Fed's Real-Time Payments Idea Presents Risks, Challenges

By Ling Ling Ang and Judy Mok (January 15, 2020, 5:51 PM EST)

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The Federal Reserve System’s announcement that it is developing the FedNowSM Service, a real-time payment and settlement service, has inspired comments about how the reduction in payment delays will reduce overdraft and short-term credit-related costs from policymakers.

Real-time payments can cut both ways for overdraft and consumer use of short-term credit. Given that real-time payment services are platforms for financial institutions, working out responsibilities and calculating restitution and damages may involve considering the dynamics between financial institutions.

Real-time payments allow financial institutions to exchange information to make debits and credits to customer accounts and notify customers of completed or failed payments almost instantaneously. The advent of real-time payment is the first change in the payment rails in the U.S. since the introduction of the automated clearing house, or ACH, system in the 1970s.[1] An ACH batch-processes transactions,[2] which means transactions may clear hours or days after they are first initiated.

On Aug. 5, 2019, the Fed announced it will develop a new, round-the-clock, real-time payment and settlement service, called the FedNowSM Service, to support faster payments in the U.S. FedNow will incorporate clearing functionality into the process of settling each payment. FedNow will provide access through the Fed’s FedLine network, which currently provides Federal Reserve payment and information services to more than 10,000 financial institutions, either directly or through their agents. FedNow is expected to launch in 2023 or 2024.[3]

Clearing House Payments Co. LLC, a private banking association owned by 25 large commercial banks,[4] established the RTP Network, a real-time payments and settlement service, in 2017.[5] While the RTP Network is available to all depository institutions, not all of the more than 10,000 depository institutions in the U.S. use it.[6]

Policymakers have raised consumer protection issues related to the development of real-time payments. A Nov. 7, 2019, letter from Commissioner Rohit Chopra of the Federal Trade Commission to Chairman Jerome Powell and the Board of Governors of the Federal Reserve discusses “problems caused by payment delays,” including “expensive overdrafts and late fees that compound and spiral.”[7] These comments were echoed during testimony by Rep. Jan Schakowsky, D-Ill., in a House Budget Committee hearing on Nov. 14, 2019.[8]

Faster payments may result in different transaction processing orders, but they may not result in fewer overdrafts. Real-time payments are not likely to affect what a consumer earns or their expenses.

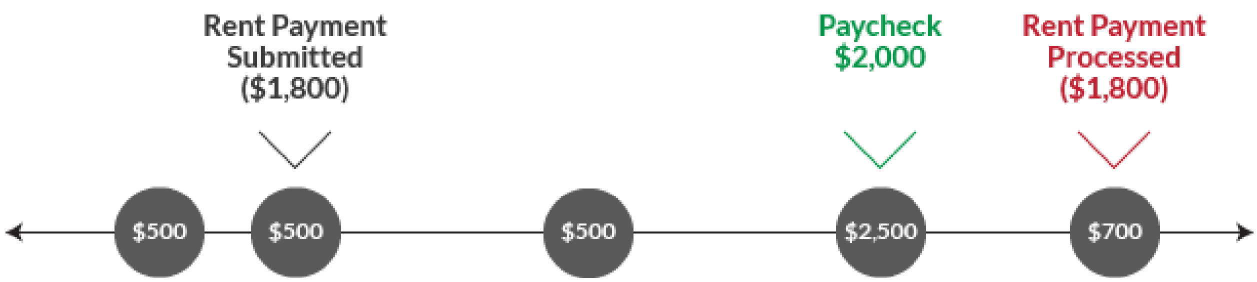
Consider a customer, Mike, who on Dec. 31 does not have sufficient funds to cover his rent, but will be able to cover rent once his paycheck arrives in his account on or before 11:59:59 pm on Jan. 1. His rent is also due on or before 11:59:59 pm on Jan. 1.

With payment delays, initiating a rent payment just before receiving a paycheck is unlikely to result in an overdraft if the transactions occur on the same day because the transactions will clear at the end of the day. However, with real-time payments, Mike may have to wait for his direct deposit to arrive in his account before sending a rent payment or risk incurring an overdraft fee.

To make this more concrete, let's look at an example. Mike's bank calculates overdrafts based on account balances, so a payment does not hit his bank balance until it settles. Until then, it's pending.

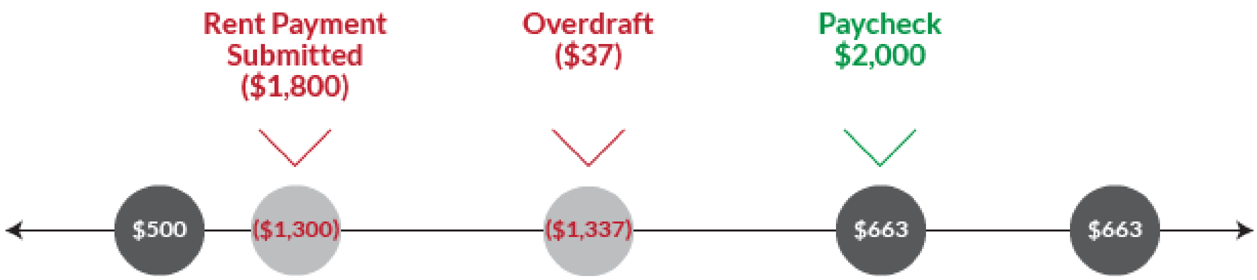
Figure 1, below, shows a series of transactions in Mike's checking account, assuming payment delays. He starts with $500 in his checking account. He initiates an $1,800 rent payment, which does not immediately affect his bank balance because it will clear at least a day later. Later that day, he receives a $2,000 paycheck, which increases his balance to $2,500. The next day, his rent payment is processed, and his balance decreases to $700. In this scenario, he does not incur any overdraft fees.

