BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIRMAN

July 26, 2019

[redacted]

Dear Senator:

Thank you for your letter dated July 22, 2019, regarding the Federal Reserve's role in faster payments. As you note, the Board issued a request for comment in November 2018 asking what actions the Federal Reserve could take to support interbank settlement of faster payments. In assessing what actions, if any, the Federal Reserve should pursue, the Board carefully considered the over 400 comments received and conducted follow-up discussions with several commenters. Of the 350 respondents who commented on whether the Federal Reserve should be involved in faster payments, over 90 percent supported the Federal Reserve building a real-time gross settlement (RTGS) service for faster payments.

These comments supporting the Federal Reserve building a RTGS service for faster payments came from a wide variety of stakeholders, including almost all small and midsize banks that provided responses, merchants, consumer organizations, service providers, and fintech companies. Additionally, the U.S. Treasury Department recommended in a 2018 report that the Federal Reserve develop a real-time settlement service allowing for more efficient and widespread access to innovative payment capabilities.

Based on the feedback received from industry stakeholders and other interested parties in response to the 2018 notice and request for comment, the U.S. Treasury recommendation, as well as our own analysis, and in keeping with the Federal Reserve's historic role in payments, we are seriously considering proceeding with two actions described in that notice to support widespread adoption of safe and efficient faster payment services in the United States. These actions would include the potential development of a new interbank 24x7x365 RTGS service to directly support the provision of faster payment services by banks (or their agents), and the potential expansion of hours for the Fedwire® Funds Service and the National Settlement Service to support a wide range of payment activities, including liquidity management for faster payments.

Through both of these potential actions, the Federal Reserve System would modernize its payment and settlement services and help foster the development of safe, efficient, and broadly accessible faster payments. If undertaken, these new and enhanced Federal Reserve services, alongside and in support of services provided by the private sector, would serve as foundational infrastructure on which banks and the broader payment industry can build the next generation of payment services for the American public.

If the actions described above are undertaken, the Board would issue a *Federal Register* notice (FRN) detailing the Board's assessment of how a potential service would meet both the requirements of the Monetary Control Act (MCA) and the Board's policy criteria for the provision of financial services. The FRN also would request public comment on the details of how a new service would operate, and the Federal Reserve would engage with industry participants to gather input that would be critical in finalizing an initial design and features of a service. The Board also would review feedback gained through written comments, industry group discussions, and forums to finalize the design and features, and would publish a description of such a service in a subsequent FRN. This approach is in keeping with how the Federal Reserve and the private sector have worked collaboratively for quite some time to bring the benefits of faster payments to all Americans, as noted in your letter.

Several responses to the request for comment to our 2018 FRN noted the importance of the Board conducting its assessment and announcing a decision quickly given the time-to-market pressure the industry is facing. I can assure you that the questions you raise in your letter are all issues the Board has thought carefully about as part of its assessment. Please see below the answers to your specific questions.

1. Please explain, in detail, why the Federal Reserve is proposing the creation of a government-run real-time payments system, the unique benefits its system would provide to consumers, and how it believes the government-run system would support innovation and interact with existing private sector solutions?

Providing settlement services to banks is a core role that the Federal Reserve has played since its founding, first in check, then in wire (large-value fund transfers) and most recently in automated clearinghouse transactions (ACH) such as direct deposit. Since its inception, as intended by Congress, the Federal Reserve has fostered its public policy objectives for the U.S. payment system by offering interbank payment and settlement services. The importance of this role has been broadly recognized, including through an independent review by the Government Accountability Office concluding that the payment system and its users have benefitted over the long run from the Federal Reserve's operational involvement.[1] Historically, the payment and settlement services offered by the Reserve Banks, such as services for funds transfers, checks, and ACH payments, have operated alongside, and in support of, similar private-sector services. Having a new RTGS service provided by the Federal Reserve operate alongside private-sector services for faster payments thus conforms with the prevailing model in the United States.

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[1] See e.g., 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.

