SWACHA
The Electronic Payments Resource™

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Submitted Electronically

The Federal Reserve Banks
c/o Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20552

SWACHA – The Electronic Payments Resource ("SWACHA")[1] respectfully submits our comments on and answers to the questions posed in the Federal Reserve Banks' Payment System Public Consultation Paper (the Paper).

We appreciate this opportunity to comment upon and express our views on this critical issue at a key inflection point in the future of the payments system in the U.S. The impact of the payments system on public policy, monetary policy and economic growth must not be underestimated. Your facilitation of a robust and public dialogue is an important first step in protecting this valuable component of our national economy.

Process for responding

SWACHA convened a panel from our membership with a broad range of banking and payments experience to discuss the Paper and to answer the various questions posed. The panel spent one full day in facilitated discussions on the topics in the Paper and our response reflects the outcome of those discussions and the consensus answers to those questions.

General comments and observations

It is our opinion that an important element of payments was omitted from the consultation paper. Replacement of currency as a significant component of payments, especially person to person and in the retail environment needs to be targeted. Many of the attributes of currency are the same as the desired end state espoused in the Paper such as anonymity, ubiquity, immediate settlement,

[1] **SWACHA – The Electronic Payments Resource®** is one of the nation's largest and most innovative regional payments associations. SWACHA is an official source for the ACH Operating Rules and represents its members in national issues and the rule-making process. SWACHA's mission is to be the resource of choice for education, training, representation and knowledge regarding payments and payments system risk.   SWACHA shares a common strategy with its membership of approximately 1,000 community based banks and credit unions: maximized business efficiencies, improved payments processes, reduced risk and cost, and increased customer satisfaction.

absence of dispute resolution and so forth. It is our position that any conversation regarding the future state of payments must include a discussion of currency.

There is a need to ensure that the demand deposit account (DDA) remains central to payments both from the perspectives of public policy, monetary policy, consumer protection and long term viability of the financial system. Core DDA drives everything and is central to the financial institution's relationship with its customer. The goal of most financial institutions is to be "the" holder of the primary DDA account because consumers are becoming disintermediated. Our members are also seeing challenges with people abandoning the DDA account; that is, consumers are using general purpose, reloadable cards with fewer protections or using check cashing services with higher fees and no protections.

Another key observation of our panel asks the question: if the payments system needs to move to real-time, then why doesn't the Federal Reserve operate its clearing and settlement mechanisms 24/7/365 (instead of just five days a week)? Changing the processing time parameters would have more impact on the payment system than anything else.

We also strongly believe that substantive changes to the payments system will require a central body such as the Federal Reserve to drive as noted in our answer to Q3 below.

<u>Answers to the specific questions</u>

QUESTIONS FOR THE PUBLIC:

Q1. Are you in general agreement with the payment system gaps and opportunities identified above? Please explain, if desired.

Yes, in general agreement.

i. What other gaps or opportunities not mentioned in the paper could be addressed to make improvements to the U.S. payment system?

An in depth analysis of the legislative, regulatory and legal constructs in place today, barriers presented by those constructs and how organizations desiring changes in the payments system will need to adapt accordingly.

As noted in our general comments, currency replacement is not being adequately addressed.

There is an overarching need to ensure there isn't an unintentional shift of greater liability to those that bear the most risk.

The U.S. payments system is not homogenous rather, it is highly fragments and siloed. We think there is an obligation to examine gaps and needs based on use cases vs. looking to make wholesale changes to "the" payment system.

The Paper does not explicitly draw a distinction between the settlement of payments vs. the way payments information travels. As we determined in our deliberations, we believe the industry should consider how consumer or commercial needs for timing of settlement are different than needs for timing of information.

Q2. Are you in general agreement with the desired outcomes for payment system improvements over the next 10 years? Please explain, if desired.

We are in general agreement, however, we believe that there should be a breakdown of the timeline. For example, look at 10-year "vision" (end state), and break down tactics/requirements to achieve that vision into a short-term plans (1 -2 years, 3-5 years and/or 5 – 7 years) to clearly communication the path to the end state.

i. What other outcomes should be pursued?

