Consumer Finance Monitor (Season 6, Episode 1): Is the U.S. Payments System Failing Business and Consumers? A Discussion with Special Guest Dan Awrey, Professor of Law, Cornell Law School

Speakers: Alan Kaplinsky, Ron Vaske, and Dan Awrey

Alan Kaplinsky:

Welcome to the Consumer Finance Monitor Podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly podcast show brought to you by the Consumer Financial Services Group at the Ballard Spahr law firm. I'm your host, Alan Kaplinsky. I'm the former practice group leader for 25 years, and now Senior Council of the Consumer Financial Services Group at Ballard Spahr. And I'll be moderating today's program. For those of you who want even more information, either about the topic that we're going to discuss today or anything else in the world of consumer financial services law, don't forget about our blog, consumerfinancemonitor.com. We've hosted our blog since 2011, so there's a lot of relevant industry content there.

We regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or to get on the list for our webinars, you should visit us at ballardspahr.com. If you like our podcast, please let us know about it. Leave us a review on whatever platform you're using today to download our show, be it Apple Podcast, Google, or any other platform you might be using. Also, please let us know if you have any idea for other topics that we should consider, or speakers that we should consider as guests for our show. So let me give you just a little bit of information about the topic that we're going to cover today, then I'm going to introduce our guests, and then we are going to get into our discussion of this topic. This is a topic that we haven't covered quite so often and we probably have been remiss in not dealing with this subject more frequently.

I originally began my search for an outside guest by thinking that we would talk about the so-called FedNow program, the real-time payments program that's being developed by the Federal Reserve Board. That's not yet in effect, and we don't yet know what the final components of that FedNow program are going to be. But as I started talking to people who are very familiar with the program, much more familiar than I am, I learned that it was premature number one, to talk about it, but then when I talked to my guest who I'm going to introduce to you immediately, my guest said the payment system in the United States that we have is really pretty bad. It's not working as well as payment systems that are in use for consumers in a lot of other countries, and we are really far be behind the eight ball.

And that light bulb went off in my head at that time and I said, well, gee, that's really a good topic. We won't focus so much on FedNow, we'll deal with that at some point during our show. But we'll talk about the payment systems that we have in the US today and why they're not working to the advantage of the industry, banking industry and consumers. So without further ado, let me introduce the guest of our show today. And I'm very pleased to introduce Dan Awrey. He's a professor of law at Cornell Law School. Dan's teaching and research interests reside in the area of financial regulation and more specifically, the regulation of banks, investment funds, derivatives markets, payment systems, and financial market infrastructure.

He's undertaken research and provided advice at the request of many, many organizations, including the US Treasury, the President's Working Group on Financial Markets, the Federal Reserve Board, and many others. And he's written for many publications, including not only the Cornell Law Review, which is where Dan teaches, but also Yale Law Journal, NYU Law Review, Georgetown Law Review, Harvard Business Law Review, and many others. He's the co-author of one of the leading textbooks on financial regulation called Principles of Financial Regulation published by Oxford University Press. He's also the founding co-managing editor of the Journal of Financial Regulation. So Dan, a very warm welcome to you. Pleased to have you on our show.

Dan Awrey:

Thank you very much, Alan. It's great to be here.

Alan Kaplinsky:

And let me now introduce to you a colleague of mine who is going to his role today will be the Chimer Inner. He will be chiming in if and when he's got something to add to the comments that Dan is going to provide as I ask Dan a bunch of questions that I think will be of interest to our listeners. Ron Vaske is a partner at Ballard Spahr. He is in the consumer financial services group and he co-leads the firm's FinTech and payments industry team. He's helped clients develop innovative products and services for more than 25 years, including payment and deposit products. His clients include banks, FinTech companies, payment facilitators, and companies that provide banking as a service. So Ron, warm welcome to you. Welcome back to our podcast show.

Ron Vaske:

Thank you very much, Alan. Happy to be here.

Alan Kaplinsky:

So Dan, just give you a softball question at the beginning. I know all these questions are probably softballs for you, but why don't you describe to our listeners what are the co-features of the US payment system?

