MODERN PAYMENT RAILS and Impact on Good Funds Laws

Description

ALTA Develops Model Good Funds Bill Due to Increased Digital Options
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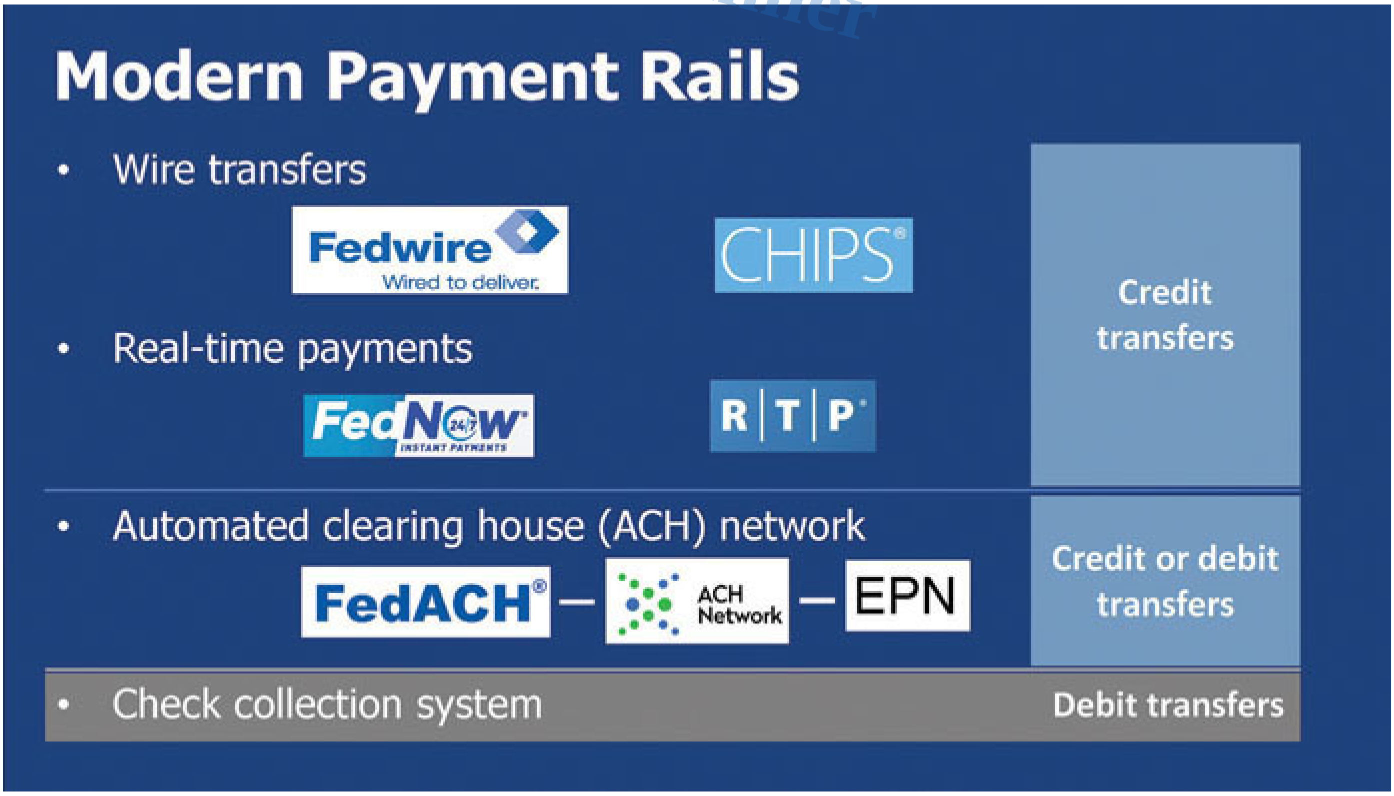
THE WAY PEOPLE SEND AND RECEIVE MONEY IS CHANGING.

Consumers and businesses are moving toward technologically advanced payment practices that better align with their evolving wants and needs. While the industry has been hearing a lot over the past few years about modern payment rails, itâ??s important for title and settlement services professionals to understand which payment methods are appropriate for real estate transactions.



