

FEDERAL RESERVE SYSTEM

[Docket No. R-1037]

Modifying Federal Reserve ACH Deposit Deadlines and Pricing Practices Relative to Private-Sector ACH Operators

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: Based on comments received in response to its request for comment last year, the Board has concluded that the Federal Reserve Banks' deposit deadlines and pricing practices for automated clearing house (ACH) transactions exchanged with private-sector ACH operators should be modified. The Board is considering specific modifications to these deadlines and pricing practices, which could be implemented as early as mid-2001, and requests comment on these proposed modifications.

DATES: Comments must be submitted on or before July 25, 2000.

ADDRESSES: Comments, which should refer to Docket No. R-1037, may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, D.C. 20551 or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson also may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments may be inspected in Room MP-500 between 9:00 a.m. and 5:00 p.m. weekdays, pursuant to § 261.12, except as provided in § 261.14, of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

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 Janice Simms, Telecommunication Device for the Deaf (202/872-4984).

SUPPLEMENTARY INFORMATION:

I. Background

The Federal Reserve Banks are collectively the largest ACH operator and process more than 80 percent of commercial interbank ACH transactions. 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. PSOs also rely on the Reserve Banks' ACH services for the delivery and settlement of some transactions in which either the originating depository financial institution (ODFI) or receiving depository financial institution (RDFI) is not their customer.

The Reserve Banks' authority to provide payment services is limited by law to services provided to depository institutions.¹ The Reserve Banks, however, allow depository institutions to send or receive their ACH transactions through intermediaries, such as PSOs, and treat those intermediaries as agents of the depository institutions they serve. Nevertheless, all depository institutions are currently subject to the same Reserve Bank prices and service guidelines regardless of how they send or receive their ACH transactions to and from the Reserve Banks.

Some industry representatives have expressed concerns that the Reserve Banks' price and service level policies have created barriers to open and vigorous competition among ACH operators because the policies do not recognize the role played by operators in the ACH system.² Specifically, these representatives have maintained that the Reserve Banks' deposit deadlines and price structure do not permit the PSOs to compete effectively in the provision of ACH services to depository institutions.

The Federal Reserve Board recognizes 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 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."³ 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."⁴

In response to the industry's concerns, the Board requested comment last year on the benefits and drawbacks of modifying the Reserve Banks' deposit deadlines and pricing practices for ACH transactions exchanged with PSOs (64 FR 27793, May 21, 1999). Specifically, the Board requested comment on whether the Reserve Banks should (1) modify their deposit deadlines and processing schedules, (2) modify their pricing structure for interoperator transactions, and (3) limit any modifications to PSOs only.

II. Summary of Comments

The Board received fifty-eight responses to its request for comment.⁵ Thirty-two commenters supported and twenty-six commenters opposed modifications to the Reserve Banks'

¹ Reserve Banks may also provide services to a limited set of other institutions, such as state member banks that are not defined as depository institutions. Further, the Reserve Banks may provide services to other entities if directed to do so as fiscal agent of the United States.

² *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.

³ *The Federal Reserve in the Payments System*, Federal Reserve Regulatory Service 7-139.

⁴ *Standards Related to Priced-Services Activities of the Federal Reserve Banks*, Federal Reserve Regulatory Service 7-136.

⁵ The Board received seventeen comments from small banks and thrifts, fourteen comments from national and regional banks, nine comments from ACH associations and clearinghouses, seven comments from

deposit deadlines and pricing practices. Those supporting modifications generally tended to be larger depository institutions and ACH associations that believed modifications would improve competition in the provision of ACH services. Those opposing modifications generally tended to be smaller or medium-sized depository institutions that believed any modifications would lead to higher Reserve Bank fees, which in turn would make them less able to compete in the market for origination services with institutions that use PSO ACH services. Given the diversity in the commenters' views, Board staff invited commenters to a meeting in December 1999 to discuss interoperator issues more fully and to explore alternative approaches to addressing these issues.⁶

A. Deposit deadlines

The Board requested comment on the benefits and drawbacks of the Reserve Banks establishing different deposit and delivery deadlines for PSOs and depository institutions. PSOs maintain that they are unable to offer competitive deposit deadlines and delivery schedules to their customers because they are subject to the same deposit deadlines and delivery schedules that Reserve Banks offer to depository institutions.

