Financial Services Management

Federal Reserve Instant-Payment System

Cite
Federal Reserve Board, Service Announcement, Service Details on Federal Reserve Actions to Support Interbank Settlement of Instant Payments

Recommended Distribution:
Payments, Retail Finance, Tech Finance, Corporate Development, Policy, Legal, Government Relations

Websites:
https://www.govinfo.gov/content/pkg/FR-2020-08-11/pdf/2020-17539.pdf

Impact Assessment

- As anticipated, the Fed has decided to launch a Fed owned/operated real-time U.S. retail payment system, further nationalizing the payment system to enhance ubiquity, finality, and stability with uncertain implications for competition, pricing, innovation, and cross-border payments.
- The Fed's system remains slow to launch, maintaining only a 2023/24 target and deferring complete, initial inter-operability with its one private competitor and refinements in an effort to achieve this goal. Following launch, FedNow's pricing construct is likely to make it the dominant interbank real-time payment provider absent structural payment-system change during this transitional period.
- Due to the rapid pace of retail-finance innovation, alternative systems premised on digital finance or constructed on the backbone of interbank settlement may continue to grow, moving more retail payments outside the regulatory perimeter.
- Unless outstripped by other dominant instant-payment systems when finally launched, FedNow is likely to create a strong platform for CBDC, giving the Fed a dominant position not only across the payment system, but also throughout retail finance.
- Only banks may directly use FedNow, but service providers may act as bank intermediaries. Who these are, how nonbanks interact with the payment system, and the nature of alternatives will determine the extent to which banks remain dominant retail finance intermediaries or become infrastructure for a fintech/nonbank consumer-finance market.
- FedNow delays combined with its market power may impede efforts to speed stimulus payments to lower-income households and businesses with uncertain banking access, as well as force vulnerable persons to rely on high-cost lending in lieu of rapid access to their wages, cash flow, and other income sources.

Overview

Following a request for views in late 2019,[1] the Federal Reserve has largely finalized its plans for FedNow, initiating a Fed-owned and -operated instant-payment service for domestic transactions. As in the proposal, the final Fed policy creates an interbank, 24x7x365 real-time gross settlement service with U.S. clearing functionality. Once dubbed "faster" payments by the Fed, the new service is now called "instant" to describe its benefits and distinguish it from other services (e.g., same-day ACH) also under development. Although not speeding instant payments, the new service will provide smaller banks with the assurances they sought – an alternative to a wholly-private real-time payment market – along with bringing the Fed into ancillary payment products (e.g., fraud prevention) that might otherwise be provided by third-party service providers. Although these private providers would likely lack the Fed's reach or capabilities, FedNow's lengthy launch plan combined with the still longer delay for ancillary services could constrain payment-system innovation due to the Fed's competitive power. The Fed's decision also to authorize a new liquidity-risk management facility for both its own and private instant payments provides an added level of safety buttressing finality across the payment system. However, inter-operability will remain uncertain and certain liquidity tools will apparently be offered only to FedNow participants, reinforcing the Fed's market clout. The definition of "bank" used in the notice gives the Fed some latitude to decide for or against access by special-purpose national bank charters, although it appears that the Fed does not intend to do so. However, the decision to allow partial FedNow access may permit industrial loan companies (ILCs) and other insured depositories to make efficient use of the payment system, perhaps doing so also in concert with nonbank affiliates that act as service providers and thus enhance the overall presence of the ILC and its nonbank parent in the retail-financial system.

Impact

As before, the Fed in part justifies its payment-system role on its lack of plenary power over the payment system as a whole, arguing that its own offerings speed innovation without undue risk and thus meeting the Fed's mission by enhancing the U.S. financial system. However, in the wake of COVID and the breakdown of many aspects of the payment system for urgently-needed stimulus checks, the Fed also references the importance of instant payments to households that, in its absence, may be forced to rely on costly overdrafts and high-cost, short-term loan products. The notice also discusses the benefits of instant payment to small businesses for cash-flow management under ordinary circumstances and, still more importantly, stress conditions such as those created by the pandemic. However, as described below, the FedNow launch is still so delayed and in some cases also so partial as to create at once a void leaving vulnerable parties at continued risk, a strong incentive for alternative interbank instant-payment options, and the prospect of so dominant a competitor as to dissuade new entrants in the interbank arena.

