

Fed Announces “FedNow” Real-Time Payments Service

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On August 5, 2019, the Board of Governors of the Federal Reserve System (“Board”) proposed the development of a real-time gross settlement service (“RTGS”) called “FedNow.”¹ The service, expected to launch in 2023 or 2024, will be independent of existing private sector faster payments initiatives and developed under the leadership of Federal Reserve Bank of Boston executive Kenneth Montgomery.

The announcement follows the Board’s October 2018 notice and request for comments on “potential actions” it could take to facilitate real-time interbank settlement for faster payments,² and the publication of recommendations for achieving ubiquitous faster payment capabilities in the United States by the Faster Payments Task Force in July 2017.³ Comments on the design of FedNow are due by November 7, 2019. The Board is also expected to issue a separate request for comment on expanding the hours of the existing FedWire Funds Service and the National Settlement Service up to 24x7x365.

In her announcement speech, Federal Reserve Governor Lael Brainard described FedNow as a service “permitting banks of every size in every community across the country to provide real-time payments to their customers.”⁴ In this regard, the Board does not see itself as crowding out private-sector options, but rather, ensuring “nationwide reach” for all depository institutions regardless of size. Governor Brainard posited that households living paycheck-to-paycheck or on fixed incomes would benefit from the ability to receive money in seconds, thus reducing wait times and potentially reducing overdraft and late fees. Small banks and credit unions, along with large retailers and technology companies, applauded the Board’s decision after urging it to provide competition with the private-sector real-time payments system, “RTP,” developed by The Clearing House (“TCH”).⁵ Democrats also expressed support for the proposal,⁶ whereas Republicans remained relatively silent following the announcement.

¹ Federal Reserve Board, Federal Reserve Actions to Support Interbank Settlement of Faster Payments, Notice and Request for Comments (Aug. 5, 2019), <https://www.federalreserve.gov/newsevents/pressreleases/files/other20190805a1.pdf>.

² Federal Reserve Board, Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments, Request for Comments (Nov. 15, 2018), <https://www.govinfo.gov/content/pkg/FR-2018-11-15/pdf/2018-24667.pdf>.

³ Faster Payments Task Force, Final Report Part Two: A Call to Action (July 2017), <https://fedpaymentsimprovement.org/wp-content/uploads/faster-payments-task-force-final-report-part-two.pdf>.

⁴ Speech by Federal Reserve Board Governor Lael Brainard at the Federal Reserve Bank of Kansas City Town Hall, Kansas City, Missouri, Delivering Fast Payments for All (Aug. 5, 2019), <https://www.federalreserve.gov/newsevents/speech/brainard20190805a.htm>.

⁵ See, e.g., Independent Community Bankers of America, Comment Letter re: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments (Dec. 14, 2018), https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/2018-letters/18-12-14_fasterpaymentscl.pdf?sfvrsn=a7a14117_3.

⁶ Press Release, Chairwoman Waters Applauds Long-Overdue Fed Decision on Real-Time Payments (Aug. 5, 2019), <https://financialservices.house.gov/news/email/show.aspx?ID=6XTM4NKWD6MWYITUWWZHDKHLVA>.

This alert provides an overview of the key proposed features of FedNow and discusses certain implications of the proposal, including regulatory considerations for institutions that are eligible to participate in FedNow as well as a discussion of the effect on those market participants that would not be eligible to participate directly such as payments-focused non-depository institution fintech companies that must rely on bank partnerships for access.

