

Building for the Future: A Public Policy Perspective

Remarks by

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers, or representatives.

I appreciate the opportunity to join you today and want to thank Ellen Bromagen and the Chicago Fed team for organizing this important conference. I look forward to the insights that will come from this year's program and its participants.

Today's theme of innovation recognizes that the changing payments landscape is both important and exciting, as well as unsettling and disruptive. While a real-time payment infrastructure for retail payments is the nation's most significant modernization in more than 40 years, other innovations such as digital currencies enabled by technological advancements continue to emerge. Determining what role they might play in safely and effectively serving the broader payments needs of U.S. households and businesses will require careful public policy research and analysis.

In the case of faster payments, the Federal Reserve's recent decision to build and operate a real-time payment system also followed years of research and analysis, including broad public engagement. Beyond their popularity for speed and convenience, faster payments demonstrate value in yielding real economic benefits. In particular, individuals and businesses could realize more flexibility to manage their money and to make time-sensitive payments whenever needed. These advantages could result in better cash flow management and efficiencies for small businesses, and enable some individuals to avoid high-cost borrowing and penalties such as overdraft or late fees.

Given these potential economic benefits, the Federal Reserve determined that upgrades to the payments capabilities of both the Federal Reserve and the private sector were important. To facilitate private-sector advancements, the Federal Reserve's Board of Governors approved in 2017 access to accounts that would allow settlement between and among banks participating in private-sector payment systems. At the same time, the Federal Reserve began to assess the Faster

Payments Task Force's recommendation, asking it to evaluate what role the Reserve Banks might play in providing real-time settlement services. This year, the Board announced its decision to operate a real-time payment service alongside the private sector. It also announced that further efforts to support private sector services through exploring expansion of hours for the Fedwire Funds Service and the National Settlement Service would follow.

Recognizing that time to market is important, the Federal Reserve has committed to launching this new service, known as FedNow, as soon as possible. Work is underway now to engage with industry participants on the initial design and features of the service.

As financial institutions prepare to connect to this critical infrastructure, some are raising questions about the strategic choices they face. I'd like to address three such questions in my remarks today. First, will the private and public options be interoperable to ensure the systems work together seamlessly and ubiquitously? Second, will the pricing scheme be the same for all banks regardless of their size? Third, how soon will the FedNow Service be operational? Before addressing each of those questions, I first want to briefly discuss the Federal Reserve's history as a payments provider as context.

FROM THE BEGINNING

Although real-time payments represents a significant evolution in our payments system, it is not the first time our payments system has been through a significant transition. History shows that the central bank has worked effectively with the private sector and that the nature of this partnership has benefitted the system, its participants and the public.

The Panic of 1907 was a catalyst in the creation of the Federal Reserve. One of the hallmarks of the 1907 financial crisis was a nationwide currency shortage that left businesses

unable to pay workers and settle accounts. Absent a central bank, a few large private institutions held tremendous influence over the financial system. When these institutions were either unwilling or unable to provide necessary liquidity, local bankers would band together and issue special certificates that effectively functioned as a privately-issued currency. Creating a central bank was intended in part to address what had been referred to as a “famine of currency,” during this crisis. This new central bank, according to Carter Glass, one of its congressional founders, needed to “tear down these tollgates upon the highways of commerce.”

Early on, the Fed developed a nationwide par clearance system for checks that ensured that a recipient of a payment received the full value regardless of location. In the 1950s, when rising check volumes and a lack of standardization even in the physical dimensions of checks were proving problematic to banks, the Fed and the American Bankers Association in partnership developed the magnetic ink character recognition (MICR) system.

In the 1970s, the Fed and private sector developed the automated clearinghouse network (ACH) to improve efficiency in the handling of many routine and recurring payments, thus eliminating the need and cost associated with processing paper checks in these instances.

During the 1990s, the Fed recognized that the internet’s growing role in our economy would prompt a similar evolution in payments, which then were still largely made by check. A national commission headed by Alice Rivlin, vice chair of the Fed’s Board of Governors at the time, explored the future of the Fed’s role in retail payment services. Through a public feedback process, the commission reached two conclusions. First, the Federal Reserve Banks should continue to serve as an operator for retail payments. Second, the Fed should work collaboratively

with the banking industry to improve efficiency and develop strategies for the movement toward a digital payments environment.¹

In the immediate aftermath of 9/11, when some banks sought to limit customer withdrawals, the Fed assured the public it was open and ready to meet liquidity needs while finding alternative ground transportation for check transfers. Importantly, the Fed pledged to immediately credit to banks all checks it processed. This promise to honor “float” provided a key source of liquidity.