However, the Board's notice also asserts that the Fed's role ensures U.S. payment-system competition, noting that only one private instant-payment service has emerged since the Board first contemplated its role in 2013. It does not address the extent to which this may be so because very few entities would found a business competing against a central bank, especially one that gives itself pricing power. The

[1] See **PAYMENT17**, *Financial Services Management*, August 19, 2019.

General Accountability Office (GAO) study cited by the FRB in support of these competitive benefits notes also that FRB price-integrity requires review. The 1980 law authorizing Fed entry into payment systems requires calculation of a private-sector adjustment factor (PSAF). The PSAF is meant to ensure that the FRB does not dominate payments solely by virtue of its ability to out-price private competitors, but the GAO report cited continuing uncertainty. For example, the Fed expects to recoup its launch costs for FedNow over at least a decade, a length of time problematic for private entities under more demanding market discipline. It may thus be that no additional private competitors emerged since 2013 due to Fed-pricing policy and that the decision now to move forward with instant-payments and pricing as desired may ensure competition for the Fed and thus for faster U.S. payments though competition through the interbank channel remains very limited.

Small banks strongly support Fed entry due to fears of big-bank power in the one current Fed real-time payment competitor, a service offered by The Clearing House (TCH). However, even if the FedNow system is necessary to protect small banks, the Fed's powerful presence combined with FedNow's slow launch may slow or even curtail innovation within the interbank construct. Innovation that the Fed is slow to introduce or to which the FRB is not receptive or responsive might thus move outside the regulatory perimeter, with banks either serving only as payment portals along lines feared in a 2018 Basel study[2] or frozen out of key payment streams.

Doubts in fact continue about the extent to which FedNow will in fact encourage innovation. The effort to create it began in 2013, moving through various iterations[3] ahead of the 2019 consultation and even now not set for initial launch until 2023 or 2024 unless the Fed determines it is possible to begin more quickly. Nearer-term pilots are possible, although the Fed has also decided now to defer certain instant-payment refinements until after initial launch. The Fed believes this appropriately balances the need for safety and finality with that for innovation, but it nonetheless puts the U.S. still farther behind the pace of faster-payment innovation around the world. Functionality of the FedNow system will also depend after launch on how essential delayed features will prove and the extent to which private providers are able to move more quickly.

In addition to competition, innovation, and pricing, a critical competitive question is the extent to which a Fed-owned system is inter-operable with private entities even if, as the Fed projects, there is only one alternative. Lack of inter-operability could lead to a faster-payment patchwork that undermines ubiquity and thus the efficiency and social-welfare purposes on which the Fed premises its own payment-system operations. The notice affirms the Fed's determination to ensure inter-operability, committing to initial use of the ISO 20022 standard and adoption of other industry best practices and perhaps also to interservice message exchange at a later time. However, the Fed states that it cannot on its own ensure inter-operability, stating also that inter-operability may take many forms, setting no time for actual inter-operability beyond a commitment to continued work with the private sector to ensure it.

[2] See **FINTECH18**, *Financial Services Management*, February 28, 2018.

[3] See **PAYMENT15**, *Financial Services Management*, February 3, 2015.

Addressing the liquidity risk inherent in instant payments, the Fed will provide 24x7x365 intraday credit to FedNow participants on the same terms and conditions otherwise applicable to intraday credit (i.e., sound condition, avoidance of overnight overdrafts); specific policy changes related to intraday credit and overnight overdrafts in relation to FedNow will be separately proposed and may not address daylight-overdraft concerns for banks using alternative instant-payment options. Although the discount window will continue to be available only during ordinary business hours, the Fed has also created a new liquidity-management tool (LMT) for instant-payment participating banks whether this is done via FedNow or by private systems such as TCH that are backed by joint accounts at a Reserve Bank. However, service providers may only access the LMT if they support banks using FedNow, another potential disincentive to use of alternative systems. Many features of the LMT remain to be built in concert with the changes related to intraday overdrafts noted above. It appears that the Fed intends these liquidity backstops to be contemporaneous with FedNow launch, but this is not clear.

