

## FEDERAL RESERVE SYSTEM

[Docket No. R-1037]

### Modifying Federal Reserve ACH Operations and Pricing Practices Relative to Private-Sector ACH Operators

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Notice; request for comments.

**SUMMARY:** The Board requests comment on the benefits and drawbacks of modifying the Federal Reserve Banks' pricing practices and deposit deadlines for ACH transactions they exchange with private-sector ACH operators. These modifications may have implications for competition in the provision of ACH services, for the efficiency of the ACH system, and for long-term ACH volume growth.

**DATES:** Comments must be submitted on or before August 6, 1999.

**ADDRESSES:** Comments should refer to Docket No. R-1037 and may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. Comments may also be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. on weekdays, and to the security control room at all other times. The mail room and the security control rooms are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, N.W. Comments will be available for inspection and copying by members of the public in the Freedom of Information Office, Room MP-500, between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in Section 261.8 of the Board's Rules Regarding Availability of Information.

**FOR FURTHER INFORMATION CONTACT:** Jack K. Walton II, Manager (202/452-2660); Michele Braun, Project Leader (202/452-2819); or Jeffrey S. H. Yeganeh, Senior Financial Services Analyst (202/728-5801); for the hearing impaired only, contact Diane Jenkins, Telecommunication Device for the Deaf (TDD) (202/452-3544).

#### SUPPLEMENTARY INFORMATION:

##### I. Background

The Federal Reserve Banks are collectively the largest ACH operator, processing more than 80 percent of commercial interbank ACH transactions as well as all ACH transactions initiated by the Federal government. Private-sector ACH operators (PSOs) process the remaining transactions and typically provide services, including processing and settling ACH transactions, similar to those offered by the Reserve Banks.<sup>1</sup> PSOs also use the Reserve Banks' ACH services

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<sup>1</sup> The National Automated Clearing House Association is currently considering modifications to its definition of an ACH operator. For the purposes of this notice, a PSO is considered to be any

for processing transactions in which either the originating depository financial institution (ODFI) or receiving depository financial institution (RDFI) is not their customer.

The Reserve Banks' relatively large market share may be attributed, in part, to their involvement in creating a nationwide ACH network, in the early 1970s, for exchanging transactions between all depository institutions and to substantial scale and scope economies in processing ACH transactions.<sup>2</sup> Some industry representatives, however, believe that the Reserve Banks' price and service level policies have, at least in part, contributed to the Reserve Banks' dominant ACH market share by impeding competition and threatening the private-sector ACH operators' long-term viability. In particular, the PSOs, the National Automated Clearing House Association (NACHA), and the Financial Services Roundtable (formerly, the Bankers Roundtable) maintain that the Reserve Banks' policies, which treat PSOs as the agents of the ODFI or RDFI, have created barriers to open and vigorous competition among ACH operators.<sup>3</sup> Specifically, the PSOs maintain that the Reserve Banks' price structure and deposit deadlines do not permit the PSOs to compete effectively in providing ACH services to depository institutions.<sup>4</sup>

The Federal Reserve Board historically has stressed the benefits of competition in the provision of payment services. In a 1990 white paper on the Federal Reserve in the payments system, the Board stated that "the role of the Federal Reserve in providing payments services is to

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entity that provides ACH services similar to those of the Reserve Banks. Currently, Electronic Payments Network (formerly, New York Automated Clearing House), Visa, and American Clearing House are considered, within the industry, to be private-sector operators.

<sup>2</sup> Other factors may include (1) the Reserve Banks' role as processors of all federal government ACH payments, (2) insufficient total ACH volume during the early years of service to viably support multiple national ACH operators, (3) the Reserve Banks' subsidy of their ACH service until the mid-1980s, (4) the generally high quality of the Reserve Banks' ACH service, and (5) the previous lack of an efficient Reserve Bank net settlement service for private-sector interdistrict clearing arrangements involving a large number of settling participants.

<sup>3</sup> ACH Vision 2000 Task Force Recommendations, NACHA, 1997; The Role of the Federal Reserve and the Banking Industry in the Retail Electronic Payments Systems of the Future, The Bankers Roundtable, April 1998.

