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Policy Perspectives

From Then to FedNow: Payments Innovation and the Federal Reserve

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Since its founding, the Federal Reserve System has evolved its payments services to be responsive to changes in the industry and to meet the needs of its customers and the public generally. To be sure, episodes of tragedy and crisis can amplify the gaps in legacy systems and approaches, and the COVID-19 pandemic is no exception as it highlights shifting consumer payments preferences.

As an operator of payments services, the Federal Reserve has long played a role in ensuring the country's payments infrastructure can effectively meet the public's needs. This commitment is best demonstrated by its ongoing partnership with the payments industry, by the continuous improvements to its own services, and by its accountability for safe, accessible, and efficient payments. In the midst of the current pandemic, the Federal Reserve has maintained its priority to develop a new payments rail in support of instant payments for all Americans. Across all of its services, efficiency, speed, and safety are essential and require the ability to adapt and innovate with the public's interest in mind.

The Federal Reserve System's role in the U.S. payments system is grounded in its founding charter. In 1913, the Federal Reserve Act, signed in the wake of the banking panic of 1907, directed the Federal Reserve to establish a national clearinghouse and to promote check collection at par. The establishment of a centralized clearing mechanism would ensure that a check written for \$10 would be paid out to the recipient at \$10. As was common in those days, some local

banks took a "cut" of the funds for processing check payments, and often sent those checks on circuitous routes before reaching their ultimate destination. The Fed's system of regional Reserve Banks recognized and eliminated these inefficiencies and inequities in check processing.

Then, in 1918, a more efficient means to transfer funds was developed by the Federal Reserve, initially utilizing Morse code – a system we now know as wire transfer. Today, the Reserve Banks continue to operate the Fedwire system for large-value transfers. Payments evolution continued throughout the 20th century, including the advent of the magnetic ink character recognition, or MICR, system in the 1960s. The Federal Reserve's support of this private sector solution sped up check processing speeds and paved the way for continued payments innovation. In the mid-1960s, Federal Reserve Governor George Mitchell, an advocate of a future "checkless society," envisioned a day when depositors would be notified of electronic postings to their accounts. It would take some time for this electronification to take hold, but the technology available at the time enabled solutions to problems arising from crisis. Indeed, in the wake of the 9/11 tragedy, the "Check Clearing for the 21st Century Act," or "Check 21 Act," went into effect, which reduced physical transportation of paper checks by converting check documents into electronic images. The MICR and Check 21 Act improvements to check processing led to increased efficiencies. These partnerships and innovations drove change.¹

¹ See "Highways of Commerce," Federal Reserve Bank of Kansas City, for a detailed discussion of the Fed's history in the payments system.

In the 1970s, the Federal Reserve supported the development of the automated clearinghouse, or ACH, system. This system has undergone recent improvements and has added conveniences, including a pending third, same-day ACH processing window to be available in 2021. For its part during the current crisis, the ACH system processed 120 million Economic Impact Payments (EIPs) to Americans.² In addition, the ACH system is leveraged as the underlying system some end-user payments options utilize today; examples include popular person-to-person payment applications. It will be important to keep an eye on the shifting payments transaction volumes as the pandemic continues, including trends with person-to-person and contactless payments, as these trends can inform both consumer and business expectations.³

Clearly, the pace with which all transactions occur today has quickened with the proliferation of technology. With that in mind, and following extensive industry consultation and public comment, in 2019, the Federal Reserve announced its plans to build the FedNowSM Service, a modern, fast, safe payment service.⁴

In August 2020, the Federal Reserve achieved a key milestone in FedNow's development, marked by the announcement of the service's features and functionality.⁵ At initial release, planned for 2023 or 2024, the service will provide a clearing and settlement infrastructure that enables participating financial institutions to provide safe and efficient instant payment services in near real-time, around the clock, 365 days a year.⁶ FedNow instant payments will continue the Fed's longstanding commitment to, and role in, supporting safe, accessible, and efficient payments in the United States.

Indeed, the Federal Reserve's involvement and partnership with the payments industry, as well as its operation of payments services, have yielded benefits to the public.⁷ The decision to build and operate FedNow instant payments infrastructure resulted not only from gathering and analyzing public comments, but also importantly from collaborative efforts throughout the 2010s. These efforts included initially consulting and subsequently announcing the Federal Reserve's Strategies for Improving the U.S. Payments System and convening the Faster Payments Task Force.⁸ Ultimately, one recommendation from the Task Force was for the Federal Reserve to develop and operate instant payments infrastructure.⁹

Looking ahead, an instant payments service operated by the Federal Reserve, alongside an existing private sector solution, has the promise of strengthening resiliency among the payments systems. The presence of multiple systems also provides competition, in the interest of efficiencies for both banking organizations and consumers. Finally, the Federal Reserve's service will be accessible by all banking organizations in all parts of the country – reaching over 10,000 diverse depository institutions and their customers.