Dan Awrey:

Sure. So I think there are four things that reside in the background of the structure of the US payment system that inform everything that we're going to talk about today, I suspect. The first one is the extreme fragmentation of the banking system in the United States. There's over 5,000 banks and just as many non-bank insured depository institutions. Relative to the US population, relative to US GDP, this is a huge number of financial institutions at the heart of the payment system. And this makes coordinating the development of financial market infrastructure really hard. Payment systems like other types of infrastructure, require coordination, think roads, bridges, the internet, but imagine trying to build an interstate highway system using thousands of local contractors. That's going to slow the process down, it's going to lead to potential conflicts of interest and potential differences in what that infrastructure should look like and how it's built.

This actually leads into the second core feature, which is that despite this fragmentation, the payment system in terms of payment flows is actually dominated by a fairly small number of very large banks. These banks enjoy enormous economies of scale in payments. They also generate float revenue from sitting on top of the banking system and in effect being the choke point, the bottleneck through which many other banks access the payment system. This has long created a conflict of interest between big banks and small banks in the United States around things like payments. This exacerbates the coordination problems that we're talking about because banks are not of one mind about what the payment should look like, who it should work for, and who should bear the burdens of developing and maintaining the necessary infrastructure. The third feature is one that marks out the United States relative to a lot of other jurisdictions, which is the fact that we're only talking about banks.

Only banks in the United States have access to Federal Reserve master accounts, and only institutions with Federal Reserve master accounts can have access to the clearing infrastructure at the heart of the payment system. This means that non-bank payment platforms rely on banks, need to use banks for indirect access to that system, which has an impact on the products and services that consumers ultimately see. Also, the level of competition and investments in technological infrastructure. That takes me to the last component, which is the role of the Federal Reserve in all of this.

Relative to a lot of other jurisdictions, the Federal Reserve has never been particularly proactive on payments. It plays a role along with various private sector clearing houses in the actual operation of the payment system, but it is not, and I include the Fed Now initiative in this observation, tended to play a proactive role in developing or spurring the use of new technology. In particular, this applies to retail payments. What does this mean? What do these four core features mean? Well, the US as I think we'll talk about more in the payment spaces, long suffered from a lack of competition. Is increasingly falling behind from a technological perspective. And as a result, American consumers experience worse payments, slower payments, more expensive payments than almost any other developed country in the world.

Alan Kaplinsky:

Wow. That's a sad commentary for sure, Dan. So let me ask you, what impact do these features that you described have on the benefits and costs that consumers experience?

Dan Awrey:

Sure. So let's start with brass tax, payments in the United States are expensive. Think of the last time you went to a food truck to get a $10 burrito and you paid using your credit card. There's a pretty good chance that somewhere between 3% and 4% of that transaction at $10 went from the merchant to some sort of payment card provider. And when you think of the merchant margins in something like food services, 4% is a pretty big number. We'll talk more about comparisons I think later on, but that is several times more than you'd likely pay in other jurisdictions. And this is despite several legislative moves, several antitrust cases that have been brought over the years around competition in financial market infrastructure. That is actually, at least in the debit card market, lowered the cost of payments, but not in the credit card market.

The second thing we see is one of the more inconvenient payment systems in the 21st century. This happens to me, I'm Canadian and spent most of the last two decades living in Europe. And whenever I go back to Europe, I always forget my bank pin number, but then I remember that I don't need a bank pin number in Europe anymore because I can just use tap and pay. That technology has been widespread in Europe, in Asia, in lots of parts of the developed world for over a decade, and it's still in the process of being rolled out here in the United States. If you're a customer of a big bank, you probably have had tap and pay introduced in the last couple of years. If you're a customer of a small bank like I am, I'm a proud Tompkins Trust Bank member here in Ithaca, I don't have tap and pay on my cards.

That makes payments less convenient. At the same time, limiting the payment system to banks means that we're effectively outsourcing the adoption of new payment technologies to a whole bunch of firms that are not technology firms, they're banks. And that's had a big impact as well relative to countries like China, where their mobile first payment system enables a whole bunch of features that here, have again rolled out much slower or not at all. As a result, Americans don't know what they're missing unless they happen to also do business or visit these other countries that have much more efficient, much better payment systems. Along the same vein, there are two features of the US system that are increasingly anachronistic. One, slow payments. Slow in particular because the US payment system turns out the lights and goes home at five o'clock every Friday afternoon and doesn't wake up again until 9:00 AM Monday morning.