The panel suggested that a "decision tree" approach should be taken to look at the systematic, legislative and industry utility components as we advance this 10 year concept.

Will there be a need for enabling legislation cover similar to Check 21 that would allow the Federal Reserve to take the lead on this initiative? Comments from our panel regarding legislative initiatives include "This is the right thing for the U.S. payments system" and we need legislators to "do the right thing".

Our members are concerned that if regulators other than the Federal Reserve attempt to drive change or try to "fix" the payments system, then the financial institution community will significantly suffer. Our panel encourages the Federal Reserve to take action to keep other regulatory bodies at bay.

The consensus among our group is that it will be difficult to obtain ubiquitous adoption of anything by consumers and there must be a compelling need for driver(s) of adoption. The panel agrees that the Federal Reserve should continue to support the check infrastructure, but price those products to modify behavior. We do not recommend there should be an official "end date" for checks but the operators of check clearing mechanisms need to help the industry progress forward, perhaps with a price correction so that there is appropriate, fully recovered costs and pricing of check products.

Our group also discussed the concept of a charter for a "payments institution" to level the playing field between financial institutions and payment intermediaries. Our group thinks that

there should the same burdens on "payments institutions" as on incumbent financial institutions currently (e.g. reserves, capital, regulatory compliance, supervision, etc.). In order to move payments system changes quickly, our group thinks industry has to leverage alternative payment networks that exist today. Granting a payments institution charter to these alternative payment networks would both level the playing field and open up these alternative networks to let all benefit from the network effects of these disparate players.

Q3. In what ways should the Federal Reserve Banks help improve the payment system as an operator, leader, and/or catalyst?

It is our group's unanimous position that the Federal Reserve must function as a leader. Change needs to come from the outside because of potential anti-trust issues, to overcome the elements of "distrust" that exist between various stakeholders (e.g. large and smaller institutions, regulatory arbitrage, charter types, etc.) and help put aside competitive frictions (e.g. incumbents with "outside" players, groups within the same financial institutions).

The Federal Reserve is really the only entity that can coordinate and create parity across parties. It is incumbent, however, for the Federal Reserve to listen to <u>all</u> financial institutions and ensure those bearing the most risk have influence to ensure that we arrive at an inclusive, risk-balanced outcome.

Our group also thinks that the Federal Reserve should play a role to develop/offer turnkey products and services to help community / smaller banks to create parity and facilitate ubiquitous solutions to enable more competition with larger institutions that have more resources.

We also believe that the Federal Reserve should take a proactive role to coordinate and manage the regulatory and legislative processes to make sure we end up on the right path forward and get to the right place. These processes need to be preemptive and strategic in nature. From a public policy standpoint, we believe the Federal Reserve may need the legislative cover to be able to move all stakeholders including other regulators in the same direction.

Our group also has several questions: If Federal Reserve leads, will that stifle innovation? Has the Federal Reserve done its own gap analysis to evaluate their ability (the necessary talent/resources) to execute this plan? Our observation is that the Reserve Banks still run from a District perspective. Will the Reserve Banks take the steps to ensure they take an enterprise view of the payments system (e.g. collapse silos between wholesale and retail)?

Ubiquitous near-real-time payments

Q4. In discussions with industry participants, some have stated that implementing a system for near-real-time payments with the features described in the second desired outcome (ubiquitous participation; sender doesn't need to know the bank account number of the recipient; confirmation of good funds is made at the initiation of the payment; sender and receiver receive timely notification that the payment has been made; funds debited from the payer and made available in near real time to the payee) will require coordinated action by a public authority or industry group. Others have stated that current payment services are evolving toward this outcome and no special action by a public authority or industry group is required.

i. Which of these perspectives is more accurate, and why?

We align with the first premise that a coordinated effort is required.

ii. What other perspective(s) should be considered?

We believe that the term ubiquity is an amorphous concept and the term needs to be more clearly defined. Who has access? What will be done to ensure no direct access to the Federal Reserve by non-regulated parties?

Safety and soundness: Do we need a "gate keeper" to maintain what's best for the industry in terms of safety and soundness?

