FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

DALLAS, TEXAS 75222

January 20, 1988

Circular 88-7

TO: The Chief Executive Officer of
all financial institutions in the
Eleventh Federal Reserve District

SUBJECT

Measures to reduce risk in the ACH payments system

DETAILS

The Federal Reserve Board of Governors has announced a series of measures, effective July 18, 1988, to reduce risk in the automated clearinghouse (ACH) payments system. The new risk reduction measures provide for monitoring problem institutions that originate ACH credit transactions and obtaining assurances from those institutions that they can meet their payment obligations on settlement day. In addition, the measures provide earlier deadlines for deposit of large-dollar return items and provide revised procedures for charging originators of ACH credit transactions that settle on nonstandard holidays or midweek closing days observed by the originator.

The new measures require that Federal Reserve Banks increase monitoring of problem institutions that originate ACH credit payments. Additionally, Reserve Banks may require advance funding or other assurances of payment for ACH credit transactions, or may reject such transactions if it appears that the originating institution will not be able to fund the payments on settlement day. The Federal Reserve believes these actions will increase the level of certainty of funding for all receivers of ACH credit transactions.

In a significant departure from past return item practices, these measures will require that debit return items of $2,500 or greater that are deposited with the Federal Reserve in electronic form must be **received by** the local Reserve Bank by the applicable night cycle ACH deposit deadline on the evening of the banking day following settlement or receipt, whichever is later. Institutions returning large-dollar items in paper form must arrange to have those paper returns **received by** their local Federal Reserve Bank no later than 7:00 p.m. Central time on the evening of the banking day following settlement or receipt, whichever is later. Please note that no longer will dispatch of such items from the financial institution's premises satisfy the requirements of large-dollar debit returns.

Those returns must be **received by** the returning institution's local Federal Reserve Bank by the deadlines mentioned here.

To ensure that Eleventh District institutions remotely located from a Federal Reserve office are able to meet the required deposit deadlines, the Federal Reserve Bank of Dallas offers several options for deposit of ACH return items. There are several electronic connections available to handle ACH return items, including direct computer-to-computer links, data links and personal computer links. Through these connections, an institution can generate return items and transmit them to the Fed as an electronic ACH file, thereby allowing institutions to meet the ACH night cycle deadlines for deposit of automated returns. Institutions that do not use a computer connection to return ACH items can use any Touch-Tone telephone together with the Dallas Fed's computerized voice-response system, CATIE. CATIE allows institutions to access the Dallas Fed's ACH history data base via a WATS line call to the computer-generated voice system. (Institutions with dedicated terminal connections to the Dallas Fed can also use their terminals to access the history data base.) Using CATIE, an institution can generate an ACH return immediately without having to make arrangements for delivery of paper returns to its local Fed office by 7:00 p.m. Although the surcharge for submitting a paper return to the Fed is $3.75, the total price for generating an automated return via CATIE is only $1.25.

The measures also require that Federal Reserve Banks settle ACH credit transactions on the settlement date with the originating institution, whether or not that institution is closed to observe a nonstandard holiday or midweek closing. Institutions will no longer be able to defer settlement for credit originations and accept an as-of adjustment or pay an explicit fee for the float caused by such originations. The Federal Reserve believes that institutions originating credit payments should be aware of their obligation when the payments are generated to fund such payments on the settlement date.

ATTACHMENTS

The Federal Reserve Board of Governors' notice is attached.

MORE INFORMATION

For more information, please contact Ms. Jonnie Miller at (214) 651-6290 or Mr. Larry C. Ripley at (214) 651-6118.

Sincerely yours,

William H. Wallace

[Docket No. R-0591]

Risks on Large-Dollar Transfer Systems; Automated Clearing House Transactions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy statement.

SUMMARY: The Board has adopted the following measures to reduce risk in the automated clearance house ("ACH") service:

(1) Uniform Reserve Bank procedures to monitor ACH credit payments originated by depository institutions in a weak financial position;

(2) Earlier deadlines for returns of ACH debit transactions of $2,500 or greater; and

(3) Uniform float accounting procedures for depository institutions originating ACH credit transactions that settle on nonstandard holidays.

EFFECTIVE DATE: July 18, 1988.

FOR FURTHER INFORMATION CONTACT: Julius F. Oreska, Manager (202/452–3878), Margaret R. Weimer, Senior Analyst (202/452–3341), Division of Federal Reserve Bank Operations; Elaine M. Boutilier, Senior Attorney (202/452–2418), Legal.

Division: for the hearing impaired *only*, Telecommunications Service for the Deaf (202/452–3544), Earnestine Hill or Dorothea Thompson.

SUPPLEMENTARY INFORMATION: On December 19, 1986, the Board of Governors requested public comment on several proposals to reduce risk in the ACH mechanism. Specifically, the Board proposed the following changes: (1) Change the posting times for ACH transactions in the *ex post* monitoring system; (2) amend the Reserve Bank operating circulars concerning the finality of ACH transactions; (3) reduce the return times for large-dollar ACH transactions; (4) charge the accounts of institutions originating ACH credit transactions, when such institutions observe midweek or nonstandard holiday closings on the settlement date; and (5) monitor ACH transactions originated by problem depository institutions.

