FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

April 22, 1991

DALLAS, TEXAS 75222

Notice 91-28

TO: The Chief Operating Officer of
each financial institution in the
Eleventh Federal Reserve District

SUBJECT

Request for Comments on Services the Federal Reserve Proposes to Offer in Relation to the Proposed Same-Day Settlement Service

DETAILS

The Federal Reserve Board is requesting comment on proposed new Federal Reserve Bank services and enhancements to certain current services related to checks not collected through the Federal Reserve. These proposed services may facilitate check collection and payor bank services provided under a same-day settlement rule, which the Board has also proposed recently.

Specifically, the Board requests comment on

- a proposed presentment point service;
- proposed Federal Reserve payor bank services that would include checks presented by private-sector presenting banks;
- enhancements to the Fedwire format to facilitate settlement for checks presented by private-sector presenting banks; and
- whether the Federal Reserve Banks should offer a new bilateral settlement service.

The Board is also providing its analysis of other Federal Reserve Bank services related to checks not collected through the Federal Reserve that were considered but are not being proposed.

Commenters are encouraged to submit their comments on this proposal separately from any comments they may make on the proposed amendments to Regulation CC to provide for same-day settlement for checks presented by private-sector banks.

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The Board must receive comments by June 28, 1991. Comments should be addressed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551. All comments should refer to Docket No. R-0727.

ATTACHMENT

A copy of the Board's notice as it appears on pages 10429-38, Vol. 56, No. 48, of the Federal Register dated March 12, 1991, is attached.

MORE INFORMATION

For more information, please contact Robert L. Whitman, (214) 698-4357, at the Dallas Office; Eloise Guinn, (915) 521-8201, at the El Paso Branch; Luke E. Richards, (713) 652-1544, at the Houston Branch; or Herb Barbee, (512) 978-1402, at the San Antonio Branch. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 651-6289.

Sincerely yours,

Robert D. McTeer, Jr.

FEDERAL RESERVE SYSTEM

[Docket No. R-0727]

Proposed Federal Reserve Bank Services

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment.

SUMMARY: The Board is publishing for comment proposed enhancements to certain Federal Reserve services and proposed new services related to checks not collected through the Federal Reserve. The proposed services are designed to enable paying banks to continue to provide timely cash management information to their corporate customers and to facilitate a paying bank's responsibility to settle for checks presented by private-sector presenting banks. Specifically, the Board requests comment on (1) A proposed presentment point service; (2) proposed Federal Reserve Bank payor bank services that would include checks presented by private-sector presenting banks; (3) enhancements to the Fedwire format to facilitate settlement for checks presented by private-sector presenting banks; and (4) whether the Federal Reserve Banks should offer a new bilateral settlement service. The Board is also providing its analysis of other Federal Reserve Bank services related to checks not collected through the Federal Reserve that were considered but are not being proposed.

DATES: Comments must be submitted on or before June 28, 1991.

ADDRESSES: Comments, which should refer to Docket No. R-0727 may be mailed to the Board of Governors of the Federal Reserve System, 20th and C Street NW., Washington, DC 20551, Attention: Mr. William W. Wiles, Secretary; or may be delivered to room B-C-223 between 8:45 a.m. and 5:15 p.m. Commenters are encouraged to submit their comments on this proposal separately from any comments they may provide on the proposed amendments to Regulation CC to provide for same-day settlement for checks presented by private-sector banks (Docket R-0723). All comments received at the above address will be included in the public comments file, and may be inspected at room B-1122 between 9 a.m. and 5 p.m.

FOR FURTHER INFORMATION CONTACT: Louise L. Roseman, Assistant Director (202/452-3874), Julius F. Oreska, Manager (202/452-3878), Thomas C. Luck, Senior Financial Services Analyst (202/452-3935), or Nalini T. Rogers, Senior Financial Services Analyst (202/452-3801), Division of Reserve Bank Operations and Payment Systems. For the Hearing impaired only: Telecommunication Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

A. Background

The Board has issued for public comment proposed amendments to Regulation CC to provide for same-day settlement by paying banks [1] for checks presented by private-sector presenting banks. (56 FR 4743, February 6, 1991). Under the same-day settlement proposal, a paying bank would be required to settle for checks presented by private-sector presenting banks on the day of presentment, if specified conditions are met. These conditions include an 8 a.m. (local time of the paying bank) presentment deadline for same-day settlement, and that the check be presented at a location of the paying bank designated by the paying bank that is consistent with the check processing region associated with the routing number encoded on the check. Under the proposal, if a bank presents a check in accordance with the time and location requirements for same-day settlement, the paying bank either must settle for the check on the business day it receives the check without charging a presentment fee or must return the check prior to the time for settlement.

[1] Regulation CC defines *bank* to include all depository institutions, including commercial banks, savings institutions, and credit unions. A *paying bank* is a bank, by, at, or through which a check is payable and to which it is sent for payment or collection. The Uniform Commercial Code defines *collecting bank* as a bank, other than the paying bank, that handles a check for collection. A *presenting bank* is a bank, other than the paying bank, that presents a check

[1] Doyle Brewer's 01-10-91 pleading was mistakenly omitted from the listing of petitions for MM Docket No. 88-140 on the "Petitions for Reconsideration" public notice, Report No. 1837-Corrected, released on February 20, 1991. Therefore, the dates for filing oppositions and replies to those petitions are extended to correspond to the due dates for responding to the petitions on this notice.

The settlement must be in the form of a credit to the presenting bank's account (or the account of a correspondent settlement agent) at a Federal Reserve Bank. Because these rules would be subject to Regulation CC's variation by agreement provision, a paying bank could agree with a presenting bank to accept checks for same-day settlement if the checks are presented by a presentment deadline other than 8 a.m. or at an alternate location (such as an intercept processor). Similarly, a presenting bank may accept settlement in another form agreeable to it.

