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Reforming the Federal Reserve, Part 3

A Glance at Interventions in Payment Services

By Nicholas Anthony

The Federal Reserve (the Fed) is widely known for its role in setting monetary policy, but far less attention is devoted to its role in the payments system.[1] As the central bank of the United States, the Fed has leveraged its position to simultaneously regulate and compete with financial service providers. In doing so, the Fed has slowly taken over many of these services.

These expansions can be seen in cash services, check services, wire services, automated clearinghouse services, real-time payments services, and the prospect of a central bank digital currency (CBDC). Time after time, the government accused the market of failing to serve the public to justify further interventions. Yet, in each of these instances, the common thread has not been a failure in the market. Rather, the common thread has been that government policies have eroded private enterprise and entrenched state-driven alternatives. Instead of continuing this history, it's time to unwind the Fed's role in this system and privatize payments.

CASH SERVICES

It is often said that the Fed was created in 1913 to put a halt to the panics and bank runs that occurred during the period of so-called free banking and followed during the period defined by the National Banking Acts of 1863 and 1864. Even today, policymakers point to tales of "wildcat banks" that collected deposits and then disappeared into the night as a reason why the government needed to step in and take over the provision of money.[2] However, this reading of history is misleading.

While it is difficult to put an exact number on the issue, wildcat banking was far from the norm during this era.[3] And to the extent such banks did exist, they were not the root cause of panics. The bigger issue was that—despite this era being labeled as a period of free banking—banks were required by law to take on risky investments and prohibited from branching across state lines.[4] When this concentration of risk led to failure, the government responded by consolidating the state-based banking system of banknote issuance into a national banking system and then consolidating that system

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further into one managed by the Fed.[5] In effect, this entry into payments became what would be the first of many examples of the government undermining the market and then inserting itself to fix the problem it had created.

CHECK SERVICES

Check settlement is another service that began when the Fed was first getting started. In general, check settlement involves collecting checks, processing the information, and then directing payments. As one might assume, there is nothing that inherently requires the government to intervene to accomplish this task. Rather, once again, this role is built upon the US government distorting the market.

As the story is often told, "[By] taking advantage of its nationwide reach, [the Fed] was uniquely positioned to streamline check collection." This unique position was not due to market failure. The problem was created by the US government—it was illegal until the 1990s for banks to branch across state lines.[6] The market did respond with clearinghouses and correspondent banks, but then the Fed undermined these solutions by not charging for its check processing services.[7] Nearly 30 percent of the Fed's employees were working on check processing in 1974, and yet it did so without fees.[8] In effect, "many local check clearinghouses could not compete and closed down." The share of checks processed by the Fed decreased when Congress required fees to cover costs in the 1980s, but the Fed had already carved out market dominance.[9]

WIRE SERVICES

The Fed also began providing wire services early in its history. The term "wire" is in reference to how the instructions for these payments were originally sent over telegraph wires. In its simplest form, however, a wire service is a way to have funds transferred between reserve accounts. As the Fed describes it, offering wire services was important in the early 1900s because the "US banking system was fragmented geographically" and "no single institution had national operations to act as an intermediary for payments."[10]

As with both cash and check services, this telling of history misses the fundamental issue. It was not a market failure that caused a lack of national operations. The root problem was instead that it was illegal for banks to branch across state lines. Had they been able to do so, both the necessary infrastructure and relationships could have been developed. Instead, the Fed's only advantage was that it was given legal privileges that tilted the playing field.

AUTOMATED CLEARINGHOUSE SERVICES

The Fed is one of two organizations currently operating an automated clearinghouse (ACH)—effectively, an electronic check collection system. Banks group outgoing payments (either credits or debits) into batches, send these batches to an ACH electronically, and then the operator of the ACH sorts through the payments to get the money where it needs to go.