I was forced to sell my tickets to a Buffalo Bills game, go Bills, and found that I couldn't access the ticket sale website on a Saturday because they couldn't verify my bank details. That is something that is purely a reflection of decisions about our technological infrastructure and have nothing to do with anything else. We can solve that problem quite easily. And most other payment systems in large, developed countries already have. Two other items here. One, checks. The United States is home to the use of the vast majority of checks still. They're ubiquitous in all sorts of types of transactions. They are slow, they are extremely costly to process, not only in terms of the infrastructure that banks have to process them, but things like the environmental cost of using pieces of paper to transfer value. And then at the other end of that spectrum, the fact that we still have checks is partially due to the same problem that has led us to be laggards globally in the development of open banking.

So shifting from manual paper-based instruments, shifting away from the technological silos of conventional deposit-taking banks and towards internet-based architectures that enable a much higher degree of interoperability between the types of financial products and services that consumers want to use. If you want to connect your bank account to PayPal or Cash App, and if you want to connect these accounts to your online app that you use for budgeting, there's a technological infrastructure that needs to be in place to do that. And the United States, both the public and private sectors, have not invested in the development of that infrastructure in the same way that elsewhere has. Now, what do all these things share in common?

Well, again, if you think that competition is good because it helps spur greater investment in new technologies and the development of technologies that consumers might find valuable, well, then all of these things make sense. The US system is not competitive. The US system hasn't invested in infrastructure, and as a result, the US has a clunky and outdated payment system that ultimately is costly for consumers in all sorts of ways, takes money out of their pocket, takes days out of their lives, and it can all be remedied.

Ron Vaske:

Yeah. Dan, I just had a question for you. You mentioned and gave the burrito example where the merchant, the burrito provider is paying 30 to 40 cents on a $10 transaction. It occurs to me that originally when that was set up and that 30 to 40 cents includes interchange that's paid to the card issuer ultimately, as well as transaction costs. Originally, the concept of interchange was seen as compensation for relieving merchants of the burden of administering their own credit program and taking credit losses and all of that. Which obviously doesn't necessarily apply in the case of debit cards, but there is a distinction there with respect to credit cards in the US, there is a difference with respect to interchange on debit versus credit cards. Do you know if that applies also outside of the US? Do other countries have a similar system?

Dan Awrey:

So yeah, virtually everywhere there are cost differences between debit and credit cards interchange fees, there are a lot less. In most of the countries, the differential is a lot less in most of the countries that we would think of as being comparators to the United States. In some cases like Europe, that's by virtue of the application of antitrust law, where the costs are, as a result of enforcement action, much lower and much more equal. In other cases like Canada, you still see the difference between credit and debit card fees, but you don't see the same amounts in effect. So you're looking at a fraction of the cost ultimately. And even Canada is relatively high relative to any other country other than the United States. Which at this point, is sort of such an outlier amongst large developed countries that it's difficult to compare them to anybody in terms of these costs, especially since a lot of developing countries are leading the way.

And here I'm thinking of countries like Brazil and China where you can have the big debit and credit card company providers provide services in that market, but you can also compete with them. Providing that infrastructure is not necessarily something that we have to stick with the infrastructure that we had before. And if there are business models, if there are technological platforms that actually do a more cost effective job, then it may be worth, from a policy perspective, opening up these legacy providers to more competition. But the short answer to your question is absolutely yes, the pattern persists across jurisdictions. It's the size of the numbers that really mark the United States.

Alan Kaplinsky:

What about, Dan, fraud? You didn't mention that the incidence of fraud is the result of some of the problems that you've identified with the payment systems in the US and how that might compare to some other countries who are doing it a lot better than us. Is the incidence of fraud higher here too?

Dan Awrey:

So it's difficult to make apples to apples comparisons here, because different speeds and different technologies have different potential for fraud. And so, the US system, its stasis, I think it's fair to say, has actually led to a relatively containable level of fraud for conventional incumbent providers, the bank-based payment system. At the same time, if you look at the early days of platforms like PayPal, fraud was a problem, but it also led them to innovate in terms of their use of algorithms for the purpose of fraud detection that have actually led to innovation that is helpful across the payments' industry. The other big issue with fraud is time. The faster your payment system, the more vulnerable you are to fraud. One of the benefits of having a slow payment system is it gives your bank or whoever is processing the payment more time to detect and potentially stop a payment before fraud actually happens, or before the money leaves your account in effect costing I say you, but most likely your bank some degree of money.

