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INSIGHT

Federal Reserve Launches FedNow

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On July 20, 2023, the Federal Reserve (Fed) launched FedNow, which "provides interbank clearing and settlement that enables funds to be transferred from the account of a sender to the account of a receiver in near real-time and at any time, any day of the year," to enable instant or real time payments (RTPs). It is available to all banks, who will be required to make those funds available to their customers immediately. The service had been pilot testing since September 2022. This Insight provides background on FedNow and discusses policy issues.

Background

An electronic payment has three parts (see **Figure 1**). First, the sender initiates the payment through a card reader or mobile app (e.g., Venmo) provided by an *end-user service* instructing the sender's bank to make a payment to the recipient. (The sender and recipient only interact with end-user services, but payments generally flow through the banking system, except in some cases when both parties are using the same end-user service.) Second, the sender's bank sends a *payment message* involving the payment details to the recipient's bank through a payment system, which is provided by a *clearing service*. Finally, the payment is completed when the two banks transfer funds through a *settlement service*. Different providers compete with each other to provide each part of the payment. FedNow provides the clearing and settlement steps of a payment.

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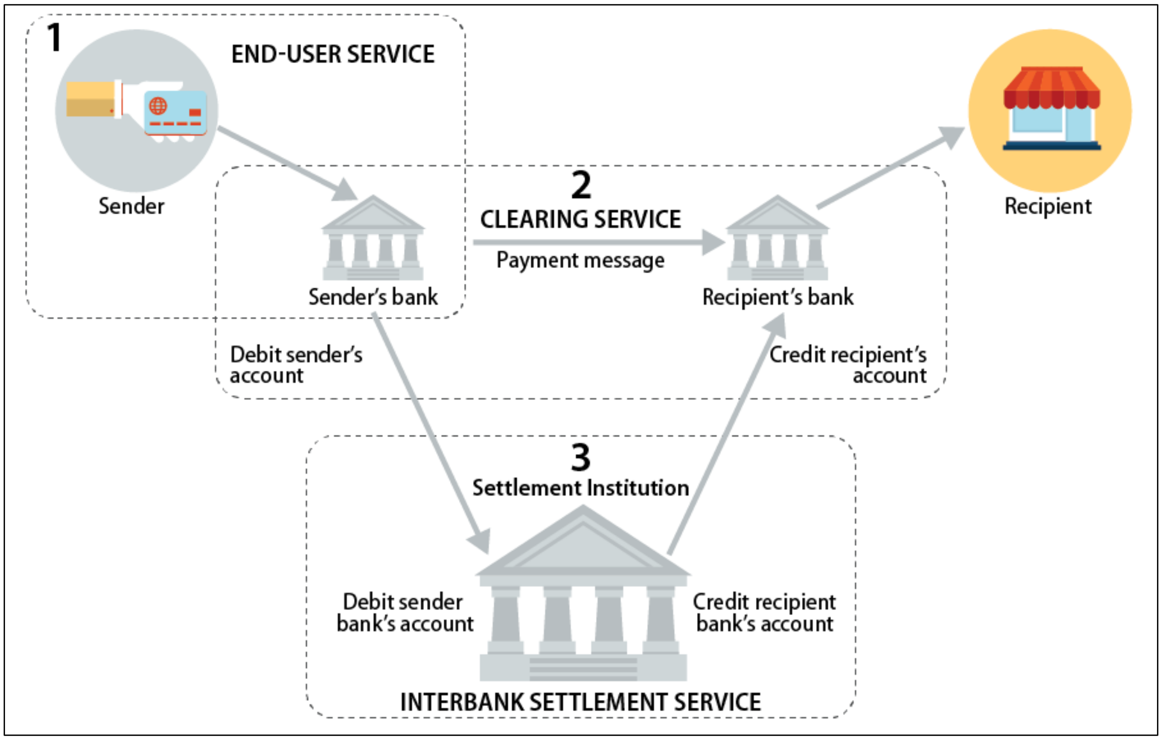
Figure 1. Parts of the Payment System



Source: Federal Reserve.

FedNow was not specifically authorized through new legislation—rather it is an operational change to the Fed's existing role in payments. The Fed has long operated its own payment settlement systems, connecting banks and selected other financial institutions through their Federal Reserve "master" accounts. FedNow does not change the Fed's role in payments, but it makes them faster.

The Fed also sets risk management standards for private-sector wholesale payment systems, which in some cases directly compete with the Fed's payment systems. However, the Fed does not have plenary authority to regulate all aspects of payments, and not all payment system participants (that are not banks) are under its jurisdiction.

Policy Issues

Competition

FedNow does not compete with, or operate, any retail end-user service directly accessed by individuals or merchants, and will not have access to any personal information on retail users. Individuals and merchants will continue to initiate payments through existing end-user services, but payments would be completed more quickly if banks decide to settle them through FedNow.

