Insight

Primer: What Is A Real-Time Payments System, And Who Should Operate It?

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Executive Summary

- A real-time payment platform would benefit American consumers, particularly those living paycheck-to-paycheck who incur significant overdraft and payday lending fees.
- Although a robust private market providing instantaneous payments exists and is improving, the Federal Reserve has taken the unusual step of seeking comment on entering the market as both participant and regulator.
- A Federal Reserve real-time payments platform would be costly, time consuming, duplicative, discourage competition, retard progress of existing real-time services, and is likely not consistent with the Fed's mandate.

Introduction

Since the first recorded uses of money in the form of stamped gold and silver coins by the Lydians in 650–600 BC, the exchange of hard currency has dominated as the world's preferred method of real-time payment. There are, of course, drawbacks to physical money, including the cost to produce cash, store it, and prevent it from being counterfeited or stolen. The cost of cash in the United States is estimated to be $200 billion annually.

The drawbacks to cash mean that people have always come up with other ways of exchanging money. People have used promissory notes and checks for centuries, although these have always taken time to convert into value. The advent of electronic banking in the 1980s and the ubiquity of the Internet now have created further options for payments, which no longer must occur in person. Mobile banking means that large sums of money need not be physically transferred or transported.

Despite these advances, one benefit that cash retains is its immediacy. As an ever-increasing proportion of financial transactions – from paychecks to rent to medical bills – occur online, more Americans may struggle with liquidity because of the lag time in the clearing of online deposits.

The Benefits and Development of Real-Time Payments

Consider the payment system as the "plumbing" or infrastructure that supports the broader financial system. If the support system is better and faster, the economy as a whole runs more efficiently. Currently, the plumbing for electronic payments in the United States creates a lag time. A consumer authorizes another party to "pull" money from his account, involving multiple parties in the process, which takes time. Even companies that offer rapid payments, such as Venmo, do not offer truly instantaneous account-to-account payments: Venmo effectively fronts the cash and then gets paid back from the payer's account.

This delay creates problems, as money shortfall is in and of itself an expensive proposition. For some portion of Americans, money transfer processing delays in and of themselves lead to increased bank overdraft fees or even a short term payday loan. Americans are paying $15 billion on overdraft fees and $9 billion on payday lending annually. To the extent that some portion of these fees could potentially be due to short term payment lags rather than more permanent mismatches in income and expenses, a faster payments system would provide a solution. Of course, these additional fees and charges disproportionately impact the less affluent. The Congressional Black Caucus noted: "The increased prevalence of overdraft fees, high cost small dollar credit, and check cashing has cost our constituencies tens of billions of dollars that a real time payments system would help ameliorate." For businesses, the lag can create similar liquidity issues as well as generate problems for tracking present assets.

Real-time payment systems, in contrast to the current system, usually use "push" technology, allowing individuals to authorize payments leaving their accounts themselves, speeding the process. Real-time payments benefit consumers and firms by providing access to funds immediately. Real-time payment systems may also allow for the transmission of more data about individual transactions, allowing businesses a better picture of cash flows and more seamless integration with other systems such as invoicing and bill payment. Firms have better access, management, and forecasting over their individual capital requirements with real-time payments, reducing back-office costs. Even consumers less likely to have a gap in personal finances prefer a system that prioritizes speed and convenience. As for safety, advanced technology solutions better mask sensitive account numbers via a "tokenization" process, which creates unique party identifiers meaning account numbers are shielded within the system.

The United States is considerably behind other developed nations regarding real-time payments, including the United Kingdom and Mexico where the government has provided real-time payment processing for retail consumers. Until recently the U.S. approach has been to allow for private industry to create solutions meeting consumers' needs. With the support of the Federal Reserve (the Fed), in 2017 The Clearing House (TCH) rolled out its real-time payment service. The TCH service now supports over half of all U.S. accounts and is expected to have total coverage by 2020. Although the most important actor in this space, it is not the only private provider of real-time (or nearly real-time) payment services, which include offerings from PayPal, Venmo, Zelle, and Mastercard.

This emphasis on private solutions makes the Fed's consideration of entering this market particularly surprising. In October 2018 the Fed announced that it was considering developing a real-time payment system directly and operating it itself.

Why The Fed Should Not Develop A Real-Time Payment Network

The Fed's Decision Appears to Contradict Its Own Mandate

The scope of the Fed's powers in this arena is determined by the 1980 Monetary Control Act, which notes that

the Fed should intervene only if "the service is one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity." Although adoption of a real-time payments system for consumers in the United States has been slow by comparison to the European Union and other nations, there is simply no evidence of a market failure that would justify the Fed's intervention.

The Fed's System Would Be Costly…

The cost of setting up another, entirely duplicative payment system would potentially cost hundreds of millions of dollars to develop, a cost borne by the taxpayer. Yet there is no clearly articulated explanation of why shouldering this unnecessary drain would be worth it.

… And Take Years To Implement

The time required to develop, test, and launch this system would, optimistically, take the Fed between three and five years. Proponents of a faster payment system argue that this delay could have an appreciable cost for U.S. consumers, particularly those with lower incomes, who more frequently incur bank overdraft fees and high payday lending interest rates as a direct result of payment processing delays. A five year development window is an optimistic view; market watchers question the ability of the Fed to produce this system in the first place. Why would the Fed's system, which would require significant new expertise at the bank, be superior to one produced by the private market, which has decades of experience and the nimbleness a government body typically does not possess?

Dual Systems Would Likely Not Be Interoperable

The European Union is currently being serviced by dual real-time payment systems, one operated by private industry and the other by the European Bank. They have acknowledged that these systems will likely not be interoperable. If the Fed were to develop its own market entrant, financial institutions would need to run multiple systems that are not necessarily capable of communicating with each other, which would be cumbersome for instantaneous clearing.

To Be Participant And Regulator Is A Conflict Of Interest

There is no indication that the Fed's entry into this market would necessarily be positive for the private industry that already exists in this space. The best analogy can be found in the closely related Automated Clearing House (ACH) industry, which also has dual public and private rails. Since 1997 the Fed has employed significant discounts by volume, a practice that does not treat its customers the same and is a form of competition with the private entities that it simultaneously regulates. TCH's pricing structure is already more generous to small banks . Meanwhile, the Fed has not conducted an audit of its cost-accounting processes for payment systems since 1984; although an audit was discussed in 2016 if it was conducted no results have been made public.

Such A Move Would Discourage Competition And Push Back The Development Of Real-Time Payments In The United States

Government bodies entering public markets reduces competition, stopping or slowing down innovation. More problematical, the Fed's actions have already had the impact of slowing down the adoption of a real-time payment network, as businesses freeze development in the wake of the uncertainty this shift has created, likely preventing some banks from joining the TCH system. During the estimated five years it would take the Fed to

develop a real-time payment system, innovation (at least in the U.S.) will not occur, stagnating the market while international private competition races ahead.

Conclusions

Were the Fed to develop its own real-time payments platform, it would be costly, time consuming, duplicative, discourage competition, slow down the progress of development of real-time services, and likely be unsupported by the Fed's own mandate. Unless the Fed can demonstrate that there has been a market failure, a decision to proceed would be entirely without basis.