Commenters suggested a number of solutions to address this issue. One suggestion was that the Reserve Banks could offer PSOs later deposit and earlier delivery deadlines to enable PSOs, in turn, to offer competitive deadlines to their customers. Another potential solution was for the industry to adopt a uniform interoperator deposit deadline at which all operators would deposit transactions with one another. Other commenters, however, advocated the status quo because they did not believe that Reserve Bank deadlines place PSOs at a competitive disadvantage.

B. Pricing Structure

The Board also requested comment on the benefits and drawbacks of the Reserve Banks modifying their pricing structure for interoperator transactions. PSOs maintain that the Reserve Banks' current pricing structure has placed them at a competitive disadvantage. Specifically, the main concern regarding the Reserve Banks' current pricing structure is the asymmetry in the ability of operators to charge each other's customers. The Reserve Banks consider both the ODFI and RDFI in an interoperator transaction to be their customers and charge both accordingly. PSOs, on the other hand, can only charge their own customer in an interoperator transaction. Some commenters also expressed concern about the Reserve Banks' ability to charge monthly account servicing fees to all depository institutions, including those that send or receive all their ACH transactions through PSOs.

Some commenters suggested that the Reserve Banks should modify their pricing structure for interoperator transactions such that they assess fees only to their direct customers. Commenters also suggested that the Reserve Banks should abolish the monthly account servicing

credit unions, five comments from Reserve Banks, three comments from private-sector operators, and three comments from consultants, law firms, and corporate associations.

⁶ This summary of comments reflects commenters' formal responses to the request for comment as well as the views expressed at the December 1999 meeting.

fee for depository institutions that send and receive all of their ACH transactions through a PSO. Commenters believed that these suggested modifications would eliminate the asymmetry noted earlier and would result in a similar customer pricing structure for Reserve Banks and PSOs in which each operator would charge its direct customer only. Other commenters were concerned that any modifications to the Reserve Banks' pricing structure could result in an increase in fees to Reserve Bank customers that do not use the services of a PSO and, thus, opposed any change to the current pricing structure.

C. Eligibility

The Board also requested comment on whether any modifications to the Reserve Banks' deadlines and pricing structure should be limited to ACH operators or extended to other intermediaries, such as third-party processors and correspondents. Specifically, because many of the characteristics that distinguish ACH operators from other intermediaries do not affect how Reserve Banks provide ACH services, the Board was interested whether all intermediaries should be eligible for modified deadlines and pricing. Further, the Board requested comment on whether the Reserve Banks should rely on the National Automated Clearing House Association's (NACHA) ACH operator definition if they were to limit modifications to ACH operators.

Some commenters suggested that only ACH operators should be eligible for modified deadlines and pricing. These commenters noted that Reserve Banks compete with ACH operators in the provision of ACH operator services and, thus, only ACH operators should be eligible for any modifications. These commenters also stated that the Reserve Banks should use NACHA's ACH operator definition to determine eligibility for modified deadlines and pricing rather than develop their own definition. Other commenters, however, suggested that if the Reserve Banks' ACH processing is not affected by the type of intermediary from which they receive transactions or to which they deliver transactions, then all intermediaries should be eligible for modified deadlines and pricing.

III. Enhancing Competition

The Board has carefully considered the commenters' views and has concluded that the Reserve Banks' deposit deadlines and pricing structure for ACH transactions exchanged with private-sector ACH operators should be modified. The Board believes that adopting certain deadline and pricing modifications for interoperator transactions would enhance competition in the provision of ACH operator services to depository institutions.

To determine what modifications might be appropriate to enhance competition in the market for ACH operator services, the Reserve Banks examined the types of services PSOs receive from the Reserve Banks when they send transactions to depository institutions through the Reserve Banks. Similarly, the Reserve Banks examined the types of services they receive from PSOs when they send transactions to depository institutions through PSOs.

First, an operator provides other operators' customers with access to depository institutions on its network. Each of these networks essentially is comprised of telecommunications links that permit the transmission of ACH files between participating

depository institutions and the operator. While each operator's network might employ different technologies with different levels of complexity, the costs associated with these networks are primarily fixed. For interoperator transactions, the ability to access depository institutions on other networks allows an operator (1) to forego the costs associated with establishing a direct connection to all depository institutions and (2) to provide its own customers with the ability to send ACH transactions to any depository institution. Thus, when an operator provides other operators' customers with access to a depository institution on its network, it provides value to those customers and the operators that serve them.