Payment Rails

Until the second half of the 20th century, the check collection system was the only widespread payment system. Wire transfers were relatively rare and governed almost entirely by private contract and custom. Today, things look drastically different. Payment rails are the underlying infrastructure and systems that facilitate the transfer of funds between individuals, businesses and financial institutions. They enable the secure and efficient movement of money, both domestically and internationally, and are important components of the global financial ecosystem.

Payment rails have many names, depending on the context and the specific payment system in question. Additional terms used to describe payment rails include:

- Payment networks
- Payment systems
- Settlement systems
- Clearing systems
- Money transfer systems

There are two basic models for transferring money between bank accounts: a â??creditâ?• transfer and a â??debitâ?• transfer, according to Michael Oâ??Neal, vice president of corporate underwriting at First American Title Insurance Co. Wire transfersâ??such as Fedwire and Clearing House Interbank Payments System (CHIPS)â??as well as the Real Time Payment System (RTP) and FedNow are credit transfers. Meanwhile, the Automated Clearing House (ACH) network is a credit or debit transfer.

Wire Transfers

The term doesnâ??t have a precise legal meaning, but Fedwire and CHIPS are the two agreed upon â??wire transferâ?• systems. Every day, Fedwire on average handles more than $4 trillion in payments while nearly $2 trillion is moved via CHIPS. Fedwire operates between more than 5,000 U.S. banks that have master accounts at one of the 12 regional Federal Reserve Banks. CHIPS is largely limited to the domestic branches of foreign banks and primarily handles cross-border payments.

â??In real estate transactions, we are almost always sending wires via Fedwire, although CHIPS may be used in some commercial transactions involving international investors or lenders,â?• Oâ??Neal said.

Both methods are governed by Article 4A of the Uniform Commercial Code.

The magical moment in a wire transfer is â??acceptanceâ?• of the funds by a beneficiaryâ??s bank.

â??The concept of acceptance under Article 4A has a somewhat counterintuitive meaning that is not the same as other areas of the law, since it can happen without knowledge or intent,â?• Oâ??Neal said. â??When a beneficiary bank places wired funds in its customerâ??s account, or gives notice that funds are available, Article 4A invalidates any attempt by the bank to make that payment provisional and therefore revocable.â?•

Additionally, the person who sent the wire has no right to claw it back except in very limited situations, such as a payment that was wired twice.

The payment finality of wire transfers has some downsides, including wire fraud and error in the payment process.

â??If money is stolen or wired in error, it may be out the door and difficult or impossible to get back,â?• Oâ??Neal said. â??In addition, there are significant timing and control issues related to wires.â?•

Wires can take up to two days to complete. Thereâ??s no statutory duty for a receiving bank to act on a payment order. Also, an originating or intermediary bank may delay or refuse to process a payment because they want to avoid â??daylight overdrafts.â?•

â??If a bank has received more outgoing wire requests than it has in its Federal Reserve master account, it may put wires in a queue before processing outgoing payments,â?• Oâ??Neal said. â??From a title company standpointâ??how are we or our customers supposed to know this is happening?â?•

Real-time Payments

A â??real-timeâ?• or â??instantâ?• payment is like a wire transfer but with several key differences. Like a wire, a real-time payment operates as a real-time gross settlement system. That is, each payment is handled one by one between participating banks by individual debits and credits to their Federal Reserve master accounts.

However, unlike a wire, where the processing time can stretch for hours or even days, in a real-time payment the entire transfer happens nearly instantaneously, according to Mickey Vandenberg, vice president of escrow operations for Stewart Title Co.

â??There are no wire cutoff times or windows in which payments must be made,â?• she said. â??These systems are intended to be used both by businesses but also for consumer, peer-to-peer payments.â?•

Complex federal lawsâ??and potentially state laws, depending on the issueâ??govern FedNow. The RTP system is governed by a complex interplay of federal and state as well. Most of the rules for RTP are found in the private system rules. RTP is also governed by UCC Article 4A as adopted in New York for any non-consumer payments.

â??So, while the two real-time payment systems share a lot of similar features, itâ??s important to understand that they may be governed by slightly different sets of rules,â?• Vandenberg said.

