Federal Reserve Announces Plan to Build Its Own Real-Time Gross Settlement System for Retail Payments

August 9, 2019

The Federal Reserve **announced** on Monday that it plans to build its own 24x7x365 real-time gross settlement (**RTGS**) system for retail payments, called the FedNow Service. At the same time, it released a **Notice and Request for Comment** on the proposed features and functionality of the planned service.[1] It also intends to seek public comment separately on whether to expand the operating hours of the **Fedwire Funds Service** and the **National Settlement Service** in order to support a wide range of payment activities, including liquidity management.

In a **4-1 decision**, with Vice Chairman for Supervision Quarles dissenting, the Federal Reserve stated that the FedNow Service would allow consumers and businesses to settle retail payments in real time through the U.S. commercial banking system at any time of the day or night, 365 days a year. The Federal Reserve anticipates that the proposed new service will be available by 2023 or 2024.

The new service will compete with the RTP network, a 24x7x365 RTGS system for retail payments launched by The Clearing House in November 2017. It will also compete with Fedwire, the Federal Reserve's existing RTGS system for large-value funds transfers between banks, and with FedACH, the Federal Reserve's existing batch system for retail payments.

While the Federal Reserve's decision to build its own around-the-clock RTGS system for retail payments has been widely supported by most smaller banks,[2] technology companies[3] and certain members of Congress,[4] it has been opposed or questioned by The Clearing House,[5] the Bank Policy Institute[6] and certain other members of Congress.[7]

Justification and Dissent

The Federal Reserve's primary justification for establishing its own RTGS system for retail payments in competition with the private sector is that otherwise the RTP Network "is likely to remain the sole private-sector provider of RTGS services for faster [retail] payments in the United States." It believes that this

[1] The Federal Reserve also released a set of **FAQs** addressing various questions about the planned service.

[2] See, e.g., Independent Community Bankers of America, **ICBA Urges Fed to Develop Real-Time Payments System** (July 24, 2019).

[3] See, e.g., Financial Innovation Now, **Comment Letter re: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments** (Dec. 14, 2018).

[4] See, e.g., Press Release, **Warren, Van Hollen, Pressley, Garcia Introduce Legislation to Require the Fed to Act on Faster Payments** (July 24, 2019); Press Release, **Chairwoman Waters Applauds Long-Overdue Fed Decision on Real-Time Payments** (Aug 5, 2019).

[5] Press Release, **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); The Clearing House Payments Company LLC, **Comment Letter re: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments** (Dec. 14, 2018).

[6] Bank Policy Institute, **Comment Letter re: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments** (Dec. 14, 2018).

[7] See, e.g., **Letter from Senators Warner, Perdue, Tester, Tillis and Carper to Federal Reserve Chairman Jerome Powell** (July 22, 2019) (**Bipartisan Letter**). See also **Response from Chairman Powell to Bipartisan Letter** (July 26, 2019).

outcome would have significant negative implications for its “policy objectives regarding the accessibility, safety and efficiency of the nation’s [retail] payment system.”

First, “a single private-sector provider of such services is unlikely to connect to the thousands of small and midsize banks necessary to yield nationwide reach, even in the long term.” In contrast, the Federal Reserve “has [already] built a nationwide infrastructure, to provide service to more than 10,000 depository institutions (or their agents) across the country, which would provide a key channel to reach thousands of smaller institutions in the United States that might otherwise not have access to an RTGS infrastructure for faster [retail] payments.”

Second, “a single provider of RTGS services for faster [retail] payments without competition is likely to create undesirable outcomes for pricing, innovation, service quality, and reach. Conversely, provision of the FedNow Service alongside private-sector RTGS service would give banks the option of choosing a service or connecting to more than one service, a choice they have today for all existing payment services.”

Third, “[a] market outcome with a single RTGS service for faster payments would also create a single point of failure. An additional RTGS service for faster [retail] payments would promote resiliency through redundancy.”

Fourth, “the Federal Reserve does not have plenary regulatory or supervisory authority over the U.S. payment system and instead has traditionally influenced retail payment markets through its role as an operator.”

In explaining his opposition to the proposal, Vice Chairman for Supervision Quarles observed that:

> “The U.S. private sector has a long history of providing efficient payment solutions to consumers and businesses. The public sector should provide its own capacity only when the evidence of market failure is clear and alternative means to achieve public goals are not feasible. In this case, I do not see a strong justification for the Federal Reserve to move into this area and crowd out innovation when viable private-sector alternatives are available.”[8]

Background

The United States arguably lags behind other countries in the development of an RTGS system for retail payments.[9] In recognition of this perceived shortcoming, the Federal Reserve organized a Faster Payments Task Force (**FPTF**) in 2015.[10] The FPTF is made up of a diverse group of stakeholders, including small, medium, and large financial institutions, business and government end users, non-bank providers, and consumer interest organizations. In 2017, the FPTF issued its **final report**, including a set of recommendations for achieving safe, ubiquitous, and efficient faster payment capabilities for the United States. Among its recommendations, the FPTF recommended that the Federal Reserve develop its own 24x7x365 RTGS system for retail payments and assess what other operational role(s) the Federal Reserve should play in faster payments.

