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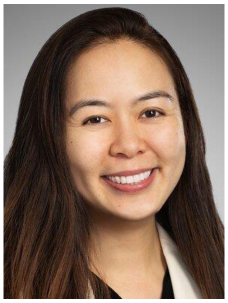
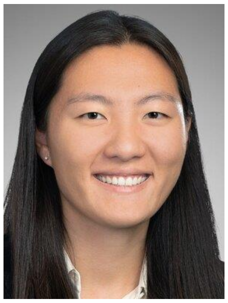
What To Know About FedNow's Instant Payments

By **Judy Mok, Merissa Pico and Dallin Earl** (August 25, 2023, 5:59 PM EDT)


Judy Mok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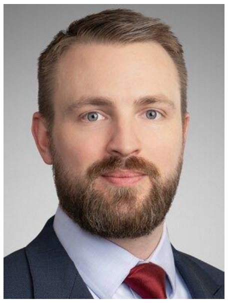
Dallin Earl

The Federal Reserve's new interbank instant payment infrastructure, the FedNow Service, went live on July 20.

FedNow offers a new payment rail through which banks, credit unions and other eligible financial institutions can offer instant payments services to their customers, allowing them to send and receive payments within seconds at any time and day of the year.

As with other Federal Reserve Bank services, FedNow will be available to any depository institution eligible to hold an account with a Federal Reserve Bank. While FedNow will support instant retail payment — i.e., payments between individual consumers and businesses — consumers and businesses will only be able to access such instant payment services through financial institutions that choose to participate in FedNow.

As an instant gross settlement system, FedNow will process and settle transactions in real-time and on a gross basis — i.e., payment-by-payment — as opposed to periodically settling transactions in batches.

Additionally, with FedNow's operating schedule of 24 hours a day, seven days a week, financial institutions participating in FedNow will be able to clear and settle such payments instantly any time of day of the year.

The first release of FedNow includes optional features such as fraud prevention tools, the ability to join initially as a receive-only participant, a request for payment capability, and tools to support participants in their handling of payment inquiries.

FedNow also has a liquidity management transfer capability to enable FedNow participants to transfer funds to one another to support liquidity needs related to payment activity in FedNow.

Prior to FedNow's launch, The Clearing House's RTP network was the only other 24/7/365 interbank, instant payments infrastructure in the U.S., which has operated since November 2017. FedNow joins the RTP network in making instant payments solutions available in the U.S.

High-Level Similarities and Differences Between FedNow and RTP

Fundamentally, both RTP and FedNow are 24/7/365 instant gross settlement payment systems based on a "credit push" process.

What makes these systems different from other and arguably more familiar, faster payments providers is that RTP and FedNow are open-loop systems, meaning each supports real-time gross settlement between payers and payees from different financial institutions.

Both platforms' eligibility criteria for financial institutions to participate is broad.

As noted, FedNow is available to any organization eligible to maintain a master account with a Federal Reserve Bank; whereas, RTP permits any federally insured U.S. depository institution to participate. Nonbanks, such as payment companies and nonbank lenders, cannot directly send or receive payments through these services, but can act as service providers for participating organizations.

Payment settlement occurs somewhat differently between the two systems.

FedNow settles payments through participants' master accounts held at the Federal Reserve Bank, while RTP settles payments in RTP's joint, master account at the Federal Bank of New York, which means that all participating banks must prefund the joint account and maintain sufficient balances to meet liquidity needs.

As mentioned above, of note is FedNow's unique liquidity management transfer feature that allows participating financial institutions to send credit transfers between each other — either directly or through service providers — even during nonbusiness hours.

Although similar in many ways, RTP and FedNow are not currently interoperable.

A financial institution cannot send or receive payments between the two systems even despite the two systems' use of the same messaging standard, ISO 20022. The lack of interoperability will require any organization that considers offering or implementing instant payments in the U.S. to determine whether one or the other — or both — systems will best fit the contemplated use case.

Ubiquity of Instant Payments

For any of this to matter, and for FedNow — and instant payments generally — to be truly successful, it will need to achieve ubiquity, since only participants in FedNow can send and receive payments through FedNow.

The Federal Reserve already provides access to its other services to more than 10,000 banks and credit unions, either directly or through an intermediary. In contrast, while the RTP network is available to nearly any bank or credit union, according to a recent RTP press release, as of July, approximately 350 financial institutions are providing instant payment services to their customers.

According to the Federal Reserve, its significant reach will enable instant payments to reach any bank in the U.S. and enable all banks — not just the big ones — to offer instantly available funds and instant payments to their customers. Although FedNow is available to all banks and credit unions, there is no requirement for them to join FedNow.

Scrutiny of Existing Payments Contracts

Based on publicly available pricing information from FedNow and RTP, instant payments cost less to process than other types of payments transactions such as debit and credit transactions.

The RTP network offers a low flat rate for each transaction and FedNow appears to similarly be following suit and is already offering key pricing discounts for new customers in 2023.

