



FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

DALLAS, TEXAS 75222

March 7, 1989

Circular 89-13

TO: The Chief Executive Officer of all
member banks and others concerned in
the Eleventh Federal Reserve District

SUBJECT

Automated Clearinghouse Transactions

DETAILS

The Federal Reserve Board has requested public comment by March 31, 1989, on a series of revised proposals regarding the finality accorded automated clearinghouse (ACH) credit and debit transactions processed by Federal Reserve Banks.

Comment was previously requested on a series of proposals in December 1986 (Docket No. R-0515-C). Since a majority of commenters opposed those proposals, the proposals have been revised to include the following provisions:

- grant finality to receivers of ACH credit transactions at 6:30 p.m. local time on the settlement day;
- treat credits given to originators of ACH debit transactions as final payments at 10:00 a.m. local time on the business day following settlement day;
- in cases where payments must be reversed, endeavor to advise financial institutions with on-line connections to Fedwire of that fact by the time set for finality of ACH payments;
- reserve the right to debit the reserve/clearing accounts of financial institutions originating ACH credit transactions at any time during the settlement day; and
- grant credit for debit-item adjustments only when the Reserve Banks can recover credit from the originating financial institution.

For additional copies of any circular please contact the Public Affairs Department at (214) 651-6289. Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank (800) 442-7140 (intrastate) and (800) 527-9200 (interstate).

Comments should be addressed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. All correspondence should refer to Docket No. R-0661 and must be received by March 31, 1989.

ATTACHMENTS

The Board's request as published in the Federal Register is attached.

MORE INFORMATION

For further information regarding this circular, please contact Sharon Sweeney at (214) 651-6228. For additional copies of this circular, please contact the Public Affairs Department at (214) 651-6289.

Sincerely yours,

A handwritten signature in cursive script, reading "William H. Wallace". The signature is written in dark ink and is positioned to the right of the typed name "William H. Wallace".

FEDERAL RESERVE SYSTEM

[Docket No. R-0661]

Risk on Automated Clearing House Transactions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board of Governors of the Federal Reserve System ("Board") is proposing several changes in the way that Federal Reserve Banks treat automated clearing house ("ACH") transactions. These changes are intended as additional steps in implementing the risk reduction policy adopted by the Board in May, 1985. (See, policy statement, "Reducing Risks on Large-Dollar Electronic Funds Transfer Systems," 50 Fed. Reg. 21120.) The changes proposed include:

- granting finality to receivers of ACH credit transactions at 6:30 p.m. local time on the settlement day;
- treating credits given to originators of ACH debit transactions as final payments at 10:00 a.m. local time on the business date following the settlement day;
- advising depository institutions with on-line connections to Fedwire that payments are being reversed by the time set for finality of ACH payments;
- endeavoring to advise off-line institutions by telephone that payments are being reversed;
- reserving the right to debit the reserve/clearing accounts of depository institutions originating ACH credit transactions at any time during the settlement day; and

- ° granting credit for debit item adjustments only when the Reserve Banks can recover credit from the originating depository institution.

DATE: Comments must be received by March 31, 1989.

ADDRESS: Comments, which should refer to Docket No. R-0661, may be mailed to the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N. W., Washington, D. C. 20551, to the attention of Mr. William W. Wiles, Secretary, or delivered to room B-2223 between 8:45 a.m. and 5:15 p.m. Comments may be inspected in room B-1122 between 9:00 a.m. and 5:00 p.m., except as provided in section 261.8 of the Board's Rules Regarding Availability of Information, 12 C.F.R. § 261.8.

FOR FURTHER INFORMATION CONTACT: Florence Young, Adviser, Division of Federal Reserve Bank Operations (202/452-3955); Oliver I. Ireland, Associate General Counsel (202/452-3625), or Elaine M. Boutilier, Senior Attorney, Legal Division (202/452-2418), Board of Governors of the Federal Reserve System, Washington, D. C. 20551. For the hearing impaired only, Telecommunications Device for the Deaf ("TDD"), Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

Background

Two types of payments flow over the ACH mechanism -- credit transactions and debit transactions. In the case of ACH credit transactions, funds flow from the originator of the payment to the receiver. The majority of ACH credit payments

are payroll, pension, or annuity payments. In the case of ACH debit transactions, funds flow from the receiver to the originator. The majority of ACH debit transactions are used to collect insurance premiums, bill payments, and mortgage loan payments. In addition, ACH debit transactions are used for cash concentration purposes, that is, to draw down balances from the accounts of affiliates or subsidiaries located throughout the country, and they account for the largest proportion of the dollar value of ACH transactions.