The Federal Reserve Banks currently provide a variety of services to banks, including check collection and net settlement services. The Federal Reserve assesses fees for its services to the banks using those services. In light of the same-day settlement proposal, the Board is proposing that the Federal Reserve Banks offer enhanced services and certain new services related to checks not collected through the Federal Reserve. These services, which are described in section B, include a presentment point service, new payor bank services to facilitate the paying bank's continued ability to provide timely cash management information to its corporate customers, and enhancements to the Fedwire service to facilitate settlement for checks presented by private-sector presenting banks.

The Board is considering whether the Federal Reserve Banks should offer a new settlement service for banks to settle for checks presented by private-section presenting banks through accounts maintained at the Federal Reserve Banks. Section C describes such a bilateral settlement service. The Board has also considered, and has determined not to propose, whether Federal Reserve Banks should provide transportation and adjustment services related to checks not collected through the Federal Reserve. The Board's analysis is included in section D.

Section E contains an analysis of the competitive impact of the proposed services and of the bilateral settlement service.

B. Proposed New Federal Reserve Services

Presentment Point Service

The Board proposes that the Federal Reserve Banks offer a new service under which a paying bank could designate its local Federal Reserve office as a presentment point for checks presented to the paying bank by a private-sector presenting bank. This new service would allow a private-sector presenting bank, with the agreement of the paying bank, to deliver checks to the paying bank's local Federal Reserve office, for subsequent pick-up by the paying bank. Under this proposed service, presentment of checks would occur at the time the checks are delivered to the Federal Reserve office. Because many banks currently maintain arrangements to transport checks to and from their local Federal Reserve office, and some banks deliver checks directly to multiple Federal Reserve offices, this service may prove convenient and economical for both presenting banks and paying banks.

Under the proposed service, paying banks could agree with presenting banks to designate the paying bank's local Federal Reserve office as an alternate presentment location. The Federal Reserve office would also require agreements with paying banks that are designating the Federal Reserve office as an alternative presentment location and with presenting banks that have agreed with paying banks to present checks at the Federal Reserve office. The paying bank would be required to provide the Federal Reserve office advance notice before presenting banks begin to present checks to the paying bank at the Federal Reserve office, and to provide advance notice to the Federal Reserve of a termination of the agreement. The Federal Reserve would assume no responsibility to determine whether a paying bank using the presentment point service has an agreement with any specific presenting bank to present checks at the Federal Reserve, nor would the Federal Reserve assume any responsibility to determine whether the presenting bank has met the presentment deadline that had been agreed to by the paying bank and the presenting bank. A presenting bank may not have made presentment by delivering checks to a Federal Reserve office as presentment point for a paying bank if the necessary agreements between the presenting bank and the paying bank and between those banks and the Federal Reserve office have not been made.

Under the proposed service, the Federal Reserve office would accept cash letters from presenting banks, time-stamp the incoming deliveries, provide verification of receipt to the delivery agent, physically control the cash letters, and provide copies of the verification of the time of receipt upon pick-up by the paying bank or its designated agent. The service would not include settlement for the checks. Presenting banks would be required to package and label separately all cash letters presented at the Federal Reserve office so as to distinguish them from other checks being deposited for collection through the Federal Reserve. The Federal Reserve office would incur no liability or accountability for the checks other than that associated with its duty to exercise ordinary care while the checks are in the possession of the Federal Reserve office. The Federal Reserve office would not provide transportation of the checks to the paying bank under this service.

The Federal Reserve's fees for this service would reflect the costs to receive and time-stamp the cash letters presented by designated presenting banks, the costs to physically control the checks at the Federal Reserve office until pick-up by the paying bank, and other administrative costs associated with providing this service. The Board proposes that a daily fixed fee, which may vary by Reserve Bank office and is estimated to be in the range of $15 to $25, be charged to the paying bank for the presentment point service. The paying bank would be assessed the fee because it is the bank for which the Federal Reserve office provides the service. The Board is proposing a fixed fee because, within a foreseeable range of activity, it is expected that the costs of providing the service would be predominately fixed rather than variable in nature. If the comments received indicate, or if subsequent experience demonstrates, that the number of presentments varies substantially among paying banks that use this service, the Board may adjust the proposed fee structure to base the fee, in whole or in part, on the number of cash letters handled by the Federal Reserve office for a paying bank.

The Board requests comment on the proposed presentment point service. Specifically, the Board requests commenters to indicate whether a paying bank would find it beneficial to have its local Federal Reserve office act as an alternate presentment site for checks presented by private-sector presenting banks and whether presenting banks would generally agree to deliver such checks to a Federal Reserve office rather than directly to the paying bank. In addition, the Board requests comment on whether a portion of the costs of providing the presentment point service should be recovered through a fee assessed to the presenting bank because this service offers the presenting bank the convenience of a central presentment location.

Supplemental Payor Bank Services

Same-day settlement for checks presented by 8 a.m., as provided under

the proposal, may narrow the processing window for some paying banks' corporate cash management operations. Currently, banks provide certain corporate customers with information regarding the amount of the corporation's check payments that have been presented early enough each day for the corporation to invest surplus balances or borrow additional funds, as necessary, while money markets are still active. The same-day settlement proposal may adversely affect paying banks that currently rely on Federal Reserve payor bank services to provide corporate cash management products because checks presented directly by private-sector presenting banks would not be included in the daily transmission of Federal Reserve payor bank service data.

The Federal Reserve Banks currently offer payor bank services with respect to checks they collect as an option to paying banks. These services, which include account totals, MICR capture, special sort, extended MICR capture, and truncation [2], are offered (1) To accelerate availability, in the case of truncation and extended-MICR capture services, (2) to assist paying banks in assembling payment data to facilitate the provision of corporate cash management services, and (3) to reduce the paying bank's operating costs.

