

Payments the Hidden Tool for Policy

Aaron Klein

Senior Fellow, Brookings Institution

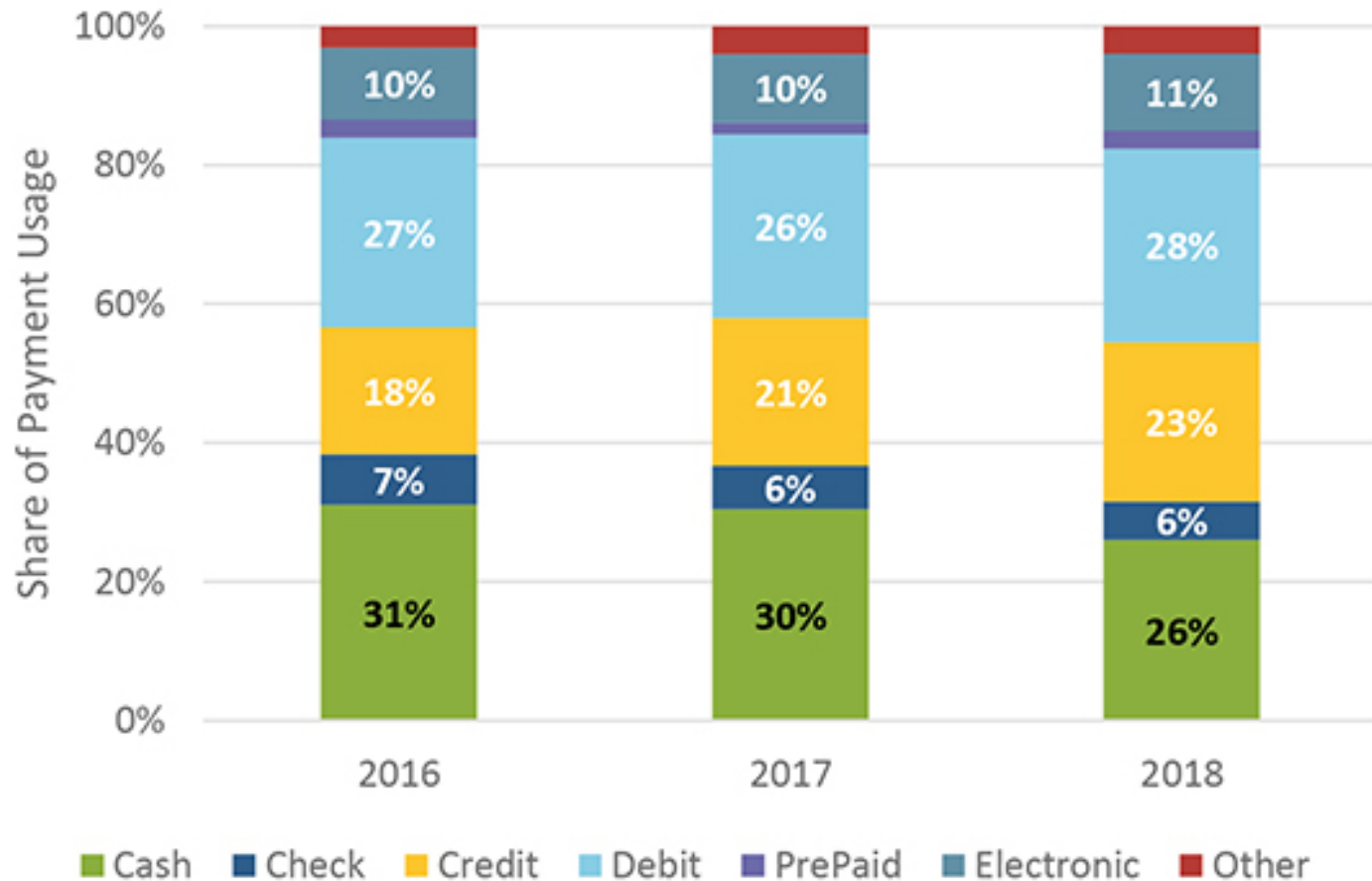
What is Money \$

- **Correct:** Money is a system of debits and credits that requires third party acceptance without prior party consent.
- **Wrong:** Money is a medium of exchange
- **Digital Money:** All forms of money that are transacted digitally: cards, electronic, and digital currency.
- **Physical Money:** Cash and checks, anything that require a process to become digitized