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[8] Hannah Lang, **Is Fed vote on real-time payments a sign of a wider split?**, American Banker (Aug. 7, 2019).

[9] *See*, *e.g.*, Table 1 in Bank of International Settlements, “Fast Payments – Enhancing the Speed and Availability of Retail Payments,” November 2016, available **here**.

[10] The convening of the FPTF was preceded by the Federal Reserve’s 2013 establishment of the Strategies for Improving the U.S. Payment System initiative and release of a **public consultation paper** on potential improvements to the U.S. payment system. Two years later, on the basis of broad agreement in the responses to the consultation paper, the Federal Reserve released its paper on **Strategies for Improving the U.S. Payment System**. The paper identified five strategies to improve the U.S. payment system, including the implementation of safe, ubiquitous, faster payments capability.

A year later, the Federal Reserve released a notice and request for comment on potential Federal Reserve actions to support interbank settlement of faster payments (the **2018 Notice**). As we **previously described in more detail**, the Federal Reserve sought comment on whether it should take action to establish:

- A 24x7x365 RTGS service provided by the Federal Reserve Banks, and/or
- A liquidity management tool that would support RTGS services.

Based on the feedback the Federal Reserve received to the 2018 Notice, recommendations from the U.S. Treasury Department,[11] and its own analysis, the Federal Reserve has decided to move forward with a 24x7x365 RTGS service to be provided by the Federal Reserve Banks.

Legal and Policy Considerations

In its Notice and Request for Comment, the Federal Reserve stated that its decision to move forward with its planned FedNow Service is consistent with applicable law and its 1984 policy statement on new and enhanced payment services.[12] Under the Monetary Control Act of 1980[13] and the Federal Reserve's 1984 policy statement,[14] the Federal Reserve is required to meet certain obligations and consider certain criteria before deciding to provide a new payment service. In particular:

- The Federal Reserve must expect that its providing the service will yield a clear public benefit (**Public Benefits Criterion**).[15]
- The service should be one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity (**Other Providers Criterion**).
- The Federal Reserve must expect to achieve full recovery of costs over the long run (**Cost Recovery Criterion**).

Federal Reserve policy also requires a competitive-impact analysis for any new service or major enhancement that would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services.[16]

According to the Federal Reserve, its proposed FedNow Service satisfies all three of these criteria for the following reasons, and it is still evaluating the competitive impact of its proposal:

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[11] As part of its **July 2018 report on fintech and financial innovation**, the U.S. Department of the Treasury recommended that the Federal Reserve "move quickly to facilitate a faster retail payments system, such as through the development of a real-time settlement service, that would also allow for more efficient and ubiquitous access to innovative payment capabilities."

[12] See Section III of the Notice and Request for Comment

[13] Section 107 of the Monetary Control Act added Section 11A to the Federal Reserve Act. Section 11A specifies certain principles upon which fees must be based, including that "[o]ver the long run, fees shall be established on the basis of all direct and indirect costs actually incurred in providing the Federal Reserve services." See 12 U.S.C. § 248a(c)(3).

[14] Board of Governors of the Federal Reserve System, ''The Federal Reserve in the Payments System,'' issued 1984; revised 1990. Available **here**.

[15] For payments services, this may include promoting the integrity of the payments system, improving the effectiveness of financial markets, reducing risk associated with payment and settlement services, or improving payment system efficiency.

[16] In addition, the Federal Reserve in the 2018 Notice indicated that it would consider the effect of a potential new service or major enhancement on other critical missions, including conducting monetary policy and promoting financial stability.

- **Public Benefits Criterion.** The FedNow Service will provide a clear public benefit by achieving nationwide reach of an RTGS infrastructure for faster payments, promoting the safety and resiliency of that infrastructure, and encouraging competition between payment services.
- **Other Providers Criterion.** Unless the Federal Reserve provides the FedNow Service, there will only be one RTGS option for retail payments in the United States and that option will not be able to provide an RTGS infrastructure for faster payments with reasonable effectiveness, scope and equity.
- **Cost Recovery Criterion.** The costs of the FedNow Service are expected to be recouped over the long run, although the Federal Reserve acknowledges that this is likely to occur outside of the 10-year period it typically applies to existing, mature services.
- **Competitive Impact Analysis**. The Federal Reserve has conducted an initial competitive impact analysis, and will conduct another, final analysis after considering comments received in response to its Notice and Request for Comment. At this time, the Federal Reserve believes it is "unclear" whether its actions would have a material adverse effect on the ability of relevant service providers to compete effectively.

Comments are due 90 days after publication of the Notice and Request for Comment in the Federal Register.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Luigi L. De Ghenghi	+1 212 450 4296	luigi.deghenghi@davispolk.com
Randall D. Guynn	+1 212 450 4239	randall.guynn@davispolk.com
Jai R. Massari	+1 202 962 7062	jai.massari@davispolk.com
Margaret E. Tahyar	+1 212 450 4379	margaret.tahyar@davispolk.com
Adam B. Fovent	+1 212 450 3542	adam.fovent@davispolk.com
Ryan Johansen	+1 212 450 3408	ryan.johansen@davispolk.com
Carol Rodrigues	+1 212 450 3718	carol.rodrigues@davispolk.com