The Board proposes that the Federal Reserve Banks offer supplemental payor bank services under which a paying bank could designate its local Federal Reserve office as a presentment point for checks not collected through the Federal Reserve, or deliver such checks to the Federal Reserve office, which would provide payor bank services with respect to those checks. The Federal Reserve would not be acting as a collecting bank with respect to such checks.

Under the proposed service, a paying bank that wishes to receive payor bank services with respect to checks not collected through the Federal Reserve generally would agree with the presenting bank to designate the paying bank's local Federal Reserve office as its presentment point. The agreement would specify the time by which the presenting bank would be required to present the checks to the Federal Reserve office based on established Federal Reserve deadlines for this service, and that the Federal Reserve would effect settlement for the checks. Delivery of the checks to the Federal Reserve office in accordance with this proposed service would constitute presentment of the checks at the time of delivery.

The paying bank and presenting bank would also agree with the paying bank's Federal Reserve Bank that the Federal Reserve office would accept presentment of checks from designated presenting banks on behalf of the paying bank and provide the payor bank services requested by the paying bank. The paying bank would indemnify the Federal Reserve for any losses incurred in connection with the provision of this service due to the characterization of the Federal Reserve as a collecting bank, notwithstanding the Federal Reserve's disclaimer of that status with respect to providing this service.

The paying bank does not have to designate the Federal Reserve office as a presentment point in order for the paying bank to obtain supplemental payor bank services on checks presented directly to a location of the paying bank. However, checks for which the paying bank desires to obtain supplemental payor bank services would have to be delivered to the Federal Reserve office by the applicable deadline.

The Board anticipates that Federal Reserve offices may offer the service in two forms—regular and premium. Under the regular service, the presenting bank or the paying bank would deliver the checks to the Federal Reserve office, generally by the latest nonpremium deadline established by the Federal Reserve office for the deposit of checks drawn on the paying bank. Presenting banks would be required to package and label separately all cash letters presented at the Federal Reserve office so as to distinguish them from checks being deposited for collection through the Federal Reserve. The Federal Reserve office would intermingle checks received under the regular service with checks being collected through the Federal Reserve that are designated for payor bank services. The checks would be processed and reconciled by the Federal Reserve office. The Federal Reserve office would credit the presenting bank and function adjustments to the presenting bank for exception conditions found during the reconcilement process. Delivery of payor bank service data to the paying bank for the checks collected through the Federal Reserve as well as the checks presented to the paying bank by private-sector presenting banks would be made simultaneously. The paying bank could function adjustments for all of the checks received in such cash letters through the Federal Reserve. If delivery of checks to the paying bank were delayed beyond the 2 p.m. Federal Reserve Bank presentment deadline, the paying bank would still be required to settle for those checks that the Federal Reserve office had handled for supplemental payor bank services because the paying bank would be obligated to settle with the presenting bank for the checks if the presenting bank presents the checks at the Federal Reserve office by the agreed upon time.

Under a premium service, at the option of the paying bank, Federal Reserve offices would accept checks from presenting banks or paying banks at a later presentment deadline. Under this service, the later receipt of the checks would not allow intermingling of the checks with those being collected through the Federal Reserve and separate processing flows at the Federal Reserve office would be required to capture the information necessary to provide payor bank services. In addition, the processing of these checks would not be completed in time to be included in the regular outgoing shipments of checks to the paying bank. Accordingly, under the premium service, the Federal Reserve would assess higher fees and the paying bank would be responsible for arranging transportation to pick-up the checks from the Federal Reserve office after processing (unless safekeeping or delayed delivery services, which are described below, are provided by the Federal Reserve office).

As they do for checks collected through the Federal Reserve, paying banks would authorize the Federal Reserve office to charge their reserve or clearing accounts for the checks presented at the Federal Reserve under the terms of this service. Credit to presenting banks would be functioned by the Federal Reserve in a manner similar to that used today for fine sort and direct send cash letters. Where the

[2] The *account totals* service provides paying banks with the dollar total and the number of checks being presented for specific individual accounts, or for a grouping of accounts. The *MICR capture* service provides paying banks, via tape or transmission, the MICR-line data from checks being presented to the paying banks. The *special sort* service provides paying banks with a specified subset of its checks, outsorted and presented separately from the remainder of its checks. The *extended MICR capture* service provides paying banks with MICR-line data from checks presented to the paying banks. Presentment occurs when the data are delivered electronically to the paying bank. The physical checks are retained at the Federal Reserve office to provide return services and are subsequently delivered to the paying bank, usually arriving at the paying bank within four or five days following presentment. The *truncation* service rovides paying banks with MICR-line data from checks presented to paying banks. Presentment occurs when the data are delivered electronically to the paying bank. The physical checks are not delivered to the paying bank, and return and retrieval services are provided.

presenting bank presents checks subject to the supplemental payor bank services at the Federal Reserve office, special cash letter forms and recap sheets, or automated input, would be used by the presenting bank to communicate the expected amount of credit to its local Federal Reserve office. Where the checks subject to supplemental payor bank services are delivered to the Federal Reserve office by the paying bank, that Federal Reserve office would provide the appropriate credit information to the presenting bank's Federal Reserve office to effect timely credit to the presenting bank.

The supplemental payor bank services products would include account total, MICR capture, and special sort services, as well as "delayed delivery" and "safekeeping" services, which would mirror the current extended MICR capture and truncation services, respectively, in all aspects except the timing of presentment. (Presentment under the delayed delivery and safekeeping supplemental payor bank service products would occur when the checks are physically delivered to the Federal Reserve. In contrast, under the extended MICR capture and truncation products, which are offered only with respect to checks collected through the Federal Reserve, presentment is based upon the electronic data transmission to the paying bank.) The timing of implementation of supplemental payor bank services at individual Federal Reserve offices would vary based on demand for the services by local paying banks and current resources in each office.

