disclose how it sets pricing and service levels, it assures greater market transparency for all. These benefits serve to mitigate any advantage it might otherwise have in the market.

Alternatively, if the FRBS's advantage comes from the fact that it would not fail in a crisis, and assuming that TCH or any of its members should be allowed to fail, then having FedNow as an alternative to the consortium provides a significant public benefit. Failure of a member of TCH would put the economy in jeopardy. Confidence in the ability to settle payments likely would be lost and without government intervention to directly bail out these banks, the financial system and economy would potentially collapse. Therefore, it is useful and logical that the FRBS provide an alternative payments and settlement mechanism, which better assures resilience and continuity of the nation's payments system at all times. This is no small matter when, as noted above, trillions of dollars of payments are transacted each day.

Thus, the FRBS, by providing a viable alternative to a single operator for a RTGS system, will provide a clear public benefit. FedNow will provide an alternative choice to the many payments users. It will enhance competition and provide greater transparency regarding pricing and service levels, both of which will facilitate greater product innovation. Also, the FRBS, as a second provider for RTGS, will assure greater resiliency and reduce the overall risk of a national payments system failure. Such an outcome is substantially in the public interest.

RTGS AND ACCESS

With the introduction of RTGS systems, payments transactions and their settlement will take place in real time. This provides for faster and safer transactions among individuals and businesses and will serve to spur further innovation across the payments spectrum. Bank and nonbank firms are increasingly introducing new payments applications and are likely to enhance and expand these services as RTGS systems enter into service.

Complementing RTGS in encouraging innovation and competition within payment systems is the advent of open banking. Open banking is a banking practice that gives third-party financial service providers open access to consumer banking, transactions, and other financial data from banks and nonbank financial institutions. It enables fintech companies and banks to access data previously available only to the individual's or business's primary bank, and increasingly governments are mandating that such systems be implemented. Open banking, therefore, is a major avenue for future innovation in payments and, with access to an improved payments and settlement system, is poised to reshape the payments industry. In this environment, for example, business-to-business and person-to-person payments can be successfully conducted among a broad array of bank and nonbank payments providers. Nonbank service companies may find it increasingly attractive to expand their provision of accounting, billing, and payroll services for commercial firms and individuals to include direct payments transactions. Banks, too, may see opportunity for expanding their payments services to include related business support services.

If implemented well and consistently, the combination of real-time payments, open banking, and enhanced payments technology charts a path to greater choice, more convenience, and more reliable payments services for the public.

In this regard, I offer the following additional comments as part of the public discussion forward:

- *Access/Settlement*. As real-time payments have developed around the globe, fintech firms, not only commercial banks, are being allowed to settle through the central bank. In the United Kingdom, for example, the Bank of England currently allows qualified nonbank firms access and settlement authority. In the United States, the Comptroller of the Currency has raised the possibility of a fintech charter. As I suggested above, the potential benefits from FedNow include increased competition, product innovation, improved service quality, and lower prices. These potential benefits need to be weighed against potential risks and costs of expanding access to real-time payment systems to new entrants within the United States.
- *Safety Net Exposure*. One important risk that follows from fintech firms' having access to RTGS is that they might also acquire access to subsidized central bank liquidity facilities and payments insurance. Some fintech firms, for example, currently are seeking FDIC insurance. Expanding the safety net to these firms necessarily increases moral hazard and exposes the safety net and the taxpayer to greater risk of loss. Such risk might be mitigated by prohibiting insurance to all institutions other than formally chartered depository firms. However, even with such prohibitions in place, the ramifications of a major fintech company failure are unclear. Thus, issues of moral hazard and the risk and consequences of contagion to other noninsured fintech companies and the banking system more generally should be explored, understood, and addressed before expanding access to the FedNow system.
- *Interoperability*. The establishment of common standards and a commitment to assuring interoperability among real-time payments systems, domestically and internationally, will add significantly to the efficiency and reliability of such systems and simplify expanding access to the payments system more broadly. Also, interoperability weakens the advantages of a single network and further fosters competition. Thus, to the extent that international messaging and transactions standards can be agreed upon, the greater will be the ability to assure the speed and integrity of transactions among bank and nonbank firms, and within and across borders. For the United States this would involve TCH and the FRBS working with the industry and agreeing to a set of standards and then working jointly with other nations to agree and implement common messaging and transaction standards.
- *Identity of Payments Parties*. Expanded payments will require wider access to systems that identify all parties to a payments transaction. In 2013, for example, the G-20 directed and the Financial Stability Board agreed to develop a concept entitled Legal Entity Identifier (LEI), which uniquely identifies legally distinct entities that engage in financial transactions. This is an international identifier that applies broadly to all firms that engage in financial activities, which could include payments transactions. LEIs offer a standardized means for identifying

business payments transactions and the originators and recipients of such transactions on a global basis. In addition, there are other technologies, such a fingerprint identity, which can uniquely recognize and validate individuals both originating and receiving payments. These technologies will make systems increasingly reliable and will facilitate access to RTGS, and their adoption should enhance the overall integrity of evolving FedNow services.

- *Compliance*. Compliance with the many laws and regulations related to payments, such as the Bank Secrecy Act, is a daunting challenge for firms and supervisors. This is made ever more challenging with the increased complexity of the evolving laws and with the expansion of potential participants in payments. Technology represents an opportunity to address this challenge in a thorough, uniform, and equitable manner, and it should be a principal consideration in the design and building of RTGS systems, including that of FedNow.
- *Privacy*. There is little doubt that the introduction of new technologies for identifying and recording individual payments transactions will be increasingly intrusive to firms and individuals. With the introduction of RTGS, firms conducting payments transactions will collect increasing amounts of data on both individuals and corporations. These data will be of considerable interest in government compliance programs and will be of substantial value to marketing firms. Defining how these data are collected and protected by payments providers should be a priority as the payments systems expand across bank and fintech firms, and as FedNow is developed.

SUMMARY

Payments transactions involve nearly every individual in the United States. The development of payments settlement systems, known as RTGSs, is a critical step in modernizing the payments and financial systems. The FRBS's role in real-time payments would likely produce a more competitive and resilient system and is thus in the public interest. Also, the development of RTGSs and the introduction of innovative payments technologies will create opportunities to provide new financial services. While further study and consideration is warranted—and I suggested some critical topics earlier—these opportunities should be fully explored.