Standards: Does the Federal Reserve need to create a standards body (historically, the Federal Reserve hasn't done a great job doing this, relying on multiple external standards bodies)? Should we/how do we create "a" (singular) standards body for the betterment of the payments system?

Q5. The second desired outcome articulates features that are desirable for a near-real-time payments system. They include:

a. Ubiquitous participation

b. Sender doesn't need to know the bank account number of the recipient

c. Confirmation of good funds is made at the initiation of the payment

d. Sender and receiver receive timely notification that the payment has been made

e. Funds debited from the payer and made available in near-real time to the payee

i. Do you agree that these are important features of a U.S. near-real-time system? Please explain, if desired.

Yes, agree. But, again, solutions should be centered and designed around use cases, e.g. is there a use case requiring both real-time information *and* real-time settlement? Does the industry really <u>need</u> real-time settlement?

ii. What other characteristics or features are important for a U.S. near-real-time system?

Tokenization or links to Directory Services that link back to the bank account. There is a compelling need for directory (directories) services to make all of this happen (especially sub-point b above).

Settlement = Final $$
Availability = "You have $$ in your account"
Information ="$$ will be in your account on _____"
Settlement vs. Information (Notice). There is friction between "faster" and "access to DDA". Isn't splitting information (the promise I will be paid) from the actual payment (settlement) sufficient? Use cases will drive above requirements and will also drive credit/risk decisions.

We need to address the legal, regulatory and legislative constructs. Regulations should follow.

Fraud: What are the fraud implications associated with "instant" payments? There will be a need to again consider use cases, the $ amount and volume impact of potential fraud. Most fraud management today is reactive. Migrating to a credit push (vs. debit pull) environment takes reactive fraud management out of the equation and puts some accountability into the hands of the consumer.

Do not ignore the receiving/paying institution. Any changes need to ensure transactions are priced appropriately and that the burden placed on the RDFI ensures that those taking on the majority of the work aren't also taking on the majority of the cost.

Q6. Near-real-time payments with the features described in the second desired outcome could be provided several different ways.

i. What would be the most effective way for the U.S. payment system to deliver ubiquitous near-real-time payments, including options that are not listed above?

ii. What are the likely pros and cons or costs and benefits of each option? What rule or regulation changes are needed to implement faster payments within existing payment processing channels?
iii. Is it sufficient for a solution to be limited to near-real-time authorization and confirmation that good funds are on their way, or must end-user funds availability and/or interbank settlement take place in near-real time as well?
iv. Which payment scenarios are most and least suitable for near real-time payments? (B2B, P2P, P2B, POS, etc.)

The right answer is "a combination of all". Considerations include time to market, need for standards, use cases, pricing models. But, we probably do need a SWIFT-like network that has the ability to move real-time messages between banks. For example, high value transactions would need immediacy, finality, and information with the payment. Conversely, Low value transactions would move information real-time, but with near real time settlement similar to a pre-authorization for debit card.

We think it is imperative to leverage existing systems; to differentiate between debit and credit transactions; and to differentiate between high-dollar and low-dollar transactions. This needs to be an evolution that preserves existing revenue models.

Other key questions to be addressed: How do we solve for the B2B payment? Is there a need for information on standards and payment credentials to reside with a trusted entity? Is there a need for real-time messaging as way to access that information? If so, do we need to build tools to make that possible? Would it be better to allow FIs to build their own value-added services around these services?

Q7. Some industry participants have said that efforts to make check payments easier to use, such as by enabling fully electronic payment orders and/or by speeding up electronic check return information, will incrementally benefit the payment system. Others argue the resources needed to implement these efforts will delay a shift to near-real-time payments, which will ultimately be more beneficial to the payment system. Which of these perspectives do you agree with, and why?

Our panel examined the question: does making payments by check easier through enabling EPO's create a diversion or inappropriate allocation of Federal Reserve resources? The consensus answer was yes, this is a diversion, a distraction. Check payments in general and EPO's in particular need an <u>appropriate</u> level of focus and, in its current state, an EPO-check-based instrument does not have the proper consumer protections around it.

