Faster Payments and the U.S. Payment System

The U.S. payment system faces a critical juncture in its evolution. Services to conduct faster payments, which are available via smart phones apps or on our computers, have begun to emerge along with the growth of digital commerce. Faster payments allow individuals and businesses to send and receive payments within seconds, any time of day, on any day of the year, such that the receiver can use the funds almost instantly. The round-the-clock, real-time nature of faster payments offers convenience that is not available with many traditional ways of making payments. In addition, faster payments can yield real economic benefits for individuals and businesses by providing them with more flexibility to manage their money and allowing them to make time-sensitive payments whenever needed.

Yet with many of the faster payment services available today, the underlying infrastructure is not designed to immediately move money between banks, creating notable delays between the initiation of a retail payment and its receipt. These shortcomings limit the degree to which the potential benefits of faster payment services may be widely enjoyed across our economy in a safe manner. Further expansion of the interbank infrastructure is needed to serve as the foundation for the development of faster payment services that are safe, efficient, and broadly accessible to the American public.

Last month, the Federal Reserve's Board of Governors (Board) announced that the Federal Reserve Banks (Reserve Banks) would develop a new service called the FedNow^{SM} Service to support widespread adoption of faster payments in the United States. The FedNow Service will provide the necessary infrastructure, alongside similar services provided by the private sector, to connect banks across the country, allowing them to offer innovative faster payment services to their customers.

Since its founding, the Federal Reserve has played a key operational role in the nation's payment system by providing interbank payment infrastructure that is available to banks across the country, regardless of size or location. This critical role, given by Congress, stems from the Federal Reserve's unique ability, as the nation's central bank, to provide interbank settlement without introducing liquidity or credit risks. In today's payment infrastructure, whether in check processing, automated clearinghouse (ACH) services, or funds transfers, you will see a Federal Reserve service operating in healthy competition with and in support of similar services provided by the private sector, all for the benefit of the American public.

The importance of this role has been recognized broadly, with an independent review by the U.S. Government Accountability Office concluding that the Federal Reserve's provision of payment services has benefited the U.S. payment system and its users.[1] It is important to point out, however, that Congress did not grant plenary regulatory or supervisory authority over the U.S. payment system to the Federal Reserve, and the Federal Reserve does not have regulatory authority over the pricing set by a private-sector system or to require a private-sector system to extend the service to banks of all sizes. In some other countries, central banks have been assigned the responsibility for regulating payment systems. In the United States, this is not the case. Thus, the Federal Reserve has historically helped to promote the accessibility, safety, and efficiency of the nation's payment system and advance innovations through its operational role as provider of payment and settlement services.

[1] See U.S. Government Accountability Office, GAO-16-614, "Federal Reserve's Competition with Other Providers Benefits Customers, but Additional Reviews Could Increase Assurance of Cost Accuracy" (2016). Available at https://www.gao.gov/products/GAO-16-614.

Path to Present

Leading up to the recent FedNow Service decision and announcement in August, the Federal Reserve took several actions to facilitate the advancement of faster payments in the United States. In 2013, the Federal Reserve began a collaborative initiative with industry stakeholders to foster improvements to the nation's payment system. As part of this initiative, the Federal Reserve convened in 2015 the Faster Payments Task Force (FPTF), comprising a wide range of industry stakeholders, to identify and evaluate alternative approaches for implementing safe and ubiquitous faster payment capabilities in the United States.

The FPTF published in 2017 a set of consensus recommendations focused on actions to support improvements to the nation's payment system.[2] Among the FPTF's recommendations were requests for the Federal Reserve (1) to develop a 24x7x365 settlement service to support faster payments and (2) to explore and assess the need for other Federal Reserve operational role(s) in faster payments. Subsequently, the U.S. Department of the Treasury recommended that "the Federal Reserve move quickly to facilitate a faster retail payments 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."[3]

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[2] These recommendations were intended to help achieve the FPTF's vision of ubiquitous faster payment capabilities in the United States that would allow any end user (that is, an individual or business) to safely, efficiently, and seamlessly send a faster payment to any other end user, no matter which banks or payment services they use. See Faster Payments Task Force, "Final Report Part Two: A Call to Action," (July 2017). Available at https://fedpaymentsimprovement.org/wp-content/uploads/faster-payments-task-force-final-report-part-two.pdf.