Money Requires Payments

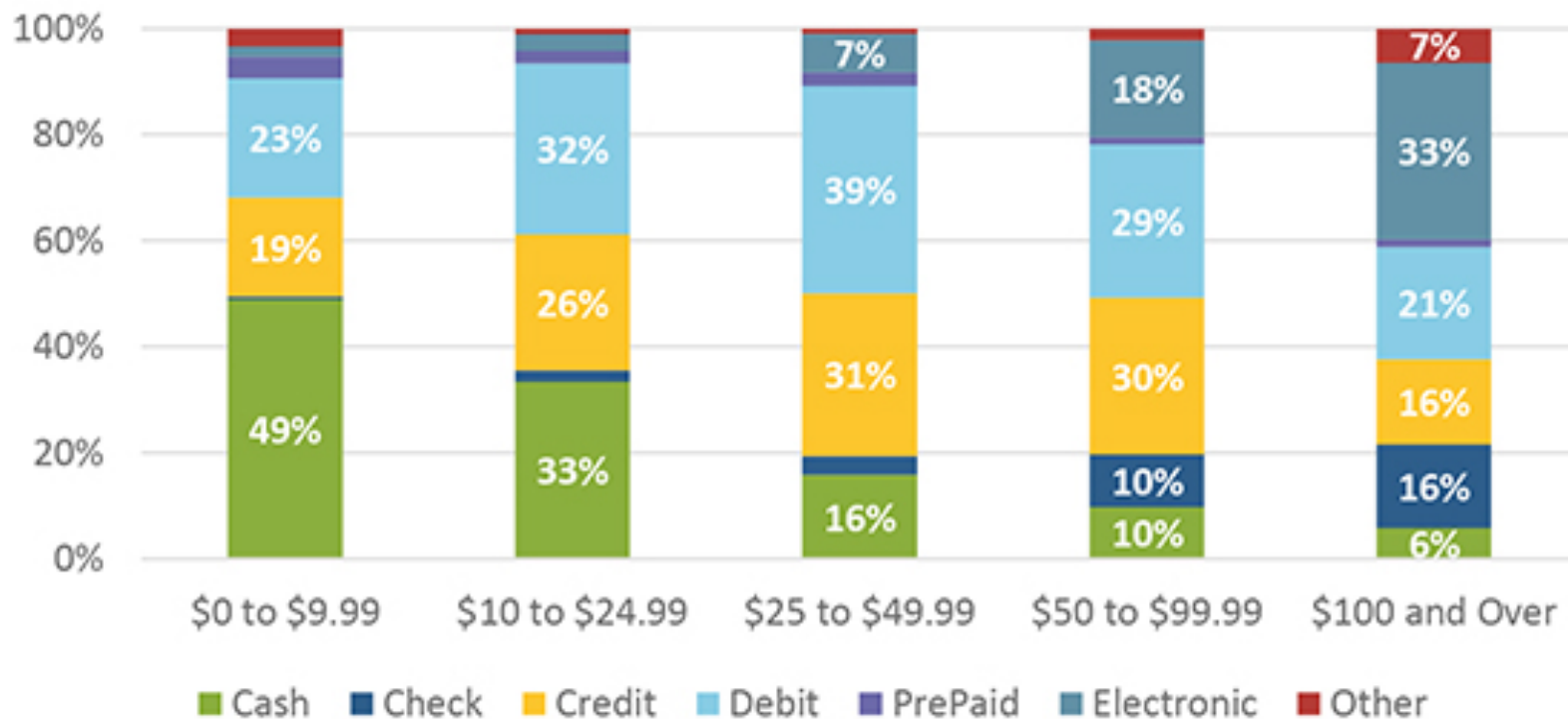
- The payment system is used to settle debits and credits
 - Payment systems should be thought of as an aspect of money as payments are a prerequisite for money.
- Electronic payment systems dominate as most money is moved electronically.
 - Growing trend propelled by technology, accelerated by COVID.

Share of instrument usage for payments



Source: 2019 Diary of Consumer Payment Choice, Federal Reserve

How you pay highly correlated to how much it costs



Payments as Policy Tools

- 1) Economic Redistribution. America's payment system increases economic inequality.
 - Underappreciated and hidden in plain sight.
- 2) Tool of social policy domestically and foreign policy internationally.
 - Knowingly done on an increasing but haphazard set of objectives.

