

**Fair Competition in the Automated Clearing House Payments System**  
**A Private Sector ACH Operator Perspective**  
**Electronic Payments Network**  
**December 18, 2002**

**Summary**

The ACH payments system is a mechanism through which electronic funds transfers (*e.g.*, direct deposit payroll payments, social security and dividend payments, payments to vendors by businesses and the government, consumer bill payments, etc.) are processed. This system generally processes small-dollar transfers and has the capability to handle a large volume of transactions efficiently. ACH transactions are generally initiated through depository institutions and involve the transmission of credit and debit orders with other depository institutions via ACH operators.

ACH is a critical component of the nation's payments infrastructure, and its volume continues to grow, representing an average volume increase of more than 18% per year and an average dollar value increase of more than 13.5% per year over the past 10 years. The dollar value of ACH transactions exceeded \$22 trillion in 2001. In addition, ACH transactions have the potential to become a major agent in the conversion of the U.S. payments system from a paper-intensive environment to a more efficient, technology-based environment.

The banking industry and private-sector operators ("*PSOs*") of automated clearing houses ("*ACHs*") have long endeavored to establish and maintain competitive alternatives for the provision of ACH services. Competition is necessary in order for the U.S. payments system, including the ACH system, to function as efficiently and cost-effectively as possible and with strong safeguards against disruption. The private sector has driven efficiencies, lower costs and has generated many major innovations in the ACH system. Competition from the private sector has yielded numerous significant advancements which include:

- the all-electronic ACH;
- two-day credits (which expanded the use of the ACH network for payroll direct deposit);
- third-party processor, direct access, and settlement bank credit risk controls;

- Windows-based software for financial institutions;
- warehousing;
- financial electronic data interchange translation software;
- automated enrollment software for government agencies that financial institutions can deploy at branch levels; and
- continuous flow processing.

The private sector continues to make major investments in new enhancements, such as the Universal Payment Identification Code, development of straight-through processing, and an early-warning system that will alert originating depository financial institutions to possible abuse of the ACH network.

Despite substantial effort, the private-sector goal of providing viable competition has been elusive since the inception of the ACH 28 years ago. The Federal Reserve Banks (the “*Reserve Banks*”) have long held a dominant position in this market, with more than 80% of the commercial ACH segment and 100% of the government segment in 2001. Previous policies, established by the Board of Governors of the Federal Reserve System (the “*Board*”), facilitated this dominance. These policies constrained growth opportunities for existing PSOs and acted as a major deterrent to new entrants. When these policies were finally rescinded in 2000 (effective in 2001), the Reserve Banks almost immediately initiated a series of unprecedented price reductions of FedACH services. The impact of these price cuts compounded the effects of previous Board policies and have likely contributed to the demise of two PSOs over the last year, leaving EPN the sole remaining competitor to FedACH. The Reserve Banks’ dramatic decreases in its item prices, rapidly following the Board’s rescission of its previous restrictive policies, are detrimental not only to PSOs but to the payments system overall and could endanger the soundness and integrity of the payments system. We therefore request that the Board commission an independent review of its most recent price reductions and their congruence with the intent of Congress when the Monetary Control Act was enacted in 1980.<sup>1</sup>

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<sup>1</sup> Pub. L. No. 96-221, 94 Stat. 140.

## Competition and Efficiency in the ACH Market

Section 107 of the Monetary Control Act of 1980 (the “MCA”) requires the Board to establish pricing principles for the provision of payments services by the Reserve Banks.<sup>2</sup> The MCA further requires the pricing principles to “give due regard to competitive factors.”<sup>3</sup> The most authoritative analysis of the legislative history of these MCA provisions notes:

The legislative history of this Act supports [the] view . . . that, at least as a general principle, the Federal Reserve Board is to set fees which would permit fair competition with private sector providers of services, unless such fees would result in a significant segment of the financial community being unable to afford these services.<sup>4</sup>

Among the sources cited in support of this conclusion was the introductory statement of Representative Henry Reuss, then Chairman of the House Banking Committee, during a House hearing on a predecessor bill (H.R. 12706):

The Stanton bill, in calling for market-competitive prices on these services, assures that private competitors of the Federal Reserve will not be undercut by unfair subsidized competition.<sup>5</sup>

In addition, then-Board Chairman William Miller testified as follows:

Our proposal on pricing is to price competitively, but not to undercut the market . . . . But we also look with favor upon the growth of optional, innovative, cost-effective techniques for handling services. And we think pricing would bring about that trend and would probably increase participation in the private sector in the performance of the services.<sup>6</sup>

Moreover, as evidenced by Senator William Proxmire’s remarks during floor debate on the MCA, the possibility that the volume of Federal Reserve services would decline as a result of private-sector competition was expressly contemplated by Congress.<sup>7</sup>

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<sup>2</sup> See U.S.C. § 248a.