The proposed price structure for the supplemental payor bank services product would differ from the price structure for payor bank services for checks collected through the Federal Reserve. In addition to the capture and delivery of payor bank data to the paying bank, the supplemental payor bank services would encompass four basic services, i.e., presentment point service (if the checks are delivered to the Federal Reserve office by the presenting bank), settlement service, adjustment service, and transportation service. Both the presenting bank and the paying bank benefit from the supplemental payor bank services. For example, settlement and adjustment services benefit the presenting bank as well as the paying bank. The presenting bank also receives the benefit of a common presentment location. The Board proposes that a portion of the cost of providing supplemental payor bank services generally would be recovered through a fee to the presenting bank, with the majority of the fee for providing the service assessed to the paying bank. The paying bank would be assessed the entire fee for the service if the presenting bank presents the checks directly to the paying bank and the paying bank delivers the checks to the Federal Reserve Bank.

The Federal Reserve's fees would generally be higher for payor bank services under the supplemental payor bank services product than for payor bank services provided with respect to checks collected through the Federal Reserve. The Board estimates that the total fees to the paying bank and the presenting bank for the regular supplemental payor bank services product would be approximately the same as the sum of the fees for providing payor bank services on fine-sort checks collected by the Federal Reserve, plus the fine sort collection fee (which would recover the settlement, transportation and adjustments costs). Under the premium service, because processing the checks in separate payor bank service runs during peak processing hours would be necessary, the costs of providing premium payor bank information would be higher than the regular supplemental payor bank services.

The Board believes supplemental payor bank services would provide paying banks with consolidated and timely delivery of data from checks collected through the Federal Reserve and from checks presented by private-sector presenting banks. The Board anticipates that private-sector presenting banks, in most instances, would agree to deliver checks directly to the Federal Reserve because Federal Reserve offices offer a convenient central location for delivery.

The Board requests comment on the proposed supplemental payor bank services, which would allow the Federal Reserve Banks to provide payor bank services on cash letters presented by private-sector presenting banks. Specifically, the Board requests comment on whether paying banks perceive a need for Federal Reserve payor bank services on checks presented by private-sector presenting banks. In addition, the Board requests comment on the following questions:

1. Do paying banks perceive a benefit in the ability to obtain supplemental payor bank services from the Federal Reserve? In which particular payor bank services, i.e., account totals, delayed delivery, MICR capture, safekeeping, or special sorts, would paying banks be interested?

2. Would presenting banks wish to present checks at the paying bank's Federal Reserve office, even if they had to agree with the paying bank to present the checks earlier than 8 a.m. in order to retain the right to obtain same-day settlement on these checks?

3. Should the entire fee for the supplemental payor bank services be charged to the paying bank, rather than assessing a portion of the fee to the presenting bank?

4. Is there an interest among alternate service providers, including private-sector presenting banks, in offering payor bank services for checks collected outside the Federal Reserve?

Criteria for Evaluating Proposed Changes

All new services or major service enhancements proposed by the Federal Reserve must meet the criteria described in the March 1990 policy statement "The Federal Reserve in the Payments System." These criteria are full cost recovery, clear public benefit, and that the service be one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity.

With respect to the criterion requiring full cost recovery, the presentment point service and supplemental payor bank services products would be priced to achieve full recovery of costs over the long run. The second criterion requires that the service yield a clear public benefit. The Board believes that the presentment point service may provide benefits to both presenting banks and paying banks. This proposed service may allow presenting banks to present checks to many paying banks at a central location to which they have existing transportation. The presentment point service may also provide paying banks that do not process their checks at a location of their bank with an alternate convenient presentment location that likely would be acceptable to presenting banks. This service may decrease the transportation resources that would otherwise be necessary for presenting banks to transport checks to paying banks and for paying banks to transport checks to their processing location.

For the supplemental payor bank services, the public benefits include support for effective account management by corporate cash managers. Facilitating cash management through payor bank services on checks presented by private-sector presenting banks allows for more efficient use of corporate funds. In addition, the supplemental payor bank services

would enable paying banks to receive payor bank service transmissions from one source, which may facilitate their internal corporate cash management operations.

The Board also believes that the supplemental payor bank services may meet the criterion that the service be one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity. Similar services are not widely offered by the private sector today, given the apparently limited demand by paying banks. Demand is low because some paying banks currently impose barriers to presentment by private-sector presenting banks if such presentments would impede their ability to provide cash management services or otherwise adversely affect their operations. The Board believes that private-sector service providers may be reluctant to offer similar services immediately if a same-day settlement rule were adopted, should significant capital investment be necessary. Without immediate and widespread response from the private sector, a level of service that would allow the product to be available with reasonable effectiveness, scope, and equity may not be available without Federal Reserve participation. The Board requests comment on whether the proposed presentment point service and the proposed supplemental payor bank services meet the criterion that private sector providers alone cannot be expected to provide such services with reasonable effectiveness, scope and equity.

Enhancements to the Fedwire Format To Facilitate Settlement

Under the same-day settlement proposal, the paying bank must settle with the presenting bank for checks presented in accordance with the regulation by credit to an account of the presenting bank at a Federal Reserve Bank or by any other form of settlement to which the presenting bank agrees. For example, settlement for checks could be made by the paying bank transferring funds to the presenting bank through the Fedwire funds transfer service, or by the paying bank and the presenting bank agreeing to settle through accounts maintained at one or both of the banks, or through accounts maintained at a correspondent bank(s). Generally, a fee of $0.50 is assessed to both the originating bank and the receiving bank for a funds transfer through the Fedwire service.