So as you move towards a faster system, you have to bring along the technology necessary to have effective fraud prevention along with it. And as you move to an instant payment system, sort of a 365, 24/7- real time payment system, there, you've either got to bring along the technology necessary to detect fraud in real time, which is incredibly difficult. Or you have to have a regime in place that makes it clear who's paying for the fraud, right, whether it's the consumer, the bank, or any sort of third party intermediary that's helping to process the payment. Historically, this has been dealt with not technologically, but legally by saying, look, we're going to make the banks responsible for eating any issues that relate to third party fraud, so not fraud by the customer, but fraud by a third party with whom the customers interacted.

But that's a policy choice. That in itself is a pretty significant consumer protection mechanism that we sort of take for granted in the United States and probably elsewhere. That does have an impact on the experience that customers ultimately have with the payment system. I've totally evaded your question here, but the key takeaway is that the reason I've done so is that the gross levels of reported fraud are so wrapped up in the technological infrastructure of the payment system that I'm loathed to make apples to apples comparisons here. In general, the technology dictates the opportunities for fraud, which then means that the numbers can be very different.

Alan Kaplinsky:

Yeah. And one other thing I'd like to get your reaction to. So in the US, one of the complaints that consumers have, particularly consumers who travel a lot and use their credit cards or their debit cards in foreign countries, is something called a foreign currency exchange fee or conversion fee charged by their bank. And I'm wondering how those fees compare to... Are there a similar fees charged to foreigners by their banks when they're buying items, goods and services in another country?

Dan Awrey:

Yeah, this is a trick that banks around the world long figured out that just as we have probably the best analog to be frank of the US payment system is the cross-border payment system. It is dominated by a small number of large banks that have had trouble coordinating on technological development, and as a result, are able to extract pretty big rents, pretty large fees in connection with cross-border payments. Especially relatively small dollar value cross-border payments where you can see pretty big chunks of your vacation dollar being taken up by these fees. I would note that this is also an area where non-bank platforms are starting to eat banks' lunch. So you've got firms like Wise, formerly TransferWise, which basically sits on top of the existing legacy cross-border payment system, but is technologically able to move faster and more nimbly than the legacy system. And in the process, is able to offer dramatically lower fees.

The downside, it doesn't really work for you when you go on vacation because it requires you to have a bank account in the country that you're sending money from to the country that you're sending money to. But for those of us who do live sort of across border existence, it's incredibly helpful if you have bank accounts in both countries because it dramatically reduces these foreign exchange fees that banks have traditionally charged. Now, the next step in that process is to move away from the bank-based system entirely and have a system that is both interoperable in both where you started and where you're traveling to, that doesn't require you to have an account in the country that you're going to.

Once we get into that world, we can really start to see some disruption and potentially more competition and ultimately lower fees in the cross border space. But this has long been one of the areas that I think policymakers and academics like myself point to as being particularly inefficient. And the thing that we point to as a matter of that inefficiency is the incredibly high cost of foreign exchange.

Alan Kaplinsky:

Right. Right. So I want to get back to some of the things you've already talked about a little bit, but I'm wondering how, and some of it you may have answered already, but how does the experience in the United States fare in comparison with similarly situated countries? I mean, you've already mentioned that the costs are much higher, but I'm wondering if you could elaborate on that.

Dan Awrey:

Sure. So let's take a day in the life of the average US consumer and say the equivalent consumer in many other large developed countries around the world. So you get up in the morning, maybe you're busy that day and you head to the local coffee shop to grab a coffee and a bagel. We've already talked about this a little bit, but you're probably, when you pay via card, whether credit or debit card, potentially paying three or four times more ultimately for that coffee and bagel. So that's a lot really. Now you might say, well, it's ultimately the merchant that's paying that, but of course, wherever possible, a savvy merchant will be passing that on back to the consumer in terms of higher prices. You go on your day, you've now got your breakfast, your coffee, you're ready to go. And it turns out it's a Friday and it's pay day and you know that you keep a pretty, or you have a pretty low amount of money in your bank account at the end of any given pay period.

You've paid your bills and your expenses and things like that. And that paycheck that is notionally going into your account today may not actually appear in your account and be usable until Monday morning. The reasons for that are twofold. One, your bank may not be particularly well-incentivized to credit your account instantly. That is to say they might be able to make some money off it by delaying the crediting to your account. But most importantly, the US payment system is closed for business between Friday afternoon and Monday morning. That means if you wanted to use that money on the weekend, you can't. And you may be thinking at this point, geez, that doesn't sound like my life. Maybe the listeners of this podcast are part of that lucky segment of America that keeps a significant positive balance in their checking account every month. But this takes us to the other side of this, is that lots of Americans don't fall into that category.

