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December 13, 2013

Via FedPaymentsImprovement.org
Federal Reserve Financial Services

Re: Payment System Improvement - Public Consultation Paper

Dear Sir/Madam:

The California Bankers Association (“CBA”) submits these comments to the Federal Reserve Board’s Payment System Improvement - Public Consultation Paper (“Paper”). CBA is a nonprofit organization established in 1891 and represents most of the FDIC-insured depository financial institutions doing business in California. CBA’s membership comprises of banks of all sizes, from community banks to the largest banks in the U.S. CBA is aligned with the Board’s goal of establishing a faster and more efficient payment system, and believes that the Board has an indispensable role in this important endeavor. Therefore we support the Board’s initiative.

Introduction

In its paper, the Board emphasizes that its role in enhancing existing payment systems is collaborative with market participants, and that it should coordinate the significant efforts needed to do this rather than issue mandates to be adhered to by all. We concur that this is an appropriate role for the Board to play. The payment systems that the Paper addresses are the “ubiquitous” systems—ACH and checks—and also wire transfers. As the term implies, ubiquitous systems are open in that they are not restricted to users of a single, proprietary platform. It would not be appropriate for ubiquitous systems to be developed solely by the private sector through competition.

Both federally insured financial institutions—the backbone of the nation’s payment systems—and a host of non-financial institution providers and operators benefit from and rely on these systems. A speedier system thus benefits all participants. An open, ubiquitous system also helps preserve and promote competition by allowing diverse participants to gain access to something that few single participants can build and maintain on their own, yet which they cannot operate without. By contrast, a market that consists of proprietary, closed networks would tend toward exclusion as a means to maximize the benefits of network usage. The Board, as a

government entity that also operates and facilitates the existing payment services, has not just an appropriate role to play in enhancing these systems but an indispensable one.

In light of the trends toward greater speed in the domestic and international markets identified by the Board in its Paper, improving the U.S. payment systems is well justified. Smaller financial institutions in particular have a great stake in the outcome of this effort. Community and regional banks in the U.S. number in the thousands, and they provide loans and other vital financial services to a diverse economy. These banks are in a position to compete in the market as they have done for decades, but they are not in a position to build their own pipelines or develop services that bridge shortfalls in the existing payment systems. CBA believes that preserving a diverse banking industry consisting of both large and small banks is a vital, long term goal. Preserving access to fast and efficient payment systems is integral to achieving that goal. We urge that the Board remains mindful of this as it proceeds in this endeavor.

What follows are our more specific responses to selected questions raised in the Paper.

Q1. What other gaps or opportunities not mentioned in the paper could be addressed to make improvements to the U.S. payment system?

A. The Paper does not directly address the greater compliance challenges likely to be faced by all banks inherent in shortening clearing and settlement times. In addition to the tasks of ensuring the availability of good funds, handling errors, and preventing fraud, all of which in an enhanced system must be conducted within compressed time frames, supervised financial institutions would also face the additional challenge of complying with suspicious activity reporting, anti-money laundering laws, OFAC, and similar laws and regulations. A faster payment system requires participants to speed up their compliance processes. Also, non-financial institution participants in the systems should be required to operate in a manner that does not impede banks' obligations, such as by masking the identity of payers and payees. As the systems become more open and speedier, the risks of banks violating government monitoring laws may rise unless systems improvements are made consistent with these existing obligations.

We also urge the Board to help ensure more consistent adherence by all market participants in an enhanced system to standards pertaining to security, reliability, and dispute resolution. A current example of such shortcomings is the debit card network in the POS space. Debit card issuers sometimes incur significant losses when there are security breaches at major retailers or third party processors partly because of their inadequate compliance with security standards. As the Paper acknowledges, a major challenge of speedier transactions is controlling losses. The Board should give high priority to establishing, with industry input, effective security standards that must be adhered to by all participants commensurate with speedier systems.

Q4. (Restated) Should implementing a system for near-real-time payments be accomplished through coordinated action or allowed to evolve without special action by a public authority or industry group?

