The Federal Reserve Takes a Small Step toward a National Faster Payments Infrastructure

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It is no secret that the United States lags behind other countries in the development of a national real-time payments infrastructure.[1] There are, of course, explanations for this lag, including widespread participation in the existing infrastructure rails and the existence of many different stakeholder interests limiting consensus over reforms. So far, the Federal Reserve has been cautious, using its powers of moral suasion and its intellectual firepower to bring together stakeholders to start conversations, convene task forces and develop governance principles.

Pressure has been building for the Federal Reserve to go further, however, including from various stakeholders convened by the Federal Reserve in the form of the Faster Payments Task Force (FPTF) and from the U.S. Department of the Treasury in its **July 2018 report on fintech and financial innovation**. In response, the Federal Reserve **released last week a notice and request for comments** that marks the first time that the Federal Reserve has taken the small, but critical, step of formally acknowledging that the Federal Reserve System itself will need to be an actor in any national faster payments solution, building on the roles it has historically played in the development and maintenance of U.S. payments systems. In **comments** at a Fed Payments Improvements Community Forum, Federal Reserve Governor Lael Brainard introduced these potential services:

- A 24x7x365 real-time gross settlement (RTGS) service provided by the Federal Reserve Banks, and
- A liquidity management tool that would support RTGS services.

Even though it is highly conceptual, the October 3 notice requesting comments on these two potential services is an important step as it puts the Federal Reserve in the mix with other central banks that have developed modern faster payments systems. The Federal Reserve seeks comment on all aspects of these services and the topics discussed in its notice. Comments are due on December 14, 2018.

Fed Faster Payments Background

The Federal Reserve established the Strategies for Improving the U.S. Payment System (SIPS) initiative in 2013 to “upgrade and enhance the nation’s payment system.” The initiative began with a 2013 consultation paper that requested public input on gaps, opportunities and desired outcomes relating to improving the U.S. payment and settlement system. The Federal Reserve also convened the FPTF, which published **consensus recommendations in 2017 on improving the U.S. payment and settlement system**. As part of its recommendations, the FPTF asked the Federal Reserve to develop a 24x7x365 RTGS service and assess what other operational role(s) the Federal Reserve should play in faster payments. Last week’s notice represents the next step for the Federal Reserve in establishing a real-time, continuous payments infrastructure in the United States.

24x7x365 RTGS Services

The Federal Reserve observes, that, as a result of advances in technology, consumers and businesses today expect instantaneous transfer of monetary value for goods and services. In response to that market demand, private-sector services, offered by banks and nonbanks, make final funds available to end-users before interbank settlement has occurred. Interbank settlement—between banks’ accounts at Federal Reserve Banks—still takes place on a deferred basis through deferred net settlement (DNS) services, including the Automated Clearing House (ACH) network and the Clearing House Interbank Payments System (CHIPS).

One benefit of DNS services is the netting of batched payments, potentially reducing balances that banks need to set aside to settle obligations. Instant, continuous end-user payments coupled with DNS interbank settlement, however, creates interbank credit and liquidity risk due to the delay between payments made available to end-users and when payments are settled between banks. Some of our readers will recognize this as a variant of Herstatt risk.[2] Most DNS systems address these risks through transaction limits, frequent settlement cycles, loss-sharing agreements, net negative position limits and collateralization requirements.

RTGS settlement eliminates the need for these risk mitigants because funds are made available to end-users only after interbank settlement has occurred. RTGS settlement, however, gives rise to other considerations for participating firms, including the need to manage liquidity needed to settle interbank payments in real time and that—as the name describes—payments occur on a gross basis without the ability to net.

The Federal Reserve favors RTGS over DNS infrastructure to support real-time payments, largely due to the lower credit risks posed by RTGS, but also because of the relative ease of inter-operability between RTGS systems and the operational burdens associated with the risk mitigants that a DNS-based faster payments service require, including the need to constantly monitor liquidity and collateral. The Federal Reserve is requesting comments on these concepts as well as on the details of the design of a 24x7x365 RTGS service offered by the Federal Reserve Banks.

Liquidity Management Solution and Ancillary Tools and Services

A 24x7x365 RTGS system would require banks to manage their liquidity on a constant basis, as interbank settlement would be required before individual end-user payments occur. In recognition of this feature of continuous RTGS, the Federal Reserve suggests that a liquidity management tool, in this case offered by the Federal Reserve Banks, would be crucial to the success of continuous RTGS services—regardless of whether those services are offered by the private sector or by the Federal Reserve Banks. This tool could enable movement of funds during nonstandard business hours between banks' master accounts at Federal Reserve Banks and accounts used to conduct or support real-time end-user payments.[3]

The Federal Reserve observes that such a tool could be based upon existing liquidity management services provided by Federal Reserve Banks, such as Fedwire Funds Service, or could be developed as a new tool. In addition to the existing funds transfer services, however, the new liquidity management tools could include features such as the ability for designated agents to coordinate simultaneous liquidity transfers across large numbers of participants in a settlement system and automated liquidity transfers based upon thresholds established by participant banks.

The notice also discusses ancillary tools and services that could be offered—either by the private sector or by Federal Reserve Banks—to further support continuous RTGS, such as interoperability mechanisms between RTGS systems so that end-user customers of any bank could quickly send payments to end-users of any other bank and enhanced fraud-monitoring capabilities.

The notice requests comment on all aspects of these concepts.

Some Preliminary Observations

The Federal Reserve's notice is a small but critical step towards a national faster payments system largely because it acknowledges that the Federal Reserve itself, as a central participant in U.S. payments systems, must play a role in any faster payments system moving forward. The conflicting concerns of different stakeholders have been an impediment to progress, but consumer demand and global competition continue to create pressure for change. Any solution will have to be built on a stable legal foundation that allocates settlement, fraud and bank failure risk in an appropriate way.[4] It may need to be built on new technology and must incorporate strong risk management and internal controls.[5] These challenges notwithstanding, a journey of a thousand miles begins with a single step.

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[1] See, e.g., Aaron Klein, *America's poor subsidize wealthier consumers in a vicious income inequality cycle* (Feb. 6, 2018) ("America has one of the slowest payment systems in the world. Americans have to wait up to seven days for money deposited in their account to be available. This contrasts sharply with other countries that have had real-time payments for decades: South African introduced real-time payment in 2006, Brazil in 2002, Turkey in 1992 and Japan in 1973.").

[2] See Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, Financial Regulation: Law and Policy at 779–780 (2016). Herstatt Bank's closure by German authorities in 1974 caused $620 million in cross-default losses on its unsettled foreign exchange positions.

[3] By contrast, Fedwire Funds Service, a RTGS system currently offered to financial institutions that hold accounts with a Federal Reserve Bank, operates only on U.S. business days.

[4] See Faster Payments Task Force, The U.S. Path to Faster Payments—Final Report Part Two: A Call to Action at 39 (July 2017), where the FPTF asks the Federal Reserve to initiate an effort with relevant regulators to evaluate current laws with respect to faster payments, clarify the applicability of and make appropriate changes to regulations and promulgate new regulations as needed.

[5] See, e.g., Council of Inspectors General on Financial Oversight, Top Management and Performance Challenges Facing Financial Regulatory Organizations at 19 (Sept. 2018), describing enhancements the Federal Reserve could make to its enterprise risk management.