The notice defines "banks" for purposes of interbank-payment access as "any" type of depository institution including – but apparently not necessarily limited to – commercial banks, savings associations, and credit unions. This appears to exclude special-purpose national banks such as the OCC's fintech charter[4] and Acting Comptroller Brooks' plans for a special-purpose payment franchise as special-purpose banks do not accept deposits as these are conventionally understood. However, the FRB does not specify that depository institutions must also be eligible for federal deposit insurance, perhaps creating latitude for non-traditional charters. ILCs and other FDIC-insured banks are clearly eligible to use FedNow which, in concert with new liquidity facilities and broad authorization for service providers, may create significant franchise value for those owned by nonbank retail-finance or -commercial entities if the FDIC decides to authorize such charters.[5]

As discussed below, many aspects of the FedNow design and launch plan remain under construction. Although some outstanding issues will be addressed via public proposals for comment, most will be finalized through communications only using "established channels" controlled by the Reserve Banks. The notice sometimes signals that these channel-provided communications will go to the "industry" and sometimes cites "stakeholders," but under most circumstances appears to intend that critical design issues are henceforth resolved without public notice and/or comment since only banks are privy to Reserve Bank communications in this arena. Doing so may further advantage FedNow versus other instant-payment services now or to come as well as give the Fed a still greater competitive edge over ancillary-service providers. The extent to which this also advantages bank charters is unclear based on the charter and broader payment-system uncertainties cited above.

What's Next

The Fed announced the FedNow construct on August 6. Its service announcement is effective September 10. As noted, it does not appear that future changes to FedNow (see below) will be made available to the general public, with announcements and solicitations for comment on issues other than pricing generally proceeding through "established channels" within the Federal Reserve System.

4 See **FINTECH20**, *Financial Services Management*, August 3, 2018.

5 See **ILC14**, Financial Services Management, April 13, 2020.

Initial launch is not expected until 2023 or 2024. The first release of the FedNow Service will provide baseline functionality supporting market needs and transition management along with offering optional features for which there is high demand (e.g., fraud prevention tools, receive-only participation, and payment-inquiry management tools). Other aspects of the service such as fee structures and governing terms will also be announced prior to launch.

The Fed intends to continue engaging with stakeholders and remain flexible building out additional features, introducing these over time but perhaps beginning with alias-based payments capabilities and fraud prevention, error-resolution, and case-management tools. Features in the future might include support for bulk payments or enhanced remittance information, with the Fed also continuing to work on cross-border payment functionality.

The Fed also continues to work on expanded hours for the Fedwire Funds Service and National Settlement System (NSS). The new notice references numerous challenges to doing so also discussed in 2019, with no time set for possible action.

When the Fed released its 2019 request for comment, Members of Congress weighed in. Republicans protested a still larger Fed payment-system role and Democrats pressed hard for far faster action.[6] Recent Democratic legislation in both the House and Senate includes the Fed's payment system role in a series of functions that would come under a new, racial and ethnic equity mandate.[7] This is in part designed to speed up Fed entry, as is an even larger Democratic bill demanding that the Fed establish a central-bank digital currency to take clearing and settlement away from the banking system.[8] No action on any of these initiatives is likely in this Congress, although partisan calls for and against the Fed's instant-payment construct will surely continue.

Analysis

A. General Description

Key FedNow features include:

- 24x7x365 functionality;
- a focus only on credit transfers at the start due to the risks also of supporting debit transfers;
- a limit now only to domestic payments despite initial ambitions also to handle cross-border ones;
- services only to institutions (e.g., banks) eligible to hold accounts at Reserve Banks, although others may be service providers or agents to banks;

[6] See *Client Report* **PAYMENT18**, September 25, 2019.

