FEDERAL RESERVE SYSTEM
[Docket No. R-1037]
Federal Reserve ACH Deposit Deadlines and Pricing Practices for Transactions Involving Private-Sector ACH Operators

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board has approved a new approach to pricing automated clearing house transactions that the Federal Reserve Banks exchange with intermediaries that are defined as operators under the operating rules of the National Automated Clearing House Association. The Reserve Banks will initiate discussions with the private-sector ACH operators (PSOs) to negotiate the structure and level of fees that will be charged by the Reserve Banks for processing interoperator transactions as well as those fees that the Reserve Banks will pay the PSOs. The Reserve Banks will work collaboratively with the PSOs to establish deposit deadlines by which they would exchange interoperator transactions with each other and to address other operational issues. To permit time for necessary software modifications, the new interoperator deposit deadlines will be implemented by the Reserve Banks no later than June 2001 while the new fees will be implemented no later than September 2001.

FOR FURTHER INFORMATION CONTACT: Jack K. Walton II, Manager, Retail Payments Section (202/452-2660); Michele Braun, Project Leader, Retail Payments Section (202/452-2819); or Jeffrey S. H. Yeganeh, Senior Financial Services Analyst, Retail Payments Section, Division of Reserve Bank Operations and Payment Systems (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 nation's largest automated clearing house (ACH) operator and process more than 80 percent of commercial interbank ACH transactions. PSOs process the remaining transactions and typically provide services, including processing and settling ACH transactions, similar to those offered by the Reserve Banks. PSOs and the Reserve Banks rely on each other for the processing of some transactions in which either the originating depository financial institution (ODFI) or receiving depository financial institution (RDFI) is not their customer. These interoperator transactions are settled by 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.[1] Specifically, these representatives have maintained that the Reserve Banks' deposit

[1] *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.

deadlines and price structure do not permit the PSOs to compete effectively in the provision of ACH services to depository institutions.

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 price structure for interoperator transactions, and (3) limit any modifications to PSOs only. Based on comments received, the Board concluded that adopting certain modifications to the Reserve Banks' deposit deadlines and price structure for ACH transactions exchanged with PSOs would enhance competition in the provision of ACH operator services to depository institutions.

In May 2000, the Board requested comment on a proposal to modify the Reserve Banks' deadlines and pricing practices for ACH interoperator transactions that would promote competition in the provision of ACH services and address the concerns raised by some commenters (65 FR 34183, May 26, 2000). Specifically, the Board proposed the following modifications to the deadlines and price structure for ACH interoperator transactions that are processed by the Reserve Banks:

- Deposit deadlines: The Board proposed 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.

- Price structure: The Board proposed the following price structure for interoperator transactions processed by the Reserve Banks with price ranges based on preliminary cost analyses by the Reserve Banks.[2] Further, the Reserve Banks indicated that they planned to maintain the current fee structure for their customers and did not anticipate any increases in fees resulting from this proposal.

  - First, the Reserve Banks would charge ACH operators a monthly network access fee of between $5 and $10 for each routing number they access on the Reserve Banks' ACH network.

  - Second, the Reserve Banks would charge ACH operators a per-item fee of between $0.002 and $0.004 for transactions they send through the Reserve Banks' ACH network.

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[2] In developing the proposed price structure for interoperator transactions, the Reserve Banks used a cost-based approach to set fees. 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 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.

- Third, the Reserve Banks would charge depository institutions that send and receive all their transactions through PSOs a monthly settlement fee of about $20 rather than the current monthly account servicing fee of $25.[3]

- Fourth, the Reserve Banks would pay PSOs for commercial and government ACH transactions they send to depository institutions through those PSOs. Fees paid by the Reserve Banks to the PSOs would compensate the PSOs for the services they provide the Reserve Banks by delivering transactions to RDFIs. PSOs would not be required to adopt the Reserve Banks' price structure and fees for transactions sent to them by Reserve Banks but rather could establish their own price structure and fees.

- Eligibility: The Board proposed limiting the modified deadlines and price structure to intermediaries that are defined as ACH operators in the operating rules of the National Automated Clearing House Association (NACHA).