A. The existing ACH and checking systems were developed through coordinated effort. It would be extremely difficult for market participants, except perhaps for the few with great means, to be responsible for enhancing the systems. Elements of the systems—such as rules governing settlement times-- are by nature established collaboratively and not amenable to change by competition. And as discussed in greater detail below, vendors that purport to provide near-real-time payments have not created their own pipelines but rather rely on existing systems and aggressively manage the risks inherent the systems.

Q6. (Restated) In what way should near-real-time payments be provided:

- a. Create a separate system patterned after the wire transfer system.
- b. Link together existing limited-participation networks.
- c. Modify the ACH; payments would be settled periodically during the day.
- d. Enhance the debit card networks.
- e. Implement an entirely new payment system.

A. The Board is asking the right questions. It is too early in the process to offer definitive answers and we do not offer a specific recommendation. Whichever route or combination of routes is taken, it would entail new, significant costs for upgrades, fraud management, error resolution, regulatory compliance, etc. It is imperative that close attention is given to the business case for each new investment, including in each instance market research to substantiate willingness by end users to pay for enhanced services.

Q.6 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?

A. This depends on the channel in question. In some instances, end users may be more concerned about confirmation of payment than near real-time transfers. The Board is correct in identifying the various forms of transactions (P2P, B2B, P2B, POS, etc.) and their enhancement as subject to different business justifications depending on costs and market demand. It may be, for example, that the existing point of sale system largely satisfies the expectations of participants in terms of certainty and timing of settlement (but not security as mentioned above). POS transactions are conducted efficiently, consumers have wide access to merchants, and merchants are able to make real-time verification of funds. Migrating toward real-time interbank settlement for these transactions might not be a high priority, especially if doing so would exacerbate losses. In contrast, none of the existing systems allows for near-real-time payment from person to person, something for which there appears to be a demand in the market.

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

A. Other participants in the system (as well as other countries) will continue to develop services to meet increasingly sophisticated demand. Institutions of all kinds with means would be

motivated to introduce their own proprietary systems, a result that runs counter to the Board's well-expressed goal of establishing a ubiquitous system. This kind of competition may be detrimental to the market--it is akin to well-heeled proprietors constructing members-only toll roads while the public infrastructure, relied on more generally, is allowed to erode. Business would be prosperous for the few but detrimental to many. Many banks may find themselves cut off from access to faster pipelines or find access to be determined at the mercy of competitors.

We note that it would not be accurate to characterize most banks as non-competitive, a conclusion that might be warranted in light of market developments referred to in the Paper that are partially driving the proposal. At present, non-bank vendors who provide purportedly real-time end-to-end payments are in fact entirely reliant on existing payment systems. Paypal is an example. The only way to participate in Paypal is to open a Paypal (non-bank) account with a credit card or a bank account. In other words, without their customers' reliance on existing payment systems, there would be no Paypal service. Paypal is able to facilitate near-real-time payments only between separate Paypal, members-only accounts, and it limits risks of bad funds and delivery failures through strict management. When a participant wishes to transfer funds out of a Paypal account to a bank account, Paypal is contractually allowed up to 8 days to do so presumably using the ACH pipeline. We hasten to add that Paypal does not comply with the many regulations applicable to banks.

Neither Paypal nor any other payment systems participant operates entirely within its own ecosystem; all are reliant on the payments infrastructure to some extent and should be governed by the same rules of the road. Without systems-level upgrades marginal improvements would continue to be made but often because operators, including banks, are willing to absorb greater risks to improve service (such as offering no-limit loss recovery for card transactions). Non-bank service providers, backed by unregulated capital, might be willing to assume greater risks. The systems would continue to function if the Board does not take any actions to implement faster payments. But all participants would benefit if the Board does act.

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

A. There is no doubt that core processing systems and a host of related systems need to be modernized to support faster payments. Systems are intricately tied to processes and procedures to manage compliance, fraud, reporting, and error resolutions. It would be prudent for the Board to engage bank third party service providers in the Board's process, as smaller banks are more dependent on them.

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On behalf of its members, CBA appreciates this opportunity to offer comments. We support the Board's efforts and will continue to be engaged as this important endeavor continues.

Sincerely,

A handwritten signature in black ink, appearing to read "Leland Chan". The signature is fluid and cursive, with a long horizontal stroke at the end.

Leland Chan
General Counsel