For RTP and FedNow, a sending bankâ??s payment to a receiving bank becomes â??finalâ?• the instant it is recorded in the transaction ledger at the Federal Reserve Bank or by the RTP system. Like with wires, this means that paymentâ??including discharge of any underlying debtâ??happens simultaneously with the posting of the payment transaction between banks.

Like with wires governed by Article 4A, once a real-time payment is made it cannot be reversed, except by a voluntary return by the receiving bank. While a sending bank may request reversal of a payment and the receiving bank is required to provide a response there is no obligation to reverse a completed payment transaction.

Both real-time payment systems offer features to help mitigate payment fraud, such as multifactor authentication. RTP uses the â??tokenizationâ?• of users to mask their underlying account numbers. This will assist preventing account information from being inadvertently used or hacked by fraudsters, according to Vandenberg. FedNow permits dollar limits for specific participants of the system and also has a â??negative listâ?• of suspected bad actors.

Both payment rails also currently have transaction limits on the size of payments. RTPâ??s is $1 million, while FedNow launched this summer with a $500,000 limit. (The system default is $100,000.) These caps are intended to restrict the amount of money that can be inadvertently sent, Vandenberg said, but are expected to rise in the future as additional fraud-mitigating technologies are deployed. The dollar caps limit the utility of these payment rails in many real estate transactions because residential property values often exceed them in several markets.

Finally, a feature known as â??request for paymentâ?• is being developed and is not yet available for real estate transactions. Once available, Vandenberg said, it should be a powerful way to prevent a lot of interloper wire fraud.

â??A request for payment will enable a companyâ??like a title agencyâ??to send an invoice or perhaps a settlement statement to a customer asking for payment in the requested amount,â?• Vandenberg said. â??Since the request comes directly from the business, this greatly reduces the risk that some fraudster will intervene and provide false wiring instructions, or that the consumer will mis-key the businessâ??s account number when setting up the payment.

â??All together, these fraud mitigating techniquesâ??which are still being developed and more widely deployedâ??hold the promise of making real-time payments significantly safer than wire transfers are today,â?• Vandenberg said.

Automated Clearing House

Automated Clearing House (ACH) transactions are electronic payments made over the ACH network governed by the Nacha Operating Rules, along with other applicable federal and state laws.

There are two major ACH network operators, the Federal Reserve Banks (FedACH) and the Electronic Payments Network (EPN) privately operated by The Clearing House.

Although FedACH processes most ACH payments, EPN handles nearly half of all commercial ACH payments.

ACH can operate as either a credit or debit transfer system. The Nacha Operating Rules provide for some different requirements that govern each type of payment. The main difference between ACH and other payment rails is that it operates as a deferred net settlement system, according to Chris Hultzman, vice president of corporate underwriting for First American Title Insurance Co.

Brief Comparison of Different Funds

ALTA's Good Funds Work Group recently published analysis of the various payment rails available today. Here's a summary of some of the results.

Payment	Wire	Real Time Payment System	FedNow	Automated Clearing House
Description	Electronic interbank credit fund transfers (domestic or international) through The Clearing House Interbank Payment System (CHIPS) or the Federal Reserve's FedWire System.	Electronic interbank credit fund transfers (currently supporting limited international availability with Immediate Cross-Border Payments pilot) through The Clearing House Payment Company's RTP system.	Electronic interbank credit fund transfers through Federal Reserve's FedNow system, which was launched July 2023.	Electronic interbank credit and debit fund transfers (domestic and international) through The Clearing House's Electronic Payments Network (EPN) and the Federal Reserve (FedACH).
Fund Availability - Time to Settle & Clear	One to two banking days. Multiple variables impact the speed of the wire including: • time of day that the wire transfer is requested. • whether the target account and initiating account are at the same financial institution.	Allows for availability of funds to payee within seconds. • Payee's bank must reply within five seconds to payment message. • Payor's bank must push funds to payee immediately, if accepted. • Settlement is final when the RTP System has recorded both the decrease in the payor bank's net position and the increase in the payee bank's net position.	Allows for availability of funds to payee within seconds. • Payee's bank must confirm response to sending message within 20 seconds. • Settlement is final at the earlier of the FedNow Service recording the transaction or when the FedNow Service sends an Advice of Credit message.	• **Regular ACH:** transactions can take one to three banking days, or even longer, depending on the type of transaction (credit or debit), because they are processed in batches. • **Same Day ACH:** transactions may be processed in one banking day but may extend to an additional banking day if batched transactions are processed after daily deadline.
Transaction Limits	Varies by financial institution but potentially unlimited (subject to system technical limitations).	Default - Up to $1 million, at discretion of participating bank.	Default - Up to $100,000. Adjustable up to $500,000 using FedNow Profile configuration.	**Regular ACH:** Unlimited Same **Day ACH:** Up to $1 million