The Board requests comment on whether the existing Fedwire format could be utilized so that banks could identify, on an automated basis, those funds transfers related to settlement for check presentments and associated adjustment activity. Those transfers could then be segregated by the receiving bank for internal processing. The designation of certain Fedwire funds transfers as check settlement or adjustment transfers could be accomplished by establishing a new product code that could be used to differentiate these transfers from other funds transfers.

The details of the check settlement transaction could be conveyed using one of the existing Fedwire structured format fields. For example, the 155 character "bank-to-bank information" field could be designated as the field in which detailed information related to the check settlement transfer would be provided. The paying bank could use the designated field to explain any differences between the transfer amount and the cash letter total. For example, a paying bank could include in the designated field the original cash letter total and the net of all adjustments applied that day to facilitate the presenting bank's reconciliation of the transfer amount. The paying bank could provide reference numbers to identify adjustment activity, so that the presenting bank could associate the payment with supporting documentation sent separately. The paying bank could also use this field to detail individual cash letter totals, if the transfer amount represents settlement for multiple cash letters.

The Fedwire service currently provides a "request for credit transfer" (subtype code 31), which is a nonvalue message that requests the receiver to originate a value transfer to the designated party. This message type may be useful to a presenting bank in notifying a paying bank of the amount of settlement due to the presenting bank. For example, if the checks are presented to a service bureau for processing, the presenting bank may wish to use a request for credit transfer message to notify the paying bank of the amount of the cash letter (although the paying bank has the responsibility to determine the amount of its settlement obligation from its designated agent).

The Board requests comment on whether enhancements to the Fedwire message format would facilitate the use of Fedwire to settle for checks presented by private-sector presenting banks and for associated adjusting entries. The Board also requests the commenters' views on which particular structured third-party field should be designated to convey the detailed information related to the transfer amount. Comments are also requested on other changes to the Fedwire service that would be desirable to facilitate the settlement for checks presented by private-sector presenting banks.

C. Possible New Federal Reserve Service

Bilateral Settlement Service

Some banks have indicated that a bilateral settlement service for making settlement through Federal Reserve accounts for checks presented by private-sector presenting banks would facilitate efficient settlement in a same-day settlement environment. The Board is considering whether the Federal Reserve Banks should offer a new bilateral settlement service for the settlement of checks not collected through the Federal Reserve. The Board is uncertain whether a Federal Reserve bilateral settlement service would be attractive to banks, because alternative settlement vehicles, such as Fedwire, may adequately meet banks' needs. Based on its preliminary analysis of the attributes of a bilateral settlement service, the Board believes that paying banks may find that settlement through Fedwire would provide more control of the timing of payments, and that presenting banks may find such a bilateral settlement service to be cumbersome and costly compared to alternatives that are available. In addition, banks may determine that the risks associated with participating in a bilateral settlement service are unacceptable. The Board, however, is providing the following description of how a Federal Reserve bilateral settlement service might be designed in order to determine whether banks have sufficient interest in its use to warrant development of a new service and to obtain the commenters' views regarding the risks associated with this potential service.

If a Federal Reserve bilateral settlement service were implemented, the paying bank and the presenting bank could authorize the Federal Reserve to settle for checks presented by the presenting bank and for subsequent adjustments by the presenting bank and the paying bank through accounts maintained at the Federal Reserve. Settlement could be made through the accounts of the presenting bank and the paying bank or through the accounts of their correspondent settlement agents. The Board believes that the bilateral settlement service, if adopted, should be an all-electronic service, in which both the presenting bank and paying bank send and receive settlement payments

through an electronic connection to the Federal Reserve. An all-electronic service would provide greater efficiency and control, and would minimize the time needed for communication of data, thus providing more time for participants to review settlement data.

The Board proposes, if it adopts a bilateral settlement service, that there would be two settlement cycles as follows:

	Deadlines (ET)	
	a.m.	p.m.
Input to the Federal Reserve	9:00	2:00
Advise of pending charges	9:30	2:30
Reversals	10:30	3:30
Post entries, or advise of reversal	11:00	4:00

Both settlements and adjustments to prior settlements could be made through the bilateral settlement service.[3] Presenting banks could obtain settlement for checks presented, and presenting banks and paying banks could obtain settlement for adjustments, either at 11 a.m. Eastern Time (ET), or at 4 p.m. ET. The second settlement cycle would allow sufficient time for data to be submitted for checks presented to west coast banks and to accommodate presentments made by agreement after the proposed 8:00 a.m. local time presentment deadline.

The presenting bank initiating the settlement entry or the bank initiating an adjustment entry would transmit payment information to the Federal Reserve by the applicable input deadline.[4] The data would be edited and, where necessary, would be transmitted to the Federal Reserve office serving the receiving bank. The Federal Reserve would make information available to the presenting bank and paying bank pertaining to pending settlement and adjustment entries 30 minutes after the input deadline. A bank may reverse a pending charge to its account if, for example, the checks represented by a settlement entry had not been presented by the specified deadline. The paying bank could also reverse a portion of a pending settlement charge to adjust for a large-dollar error, such as an encoding error or a missing bundle, found in the cash letters being settled. Reversals would have to be made within one hour following the time the banks are advised of the pending charges.

Data concerning reversals would be made available to affected banks at the scheduled posting time, which would be 30 minutes following the reversal deadline. At the scheduled posting time, the banks' accounts at the Federal Reserve would be credited and debited, as applicable, and the entries would be reflected in the account balance monitoring system. Payments would be final at the end of the day.[5] If the bank subject to the charge either reversed the pending charge or the Federal Reserve decided not to post the transaction, the presenting bank and the paying bank would be notified at the scheduled posting time that the transaction had not been posted. A daily summary of settlement charges and credits would be provided to the banks participating in the settlement service.

The bilateral settlement service would not be used to function "as-of" [6] adjustments to correct bank errors resulting from the settlement process. The Board believes that it would be a time-consuming and costly administrative effort for the Federal Reserve to verify that both parties approved the "as-of" adjustment, that the "as-of" adjustment was being made for valid reasons, and that it was being made to the appropriate reserve periods. The Federal Reserve would function "as-of" adjustments to compensate for its errors in functioning settlement service transactions.