The ACH is a value-dated mechanism. Transactions may be originated one or two days before the settlement date and may be processed on one of two operating cycles -- a day or a night cycle. All ACH transactions are provisional payments. The Reserve Banks currently reserve the right to reverse credits given to receivers of ACH credit transactions until the entries are posted on the settlement day, and credit given for debit transactions may currently be reversed by a Reserve Bank until the opening of business on the day following settlement. In addition, institutions receiving debit transactions have the right to return them.

Previous proposal and comments.

In December 1986, the Board requested comments on the following proposals (Docket No. R-0591):

- ° to provide finality to receivers of ACH credit transactions amounting to \$5,000 or less at 1:00 p.m. local time on the settlement date;
- ° to provide finality to receivers of ACH credit transactions amounting to more than \$5,000 when the Reserve Banks have received actually and finally collected funds;

- ° to notify receivers of ACH credit transactions if payments were reversed before the time of finality on a "best efforts" basis; and
- ° to retain the right to reverse ACH debit transactions at any time until the Reserve Bank has received actually and finally collected funds.

The Board received 112 comments on these proposals. The majority of commenters opposed the proposals. In the case of the proposals concerning ACH credit transactions, commenters stated that there was no good reason to distinguish between small and large-dollar credit transactions, that the dollar amounts proposed were arbitrary, and that finality should be granted at a specific time for all ACH credit transactions. Eighty-five percent of the commenters believed that small-dollar credit transactions should be treated as final at the opening of business on the settlement day. All commenters believed that a specific time should be set for the finality of large-dollar credit transactions, and more than 50 percent believed that all ACH credit transactions should be treated as final at the opening of business on the settlement day.

Commenters believed that delaying finality for ACH credit transactions amounting to \$5,000 or more and ACH debit transactions until the Reserve Banks had received actually and finally collected funds would add substantially to the risk of participating institutions and their customers. They indicated that the increased uncertainty resulting from adoption of this proposal would reduce the attractiveness of the ACH mechanism.

A majority of commenters argued that finality should be granted at a specific time and indicated that they would prefer that the same time be designated for both debit and credit transactions.

If the Reserve Banks were to grant finality for all ACH credit transactions at the opening of business on the settlement day, as many commenters on the 1986 proposal suggested, the credit exposure currently faced by receiving institutions would be eliminated. The Reserve Banks' risk, however, would be substantially increased because they would not be able to reverse any payments on the settlement day without regard to whether the originating institution had sufficient funds in its account to cover the payments.

The Board believes that no distinction should be made concerning the finality accorded large and small-dollar ACH credit transactions. While commenters would prefer that finality be granted at the opening of business on the settlement day, the Board believes that the risk faced by the Reserve Banks is too great to adopt this proposal. In order to balance the risk faced by the Reserve Banks with that faced by receiving institutions, the Board believes that finality for ACH credit transactions should be granted at 6:30 p.m. local time, a time late enough on the settlement day to permit the Reserve Banks to recover some funds, if it is determined that an originator is unable to cover the payments that it has originated.

With regard to the proposal to treat credits given for ACH debit transactions as final only after they had received actually and finally collected funds, the majority of commenters opposed this proposal. They indicated that a specific time should be adopted after which a Reserve Bank would not reverse credits given for ACH debit transactions.

The Reserve Banks' risk would not differ substantially under the terms of the current operating circular or the proposal published for comment in 1986. To provide greater certainty for depository institutions, the Board proposes to treat credits given to originators of ACH debit transactions as final at 10:00 a.m. local time on the business day following the settlement day.

Discussion

Three issues have been considered in the timing of finality for ACH credit transactions: (1) current practices and customs; (2) the credit exposure faced by the Federal Reserve and by depository institutions; and (3) the potential that changes in the treatment of finality for ACH transactions may result in shifts in the use of payment mechanisms.