A Federal Reserve RTGS service for faster payments would create a foundation on which banks across the country can build modern, innovative, and safe faster payment services to serve the American public. In doing so, these faster payment services would yield tangible 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. Individuals and businesses would be able instantly pay anyone at any time, a growing expectation in many other aspects of our lives and economy. Some existing services offer real-time funds availability to certain consumers, but they conduct interbank settlement on a deferred basis using legacy systems. This type of settlement entails a buildup of obligations—like IOUs between banks—that could present real risks to the financial system in times of stress. The United States does not have resilient long-term solutions for our dynamic economy and the banks that support it, and the Board is concerned that this situation is likely to persist without the Federal Reserve's help. A Federal Reserve RTGS service, operating alongside and in support of private-sector services, would provide a modern, reliable, resilient, nationwide, and real-time retail payment infrastructure supporting faster payments.

The Board has been conducting an analysis to assess whether a Federal Reserve RTGS service for faster payments could be expected to generate public benefits that private-sector services alone may be unable to achieve. In particular, in its analysis, and in light of the comments received on the 2018 FRN, the Board has considered the ways in which such a service would offer public benefits related to accessibility, safety and resiliency, and efficiency.

Accessibility

Providing payment services that are accessible to virtually all U.S. banks benefits all payment system participants because it allows individuals and businesses to make payments to any other party for a wide range of purposes. In its assessment, we have identified significant challenges that private-sector services are likely to face in extending equitable access to real-time infrastructure for faster payments to the more than 10,000 diverse depository institutions across the country. By contrast, the Federal Reserve is uniquely placed to overcome the challenge of extending nationwide access to an infrastructure for faster payments, due in large part to its existing nationwide payment infrastructure and established customer service relationships with more than 10,000 depository institutions (or their agents).

Safety and Resiliency

A safe payment system is crucial to economic growth and financial stability because the effective operation of markets for virtually every good and service is dependent on the smooth functioning of the nation's banking and payment systems. Our analysis and the comments received suggest that, if undertaken, a Federal Reserve RTGS service for faster payments would promote the safety of the U.S. payment system in multiple ways. As the nation's central bank, the Federal Reserve has a unique ability to provide interbank settlement without introducing credit and liquidity risks. In addition, as the prominence of faster payments in the United States grows, the development of such a 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. Further, 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 are especially important for faster payments. The development of a Federal Reserve RTGS service would promote resiliency through redundancy by allowing banks to establish backup connections in case their primary service experiences an operational outage or other problem.

Efficiency

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. A Federal Reserve RTGS service for faster payments could facilitate an efficient payment system by creating a foundation on which depository institutions across the country and fintech companies (through their depository institutions) can build modern, innovative, and safe faster payment services, increasing innovation and competition in the market for end-user faster payment services. Also, the presence of a Federal Reserve service -- in addition to the single private-sector service -- could yield efficiency through lower prices and greater choice.

The Federal Reserve has a record of cooperating with and supporting private-sector services, while fostering competition for the public's benefit. Importantly, by providing a special-purpose joint account at the Reserve Banks, the Federal Reserve supported and will continue to support the establishment of the sole private-sector provider of services for faster payments. Moreover, if undertaken, the possible expansion of Fedwire Funds Service and National Settlement Service operating hours would support the efficiency of the joint account structure for private-sector services for faster payments and benefit financial markets more broadly.

2. As noted above, the Federal Reserve's policy statement, "The Federal Reserve in the Payments System," requires the Federal Reserve to satisfy three conditions before considering a new service. Among those is a finding that the private sector "cannot be expected to provide [such service] with reasonable effectiveness, scope, and equity." Has the Federal Reserve made this finding and, if so, on what empirical grounds was it made?

The Board's longstanding policy criteria for the consideration of new or enhanced Federal Reserve payment services require a forward-looking evaluation of the probable or likely future state of the payment system over the long run, with or without Federal Reserve action.

