



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

LOUISE L. ROSEMAN
DIRECTOR
DIVISION OF
RESERVE BANK OPERATIONS
AND PAYMENT SYSTEMS

January 17, 2003

Mr. George Thomas, AAP
President, Chief Operating Officer
Electronic Payments Network
1500 Harbor Boulevard
Weehawken, NJ 07087

Dear George:

In your December 18 letter to me, you expressed concern that recent Reserve Bank price reductions for FedACH services may have had an inappropriate and detrimental effect on competition within the market for ACH operator services. You asked that the Federal Reserve Board review the Reserve Banks' role in the ACH business and commission an independent study of the Reserve Banks' recent price reductions.

You may recall that a few years ago the Board commissioned a study of the role of the Federal Reserve in the retail payments mechanism.¹ This study, chaired by then-Federal Reserve Board Vice Chair Alice Rivlin, obtained the views of more than 450 organizations that are providers or users of payment services. The study concluded, among other things, that the Federal Reserve should remain a provider of ACH services with the explicit goal of enhancing the efficiency, effectiveness, and convenience of the system, while ensuring access for all depository institutions.

We share your desire to ensure fair and vigorous competition in the market for ACH operator services and the rest of the payments system. I have no doubt that competition has encouraged all participants in the ACH market to seek to improve the efficiency of their operations. The Reserve Banks, for their part, have streamlined their operations significantly to improve customer service while reducing costs. The cost savings resulting from these actions have enabled the Reserve Banks to reduce the fees they charge their customers, while fully recovering the costs of providing their ACH service. Consistent with the requirements of the Monetary Control Act and the Board's pricing principles, the Reserve Banks set their fees to recover, over the long run, the actual costs of providing the service as well as the taxes and other imputed expenses that would have been paid and imputed profit that would have been earned had the Reserve Banks' ACH service been provided by a private business. Indeed, the Reserve Banks have fully recovered all costs of providing their ACH service, including imputed expenses

¹ *The Federal Reserve in the Payments Mechanism*, Report of the Committee on the Federal Reserve in the Payments Mechanism, January 1998. <http://www.federalreserve.gov/boarddocs/press/general/1998/19980105/default.htm>.

and profits, in each year since 1995. Competition that has encouraged this continued search for increased efficiency has also yielded lower fees for the banking industry and, I hope, the business and consumer users of electronic banking services.

We recognize that the Reserve Banks' continuing sizeable (but diminishing) market position in the provision of ACH operator services has contributed to the Reserve Banks' ability to offer ACH services at attractive costs. Currently, given the economies of scale associated with the ACH service, an operator with a large market share is able to spread the relatively high fixed cost of providing the service over a large volume base. The Rivlin Committee report discussed the tension between the efficiencies that result from market competition and those that are derived from economies of scale.²

As part of our efforts to ensure that Federal Reserve actions, including the Reserve Banks' provision of priced services, do not inappropriately hinder competition, Board policy requires a competitive-impact analysis when we consider an operational or legal change. In this analysis, we assess whether the change 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 due to differing legal powers or constraints or due to a dominant market position of the Federal Reserve deriving from such legal differences. We have not identified any legal powers or constraints that prevent other service providers from competing effectively with the Reserve Banks. If you believe that there are legal differences that prevent EPN from competing effectively with the Reserve Banks, I would appreciate the opportunity to discuss them with you. This will help us determine whether a more formal review is required. Currently, the Reserve Banks' price reductions and the decisions of private businesses to enter or exit a market for electronic payment services do not suggest to me that the Reserve Banks' pricing practices unfairly disadvantage competitors.

Thank you for your letter and the opportunity to discuss the Board's perspectives on competition in the provision of ACH operator services.

Sincerely,

A handwritten signature in cursive script, appearing to read "Louise".

c: Vice Chairman Roger W. Ferguson
Governor Susan S. Bies
Governor Mark W. Olson

² Ibid., pages 27-28.