Lots of Americans do live paycheck to paycheck, and that three days is really impactful on their lives. And this is where I think from a policy perspective, I often see the most amount of interest in this is that a slow, expensive payment system is hardest on the people who can least afford it. This is basic infrastructure. But instead of letting rich people and poor people drive on the same roads, in this particular case, we are letting rich people and poor people pay the same price. But this has a disproportionate impact on people who can't afford it or on people who need their paycheck right away. The technology exists and is being used in other countries to solve this problem.

Your paycheck can be deposited into your bank account the moment that the funds are released by your employer. In the future, we're probably going to have a world with even people who work on a daily basis, so who only get paid on the days they work, can be paid the day that they do the work. This is only a technological problem combined with some policy reticence around actually building the infrastructure necessary to do this. So this day in the life of the US consumer is more expensive, it is less convenient, they'll face fewer choices. And if they're part of that segment to the American population that is living paycheck to paycheck, the real costs in terms of their choices and standard of living can be impacted quite harshly relative to those in a similar economic circumstance in other countries.

Alan Kaplinsky:

So I'm wondering what you think about the FinTech industry has developed a new product relatively new. Although I actually did a recent podcast recording with a company that says that they've been in the business for 13 years. And that is earned wage access, where there are a lot of companies out there today that will facilitate an employee being paid essentially on a daily basis if he or she wants to do it. And sometimes, there are fees associated with that, but very often, the fees will be paid by the employer, because it's considered an important employee benefit. And it's been harder to attract qualified employees. So that kind of a benefit, it seems to me is a pretty neat idea. But what do you think about that in terms of other things that you've commented on?

Dan Awrey:

Yeah, so I would divide that marketplace into two marketplaces. One that I'm absolutely in favor of, one that I have some concerns of. The one that I'm in favor of is where you have completed the work in question and are entitled to payment, and the FinTech is just facilitating a faster, more timely payment for work already done. The other is where in effect, the FinTech is extending a loan to you or the employer for work that has yet to be done. The latter involves the extension of credit in some very low level ways that my colleague, Nakita Cuttino, at the University of Georgetown, has done a great job of shining a light on. So if it's a payment product-

Alan Kaplinsky:

You're referring to payday lending though, isn't that really what the second product is?

Dan Awrey:

Absolutely right. The second category is payday lending, but because payday lending is increasingly subject to scrutiny by state and sometimes federal regulators, the business models of some of these firms have evolved such that I think there's a blurring sometimes. And when I look at this, I often have to look deep into the bowels of the way that they conduct their business to understand whether there's any extension of credit going on. But to me, that would be the point on which my answer would hinge. If there's no extension of credit, then I think these FinTechs are a valuable workaround to the existing US payment system and its slowness in effect. Where it does involve credit, I think that a different set of policy implications do come into play that are effectively those associated with payday lending.

Alan Kaplinsky:

Yeah, yeah. Hey Ron, I'm wondering, I mean, I know you've done some work in the earned wage access area. And it's a tricky area, isn't it, to make sure that you can navigate your way, to do it in a way where it is not considered to be credit and thereby triggering state usury laws and federal truth and lending laws, et cetera. I'm wondering what you think about that.

Ron Vaske:

Yeah, you're right. It is very tricky and it varies potentially from one state to the next with respect to the usury question at least. And certainly there are state disclosures and other consumer protections that would apply. So yeah, it's very tricky. It's very difficult to offer a program on a nationwide basis, especially if you're not a national bank. It's a little easier if you're a national bank because you enjoy more [inaudible 00:35:52].

Dan Awrey:

So we haven't talked about this yet, but it is sort of the elephant in the room when it comes to all of this that the federal state dynamics in financial institution regulation in the United States are doubtlessly part of this problem. The system as it has evolved since the 1860s, is one of competing in overlapping jurisdictions that in the event that you want to do something new, especially you are having to navigate a complex and sometimes conflicting thicket of state rules that are going to apply in any state that you do business. And then potentially interact that with federal law. That adds another layer of expense to a lot of this, quite frankly. And at the same time, it means that a lot of the rules aren't particularly well-rationalized. That is to say that compliance costs are not only high, but actually developing a business model that can comply across states and with any federal law is becoming a bit of a gymnastics exercise that then leads to further competitive distortions relative to say, banks that have a clear place within this system.