Second, an operator processes transactions it receives from other operators and delivers those transactions to depository institutions on its network. Processing ACH transactions requires computing and other resources, which have both fixed and variable components. Therefore, it is reasonable for an operator to charge transaction fees to recover the costs associated with processing ACH transactions.

Third, the Reserve Banks provide settlement for all ACH transactions they process, including interoperator transactions. Other operators do not settle interoperator transactions that are processed by the Reserve Banks. As a result, the Reserve Banks incur accounting, computing, and other costs when they settle ACH interoperator transactions for depository institutions that use PSOs. Thus, the Reserve Banks are providing a service not provided by other operators when they settle interoperator transactions they process.

The Board has concluded that competition in the provision of ACH operator services would be enhanced through modifications to the deposit deadlines and delivery schedules for interoperator transactions and the adoption of a new pricing structure for these transactions. Specifically, the Board believes that deposit deadlines for interoperator transactions should enable Reserve Banks and PSOs to establish competitive deposit deadlines and delivery schedules for their customers. The Board also believes that the Reserve Banks should adopt a price structure for interoperator transactions that is consistent with the cost structure associated with processing interoperator transactions. This new price structure should include a fee to access depository institutions on the Reserve Banks' ACH network, a fee to process interoperator transactions, and a settlement fee to recover the Reserve Banks' settlement costs. The Board believes that these changes, along with the ability of PSOs to assess interoperator fees to Reserve Banks, should enhance competition in the provision of ACH operator services to depository institutions.

IV. Proposed Modifications

The Board has developed a specific proposal to modify the Reserve Banks' deadlines and pricing structure for ACH interoperator transactions that it believes will promote competition in the provision of ACH services and address the concerns raised by some commenters. The Board is requesting comment on this proposal.

The Board proposes the following deadlines and pricing structure for ACH interoperator transactions that are processed by the Reserve Banks:

- **Deposit deadlines:** The Board proposes that the Reserve Banks work collaboratively with ACH operators to establish interoperator deposit deadlines by which the Reserve Banks and the PSOs would exchange interoperator transactions.
- **Pricing structure:** The Board proposes the following price structure for interoperator transactions processed by the Reserve Banks.
 - First, the Reserve Banks would charge ACH operators a monthly network access fee for each routing number they access on the Reserve Banks' ACH network.
 - Second, the Reserve Banks would charge ACH operators per-item fees for transactions they send through the Reserve Banks' ACH network.
 - Third, the Reserve Banks would charge depository institutions that send and receive all their transactions through PSOs a monthly settlement fee rather than the current monthly account servicing fee.
 - Fourth, the Reserve Banks would pay PSOs for transactions they send to depository institutions through those PSOs.
- **Eligibility:** The Board proposes to limit the modified deadlines and pricing structure to intermediaries that are defined as ACH operators in the NACHA rules.

A. Deposit deadlines

The Board proposes that the Reserve Banks work collaboratively with ACH operators to establish interoperator deposit deadlines by which the Reserve Banks and the PSOs would exchange interoperator transactions. The Reserve Banks' preliminary recommendation is that one interoperator deposit deadline be established at 2:30 p.m. eastern time for immediate settlement items and that another interoperator deposit deadline for next-day settlement items be established at 3:00 a.m. eastern time.⁷ The Reserve Banks would accept interoperator transactions from PSOs and send interoperator transactions to PSOs at the new deposit deadlines. Clearly, ACH operators, including the Reserve Banks, would need to establish their own deposit and delivery deadlines for their customers. Further, the PSOs could establish other deadlines by which they would exchange interoperator transactions among themselves.

If the Reserve Banks' preliminary recommendation for interoperator deposit deadlines were adopted, the Reserve Banks would require their customers to deposit next-day settlement items half an hour earlier than they do today. The Reserve Banks, however, currently receive almost all their ACH volume well before the deposit deadlines and deadline extensions have become much less frequent. The recommended deposit deadlines would require no change in deposit times for Reserve Bank customers depositing immediate settlement items. As a result, the recommended exchange

⁷ Immediate settlement items are items that are settled on the same banking day as they are received while next-day settlement items are items that are settled on the banking day after they are received. The Reserve Banks' banking day for the receipt of ACH items is from 3:00 a.m. eastern time to 2:59 a.m. eastern time on the next calendar day. Only returns and National Association of Check Safekeeping items are eligible for immediate settlement.

deadlines would likely have minimal effects on the processing schedules of Reserve Bank customers. Further, because Reserve Banks would deposit transactions with PSOs at the interoperator deposit deadlines, PSOs should be able to offer their customers deposit and delivery deadlines that are competitive with those offered by the Reserve Banks. Thus, the Board's general proposal for interoperator deposit deadlines, as well as the specific Reserve Bank deposit deadline recommendation, would likely enhance competition with minimal effect on depository institutions.