The origins of the ACH system can be traced back to the late 1960s when private-sector associations began investigating improvements to check processing. In 1972, the first ACH association was formed in California with support from the Fed.[11] By 1978, the Fed managed a national network of ACH systems.[12] Across this system, the Fed subsidized services such that prices did not reflect the true cost of doing business.[13] Had ACH adoption depended on profit and loss, the system could have evolved into better, and more diverse, services. Instead, early government interventions effectively locked the US payments system into a less dynamic, less private system than what the market might have produced.

REAL-TIME PAYMENTS SERVICES

FedNow is a real-time payments system designed to allow banks to transfer funds instantly. Whether FedNow is really needed remains an open question. For years, the Fed shelved improvements that could have been made to its existing services. It was only after the private sector created a faster payment system that the Fed announced FedNow.

The Fed delivered a call to action in 2012: Payments needed to settle faster, more efficiently, and more effectively.[14] Over the next five years, the Fed convened task forces, held meetings, and published reports.[15] During this period, the idea of improving existing systems (e.g., expanding operating hours) repeatedly came up as a low-cost way to increase the speed of payments. Although the private sector introduced a new faster payments system in 2017, the Fed announced in 2019 that it would launch FedNow in 2023.[16] Seemingly repeating history, FedNow has cost $1.1 billion, but the Fed has waived monthly service fees and discounted transfer fees year after year. The law requires that the Fed recoup its costs. However, the Fed argued that pricing the service to recoup costs "would result in prohibitively high or unnecessarily volatile pricing."[17]

CENTRAL BANK DIGITAL CURRENCY

The United States does not currently have a central bank digital currency (CBDC), but the arguments for a US CBDC mirror the justifications used for the Fed's previous expansions. At its most basic level, a CBDC allows the public to make payments digitally in a system provided directly by the central bank. The creation of a CBDC would be another instance of the Fed intervening where it isn't needed.

Consider the argument that a CBDC would improve financial inclusion. Although many central bankers have made this claim, arguing that a CBDC is needed ignores the progress the private sector has made.[18] First, the rise of mobile banking has largely eliminated "inconvenient locations" as a reason for not having a bank account.[19] Second, many banks have worked to offer entry-level accounts with little to no fees so that people have an opportunity to build a banking relationship that was otherwise unaffordable. Third, alternatives like prepaid cards, fintech services, and cryptocurrencies have reduced the cost of living without a bank account. Put simply, the market is working. There is no need for the government to intervene with a CBDC.

RECOMMENDATIONS TO PRIVATIZE PAYMENTS

The Fed never should have taken over these payments services. It's time to end the Fed's involvement and return these functions to the private sector. Policymakers have two options: a direct solution and an indirect solution.

The most direct solution is to get the Fed out of the payments system entirely. At a minimum, that could mean separating functions such that the Fed does not simultaneously act as a competitor and a regulator. To better privatize payment functions, however, each of the services currently provided should be phased out of public services completely. Doing so would allow the private sector to take over services and minimize disruptions during the transition.

To ease the transition, services could be rolled back in reverse chronological order. Congress could begin by taking a US CBDC off the table. Then, attention could turn to FedNow, followed by ACH services, and so on. Doing so would allow the private sector to build upon the most familiar services before turning to services that had been taken over long ago.

An indirect solution is to strengthen legislation that was meant to level the playing field: the 1980 Depository Institutions Deregulation and Monetary Control Act. Among other things, this legislation was supposed to prevent the Fed from unfairly competing with the private sector, but it failed to set sufficiently binding constraints on the Fed.[20] By allowing the Fed to establish its own criteria for measuring success and then change the criteria as it goes, the law fails to adequately restrict the activities of the central bank. That much should be evident given the Fed's argument that adhering to the law's cost-recovery provisions as applied to other services would result in "prohibitively high" pricing.[21]

Congress should establish concrete deadlines so that the Fed is actually required to recover its costs when offering services. Furthermore, Congress should also require that the Fed's compliance with the Depository Institutions Deregulation and Monetary Control Act's cost-recovery provisions be subject to regular audits by third parties so that there is no question as to how the central bank covers its costs.