<sup>4</sup> The PSOs, other private-sector clearing organizations, and industry trade groups had also indicated that the design of the Reserve Banks' net settlement services created an additional barrier to private-sector competition with the Reserve Banks. The Board believes that the Reserve Banks' new enhanced net settlement service, which was introduced in March 1999, addresses the limitations inherent in their net settlement services and should provide an effective mechanism for the settlement of private-sector clearing arrangements, including large interdistrict settlement arrangements (63 FR 60000, November 6, 1998).

promote the integrity and efficiency of the payments mechanism and to ensure the provision of payment services to all depository institutions on an equitable basis, and to do so in an atmosphere of competitive fairness.”<sup>5</sup> In addition, the Board’s standards for priced services activities note that “Federal Reserve actions are implemented in a manner that ensures fairness to other providers of payment services.”<sup>6</sup>

## **II. Current Federal Reserve Practices**

The Reserve Banks have generally treated PSOs similar to third-party processors, that is, as agents of the depository institutions for which they send or receive items.<sup>7</sup> Further, the Reserve Banks make little distinction between PSOs and third-party processors in processing ACH transactions. As a result, the Reserve Banks’ pricing of ACH services has not differentiated between PSOs, third-party processors, and depository institutions.

The Reserve Banks offer depository institutions ACH services under terms established in the Reserve Banks’ ACH operating circular, which is a contractual arrangement, and charge fees for ACH services based on published fee schedules. For each ACH transaction that they process, the Reserve Banks consider both the ODFI and RDFI to be their customers and charge each of them a per-item fee. Further, the Reserve Banks charge a per-file fee for each ACH file they receive.<sup>8</sup> The Reserve Banks also assess monthly account servicing fees to each institution whose ACH transactions they process. In addition to ACH service fees, the Reserve Banks assess electronic connection fees based on the type of connection an institution maintains for sending and receiving ACH transactions as well as other transactions or information. The Reserve Banks use their reserve account posting capability to automatically debit the accounts designated by each ODFI and RDFI, either their own or those of correspondents, for the purpose of settling ACH transactions and fees.

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<sup>5</sup> The Federal Reserve in the Payments System, Federal Reserve Regulatory Service 7-139.

<sup>6</sup> Standards Related to Priced-Services Activities of the Federal Reserve Banks, Federal Reserve Regulatory Service 7-136.

<sup>7</sup> The exception to this practice was the arrangement between the Federal Reserve Bank of New York and Electronic Payments Network (EPN) from 1975 through 1996. During this period, the New York Reserve Bank did not provide commercial ACH services and EPN processed almost all commercial items for Second District depository institutions.

<sup>8</sup> The sending point for an ACH file is assessed a per-file fee. The sending point could be an ODFI that sends its file directly to the Reserve Banks, or a third-party processor or PSO that is acting as agent for the ODFIs whose transactions are in the file.

On the other hand, PSOs do not have the similar contractual arrangements to charge ODFIs or RDFIs that are not their customers. That is, PSOs are not able to charge an RDFI per-item fees for transactions they transmit through the Reserve Banks nor are PSOs able to charge an ODFI per-item fees for transactions they receive from the Reserve Banks. Further, the Reserve Banks do not pay file fees for files provided to the PSOs.

### **III. Request for Comment**

#### **A. Reserve bank ACH customers**

PSOs maintain that, to the extent that depository institutions send or receive their ACH transactions through a PSO, the institutions are PSO customers and not Reserve Bank customers. The Federal Reserve's authority to provide payment services, however, is limited by law to services provided to depository institutions.<sup>9</sup> Further, many depository institutions send transactions directly to and receive transactions directly from both the Reserve Banks and PSOs. Thus, Reserve Banks consider all depository institutions designated as the ODFI or RDFI in ACH transactions they process to be Reserve Bank customers, and the PSOs involved in the transactions to be agents of the ODFI or RDFI. Given the limitations on the types of entities that are eligible to receive Reserve Bank payment services, the Board requests comment on how the ACH service might be structured to address the differences in the way that the Reserve Banks' and PSOs' customer bases are defined. Specifically, the Board is interested in commenters' views on whether the Reserve Banks should continue to consider the ODFI and RDFI for ACH transactions they process to be their customers, and charge them accordingly, even though the institution sent the transactions through or received the transactions from a PSO.

#### **B. Price structure**

The PSOs maintain that modifications to the Reserve Banks' price structure would permit them to compete more effectively in providing ACH services to depository institutions. The Monetary Control Act (MCA) and the Board's pricing principles require that fees for the ACH service be set so that revenues match costs. The Reserve Banks set their fees to meet these requirements. Thus, any modifications that reduce the revenues or increase the costs of the ACH service would have to be offset by commensurate increases in revenues elsewhere in the ACH service.