[3] The U.S. Department of the Treasury also noted that "[i]n particular, smaller financial institutions, like community banks and credit unions, should also have the ability to access the most-innovative technologies and payment services. While Treasury believes that a payment system led by the private sector has the potential to be at the forefront of innovation and allow for the most advanced payment system in the world, back-end Federal Reserve payment services must also be appropriately enhanced to enable innovations." 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/2018-07/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financi.pdf.

The Federal Reserve also has directly supported the development of private-sector real-time gross settlement (RTGS) services for faster payments. The Board approved in 2017 final guidelines for evaluating requests for joint accounts at the Reserve Banks intended to facilitate settlement between and among banks participating in private-sector payment systems for faster payments.[4] The impetus for allowing broader use of joint accounts was to support these private-sector arrangements.

In November 2018, the Board published a Federal Register notice (2018 Notice) requesting comment on two potential actions that could be taken by the Federal Reserve consistent with the FPTF recommendations: (1) a service for 24x7x365 real-time interbank settlement of faster payments; and (2) a liquidity management tool that would enable transfers between accounts held at Reserve Banks on a 24x7x365 basis to support services for real-time interbank settlement of faster payments.

The Board explained that a Federal Reserve RTGS service for faster payments, alongside private-sector RTGS services, would provide the infrastructure needed to achieve ubiquitous, safe, and efficient faster payments in the United States. Other parties, such as banks, payment processors, and providers of payment services, could utilize this platform as a basis for innovation to meet the specific needs of the businesses and households they serve. The Board further explained that a liquidity management tool, in turn, could help alleviate liquidity management issues for banks engaged in RTGS-based faster payments, notably those utilizing settlement services offered by the private sector. In particular, such a tool would enable

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[4] Board of Governors of the Federal Reserve System, "Guidelines for Evaluating Joint Account Requests," (Issued 2017). Available at https://www.federalreserve.gov/paymentsystems/joint_requests.htm. In 2016, Federal Reserve staff received a request from a private-sector service provider to open a new joint account for that organization's proposed faster payment system. The use of a joint account at a Reserve Bank to support settlement mitigates certain risks by reproducing, as closely as possible, the risk-free nature of settlement in central bank money.

movement of funds between accounts at the Reserve Banks during hours when traditional payment and settlement services are currently not open to allow liquidity to be moved, when needed, to an account or accounts used to support real-time settlement of faster payments. The 2018 Notice proposed that the tool could be provided by expanding operating hours of current Federal Reserve services or through a new service.

In the 2018 Notice, the Board requested comment on the appropriateness of real-time gross settlement as the strategic foundation for faster payments in the United States and the public benefits, implications, and challenges of the Federal Reserve taking either, both, or neither of the potential actions.

Consideration of Comments and Policy Assessment

The Board received over 400 comment letters representing over 800 entities in response to the 2018 Notice. Comments were submitted by a wide variety of stakeholders in the U.S. payment system, including community banks, individuals, consumer organizations, merchants, service providers, private-sector operators, fintech companies, trade organizations, and other interested parties.[5] Consistent with the diversity of the payment industry, commenters represented a broad range of viewpoints.

Almost all commenters addressed the question of whether the Federal Reserve should develop a real-time interbank settlement service for faster payments. The vast majority of these commenters, representing nearly every stakeholder segment, supported the Federal Reserve

[5] Overall, banks were the largest group of respondents, with community banks (small and midsize banks) comprising approximately 60 percent of the total comments—the largest specific segment—and representing institutions from 34 states.

taking this action. In contrast, large banks, some trade organizations, and private-sector operators were generally not supportive of the Federal Reserve developing such a service.[6]

In reaching its decision to offer the FedNow Service, the Board was informed by these public comments and the history of the U.S. payment system, in which the Federal Reserve has played a role since its inception. In addition, any decision by the Board to offer a new payment service is subject to the factors set out in longstanding Federal Reserve policy, and the pricing of Reserve Bank services is subject to the requirements of the Monetary Control Act of 1980.[7] Specifically, in considering new services, the Board assesses three criteria: whether the service is one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity; whether the service will yield a clear public benefit; and whether the Federal Reserve will achieve full cost recovery over the long run.[8]

Other Providers Criterion

Through this assessment, the Board has concluded that other providers alone cannot be expected to provide an RTGS infrastructure for faster payments with reasonable effectiveness, scope, and equity. So far, only one private-sector RTGS service for faster payments has been established in the United States. Due to coordination challenges and the high fixed costs necessary to develop a new payment and settlement service, this service is expected to remain the sole private-sector RTGS service for faster payments in the United States. The ability of a

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[6] Approximately half of the commenters discussed the liquidity management tool, with almost all supporting the Federal Reserve offering such a tool.