CONCLUSION

The Fed's role in the payments system may not get the same public attention as its role in monetary policy, but the expansions that have taken place over the past 100 years should not go unnoticed. Since the creation of the Fed in 1913, the market has been undermined by government favoritism, subsidized pricing, and barriers to entry. In doing so, the government has discouraged or outright prevented the private sector from building the financial infrastructure needed to support payments. If competition, innovation, and true inclusion matter, we must question why the central bank still runs payments—and demand it step aside.

NOTES

1. Due to limits on the word count of this publication, "the Federal Reserve" (abbreviated as "the Fed") is used to refer to both the Board of Governors of the Federal Reserve System and the regional Federal Reserve banks. Furthermore, this publication is meant to offer only a brief history of the Fed's interventions in the payments system.

2. For the purposes of this brief publication, banking history in the United States can be divided into three main periods: 1837–1862, 1862–1913, and 1913–present day. The first period (1837–1862) is what most people refer to when describing the US free banking experience. It was a time when state-chartered banks could issue their own notes, and it worked relatively well—far better than what has been claimed by critics. That began to change in the second period (1862–1913) with a series of federal government interventions. Among them, the combination of the Legal Tender Acts of 1862 and 1863, National Banking Acts of 1863 and 1864, and the Revenue Act of 1865 resulted in the US government issuing its own notes (the greenback), a system for federally chartered banks, the creation of the Office of the Comptroller of the Currency to oversee this new system, and a tax on notes issued by state-chartered banks. In short, 1862–1913 was a period of consolidation. The third period (1913–today) characterizes the completion of that consolidation with the creation of the Federal Reserve. Kevin Dowd, *The Experience of Free Banking* (Institute of Economic Affairs, 2023); George Selgin, "The Fable of the Cats," *Cato at Liberty* (blog), Cato Institute, July 6, 2021; and George Selgin, "Real and Pseudo Free Banking," *Cato at Liberty* (blog), Cato Institute, July 23, 2015.

3. George Selgin, "The Fable of the Cats," *Cato at Liberty* (blog), Cato Institute, July 6, 2021.

4. As George Selgin has documented, "The free banking laws of several states forced banks to invest in what [were] very risky securities—and especially in risky state government bonds—while the rule against branching limited their ability to diversify around this risk, especially by relying more on deposits than on notes. It was owing to these restrictive components of U.S.-style free banking that scads of American free banks ended up going bust." George Selgin, "Real and Pseudo Free Banking," *Cato at Liberty* (blog), Cato Institute, July 23, 2015.

5. Bruce J. Summers and R. Alton Gilbert, "Clearing and Settlement of US Dollar Payments: Back to the Future?," Federal Reserve Bank of St. Louis *Review* 78, no. 5 (September/October 1996).

6. "Check Payments," Federal Reserve History, September 28, 2023.

7. Bruce J. Summers and R. Alton Gilbert, "Clearing and Settlement of US Dollar Payments: Back to the Future?," Federal Reserve Bank of St. Louis *Review* 78, no. 5 (September/October 1996).

8. "Check Payments," Federal Reserve History, September 28, 2023.

9. Bruce J. Summers and R. Alton Gilbert, "Clearing and Settlement of US Dollar Payments: Back to the Future?," Federal Reserve Bank of St. Louis *Review* 78, no. 5 (September/October 1996).

10. "Fedwire," Federal Reserve History, August 28, 2023.

11. Terri Bradford, "The Evolution of the ACH," Payments System Research Briefing, Federal Reserve Bank of Kansas City, December 2007; and "History of Nacha and the ACH Network," Nacha, April 20, 2019.

12. James McAndrews, "The Automated Clearinghouse System: Moving Toward Electronic Payment," Federal Reserve Bank of Philadelphia *Business Review*, July/August 1994.

