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The Federal Reserve and the banking industry have been studying options to improve the U.S. payments system for several years. Thus, the recent release of a discussion paper regarding a Real Time Gross Settlement (RTGS) system and request for comment is a welcome development. As a former president of the Federal Reserve Bank of Kansas City, and member of the Federal Reserve Banks' Technology and Financial Services Policy Committees, and as a former vice chairman of the FDIC, I appreciate the opportunity to submit comments.

In its request document, the Federal Reserve poses several questions. However, many of them are technical in nature and in my judgement can be addressed as part of the process to define user requirements should it choose to move forward with building an RTGS payments network. I, therefore, will confine my comments to two questions, the resolution of which will influence the development of payments in the U.S. for decades to come. First, should the U.S. develop a RTGS system? Second, should the Federal Reserve Banks build such a system. The U.S. payments system has characteristics of a public good, as it is essential in every way to the successful operation of, and confidence in, its financial system and economy. Therefore, the answer to each question is "yes".

Should the U.S. develop a RTGS system? Yes, and as the discussion paper makes clear, the issue is not so much whether the U.S. should move to a RTGS system but how quickly it should move to such a system. We know from experience that when technology is moving forward, a system designed around old technology and processes will not long be accepted by the public.

The role and advantages of an RTGS system is that it will move payments and messages directly from sender to receiver on a 24x7x365 basis without relying on an intermediary to hold, forward funds and settle transactions. In contrast, a deferred net settlement system leaves one or more parties exposed to credit risk as payments are passed to the receiving party before the payment is settled. As the paper notes, a RTGS system eliminates the need for activities such as storing, netting, and submitting groups of payments for settlement not relevant for the provision of faster payments to end users. It reduces or eliminates the counterparty credit risk that comes from deferred settlement. It avoids one liquidity effect that occurs in the event of settlement failure when interbank settlement positions are netted by a central party. It facilitates interoperability by avoiding the need to reconcile different measures to mitigate cross-system settlement risk. Put most simply, RTGS if designed correctly, will reduce and in some cases eliminate these kinds of risk and will facilitate faster payment by immediately settling each payment when it passes from payor to receiver.

A RTGS system will be more efficient as, for example, it reduces the need to set up credit review processes and collateral systems that address the credit exposures resulting from deferred settlement. Staff assigned to such reviews can be directed to other activities, thus improving performance and controlling costs.

Therefore, a RTGS system will be faster, more efficient and safer. Much of the world recognizes this and is on the way to adopting such a system as a superior means to conduct payments. It makes little economic sense for the U.S. to fall behind in modernizing it's payments system if it wishes to remain the world's leading force in financial and economic activity.

Should the Federal Reserve Build a RTGS system? Yes, the Federal Reserve has the knowledge and experience to build and operate a RTGS system, with the goal of assuring safety, access, and competitive pricing within a rapidly changing industry.

The Federal Reserve through its twelve bank system, currently provides a national infrastructure available to all U.S. banks, smallest to largest. Its knowledge gained from decades of operating both wholesale and retail systems — Fed wire, check and ACH processing, Treasury payments — make it well qualified to develop a RTGS system. Its mission and experience in payments will assure access to all participants entitled to access. Even today there are thousands of depository institutions ranging in size from a few million to trillions of dollars of assets that will require access and for which the Federal Reserve has shown the most consistent provision of such service over the last several decades. The system of 12 reserve banks currently serve this broad base of institutions and given the Federal Reserve's mission, having it develop and operate an RTGS system would assure high quality, consistent and universal access to payments products for all depository institutions and the public.

Also, the Reserve Banks' deep knowledge and broad coverage in the payments system give greater certainty to achieving full interoperability. Since the Federal Reserve serves the broadest network of depository institutions, it would have the critical mass and be in an ideal position to work with the industry to develop a common set of operational payments standards that would better assure interoperability on a national and international basis. It was, for example, the Federal Reserve that led the industry in modernizing the check system and then the development and implementation of the ACH system, with the broadest access, common standards and reliable service.