In the months after the 9/11 attacks, the Fed played a key role in promoting greater use of electronic check processing to eliminate significant inefficiencies in the payments system. Congress ultimately passed legislation, known as Check 21, to support the nationwide achievement of this improvement to our payment system.

This historical record shows that having the Federal Reserve as an operator within the payments system has yielded public benefits. This record also suggests that participation in real-time settlement services will raise performance and accountability for the FedNow Service and others.

THE ROAD TO FEDNOW

From the Rivlin Commission to the efficiencies gained through Check 21, the Federal Reserve, working with the industry, had already taken the first steps on the road that would lead to today’s faster payments supported by real-time settlement infrastructure. Over the past six years, there have been a number of collaborative initiatives between the Federal Reserve and industry stakeholders on strategies for improving the payment system.

¹ “The Federal Reserve in the Payments Mechanism.” Federal Reserve System. January 1998. <https://www.federalreserve.gov/boarddocs/press/general/1998/19980105/19980105.pdf>

Among these, in 2015, the Federal Reserve convened the Faster Payments Task Force, a 320-member group comprised of a broad range of industry participants. Its conclusions – that the Federal Reserve should develop a 24x7x365 settlement service to support faster payments and explore and assess the need for other Federal Reserve operational role(s) in faster payments – aligned with both the outcomes of the Rivlin Commission and the Fed’s longstanding role in payments. The United States Treasury shared that view, recommending last year that “the Federal Reserve move quickly to facilitate a faster retail payment system, such as through the development of a real-time settlement service, that would also allow for more efficient and ubiquitous access to innovative payment capabilities.”²

Throughout its history, access to Fed payment services, such as check, ACH, and funds transfer services, has facilitated the banking system’s ability to deliver its services with nationwide reach. In addition, these services have traditionally operated alongside private-sector services, achieving broad public benefits. Giving the industry choices in payments services, this competition has spurred lower costs, increased efficiencies and better service for users, as noted by independent reviews including the Government Accountability Office in 2016.³

QUESTIONS

With this historical context, I’ll turn to each of the three questions I noted earlier: 1) will the private and public options be interoperable to ensure the systems work together seamlessly

² U.S. Treasury, “A Financial System That Creates Economic Opportunity: Nonbank Financials, Fintech, and Innovation,” (July 2018) at 156. Available at <https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation.pdf>

³ “Federal Reserve’s Competition with Other Providers Benefits Customers, but Additional Reviews Could Increase Assurance of Cost Accuracy.” U.S. Government Accountability Office. August 30, 2016. <https://www.gao.gov/products/GAO-16-614>. <https://www.gao.gov/assets/680/679388.pdf>

and ubiquitously? 2) Will the pricing scheme be the same for all banks regardless of their size?
3) How soon will FedNow be operational?

The importance of interoperability was prominent in the desired attributes of a faster payment system based on the Faster Payments Task Force's work. In a market structure with multiple operators of real-time gross settlement services for faster payments, the ability to secure nationwide access is advanced when customers of a bank participating in one service are able to reach the customers of a bank participating in another service. Similar to the efficiencies gained through the development of a consistent MICR system with checks in the 1950s, and the nationwide reach achieved with existing payment services, common standards and rules for seamless processing of real-time payment messages is a desirable feature. But it is one the Federal Reserve recognizes may be difficult to achieve, at least early on.

Across the existing payments landscape, services with multiple operators have been able to achieve the goal of nationwide reach. Although the approaches differ, they have functioned effectively.

One approach allows the direct exchange of payments between operators, where payments originated by a participant of one service could be received by a participant of another service. This situation exists today in the case of the ACH system. The direct exchange of messages between operators would require technical functionality to move the messages and a method to enable settlement across systems and participants. The level of cooperation between operators and complexity increases significantly with this approach. I don't consider it an insurmountable challenge, but it could take time to achieve, and thus, it may not be an initial element of the FedNow Service.

Another approach to achieving nationwide reach is for financial institutions to participate in multiple services that are not interoperable, but where at least one service has achieved nationwide reach on its own. Such an approach is used today in the funds transfer system. A financial institution that participates in multiple services can choose which service to use for transactions, depending on any number of factors, such as fees, functionality, and counterparties a particular service can reach.

