Testimony of Sheila C. Bair
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Senate Committee on Banking, Housing, and Urban Affairs
"Facilitating Faster Payments in the U.S."
September 25, 2019

Chairman Crapo, Ranking Member Brown, members of the Committee. Thank you for the opportunity to testify today to present my personal views on the need to facilitate faster payments in the U.S. I applaud the Federal Reserve Board's recently announced plans to build "FedNow" --an interbank settlement system to support real time payments. This initiative by the Fed will provide the foundation upon which to build the next generation of instantaneous payment services, in partnership with the private sector. At the same time, the Fed's operational involvement will ensure that the payments system of the future is resilient, safe, and broadly accessible on fair and equitable terms.

Payments are the lifeblood of an economy. Any major disruption in the ability of households and businesses to transfer funds in payment of goods and services would have catastrophic results. As such, our payments system is an essential public utility and like other public utilities, cannot be left solely in the hands of private enterprise. This is why the Federal Reserve has long played a core role in payment services, typically operating alongside and in support of private sector systems.

The current payments system is fraught with frictions and inefficiencies. When we send money, the withdrawals from our bank accounts are usually immediate. However, it can take days for the money to go from our banks to recipients' banks where the funds can be accessed. The wait creates costs and hardships, particularly for households and small businesses on tight budgets- for the house keeper waiting for her clients' check to clear before she can pay her rent, or the small business waiting for a customer's check to clear before it can pay its workers. These delays in payments can lead to a cascade

of negative consequences, including forcing households and businesses to rely on expensive forms of credit to tide them over, such as overdraft protection or payday loans.

A handful of financial technology startups have tried to provide real time payment services, but they are limited networks, typically working only if both the sender and recipient are subscribers and/or have accounts at participating banks. Moreover, they still rely on legacy systems to settle funds between banks. This results in a buildup of obligations between sending and receiving banks, as the actual transfer of payments between banks can take several days. If allowed to grow, this complex of IOUs among banks is a potential source of fragility in our payments infrastructure that could present significant risks in times of stress.

In 2017, a group of large banks under the auspices of The Clearing House or TCH launched a real time payments platform called the RTP Network. This network aspires to achieve the ubiquity lacking with fintech initiatives. It requires participating banks to pre-fund a joint account that stands behind payment transfers. Debits and credits are tracked in a centralized ledger maintained by TCH. As yet, RTP has failed to gain significant traction, with relatively low volumes and few banks participating beyond mostly the big ones which own TCH. Importantly, its safety and resilience is heavily reliant on the larges banks which built and back it.

What's needed- but what the private sector has yet to deliver— is a trusted and universally available infrastructure that would allow banks and credit unions of all sizes to send and receive money in "real time". After years of study and public outreach, the Fed has now decided to develop and launch such a system: FedNow. The Fed is already connected to virtually every depository institution in the country and thus is well-positioned to provide the basic infrastructure to move money quickly between banks.

Not surprisingly , the Fed's decision has been widely applauded by smaller institutions and fintechs, but roundly criticized by TCH and its advocates, who argue that FedNow will unnecessarily compete with the RTP Network and stifle innovation.

History has shown the folly of exclusively relying on big Wall Street banks for financial infrastructure. Indeed, one political catalyst for Congress creating the

Federal Reserve System in 1913 was the inability of midwestern farmers to access funds during planting season. The large New York institutions rural banks then relied upon to keep their reserve deposits had a bad habit of lending those funds to securities speculators, instead of keeping them safe and readily accessible. Currently, nearly all major payments systems -including those for processing checks, facilitating direct deposits, and wire transfers — depend on both private and Fed systems.

Smaller depository institutions and fintechs are understandably wary of a system controlled by big bank competitors. For now the TCH has promised its system will be accessible to all on fair and equitable terms, but will those promises hold in the future if they achieve market dominance? Until recently, the TCH website acknowledged its pricing could change if it has to "react competitively". The Federal Reserve lacks regulatory authority to require TCH to make its system accessible to everyone or regulate its fees to prevent anti-competitive pricing.

FedNow will promote competition, not stifle it, by protecting against potential anti-competitive behavior by TCH or any other dominant private actor of the future. The Fed wants private sector innovation. Indeed, it worked closely with TCH to set up the joint account which underpins the RTP Network. And it is exploring making its current wire and net settlement services available on a 24x7x365 basis to support private initiatives to provide faster payments around the clock. But the Fed wants multiple players in this space, competing on fair terms. With FedNow, it will give all depository institutions and their fintech partners a ubiquitous infrastructure upon which they can build their own platforms and services.