FedNow key features

Features	Summary
1. Permitted participants	<p>Depository institutions, including retail banks, commercial banks, savings banks, savings and loan associations, and credit unions; and US branches and agencies of non-US banks (generally, “banks”)</p> <p>Banks would be able to designate a service provider or agent to submit or receive payment instructions on their behalf</p> <p>Banks could choose to settle payments in the account of a correspondent bank</p>
2. Dollar limit	US\$25,000; individual bank participants could further limit this amount
3. Hours	24x7x365 continuous processing
4. Individual payment processing time	“Within seconds”
5. Type of transfer	Credit transfers: sender initiates a payment to an intended receiver (as opposed to an authorized debit from an account)
6. Settlement	FedNow would settle interbank obligations through debit and credit entries to balances in banks’ master accounts at the Federal Reserve Banks
7. Finality	All settlement entries for transactions through FedNow would be final; cannot be cancelled/revoked once processed
8. Message standard	<ul style="list-style-type: none"> • ISO 20022 (latest international standard) • Clearing functionality with messages to complete end-to-end payments (e.g., account information for sender and receiver) and interbank settlement information • Additional descriptive information (e.g., remittance or invoice information) • Nonvalue message types (e.g., “request for payment” message, whereby an intended receiver requests payment from a sender)
9. Business day	<p>Would establish a “business day” that aligns with the Fedwire Funds Service, which would <i>not</i> affect the 24x7x365 continuous processing of payments:</p> <ul style="list-style-type: none"> • To calculate end-of-day balances • To calculate interest • To conduct associated reserve and interest calculations • For transaction reporting account reconciliation
10. Use of Master Accounts	<ul style="list-style-type: none"> • Like other Federal Reserve payment and settlement services, FedNow would settle payments in master accounts • Banks that use multiple RTGS services would have to closely monitor their accounts in light of potentially different settlement times
11. Accounting regime	<ul style="list-style-type: none"> • Based on FASB principles, the Federal Reserve Banks would record and report transactions for accounting purposes as they occur, each day of the week, including weekends and holidays (seven-day account regime). End-of-day balances would be calculated for master accounts on each calendar day. • Does not dictate or preclude use of specific other accounting regimes by participating banks • FedNow would provide queries, confirmations, and reports to support transaction monitoring, reporting, and reconciliation by participating banks under their chosen internal accounting approach

12. Liquidity and credit considerations	<ul style="list-style-type: none"> • The Board is considering the impact of providing intraday credit on a 24x7x365 basis under the same terms and conditions as for current Federal Reserve services • Banks would be expected to manage their master accounts in compliance with Federal Reserve policies, including avoiding overnight overdrafts, including over weekends and holidays • Banks may need to adjust internal account monitoring practices to manage intraday liquidity • Banks would need to carefully monitor transactions in real time or ensure that sufficient funding is available in their master accounts to cover payments that may arise shortly before the end of the FedNow business day • The Board does not expect that it will extend discount window operations to include weekends and holidays in the short term, but is analyzing whether such an extension may be beneficial
13. Network access	Banks would access FedNow through the FedLine network, which would be enhanced to support 24x7x365 processing
14. Service pricing	<ul style="list-style-type: none"> • Based on prevailing market practices, the Board expects that the fee structure would include a combination of per-item fees, charged to sending and potentially to receiving banks, and fixed participation fees • Separate per-item fees could also be charged for other message types that may be offered in the future • Board officials have noted that pricing decisions such as whether to offer volume discounts, which would benefit larger banks, would be made based on market practices at the time when the system is launched
15. Requests for payment	<ul style="list-style-type: none"> • A request for payment would be a separate nonvalue message type that, when received through an end-user service, would prompt a sender to initiate a payment to the receiver who is requesting funds • This functionality may increase the use of faster payments by allowing end users to more easily conduct certain types of transactions, such as bill payments
16. Directory service	<p>The Federal Reserve intends to engage with industry stakeholders to determine whether:</p> <ul style="list-style-type: none"> • Banks should establish connections to existing private-sector directories and develop an automated mechanism for populating payment messages with information provided by these external directories • The Federal Reserve Banks should establish a centralized link with private-sector directories on behalf of participating banks, rather than each participating bank needing to do so individually • The Federal Reserve Banks should build their own directory, enabling a message type that would allow banks to query the directory as part of FedNow
17. Fraud prevention	<ul style="list-style-type: none"> • Participating banks would continue to serve as a primary line of defense against fraudulent transactions, with solutions to mitigate fraud enabled as part of the end-user services banks offer their customers • At the payment system level, FedNow could offer additional fraud mitigation features, such as payment monitoring to alert participating banks of unusual transactions
18. Interoperability with private sector alternative(s)	The Board expects to work towards interoperability with systems such as RTP but does not anticipate having interoperability initially

Comparison to the existing private sector solution

The proposed FedNow service shares many similarities with RTP, in part because both solutions were designed to reflect the recommendations of the Faster Payments Task Force. For example, the proposed FedNow and existing RTP rules⁷ are similar, and in some cases identical, with respect to permitted participants, transaction limits, operating hours, transfer types, and finality of transfers, among other things. There are, however, expected to be certain material differences between the two services that the Board highlights in its request for comments. FedNow participants would be permitted to use their master accounts, with the funds in such accounts earning interest and counting toward reserve requirements. RTP participants, on the other hand, prefund amounts into a joint account that does not earn interest or count towards reserve requirements. In addition, the prefunding required of RTP participants could have the effect of removing liquidity from such participants' master accounts.