Interoperator deposit deadlines, however, pose problems for transactions that involve three operators. Currently, a small fraction of the volume that PSOs deposit with the Reserve Banks is destined to other PSOs, which results in some transactions being processed by three operators.⁸ With interoperator deposit deadlines, however, if an operator receives a transaction from another operator at the interoperator deposit deadline that is destined to a third operator, the middle operator would be unable to forward the transaction timely because the deadline to deposit transactions with the third operator would have already passed. Moreover, three-operator transactions tend to be inefficient because they result in redundant processing by multiple operators before they are delivered to the RDFI.

One way to address this issue is for NACHA to prohibit three-operator transactions. The Board suggests that NACHA evaluate whether its ACH operator definition should be revisited to require operators to exchange interoperator transactions directly with the operator serving the RDFI. In any case, to ensure that the Reserve Banks are able to forward the transactions to the RDFI's PSO by the interoperator deposit deadline, the Board proposes that the Reserve Banks require all ACH transactions that need to be forwarded to another operator, including transactions deposited by a PSO, be deposited by the Reserve Banks' regular customer deposit deadline.

B. Pricing structure for interoperator transactions

The Board proposes a new three-tiered pricing structure for interoperator transactions processed by the Reserve Banks. Under the proposed structure, the Reserve Banks would charge PSOs and their customers fees (1) to access the Reserve Banks' ACH network, (2) to process interoperator transactions they receive from PSOs, and (3) to settle interoperator transactions for depository institutions that send and receive all their transactions through a PSO. The Reserve Banks plan to maintain the current fee structure for their customers and do not anticipate any increases in fees resulting from this proposal.

In developing a pricing structure for interoperator transactions, the Reserve Banks used a cost-based approach to set fees. In their analysis, the Reserve Banks attempted to identify costs related to network access, processing, and settlement and to price those components separately. Further, the Reserve Banks excluded certain

⁸ The Board understands that some depository institutions that use a PSO prefer to minimize the number of settlements they receive for their ACH transactions. Most of these institutions already receive and reconcile two settlements—one from their PSO, another from the Reserve Banks—and do not want to receive a third settlement for ACH transactions that PSOs exchange directly using the Private ACH Exchange (PAX) system. Thus, PSOs use the Reserve Banks to send some transactions destined to other PSOs, which minimizes settlements but results in three-operator transactions.

costs that might not be incurred when services are provided to ACH operators so that the interoperator fee structure would reflect, as closely as possible, the cost structure for interoperator transactions.

Specifically, the Board proposes the following fee structure for interoperator transactions. The price ranges outlined below are based on preliminary cost analyses by the Reserve Banks. First, the Reserve Banks would charge the PSOs a monthly network access fee of between \$5 and \$10 for each routing number to which they send transactions on the Reserve Banks' ACH network. Second, the Reserve Banks would charge PSOs a per-item fee of between \$0.002 and \$0.004 to process interoperator transactions sent to RDFIs on the Reserve Banks' ACH network. And third, rather than the current monthly account servicing fee, the Reserve Banks would charge depository institutions that send and receive all their transactions through PSOs a monthly settlement fee per routing number (projected to be about \$20) to settle interoperator transactions.⁹

An important additional feature of the Board's overall proposal is that the Reserve Banks would pay PSOs for commercial and government ACH transactions they deliver to RDFIs through PSOs. These fees would compensate the PSOs for the services they provide to Reserve Banks by delivering transactions to RDFIs on their networks.