<sup>3</sup> See *id.*

<sup>4</sup> Raymond Natter, *Legislative Intent Regarding Pricing of Services by the Federal Reserve Board*, 2 (Jan. 25, 1984).

<sup>5</sup> *Id.* at 4.

<sup>6</sup> *Id.* at 5.

<sup>7</sup> 126 Cong. Rec. 6897 (March 27, 1980) (remarks of Sen. Proxmire).

The Board has explicitly recognized that Congress intended for these principles “to encourage competition in order to assure provision of these services at the lowest cost to society.”<sup>8</sup> The Board’s Pricing Principles make numerous references to the importance of competition and the Board’s obligation to foster competition. For example, in describing its role in the provision of payments services, the Board states that such role is to “promote the integrity and efficiency of the payments mechanism . . . and do so in an atmosphere of competitive fairness.”<sup>9</sup> The Board has also asserted its “fundamental commitment to competitive fairness.”<sup>10</sup>

More specifically, the Board, by its own policy, must conduct a competitive impact analysis whenever considering operational or legal changes — including fee reductions — to a priced services system that 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 Reserve Banks deriving from such legal differences.<sup>11</sup>

Indeed, the stated Board concern about an adverse competitive effect is so great that “[a]ll operational or legal changes having a substantial effect on payments-system participants will be subject to a competitive-impact analysis, even if competitive effects are not apparent on the face of the proposal.”<sup>12</sup>

The Board has established several factors that it must consider when conducting its anti-competitive analysis, including possibly modifying the proposal to lessen or eliminate the “adverse impact on competitors’ ability to compete.”<sup>13</sup> If the proposal creates an adverse effect on competitors’ ability to compete, the Board must further evaluate the proposal to assess whether the anticipated benefits — such as contributions

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<sup>8</sup> Principles for Pricing of Federal Reserve Bank Services – Background, FRRS 7-133.

<sup>9</sup> The Federal Reserve in the Payments System, FRRS 7-139.

<sup>10</sup> See Criteria for Evaluating Proposed Payments-System Changes – Conclusion, FRRS 7-146.1.

<sup>11</sup> Criteria for Evaluating Proposed Payments-System Changes – Competitive-Impact Analysis, FRRS 7-145.2.

<sup>12</sup> See *id.*

<sup>13</sup> *Id.*

to payments system efficiency, payments system integrity, etc. — are significant enough to proceed with the change despite the adverse effects on competition.<sup>14</sup>

The Board has recognized that the concern about an adverse effect on competition exists independently of cost issues. A vital contribution of competition is “the promotion of operating efficiency,” which will “remain at the core of the [Board’s] role and responsibilities regarding the operation of the payments system.”<sup>15</sup> Innovation, both systemically and technologically, is necessary to make the payments system as efficient and cost-effective as is possible.<sup>16</sup> Competition is a major source of innovation.

Although not explicitly recognized in the Board’s policy statement, competition now has an independent rationale beyond its effect on efficiency, innovation, and cost. The safety and soundness of the payments system would benefit from more than one provider of each essential payments service. This would enable payments processing to continue uninterrupted if one provider is disabled.

### **Reserve Bank Domination of the ACH Market**

As mentioned earlier, since the inception of the ACH, the Reserve Banks have dominated the ACH market. This is due, in part, to the policies promulgated and followed by the Board through 2001 that discouraged private-sector competition, contributed to Reserve Bank dominance by constraining growth opportunities for existing PSOs, and served as a major deterrent to new entrants into the ACH processing market.

In October of 2000, following years of numerous complaints about these policies by the private sector, the Board changed the manner in which the Reserve Banks interacted with PSOs.<sup>17</sup> It eliminated the anti-competitive policies described above, which should have permitted all parties to compete on a more equitable basis. The new policies became effective in June and September of 2001. It should be noted, however,

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<sup>14</sup> *See id.*

<sup>15</sup> The Federal Reserve in the Payments System – Role of the Federal Reserve, FRRS 7-140.