The Board requests comment on the number of daily cycles that should be provided in a bilateral settlement service and the optimal time(s) of the cycle(s). Under the proposed same-day settlement amendments to Regulation CC, the paying bank is not obligated to settle for checks until the close of Fedwire. The Board requests comment on whether one cycle late in the day would adequately address the needs of paying banks and presenting banks. The Board also requests comment on whether modifications to the timing and number of settlement cycles should be made if the Board adopts a same-day settlement rule with a requirement that the paying bank settle for checks earlier on the day of presentment. The Board recently proposed amendments to Regulation J (12 CFR part 210) that would require a paying bank to settle for checks presented by a Reserve Bank by a specified time during the day of presentment, shortly after presentment. (56 FR 3047, January 28, 1991) The Board also requested comment, in its recent proposal to amend Regulation CC to provide for same-day settlement, on whether the time by which a paying bank must settle for checks under the same-day settlement rule should conform to the time by which a paying bank must settle for checks with its Federal Reserve Bank under any future Regulation J amendment. Such a regulatory change would not mandate a change to the settlement service, because the settlement service would be used only by the agreement of the presenting bank and paying bank; by agreeing to use the settlement service, the participating banks would be agreeing to accept settlements by a time(s) provided under that service.

All fees for the bilateral settlement service would be paid by the presenting bank. The fee structure would have both a fixed and variable component. A fixed fee would be assessed for each transmission by the presenting bank, except for transmissions consisting solely of adjustment entries or of a reversal of a pending charge. The fixed fee would cover the fixed costs associated with processing the data in the transmission, the amortized software development and maintenance costs, and the costs of handling transmissions of adjustment entries by a paying bank. A per transaction fee would be assessed to cover the costs of functioning each settlement or adjustment entry or of reversing a pending charge. The presenting bank, rather than the paying bank, would pay the per transaction fee for adjustment entries initiated by the paying bank.

The Board estimates that the per transmission fee would be in the range of $5.00 to $10.00, and that the per transaction fee would be approximately $1.00. The relatively high fees projected for the bilateral settlement service, compared to the fees for other Federal Reserve electronic payments services, reflects the anticipated small number of presenting banks from which such costs would be recovered.

[3] The Federal Reserve would not handle the accompanying adjustment documentation. (See discussion in Section D.)

[4] The data elements for entries would consist of the presenting bank's routing number, the paying bank's routing number, the dollar amount of the entry, a transaction code identifying the transaction as a settlement transaction or an adjustment transaction, and optionally, in the case of settlement transactions, the dollar amount of the cash letter, the net amount of any adjustments to prior settlements, and a reference number assigned by the presenting bank. Banks may choose to summarize the settlement for adjustments in one entry to minimize fees, or may choose to make separate entries for each adjustment to provide control.

[5] Finality of settlement does not affect the paying bank's right to return a check or to process a subsequent adjustment to the settlement amount.

[6] "As-of" adjustments are memorandum items that are applied to the cumulative deposit position of a bank to correct the impact of an error. The cumulative deposit position is the base from which required reserves, are calculated. These adjustments affect the amount of a bank's required reserve or clearing balance, but do not directly affect the balance in the account.

Firm cost projections cannot be made at this time because the final system design would be contingent upon an assessment of the public comments received. The estimated fees reflect those that would be assessed if the bilateral settlement service were implemented as described above with relatively few users of the service. The actual per transmission fee could be less if there were a substantial number of users, or could be significantly higher if the number of users is very low. If a high volume of settlement transactions and service users evolves, a fee structure consisting solely of per transaction fees, similar to the Fedwire service, could become feasible. The Board requests comment on the price structure of the proposed bilateral settlement service.

The Board is concerned that a bank participating in the bilateral settlement service described above may incur significant risk due to the ability of another bank to instruct the Federal Reserve to charge its account. While the bank subject to the charge would have some opportunity (i.e., one hour) to instruct the Federal Reserve to reverse the pending charge, this time may not be adequate in all cases. If the bank did not reverse the pending debit to its account, it generally would be able to function an adjustment in a subsequent settlement cycle to recoup the improper charge to its account. Despite this capability, the bank might incur a loss, (1) if the bank receiving the debit adjustment reversed the pending charge, or (2) if the Federal Reserve were unable to post the adjustment due to the failure of the bank receiving the debit adjustment, or because the bank receiving the debit adjustment did not have sufficient funds in its account. The Board requests comment on the risks associated with the bilateral settlement service and whether these risks can be minimized by modifying the design of the proposed service.

In addition to the issues raised above, the Board requests commenters to consider and address the following issues with respect to the bilateral settlement service:

1. Do existing settlement options adequately meet the settlement needs of presenting banks and paying banks? If not, would a bilateral settlement service as described above adequately meet these settlement requirements?

2. Would paying banks and presenting banks use the bilateral settlement service?

3. To what extent would the decision to use, or not use, the bilateral settlement service be based on the fees assessed for the service?

4. Would the service be used for settling adjustment differences? If the bilateral settlement service were used to settle adjustments, how would the participants exchange documentation related to the adjustments?

5. Would additional data elements, other than those described above, be necessary to meet the informational requirements of paying banks and presenting banks?

6. Should a portion of the fees for the bilateral settlement service be assessed to the paying bank, rather than assessing all fees on the presenting bank. If so, how should the fees be allocated between paying banks and presenting banks?

7. How could the bilateral settlement service be modified to make it more attractive to presenting banks and paying banks?

Criteria for evaluating proposed changes.