Overdrafts Based on Balances



Let's consider the same series of transactions with real-time payments, shown in Figure 2, below. Like before, Mike starts with $500 in his account, then pays his $1,800 rent. Since real-time payments are instantaneous, his balance becomes negative, ($1,300), and he incurs a $37 overdraft fee. He later receives his paycheck, which brings his balance back up to $663. His bank balance is lower with real-time payments than with payment delays with the same sequence of events, so he is worse off with real-time payments in this scenario.

Potential Overdrafts with Real-Time Payments



Real-time payment networks and ACH networks are examples of platforms: For a transaction to clear, both the sending and receiving financial institutions have to participate in the platform.

If Judy sends $25 from her checking account to Ling Ling's checking account at a different bank, the $25 has to travel over a payment rail. If Judy's bank belongs to a real-time payment network, but Ling Ling's bank does not, the $25 will have to find another way to Ling Ling's account, likely through an ACH.

If some institutions have real-time payment capabilities but others do not, there may be related uncertainty about when payments process. The uncertainty may be further compounded if available real-time payment networks (e.g., RTP Network and FedNow) are not interoperable. Consequently, the dynamics of moving to real-time payments may be complicated for both financial institutions and customers (e.g., businesses and consumers).

For example, rent payments between a renter and his landlord could run over an ACH one month, and be real-time payments the next month. The renter and the landlord may not know who the other party banks with nor when the banks are transitioning to real-time payments. If financial institutions adopt real-time payments at different times, there may be an increase in overdrafts for some consumers or businesses during the transition.

The likely transition to real-time payments raises important product and contract design, compliance and litigation risk issues. Real-time payments participants will have to enter into contractual arrangements to address the allocation of various risks and liability among themselves. To the extent these risks and liabilities affect consumers, it is more likely than not that they will catch the attention of regulators who will scrutinize real-time payments transactions and contractual arrangements from a consumer protection standpoint.

For example, one risk that many people in the payments industry are concerned about with the settlement of payments in real time is that there is less time to examine the transactions for fraud. Banks have acknowledged that faster payments open up greater fraud potential, so participating banks would need to have appropriate fraud controls and checks in place given the irrevocable nature of real-time payments.

One of the best ways to prevent fraud in a real-time payments environment is to stop fraudulent transactions at the point of initiation. At the end of the day, the sending bank (as the party that is sending and initiating the real-time payment transaction) is likely to be in the best position to understand who its customers are and authenticate their transactions. When parties negotiate contract provisions for fraud liability in a real-time payment arrangement, the parties will probably consider who is in the best position to prevent fraud, and what each party is willing to pay in exchange for that protection.

Additional risks and challenges will surface as real-time transactions become more mainstream and as participants adapt to the transition to real-time payments for everyday use. Financial institutions will need to implement the transition to real-time payments while customers continue to transact.

It will be interesting to see how financial institutions will negotiate allocation of risk and liability among themselves, and in particular how they will address the consumer's liability for things like fraud and overdraft fees with respect to any FedNow transactions. In some cases, calculating restitution of damages may involve considering the alleged conduct, policies and data of multiple financial institutions and how they interact.

Whether real-time payments would result in more or fewer overdrafts is an empirical question that involves not only how transaction ordering would change under real-time payments, but also how users — businesses and consumers — may respond to changes in payment processing.

Some users may be affected differently than others. Users may adjust the timing of their expenditures and how much they keep in cash. Financial institutions may change overdraft policies and disclosures. Users are likely to respond, if at all, in different ways, which may vary as penetration of real-time payments evolves.

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[1] Federal Reserve Bank of New York, Automated Clearing Houses (ACHs), May 2000, https://www.newyorkfed.org/aboutthefed/fedpoint/fed31.html.

[2] Board of Governors of the Federal Reserve System, Automated Clearinghouse Services, Nov. 6, 2019, https://www.federalreserve.gov/paymentsystems/fedach_about.htm.

[3] Board of Governors of the Federal Reserve System, Federal Reserve announces plan to develop a new round-the-clock real-time payment and settlement service to support faster payments, Aug 5, 2019, https://www.federalreserve.gov/newsevents/pressreleases/other20190805a.htm;

Federal Reserve Actions to Support Interbank Settlement of Faster Payments, 84 FR 39297, Aug. 9, 2019 (Federal Register Notice).

[4] The Clearing House. Owner Banks, https://www.theclearinghouse.org/about/owner-banks (last visited Dec. 10, 2019).

[5] The Clearing House, The RTP Network: For All Financial Institutions, https://www.theclearinghouse.org/payment-systems/rtp/institution (last visited Dec. 10, 2019).

[6] Ibid.; Federal Register Notice.

[7] Letter from Rohit Chopra to Jerome Powell and the Members of the Board of Governors, Nov. 7, 2019, https://www.ftc.gov/system/files/documents/public_statements/1553340/chopra_-_comment_to_federal_board_of_govs_docket_no_op-1670_11-7-19.pdf, at 3.

[8] See, e.g., Jon Hill, FedNow Could Arrive Sooner than You Think, Fed Chair Says, Law360, Nov. 14, 2019, https://www.law360.com/articles/1219926/fednow-could-arrive-sooner-than-you-think-fed-chair-says.