

03. July 2024

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N. W.

Washington, DC 20551, USA

Via Email: regs.comments@federalreserve.gov

Docket No. OP-1831

Ladies and Gentlemen,

M|E|W Consul (MEW) is honored to participate in Federal Reserve System consultation (Docket No. OP-1831) “Expansion of Fedwire Funds Service and National Settlement Service Operating Hours”. (FFS and NSS respectively)

Area of expertise of MEW is risk management, especially system risk. Hence, following remarks will focus on two interrelated central issues:

1. What is the best timing to extend operating hours of FFS and NSS, plus
2. Which preconditions must be fulfilled to safely extend operating hours?

TIMING

For MEW it's beyond any doubt, the extension of FFS and NSS operating hours as part of digitization of the financial system is indispensable to achieve a stable, stress resistant safety architecture.

Talking about digitization it seems advisable to differentiate between two procedures:

1. Digitization of existing analogue business models and/or financial infrastructure, in essence technical progress as usual, and
2. Replacing existing analogue business models and/or financial infrastructure (even digitized one) with complete new, pure digital business models and/or financial infrastructure (disruption).

(As a side note, similar differentiation can be made regarding artificial intelligence (AI). Remarkable, regulator authorities focus usually on technical progress only, potential of AI as enabler for disruption mostly ignored. See latest BIS Annual Economic Report.)

Ad 1:

In case of digitization of existing analogue business models and/or financial infrastructure, established financial institutions often take central position. Meaning, they are developing new digital solutions and structures themselves or are early and critical users. As a result, financial institutions have direct influence on success of digitization, including timing and wider adoption.

Ad 2:

In case of digitization defined as replacing analogue with new digital solutions or introducing completely new business models, established financial institutions are not in the driver seat, potentially are even threatened in their long-term survival in particular areas of business or altogether. Innovators, large or small, established or newcomer, are in the driving seat, determine timing and direction of digitization.

MEW is convinced, above distinction is important when discussing the best timing re extending operating hours of FFS and NSS. It seems, the proposal to introduce changes no earlier than 2027, two years after the implementation of the ISO 20022 message format for Fed Wire Service is based on the capacity within established banking sector. Innovators, introducing new business model, unlikely show considerations for the constrains of financial institutions whose business model they are looking to replace. For central banks and regulatory authorities in general it should not matter who the driving force is behind change, if regulatory and technical standards are complied.

1st interim conclusion, it makes sense to plan extension of FFS and NSS operating hours in 2027, or as soon as financial institutions are ready to act, while at the same time have plans ready should disruptor decide to enter market earlier. Innovation should not be blocked or delayed due to unprepared established financial institutions, which they are in general.

MEW is an early member of the Fed Now community. Several times during webinars especially smaller banks without direct access to central bank balance sheet raised the issue of liquidity management in off-market hours. The referral to standard market practices to manage liquidity risk did not seem to convince, problem is still unsolved. I personally discussed new and unprepared risk due to 24/7 real-time payments and newly developed solution with your colleagues.

The more successful Fed Now becomes, the wider the adoption by market participants, including non-bank financial institutions (NBFI) and non-financial corporations (NFC), the more pressing this issue becomes. One could argue, the success of Fed Now impacts the need for extended operating hours of FFS and NSS. Or, to put it the other way round, the success of Fed Now also depends on 24/7 operating hours as general market standard across all platforms.

2nd interim conclusion, from perspective of Fed Now initiative it seems in the interest of the Fed to move to 24/7 operating hours across all platforms as soon as possible.

RISK

In the proposal, to address potential liquidity risk and in preparation for future stress situations, Federal Reserve staff recommends extending availability of the Fed discount window to match expanded operating hours of FFS and NSS respectively.

MEW fully agrees, extension is necessary, but unfortunately not sufficient. Reference for safety architecture naturally must be standards and risks in the private sector. A digital financial system can be described by three distinct features:

1. Dynamic,
2. Real-time, and
3. 24/7.

Combination of all three features consequently require continuous, automated access 24/7, doesn't allow analyzing market situation, source or cause of stress, responsibility of individual market participant, etc. For example, there will be no distinction between irresponsible even illegal behavior and market participants being casualties of developments outside their own control. The result, permanent discount window will become integral part of private sector risk management and managerial decisions. The overall shift in the private sector to take on more risks and less precautionary measures is economically rational, direct result of competitive pressure. Permanent, automated central bank discount window on a standalone basis appear counterproductive and risk increasing.

Additional weakness, pricing of discount window liquidity is single-factor based, quality of collateral pledged/not counter-party, whereas private market standard is two-factor.

Every private corporate insurance follows two-factor pricing model: (1) probability that insurance case occurs, plus (2) expected payout under insurance cover.

The probability that insurance case occurs includes individual corporate insurance taker risk: business model and sector, credit standing, location, management quality, etc. No two businesses have identical profiles. Plus, making use of insurance cover will have implications on future insurance conditions, premiums and access. That is why private insurance in contrast to central bank back-up automatically is self-disciplinary.

On top of the above, liquidity under central bank discount window only reach financial institutions in real-time with direct access to central bank balance sheet. The business model follows a trickle-down approach. Unfortunately, in a digitized financial system emergency liquidity must be provided near instantaneous wherever the center of stress originates. Smaller and less sophisticated market participants as a group can also pose a systemic risk, including non-financial corporations.