Liquidity: One matter that cannot be ignored regarding modern payments systems is their vulnerability to disruption during crisis. This was learned beyond doubt with the tragic 9-11 crisis. Under RTGS, whether through a Master Account or Alternative Account, the movement through the payments system will be disrupted when an unexpected attack on the system or a financial crisis erupts within the economy. This is all the more so within a 24x7x365 operating framework. Pooled accounts under such circumstances, for example, will fail to function as confidence and the willingness of private sector players to fill the liquidity gap disappears. In every such case the final provider of liquidity will be the Federal Reserve and it will be best able to fill that gap if it is part of the infrastructure, with knowledge, experience, and the necessary operating links that tie directly to the nation's payments system.

Safety: The Federal Reserve is well recognized as the ultimate protector for the U.S. payments system. Its history as an operator in both wholesale and retail payments shows repeatedly that it is best able among operators to step forward and conduct payments activities during the extreme economic and political stress. This was demonstrated following 9-11 and the national crisis following that terrorist attack. It was the Federal Reserve, as operator, that assured operational continuity, liquidity and confidence that assured both retail and wholesale payments systems operated through the worst hours of the crisis. More recently during the financial crisis of 2008, the Federal Reserve played a key role in assuring the payment system operated seamlessly, providing an essential backstop that served to maintain confidence that payments would be successfully processed. History tells us, therefore, that the Federal Reserve is the one reliable payments operator when no other party is able or willing to meet the challenge and risks that accompany crisis and a breakdown in the national payments infrastructure.

Security: Cyber security is a foremost requirement for a smooth functioning national and international payments system. The Federal Reserve has long led and worked with the financial industry in setting the highest standards of security and reliability for payments within the U.S. and in its transactions with other nations. Important to this success has been its role as an operator, possessing the skills needed to help set operating standards and advance the adoption of the most sophisticated encryption technology. As RTGS is adopted, the Federal Reserve must be part of the working solution, which is best accomplished if it is also an operator.

Effect on Competition: Payments systems possess the attributes of a natural monopoly. They involve millions of transactions and trillions of dollars each day, and they benefit from economies of scale in which unit costs decline with increases in volume. However, a common effect of such economies of scale is the inevitable consolidation of firms within the industry toward an oligopoly or monopoly structure. And most monopolies are inclined to act accordingly. We have seen some evidence of this in the credit card side of the payments system, which over the past four decades has seen the industry consolidate with a very few payments operators dominating this business. As revealed in various law suits, we know that the fees sought by these largest credit card processors have systematically increased over time, while unit operating costs appear to have increased less.

One instance where such pricing power has been less evident in the check and ACH processing business. In these instances the 12 Federal Reserve Banks have an operational role and are able to compete with the largest service providers. In each instance the Reserve Banks provide payments service and, as required, recover operating costs plus a return on investment comparable to that of private sector participants. Importantly also the Reserve Banks have consistently achieved these results while providing services to all depository institutions, largest to smallest, seeking access. Such an approach permitted the industry to provide a profitable service while inhibiting those participants who might otherwise seek to capture economic rents when holding a dominant market position.

With the Federal Reserve Banks as operators in the RTGS payments market, there would be a check on the effects of continued consolidation within the industry. It would promote competitive pricing, allow for continued innovation in payments, while also joining the industry in developing faster, safer, and more secure payment access to the broadest number of banks and the public.

It has been suggested that an alternative way to achieve these goals without the Federal Reserve being an operator is for it to regulate the RTGS system. But regulation is not market driven. It will more likely impede innovation and slow payments development. Regulations invite political maneuvering in which special interest groups curry favor for themselves to achieve and maintain dominance and influence outcomes. As an example, recent regulations setting credit card interchange fees (setting prices) is a conflicted, controversial and an always political process.

Conclusion: The U.S. should move forward and develop a RTGS system, and the Federal Reserve should be a full participant in its development and operations. This path provides the best opportunity to achieve an efficient, safe, secure, competitive and innovative market. Finally, decisions must be made expeditiously if the U.S. is to keep current with emerging global payments systems and remain competitive in a rapidly changing global market.

Thomas Hoenig