<sup>16</sup> “It is recognized that the most significant further gains in payment efficiency are likely to come from the application of advances in electronic technology.” The Federal Reserve in the Payments System – Efficiency of the Payments System, FRRS 7-142.

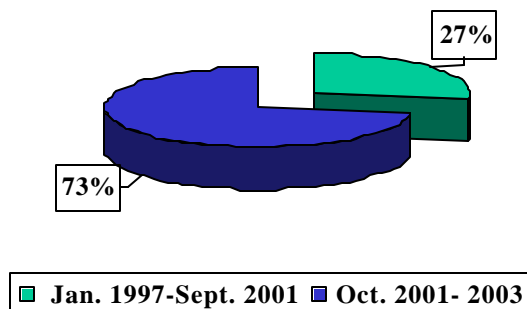
<sup>17</sup> *See generally* Federal Reserve ACH Deposit Deadlines and Pricing Practices for Transactions Involving Private-Sector ACH Operators, 65 Fed. Reg. 66,249 (2000).

that the cumulative effect of these policies prior to the change had served to weaken PSOs in the ACH market.

### Price Reductions Following the New Policy

Shortly after the 2000 policy change became effective, the Reserve Banks lowered their ACH item pricing in an unprecedented action.<sup>18</sup> The Reserve Banks' price reduction, which was implemented on October 1, 2001, was unique in two respects. First, this was the first significant price reduction in five years. Second, the reduction did not occur at a year-end. The Reserve Banks then effected a second and even more radical price decrease on February 1, 2002, further reducing prices for originated items by 37% and receipt items by 50%. On October 31, 2002, the Board announced yet another price reduction — the third one in 15 months — effective January 2, 2003. During this 15-month period following the Board's elimination of its competition-deterrent policies, the cumulative effect of these changes was a reduction of 44% for originated items, 64% for received items, and 50% for addenda records. In contrast, during the 57-month period from January 1, 1997 until October 1, 2001, originated items were reduced by 34%, received items were reduced by only 22% and there was no reduction in addenda records. The chart below clearly demonstrates that 73% of the item price reductions have taken place since October 1, 2001.

**Federal Reserve ACH Item Reductions  
Since 1996 Consolidation**



<sup>18</sup> Despite the consolidation of FedACH services in 1996, the most significant FedACH price reductions did not occur until after the Board leveled the playing field in October of 2001.

We also note that the most recent price reductions occurred in a year when the Reserve Banks expect to recover only 92% of their costs for all their priced services<sup>19</sup> — the lowest recovery rate in more than ten years — which creates a *per se* question of compliance with section 107 of the MCA. This remains important because (i) next year’s anticipated recovery rate is only 94% despite a significant increase in check processing fees; and (ii) the 2000 recovery rate was only 95%. The Reserve Banks’ argument that section 107 only requires them to recover costs “in the long run” basically negates any recovery test. The private sector must recover costs in a much shorter time frame if a business is to remain viable.

### **The Anti-Competitive Effects of the Price Reductions**

Although price reductions are generally regarded as positive for consumers, both economists and our legal system have long recognized that price reductions made with the intent, or even the effect, of preserving market share ultimately have an adverse impact. The general rationale for reducing prices is to increase demand for products or services, thereby increasing market share. An objective observer could question whether or not sufficient time passed between the Federal Reserve’s price reductions to stimulate increased demand or if the price reductions were purely targeted to preserve market share.

Within several months after the Reserve Banks’ first two price reductions, the American Clearing House Association announced that it could no longer compete in the new pricing environment and elected to cease operations effective October 31, 2002.<sup>20</sup> In addition, during the summer of 2002, VISA ACH announced that it would discontinue its ACH operating service by March 14, 2003, leaving the Electronic Payments Network (“EPN”) as the only PSO actively competing with the Federal Reserve. The operations of these two other PSOs were terminated largely due to the cumulative effects of pre-2001

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<sup>19</sup> See the announcement of the approval of fee schedules for Federal Reserve priced services, 67 Fed. Reg. 67,834 (Nov. 7, 2002).

<sup>20</sup> See *ACHA to Exit ACH Operator Services*, PRO REPORT, Summer 2002, at 1 (statement of ACHA President and CEO referring explicitly to the impact of Federal Reserve price reductions on the decision to exit the ACH market).