Q8. How will near-real-time payments affect fraud issues that exist with today's payment systems, if at all?

i. Will near-real-time payments create new fraud risks? If yes, please elaborate on those risks.

Yes. The risks may not be new risks rather the process will expedite the risks we see today. There will always be risks. Will overall risk go up? Maybe, but probably not. Near-real-time also has the potential to help drive overall risk down.

Q9. To what extent would a ubiquitous near-real-time system bring about pivotal change to mobile payments?

It is our opinion that near-real-time alone won't drive pivotal change, that this change will not really create an inflection point with mobile because this concept does not address some key questions. Consumer trust and confidence will need to be much further enhanced. Security will need to be stronger for all parties. In order for mobile payments to achieve strong levels of adoption, the use of a mobile payment device needs to be easier than swiping a card. In our opinion, there needs to be strong industry standards in place to make mobile payments more ubiquitous, interoperable and more widely adopted.

Q10. What would be the implication if the industry and/or the Federal Reserve Banks do not take any action to implement faster payments?

i. What is the cost, including the opportunity cost, of not implementing faster payments in the United States?

The implications of "no action": The U.S. will continue to fall behind the world, putting our economy and our financial system in the U.S. at a competitive disadvantage. We run the risk of marginalizing the U.S. dollar as a global currency. Within the U.S., "no action" creates scenario where financial institutions could lose their ownership of the payments franchise. By not taking action, new entrants and further "noise" (and associated risk and consumer confusion) will proliferate. The industry will see too many new closed solutions or networks without standards or interoperability—a reverse network effect.

Q11. To what extent will the industry need to modernize core processing and other backend systems to support near-real-time payments?

i. What is the likely timeframe for any such modernization?

It is the consensus of our group that about every 3 – 5 years core processors will go through significant change. In our opinion, there needs to be a mandate that these changes have to happen, standards for how it should happen should be set, and to what extent these changes will be made, and that core processors will be expected to include changes in new releases and updates. There should also be a process that

enables differentiation between financial institutions (one may not need it as fast as another) and let market forces drive change.

Likely timeframe… much less than 10 years.

Q12. Some industry participants suggest that a new, centralized directory containing account numbers and routing information for businesses and/or consumers, to which every bank and other service providers are linked, will enable more electronic payments. A sender using this directory would not need to know the account or routing information of the receiver.

i. What are the merits and drawbacks of this suggestion?
ii. What is the feasibility of this suggestion?

Key question: would there be more security with a centralized directory with payment credentials or would it be better stored in a decentralized, less protected fashion?

A single, centralized directory, rather directory (directories) services would be an elegant solution but potentially also a security risk (one panelist's comment: a hacker's dream.) Decentralized may have its own security drawbacks and there are major issues around standards.

We believe the answer is not <u>one</u> centralized but rather directory (directories) services, with the right security, standards (universal) that are monitored and regulated.

Electronification

Q13. Some industry participants say that check use is an enduring part of the U.S. payment system and that moving away from checks more aggressively would be too disruptive for certain end users.

i. Is accelerated migration from checks to electronic payment methods a high-priority desired outcome for the U.S. payment system? (Accelerated means faster than the current trend of gradual migration.)
ii. Please explain, if desired.

We believe this is not a high priority but, as previously stated, we perceive a need to drive behaviors through pricing corrections.

We also expect that consumer use will dramatically decline with one more generational shift.

iii. If yes, should the Federal Reserve Banks establish a target for the percent of noncash payments to be initiated via electronic means, by a specific date? For example: "By the year 2018, 95% of all noncash payments will be made via electronic means."
iv. What is the appropriate target level and date?

We do not believe establishing targets is wise. We believe that use cases will drive the migration.

Q14. Business-to-business payments have remained largely paper-based due to difficulties with handling remittance information. Consumer bill payments also are heavily paper-based due to the lack of comfort some consumers have with electronic alternatives. In addition, many small businesses have not adopted ACH for recurring payments due to technical challenges and/or cost constraints. The payment industry has multiple efforts underway to address these issues.

i. To what extent are these efforts resulting in migration from checks to other payment types?