As we engage with the industry, we are exploring these approaches and other potential paths to achieving the ultimate goal of nationwide reach for faster payments. We also recognize that the initial approach may change over time as technology, industry practices, and the relationship between real-time gross settlement services for faster payments evolve. To be sure, the Federal Reserve is committed to exploring with the industry interoperability and other paths to achieving ubiquity.

A second question that has surfaced relates to how the FedNow service will be priced. As noted in the Federal Register Notice, the Board of Governors will announce the FedNow fee structure and fee schedule before the service is launched. This transparency in pricing will take into account prevailing market practices and can be expected to include a combination of per-item fees, charged to sending and potentially to receiving banks, and fixed participation fees.

As with existing services, the FedNow Service will be subject to the Monetary Control Act which requires that aggregate revenues match costs over the long run and requires the Board of Governors to adopt pricing principles specifically to avoid unfair competition with the private sector. The Federal Reserve follows a transparent process in describing its schedule of fees for each service line in an annual notice to the public.

Because the current private sector service initially proposed flat-fee pricing, questions have been raised about whether the Fed will offer the same pricing or a volume-based pricing structure. Implicit in this question is whether one approach is fairer than the other.

Pricing based on volume or bulk is common in many industries. In the context of payment services, there are often large fixed costs. When a service has more volume, it is able to offer the service at a lower price because the costs are spread out over more transactions. Unlike services provided to a small group of participants with high transaction volumes, Federal Reserve services are provided to a diverse group of participants that vary in terms of size and transaction volume.

In such circumstances, volume-based pricing helps ensure sufficient use of the service to spread costs over greater volumes, yielding lower prices for all participants. Because of these benefits, volume-based pricing has been considered an acceptable pricing strategy, as noted in the 2016 GAO review. That said, a pricing structure for the FedNow Service has not yet been determined.

Finally, we have received a number of questions about the timing and a desire to see the new service delivered quickly. Recognizing that time to market is an important consideration for many industry participants, the Federal Reserve has committed to launching the new FedNow Service as soon as we can. Efforts are now underway to gather input from industry participants on the initial design and features of the service. As these details are finalized, the Board of Governors will publish a final service description.

While the initial availability of the FedNow Service is a top priority for the Federal Reserve, the achievement of true nationwide reach remains a critical measure of success for faster payments for any service, including the FedNow Service or a private-sector service.

Connecting more than 10,000 financial institutions to a faster payment service will take some time. For example, by the middle of 2019, banks that had joined the private-sector service represented less than 1 percent of all U.S. banking institutions.

In addition to moving quickly to deliver the service, we will ensure that industry participants are prepared to connect to the FedNow Service. Ahead of the service's availability, the Federal Reserve will be working closely with banks and their technology partners to prepare for expeditious onboarding.

Beyond the questions related to interoperability, pricing and time to market, the safety of the payment system is crucial to the nation's economic growth and financial stability. The Federal Reserve has historically played an important role in promoting the safety of the U.S. payment system by providing liquidity and operational continuity in times of crisis. As prominence of faster payments in the United States grows, the development of the FedNow Service will allow the Federal Reserve to retain its ability to provide stability and support the banking system and the broader economy.

As operator of the FedNow Service, the Federal Reserve also will be in a position to promote the development and implementation of industry-wide standards, as has been the case in other payments systems where the Fed plays an operational role. Given the irrevocable, real-time nature of faster payments, the ability to detect and prevent fraud will be a key aspect of ensuring safety of the system.

CONCLUSION

Innovation brings important benefits to our economy. We are seeing faster payments services grow in popularity. An efficient payment system facilitates and encourages economic

activity by making it faster, cheaper, and more convenient for individuals and businesses to pay for goods and services. Creating real-time settlement services in the U.S. lays a foundation on which both banks across the country and the broader payment industry can build modern, innovative, and safe faster payment services.

The Federal Reserve has been core to that system for more than a century. In response to today's need for real-time settlement services, we are moving quickly to deliver the FedNow Service. Decisions about interoperability and pricing across multiple providers are yet to come, but the Federal Reserve's history points to a strong public policy focus on objectives for access, equity and safety that will guide the answer to these questions. Importantly, the FedNow Service will support the innovative solutions available to consumers and businesses today, and many more I anticipate are yet to be thought of, although they may only be just around the corner.