Currently, there is only one private-sector service for faster payments in the United States. Several comments received in response to the 2018 FRN project that a single RTGS provider is the most likely outcome if the Federal Reserve does not provide a service. Due to coordination challenges and the high fixed costs necessary to develop a new payment and settlement service, the Board's analysis indicates that this service will likely remain the sole private-sector service for faster payments in the United States. With that expectation in mind, there are significant concerns that other providers alone may not be expected to provide an RTGS infrastructure for faster payments with reasonable effectiveness, scope, and equity. The inability of other providers to offer such infrastructure would have significant implications for the Board's policy objectives regarding the accessibility, safety, and efficiency of the nation's payment system.

Based on its analysis and comments received in response to the 2018 FRN, we expect that a single private-sector provider of such services is unlikely to connect to the thousands of small and midsize banks necessary to yield nationwide reach, even in the long term. Indeed, no traditional payment system, including checks, ACH, funds transfers, or payment cards, has ever achieved nationwide reach through a single private-sector provider. The Federal Reserve has long-standing relationships with, and has built a nationwide infrastructure to provide service to, more than 10,000 banks (or their agents) across the country, providing a key channel to reach thousands of smaller banks in the United States that might otherwise not have access to an RTGS infrastructure for faster payments.

Additionally, the lack of competition resulting from a single provider of RTGS services for faster payments is likely to create undesirable outcomes for pricing, innovation, service quality, and reach. Conversely, if undertaken, provision of a new Federal Reserve RTGS service for faster payments, alongside private-sector services, would give banks the option of choosing a service or connecting to more than one service, a choice they have today for all existing payment systems. Indeed, Federal Reserve and private-sector payment services operating alongside one another would be consistent with the structure of other existing payment systems. The presence of multiple RTGS services for faster payments could yield efficiency benefits, such as lower prices, higher service quality, and increased innovation.

A market outcome with a single RTGS service for faster payments would also create a single point of failure. An additional RTGS service for faster payments would promote resiliency through redundancy, a common solution in many retail payment systems. Serving an operational role in the payment system also allows the Federal Reserve to provide stability and support to the banking system and the broader economy in normal times as well as in times of stress.

Overall, a likely market outcome with a single provider is that only a portion of banks in the United States would actually join the current private-sector service for faster payments, while the remaining, potentially substantial portion of banks across the nation would instead either not join any faster payment service or may explore ways of offering faster payments to their customers that are not based on real-time settlement. The resulting fragmentation of the end-user faster payment market could prevent end users and the U.S. payment industry as a whole from realizing fully the benefits associated with nationwide RTGS-based faster payments.

3. Please explain how long it would take the Federal Reserve to stand up its own competing real-time payments system, how much it would cost, and how those costs would be recouped, as required under the Monetary Control Act?

The Federal Reserve recognizes that, if undertaken, establishing a new service would need to be carried out as soon as practicably possible and that time-to-market is an important consideration for many industry participants. However, the achievement of true nationwide reach, as opposed to initial availability of a service, is a critical measure of success for faster payments. We expect that it will take longer for any service, including a Federal Reserve service or a private-sector service, to achieve nationwide reach regardless of when the service is initially available. Should we determine to proceed, we would anticipate engaging in the coming months with industry participants to gather input for finalizing the initial design and features of such a service.

In keeping with the requirements of the Monetary Control Act (MCA) and our longstanding principles for the pricing of Federal Reserve services, we would fully expect any new service to achieve full recovery of costs over the long run, giving due regard to competitive factors and the provision of an adequate level of such services nationwide.[2] For any new service, we would follow the similar approach to long-run cost recovery applied to the Federal Reserve's FedACH service, the last new retail payment service developed by the Federal Reserve.

As noted above, should we proceed with a Federal Reserve RTGS initiative, next steps would include issuance of a formal FRN requesting comments on various aspects of the potential new service. With this input, the particular parameters of the new service would be developed, likely in an iterative fashion involving multiple rounds of discussions with a wide range of banks, fintech firms, payment system operators, and service providers to all of these entities. As part of that development process, preliminary and ultimately more refined cost estimates would be produced. Our analysis to date has relied on the Federal Reserve's broader experience over many years with other major payment system development and modernization programs, both those undertaken internally and those relying on outside vendors, and detailed consultations with other major central banks that have executed or overseen initiatives to support faster payments in recent years.

