Fed Should Tread Carefully in Faster Payments Plan

by Eric Grover

American Banker

February 18, 2015

Electronic payment systems improve people's lives and facilitate commerce. The Federal Reserve, commendably, wants to speed them up. To that end, the central bank recently released a road map outlining a number of goals and desired outcomes for faster interbank payments. The Fed has also given itself a lead role in shepherding the industry toward this vision.

The Fed should tread carefully. Encouraging the industry to explore faster payments is all well and good. Effectively directing it to do so, however, is beyond its authority and would be a mistake.

In a bout of cognitive dissonance, the Fed's paper acknowledged "high levels of innovation in the U.S. payment system" while lamenting "a lack of coordination." But the truth is that central planning stifles innovation. Take the example of France's centrally-engineered, pioneering online service Minitel, which died a long, slow death after failing to embrace the Internet and graphical user interfaces.

Private-sector enterprise, on the other hand, is responsible for everything from ATMs to credit, debit and prepaid cards to mobile payments and digital wallets like Apple Pay. The payments innovation that the Fed applauds exists because of, not in spite of, a lack of direction from enlightened regulators.

Although the Fed has a systemic role, interest and expertise in payments, and is the financial system's paramount regulator, it does not have statutory authority to order the industry to make payments faster. Fed officials have acknowledged this fact. Yet given the enormous power it wields over financial institutions, it would be a brave and foolhardy bank that failed to comply with the central bank's wishes.

Other regulators have also been leaning on banks to speed up payments. New York's politically ambitious top financial regulator Benjamin Lawsky lambasted the ACH system as "ossified," in "desperate need of repair and improvement," "disco-era" and "monopoly-like system" while speaking at the Bipartisan Policy Center.

"If banks do not make significant progress soon, regulators should consider actively pushing for, or even perhaps mandating improvements," Lawsky said in a thinly-veiled threat.

The truth, however, is that ACH does exactly what it was designed to do: provide low-cost, reliable, non-spontaneous payments between known parties. With a single monopoly-like governing scheme (the industry-owned rule-setting group Nacha) and only two processors (the Fed and the banked-owned group The Clearing House), it's hardly surprising the ACH system has failed to be a fount of innovation.

Meanwhile, Consumer Financial Protection Bureau director Richard Cordray all but ordered banks and their processor to build a real-time payment system at The Clearing House's annual conference. Even given the Bureau's near unfettered power over consumer finance, it's hard to see how it has authority to mandate faster payments.

In retail, where speed matters most, payments are already real-time. Cash is immediate, while electronic check verification and guarantee systems provide merchants with real-time risk assessment and payment guarantees for checks. Real-time payment card authorization systems have existed for four decades and are ubiquitous. And American Express, Discover, MasterCard and Visa didn't need the government to lead them to delivering real-time payments. The business case was compelling.

The business case for faster interbank payment systems, on the other hand, is "net neutral to negative" over the next decade according to the Fed's own study. Many consumers and businesses say they'd prefer faster payments, but most of them aren't willing to pay for it for most transactions. For routine bill payments and payroll deposits, for example, next-day processing is generally good enough.

Nonetheless, Nacha is proposing to switch to same-day ACH and The Clearing House plans to build a real-time payments system. If the private sector voluntarily deploys capital for faster payments, bravo.

The Fed paper has identified multiple options for supporting faster payments. But the central bank should resist the impulse to act as a wise man on the hill, designating the right solution from on high. Permitting — indeed encouraging — competing approaches in the market is a better path to creating value.

Moreover, just because a change is a good idea doesn't mean regulators have the prerogative to command it. If Congress wants to the Fed to speed up payments, it can say so.

It could also direct the central bank to develop a plan for spinning off its payment processing assets and fostering ACH competition. The Fed is currently charged with processing payments along with its many other duties. But it is neither necessary nor desirable for the Fed to process payments when the same job could be done as well or better by the private sector. Many of its processing assets could be privatized, sold to the public market, private equity or a payment network or processor.

Eric Grover is principal at Intrepid Ventures, a corporate development and strategy consultancy advising payment issuers, networks and processors, and other payments companies.