In general, favorable comments were received on the proposal to reduce the return times for large-dollar ACH debit transactions, the proposal regarding treatment of ACH credit transactions orginated by institutions observing midweek or nonstandard holiday closings, and the proposal to monitor ACH transactions. The other two proposals, regarding posting for the *ex post* monitor and finality of ACH transactions, generated considerable comment and are still being reviewed. It is expected that recommendations will be considered by the Board on *ex post* monitoring procedures and finality by mid-1988.

Risks Relating to ACH Transactions

The ACH is a value-dated electonic payment mechanism, in which transactions may be originated one or two days before the settlement date. In 1986, over 700 million payments were originated with a value of about $2.2 trillion. There are two types of ACH payments—credit transactions and debit transactions.

In an ACH credit transaction, the originator of the payment orders funds to be credited to the receiver's account. Unlike Fedwire transfers, which are irrevocable to receivers, the Reserve Banks reserve the right to reverse credits given for ACH transactions until the close of business on settlement day. The risk to the Federal Reserve in processing ACH credit transactions arises from the potential failure of an originating institution before its obligation has been fully funded and the Reserve Bank's potential inability to reverse all payments that were originated by the closed institution. The risk faced by depository institutions receiving ACH credit transactions is due to the institutions' typical practice of making the funds available to their customers on the day of settlement. Thus, if payments must be reversed as a consequence of an originating institution's failure, the receiving institution may suffer a financial loss, or if the receiving institution has made the funds available to its customers, the customers may suffer the loss.

In ACH debit transactions, funds flow to the originator of the payment from the receiver. Like checks, ACH debit transactions are provisional payments and receiving institutions have the right to return them. The Federal Reserve's risk in handling ACH debit transactions arises from return item processing. The Reserve Banks must reverse debit entries when items are returned by receiving institutions. If the originating institution has failed and the Reserve Bank is unable to recover funds from the originating institution or its customer, the Reserve Bank would absorb the loss.

Institutions receiving ACH debit transactions are exposed to very little risk because they have the right to return the items if their customers do not have sufficient funds to cover the payments. The primary risk faced by the receiving institutions is the operational risk associated with missing the return deadline.

The originators of ACH debit payments usually release funds to their customers on the day of settlement. Returns, however, typically are not received by originating institutions until five or six days following the settlement day. This exposes the originating institutions to temporal risk directly related to the return item process.

1. Monitoring ACH Originations

The commentors on the ACH risk proposals agreed with the concept of real-time monitoring of ACH transactions and noted that they would prefer risk control measures that would minimize the disruption to the ACH payments mechanism and would be focused primarily on those problem participants that pose the greatest risk. Accordingly, the Board has adopted monitoring procedures developed specifically for problem ACH originators, that is, those institutions in greatest risk of failing.

Each Reserve Bank will be responsible for identifying the problem ACH originators in its district. Each problem depository institution that originates ACH credit transactions will be required to notify the payment system risk monitoring staff at its account-holding Reserve Bank of the value of the payments that it plans to originate before submitting them for processing. The institution must specify the value of the credit payments it plans to originate both in the aggregate and by settlement date.

The Reserve Bank will maintain a cumulative total of ACH transactions by processing date and by settlement date. After the ACH payments are processed and delivered to receiving institutions, the value of the credit payments reported by the problem institution will be compared to the actual transactions that were processed. Any discrepancies will be reviewed with the institution's management immediately. In Districts where private ACH processors perform the processing, the details of monitoring the problem institutions' credit originations still will be addressed by the Reserve Banks which may require the private processors to provide additional information to facilitate the monitoring.

The risk monitoring staff will assess the Federal Reserve's exposure resulting from the ACH credit payments originated by the problem instititution. When necessary, the Reserve Bank will require advanced funding or other assurance of payment to cover the value of the payments at the time of deposit as a surety against the inherent risk. If the institution fails to provide adequate funding or other assurance, then the Reserve Banks may refuse to process the ACH transactions.

Debit transactions originated by problem institutions pose little risk to the recipients. This is because debit payments are provisional payments and the receivers are protected by legal rights to return the debit transactions within specified time frames. Consequently, no special monitoring procedures are necessary for debit originations. Nevertheless, there may be special concerns that a problem originator will fail with little likelihood that the institution will be merged with or absorbed by a healthy institution. Accordingly, the Board has determined that the Reserve Bank may defer the availability of some or all of the credit from the debit payments the institution has originated. This would parallel § 210.10(b) of Regulation J, which permits Reserve Banks to defer credit for checks. It should be noted, however, that this provision would not fully address the risk to Reserve Banks in instances where the receiving institution returns a debit adjustment entry as late as 45 days after settlement to a failed originating institution. This issue will be considered by the Board together with the recommendations on finality and *ex post* monitoring.