Current Practices -- The Reserve Banks' ACH operating circular currently indicates that credit given to receivers of ACH credit transactions is available for use on the settlement day. At the same time, the Reserve Banks reserve the right not to settle for an item after notice of the suspension or closing

of the originator or the receiver is received.^{1/} In addition, the Reserve Banks may cease acting on or settling for a credit item if a Reserve Bank judges that there may not be sufficient funds in the originator's account on the settlement day to cover the item.^{2/} Based on these provisions, the Reserve Banks have the right to reverse credit transactions until all transactions affecting reserve or clearing accounts have been posted on the settlement day. Further, Reserve Banks are not obligated to notify depository institutions before transactions are reversed although notices would typically be provided the business day following the reversal of transactions.

Other rules and regulations -- Regulation CC, Regulation E, and NACHA rules -- also influence depository institutions' treatment of ACH credit transactions. The Board's Regulation CC requires depository institutions to make funds received via ACH credit transactions available for withdrawal no later than the opening of business on the business day following the settlement date, but does not preempt existing rules that may require earlier availability. (12 C.F.R. § 229.10(b)) The Board's Regulation E requires depository institutions to credit consumers' accounts as of the settlement day but does not specify a time of day, and it does

^{1/} Uniform ACH Operating Letter, paragraphs 24 and 25.

^{2/} Ibid., paragraph 31.

not require depository institutions to make funds available for use on the day they are credited. (12 C.F.R. § 205.10(a)(2) and Official Staff Commentary, Q10-13.) NACHA rules, which are incorporated in the Reserve Banks' Uniform ACH Operating Letter, are more stringent and require depository institutions to make funds available for both consumer and corporate payments on the settlement day.^{3/} Further, NACHA guidelines encourage depository institutions to make funds available to consumers at the opening of business on the settlement day.^{4/}

Current Practices -- Payroll, pension, and annuity payments are typically processed one or two days before the settlement date, and transaction data are generally provided to receiving institutions before the settlement date. The majority of depository institutions make these payments available to consumers at the opening of business on the settlement day. Larger dollar corporate-to-corporate payments are typically processed at night, with transaction data generally provided to receiving institutions at the opening of business on the settlement date. Funds availability practices vary; funds may be made available to customers on the settlement day, or not until the business day following the settlement day.

^{3/} Operating Rules of the National Automated Clearing House Association, pages OR 12.

^{4/} Operating Guidelines of the National Automated Clearing House Association, pages OG V-8.

Credit Exposure -- The credit exposure faced by depository institutions and the Federal Reserve varies inversely based on the finality accorded ACH credit transactions. That is, as Federal Reserve risk is reduced, depository institutions' risk tends to rise.

Under the Reserve Banks' current ACH operating circular, receiving depository institutions are generally exposed to some risk of loss on the settlement day as well as the business day following the settlement day. This risk is due to most institutions' practice of making funds available to their customers on the settlement day even though the Reserve Banks reserve the right to reverse transactions until the time all reserve and clearing accounts have been posted. If payments are reversed and customers do not reimburse their depository institution for the funds they have used, the institution would experience a loss. The Reserve Banks' risk is limited to situations in which it is not discovered that an originator is unable to fund its payments until the day following the settlement day.

While receiving institutions are exposed to the risk of financial loss, the Federal Reserve has taken steps to reduce this risk. The Reserve Banks have implemented procedures to monitor ACH credit transactions originated by "problem" institutions, that is institutions in weak financial positions. In addition, the Reserve Banks are implementing procedures that permit them to require problem depository

institutions to prefund or pledge collateral to cover the value of credit transactions originated at the time they are deposited for processing.

Furthermore, over 90 percent of all ACH credit transactions are payroll, pension, and annuity payments. The median value of these payments is less than \$600, and the depository institutions receiving such payments are generally a highly diverse group. As a result, the potential financial loss faced by institutions receiving small-dollar payments is not substantial.

Changes in the Use of Payment Transactions -- It does not appear that there has been a shift of funds transfers to the ACH. Nevertheless, the Board believes that granting finality for ACH credit transactions at the opening of business on the settlement day could lessen the distinction between the ACH and the funds transfer mechanisms and provide incentives for depository institutions to change their payment practices.

