Federal Reserve System
Regulation J - Docket No. R-1750

Response to the Federal Reserve Board's Request for Comments on Proposed Amendments to Regulation J to Govern Transfers over the FedNow Service

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This is in response to the request by the Board of Governors of the Federal Reserve System (Board) for public comments on its notice of proposed amendments to Regulation J to support the new FedNow service. My credentials pertaining to the subject are provided in two earlier public comments: November 26, 2018, response to the request for comments on potential Federal Reserve actions to support interbank settlement of faster payments; and October 16, 2019, response to the request for comments on actions to support interbank settlement of faster payments. Further, I have familiarized myself with the Board's August 11, 2020, publication "Service Details on Federal Reserve Actions to Support Interbank Settlement of Instant Payments." I have also published research that foreshowed the Board's establishment of FedNow.[1]

While I am not a lawyer, I have considerable experience applying regulations and their supporting operating letters to the day-to-day management of payment systems. My comments, therefore, offer a practical perspective on the Board's proposed Regulation J amendments in support of FedNow.

The Board's current proposal to modify Regulation J rounds out the public policy and operational framework for the new FedNow service. My comments below are intended to help ensure that the proposed legal foundation supports the Board's original public policy aims and is consistent with operational details the Board has already published.

My response has four main parts. The first part highlights attributes that distinguish FedNow from other methods of payment, and that compel a "ground up" approach to developing Subpart C. The second part critiques the Board's approach to developing new Subpart C. The third part addresses the Board's specific questions regarding 1) time parameters to define operationally the meaning of "immediate," and 2) conditions under which a beneficiary's bank may delay acceptance of FedNow transfers. The fourth part summarizes my comments.

I. Subpart C is the foundation for an entirely new means of payment

FedNow is designed to support, in the Board's words, "immediate" or "instant" end-to-end funds transfers through depository institution accounts. As such, FedNow has the potential to connect all demand deposit accounts across all depository institutions (possibly including special-purpose banks specializing in payment services) for use by all combinations of account owners. FedNow, like the analogous RTP service offered by The Clearing House, will provide back-end clearing and settlement for

[1] Summers, Bruce J. and Kirstin E. Wells (2011). "Emergence of immediate funds transfer as a general-purpose means of payment," *Economic Perspectives*, Federal Reserve Bank of Chicago, 3Q/2011; and

Summers, Bruce J. (2012). "Facilitating Consumer Payment Innovation Through Changes in Clearing and Settlement," Proceedings of the March 2012 international payments conference sponsored by the Federal Reserve Bank of Kansas City, *Consumer Payment Innovation in the Connected Age*.

new payment services offered by depository institutions to their customers. If supported well on the back-end, new depository institution services promise to be competitive with the funds transfer services offered by privately-issued cryptocurrencies.

The most distinguishing attribute of FedNow beyond immediacy of payment is its versatility. FedNow will support payments involving <u>all combinations</u> of payors and payees, including individuals, financial and non-financial businesses, and governmental bodies. The versatility is unlike that which is offered by other means of payment, including Fedwire and ACH, or credit and debit cards. In this sense, FedNow is most like the paper check, which can be used for virtually any type of transaction across all combinations of payors and payees. The potential number of FedNow use cases is large and probably unimaginable at this time, and will include P2P, P2B, B2P, B2B, etc.

Moreover, FedNow, like other Federal Reserve clearing and settlement services, will be managed and priced like a utility. This means that inter-bank clearing and settlement for immediate payment services will exhibit economies of scale which will be passed on directly to FedNow participants and indirectly to the participants' customers. Moreover, management transparency, a hallmark of Federal Reserve operations, will provide incentives for efficient cost management.

The distinguishing features highlighted above – immediacy, versatility, and utility-style management – set the stage for significant disruption to markets for established methods of payment, including credit and debit cards, ACH, and even traditional large-value payment methods such as Fedwire.[2] To cite but one example of potentially significant "creative disruption," retail merchants can re-fashion POS checkout based on an immediate payment alternative to credit and debit cards. The incentive for doing so is avoidance of monopoly-style interchange fees, with savings shared between merchants and their POS customers. Accordingly, "merchant banks" and "issuing banks" would take on new roles as "immediate payment banks." These banks would cooperate in a deposit-account network, not unlike that for checks, and would offer immediate payment services to shoppers through their mobile devices, and services to merchants that efficiently integrate the merchants' POS checkout with shoppers' bank-enabled immediate payment capabilities.