The bilateral settlement service, if adopted, would be priced to achieve full cost recovery over the long run. The bilateral settlement service generally would yield a number of the same public benefits as settlement via Fedwire. The bilateral settlement service would provide an alternative means of settlement that may encourage direct presentment of checks where such presentments are more efficient than collection through intermediaries. The bilateral settlement service also could yield a public benefit by providing an additional mechanism through which banks could settle for checks through accounts maintained at the Federal Reserve Banks. The use of Federal Reserve accounts for settlement minimizes the correspondent balances banks would otherwise have to maintain in order to settle payment transactions. However, as described above, the bilateral settlement service may impose additional risk on the participants in the service.

The Board believes that the bilateral settlement service meets the criterion that the service be one that other providers alone cannot be expected to provide with reasonable effectiveness, scope and equity. The Federal Reserve currently provides net settlement services for numerous check clearinghouses, and the Fedwire system is an effective vehicle that can be used for settlement of payment transactions between banks. The proposed bilateral settlement service is an alternative to the Fedwire service for banks wishing to use balances maintained at the Federal Reserve Banks to settle for checks not collected through the Federal Reserve. Other service providers currently provide, and are expected to continue to provide, settlement services to banks. However, a large number of banks are unlikely to establish and maintain new accounts at a central depository, in addition to those accounts already maintained at the Federal Reserve, in order to provide the basis for a major new private-sector alternative settlement system.

D. Other Potential Services Evaluated But Not Proposed

The Board evaluated several services that certain banks requested that the Federal Reserve provide in a same-day settlement environment, which it has determined not to propose to adopt.

Conjunctive Business on Federal Reserve Intradistrict (Local) Transportation Networks.

The Board evaluated whether the Federal Reserve Banks should be required to permit couriers hired by the Federal Reserve to seek conjunctive business on all intradistrict transportation routes. Conjunctive business means that the courier could carry goods for other customers on routes on which they transport checks for the Federal Reserve. Currently, Federal Reserve offices allow conjunctive business on nearly 90 percent of the local courier routes that deliver checks to banks in the region served by the Federal Reserve office. On those routes where conjunctive business is not allowed, the Federal Reserve offices have exclusive-use contracts because of the time-critical nature of the route. The preponderance of Federal Reserve contracts permitting conjunctive business indicates that presenting banks should encounter few problems in arranging courier services with private couriers for presentment of checks.

The Board believes that the Federal Reserve Banks currently allow conjunctive business on intradistrict transportation networks when it is operationally feasible and does not jeopardize the expeditious collection of checks by the Federal Reserve. Based on this evaluation, the Board does not propose to change the current policy with respect to the intradistrict transportation networks.

Conjunctive Business on the Federal Reserve's Interdistrict Transportation System (ITS).

The Board evaluated whether the Federal Reserve Banks should allow conjunctive business on the ITS network. The ITS network is currently

an exclusive-use, largely air, delivery system connecting Federal Reserve offices, through a hub-and-spoke arrangement, for the transportation of checks collected by the Federal Reserve as well as other Federal Reserve materials. Close coordination and timing among the various air couriers under contract to the Federal Reserve is essential for the network to operate smoothly.

The Federal Reserve System experimented with conjunctive business on the ITS network during the late 1970s. As a direct result of ITS couriers serving the differing needs of other business clients, the Federal Reserve was unable to obtain reliable delivery of its checks at scheduled times. Delays in delivering checks among Federal Reserve offices caused debit float to rise to high levels.

Because of the difficulties in forecasting accurately the daily level of debit float, management of the Federal Reserve's open market operations was made more difficult.

Based on this past experience, the Federal Reserve prohibited conjunctive business on ITS beginning in 1980 in order to retain control over the network. Because of its many interdependent connections under tight deadlines, the ITS network cannot operate effectively under decentralized decision-making by parties with divided loyalties. In order to ensure the efficiency of its check collection system, the Federal Reserve must retain control over the nightly decisions (e.g., when to hold a plane or instruct it to leave) and the network design decisions (e.g., when to change a scheduled departure time).

The Board believes that the only way to ensure control over the ITS network is to employ couriers that are responsible solely to the Federal Reserve. Based on past experience, and the time-critical nature of the interdistrict check collection system, the Board has concluded that the Federal Reserve Banks should not allow conjunctive business on the ITS network.

Transportation Services

The Board evaluated whether the Federal Reserve Banks should offer a new transportation service, under which banks could pay the Federal Reserve to arrange the delivery of checks to paying banks. Currently, the Federal Reserve Banks arrange transportation of only those checks for which the Federal Reserve is acting as a collecting bank or returning bank.[7] A Federal Reserve Bank assumes certain duties and rights with respect to checks it collects, incurs assets and liabilities on its balance sheet during the collection process, and provides warranties as an indorser of the check. Arranging for transportation, both intradistrict and interdistrict, is a function necessary for the collection of checks deposited with the Federal Reserve Banks. If the Federal Reserve Banks were to introduce a new priced transportation service that was not integrally related to the Federal Reserve's check collection responsibilities, the Federal Reserve Banks could be considered "common carriers," potentially subject to applicable Federal and state regulations.

Private-sector couriers can and do deliver checks for presenting banks and banks generally have adequate access to couriers in their local transportation markets. In addition, some correspondent banks maintain extensive networks to transport checks and other material to and from branches and respondents, which could be used by presenting banks to present checks to paying banks.

The Board has determined that the Federal Reserve Banks should not offer a priced check transportation service.[8] Because of the ready availability of courier services to presenting banks, a transportation service would not meet the criterion that new Federal Reserve services should be ones which other service providers cannot be expected to provide with reasonable effectiveness, scope and equity. On balance, it appears that there would be no clear public benefit if the Federal Reserve Banks were to offer a check transportation service.