Proposed Finality Terms -- After review of the current practices, the credit exposure of depository institutions and Reserve Banks, and the potential for shifts in payments transactions, the Board has determined that Federal Reserve policies should provide receivers of ACH credit transactions more certainty regarding the time at which the Reserve Banks grant finality. Accomplishing this objective poses several problems for the Reserve Banks. First, supervisors of depository institutions typically close institutions late in the day. The Reserve Banks, therefore, generally would not be

able to begin notifying receiving institutions that an originator is being closed until late in the afternoon. Second, over 20,000 institutions use the ACH mechanism. While all of these institutions ordinarily would not be affected by the closing of one originating institution, a potentially large number of institutions may be affected and a considerable amount of time may be required to notify those institutions that transactions will be reversed.

In order to balance the risks faced by the Reserve Banks and receiving depository institutions, the Board proposes that ACH credit transactions be treated as final payments to the receiver at 6:30 p.m. local time for the receiver on the settlement day. The Reserve Banks will provide receiving institutions the name of the originating institution whose transactions will be reversed by means of a wire notice to institutions with on-line connections to Fedwire before 6:30 p.m. local time. If notice of reversal is not sent to an on-line receiving institution by 6:30 p.m. local time, then the items will be considered to be final. For those institutions that do not have on-line connections to Fedwire, the Reserve Bank will attempt to give notice by telephone by 6:30 p.m. local time. Due to the difficulty of making potentially numerous telephone calls to institutions that have already closed for business for the day, the Board does not believe that it should accept the losses that may accrue if notice can not be given by 6:30 p.m. Therefore, the firm 6:30 p.m.

finality only applies to on-line institutions. For other institutions, the Reserve Bank will attempt to give notice, but the transactions will not become final if such notice is not given by 6:30 p.m.

The Board requests comments on the proposed 6:30 p.m. finality. The Board also requests comment on whether this notice is useful to the receiving institution without the accompanying transaction data, and how late after 6:30 p.m. this notice may be given and still be useful to the receiving institution. Because timely notice can be best provided through computer connections, the Board requests comments on how the 6:30 p.m. time for notification of reversals should be handled if (1) a Reserve Bank's computer is down; or (2) a receiving institution's computer is down or shut off.

Granting finality at 6:30 p.m. local time exposes the Reserve Banks to some risk of loss. Specifically, losses may be incurred if an originator were closed unexpectedly and had not funded the ACH credit transactions it had originated before it was closed. In addition, losses could be incurred if institutions located in the mid-west and western parts of the country are closed late in the day. For example, if an institution located in California were closed at 5:00 p.m. Pacific Time, the Reserve Banks may be able to notify receiving institutions located in the Mountain and Pacific time zones that transactions originated by the institution would be reversed before 6:30 p.m. local time. Because the time set for finality in the Central and Eastern time zones would have

passed before the California institution was closed, the Reserve Banks would not be able to reverse transactions in those regions of the country and would absorb any losses incurred. The Board requests comments on whether it is appropriate for the Federal Reserve to accept such risk of loss and whether commenters believe that a private ACH processor would accept this type of risk.

It is proposed that, after giving a receiving institution notice of the closing of an originator, the Reserve Banks will make available to receiving depository institutions data on the individual transactions that are being reversed. This transaction data will be provided before the opening of business on the business day following the settlement day. In the case of institutions with electronic connections to the Reserve Banks or that pick up their ACH transactions at a Federal Reserve office, reversed transactions would be made available no later than the close of the night cycle. For institutions whose transactions are delivered via courier or mail, the data would be included with transactions delivered on the next delivery to the institution. In addition to comments on this proposal, the Board also requests that commenters give the latest time that a depository institution could receive reversal transactions and still update its accounts before opening for business on the day following the scheduled settlement date.

As an added protection against potential losses, the Board proposes that the Reserve Banks reserve the right to charge the accounts of originating institutions any time during

the settlement day for all ACH credit transactions settling on that day. The Reserve Banks would use this right in situations where there were concerns about an originator's ability to fund ACH credit transactions on the settlement day. This change would reduce the probability that the Reserve Banks would need to reverse transactions that had been delivered to receiving institutions. As a result, it would reduce the risk faced by receivers of ACH credit transactions.