Some critics have scoffed at the notion that "government bureaucrats" at the Fed could come up with an innovative new system, and point to the fact that FedNow is not expected to launch until 2023 or 2024. Given the Fed's long history in payments, the expertise of the Fed's staff is unparalleled, while private sector innovation in this space has been sluggish. Work on the TCH system started in 2014. It did not go live until 3 years later, and TCH acknowledges that it will not be easily available to all depository institutions until the end of 2020. The widely used ACH system, which facilitates direct deposits, took 6 years to develop during the late 1960's and early 1970's, and even longer after it was developed to mature in its current widely used form. Four to five years does not seem like an inordinate amount of time to

build FedNow, particularly given the Fed's commitment to work with all industry stakeholders and fully explore use of new technologies to construct the system.

Perhaps most importantly, FedNow will promote financial system resiliency. As we discovered in 2008, big banks can fail. The Fed cannot. The TCH has tried to construct a system that comes close to replicating central bank settlement, but it is not the Federal Reserve. We hope that post-crisis reforms will prevent the failure of large, systemic institutions in the future, but we cannot be sure. Only the Fed has the institutional capability and proven track record to operate under the most highly stressed conditions. Without a backup system, a failure to fund RTP's joint account by a major bank could impact continuity in payment services for millions of Americans. This could leave taxpayers with a conundrum similar to the one they faced in 2008: bail the banks out or expose households and businesses to disruptions in essential payment services. If the big banks were truly interested in the resiliency of the financial system—and rebuilding trust with the public-- they would be applauding FedNow as a parallel system that could serve as a backup to their own. FedNow would also serve as an important backstop to potential operational breakdowns in the RTP system, including compromise of its centralized ledger.

Finally, while I strongly support the Fed's decision to build "FedNow" let me also express the hope that the Fed fully explores the use of digital currency, including a cryptocurrency based on distributed ledger technology (DLT), in effectuating real-time settlement between banks. As I have written in the past, the Fed should consider development of a Central Bank Digital Currency (CBDC) that could eventually be used by members of the public to transfer money directly between each other without the need for bank intermediation and its attendant costly fees. If based on DLT, such a system promises to be more secure, efficient and less costly than intermediated systems that rely on centralized ledgers and master accounts. Given the permanence and immutability of DLT, it could also provide important law enforcement benefits. In moving toward such a system, using DLT to support settlement between banks might be a good place to start.

Importantly, major private sector proposals, such as Facebook's recent proposal to create a new global cryptocurrency called "Libra" rely on DLT. Libra faces many roadblocks. However, even if the Facebook initiative

fails, it certainly won't be the last private sector attempt to leverage DLT to dominate global payments. If the Fed does not stay ahead of this rapidly maturing technology, I fear private sector efforts to eclipse fiat monetary systems will get ahead of them, with potential disruptions to our banking system and in a worst case scenario, loss of control of our own currency. Since leaving the FDIC, I have become involved as a board member or advisor to a number of financial technology startups developing use cases for DLT ranging from securities to mortgages to gold to a stable coin tied to the dollar. While the promise of such technology is great, I am convinced that when it comes to payments, the Federal Reserve is in the best position to utilize it in a way that maximizes the public good.

Whether the threat comes from big banks or big tech, private interests should not dominate payments services so crucial to the financial well-being of the public. They should have the right to compete, but not monopolize, how we move our money. Only the Fed has the resources, expertise, and public mandate to build a payments system infrastructure that can capture the benefits of private innovation while ensuring a competitive playing field and most importantly, a stable system that will serve the public during good times and bad.

For the Committee's information, I have attached some of my previous writings on Facebook's Libra and the need for a CBDC.

I would be happy to answer the Committee's questions.

Attachments:

https://finance.yahoo.com/news/fed-libra-sheila-bair-160930832.html

https://finance.yahoo.com/news/former-fdic-chair-fed-needs-get-serious-digital-currency-131756819.html

Why the Fed should oversee Facebook's Libra

Sheila Bair
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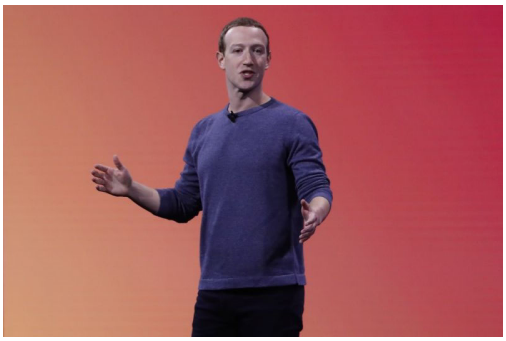
Facebook (FB) Mark Zuckerberg's recent announcement of ambitious plans to launch a new, global cryptocurrency called Libra has been met with understandable alarm, particularly among regulators and consumer advocates.