â??This means that ACH processes payments in batches, not individually,â?• Hultzman said. â??So, there are certain windows where many payments are collected together and processed in a batch at set times throughout the day.â?•

In addition, ACH, like wires, processes these batches on a net basis. Each bankâ??s debits and credits within the batch are tallied up and offset against each other, so that the actual money that changes hands between banks is only the resulting net position. Hultzman said whenever an ACH credit transfer involves only non-consumer originators and receivers, ACH is also governed by UCC Article 4A.

There are different timelines between ACH credit transfers and same-day ACH payments, which permits same-day value transfers for up to $1 million.

â??For a standard ACH credit transfer, you have to initiate payment up to two banking days in advance,â?• Hultzman said. â??With same-day ACH, you can obviously initiate it on the same day you want the settlement to occur.â?•

The real key, however, is the reversal risk under the Nacha Rules. Hultzman said the originator of a payment has the right to reverse the paymentâ??or â??entry,â?• as it is called under the ACH rulesâ??up to five banking days after the settlement date.

â??That means someone receiving an ACH credit payment is not free of that reversal risk until the sixth banking day at least,â?• Hultzman added. â??ACH, therefore, provides less certainty on the question of payment finality than either the wire transfer systems or the real-time payment systems today.â?•â?•

Good Funds Laws

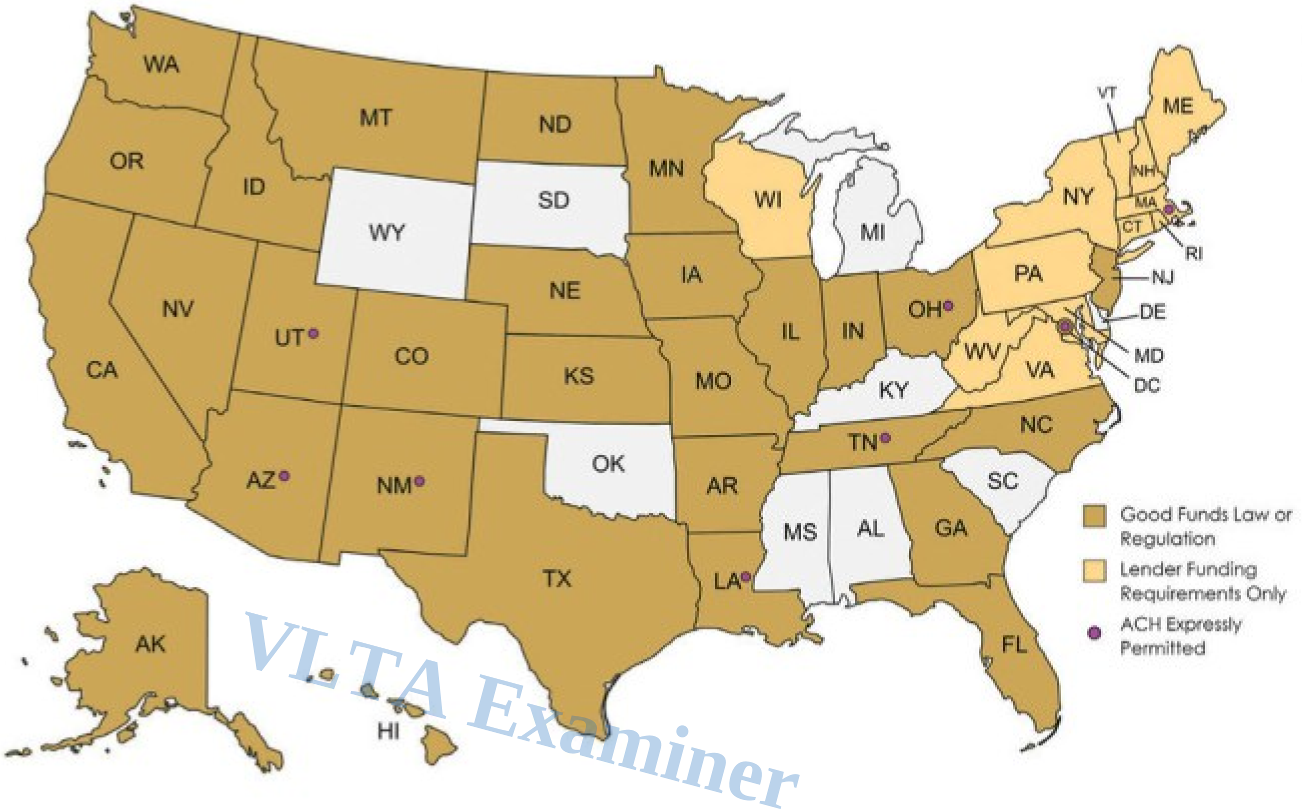
The use of various payment rails in real estate transactions is governed by state good funds laws, which set requirements for acceptable forms of closing funds. They help to ensure final and disbursable funds are received prior to real estate transfers or closings.