In case of central bank discount window being the sole backstop, liquidity risk of large banks is eliminated. But too slow trickle-down will lead to liquidity crunch in other parts of the financial system, and as a result corporate default. For large banks, the initial liquidity crunch converts into credit issue. Instead of liquidity, capital will be impacted, for which a real-time, automated solution is still possible, but more challenging than addressing liquidity stress directly and punctually in the first place.

MEW has participated in numerous consultations over the last 10 years, including Fed, BIS, FSB and Bank of England. Every risk MEW highlighted later materialized, a proven and verifiable track record, even if with some years delayed: US mid-size banks, UK pension funds, German utility companies. Our conclusion, if structural weaknesses are not addressed, this trend will continue. A comprehensive safety architecture is needed, emergency liquidity facility must cover all scenarios, all time-frames, all products, all segments, and all market participants, individually and as a group, making transactions in institutional size. Current Fed consultation seems to be an excellent opportunity for the needed upgrade.

3rd interim solution, in case of extended operating hours, and Fed discount window being the only adjustment of safety architecture, Fed will achieve the opposite of what you are aiming for. Private sector risk management will be weakened, counter-party risk will increase, number of disruptions and central bank interventions will become standard procedure.

SOLUTION

MEW believes, what is needed is a set-up which makes it economically more attractive for the private businesses – financial and non-financial, public and private – to manage the heightened liquidity risk of 24/7 instant payment themselves, instead of relying on central bank intervention in case of emergency. Not forcing but incentivizing, to also reach non-financial businesses outside traditional regulatory control, but nonetheless potentially causing systemic stress. We must create a better, economically favorable alternative.

The road to private low-cost solutions includes:

1. Simplification of structural design,
2. Standardization of execution, and
3. Certification of structure and procedure.

The only known and proven solution developed so far is a single insurance contract. Implementation within current regulatory framework, using existing financial market infrastructure, realization seamless integrated easily with central bank initiatives such as new precautionary facilities.

According to MEW calculations, insurance premium will only be a fraction compared to active liquidity management. In the medium-term to fall below 10%, not exceptional for digital solutions.

For private businesses to have access to central bank emergency measures, insurance cover precondition. 100% of credit risk, 100% of interest rate risk, 100% of collateral risk and 99% of cash liquidity risk stays within private sector. Central banks lender-of-last-resort only, covering liquidity tail risk solely.

With ISO 20022 standard from 2025, central banks always have full transparency, full control, can apply targeted interventions, and all of that in real-time. No longer trickle-down or shotgun approach.

4th interim solution, with discount window as sole tool to supply emergency liquidity during extended FFS and NSS operating hours, competition pressure will push market participants to lowest acceptable safety standards. By contrast, in combination with preceding private insurance contract higher standards will be rewarded.

OPTIMAL TIMING

Once a comprehensive solution is available to address heightened liquidity risk due to 24/7 instant money transfer, then seems to be the right time to immediately expand operating hours of FFS and NSS respectively. The fact that not all banks and financial institutions in general will be ready should not be taken into consideration.

Not all banks will embrace change and digitization, are even capable. Revenue pool of banking industry will shrink continuously with advancing automation due to shift to real-time execution, all business areas including risk management, and expanding market share of NBFIs and digital companies.

Waiting for too long widely opens the window for external disruption. That could result in radical change, with far less time for private businesses and authorities to adapt, if at all. MEW is far more concerned about the black box of digital disruption, than known weaknesses of established banks, central banks are used to handle. Steady reduction of number of banks, large and small, seems to be the preferred development then uncontrolled big bang market clearing.

To give an example, Eastman-Kodak had about 80-100.000 employees when Apple launched the iPhone. That number was cut by half within two years. It takes only one software engineer to develop basic photo app, no capital, no individual distribution channel needed. Similar experiences should be expected for the financial sector. True digitization, meaning replacing analogue (even digitized ones) with digital solution, especially in combination with the big equalizer artificial intelligence, needs only single financial engineer as innovator and disruptor. C'est tout!

One does not know in advance if the objectives of disruptors are aligned with the one of regulators. Are they interested in building a better, fairer and more inclusive financial system? Or is their prime objective destruction of current business models for short-term economic, political, ideological or whatever reason?

In a digital world, stretching consultation plus implementation process over years looks extremely dangerous, especially when market dominance by new product is achievable within months. If product cycle is shorter than regulatory initiatives time-frame, then we are back to self-regulation, which as we know never works.

Finally, with comprehensive digital solution in place, emergency measure and standard monetary policy will be strictly separated again. It might even make sense to set up a dedicated precautionary facility special purpose vehicle. Concerns from private sector regarding potentially negative feedback loop to be addressed via inclusion of central counter-parties and correspondent banks. Central banks will be the only party involved with complete overview.

CENTRAL CONCLUSION

IT'S TIME TO GO DIGITAL

MEW would recommend to not set a firm time schedule, instead align extended operating hours of FFS and NFS with updated technical standards. Thereby, incentivize banks to immediately start working on internal systems, instead of waiting until close to the end of transition period, as it is currently often practice. Plus, to signal to potential innovators that authorities support disruption, but in a controlled fashion.

With ISO 20022 being general standard from 2025 the necessary technical precondition for comprehensive, digital emergency liquidity back-up – central bank plus private – is fulfilled. Remaining open issues are introduction of central bank precautionary facility, plus full certification and seamless integration of private insurance contract, which should be achievable within same time-frame.

Executed accurately and with digital focus, this may be the iPhone-moment of finance.

Best Regards

Manfred E. Will
Founder & CEO