The Board requests comment on whether the Reserve Banks should charge lower fees for ACH transactions that are also processed by a PSO than they do for ACH transactions in which the Reserve Banks are the only ACH operator, and if so, the basis that should be used to charge

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<sup>9</sup> A Reserve Bank may also provide services to a limited set of other institutions, such as state member banks that are not defined as depository institutions and other entities if the Reserve Bank is directed to do so as fiscal agent of the United States.

the different fees.<sup>10</sup> With the possible exception of customer service costs, the Reserve Banks' costs for handling ACH transactions that are also processed by a PSO do not currently differ from their costs for handling other ACH transactions. Thus, there may be little cost justification for the Reserve Banks to offer lower fees to PSOs, unless the Reserve Banks offered different ACH service levels for transactions also involving a PSO. Different service levels might eliminate some of the processes that the Reserve Banks currently perform to process ACH transactions transmitted through PSOs, which in turn could provide a justification for lower fees.

In addition, the Board requests comment on whether the Reserve Banks should pay transaction fees to PSOs that send files to the Federal Reserve and transaction and file fees to PSOs that receive files from the Federal Reserve. A PSO's costs for handling ACH transactions that are also processed by the Reserve Banks likely differ from the costs for handling other ACH transactions only with respect to costs related to customer service and settlement. The Board is interested in commenters' views on what services PSOs provide that would justify the payment of fees to PSOs, on whether Reserve Banks should pay fees to PSOs, and on whether, and how, market discipline may constrain the fees charged by PSOs.

The Reserve Banks assess an ACH monthly account servicing fee for each routing number that a depository institution elects to have included in the FedACH customer directory. The Reserve Banks must maintain routing numbers for depository institutions served by PSOs to provide processing, routing, accounting, and settlement services for ACH transactions exchanged between PSO and Reserve Bank customers, and charges this fee to recover associated costs. NACHA and the PSOs believe that it is inappropriate for the Reserve Banks to assess monthly account servicing fees to ODFIs and RDFIs that do not send transactions directly to or receive transactions directly from the Reserve Banks. The PSOs maintain that the imposition of this fee on their customers allows the Reserve Banks to establish lower transaction fees and competitively disadvantages the PSOs. The Board requests comment on whether the Reserve Banks should continue to assess this fee to customers that use PSOs to send transactions to and receive transactions from the Reserve Banks and, if not, the rationale for eliminating the fee for the PSOs' customers.

Any of the changes to the ACH system's price structure discussed above could lead to a reduction in Reserve Bank net revenue either through reductions in Reserve Bank fees or increases in Reserve Bank costs. To fulfill the requirements of the MCA and the Board's pricing principles, however, any reduction in ACH net revenues would have to be recouped elsewhere in the ACH service. Thus, it is likely that fees assessed to some Reserve Bank customers might decline while fees assessed to other Reserve Bank customers might increase.

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<sup>10</sup> Some ACH transactions processed by the Reserve Banks involve two PSOs—a sending PSO and a receiving PSO. Other ACH transactions involving two PSOs are settled through the PAX (Private-Sector ACH Exchange) network without Reserve Bank involvement as ACH operator.

### C. Deposit deadlines and processing schedule

The Board requests comment on the benefits and drawbacks of the Reserve Banks establishing different deposit and delivery deadlines for PSOs and depository institutions. The PSOs maintain that the Reserve Banks' deposit and delivery deadlines place them at a competitive disadvantage. To meet Reserve Bank deposit deadlines, PSOs must establish earlier deposit deadlines and later delivery schedules for their customers than those offered by the Reserve Banks to their customers. For example, the Reserve Banks have established a 3:00 a.m. eastern time deadline for the deposit of ACH transactions for all depositors, and make those ACH transactions available to the RDFI or its agent (including a PSO) by 6:00 a.m. eastern time. If the Reserve Banks were to offer different deposit and delivery deadlines to PSOs and depository institutions, PSOs would be able to establish deadlines for their customers that would be equivalent to those offered by the Reserve Banks. If the deadlines were changed, however, the Reserve Banks either would have to move the depository institution deposit deadline to earlier in the evening or reduce the time they have to process ACH files. In either case, the level of service offered to depository institutions that deal with the Reserve Banks directly may be reduced.