A major goal of ALTAâ??s Good Funds Work Group was to research and understand what changes might need to be made to existing state good funds laws to accommodate modern real-time payments.

â??The most basic thing to keep in mind, however, is that these laws govern the conduct of escrow and title agents,â?• Oâ??Neal said. â??They do not govern the payments themselves.â?•

These laws are designed to provide protections to clients and customers, provide strong safeguards of money deposited into escrow and prevent the inadvertent spending of other client/ customer funds.

State good funds laws



â??Even in the absence of a good funds law, an escrow agent likely has other fiduciary, contractual or for lawyers, even ethical duties to safeguard customer funds,â?• according to Oâ??Neal. â??A good funds law may provide more specificity for these other duties.â?•

Good funds laws also provide systemic protections to the real estate market by protecting the financial stability of escrow agents and helping to prevent fraud.

There are several categories of risks that payment finality is designed to alleviate, including:

- Payor credit risks
  - Insufficient funds
  - Stop payment orders
- Payee entitlement and reversal risks
  - Unauthorized payments (fraud, forgery, counterfeit, etc.)
  - Payment errors (amount, payee, date)
  - Non-holder, missing indorsement, etc.
- Bank credit and liquidity risks
  - Insolvency, suspension of payments
  - Intraday credit risk (daylight overdrafts)
- Payment system risks
  - Spillover participant liquidity risks
  - Technical malfunctions or operational mistakes
  - Legal uncertainty
  - Disruption of the system itself

ALTAâ??s research found that 29 states plus Washington, D.C., have good funds laws. A number of statesâ??mostly around the Northeastâ??impose requirements on acceptable payment methods for lenders funding a mortgage loan, but not directly on escrow agents for other kinds of funds received into escrow.

According to Oâ??Neal, the review of each state law or regulation also found existing laws use a considerable amount of unclear terminology that makes them hard to analyze with precision.

Many good funds laws are decades old and were drafted prior to the development of new payment rails such as FedNow or RTP. With all the ambiguity of these laws, the research determined that in most jurisdictions it is often unclear whether current laws allow, or possibly allow, FedNow or RTP.

The final step for the work group was to draft a model good funds law. Given the increased options in todayâ??s marketplace, ALTA supports the adoption of updated good funds laws, especially those that enable â??instantâ?• or â??real-timeâ?• payments, in a safe and compliant manner.