Opposition, uncertainty, and Bank Service Company Act considerations

Opposition

Despite approval from over 90 percent of commenters in favor of a Board-operated real-time payments system,⁸ notable opposition groups include TCH,⁹ the Bank Policy Institute,¹⁰ American Bar Association,¹¹ and the consortium of large banks that spent over US\$1 billion to build RTP. The Board's Vice Chair of Supervision Randy Quarles echoed the opposition groups, casting the sole dissenting vote on the RTGS from among the Board's governors.¹²

Opponents question whether FedNow will be interoperable with other real-time payments systems and the potential impact on the payments market and operating costs of competing networks that are not interoperable. Although the Board has stated that interoperability is desirable, it admitted interoperability would be "difficult to achieve, especially early on."¹³ TCH agrees, noting it "does not think two RTGS systems are likely to be interoperable."¹⁴ It is unclear to what extent the Board's initiative will have a chilling effect on the development of, or banking industry adoption of, private-sector alternatives to FedNow. However, at a recent press conference, Chairman Jay Powell observed that, "in many places, the Fed operates alongside private sector operators, for example, in wholesale payments, in ACH, and in check[s],"¹⁵ a point echoed by Governor Brainard. The Board further explained in its request for comment that, for instance, it would still consider applications for the type of joint accounts at the Federal Reserve Banks that make RTP possible.¹⁶

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- ⁷ See The Clearing House, Real-Time Payments Operating Rules (Oct. 30, 2017), <https://www.theclearinghouse.org/payment-systems/rtp/-/media/6de51d50713841539e7b38b91fe262d1.ashx>; The Clearing House, Real-Time Payments Participation Rules (Oct. 30, 2017), <https://www.theclearinghouse.org/payment-systems/rtp/-/media/d0314d2612ab4619b3c09745b54cf96f.ashx>.
- ⁸ See Lael Brainard, Delivering Fast Payments for All, *supra* note 4.
- ⁹ See Press Release, The Clearing House, TCH Says Yes to Liquidity Service but Believes Fed RTGS Service is Not Needed and is Likely to Harm Faster Payments Marketplace (Dec. 14, 2018), <https://www.theclearinghouse.org/advocacy/articles/2018/12/interbank-settlement-faster-payments-12-14-18>; The Clearing House Payments Company LLC, Comment Letter re: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments (Dec. 14, 2018), https://www.federalreserve.gov/SECRS/2019/February/20190207/OP-1625/OP-1625_121418_133156_423844567989_1.pdf.
- ¹⁰ See Bank Policy Institute, Comment Letter re: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments (Dec. 14, 2018) https://www.federalreserve.gov/SECRS/2019/January/20190128/OP-1625/OP-1625_122118_133367_638832710467_1.pdf.
- ¹¹ See American Bar Association, Comment Letter Regarding Request for Comment: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments (Dec. 10, 2018), <https://www.aba.com/Advocacy/commentletters/Documents/ABA-Comment-on-Federal-Reserve-RTGS-Proposal-FINAL-12102018.pdf>.
- ¹² Federal Reserve Board, Board Votes (Aug. 2, 2019), <https://www.federalreserve.gov/aboutthefed/boardvotes.htm>.
- ¹³ See Federal Reserve Actions to Support Interbank Settlement of Faster Payments *supra* note 1.
- ¹⁴ See TCH Says Yes to Liquidity Service but Believes Fed RTGS Service is Not Needed and is Likely to Harm Faster Payments Marketplace, *supra* note 9.
- ¹⁵ Federal Reserve Board, FOMC Press Conference (July 31, 2019), <https://www.federalreserve.gov/newsevents/live-broadcast.htm>.
- ¹⁶ In 2017, the Board published final guidelines for evaluating request for joint accounts at Federal Reserve Banks with the intention of facilitating settlement between and among banks participating in private-sector payment systems for faster payments in a manner that closely reproduces central bank settlement mechanisms. Board of Governors of the

Uncertainty

Questions also remain about the Board's supervisory role in this space. Although the Board maintains it is an operator rather than "a plenary regulatory or supervisory authority over the US payment system," the Board notes that faster payments may pose "operational" risks to bank participants.¹⁷ Examples of these risks include those posed by the expansion of FedWire operating hours (to support liquidity) and the use of the new ISO 20022 standard. Other risks include anti-money laundering and sanctions compliance risks, among others, that become more acute in the real-time payments context. The Board, however, did not include a discussion of how transaction monitoring, reporting, and blocking would work (or be expected to work) in such context. Although the Board does not regulate payment systems, it does regulate and supervise the banks or their holding companies, and therefore could increase its expectations concerning risk management systems that banks should have in place to handle real-time payments.