[7] In 1984, the Board established criteria for the consideration of new or enhanced Federal Reserve payment services in its policy The Federal Reserve in the Payment System. Board of Governors of the Federal Reserve System, "The Federal Reserve in the Payments System," (Issued 1984; revised 1990). Available at https://www.federalreserve.gov/paymentsystems/pfs_frpaysys.htm.

[8] In addition, the Board performs a competitive impact analysis when considering an operational or legal change to a Reserve Bank service or price that would have a direct and material adverse effect on the ability of other providers of services to compete with the Reserve Banks.

sole private-sector provider to extend access to a few thousand banks, let alone the more than 10,000 diverse banks necessary to achieve true nationwide scope, would be costly and time-consuming given that the existing service has limited relationships with and connections to these institutions.

In addition, the Board concluded that the private-sector operator alone cannot be expected to provide the service with reasonable effectiveness, as viewed through the lenses of safety and efficiency. From a safety perspective, a sole provider may serve as a single point of failure in the market for RTGS-based faster payments. From an efficiency perspective, a market with only a single operator may cause challenges related to competition, innovation, and market fragmentation. According to established economic theory and experience from other markets, a single service provider not facing competition can yield undesirable outcomes, such as higher prices or lower service quality. Such undesirable outcomes could limit adoption of faster payments by end users, which could in turn curtail efficiency benefits to the broader economy.

Public Benefits Criterion

The Board also determined that the FedNow Service will yield a clear public benefit. Since its inception, an underlying public policy rationale for the Federal Reserve's involvement in the payment system has been to provide services in a safe and efficient manner to banks nationwide. Because of this long-standing policy commitment, the Federal Reserve has historically extended access to banks of all sizes, including smaller banks in rural and remote areas of the country. The Federal Reserve's relationships with and connections to thousands of banks across the country provide a solid foundation for the FedNow Service to facilitate those banks gaining access to an RTGS infrastructure for faster payments, which would benefit small and midsize banks and the communities they serve.

In a payment system with multiple operators, banks would have a choice whether to join a single service or multiple services. An RTGS infrastructure could, therefore, achieve nationwide reach in two main ways, either through interoperability via direct exchange of payments between operators, such as in the U.S. ACH system, or through at least one service connecting to virtually all banks, such as in the funds transfer system.

The FedNow Service would promote payment system safety in multiple ways. As noted by commenters, 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 response to financial turmoil, terrorist attacks, natural disasters, and other crises. As the prominence of faster payments in the United States grows, the development of the FedNow Service would allow the Federal Reserve to retain its ability to provide stability and support to the banking system and the broader economy in times of crisis. In addition, as the operator of the service, the Federal Reserve would be in a position to promote the development and implementation of industry-wide fraud-mitigation standards, which commenters highlighted are especially important for real-time payments. The development of the service could also enhance the safety of the U.S. payment system by promoting resiliency through redundancy.

Finally, the FedNow Service could provide efficiency benefits by serving as a platform for innovation and the development of end-user services by the private sector. In addition, an RTGS infrastructure with nationwide reach would make the development of new faster payment services based on real-time settlement more attractive, increasing innovation and competition in the market for end-user faster payment services. Such competition could yield efficiency benefits by leading to lower prices and higher service quality.

Cost Recovery Criterion

The Board expects that the FedNow Service will achieve full recovery of costs over the long run. The MCA requirement to require cost recovery "over the long run" is not associated with a specific timeframe. Beginning in 1995, the Board adopted a convention of evaluating long-run cost recovery for existing services using a rolling 10-year period. At that time, Federal Reserve services were in mature states, characterized by widespread adoption by banks of all sizes throughout the country, with relatively stable volumes and costs. At other times, notably as the ACH service was evolving, the Board considered long run over an extended time period in order to encourage the adoption of electronic payments for the benefit of the economy.[9]

Given the time frame necessary to create a broad network of banks connecting to the service, the Board determined that a longer time frame for cost recovery is consistent with the intent of the MCA to encourage the adoption of new services that have the potential to bring widespread economic benefits to the country.

Expanded Hours for Existing Services

The second proposed action in the 2018 Notice entailed the exploration of the expansion of operating hours for the Fedwire Funds Service, which is our existing funds transfer service, and National Settlement Service (NSS) hours, which is our service that supports private-sector net settlement arrangements, potentially up to 24x7x365, to facilitate liquidity management, notably for users of private-sector RTGS services.