To protect consumers and the real estate economy, ALTA believes good funds laws should:

- Enable the use of modern payment rails, such as FedNow or RTP.
- Facilitate the use of technology linked to approved payment rails that provides consumer convenience and anti-fraud protections.
- Provide certainty in real estate financing and transfer through the use of finally settled funds.
- Require funds not be subject to exchange risk when converted to U.S. dollars and be transferred within or between federally insured depository institutions.
- Establish that funds received should be directly transferred from a consumerâ??s federally insured depository institution, and not sourced from a credit card, cryptocurrency or any other non-depository source.

In addition to these principles, the work group wanted the model bill to avoid the ambiguities of many existing laws by creating a simple, easy-to-use framework.

â??We wanted something that could almost be used like a checklist for escrow agents or even handed to and used by a consumer or regulator,â?• Vandenberg said. â??Another goal is that you shouldnâ??t have to be an expert in payment law in order to use the model. You shouldnâ??t have to determine the results of interbank processes, like â??final settlement,â?? or need to look up other bodies of law to understand what is required.â?•

Vandenberg said the work group also wanted to avoid the implication that escrow agents must accept payment in the form of â??good fundsâ?• just because it appears on the list.

For example, if a customer walks in with a large bag of cash or a suspicious cashierâ??s check. Therefore, the model expressly permits escrow agents to set a higher standard of care as a matter of sound business practice or perhaps because some other legal duty requires the higher standard.

Hultzman said the group determined the model bill should cover the receipt of funds by escrow agents, but not the form of disbursement from escrow. The bill also focuses solely on the real estate transaction because title and escrow agents may hold client funds for other reasons.

Finally, the model bill addressed the problem with checks. Since thereâ??s ambiguity on when a payment made by check is truly final, the language and terminology in the model bill attempts to be concise.

â??Whenever we explained what forms of payment are acceptable, like a â??wire transferâ?? or â??real-time payment,â?? we follow that up by indicating what underlying payment rail is meant by those phrases,â?• Hultzman said. â??In this way, we tried to capture the best of both worlds by using terms that actual customers and other normal people understand, while providing specificity for what those terms mean.â?•

Hereâ??s how ALTAâ??s model bill defines the term â??good fundsâ?•:

(f) â??Good fundsâ?• means funds denominated in United States dollars directly deposited or received in the form of:

i. United States currency;
ii. a wire transfer through the Fedwire Funds Service or the Clearing House Interbank Payments System (CHIPS);
iii. a credit transfer through the automatic clearing house system governed by the rules of the National Automated Clearing House Association and operated by the Federal Reserveâ??s FedACH service or The Clearing House Payment Companyâ??s Electronic Payments Network (EPN);
iv. a real-time or instant payment through the FedNow Service operated by the Federal Reserve Banks or The Clearing House Payment Companyâ??s Real-time Payments (RTP) system;
v. a debit entry to another account on the books of the depository bank, and a credit entry in the same amount to the escrow account on the books of the depository bank, other than by check;

The model bill also provides a definition for different types of checks that qualify as â??good funds,â?• although the high variability between existing state good funds laws makes the modelâ??s language merely a recommended approach for states to consider.

Additionally, ALTAâ??s Good Funds Work group outlined the following conditions for disbursement in real estate transactions:

- **Deposited:** Funds must be deposited with a Federally Insured Depository Institution.
- **Balanced Ledger:** Deposited funds must be at least equal to transaction disbursements.
- **â??Good Fundsâ?•:** Funds must be directly received by the escrow agentâ??s Federally Insured Depository Institution in a form deemed to be â??good fundsâ?• under state statute.
- **Funds Availability:** A Federally Insured Depository Institution must make the funds available for immediate use or withdrawal.

â??The definition of â??good fundsâ?? is the first major checklist to follow in our model,â?• Vandenberg said. â??First, you should only close a transaction if the funds you have received are in a form included in that definition. Second, your escrow ledger must balance. That is, your scheduled disbursement must not exceed what you have received or deposited, so you donâ??t have an escrow shortfall. Finally, besides being on the approved â??good fundsâ?? list, the payment must also have been made available by your bank for use or withdrawal. It is axiomatic that if you are disbursing funds from your account before they are available for use, then you might have inadvertently spent other client funds instead of funds for the specific transaction in question.â?•

image of JEREMY YOHE

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