[7] See **FEDERALRESERVE58**, *Financial Services Management*, August 6, 2020.

[8] See **CBDC**, *Financial Services Management*, April 16, 2020.

- irrevocable settlement;
- participating-bank agreement to provide payments in "near" real time. The FRB will assess applicable law and rule and, if needed, propose changes to provide certainty about what this means. Details for participating banks will be addressed by the Reserve Banks;
- authorization for banks to designate service providers and correspondent banks that process FedNow payments on their behalf; and
- authorization for banks to join FedNow as "receive-only" participants.

B. Core Features

These will include:

- pre-settlement confirmation option;
- use of credit-transfer messages establishing payment flows and returns as detailed in the notice;
- a payment limit set at launch that is consistent with market practice instead of the $25,000 limit proposed in 2019. Banks may establish lower transaction limits as desired to reduce fraud risk;
- business-day and account procedures consistent with other Fed services, although banks may use their own processes for internal purposes. A new seven-day accounting protocol is also detailed, with banks again allowed to use five-day or other internal procedures. Banks using internal procedures must still provide real-time settlement 24x7x365; and
- reporting capabilities.

C. Liquidity

As noted, the FRB will provide intraday credit to FedNow banks on a 24x7x365 basis but will not open the discount window during non-business hours subject to subsequent review about the benefits of doing so. Overnight overdrafts will be allowed for FedNow users following a public-notice process. A new LMT has also been created for banking organizations making use of FedNow even if not as full participants and users of private bank-based real-time payment systems, which for now is limited only to TCH. Providers of liquidity to FedNow users – but apparently not also to TCH's – are also given LMT access, with the Fed apparently here intending to ensure that small banks used to obtaining liquidity from a bank that is not within FedNow may still do so. Reserve Banks will impose numerous controls on LMT use that are only outlined in this notice (e.g., possible transaction-value limits, or limited hours) to ensure that LMT liquidity is solely for purposes of instant-payment liquidity management. The Fed says only that these controls will be announced prior to FedNow launch.

D. Network Access

FedNow access will be obtained via FedLine Solutions, a set of Fed electronic-connection products. Over time, alternative messaging networks and telecommunications interfaces that may be problematic for smaller banks will also be reviewed.

E. Ancillary Services

The notice includes a list of the fraud-prevention tools the Fed will offer at FedNow launch, with other fraud-prevention features from the Fed under consideration as the system becomes operational (e.g., centralized monitoring performed by the FedNow service). Additional ancillary features that may follow launch include support for:

- alias-based payments, with extensive details provided on how this might be done;
- bulk payments;
- enhanced remittance information;
- application program interfaces; and
- other services the Fed selects based on stakeholder involvement through established Reserve Bank channels.

F. Pricing

Consistent with the 2019 statement, the final notice reaffirms that cost recovery will take longer than the ten years in which the Fed usually holds itself to ensure compliance with the PSAF. At the launch, transaction pricing will be based on “mature volume estimates” – i.e., pricing will be subsidized unless or until the Fed’s volume estimates materialize. The Board interprets the PSAF as permitting this due to the need also to ensure competitiveness and the need to ensure an “adequate level” of nationwide service. The fee structure will include per-item fees, charged to the sender’s bank and potentially to the receiver’s bank, and fixed participation fees, with the ambiguity over the role of receiving banks likely creating additional uncertainty about bank participation. The ultimate fee structure and schedule will be based on the Fed’s assessment of market practices at implementation, with the Reserve Banks publishing the initial fee schedule “well before” its launch through established communication channels.

The notice also describes how the Board will judge market pricing when it finally sets its fee schedule. Rejecting suggestions for a broad sector survey, the Fed will instead consider only interbank real-time payment services. Reflecting this, the Fed conducted an analysis of TCH – its only competitor under this methodology – and concluded that it has no competitive advantages of note versus the private sector.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com