Much of the controversy has centered around antitrust issues, consumer privacy, and the ability of crooks to anonymously use the system for illicit purposes. Those are all legitimate concerns, but to my mind, the biggest risks are financial, both to users of Libra and the financial system as a whole. Those risks include the possibility of bank runs, credit disruptions, or consumer losses arising from foreign currency risks or financial mismanagement of the Libra reserve. The best way to understand these risks is to follow the money.

Buying and redeeming Libra

Let's start with the process of buying and redeeming Libra. Most cryptocurrencies, including the granddaddy of them all, Bitcoin, have failed to gain widespread acceptance as a method of payment because of their volatility. Zuckerberg hopes to avoid this problem by backing Libra with a reserve of stable world currencies, including the dollar, Euro, and Swiss franc. So you can buy Libra with pretty much any fiat currency — a U.S. dollar, Brazilian Real, Mongolian Tugrik, Indian Rupee — but the amount of Libra you receive will depend on the exchange rate between your currency and the basket of currencies in the reserve at the time of purchase. When you want to redeem your Libra back into your fiat currency, you may get more. But you may also get a lot less, particularly in developing countries with unstable currencies. It will depend on the exchange rate at the time of redemption.



Facebook CEO Mark Zuckerberg makes his keynote speech during Facebook Inc's annual F8 developers conference in San Jose, California, U.S., April 30, 2019. REUTERS/Stephen Lam

Let's say you still want to buy this hip new digital coin, regardless of the foreign exchange risk. Where do you get the money? For citizens in the U.S. and other developed countries, the money will probably come from your bank account. It's not going to hurt the banking system if you withdraw a few hundred a month for Libra transactions. But what if everyone decides they want to replace their bank accounts with Libra? After all, this would be a great way to avoid checking account fees. Retailers will love Libra as a way to avoid paying network fees on debit and credit card transactions. All of a sudden, that giant sucking sound is money coming out of the banks and into Libra's kitty.

You may think, “Fine. Let’s stick it to the banks. Look what they did to the economy in 2008.” But most of that money you withdraw from the banks is money they will no longer have to lend to the economy. So as Libra captures your cash, banks have less to make loans. With a run on the banks, we also get a credit contraction.

What happens after Libra has your money?

Now Libra has your money (not the banks) and you have your digital coins. What will Libra do with your money? Libra’s white paper says your digital coin is safe because it will be backed by a basket of the most stable world currencies. But it’s not as if Libra will be purchasing paper money in each of these currencies and piling them in a bank vault. What this really means is that Libra will be taking your money and investing it in instruments denominated in those currencies.

The return on these investments is how Facebook and other Libra founders will make money. Thus they will have incentives to invest in instruments that will maximize those returns, which may or may not maintain the stable value Libra’s founders are promising. The white paper promises to invest in low volatility assets such as bank deposits and short-term government securities, using “investment grade” financial institutions as custodians. (Reminder: Lehman Bros had an “A” rating from Standard and Poor’s before its collapse in 2008.) But there is no regulatory body to ensure that it does so, nor to require that Libra’s sponsors put up any of their own capital or reserves to backstop those investments if they go sour.

People stand next to windows above an exterior sign at the Lehman Brothers headquarters in New York in this September 16, 2008 file photo. REUTERS/Chip East/Files (UNITED STATES BUSINESS EMPLOYMENT ANNIVERSARY) In essence, Libra proposes the failed business model used by money market funds prior to the financial crisis. It wants you to buy Libra on the promise that the coin will maintain stable value, but there will be no regulatory oversight of what Libra actually does with your money and no capital and liquidity requirements that you would typically find with a bank. That structure proved disastrous during the 2008 crisis, when the Reserve Fund, a money market fund that heavily invested in Lehman Bros debt, “broke the buck” and prompted widespread runs on other money market funds.