Board policies and the unprecedented, back-to-back-to-back price reductions between October 1, 2001 and October 31, 2002.<sup>21</sup>

The Reserve Banks' dominant market share, combined with their unique ability to regulate their competitors, makes their actions with respect to service pricing a major concern to the private sector. We believe that the recent extraordinary set of price reductions of FedACH services violates Board policy and Congressional intent. The implementation of three significant price reductions within 15 months for large-volume originators and receivers clearly has a direct and material adverse effect on the private sector's ability to continue as an effective competitor with the Reserve Banks (as well as creating a disadvantage for the mid-sized and small financial institutions using FedACH services). The departure of two of the three PSOs during that same period of time helps to confirm this view.

As discussed above, the Board is prohibited from using its dominant market position or legal and regulatory power — including changes in pricing — in a way that adversely affects its competitors unless improvements to payments system efficiency or integrity can be demonstrated. The recent rapid succession of price reductions does not improve payments system efficiency or integrity; to the contrary, they will have (and have had) a long-term negative effect on the payments system by stifling the innovation and creativity that has promoted payments system efficiency, stability, and integrity.

### **Desirability of Multiple Players for the Security of the Payments System**

There is another crucial reason why competition in the ACH market should be encouraged and any Federal Reserve actions that could have the effect of discouraging competition should be carefully scrutinized. Competition in the ACH market helps ensure that the payments system is secure and that it can continue to function in the event of an internal malfunction or external disaster. The events of September 11, 2001, have spurred efforts in many sectors of the payments system to create back-up facilities and to implement procedures and processes to ensure that the nation's financial transactions can

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<sup>21</sup> See Jennifer A. Kingston, *ACH Shakeout: Two Players Retrenching*, AMERICAN BANKER, December 3, 2002, at 1.

continue uninterrupted in the event of large-scale disaster. The Reserve Banks and EPN have both made efforts to implement and maintain backup systems for this purpose.

Nevertheless, though back-up systems are in place, it is important to have more than one participant in this market, a market that grows larger by the year and is crucial to our payments system infrastructure. For the reasons discussed above, however, the recent pricing activity of the Reserve Banks discourages the continuation of PSOs in the ACH sector.

### **Current Trends in ACH**

In 1998, the Federal Reserve issued a report<sup>22</sup> that discussed the role of the Reserve Banks in the payment system, including the provision of ACH services. Since that report was released, the ACH has been transformed from a system that focused primarily on recurring payments to a more general payments network. The fastest growing ACH applications are one-time "e-check" payments that are originated by consumers using paper checks, the telephone, and web sites.

Related to this transformation is the large role that third-party payment processors play in processing "e-check" payments. Often these payments processors send the ACH transactions directly to a Reserve Bank, by-passing the originator's depository financial institution. The combination of "e-check" volume and "direct access" by payment processors to the ACH network has led to a dramatic increase in fraudulent ACH transactions and customer-service costs at financial institutions.

The NACHA board of directors recently approved a major fraud-reduction and risk-management initiative. This initiative will require the ACH operators to implement several new services that significantly change their role.

Because of the transformation cited above and the new services that the ACH operators will have to provide, EPN believes that the Board needs to initiate a strategic

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<sup>22</sup> Committee on the Federal Reserve in the Payments Mechanism, *The Federal Reserve in the Payments Mechanism*, January 1998.

review of the role of the Reserve Banks in the ACH business. As part of that review, the Board should solicit the views of the public.

## **Conclusion**

Competition is necessary in order for the U.S. payments system, including the ACH system, to function as efficiently and cost-effectively as possible and with strong safeguards against disruption.

Congress and the Board have explicitly acknowledged the link between competition and efficiency.<sup>23</sup> The history of the ACH market demonstrates that competition has engendered efficiency within that market by driving market players to constantly update and refine their processes and technologies. It has stimulated innovative ideas needed to improve the system and move it toward an electronic environment. Further, competition pushes competitors to enhance the integrity and reliability of the system.

The elimination of anti-competitive policies, immediately followed by the imposition of three significant price reductions in a 15-month period, had the effect of eliminating, and then immediately restoring competitive inequity, and is not consistent with the Board's stated policy of assuring competitive fairness and efficiency in the ACH sector. We therefore urge that the Board commission an independent review of its most recent price reductions and ensure that future price reductions do not continue to disadvantage the provision of ACH services by the private sector.

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<sup>23</sup> “[C]ompetition between the Federal Reserve and other providers of payment services has resulted in a more efficient payments system.” The Federal Reserve in the Payments System – Efficiency of the Payments System, FRRS 7-142.