As the development of FedNow is underway, it will benefit from opportunities to learn from the current crisis when considering how consumers might use the service. For example, initial insights suggest growing consumer interest in digital payments, including contactless payments technology, during the COVID-19 pandemic.¹⁰ Transfers of relief funds from the government to individuals were made via multiple different systems, including electronic transfers, paper checks, and prepaid cards. The current pandemic has demonstrated that infrastructure, if widely available, would be critical to a more

² <https://home.treasury.gov/news/press-releases/sm1025>

³ <https://www.kansascityfed.org/publications/research/rwp/psrb/articles/2020/covid19-pandemic-may-reshape-digital-payments-landscape>

⁴ <https://www.federalreserve.gov/newsevents/pressreleases/files/other20190805a1.pdf>

⁵ <https://www.federalregister.gov/documents/2020/08/11/2020-17539/service-details-on-federal-reserve-actions-to-support-interbank-settlement-of-instant-payments>

⁶ <https://www.federalreserve.gov/newsevents/pressreleases/other20200806a.htm>

⁷ www.gao.gov/assets/680/679388.pdf

⁸ <https://fedpaymentsimprovement.org/wp-content/uploads/strategies-improving-us-payment-system.pdf>

⁹ <https://fedpaymentsimprovement.org/strategic-initiatives/faster-payments/faster-payments-task-force/>

¹⁰ See <https://www.frbsf.org/cash/files/consumer-payments-covid-19-pandemic-2020-diary-consumer-payment-choice-supplement.pdf> and <https://thefinancialbrand.com/101415/payment-contactless-card-mobile-wallet-digital-coronavirus-covid-19-pandemic-trend/>

efficient means to make instant payments.¹¹ Lessons from our current crisis could better inform not only development of the FedNow service, but also, importantly, future services that will utilize the FedNow infrastructure to reach end users. COVID-19 could provide a glimpse at the future of payments and enable FedNow and associated add-on applications to factor in consumer trends while modernizing payments solutions to meet customer demand. As is the case today, innovative solution providers can partner with banking organizations to bring their products to consumers' computers, mobile phones, and even watches, to facilitate payments transactions through their banking relationships. Financial technology companies and innovative payments solutions providers that will leverage the FedNow payments rail may be gathering the information and data points they need to build their products better, in response to COVID-19 trends.

As consumer preferences continue to shift and respond to the pandemic, banks of all sizes will be evaluating the likely adoption path of instant payment services in the United States. Banks are already planning today for what payments may look like tomorrow. The Federal Reserve supports this forward-looking approach through its FedNow Community where bankers and industry stakeholders can stay informed and offer input on the development of the FedNow Service.¹² FedNow Community mem-

bers will be important partners to inform service design; to influence product development; to consult on service features, technology, and implementation plans; and to provide insights on readiness for, and barriers to, onboarding. Additionally, the Federal Reserve announced a FedNow pilot program, which will support the development, testing, and adoption of the service.¹³ These opportunities for involvement provide a forum for payments industry participants to engage and stay abreast of changes.

The Federal Reserve's longstanding commitment to providing efficient, secure, accessible payments is underscored in each of its current services. Strong partnerships with payments industry participants – from banks to fintechs – have enabled the Fed's services to remain innovative and responsive over the years and throughout crises. An investment in developing and operating new, instant payments infrastructure further demonstrates a commitment to this core mission area of the Federal Reserve System. Building FedNow is the next chapter in the Federal Reserve's payments services offerings and will pave the way for other technological advances and, as observed by the current crisis, will present opportunities to address shifting consumer preferences. This instant payments infrastructure will be foundational to the future of payments services, and the Federal Reserve stands ready to provide these innovative services with equitable access, efficiency, and safety.

¹¹ <https://www.kansascityfed.org/publications/research/rwp/policy-perspectives/articles/pondering-payments-challenges-of-reaching-all-americans>

¹² <https://www.frbservices.org/financial-services/fednow/fednow-community.html>

¹³ https://www.frbservices.org/financial-services/fednow/announcing-the-fednow-pilot-program.html?utm_source=home-091720&utm_medium=banner&utm_campaign=fednow&utm_content=fednow-pilot-program



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