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[9] ACH began as a Federal Reserve service in the 1970s, prior to the passage of the MCA. In 1981, when the pricing principles were first applied to ACH, the Board recognized that the ACH service was still evolving and allowed fees to be set based on mature volume costs rather than current costs for a number of years and only at the end of that time began marking 10-year cost recovery. The Board concluded that doing so would result in a more efficient payment mechanism and was consistent with the MCA. See 46 FR 1343 (January 6, 1981).

As described in the 2018 Notice, RTGS-based faster payment services require banks to have sufficient liquidity positioned in a specified account to perform interbank settlement at any time, on any day. Without sufficient liquidity so available to conduct settlement, a faster payment cannot be completed in an RTGS-based service where, by design, interbank settlement occurs before final funds can be made available to the receiver. At present, the Federal Reserve does not provide a service that would provide a means to position additional liquidity in the specified account outside standard business hours. In light of these considerations, in its 2018 Notice the Board proposed developing a liquidity management tool that could help address these needs by facilitating transfers to and from other accounts held by participants at Federal Reserve Banks.

In response to the 2018 Notice, several large banks and other commenters indicated that the proposed tool could help with managing liquidity in the recently established private-sector RTGS service for faster payments. The private-sector RTGS service is supported by funds in a joint account at a Reserve Bank, and the proposed liquidity management tool would enable movement of funds between a joint account and banks' reserve accounts during hours when existing services are not currently open. Commenters suggested that the Federal Reserve should provide this tool through expansion of operating hours for the Fedwire Funds Service.

Commenters also noted that expanded Fedwire Funds Service hours, and relatedly, NSS hours, could provide benefits for a variety of payment activities beyond those related to faster payments. Payment activity supported by expanded hours could include additional settlement windows for the ACH service and wholesale payment activity in global markets. Because of the systemic importance of the Fedwire Funds Service, in particular, additional risk, operational, and policy analysis is required for this action, and the draft notice indicates the Federal Reserve's intention to engage actively with the industry to conduct this analysis.

The FedNow Service

As explained in the August announcement, the FedNow Service would conduct real-time, payment-by-payment, settlement of interbank obligations through debits and credits to banks' balances in accounts at the Reserve Banks. Real-time settlement in accounts at the Reserve Banks means that settlement occurs without liquidity or credit risks, which enhances the safety of these payments. The FedNow Service would incorporate clearing functionality, allowing banks, in the process of settling each payment, to exchange information needed to make debits and credits to the accounts of their customers. The service's functionality would support banks' (or their agents') provision of end-to-end faster payments to their customers.

Ultimately, the FedNow Service will provide, alongside similar private-sector services, core infrastructure to promote ubiquitous, safe, and efficient faster payments in the United States. In fact, for all payment systems in our country, no single private-sector provider has ever achieved nationwide reach on its own. With the FedNow Service, banks will now have a choice in providers or could choose to use both a Federal Reserve and private-sector service for back-up purposes, as some do today for check, ACH, and wire services.

The Federal Reserve recognizes that time-to-market is an important consideration expressed by many commenters in response to the 2018 Notice. Our objective is to implement the service as soon as practicably possible. However, the achievement of true nationwide reach over the long term, as opposed to initial availability of a service, is the most important measure of success for faster payments.

At the same time as the Board published its decision regarding the new service, the Board requested public comment on how the FedNow Service might be designed to most effectively support the full set of payment system stakeholders and the functioning of the broader U.S. payment system. In the same notice, the Board also announced its intention to explore the expansion of Fedwire Funds Service and NSS hours, up to 24x7x365, to facilitate liquidity management in private-sector real-time gross settlement services for faster payments and to support a wide range of payment activities, beyond those related to faster payments.

The Board’s important decision to approve a new payment service comes over 40 years after the last service, ACH, was approved for implementation back in the 1970s. The decision to establish ACH came at a pivotal moment when the industry was overwhelmed by the volume of paper checks, and the new technology at that time allowed for what is essentially an electronic version of paper checks. Remarkable new technology enables the Federal Reserve to support the financial sector in offering an ever-growing array of options 24x7x365 in a safe and efficient manner. Providing such payment services is very much consistent with our historical role in the payment system, one that has helped banks to meet the needs of business and households in a growing economy for over a century.