Under this approach, until any new service reaches maturity with relatively stable costs and revenues and a critical mass of bank participation, fees would likely be based on costs associated with mature volume estimates. This fee structure could include a combination of per-item fees, charged to sending and potentially to receiving banks, and fixed participation fees. In analyzing cost-recovery issues, as noted above, we also consider the MCA's requirement that the Federal Reserve "give due regard to competitive factors and the provision of an adequate level of such services nationwide."[3]

4. Please explain, in detail, why the Federal Reserve believes that its proposed RTGS system and the existing private sector real-time payments solutions would be fully inter-operable, the basis for that assumption, and whether such future inter-operability would require the private sector system to significantly alter their current design and/or operation? In your testimony [last week] before the House Financial Services Committee, you stated that the Federal Reserve "will need to work to make [inter-operability] may not be perfect." To the extent that the Fed cannot guarantee full inter-operability, please

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[2] 12 U.S.C. § 248a; "Depository Institutions Deregulation and Monetary Control Act of 1980," Pub. L. No. 96-221, Sec 102 (Mar. 31, 1980), available at https://fraser.stlouisfed.org/title/1032; 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.

[3] See 12 U.S.C. § 248a, supra note 2.

explain how this would impact costs and availability of ubiquitous real-time payments for smaller banks and credit unions.

We view nationwide reach as a key objective for an RTGS infrastructure. A payment system with multiple operators could achieve this in two main ways. First, interoperability via direct exchange of payments between RTGS infrastructure operators could allow payments originated by a participant of one service to be received by a participant of another service. This first approach exists today in the case of the ACH system (which includes direct deposits). Second, banks could participate in multiple services that are not interoperable, but nationwide reach could still be achieved through at least one service achieving nationwide reach on its own. Again, this situation exists today in the case of the funds transfer system. A bank that participates in multiple services would have the ability to choose which service to use for transactions, depending on any number of factors, such as fees, functionality, and the counterparties a particular service can reach. If the Federal Reserve provides an RTGS service for faster payments, the Federal Reserve would be committed to exploring interoperability and other paths to achieving the ultimate goal of nationwide reach through continued engagement with the industry.

If banks choose to connect to more than one RTGS service for faster payments they may incur an additional connection cost, as they do today when choosing to establish multiple connections to other payment services. However, it would be expected that the benefits of a new service, as discussed in response to Question 1, would ultimately outweigh additional costs, to the extent they arise.

5. Should the Federal Reserve choose not to operate a competing system, what regulatory authority and oversight tools do the Federal Reserve and other government agencies, including the Antitrust Division of the Department of Justice, have at their disposal to maintain a private sector system that promotes healthy market competition and fair and equitable access to participants of all sizes?

Currently, the Federal Reserve functions solely as a service provider to the current private sector payments operator. The Federal Reserve does not have regulatory authority with respect to the pricing set by a private-sector system or requiring a private-sector system to extend the service to banks of all sizes, particularly the last mile, at the same cost and in the same timeframe. The Board does not have plenary regulatory or supervisory authority over the U.S. payment system, a role that is assigned to some other central banks in other jurisdictions, but not to the Federal Reserve.

Instead, the Federal Reserve has historically exercised influence in the U.S. payment system through the Reserve Banks' provision of payment and settlement services to depository institutions, and indeed by providing its services to other operators of payment systems. The Federal Reserve's role as an operator has long served as an effective approach to promote accessible, safe, and efficient payments in the United States. With respect to antitrust concerns, we defer to the Department of Justice on the extent of its authorities under federal antitrust law.

I hope you find this information helpful. Please let me know if I can be of further assistance. I look forward to continuing our dialogue on this important issue.

Sincerely,

Jerome H. Powell