ACH Debit Transactions -- The Reserve Banks' ACH operating circular currently indicates that credits given for ACH debit items will not be reversed after the opening of business on the business day following the settlement day. It also indicates that a Reserve Bank may refuse to permit the use of credit given for a debit item if it judges that there may not be sufficient funds in the originator's account to cover chargeback or return of the item.^{5/} This finality granted by the Reserve Banks does not change the receiver's right of return.^{6/}

Credit Exposure -- The risk faced by institutions originating ACH debit transactions is not affected substantially by the finality granted by the Federal Reserve. In most cases, some portion of debit transactions are returned by receiving institutions, and the return items may not be received by the originating institution until as many as five days following the settlement day. Most depository

^{5/} Uniform ACH Operating Letter, paragraph 23.

^{6/} Ibid, paragraph 33.

institutions have agreements with their customers to charge back such items. Alternatively, they place holds on funds collected through the ACH if they are concerned about the financial stability of their corporate customer.

Because institutions receiving ACH debit transactions are obligated to settle for them by the close of business on the settlement day, the Reserve Banks are able to determine whether debit items have been paid when all transactions have been posted to reserve or clearing accounts. As a result, a Reserve Bank would be able to determine whether payments needed to be reversed in the morning on the business day following the settlement day. To provide greater certainty for depository institutions, the Board proposes to treat credits given to originators of ACH debit transactions as final at 10:00 a.m. local time on the business day following the settlement day. If a receiver of debit transactions fails and the ACH transactions are to be reversed, the Board proposes to advise originators of ACH debit transactions of the name of the receiving institutions whose payments are being reversed by 10:00 a.m. on the business day following the settlement day. Transaction data on these reversals would be made available to institutions with electronic connections to the Reserve Banks or to those that pick up their transactions at a Federal Reserve office no later than the close of the day cycle on the business day following the original settlement date. Reversal transactions would be included on the next delivery to institutions served by couriers or the Postal Service.

Debit Item Adjustments -- The NACHA rules permit receiving institutions to return consumer debit transactions up to about 45 days after the settlement date, if a consumer provides notice that such debit entry was, in whole or in part, not authorized by the consumer.^{7/} Such returns are called debit item adjustments and the Reserve Banks process and settle for them. If the originator of the debit item has failed before the item is submitted for processing, the Reserve Banks currently would be obligated to credit the returning institution and would only have a claim against the failed bank or possibly the failed bank's customer. Processing debit item adjustments, therefore, exposes the Reserve Banks to some risk of loss.

This right of a consumer to obtain credit on the basis that an ACH debit transaction was not authorized differs from a customer's right to obtain credit in the case of a forged or altered check. In the case of a forged check, the payor (receiving) bank bears the risk. In the case of a forged indorsement or an altered check, the customer must prove the alteration or forgery, and the receiving bank must claim against prior banks on the basis of breach of warranty.

The Board does not believe it is reasonable for an intermediary, such as a Reserve Bank, without any knowledge of the transaction to assume the risk of loss. Rather, this risk should be borne by the parties involved. Therefore, the Board

^{7/} Operating Rules of the National Automated Clearing House Association, page OR 17.

proposes that the Reserve Banks grant credit for debit item adjustments only when they can recover credit from the originating depository institution.

Proposals -- Based on the preceding discussion, the Board of Governors requests public comment on the following proposals concerning the finality of ACH transactions:

- ° granting finality to receivers of ACH credit transactions at 6:30 p.m. local time on the settlement day;
- ° treating credits given to originators of ACH debit transactions as final payments at 10:00 a.m. local time on the business day following the settlement date;
- ° advising receiving depository institutions with on-line connections to Fedwire that payments are being reversed by the time set for finality of ACH payments;
- ° endeavoring to advise off-line institutions by telephone that payments are being reversed;
- ° reserving the right to debit the reserve/clearing accounts of institutions originating ACH credit transactions at any time during the settlement day; and
- ° granting credit for debit item adjustments only when the Reserve Banks can recover credit from the originating depository institution.

By order of the Board of Governors of the Federal Reserve System, February 23, 1989.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board