A big re-allocation of resources

Even if Libra keeps its promise to put your money only in relatively safe bank deposits and government securities, we still have a problem. If the money comes out of banks (where it supports private sector lending) and goes into government securities, we would see a massive re-allocation of resources from the private to the public sectors. If you believe (as do I) that the market is generally a better allocator of economic resources than the government, this re-allocation will serve as a drag on economic growth.

Libra says it will also put your money into bank deposits. Bank accounts have the advantage of maintaining stable value. Your bank account balance doesn’t fluctuate as would a securities investment. And perhaps this helps with our bank run problem. You take money

out of your bank to buy Libra. Libra puts yours and other users' money into other banks, which will presumably use it to make loans.

But banks do fail, and depositors take losses on their uninsured deposits. So while Libra is saying it's offering a better alternative to banks because it won't be taking risk by lending out your money the way banks do, it will be putting at least some of your money right back into banks of its choosing. When you withdrew money from your bank to buy Libra, you probably had less than $250,000 in your account, meaning it was fully protected by the FDIC. But Libra's founders hope to have a global reserve of hundreds of billions of dollars. Even if they spread the funds among multiple banks, at those levels, the lion's share will likely be uninsured.

The need for regulation

Anyone who has followed my writings on blockchain knows that I'm enthusiastic about the use of distributed ledger technology to remove frictions in the payments system. So I don't mean to sound too negative. The problem is, so long as cryptocurrencies have to rely on fiat currencies to maintain stable value, they will be exposed to the same kinds of risks embedded in the banking systems that support those currencies. I believe most of these risks can be addressed with thoughtful regulation. But before Mark Zuckenberg or anyone else tries to create his own global currency, we need to settle on an adequate regulatory framework to govern them.

WASHINGTON, DC - JUNE 19: Federal Reserve Board Chairman Jerome Powell speaks during a news conference after the attending the Board's two-day meeting, on June 19, 2019 in Washington, DC. Powell said the Fed will keep rates steady and hinted at a possible rate cut later in the year. It would make sense for Congress to give the Federal Reserve Board lead authority for overseeing Libra, given its responsibility to conduct monetary policy and oversee an effective and efficient payments system. It is also an experienced financial supervisor, well-equipped to develop capital and liquidity requirements for Libra and other such ventures. In exercising that authority, the Fed could build on the pioneering work of the New York Department of Financial Services which currently regulates two trust companies which have successfully launched stable coins backed by the U.S. dollar. (Disclosure. I serve on the board of one of those trusts, Paxos.)

Technology has the potential to dramatically change how the world pays for things in the future. Whether that transition is beneficial to consumers and businesses or financially disruptive will depend on whether regulators can stay ahead of this potentially rapid transformation. It's open to question whether Mark Zuckerberg and Facebook are the right stewards for a new global cryptocurrency. But by firing this warning shot to government policy makers that such a change is coming and potentially coming soon, they have done a public service.

Sheila Bair is the former Chair of the FDIC and has held senior appointments in both Republican and Democrat Administrations. She currently serves as a board member or advisor to a several companies and is a founding board member of the Volcker Alliance, a nonprofit established to rebuild trust in government.

Former FDIC chair: The Fed needs to get serious about its own digital currency

Sheila Bair
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NOTE: This post was originally published on June 8, 2018.

Last week's market volatility reminds us — again — of the fragility of modern-day financial systems. In just the past decade, we've experienced our own subprime crisis, followed by Europe's sovereign debt crisis, followed by assorted calamities in Portugal, Venezuela, Russia, Ukraine, Brazil, and now the risk of Italy exiting the Eurozone.

Lack of confidence in our banking systems motivated the mysterious Satoshi Nakamoto to develop bitcoin. He (she, they?) originally intended it as a widely accepted method of payment that could function completely outside of the banking system. Unfortunately for M. Nakamoto, bitcoin has failed miserably as a method of payment. Its extreme volatility has made it popular as a speculative investment and store of value, but who wants to pay for something in bitcoin when its value could double in a month, or accept it as payment if its value could just as precipitously drop?

A radical idea that's gaining credibility

But what if the Fed or other central bank issued their own digital money? Though it sounds radical, the idea is gaining credibility among an increasing number of mainstream economists and central bankers themselves. Presumably, a central bank-issued digital currency (CBDC) would be as stable as traditional fiat currency, while reducing the risk of financial crises and improving monetary policy tools. To be sure, a sudden, wholesale shift from bank accounts to CBDC could have severely negative consequences for credit availability given banks' reliance on deposits to fund loans.