Alan Kaplinsky:

I take it in other countries, the problem that you've just identified as not as prevalent.

Dan Awrey:

That's true. So most countries that have federal systems figured out a long time ago that money and payments should be federal. It is the weird quirk of US, well, really the National Bank Acts of 1863 through '65 and the jurisprudence that then the states used to fight back against the exertion of federal authority over banking. That led to the dual system that we have now, that history is a unique US history and it's one that that's had incredible path dependency in terms of the continuing existence and separate evolution of state laws in the financial services realm. Even in Canada, which prides itself on being a dysfunction of federalism, they haven't had the same level of problems bringing banking money and payments largely under federal jurisdiction.

Alan Kaplinsky:

Yeah. It is always puzzled me why, at least I've been told, there are only a handful of banks in Canada, right? There aren't many.

Dan Awrey:

Yeah. So I keep a database, I believe as of this morning, there are 84 banks in Canada.

Alan Kaplinsky:

Oh, okay. It's more than I thought. But that compares to how many in the US if you count the federal , all the thrift institutions, and it's thousands.

Dan Awrey:

Just under 10,000. So that number's been coming down for a long time now. We recently crossed the 10,000 threshold. The last time I looked was about 9400, 9500, I think. Even Europe with a more similar population has a fraction of the number of banks that the US has.

Alan Kaplinsky:

So we've now gotten to the point of our show where I want to get your reaction to these real-time payment systems that have been developing. And in particular, to the FedNow program that the Federal Reserve Board, Federal Reserve has been working on for years. It still hasn't completed its work. What do you think about that? What impact are these initiatives going to have on the experience that consumers have with payments?

Dan Awrey:

Yeah, so my really unfortunately pessimistic answer is none. I don't think the US consumer is going to notice at all that FedNow happened. And I'm already using it in the past tense, because I don't think it's going to exist for very long. And I say this for a couple of reasons. One is that we've had a real-time payment rail, wholesale payment rail now in the United States for several years in the form of RTP, that basically does the thing that FedNow is going to do, but from a private sector perspective. So RTP is a consortium of many of the biggest banks. It uses the fed's existing infrastructure to make for realtime payments because it's just crediting and debiting sub-accounts within the master account architecture of the Federal Reserve. So if FedNow was going to have an impact, it probably wasn't going to be just being the wholesale payment rails that now already exist, realtime payment rails that already exist in the form of RTP.

And the obvious pivot would've been to have a public-facing interface that enabled people in the US, consumers in the US to actually have a transparent look at their payment choices and what those costs are going to be. These interfaces exist everywhere outside of the United States and nowhere inside of it, but FedNow decided not to go in that direction. There isn't going to be a user-facing piece of FedNow. It's going to largely replicate, albeit in a technological form that none of us yet fully know outside of the Federal Reserve and its various vendors, that is from a service perspective, going to be absolutely identical at best to RTP. And now that then raises the question, who's it going to work for? The obvious answer is the banks who aren't members of RTP. Those are regional banks, smaller local banks, and there the question mark is whether FedNow ultimately is going to be more cost effective than the existing correspondent banking system through which the vast majority of these banks execute payments on behalf of customers.

Up until a week ago, I would've said that it seems unlikely that it's going to be that economical. And I'm guessing that the Federal Reserve agreed with me, because it recently announced towards the end of November, that it is going to basically cut rate fee, price its services on FedNow at the beginning of the service. It wants to try to bring people on board into the service. And so, it's going to offer in the short term at least, hyper-competitive pricing for the purposes of trying to get people or banks to start to use the system. Now, there's some question marks there, and I'm loathed to bring it up, but the Monetary Control Act of 1980 says that when the Fed does stuff like this, they have to do it in a way where they're going to recover their costs over the longer term.

And so, I do suspect that that ultimately means that this will be a short-term pricing bump, and that the long-term competitiveness of FedNow versus RTP as competing wholesale systems is going to most likely not result in any benefits for the banks that use it, let alone their customers. And the one thing I'll say here on this point is going back to my earlier observation about where payments flow in the United States. The economics of these two systems, RTP versus FedNow are ultimately going to come down to the flows that go through these systems. And all of the biggest banks that process the vast majority of payments in the US are members of RTP.