Payment System Promotes Income Inequality

1) Growth of tax-free rewards on credit cards available only to the wealthy (by design).

-- Rewards paid for by increased costs born by middle/lower income debit/cash users and merchants.

2) High fees/costs on people with liquidity constraints: people living paycheck to paycheck.

— Examples: Overdraft, check cashing, payday lending

America's payment system has become a silent reverse Robin Hood system:

Rewards come in all flavors, but who is really paying for them?

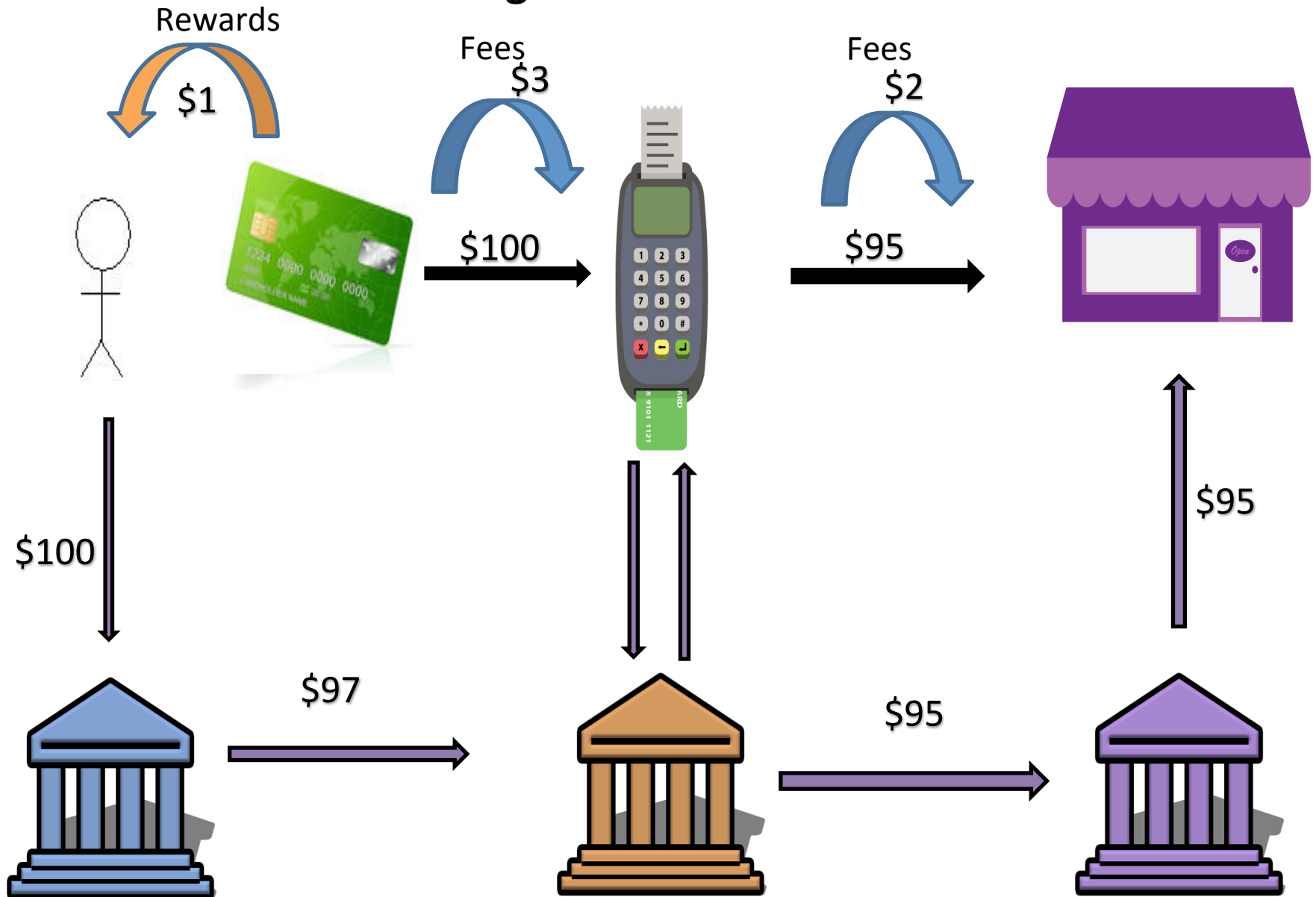
Average Credit Score by Income⁹

Annual Income	Average FICO Score
\$50,000 - \$74,999	737
\$30,001 - \$49,999	643
\$30,000 or less	590