II. Summary and Analysis of Comments

The Board received twenty-nine responses to its request for comment. The following table shows the number of comments received by category of commenter:[4]

Commenters	**Number**
Small banks, thrifts, and credit unions	9
Large banks	6
ACH associations	3
Bankers' banks and corporate credit unions	3
Private-sector operators	3
Federal Reserve Banks	2
Trade associations	2
Clearing houses	1
Total	**29**

Overall, fifteen commenters supported and fourteen commenters opposed the Board's proposal. Those supporting the proposal generally tended to be smaller depository institutions; however, the American Bankers Association, two large banks, a bankers' bank, and the Reserve Banks supported the proposal as well. These commenters believed the proposal would enhance

[3] 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.

[4] Responses from trade associations were included with the organizations they represent. Two trade associations (The American Bankers Association and The Association for Financial Professionals), however, did not fall into one specific category and are listed separately.

competition. They also believed that the proposal reflected a balanced approach towards addressing the competitive concerns of PSOs and the pricing concerns of small banks. Those opposing the proposal generally tended to be PSOs, ACH associations, and larger banks; however, two corporate credit unions, a clearing house, and the Association for Financial Professionals opposed the proposal as well. These commenters believed that the proposed modifications would not improve competition in the provision of ACH services and were primarily concerned that the proposed price structure would exacerbate current competitive imbalances.

A. Deposit Deadlines

Summary of Comments—In its May 2000 request for comment, the Board proposed 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 was 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.[5] Under the proposal, PSOs would continue to be free to establish other deadlines by which they would exchange interoperator transactions among themselves. Further, all ACH operators, including the Reserve Banks, would be free to establish deposit and delivery deadlines for their customers.

Almost all commenters supported the Board's proposal to modify deposit deadlines. Commenters indicated that the proposal provided an excellent starting point for discussions between the Reserve Banks and PSOs to establish deposit deadlines for interoperator transactions. These commenters believed that the preliminary recommendation would help level the playing field between Reserve Banks and PSOs and thus improve competition. Further, they believed that because the Reserve Banks currently receive almost all of their next-day item deposits well in advance of the 3:00 a.m. deposit deadline, most Reserve Bank customers would not be adversely affected. Most commenters believed that the deposit deadline modifications could be implemented independent of the remainder of the proposed modifications and that the Reserve Banks and PSOs would have to address a number of technical issues, such as how to handle requests for deadline extensions.

One commenter, however, indicated that it would not be in favor of modifications that would shorten current deposit deadlines for Reserve Bank customers. Wachovia Bank noted that while the adverse impact of changes in deposit deadlines on Reserve Bank customers might be minimal, the Board should avoid any adverse impact. Another commenter, ABN AMRO, also voiced concerns about the potential earlier

[5] Immediate settlement items are settled on the same banking day as they are received while next-day settlement items are settled one or two banking days 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 return items and National Association of Check Safekeeping items are eligible for immediate settlement.

Reserve Bank customer deposit deadline for next-day items and suggested that the Board's long-term goal should be to make the deadline later than it is today.

When it requested comment, the Board noted the problems posed by transactions that involve three operators. Currently, some of the transactions that PSOs deposit with the Reserve Banks are destined to other PSOs, which results in some transactions being processed by three operators.[6] 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. To address this issue, the Board suggested 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 operator by the interoperator deposit deadline, the Board proposed 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' customer deposit deadline.

Commenters believed that the three-operator transaction issue could be addressed through NACHA operating rules but were careful to note that any NACHA operating rule modifications should not result in a degradation of service to RDFIs. The Chicago Reserve Bank, however, suggested that files deposited with the Reserve Banks by a PSO that contain transactions destined to a third operator should not be eligible for modified deadlines and pricing.

Board Analysis—The Board has concluded that the Reserve Banks should work collaboratively with ACH operators to establish interoperator deposit deadlines by which the Reserve Banks and the PSOs would exchange interoperator transactions. The PSOs would continue to be free to establish other deadlines by which they would exchange interoperator transactions among themselves. Further, the Reserve Banks and the PSOs would be free to establish deposit and delivery deadlines for their customers.