13. "At its inception, ACH processing required a very significant investment in computer technology. Only a large organization like the Federal Reserve System, with its established technical infrastructure and its extensive access to capital, was in a position to invest in a venture of this magnitude, for which the return was still uncertain. Moreover, the volume of payments at ACH's inception was not sufficient to justify the costs of the large initial investment for most companies." Bruce J. Summers and R. Alton Gilbert, "Clearing and Settlement of US Dollar Payments: Back to the Future?," Federal Reserve Bank of St. Louis *Review* 78, no. 5 (September/October 1996); Alan Greenspan, "Remarks at the US Treasury Conference on Electronic Money and Banking: The Role of Government," Federal Reserve Bank of St. Louis *Statements and Speeches of Alan Greenspan 1987–2005*, September 19, 1996; "ACH Shakeout: Two Players Retrenching," American Banker, December 3, 2002; Board of Governors of the Federal Reserve System, "Federal Register Notice: Federal Reserve ACH Deposit Deadlines and Pricing Practices for Transactions Involving Private-Sector ACH Operators," *Selected Regulations of the Board of Governors of the Federal Reserve System 1998–2015*, November 3, 2000; and "History of Nacha and the ACH Network," Nacha, April 20, 2019.

14. Sandra Pianalto, "Collaborating to Improve the US Payments System," Federal Reserve Bank of Cleveland, October 22, 2012, last archived July 17, 2024.

15. Sandra Pianalto, "Collaborating to Improve the US Payments System," Federal Reserve Bank of Cleveland, October 22, 2012, last archived July 17, 2024; "Payment System Improvement—Public Consultation Paper," Federal Reserve Banks, September 10, 2013; "Strategies for Improving the US Payment System," Federal Reserve System, January 26, 2015; and "Strategies for Improving the US Payment System: Federal Reserve Next Steps in the Payments Improvement Journey," Federal Reserve System, September 6, 2017.

16. "Federal Reserve Announces Plan to Develop a New Round-the-Clock Real-Time Payment and Settlement Service to Support Faster Payments," press release, Board of Governors of the Federal Reserve System, August 5, 2019.

17. "2023 FedNow Service Pricing Now Available," FedNow Explorer, Federal Reserve Banks, November 8, 2022; "Federal Reserve Announces That Its New System for Instant Payments, the FedNow Service, Is Now Live," press release, Board of Governors of the Federal Reserve System, July 20, 2023; "Payment System and Reserve Bank Oversight," *110th Annual Report of the Board of Governors of the Federal Reserve System* (Board of Governors of the Federal Reserve System, 2023); and Federal Reserve Bank Services, 89 Fed. Reg. 93584 (November 27, 2024).

18. As explained at length in my book, there are many other problems with the idea that a central bank digital currency would be a solution for financial inclusion. Nicholas Anthony, *Digital Currency or Digital Control? Decoding CBDC and the Future of Money* (Cato Institute, 2024).

19. Garret Christensen et al., *FDIC National Survey of Unbanked and Underbanked Households* (Federal Deposit Insurance Corporation, 2023).

20. The 1980 Depository Institutions Deregulation and Monetary Control Act touched on many issues. For example, it deregulated the financial system by removing caps on interest rates paid for deposit accounts. However, the law also increased regulatory burdens by requiring that all depository institutions meet reserve requirements. This requirement was previously limited to institutions with accounts at the Federal Reserve. The law also expanded the supervisory role of the Fed by authorizing it to require financial institutions to submit financial reports. Committee on Banking, Finance, and Urban Affairs, Depository Institutions Deregulation and Monetary Control Act of 1980, US House of Representatives, 96th Cong., 2nd Sess., Report no. 96-221, 1980.

21. Federal Reserve Bank Services, 89 Fed. Reg. 93584 (November 27, 2024).