Bank Service Company Act considerations

The Board also explained that, under the Bank Service Company Act,¹⁸ a non-depository institution providing payment services to federally supervised banks could be subject to Board examination and regulation to the same extent as a bank¹⁹—a candid reminder to private sector alternatives such as RTP.

Payments-oriented fintechs cannot be direct participants in FedNow

Notably, the Board intends to limit access to FedNow to types of financial institutions that are currently eligible to establish a master account at a Federal Reserve Bank to access Federal Reserve payment services that include wire transfer services through FedWire.²⁰ Generally, eligible institutions are the financial institutions that are regulated by one or more of the federal banking regulators, such as depository institutions (including retail and commercial banks, savings and loan associations, savings banks, and credit unions) and US branches or agencies of non-US banks.²¹

While the Board did not explicitly explain why, for instance, payments-oriented fintechs that are not depository institutions would be excluded from direct participation in FedNow,²² the Board's proposal to limit direct participation in FedNow to only the institutions that qualify for a master account is a telling sign of the Board's view that banks—as federally regulated entities that hold public trust and confidence—should continue to have a critical and preeminent role as the US payments system develops.²³ The Board's view is also reflected in ongoing litigation involving eligibility criteria for establishing a master account,²⁴ which ultimately may decide if access to the Federal Reserve's payment infrastructure is a right for certain financial institutions under the Depository Institutions Deregulation and Monetary Control Act of 1980,²⁵ or a privilege subject to terms developed by the Board and Federal Reserve Banks.

Federal Reserve System, Guidelines for Evaluating Joint Account Requests (2017), https://www.federalreserve.gov/paymentsystems/joint_requests.htm.

¹⁷ See Federal Reserve Actions to Support Interbank Settlement of Faster Payments, *supra* note 1.

¹⁸ 12 U.S.C. §§ 1861 *et seq.*

¹⁹ 12 U.S.C. § 1867(c)(1).

²⁰ Other Federal Reserve payment services include automated clearinghouse (ACH), cash, and check clearing and settlement services. See <https://www.FRBservices.org>.

²¹ See definition of "Financial Institution" in the Federal Reserve Banks Operating Circular 1 § 2.2(c). A participating bank may designate a service provider or agent to submit or receive FedNow payment instructions on the bank's behalf. However, as accountholder, the bank would remain primarily liable and be ultimately responsible for obligations arising under the master account and the actions of the service provider or agent.

²² The fact that FedNow would operate with other Board services and might one day enable participants to have access to the discount window may also provide a further possible explanation for the omission.