Source: <https://www.americanexpress.com/en-us/credit-cards/credit-intel/credit-score-by-age-state/>

High End Credit Card



Richie Rich

Spends \$100,000 on a luxury credit card

Earns 1.5% cashback →
\$1,500

Pays no taxes on that

Pre-tax earnings: \$2,500--
\$3,000



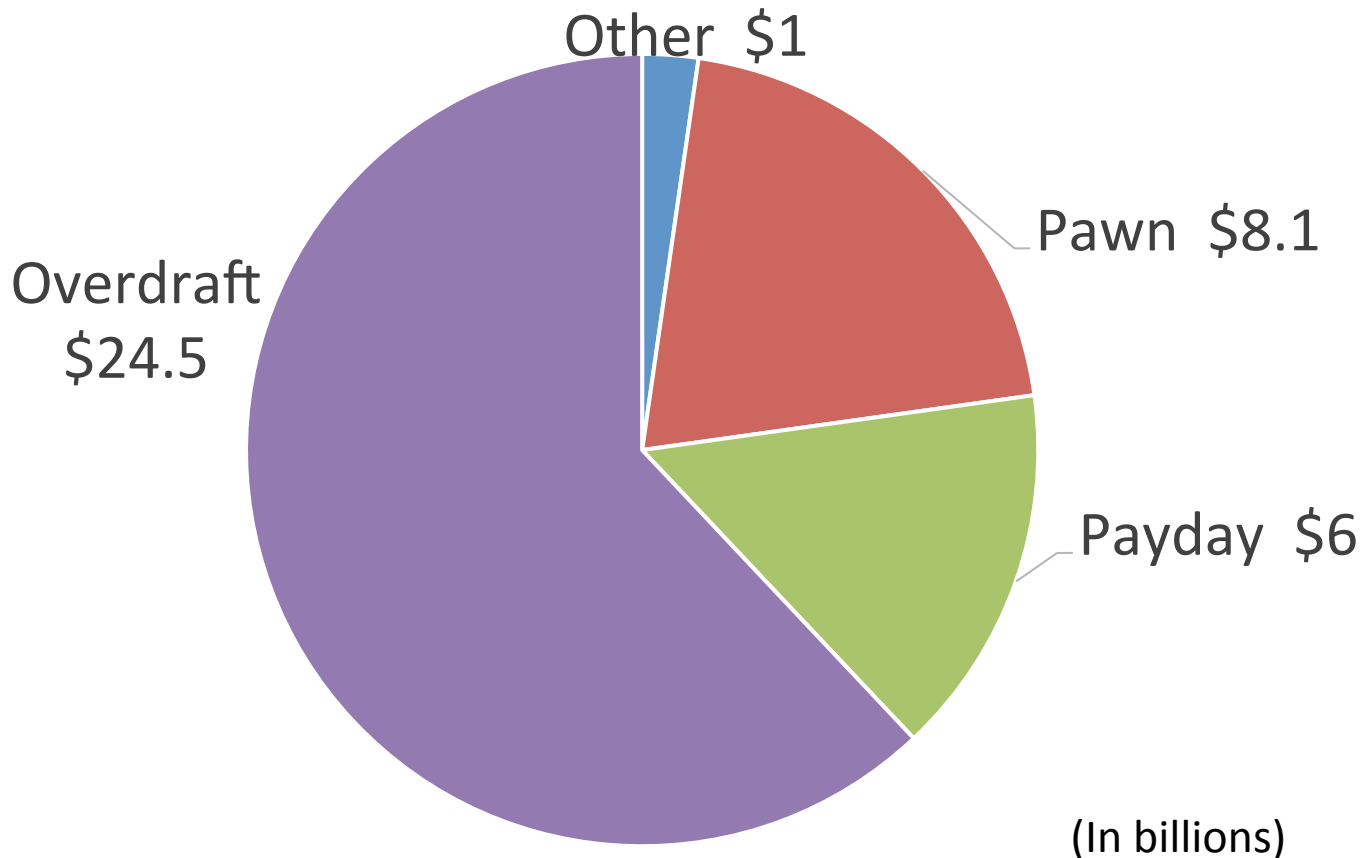
Joe 6 Pack

Spends \$10,000 a year on a debit card

Gets 4 overdrafts a year: \$35
each = \$150



Consumers spent **\$40 billion** on fees and interest for single payment loan products