For institutions that are not classified as problem institutions, the Federal Reserve is still exposed to the risk that an institution might unexpectedly be closed or suspended. Consequently, the Reserve Banks continue to reserve the right to reverse credit payments if the originating depository institution fails.

In order to increase their knowledge about ACH originators' activity and to identify unusual trends in ACH originations, the Reserve Banks will review all ACH originations over a two-week reserve accounting period at least once quarterly. This may be done via exception reports that can be generated when average and peak-day origination volumes and dollar value of individual originating institutions exceed a predetermined range, based upon actual origination patterns for each originator. It is expected that this range will be revised at least semiannually.

2. ACH Return Items

To reduce risk to originators of large-dollar debit transactions, the Board changed the deadline for depositing automated ACH debit return items of $2,500 or more at the Reserve Banks from the current deadline of midnight of the business day following settlement or receipt, whichever is later, to the deposit deadlines for the night processing cycle on the business day following settlement or receipt, whichever is later.[1] Presently, ACH returns take five or six days, on average, to reach the originating institutions. Upon implementation of the earliar deadlines, it is expected that the returns will reach the originating institutions by the morning of the second business day following settlement or receipt of the original transaction, whichever is later.

With regard to debit returns of $2,500 or more submitted to the Reserve Banks in paper form, where Reserve Banks must convert the items to electronic form, the Board proposed a return deadline of between 5:00 p.m. and 8:00 p.m. eastern time. This deadline provides the Reserve Bank time to convert the returns in time for processing at night, with delivery to the originating institutions the following morning.

Most of the commenters believed that setting earlier return item deadlines would reduce risk in the ACH mechanism. Therefore, the Board has adopted an 8:00 p.m. (eastern time) deadline for the paper returns and the regular night deposit deadlines for the automated returns.

For those institutions that cannot meet the paper return item deadline, the Board proposed that a telephone return item service be offered at a fee of $6.00 per return item. Most commenters supported the proposal to offer this service, but questioned the fee, believing it should be lower. The costs of implementing this service were reviewed and the Board has determined that the $6.00 fee is appropriate to cover the cost of staff time and equipment that would be needed to implement the service. Therefore, the telephone return service will be implemented for large-dollar return items and the fee will be set initially at $6.00 per return item.

Two other improvements in the return item area proposed by the Board were not well received: (1) To require notification by 3:00 p.m. eastern time, on the business day following settlement or receipt, of any return items of $100,000 or more, and (2) to offer an optional service to segregate return items from regular transactions being delivered to originating institutions that have electronic access to the Reserve Banks.

The commenters' concerns with the large-dollar notification requirement centered primarily on the use of a uniform time nationwide. West Coast institutions believed that the deadline was too early, while a later notification may be too late in the day to be useful to East Coast originating institutions. Also, commenters disagreed on the appropriate dollar cutoff for such a notification requirement. In view of these concerns, and the likelihood that the notification requirement would be of marginal benefit to the originators, the Board did not implement this proposal.

The proposal to provide an optional service to segregate return items from regular transactions and deliver the returns earlier received only 30 comments. In view of the limited response to this proposal, and the automation expense of providing such a service, the Board did not adopt this proposal.

3. Midweek and Nonstandard Holiday Closings

Under current procedures, originators of ACH credit transactions that are closed on the settlement day, because of a nonstandard holiday or midweek closing, are charged for the transactions on the next business day. The cost of the float from crediting the reserve or clearing accounts of the receiving institutions but not charging the closed originating institution is recovered from the originating institution through an as of adjustment or an explicit fee. Because Reserve Banks can reserve ACH credit payments only until the entries are posted on the settlement day, the current procedure of delaying charges to originators of ACH credit transactions increases the Reserve Banks' exposure to the risk of loss compared with settlements occurring on days that the originator is open.

The Board proposed that originating institutions that will be closed on the day credit transactions that they have originated are scheduled to settle be charged for the transactions on the settlement day as though they were open. This policy would apply to both voluntary and mandatory holiday because the institutions making these payments are aware of their obligations one or two days before the settlement date.

A majority of the commenters concurred with this proposal. Most of the commenters agreed with the Board's views that the proposal was equitable, because the originators are aware of their obligation to fund the credit payments in advance of the settlement date. Most of the commenters opposing the proposal wanted the option of being charged on the holiday or deferring the debit and paying for the consequent float through explicit fees. Deferring the debit, however, creates risk for the Federal Reserve because the Reserve Banks may not be able to reverse the credit transactions after they have been

[1] Presently the night cycle deposit deadlines vary depending on whether the payments are interregional or local, unsorted or presorted by receiving Reserve office. They range between 8:00 p.m. for interregional unsorted deposits (with provision for a file remake) to the local deposit deadline of 1:30 a.m. (for files without remake capability). Most files are depsotied by the interregional deadline for unsorted deposits (without remake)—11:00 p.m.

posted to the receivers' accounts on the settlement day. Therefore, the Board has adopted the proposal that originating institutions be charged on the settlement date as if they were open.

By order of the Board of Governors of the Federal Reserve System, December 22, 1987.

James McAfee,

Associate Secretary of the Board.

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