Consideration of the new legal framework for FedNow and immediate payments should give center stage to the distinguishing features highlighted above and to the FedNow business process step "acceptance" described in Figure 1 of the Board's August 11, 2020, announcement of service details. The Board's service announcement is unambiguously clear about the way an immediate funds transfer between depository institution accounts is completed, especially the way a beneficiary's bank signals it is ready to accept and credit funds to the beneficiary. The FedNow processing flow calls for in-line confirmation by the receiving bank that it will accept the transfer. The sending and receiving Federal Reserve Banks, in turn, will continue to process and complete the transfer once the receiving bank positively acknowledges acceptance. Imbedding this step directly in the FedNow processing flow as a condition to inter-bank completion is the surest way to achieve timing efficiency and operational certainty. This unique operational design should be explicitly recognized in proposed Subpart C, its commentary, and the Federal Reserve operating circular that is written in support of the regulation and FedNow procedures.

II. Proposed Subpart C should be tailored to FedNow and immediate payments

[2] The medium value of a Fedwire transfer is $20 thousand, suggesting that the majority of Fedwire payments are so-called "small-value" payments. See "The Fedwire Funds Service: Assessment of Compliance with the Core Principles for Systemically Important Payment Systems," Revised July 2014.

Proposed Subpart C and its commentary appear to cobble together existing laws and regulations whose principal purposes are to govern different and older means of payment. This approach to crafting the new Subpart C relies so heavily on regulatory concepts tailored for older methods of payment that it could inhibit participant use of FedNow to enable innovative immediate payment services.

The proposal incorporates UCC Article 4A into Subpart C, as does current Subpart B applying to Fedwire. It notes potential "minimal" inconsistencies with EFTA and Regulation E which would apply and prevail for electronic funds transfers involving consumers. The commentary does not explicate what these inconsistencies might be or elaborate how they would apply to use cases involving combinations of payors and payees, such as individuals and businesses, or individuals and governmental entities.

The proposed Subpart C sets up a whole new area of practice for lawyers as FedNow spurs innovation in a variety of settings involving many different combinations of payors and payees. At a minimum, I recommend that the proposal and its commentary be elaborated with examples of use cases where conflicts are likely to arise in the payment chain. The critical step of "acceptance" may provide a useful example of the type of elaboration that would help.

My practical experience is that conflicts surrounding acceptance of large-value funds transfers can be contentious, litigious, and expensive to resolve. Relying on UCC 4A as a basis for Subpart C, as incorporated by reference into Regulation J, Subpart B, is replete with operational pitfalls. In particular, acceptance of a payment order by a beneficiary's bank under UCC 4A occurs at the earliest time when: the bank pays the beneficiary or notifies the beneficiary of receipt of the payment order, or credits the beneficiary's account; when the beneficiary's bank receives the entire amount of the sender's order; or the opening of the next funds-transfer business day. This menu of possibilities for acceptance of a large-value funds transfer reflects a Fedwire business process that is indifferent to the end-to-end transfer of funds, rather focusing solely on inter-bank settlement in Federal Reserve Bank accounts.

Fedwire, in direct contrast to FedNow, does not have an "acceptance" step. Further, UCC 4A contemplates a funds transfer process that allows for next day availability of funds for beneficiaries. The public would benefit from a more streamlined and elegant Subpart C that clearly depicts rights and responsibilities involving acceptance of a funds transfer.

The Board's request for help defining conditions under which a receiving bank may withhold its acceptance of a FedNow payment (see footnote 9 in the May 7, 2021, staff memo to the Board) reflects the dissonance between the world of UCC 4A and large-value funds transfer systems such as Fedwire, on the one hand, and the soon-to-be world of FedNow, on the other hand. There is no definitional room to think about withholding an immediate payment. Practically speaking, there is no time capacity available for a receiving bank to ponder whether it should or should not accept a payment, much less to confer with its Federal Reserve Bank. Rather, acceptance of a FedNow transfer is a clear binary choice – accept or reject. I address this issue further in the third section below.

Everything about the FedNow design and operational structure is new, including the business process illustrated in the Board's August 11, 2020, publication of service details. My understanding is that the FedNow operational platform is being built from the ground up, and I surmise that controls and security features will also reflect new thinking. I recommend that the Board consider whether its proposed legal foundation provides the best possible support for the FedNow service.

III. Responses to the Board's specific questions

The Board poses two specific questions about FedNow (see page 22 of the request for comment Docket No. R-1750). These questions are summarized and then answered below.