As a result, businesses could potentially lower their costs considerably with the use of instant payments for certain types of transactions. Accordingly, businesses may scrutinize the rates they currently pay to facilitate payment transactions and reevaluate the existing commercial arrangements in their payments contracts.

This scrutiny will likely result in downward pressure on the rates for existing payments products as merchants and businesses attempt to renegotiate the rates they pay for all types of payments transactions.

Increase in Merchant Services and Consumer Use Cases

From insurance payouts to gig economy paychecks, there are many beneficial applications of instant payments.

The addition of FedNow as the second major player in the real-time payments space within the U.S. is expected to make instant payments more accessible to consumers and result in an uptick in new consumer use cases for their day-to-day transactions.

While today's consumers already experience "faster" payments in the form of transactions on certain peer-to-peer, or P2P, platforms, as noted, many of these platforms are closed-loop systems, and as a result, can only move money instantaneously between users within their own respective platforms.

For any transactions, deposits from, or withdrawals to accounts outside the platform, such transactions still require the use of traditional payment rails where it may take a few days to settle.

With both FedNow and RTP now offering instant payment capabilities, we may see more P2P platforms in the U.S. enable instant payments functionality to facilitate transactions, which would expand the number of use cases, especially for individual consumers and businesses.

From a merchant perspective, the availability of instant payments increases the number of payment options available for customers beyond traditional card rails. Not only will point of sale payment acceptance options increase, but instant payments may also facilitate a better overall customer experience, especially when it comes to refunds back to the customer — imagine no longer waiting five to 14 days for a refund to clear.

Whether FedNow, RTP, or both, will be better for any particular use case will likely depend on the economic incentives provided to financial institutions and payment service providers.

As discussed above, FedNow will charge fees to its participating financial institutions for instant payment transactions that are equivalent to those charged by RTP as of now, but it is unclear to what extent financial institutions will pass on these costs to their customers.

Innovation in Payments Products

In light of anticipated expanded demand for and use of instant payments, there will likely be a focus on innovation and new hybrid payments offerings from financial institutions and other payments service providers.

While consumer credit products are not going anywhere, they may evolve to meet consumer and business needs. It is important to remember that while instant payments have benefits, not every aspect of instant payments will be desirable in every situation or advantageous over other payment methods, such as credit cards, where businesses and consumers will still benefit from the ability to pay later.

Merchants in particular may consider reevaluating customer appetite for different kinds of functionalities in payment methods, each of which may implicate different fees imposed on the merchants.

Whether or not merchants pass down those fees to consumers could depend on incentives that merchants may have to offer such functionalities and possible avenues for merchants to recoup these incremental costs.

Certain features of both credit and debit card products may benefit from instant payments, and some aspects of instant payment services and functionalities may find their way into traditional credit and debit products and their related services.

Expect these offerings to involve a technology component as greater interactivity and "always on" status will be a focus for instant payments and hybrid products.

Fraud and Risk Allocation

Instant payments introduce 24/7/365, always-on service and payment finality to a payments landscape wrought with fraud thereby resulting in new and different fraud risks.

For example, the "push" payment nature of instant payments means that after the transaction has been initiated and pushed to a designated bank account, that money cannot be recalled.

With this feature, we are likely to see an increase in social engineering and authorized fraud scams, where fraudsters pretend to be someone the victim is familiar with and therefore whose instructions to send payments to them would appear to be reasonable to the victim.

For example, the fraudster may pretend to be a colleague or senior executive at the victim's company or a family friend who, in each case, is requesting money for seemingly reasonable and legitimate purposes. The fraudsters' growing sophistication in hacking email accounts and gathering data from social media makes it difficult to spot and prevent such fraudulent behavior.

Additionally, the speed with which these transactions take place will strain, and may even render obsolete, the traditional mechanisms that banks have in place to identify and stop bad transactions before they occur.

That is not to say that fraud cannot be stopped.

Both RTP and FedNow provide tools to assist in defending against fraud. For example, FedNow's "negative list" feature will aid participating financial institutions in identifying bad actors and blocking transactions or imposing temporary holds when warranted.

However, both RTP and FedNow make it clear in their documentation and contractual terms that as between them and the participating financial institutions, liability for fraud or misdirected payments lie almost entirely with the financial institutions and their customers.

And while regulations such as Regulation E and Article 4-A of the Uniform Commercial Code will play a role in allocating risk responsibilities for instant payments, there will be gaps to cover in the commercial agreements negotiated between business parties.

Conclusion

Most payments products in the market today were designed under different economic conditions and for a different generation of consumers.

From P2P payments to rising gig industries to metaverse economies, consumers and business customers today seek innovation, flexibility and speed. These changes and the ubiquity of instant payments will likely take time, but we can expect to see an acceleration of the development of hybrid and new innovative payments products.

In the meantime, there will be much work to be done as businesses and their lawyers grapple with the implications of the launch of FedNow.

Judy Mok is of counsel, and Merissa Pico and Dallin Earl are associates, at Covington & Burling LLP.