This is unclear. Most evidence is anecdotal and we are anticipating the release of the latest study by the Retail Payments Office.

ii. What other barriers need to be addressed to accelerate migration of these payments?

Bill Pay Models: a significant volume of checks is still being generated by large bill pay aggregators. Are the Federal Reserve Banks aware of the volumes of checks produced by these providers? Bill payment providers need acceptance by receivers to migrate away from checks We believe remittance standards needed.

iii. What other tactics, including incentives, will effectively persuade businesses and consumers to migrate to electronic payments?

Small and mid-sized enterprises (SME's) need incentives to accelerate their migration away from checks. Smaller financial institutions need turnkey solutions to provide to their SME customers to enable migration.

iv. Which industry bodies should be responsible for developing and/or implementing these tactics?

The Federal Reserve Banks working with collaboration with banking industry associations (such as ABA, ICBA, CUNA, NAFCU, NACHA and others), trade groups (such as AFP, NFIB, US Chamber and others) and government agencies (SBA, Fiscal Services and others) to develop educational materials, workshops and payment toolboxes for SME's.

Cross-border payments

Q15. To what extent would the broader adoption of the XML-based ISO 20022 payment message standards in the United States facilitate electronification of business payments and/or cross-border payments?

ISO 20022; To quote a member of our group: a "no brainer"

Q16. What strategies and tactics do you think will help move the industry toward desired outcome four - consumers and businesses have greater choice in making convenient, cost-effective, and timely cross-border payments?

Fed needs to create more endpoints with other central banks and direct clearing with those enabled, which will increase competition and decrease the total cost of those transfers. However, this should not be a priority because those that currently use cross border payment already know where/how to make and route those payments, i.e. it's not "broken" today.

Safety

Q17. Payment security encompasses a broad range of issues including authentication of the parties involved in the transaction, the security of payment databases, the security of software and devices used by end users to access payment systems, and security of the infrastructure carrying payment messages.

i. Among the issues listed above, or others, what are the key threats to payment system security today and in the future?

Key threats include outside actors, internal collusion and the proliferation of payments credentials/number of systems that contain information. (Because of opt-in programs, too many entities can carry consumer payment information—a large number of organizations are storing this information in one way or another).

ii. Which of these threats are not adequately being addressed?

Need standards around data security, which currently vary from payment channel to payment channel.

iii. What operational or technology changes could be implemented to further mitigate cyber threats?

With use of mobile technology and processing capability, we have a tremendous opportunity to enhance authentication. The technology needs to be leveraged in a way that is meaningful; i.e. sell the value to consumers to adopt and do so in a coordinated fashion. For example,

promoting the value and enhancement of security by using the device for out of band authentication.

Q18. What type of information on threat awareness and incident response activities would be useful for the industry?

i. How should this information be made available?

Our group believes that this area is beyond the Federal Reserve's scope. In our opinion, any efforts by the Federal Reserve would be duplicative.

Law enforcement and others (FS-ISAC, for example) are in a better position to address these issues especially globally. We would encourage the Federal Reserve to not take resources away from its primary mission.

Q19. What future payment standards would materially improve payment security?

i. What are the obstacles to the adoption of security-related payment standards?
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There needs to be a balance between security/fraud migration measures and ease of use.

Q20. What collaborative actions should the Federal Reserve Banks take with the industry to promote the security of the payment system from end to end?

See #18. We believe the Federal Reserve Banks' role is to listen to groups that know and set standards for how security should be done in relation to the payment system.

Enforce existing regulations on non-financial institutions and level the playing field.

Q21. Please share any additional perspectives on U.S. payment system improvements

With the evolution of consumer protection, there is a need to ensure the cost of compliance is factored into the overall costs of any of these initiatives. Financial institutions cannot operate at a loss—they will fail. Any changes to the payments system will have to balance what's best for the customer, especially consumers, with the value proposition that enables financial institutions to offer and provide the best solutions and products.

Sincerely,

Dennis Simmons, AAP

President and Chief Executive Officer