Former FDIC director Sheila Bair on Capitol Hill in Washington June 26, 2013. REUTERS/Yuri Gripas

Consider the current bank-dominated payments system. Institutions and individuals place most of their ready cash with banks, either through deposit accounts (a portion of which is FDIC insured) or by purchasing banks' short-term debt. The system works smoothly under benign conditions, but in times of extreme stress, people lose confidence in their banks. So they pull their uninsured money out of the banking system, disrupting the free flow of payments. This problem of "bank runs" is as old as banking itself, and has yet to be fully conquered, notwithstanding the advent of deposit insurance.

However, suppose consumers and businesses could convert their bank deposits into a digital currency that would be issued and backed by the Fed? Let's call it FedCoin. They would no

longer need to worry about bank instability. Since the Fed can print its own money, by definition, it can always make good on its financial obligations. What's more, the costs and inefficiencies in the current payments system would be greatly reduced. Consumers would no longer need to maintain checking accounts, with their expensive maintenance and overdraft fees, to effectuate payments. At the same time, businesses accepting Fedcoin could avoid the interchange fees charged by banks and their card networks — fees that are particularly burdensome to small firms.

A better tool to conduct monetary policy

Importantly, the Fed would have much more effective tools for conducting monetary policy to address economic cycles. The Fed now manipulates the money supply through buying and selling securities with a select group of big banks and by paying them interest on the reserves they deposit at the Fed — currently a tidy 1.75%. When the Fed wants to stimulate the economy — as it did after the crisis — it buys securities from these banks and reduces the rates it pays them on reserves, inducing them to lend the proceeds to the real economy to get a better return. When it wants to raise rates — as it is doing now — it reduces its holdings of securities and increases the rates it pays on reserves.

This is a nice deal for the banks, but hasn't done a whole lot to help the rest of us. The past 10 years are proof positive that current monetary tools are woefully inadequate to stimulate broad-based economic growth. The super rich have gotten a lot richer, while the middle class has struggled.

But imagine that we all held interest-bearing FedCoin. During inflationary periods when the economy is overheating, the Fed could raise rates on interest which would be paid directly to the general public, giving us an incentive to put more savings into FedCoin and spend less. During recessionary periods, the Fed could reduce the interest rate on that currency, giving us more incentive to spend to stimulate economic growth. If the Fed reduced rates to zero and the economy still spiraled downward, it could issue special digital coins that would disappear, within a time certain, if not spent on consumption. This would be much more effective stimulus than the deficit-funded tax and Social Security refunds we employed during the Great Recession. Instead of spending that money, most people either saved it or paid down existing debt.

Why the Fed needs to stay ahead of this technology

This may sound like monetary nirvana, yet FedCoin could have major disadvantages as well. The biggest is disruption to credit availability. Over $10 trillion is currently deposited in demand deposit accounts with banks. This is money banks use to lend to consumers and businesses, but could theoretically disappear if the public moved their all of their bank transaction accounts into FedCoin. Yet, this risk could be mitigated by limiting the amount of FedCoin issued and allowing banks to compete with FedCoin for deposits (though they might have to offer better rates and service to do so).

Many central banks — including those in the UK, Singapore, China, and Sweden — are proactively evaluating the merits of a central bank-issued digital currency. Meanwhile, tech geniuses in the private sector have not given up on Nakamoto's original vision to create a privately issued, stable digital currency that could be widely used for payments. Perhaps the

most well-publicized effort is Basis, a startup backed by such luminaries as billionaire investor Stanley Druckenmiller and highly regarded former Federal Reserve Governor Kevin Warsh. Basis's algorithm stabilizes its value by issuing more of the currency when the price goes up relative to the dollar, and buying it back when the price declines.

It is far from certain whether Basis or similar private sector efforts will be successful, at least in the short term. However, think of the ramifications if they were. Retailers, large and small, loathe paying interchange fees on card transactions, as much so as consumers hate getting trapped in high account fees. One can imagine they would be eager to start using digital currency as payment, bypassing the banks. That could prompt a different kind of run on banks, as fiat money quickly migrated out of deposit accounts into digital coins.

That would be very bad for the banking system, but also the Fed, as its current monopoly on currency issuance would be threatened, as would its ability to control the money supply. To avoid that result, the Fed needs to get serious now about evaluating the relative merits of issuing its own digital currency. If it does not stay ahead of this technology, not only could banking be disrupted — but the Fed itself could also be at risk.

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