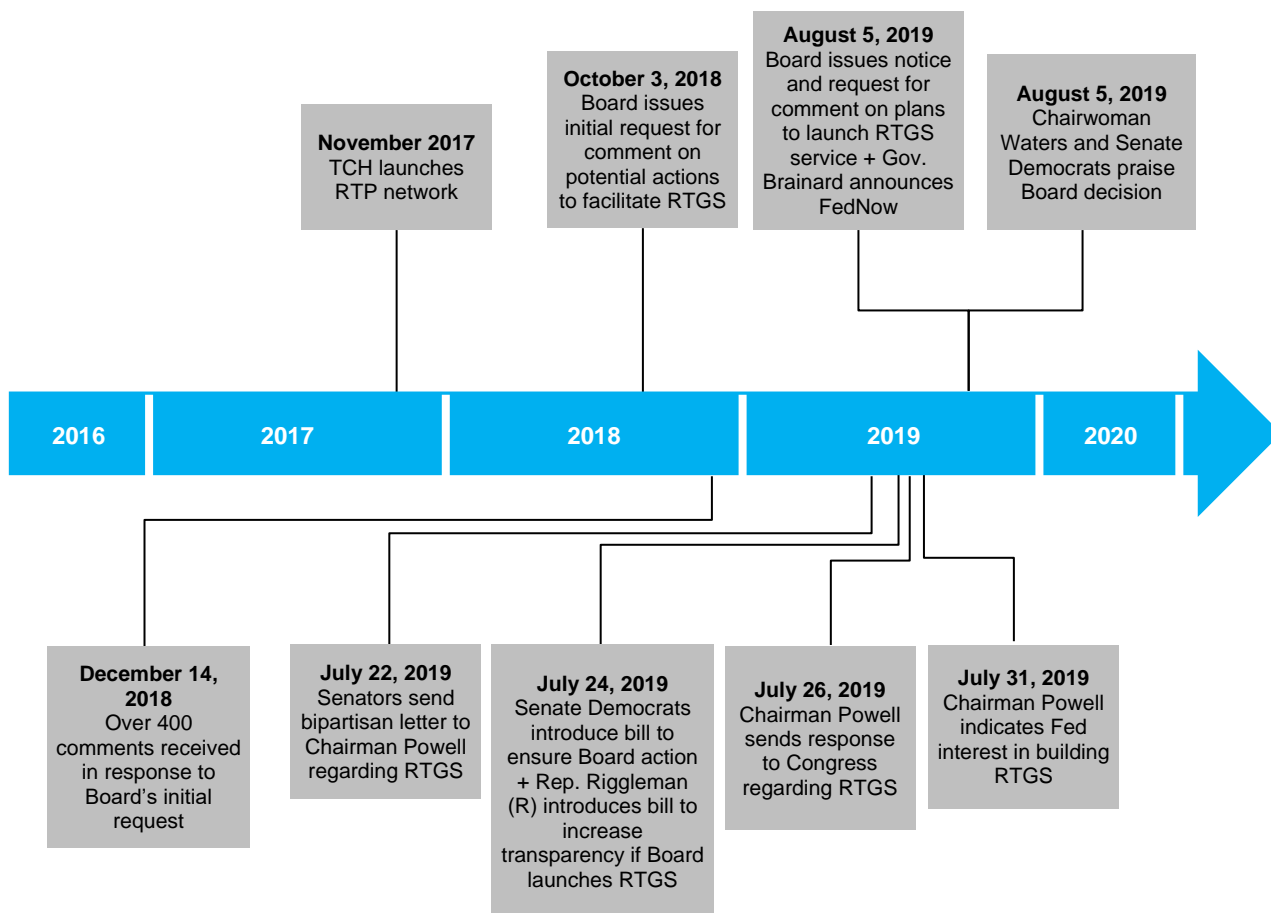
²³ See, e.g., Speech by Federal Reserve Board Governor Lael Brainard, "Where Do Banks Fit in the Fintech Stack?" (April 28, 2017), <https://www.federalreserve.gov/newsevents/speech/brainard20170428a.htm> (noting that banking "regulations enable consumers to trust their banks to secure their funds and maintain the integrity of their transactions" and, "[m]ore often than not, there is a banking organization somewhere in the fintech stack").

²⁴ *TNB USA Inc. v. FRB of N.Y.*, No. 1:18-cv-07978-ALC (S.D.N.Y. filed Aug. 31, 2018).

²⁵ See 12 U.S.C. § 461(b)(1)(A)(i) (defining "depository institution" to include any bank eligible to apply to become an insured bank under section 5 of the Federal Deposit Insurance Act, 12 U.S.C. § 1815); *id.* § 248a(c)(2) (indicating that Federal Reserve Bank services "shall be available to nonmember depository institutions").

It is possible that TCH, or another private sector alternative, could offer such services to meet the payments-system needs of non-depository institution fintechs in order to compete with FedNow.²⁶ For the time being, if FedNow is finalized as proposed, the ineligibility of non-depository institution fintechs to directly participate in FedNow would be another business consideration for fintechs examining the merits of obtaining a bank charter to access the US payments system, or otherwise continuing to rely on bank partnerships to bring payment products and services to market.

High-level timeline of events



²⁶ Currently, RTP participation is limited to insured depository institutions as defined in the Federal Deposit Insurance Act, 12 U.S.C. § 1813(c)(2), uninsured branches or agencies of a foreign bank that is included in the term “insured depository institution” under 12 U.S.C. § 1813(c) for purposes of 12 U.S.C. § 1818, and insured credit unions as defined in the Federal Credit Union Act, 12 U.S.C. § 1752(7).

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