Source: 2017 Financially Underserved Market Size Study, Center for Financial Services Innovation

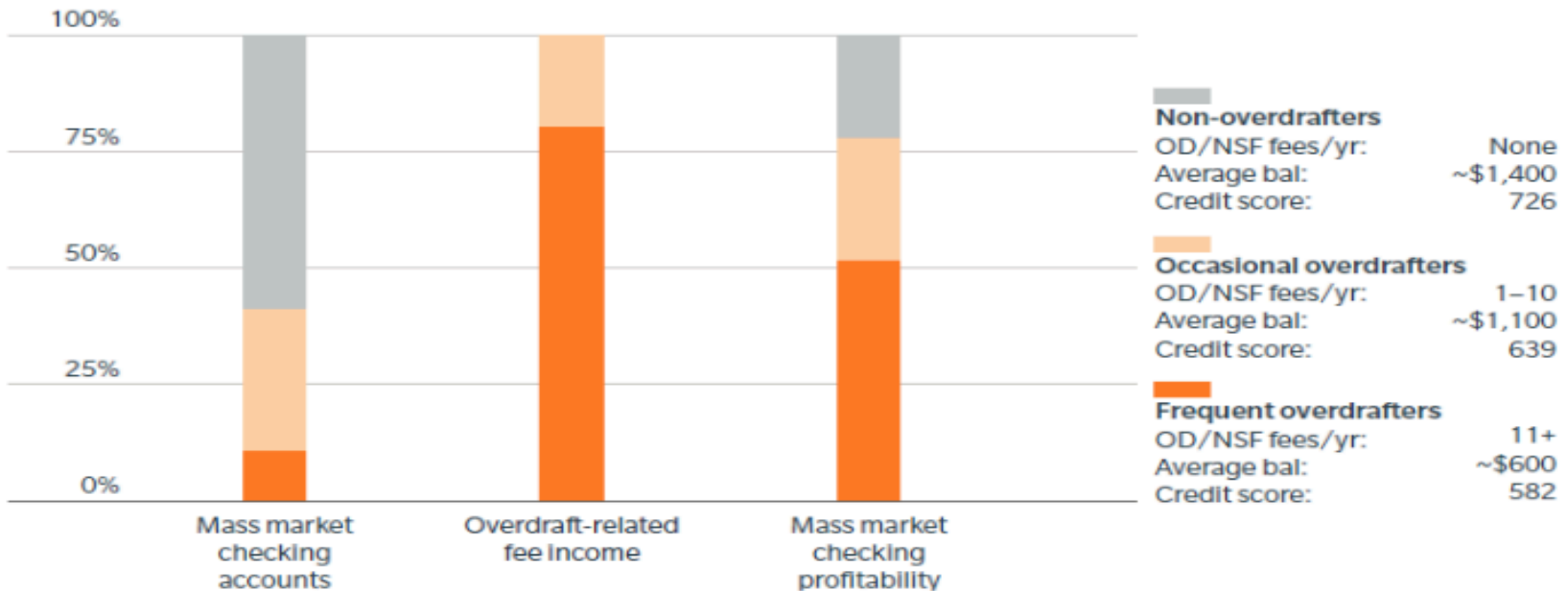
Payment System Drives Check Cashing not 'unbanked'

Share of Population Used Check Casher Adjusted share

	Share of U.S. population	Use Check Cashers (%)	Population adjusted use of check cashers	Share of checks cashed
Banked	94.6	4.0	3.8	70%
Unbanked	5.4	31.9	1.6	30%

Free Checking – Paid for by Overdraft

FOR MASS MARKET CHECKING



Source: CFPB ("Data Point: Frequent Overdrafters", Aug 2017), Bank Call Reports, Oliver Wyman analysis

<9% of bank customers are frequent overdrafters accounting for almost 80% of all overdraft revenue.

100% of overdrafts come from customers who run out of money in their bank account.

Payments Tool of Social Policy

“Why rob banks? Cause that’s where the money’s at” – Willie Sutton

Crime tends to involve money. The payment system can have tremendous value for policing society. But should it?