It's the smaller banks, as I said before, that don't now have a lot of payment flow that are ultimately going to be users of this system. Which mean that when you amortize the cost of developing and maintaining this system, it's not going to be particularly competitive I don't think with RTP. And that's why I don't think it's going to survive in the longer term. It's just not going to be viable for the Fed to continue to offer this service given that the quality of service is going to be identical at best and that the brutal economics of infrastructure and payments mean that it's from a cost perspective going to be worse than RTP.

Alan Kaplinsky:

Yeah. Boy, that's certainly discouraging. So let me ask you, I guess a final question, and that is, what's the appropriate solution here? A system now isn't working real-time RTP, it may work for the banks that belong to it or own it, but not for most of the other banks or depository institutions in the country. The costs are too high. Overall, what do we do? You are now the treasury secretary or well, we'll even maybe make you the president and now you understand the problem that we have in the United States with payments. What would be your platform? What would you do to change it?

Dan Awrey:

I'm going to switch out of the treasury and the executive branch and into Congress because I think that's where the action needs to happen. First, I think there needs to be more private sector competition in payments. And right now, the Federal Reserve Act restricts who can access the system to banks. And I think that, and I've proposed this in my own work and work I've done with many of my colleagues where we want to expand access and create a regulatory framework for non-bank payment institutions so that they can run on the same rails. That the clearing and settlement system is not a bank only club, that firms that actually have a lot of technology to bring to the table that can benefit consumers can directly access the system in which they compete. And not have to rely on banks in order to access that system. So that's the first thing that I would do.

Alan Kaplinsky:

Of course, just staying with that for a while, the banks don't like that, right? And their argument is you can't let these FinTechs and non-banks get involved because they're not subject to the same supervision of regulation. And my guess is they would point to the collapse of FTX, the crypto exchange company that recently went under.

Dan Awrey:

We have solutions to all of those problems. If you're a payment company and you are competing against banks, that 40 cents on the $10 for that burrito, that's a lot of margin that I can capture if I can use technology to do it cheaper. And so, you can have a fee-based system that does not involve financial intermediation. These are payments companies, they're not money creators. And so, the proposal that I've sort of, I guess most closely associated with is one that would require them to keep customer money in a Federal Reserve account, making it default-free, making it riskless from the perspective of financial intermediation. And meaning that you could have a much different, smaller, more bespoke regulatory framework that then meant that all the reasons why we regulate banks so tightly just don't apply. We regulate banks not because they take deposits alone, but because they combine deposit taking with financial intermediation, they use that money.

And if you take that element out of the equation, you can come up with a different regulatory framework that nevertheless does not pose any of the risks that things like bank capital requirements, FDIC, deposit insurance and the like are designed to address. The other side of what banks are arguing obviously is that, well, wait a minute, I need all of these deposits because that ultimately is how I make my bones by collecting those deposits, paying as little interest as I possibly can on them, and then using that money for the purposes of making loans that charge more interest. And there's a couple of responses to that. One is that, well, that's not entirely true. There's a lot of deposit funding in banks, but it's not all of their funding. And banks are in the unique position that when they make a loan, that also happens to make a new deposit.

At the same time, sometimes competition is a good thing and the losers are going to be the people who charge rents in uncompetitive markets, and that's banks. They're absolutely right. They are going to have to compete more. But that's kind of the point is that they're so used to not having to compete that their initial response to all of this is, wait, don't make me do this. I don't want to have to compete, because they're not good at it. And I feel for them, I really do. But if you like markets and you think that over time if properly regulated markets can yield improvements for consumer welfare, it's really not that much of compelling arguments at all.

Alan Kaplinsky:

Okay. So Dan, you've said, okay, one thing seems like an easy fix is to give the non-banks access to the Fed.

Dan Awrey:

Yeah, that's part one of the solution. And by no means do I think it's the only one.

Alan Kaplinsky:

Yeah. What are the other things that need to be done?

Dan Awrey:

So the second one you referenced a moment ago, and I sort of elaborated on, which is the development of an on-ramp for these non-bank financial institutions to then participate at the federal level in clearing and settlements. You can't just give everybody access and then walk away. You have to build a framework that limits the activities that these institutions can perform in exchange for access to that framework. But then the third big one, which comes from the entire other direction, is that the Federal Reserve needs to change both its outlook and potentially Congress needs to change elements of the Monetary Control Act to enable it to coordinate more in the development of infrastructure.