An open issue that remains unresolved is how fees that PSOs would charge Reserve Banks would be restrained. The Board examined alternative approaches to restrain fees charged by operators. First, the Board considered limiting the interoperator fees Reserve Banks would pay to PSOs to the PSOs' published fees. In practice, however, because a PSO's published customer fee structure may be different from its interoperator fee structure and because not all operators publish fees or charge all of their customers their published fees, it would be difficult to ascertain whether the interoperator fees charged by an operator are reasonable. Alternatively, the Board considered allowing the Reserve Banks to pay PSOs the same fees they charge PSOs. This mechanism, while creating parity, would require PSOs to adopt the Reserve Banks' pricing structure, which may not be reflective of the PSOs' cost structures. The Board believes that the continued growth of the ACH network would be enhanced by maintaining low, cost-based interoperator fees. Thus, the Board requests comment on how the fees that operators charge each other might be restrained to encourage the continued growth of the ACH network.

C. Eligibility

The Board proposes that the deadline and price structure modifications be limited to any intermediary that is defined as an operator under NACHA rules.¹⁰ The role

⁹ The Reserve Banks would no longer provide customer service to depository institutions for transactions they send or receive through a PSO. These institutions would have to direct transaction and service-related inquiries to their PSOs. The Reserve Banks, however, would continue to provide customer service on settlement-related questions.

¹⁰ NACHA recently adopted modifications to its definition of an ACH operator (NACHA Operating Rules, section 13.1.1). To qualify as a private-sector ACH operator, an entity must execute an agreement with NACHA to comply with or perform all of the following: adhere to NACHA operating rules and other applicable laws and regulations; execute agreements with a minimum of twenty independent depository

of operators in the ACH system is separate and distinct from the role of other ACH intermediaries. Generally, ACH operators play a significant role in protecting the integrity of the overall ACH network and ensuring the interoperability and efficiency of the overall network. From a service perspective, the primary distinction between ACH operators and other intermediaries is that operators provide clearing, delivery, and settlement services for intraoperator transactions and exchange interoperator transactions with other operators. Third-party processors typically do not provide settlement services for transactions they process while correspondent banks typically do not provide the comprehensive clearing and delivery services provided by operators. Thus, the Reserve Banks tend to compete with PSOs, and not third-party processors or correspondent banks, in providing services to depository institutions. Further, because NACHA's operator definition does not preclude other entities from becoming new operators, it is possible that some of the larger correspondents or third-party processors might become operators to compete with the established operators.

V. Competitive Impact

The Board must conduct a competitive impact analysis when it considers a major operational change such as that being proposed for interoperator transactions.¹¹ Specifically, the Board must determine whether the proposed deadlines and pricing structure have a direct and material adverse effect on the ability of other service providers to compete effectively with the Reserve Banks in providing similar services, and if so, whether the adverse effect on competition is due to differing legal powers or constraints, or due to a dominant market position deriving from such legal differences.

The purpose of the proposed modifications is to address the concerns expressed by commenters with respect to the Reserve Banks' current deposit deadlines and pricing practices. The proposed modifications will enhance the ability of PSOs to compete with the Reserve Banks in providing ACH operator services to depository institutions. Further, depository institutions and other intermediaries should also benefit as they are likely to see a more competitive market for the provision of ACH operator services, which could result in lower costs to process their ACH transactions. Thus, the Board does not anticipate any adverse effects on competition resulting from this proposal.

VI. Conclusion

The Board requests comment on the proposed modifications. Specifically, the Board is interested in commenters' views on whether the proposed modifications

institutions that bind the depository institutions NACHA operating rules and the private-sector ACH operator's rules; provide clearing, delivery, and settlement services for intraoperator transactions; exchange interoperator transactions with other ACH operators; process and edit files based on the requirements of NACHA operating rules; evaluate the creditworthiness of and apply risk control measures to their customers; adhere to the Federal Reserve's Policy Statement on Privately Operated Multilateral Settlement Systems; and adhere to any NACHA performance standards for ACH operators. Under this definition, Electronic Payments Network, Visa, and American Clearing House are considered to be private-sector ACH operators. The Reserve Banks reserve the right to preempt any NACHA rule in their ACH operating circular. Thus, the Reserve Banks reserve the right to establish their own operator definition should they object to any future modifications to NACHA's definition of an ACH operator.

¹¹ Federal Reserve Regulatory Service, 7-145.2.

enhance competition in the market for ACH operator services. Further, the Board requests comment on how the fees that operators charge each other might be restrained to encourage the continued growth of the ACH network.

By order of the Board of Governors of the Federal Reserve System, May 22, 2000.

(Signed) Jennifer J. Johnson

Jennifer J. Johnson
Secretary of the Board.