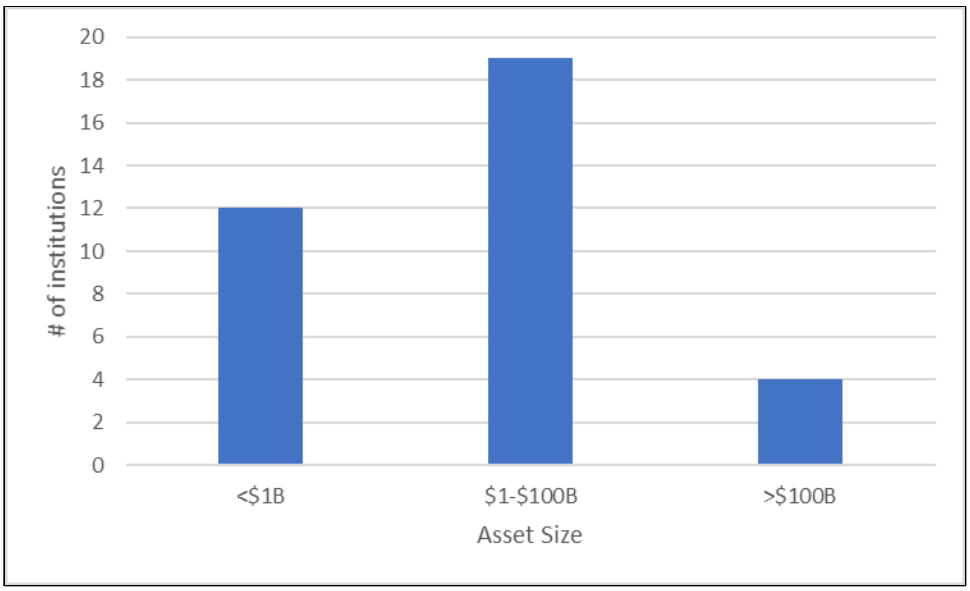
By contrast, FedNow directly competes with private sector settlement services. Several private-sector initiatives are also underway to implement faster payments. Notably, The Clearing House, an association of large banks, introduced its RTP network in November 2017; according to The Clearing House, it currently "reaches 65% of U.S. demand deposit accounts."

Some fear that FedNow will hold back or crowd out private competitors, will be underpriced since the Fed is not a for-profit organization, and could be a duplicative use of resources. Statute requires the Fed to charge users enough to eventually recoup the costs of developing and running the system—but in this case the Fed does not expect to recoup costs in its typical 10-year window. From a societal perspective, it is unclear whether it is optimal to have a single provider or multiple providers in the case of a natural monopoly. Multiple providers could spur competition that might drive down user costs, but more resources are likely to be spent on duplicative infrastructure. It is also ambiguous whether single or multiple providers would be better for innovation, ubiquity, equity, and security.

Uptake

The Fed states that its goal is to eventually reach "all 10,000 U.S. financial institutions." In comparison, there were relatively few participants—35 financial institutions and 16 service providers—at launch. As shown in **Figure 2**, initial participants (not including service providers) are both small and large institutions. Uptake depends on demand, the cost of services compared to alternatives—both private sector RTPs and traditional payment services—and a bank's technical capabilities.

Figure 2. FedNow Financial Institutions Participating at Launch



Source: CRS calculations.

Interoperability

Interoperability refers to the ability of the sender's bank and recipient's bank to make payments across different settlement systems. Initially, FedNow is not interoperable, meaning a payment can only be completed using FedNow if both banks (or their agents) are participants. A lack of interoperability initially reduces the scale of use, and may discourage uptake. In the long run, it could reduce competition if banks leave competitors to join FedNow. The Fed has stated that it is open to interoperability,

> however, [it] cannot accomplish interoperability… alone. The industry … must work towards this common goal, as it has in the past with other payment services. The model and timeline for achieving interoperability will depend on the level of commitment and engagement across the industry.

Consumer Protection

Fraud and errors can be harder to avoid with any RTP system since payments settle irrevocably without time to catch mistakes. FedNow has fraud prevention features, but financial institutions, not the Fed, are responsible for addressing fraud and errors, which are governed by consumer protection regulations.

Fed Lending

Unexpected payments risk depleting a bank's master account. While this is also true of traditional payments, risks may be harder to manage with RTPs. To prevent payments from failing to settle because of insufficient funds, the Fed offers banks intraday credit for daylight overdrafts. Banks face a penalty fee if they do not repay intraday credit by the end of the day. According to the Fed, "Overnight overdrafts pose a greater risk to the (Fed) than do discount window loans because there is no assurance that overnight overdrafts would be collateralized." FedNow also includes an optional liquidity management tool to reduce reliance on intraday credit.

Central Bank Digital Currency

FedNow is not a central bank digital currency (CBDC), and no decision has been made on whether to introduce a U.S. CBDC. However, since FedNow enables RTPs, it reduces one of the benefits of introducing a CBDC.

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