All of these banks, all of these FinTechs coming together need somebody sitting on top who can make longer-term decisions about what kind of rails to build, what sort of technology to build them on, and ultimately, how to make sure that those investments pay off for the people for whom that system is being built, namely consumers. Other countries that have moved past the United States in this regard, one of the key features, even where they've allowed a lot of private innovation is a level of public sector oversight and push towards that innovation.

So Brazil with its Pix system, really cost efficient system that's fundamentally changed payments in Brazil in less than two years. China had a great deal of initial cooperation from the People's Bank of China in building out platforms like WeChat Pay and Alipay. Central banks around the world have just been more proactive than the Fed in basically being a coordination mechanism that helped move the system forward in its technological evolution. The Fed is hamstrung in this regard currently. It's hamstrung by law. So the Monetary Control Act, at least by the Bank Policy Institute's reading greatly impinges on the ability of the Federal Reserve to coordinate in building any public sector infrastructure. Congress could change that, provide scope for a degree of coordination, if not necessarily direct competition. And then too, the mindset needs to change. For too long in the United States, there's just been and I experience that every day is somebody who's trying to agitate for change, is that people think there's just not a lot of skin in this particular game, that the payment system works good enough.

That existing impetus within the private sector is moving us forward at a sufficient pace in order to realize our long-term economic objectives. What's happening from my perspective of somebody who has, I guess, a more international outlook and one that brings together issues around not only domestic competitiveness, but also the international rule of the US dollar in the payment system, national security concerns surrounding payments and any money laundering in tariffs financing laws, is that the longer we delay, the farther and farther, farther we fall behind. And tiny numbers in the payment system add up to huge things. The sheer scale of the payment system and the law of large numbers means that that 40 cents on that burrito is cutting into the margins of my merchant making that burrito. Those tiny little bits of money that are leaving the economy and going towards these infrastructure providers that are not subject to competition and don't have sufficient impetus to develop and implement new technologies, are a drag on the economy.

As other countries move ahead of us, they're a drag on our international competitiveness. And given the incredible benefits that come with the dominance of the US dollar in international payments, protecting our competitive position there has huge knock on effects. If we ultimately find that we've fallen so far behind that the US dollar just becomes more difficult to use, and we start to see a shift in international currency usage. And so, all of this to me really points in the same direction, which is that these are huge and public benefits that can only be addressed by a more assertive force from the public sector using Congress. And I get to be Congress, so I'm definitely going to open up this system to more competition. But then in the process of opening up to more competition, I want to open up the public sector, the treasury, and the Fed to actually engage with and help to build the next generation of payment systems in the United States.

Alan Kaplinsky:

Okay. Ron, and do you have any closing remarks?

Ron Vaske:

I guess, Dan, one question, you're not Congress, are we going to get there?

Dan Awrey:

I don't think we are, no. I think if I read the tea leaves correctly, and I'm not a professional tea leave reader, there isn't a sufficiently tractable reason at this point to move forward. The one exception to this is all the work that's currently being done on Central Bank digital currencies where all of these issues are at play. But in my view, as somebody who's sort of deep in the weeds on all of this, we're still several years from finding out that that project is a white elephant, that it's not going to yield any of the benefits that we want it to. And that we could have gotten all of those benefits by upgrading the existing payment system instead of getting caught up in the FOMO of Central Bank digital currencies.

Alan Kaplinsky:

Okay. Well, we've come to the end of our program and first, Dan, thank you very much for being our guest today. I know I personally have learned a great deal and I'm sure our listeners have as well. So a pleasure having you on our program.

Dan Awrey:

This was really fantastic. Thank you, Alan. Thank you both for some great questions and I'm happy to come back on at some point, several years from now to say, I told you so about FedNow and the future of the US payment system.

Alan Kaplinsky:

Right. And Ron, my thanks to you as well for being a part of the show today. And of course, want to thank all of our listeners who are downloading this program. And to make sure that you don't miss our future episodes, subscribe to our show on your favorite podcast platform, be it Apple Podcast, Google, Spotify, or any other platform. We're on all of them. Don't forget to check out our blog, consumerfinancemonitor.com, for daily insights on the consumer financial services industry. There's generally three or four articles that get post in our blog every day. And if you have any questions or suggestions for the show, please email us at podcast, singular, podcast@ballardspahr.com. And stay tuned each Thursday for a new episode of our show. Thank you for listening and have a good day.