Based on the comments received in response to its request for comment, the Board believes that establishing interoperator deposit deadlines by which Reserve Banks and the PSOs would exchange transactions would enhance the competitive environment with minimal operational impact on Reserve Bank customers. Preliminary discussions between the Reserve Banks and the PSOs suggest that the interoperator deposit deadline for immediate settlement items would likely be set at 2:30 p.m. eastern

[6] The Board understands that some depository institutions that use a PSO prefer to minimize the number of settlement entries 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 the number of settlement entries for a given institution but results in three-operator transactions.

time and the interoperator deposit deadline for next-day settlement items would be set at 3:00 a.m. eastern time. As a result, PSOs should be able to deliver transactions to RDFIs earlier than they do today, which should result in competitive RDFI delivery schedules between the Reserve Banks and PSOs. Assuming these deadlines are adopted, the Reserve Banks' customer deposit deadline for next-day items will be adjusted to permit the Reserve Banks to forward interoperator transactions to PSOs by the 3:00 a.m. deadline. Reserve Bank customer deposit deadlines will be finalized after the Reserve Banks and the PSOs set the interoperator deposit deadlines. In addition, the Reserve Banks and the PSOs will work together to address technical operational issues to ensure that the ACH system operates as efficiently and effectively as possible. The new interoperator exchange deadlines will be implemented no later than June 2001.

The Board agrees with commenters that the three-operator transaction issue should be addressed through NACHA operating rules. Accordingly, the Board recommends that NACHA revisit its ACH operator definition and require operators to exchange interoperator transactions directly with the operator serving the RDFI. Further, to ensure that the Reserve Banks are able to forward interoperator transactions by the interoperator deposit deadline, the Reserve Banks will 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. The Board anticipates that the adoption of interoperator exchange deadlines will enable the Reserve Banks and PSOs to offer RDFIs competitive delivery schedules and believes that ODFIs will be able to modify their deadlines or operational procedures to meet an earlier Reserve Bank customer deposit deadline for next-day items.

B. Price Structure for Interoperator Transactions

Summary of Comments—Commenters were split on the appropriateness of the proposed price structure for interoperator transactions processed by the Reserve Banks. Supporters believed that the proposed price structure would promote competition in the provision of ACH operator services. Some supporters of the proposal, however, indicated that their support was premised on the assumption that these pricing changes would not result in higher fees to Reserve Bank customers, a result they would oppose.

Commenters opposing the proposed price structure believed that it would not correct the current competitive inequities and could possibly harm competition. These commenters suggested that the proposed price structure would permit the Reserve Banks to continue to dominate the market for ACH operator services. These commenters believed that the proposal's use of network access fees based on the number of RDFI routing numbers accessed and per-item fees based on the volume of transactions processed did not accurately reflect the Reserve Banks' cost structure. As a result, these commenters believed that the proposed structure would threaten the viability of PSOs and would result in PSO customers subsidizing Reserve Bank customers. These commenters recommended that the Reserve Banks and the PSOs exchange interoperator transactions at par, i.e., with no fees being assessed. If par exchange were not possible, commenters suggested recovering the network access costs through per-item fees.[7]

The Board also requested comment on how the fees that operators would charge each other might be restrained. The Board was concerned that an operator might be able to charge other operators excessive fees for access to RDFIs on its network if RDFIs were unwilling to accept the delivery of ACH transactions directly from multiple operators. The Board was also concerned about fee increases to Reserve Bank and PSO customers that could result from potentially spiraling interoperator fees as the Reserve Banks and PSOs attempted to cover the costs of interoperator transactions by charging each other higher fees. The Board noted that it believed that maintaining low, cost-based interoperator fees would enhance the continued growth of the ACH network.