### D. Correspondent banks and third-party processors

If the Reserve Banks were to modify their price structure or deadlines to treat transactions also processed by PSOs differently, the Board requests comment on whether this treatment should be limited to transactions processed by PSOs or expanded to encompass other ACH transactions, such as those sent or received by correspondent banks or third-party processors. The Board is interested in commenters' views on the extent to which the arguments to modify Reserve Bank practices regarding PSOs also apply to other entities that act as sending and receiving points for multiple institutions. The Board requests comment on how the Reserve Banks should determine the entities that qualify for treatment as PSOs if the Reserve Banks were to modify the terms of their ACH services to treat transactions involving PSOs (but not correspondent banks and third-party processors) differently.

### E. Other implications

Finally, the Board requests comment on the implications on competition, the efficiency of the ACH system, and on overall ACH volume growth should the Reserve Banks modify their price structure or deadlines to treat transactions processed by PSOs differently than those received from or sent to other parties. One of the Reserve Banks' primary objectives is to foster competition, improve the efficiency of the payments mechanism, and lower the cost of these services to society at large, while maintaining the integrity and reliability of the payments mechanism and providing an adequate level of service nationwide. To the extent that commenters are suggesting modifications to the Reserve Banks' ACH service, the Board requests that they indicate whether and how those modifications are likely to affect competition in the provision of ACH services, the efficiency of the ACH system, and the growth of the ACH system.

#### **IV. Summary of Comments Requested**

To assist commenters in the preparation of their responses to this notice, a summary of the questions on which the Board is requesting comment follows:

##### **A. Reserve bank ACH customers**

1. Given the limitations on the types of entities that are eligible to receive Reserve Bank payment services, how should the ACH service be structured to address the differences in the way that the Reserve Banks' and PSOs' customer bases are defined?
2. Should the Reserve Banks continue to consider the ODFI and RDFI for ACH transactions they process to be their customers, and charge them accordingly, even though the institution sent the transactions through or received the transactions from a PSO? If not, why not?

##### **B. Price Structure**

1. Should the Reserve Banks charge lower fees for ACH transactions that are also processed by a PSO than they do for ACH transactions in which the Reserve Banks are the only ACH operator? If so, on what basis should the different fees be set? For example, should the Reserve Banks offer different ACH service levels for transactions also involving a PSO?
2. Should the Reserve Banks pay transaction fees to PSOs that send files to the Federal Reserve and transaction and file fees to PSOs that receive files from the Federal Reserve? What services do the PSOs provide to Reserve Banks that would justify the payment of fees to PSOs? Would market discipline constrain the fees charged by PSOs to Reserve Banks? If so, how?
3. Should the Reserve Banks continue to assess the ACH account servicing fee to customers that exclusively use PSOs to send transactions to and receive transactions from the Reserve Banks? If not, what would be the rationale for eliminating the fee for the PSOs' customers?

##### **C. Deposit deadlines and processing schedule**

1. What are the benefits and drawbacks of the Reserve Banks establishing different deposit and delivery deadlines for PSOs and depository institutions?

##### **D. Correspondent banks and third-party processors**

1. If the Reserve Banks were to modify their price structure or deadlines to treat transactions also processed by PSOs differently, should this treatment be limited to transactions processed by PSOs or expanded to other ACH transactions, such as those sent or received by correspondent banks or third-party processors? Why or why not? Do the arguments to modify Reserve Bank practices

regarding PSOs also apply to other entities that act as sending and receiving points for multiple institutions? Why or why not?

2. How should the Reserve Banks determine the entities that qualify for treatment as PSOs if the Reserve Banks were to modify the terms of their ACH services to treat transactions involving PSOs (but not correspondent banks and third-party processors) differently?

E. Other implications

1. What are the implications on competition, the efficiency of the ACH system, and overall ACH volume growth if the Reserve Banks were to modify their price structure or deadlines to treat transactions processed by PSOs differently than those received from or sent to other parties?

2. To the extent that you are suggesting modifications to the Reserve Banks' ACH service, please indicate whether and how those modifications are likely to affect competition in the provision of ACH services, the efficiency of the ACH system, and the growth of the ACH system.

By order of the Board of Governors of the Federal Reserve System, May 18, 1999.

(Signed Jennifer J. Johnson)

Jennifer J. Johnson  
Secretary of the Board.