1. The first question is in two parts, a) should specific time parameters be set out to clarify the meaning of "immediately" and b) what are the benefits and drawbacks of specifying that "immediately" means that the beneficiary's bank must make funds available within seconds or within one minute of a payment order's being accepted?

   In response to part a) of the question, and upon considerable reflection, I advise that the Board not specify specific time parameters to clarify the meaning of "immediately." Rather, the Board and its lawyers would best rely on the dictionary definition of immediately, namely, "at once" or "directly" or "without interval of time" to convey the general intent for completing a FedNow transfer from end-to-end. Relying on the dictionary definition sufficiently conveys the intention that receiving banks, once they complete the business process step of accepting a transfer, not introduce delays that would interfere with getting funds "directly" to the beneficiary.

   The Board's commentary is clear about the general intent that the time unit of measure is seconds, not minutes, hours, or even overnight as in the case of a Fedwire, and it establishes this expectation as a term of service for FedNow participants. That said, the May 7, 2021, staff memo states that this term of service "would not provide a private right of action to a customer…with respect to the failure by the FedNow participant to satisfy…the availability requirement." While understandable, this staff position weakens the Board's stated intent. I suggest that the Board be more clear about how it will ensure that this term of service is met, for example, by pointing out that bank examinations will give attention to FedNow terms just as attention is given to adherence to the rules and regulations governing participation in other payments services.

   In response to part b) of the question, the downside to specifying a specific time measurement for funds availability is that the quality of customer service is likely to be determined not only by funds availability but also the timeliness, completeness, and convenience of notification of funds availability. That is, while I may have final funds credited to my account, the funds are of no use unless I know they are on deposit. So, fulfilling the intent of end-to-end availability is a function of both crediting accounts and letting the account owner know that funds have been credited.

   By way of hypothetical example, say the Board specified one second as the operational definition of funds availability for an immediate payment. Then, say that bank A credits funds in one second but is tardy in notifying its customer (say, in real-time over a mobile app) that the funds are available for use. But say that bank B takes two seconds to credit funds and provide notice to its customer. While bank A would be in compliance with the Board's quantitative rule, bank B, while not in compliance, would clearly be providing a higher quality service.

   In conclusion, to achieve its public policy aims and in the interest of regulatory efficiency, the Board would best rely on plain-English use of the word "immediate" in its rules governing FedNow. The private contracts between depository institutions and their customers, responding to a plain-English regulation, will best lead to a new payments world where the public instinctively thinks "pay with IFT – immediate funds transfer."

2. The second question is, should Subpart C accommodate a FedNow feature that permits a participant to notify a Reserve Bank that it requires “additional time” to determine whether to accept a FedNow payment order.

   In response, it is not at all clear what the Board’s intent is in asking this question. There is no basis in the Board’s operational description of the FedNow business process that receiving banks would be making anything other than crisp, binary decisions to accept or not accept (step 5 in the August 11, 2020, description of service details). The Board’s question seems rooted in the “old” Subpart B and Fedwire business conventions that allow for delayed acceptance and notification of receipt of funds transfers. Extending this thinking undermines the Board’s public policy aims and the market potential of immediate payments.

   A streamlined acceptance process, in-line with transactions processing conducted by the Federal Reserve Banks, is the only model that supports immediate and reliable end-to-end funds availability. The Board should consider what measures receiving banks should be taking in order to conform to such a process. Such measures would include advance KYC review before depository institutions enroll customers in their immediate funds transfer services, strong information security and authentication procedures, and strong controls over use of funds on deposit.

   In short, I advise that the Board not deviate from the business-process model for acceptance of FedNow transfers that it laid out in August 2020.

IV. Summary

The Board’s proposed amendments to Regulation J to support the new FedNow service can be better adapted to the technical and market changes that underlie immediate funds transfer (IFT). The legal regime as proposed is backward-looking, building on timing conventions and less-than-certain transfer and availability of funds that can characterize third-party Fedwire payments. The proposal is an alphabet soup of older regulations that is difficult to apply in the IFT world.

A more promising approach is to craft a new Regulation J Subpart C that internalizes and gives center stage to the distinguishing features of FedNow – immediacy, versatility, and utility-style management. This approach is most likely to provide a legal foundation that enables private sector innovation resulting in IFT services that creatively disrupt traditional payments markets and produce digital payment alternatives using commercial-bank money that are competitive with privately-issued cryptocurrencies.

The Board’s public policy aims can be visualized as a world where consumers, businesses, and governmental bodies think “pay by IFT.” A different approach to rule-making, as described in these comments, will best support this public policy vision.

Thank you for the opportunity to comment on this important notice of proposed rulemaking.

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