Commenters stated that the Federal Reserve does not have the legal authority to restrain or impose the fees that PSOs charge the Reserve Banks. These commenters noted that the potential need for fee restraints suggested that the proposed price structure was not economically viable. These commenters believed that the only restraints on interoperator pricing should be market-based. If interoperator fees become unreasonable, operators could establish direct connections to its competitors' customers thereby bypassing the operator assessing the unreasonable fees. These commenters, nevertheless, believed that restraints would not be necessary because it is likely that PSOs would charge Reserve Banks the same fees they are charged by the Reserve Banks. Other commenters, however, suggested that the Reserve Banks should negotiate interoperator fees with the PSOs and that Reserve Banks should not pay PSOs a higher fee than they charge the PSOs. By adopting these approaches, these commenters indicated that the Reserve Banks could ensure that their customers are not subsidizing the PSOs' operations.

<u>Board Analysis</u>—The Board has approved a new approach to pricing interoperator transactions. As the Board noted in its request for comment, the Reserve Banks expend resources when they receive, process, and deliver interoperator transactions. Thus, exchanging interoperator transactions at no charge, as suggested by

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[7] Several commenters appeared to have misconceptions about the proposed price structure. For example, Visa USA misunderstood the Board's proposed network access fee as applying to all routing numbers on the Reserve Banks' ACH network. The Board's proposal, however, stated that the Reserve Banks would charge PSOs a network access fee only for those routing numbers to which they actually sent transactions. Due to this misinterpretation, Visa significantly overestimated the fees that PSOs would pay for access to the Reserve Banks' ACH network under the proposed price structure. Similarly, the American Clearing House Association (ACHA) misinterpreted the Board's proposal as restricting how PSOs could establish fees they would charge Reserve Banks for interoperator transactions and as requiring PSOs to adopt a price structure that was based on the Reserve Banks' ACH cost structure. The Board's proposal indicated that the proposed price structure was how the Reserve Banks would charge PSOs for accessing the Reserve Banks' ACH network. The proposal did not require, as suggested in ACHA's response, that the PSOs adopt the proposed price structure when they set fees for Reserve Bank access to the PSOs' ACH networks. Indeed, the Board's concern about a potential escalation in the fees that operators might charge each other indicates that the Board recognized that operators would likely charge each other different fees under different price structures.

some commenters, could lead to inefficiencies in the processing of ACH transactions. The Board, however, has determined that the proposal to recover network costs through a network access fee based on the number of routing numbers accessed by PSOs would not be an appropriate component of a price structure for interoperator transactions.

Based on its analysis of comments, the Board has concluded that the Reserve Banks should initiate discussions with the PSOs to negotiate the structure and level of fees that would be charged by the Reserve Banks for interoperator transactions as well as those fees that the Reserve Banks would pay the PSOs. The Board believes that negotiations between the Reserve Banks and PSOs should result in interoperator fees that would enhance competition in the provision of ACH operator services.[8]

The Board has also approved, as originally proposed, the settlement fee that would be assessed to depository institutions that send and receive all their transactions that are processed by the Reserve Banks through PSOs. Specifically, the Reserve Banks would charge a monthly settlement fee of about $20 per routing number, rather than the current monthly account servicing fee of $25, to settle interoperator transactions processed by the Reserve Banks for institutions that do not send ACH transactions directly to or receive ACH transactions directly from the Reserve Banks. This fee would enable Reserve Banks to recover the costs associated with settling interoperator transactions processed by the Reserve Banks.

In addition, the Board has determined that PSOs should pay a reduced electronic connection fee. PSOs are currently charged electronic connection fees in accordance with the Reserve Banks' fee schedules. PSOs use their electronic connections to send interoperator transactions to the Reserve Banks. The Reserve Banks, however, also use these electronic connections to send interoperator transactions to the PSOs. As a result, Reserve Banks derive benefits from these electronic connections similar to those derived by the PSOs. Thus, the Board believes that the Reserve Banks should charge the PSOs only half the electronic connection fees they are being charged currently.

The Board anticipates that the new price structure would be implemented no later than September 2001. The specific implementation date of prices for interoperator transactions will be announced well in advance of the effective date.

C. Eligibility

Summary of Comments—The primary distinction between ACH operators, as defined by NACHA rules, and other intermediaries is that operators provide clearing, delivery, and settlement services for intraoperator transactions and exchange

[8] The negotiated fees would apply to both commercial and government ACH transactions that the Reserve Banks send to depository institutions through PSOs.

interoperator transactions with other operators.[9] 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.