Payments Policy Changing: Equilibrium

- Old Equilibrium: law enforcement search for criminals and then use the payment system to identify crimes/criminals for prosecution
 - Regime based on knowing your customer (KYC), tracking and reporting suspicious activity (SARs, CTRs, etc...)
 - Ex: Dennis Hastert, Mike 'the Situation' Sorrento
- New Equilibrium: payment system searches for and actively blocks criminal activity

On-line Poker: Payments Transformed

- On-line poker crazy swept America in 2000s
 - Number of players doubled every year 2003-2006
- Unlawful Internet Gaming Act 2006
 - Requires payment system to identify and kickoff internet wagering. Treasury and the Fed responsible for regulations.

UIGA is a big deal

- Congress places burden on the payment system to police activity.
 - Large bipartisan support 409-2 vote in House
- UIGA “requires certain participants in the designated payment systems to establish policies and procedures that are reasonable designed to identify and block or otherwise prevent or prohibit restricted transactions.”

Payment system used to restrict activity

State Licensed Cannabis: \$15 billion industry in 2021, but less than 1% of banks and credit unions will touch it, even though they are allowed to.

- Access to the payment system is frequently denied and when available very costly to cannabis companies.
- Stated policy is compliance with AML/KYC/BSA regulations. But if the goal is to identify criminals there is an easier way: Google maps.
- Payment system used again as a gatekeeper.

More Payment System Restrictions

- Money transmission/remittances face growing de-risking threat (Barr, Klein, Gifford 2018)
 - GAO found money transmission losing access to banking system for multiple countries as “several banks reported they had closed the accounts of money transmitters because of the high cost of due diligence actions they considered necessary to minimize the risk of finds under the Bank Secrecy Ac regulations.”
 - “As banks’ appetite for risky and less profitable business has declined, new challenges are being introduced that could halt, or even reverse, the progress of financial inclusion... This is especially the case for the most vulnerable groups like women.” (Oxfam 2015)

International Payment Police

- Use of the dollar as world reserve currency makes access to America's payment critical.
- America is increasingly relying on its payment system as part of 'tougher sanctions'
 - Provides tool to cut off foreign countries and firms
 - Provides financial intelligence

Special Report: How the Federal Reserve serves U.S. foreign intelligence

By Jonathan Spicer

12 MIN READ



NEW YORK (Reuters) - The Federal Reserve's little-known role housing the assets of other central banks comes with a unique benefit to the United States: It serves as a source of foreign intelligence for Washington.

"The U.S. has thus found payments systems, and the financial system in general, a useful tool to combat crime and to enforce foreign policy."
Leibrandt and De Teran (2021)

Dollars for Policy

- Ability to clear in dollars is required for all international banks. Access to dollars can be denied by US lawmakers and regulators.
- New sanctions policies (Iran) threaten global banks access to US dollars.
- Globalization increases payments leverage compared to Cold War era.

FinTech Future: Threat or Savior?

- Crypto: Non-state money now possible.
 - Ability to have a monetary instrument without a central government could be attractive for a group of nations who want to move away from dollars but lack an alternative.
- Central bank digital currency: is the dollar left behind?
 - Growth of digital foreign currencies (China, Sweden, Bahamas) will the US follow and if so, will that allow for easier evasion of controls?

Payments Solutions -- Equality

- Move to Real-time payments
 - 20 percent reduction in overdrafts, payday loans, check cashing could result in \$3-5 billion / year saved for families living paycheck to paycheck.
- Credit Card Solutions more challenging
 - Empower merchants to pass on fees/selectively deny high cost cards.
 - Supreme Court in Amex v Ohio (2018) impediment.
 - IRS could revisit decision to deem credit card rewards rebates vs. income.
 - Regulate exchange rates.
 - Durbin Amendment tried with debit exchange with mixed results. (Sarin and Mukharlyamov 2019)

Payment Solutions -- Domestic

- What is the proper role of payments for law enforcement/social policy?
 - Bring criminals into the system for detection vs. keep criminals out of the system to make crime more difficult.
 - Nature of crime not well aligned with current policy focus.
 - Child pornography vs on-line gaming.
 - Elder financial abuse vs cannabis. (Klein 2020)

Payment Solutions -- International

- How much can/should the US use its status with the dollar to achieve geopolitical goals?
 - Substantial benefits appear with little cost as long as dollar remains world reserve currency.
 - Tipping points can be sudden and substantial.
 - Once leverage is lost it may not be able to be regained.
 - Broader economic consequences from dollar dethronement.
 - Is Crypto a game changer?