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## Check Clearing Via FedNow?

Recently I was asked if the Federal Reserve (Fed) is planning to clear checks through its new service, FedNow. This question emanates from comments by executives at the Fed implying that FedNow will accelerate the clearing of check payments. Let us consider that possibility for a few minutes. Could FedNow accelerate check clearing, how might that happen and what are the implications of such an inclusion?

**Accelerating check clearing** - Is it possible to accelerate check clearing and, if so, by how much? First, let us consider checks continuing to clear much as they are today and not via FedNow. I will address potential clearings through FedNow below. Today, some checks are cleared through the Fed's check system and some directly between financial institutions.

- For checks cleared directly between financial institutions, a high percentage are posted at the paying bank on the same day they are deposited with the depository bank. This is because the check clearing system is virtually all electronic. Also, a growing percentage of checks are deposited electronically by the payee. Once the payee receives a check, that check can be deposited and cleared all the way through to the paying bank the same day as received by the payee. Therefore, the primary opportunity to accelerate the clearance of these checks is to accelerate the delivery of the checks between the payor and the payee. This paper does not address that option but information concerning electronic payments cleared through the check system as if they were checks is available at [www.tillereendeavors.com/endeavors](http://www.tillereendeavors.com/endeavors).
- Some financial institutions clear all of their non-on-us deposited checks through the Fed and some clear through the Fed only those checks that are not cleared directly between the financial institutions. The clearing times for checks cleared through the Fed are dictated by the schedules and prices established by the Fed. Receipt cutoff times for inbound cash letters at the Fed are typically earlier than the receipt deadlines for direct exchanges between banks. Therefore, there are checks sent to the Fed that are not delivered to the paying bank until the next day. This delay is the result of multiple, additional steps not required for direct exchanges between banks and those additional steps do not leave much opportunity for acceleration.

**Clearing checks via FedNow** – The gating factor to clearing checks via FedNow is that the FedNow service, as planned, will support only credit push payments. By contrast, checks are debit pull payments. Additional information about debit pull vs. credit push payments can be found at <https://tillereendeavors.com/wp-content/uploads/2019/02/Comparison-of-Key-Requirements-for-Real.pdf>.

Having said that and for the purpose of this paper, let us now consider what might happen if the Fed were to offer check clearing via FedNow. First, there would have to be a check payment. A payment that meets the legal definition of a check would have been originated in paper form and transferred from the payor to the payee. Once received by the payee, there might be two options for clearing the payment via FedNow.

- One option for the payee, once it receives a check, would be to electronically provide the check payment directly to the paying bank, not the depository bank. The paying bank would then morph the debit pull check payment into a credit push payment to be sent to the depository bank via FedNow.
- Another option might be for the payee to send the check to its bank (depository bank) where the payment would mutate from a debit payment to a request for payment (RFP). The RFP would then be sent to the paying bank that would respond to the RFP by initiating a credit push payment to be sent back to the depository bank via FedNow.

Both of these options are complicated operationally and legally and would likely cost more than the current process of clearing checks electronically directly between two banks or through the Fed. The results would be a more expensive check clearing system with marginal, if any, clearing acceleration. It is unlikely that either of these options would yield a positive ratio of benefit to expense.

**Other implications of clearing checks via FedNow** – This is the really interesting part.

- Under the assumption that the Fed would offer check clearing via FedNow, what law would govern these hybrid, check/FedNow payments? Because they begin as checks, the Uniform Commercial Code (UCC), Regulation CC and agreements would apply. Regulation J and Operating Circular 3 might also apply, depending on where the transition occurs with paper checks becoming electronic FedNow payments. Additionally, because they are ultimately cleared via FedNow, a new FedNow Operating Circular for credit push payments would apply and potentially Regulation E for consumer payments. This tangle of legal governance would greatly complicate resolution of disputes between the various parties. Just one example is the difference in finality between a check with delayed availability and a real-time, irrevocable FedNow payment. When would these hybrid payments be final and would there be a check-like option to return unpaid payments? Finally, when governing legal provisions are in conflict, which would prevail?
- The most interesting implication, however, results when an originated paper check morphs mid-collection stream from a check, which is a debit pull payment, into an electronic FedNow payment which is a credit push payment. Magically creating deposits (credits) from debit payments would generate a remarkable amount of interest and probably yield unintended and fraudulent consequences.

Given all this, it is unlikely that the Fed will consider adding check clearing to its FedNow, credit push only service. In the absence of a debit pull option, it is improbable that FedNow will have any significant impact on the clearing times of checks and especially those cleared through the Fed. For more details about the FedNow service as it is currently envisioned by the Fed please visit

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

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