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Pricing the Fed's Planned Real-Time Payment System: A Recent Announcement Defers a Painful Choice

Greg Baer | Feb. 2, 2022

Last week, the Federal Reserve released some pricing details on its FedNow service, which it projects to launch in some form next year. For those new to this game, FedNow is planned as a real-time payment service, and would serve as a rival to the RTP network, the real-time payment system operated by the Clearing House, which began operation in 2017 and now reaches 61 percent of all U.S. demand deposit accounts.

Before the RTP network launched, the Clearing House committed that it would offer the same pricing to all banks and credit unions, regardless of the volume they contributed to the system. (Since the Clearing House operates as a *de facto* utility and does not look to earn profits, that price is very low.) Flat pricing runs counter to general business strategy, which provides volume discounts. But as stated in the TCH RTP Business Principles as well as listed in the RTP Participant Fee Schedule, the largest bank pays the same fee to use the utility as a community bank or credit union. To date over 175 community banks and credit unions are live on the system with over 200 committed to join in coming months.

The RTP commitment served as insulation against antitrust concerns but was driven mainly by network effects. For a real-time payment system to realize its full potential, it needs to be ubiquitous: that is, anyone needs to be able to pay anyone else. While the large banks that own the Clearing House hold customer relationships with the businesses *sending* the vast majority of payments, consumers *receiving* those payments are banked by thousands of different banks and credit unions. To get them to sign on, TCH offers flat pricing, charged them nothing to sign up, and in some cases subsidized their participation.

Nonetheless, when the RTP network launched, some small banks objected to the notion that a major payment system would be run by a dozen or so large banks, and they and some Congressional allies importuned the Fed to build its own system, believing that they would do better with a government-run system than a private sector one. This plea dovetailed nicely with the desire of the Federal Reserve Banks to remain engaged in the payment system, as real-time systems will cannibalize their ACH system and deprive them of a core occupation.

Furthermore, those same critics expressed concern that the Clearing House provided one caveat to its flat pricing policy: it might offer discount pricing for large-volume users if a rival real-time payment system (that is, FedNow) were doing so.

A Fed system was never going to be a windfall, though, because the Fed operates its payment systems under an important legal constraint: the Monetary Control Act of 1980 requires it to recapture its costs, including all operating and float costs, imputed taxes and compliance costs, and a return on capital. In other words, the Fed cannot subsidize its payments operations with interest earned on its securities portfolio that otherwise would be returned to the taxpayer. In the ACH world, that has meant that the Fed charges community banks *more* than it charges large banks, because it needs the volume that only the latter can provide, especially given that its operating costs are significantly higher than those of the Clearing House.

So, last week, the Federal Reserve released its planned pricing schedule for its FedNow service. Of course, a lot of suspense had built up about what the Fed would say about volume discounts. And the Fed said … nothing. The prices it listed generally mirrored the pricing of the Clearing House's RTP network, and if that were that, the Fed could easily have made the same flat-pricing commitment that the Clearing House made five years ago. But it did not.

To be clear, this omission is perfectly understandable. The Fed will eventually have to face very unappetizing choices. It can maintain the pricing that it has announced – basically the same flat rates already being charged by the Clearing House – but with no hopes of attracting significant volume from large banks invested in a well-established RTP system that is operating seamlessly and nearing ubiquity. In that case, the Fed will be funding FedNow with taxpayer money, in violation of the Monetary Control Act. Alternatively, it could try to undercut Clearing House prices for the largest issuers in the hopes of somehow attracting their volume and earning back more of its costs, while earning the statutorily required return on capital by charging captive small banks more, as it does with ACH. That would be a political nightmare. Or the Fed could simply slash prices for *all* banks, operate at a significant loss until it drove its private sector competitor out of business, and then raise prices significantly. That approach would not only violate the Monetary Control Act and create a different kind of political nightmare, but likely invite litigation.

Wise minds at the Fed might consider a third option: repurposing FedNow as a warm backup to RTP for purposes of cyber resiliency but exiting a market where it is required to compete on level terms but at this point simply cannot.

We don't know how this will all turn out, but a prudent small bank or credit union might wish to study up on network effects and hedge its bets by clicking here. And now, not later.

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