Commenters strongly supported the use of NACHA's operator definition to determine eligibility for deadline and price structure modifications. The Federal Reserve Banks of Chicago and Richmond, however, opposed the use of NACHA's operator definition. The Chicago Reserve Bank believed that, given some of the arbitrary aspects of NACHA's operator definition, limiting eligibility for deadline and price structure modifications to intermediaries that meet NACHA's operator definition could worsen the competitive position of other ACH intermediaries vis-à-vis operators and the Reserve Banks. The Richmond Reserve Bank believed that limiting eligibility to only a certain group of intermediaries that provide all of components of the bundle of services that comprise ACH operator services would be inconsistent with the spirit of the proposal, which recognizes the improved competitive environment associated with unbundling services.

<u>Board Analysis</u>—The Board has concluded that the Reserve Banks' deadline and price structure modifications be limited to any intermediary that is defined as an operator under NACHA rules. The Board believes that the role of Reserve Banks in the ACH system is analogous to the role played by PSOs. ACH operators play a significant role in protecting the integrity of the overall ACH network and ensuring its interoperability and efficiency, a role that is separate and distinct from the role of other ACH intermediaries. Further, while the Board believes that certain aspects of NACHA's operator definition could be strengthened, the current definition does not preclude other entities from becoming new operators and competing with established operators.

III. Competitive Impact

The Board conducts a competitive impact analysis when it considers a major operational change, such as that being proposed for ACH interoperator transactions.[10]

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[9] 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 institutions that bind the depository institutions to NACHA operating rules and the 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 Association are considered to be private-sector ACH operators. 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.

[10] Federal Reserve Regulatory Service, 7-145.2.

Specifically, in its analysis, the Board has assessed whether the interoperator deadlines and price structure would 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 deadline and price structure modifications discussed above is to further enhance the competitive environment for ACH operator services. These modifications should enhance the ability of PSOs to compete with the Reserve Banks in providing ACH operator services to depository institutions. Specifically, PSOs will be able to establish customer deposit deadlines similar to those of Reserve Banks. Further, the Reserve Banks and PSOs will have the same ability to charge each other for the processing and delivery of ACH transactions to RDFIs that they serve. Moreover, depository institutions and other intermediaries might benefit from lower ACH transaction fees that could result from a more competitive market for the provision of ACH operator services. Thus, the Board does not anticipate any adverse effects on competition resulting from this proposal.

IV. Conclusion

The Board has decided on the following modifications to the Reserve Banks' deposit deadlines and price structure for interoperator transactions that the Reserve Banks exchange with PSOs.

- First, the Board has decided that the Reserve Banks should work collaboratively with ACH operators to establish interoperator deposit deadlines by which the Reserve Banks and the PSOs would exchange interoperator transactions. The PSOs would continue to be free to establish other deadlines by which they would exchange interoperator transactions among themselves. The interoperator deposit deadlines will be implemented no later than June 2001.

- Second, the Board has approved a new approach to pricing interoperator transactions that PSOs send to RDFIs on the Reserve Banks' ACH network.

    - The Reserve Banks will charge depository institutions that send and receive all their transactions through PSOs a monthly settlement fee of $20 per routing number, rather than the monthly account servicing fee (currently set at $25), to settle interoperator transactions processed by the Reserve Banks.

    - The Reserve Banks will initiate discussions with the PSOs to negotiate the structure and level of fees that will be charged by the Reserve Banks as well as those fees that the Reserve Banks will pay the PSOs.

    - The Reserve Banks will charge ACH operators half the published electronic connection fee to reflect the use of the connection by both ACH operators and the Reserve Banks to send each other interoperator transactions.

The new prices for interoperator transactions will be implemented by the Reserve Banks no later than September 2001.

- Third, the Board has decided that the Reserve Banks' deadline and price structure modifications be limited to any intermediary that is defined as an operator under NACHA rules.

The specific implementation date for each of the modifications outlined above will be announced well in advance of the effective dates.

By order of the Board of Governors of the Federal Reserve System, October 30, 2000.

(Signed) Jennifer J. Johnson

Jennifer J. Johnson,
Secretary of the Board