Adjustment Service

The Board evaluated whether the Federal Reserve Banks should offer a new priced adjustment service to handle adjustments for checks not collected through the Federal Reserve. Currently, the Reserve Banks handle adjustments only for checks collected or returned through the Federal Reserve.[9] A new adjustment service could be limited to providing a clearinghouse for exchanges of claims for adjustments by paying banks and presenting banks, or the Federal Reserve Banks could play the role of resolving disputes between paying banks and presenting banks.

As a clearinghouse, a Federal Reserve office would receive documentation of an alleged error from one party involved in a presentment of checks, record and edit the documentation, and forward it, via mail or electronic transmission, to the other party involved in the presentment. The second party would respond either by accepting the reported error or by refuting the allegation in writing. The Federal Reserve Bank would serve as an intermediary handler of documentation until the two parties either resolved the issue or sought resolution through some other means outside of the Federal Reserve (e.g., the courts).

In the alternate case, a Federal Reserve office not only would serve as a clearinghouse for adjustment documentation, but also would resolve any dispute between the two parties to the check presentment. This form of an adjustment service raises the issue of whether it is appropriate for the Federal Reserve to make a decision involving a check which the Federal Reserve itself did not handle.

The Board has determined that the Federal Reserve Banks should not offer a priced adjustment service to handle adjustments for checks not collected or returned through the Federal Reserve, or otherwise processed by the Federal Reserve. Other service providers would be able to serve as intermediaries in exchanges of adjustment documentation or as arbiter for check adjustments. Because (1) it appears that there would be no clear public benefit if the Federal Reserve Banks were to offer an adjustments service, and (2) other entities alone could provide this service with reasonable effectiveness, scope, and equity, the Board believes it would be inappropriate, under its criteria for offering new services, for the Federal Reserve Banks to offer an adjustment service.

[7] One proposed exception is the provision of outgoing transportation from the paying bank's Federal Reserve office to the paying bank for checks not collected through the Federal Reserve for which the Federal Reserve provides payor bank services under the proposed regular supplemental payor bank service. These checks would be intermingled with checks collected through the Federal Reserve that are designated for payor bank services. The Federal Reserve would have to provide transportation for those checks collected through the Federal Reserve in order to fulfill its presentment obligation. It would not be operationally practical for the Federal Reserve to provide regular supplemental payor bank services on all of these checks and provide transportation for only those checks collected through the Federal Reserve.

[8] Cash transportation provided by four Federal Reserve Banks is the sole priced transportation service currently provided by the Federal Reserve. This cash transportation service is offered only with respect to cash for deposit to or withdrawal from a Federal Reserve Bank. The Federal Reserve does not provide cash transportation between private-sector banks.

[9] Under the proposed supplemental payor bank services, the Federal Reserve would also handle adjustments for checks processed by the Federal Reserve in order to provide the payor bank services, even though the checks were not collected through the Federal Reserve.

E. Competitive Impact Analysis

The Board recently formalized its procedures for assessing the competitive impact of changes that have a substantial effect on payments system participants.[10] Under these procedures, the Board assesses whether the proposed change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services and if such effects are due to legal differences or due to a dominant market position deriving from such legal differences. Following are the competitive impact analyses for the proposed new services and for the bilateral settlement service.

Presentment Point Service

The proposed presentment point service would allow a paying bank to designate its local Federal Reserve office as a presentment point for checks presented to the paying bank by a private-sector presenting bank. Because many banks currently maintain arrangements to transport checks to and from their local Federal Reserve office and some banks deliver checks directly to multiple Federal Reserve offices, this service may prove convenient and economical for both presenting banks and paying banks.

It does not appear that private-sector entities that could be designated as presentment points by paying banks would be adversely affected by the proposed Federal Reserve presentment point service. The Federal Reserve's proposed service does not rely on the existence of legal differences between the Federal Reserve Banks and other service providers, nor does it rely on the dominant market position of the Federal Reserve Banks in the provision of check collection services deriving from such legal differences. Typically, a paying bank would designate as its presentment point the location of a data processing firm or a correspondent bank that performs demand deposit accounting for the checks drawn on the paying bank. The Federal Reserve Banks do not provide demand deposit accounting services and do not have any inherent advantages in providing a presentment point service, with the possible exception of the convenience of a location where checks are already delivered and picked up by collecting banks and paying banks.

[10] These procedures are described in the Board's policy statement, "The Federal Reserve in the Payments System," which was revised in March 1990. (55 FR 11648, March 29, 1990)

Supplemental Payor Bank Services

The proposed supplemental payor bank services would allow a paying bank to designate its local Federal Reserve office as a presentment point for checks not collected through the Federal Reserve, or to deliver to its Federal Reserve office checks that it has received directly, and instruct the Federal Reserve office to provide payor bank services with respect to those checks. The Federal Reserve Banks currently offer payor bank services as an option to paying banks for checks collected through the Federal Reserve.

The provision of supplemental payor bank services should not adversely affect the provision of similar services by private-sector providers due to legal differences between the Federal Reserve Banks and other service providers or due to a dominant market market position deriving from such legal differences. Generally, a presenting bank, because it has possession of the checks, would have an advantage in offering timely and cost-effective payor bank services to the paying bank. Thus, the Federal Reserve's market position does not provide an advantage in the provision of the proposed supplemental payor bank services.

Bilateral Settlement Service

The proposed same-day settlement rule requires the paying bank to settle with the presenting bank by credit to an account of the presenting bank at a Federal Reserve Bank. Settlement may also be in any other form to which the presenting bank and the paying bank agree. While other private-sector service providers may offer bilateral settlement services, most banks either hold accounts directly with the Federal Reserve Banks or have established relationships with correspondent banks that have accounts at the Federal Reserve. These accounts serve to maintain reserves and/or to permit participation in Federal Reserve payment services. The current base of accounts, especially the account relationships with all major participants in the payments system, provides the Federal Reserve Banks with an inherent advantage in providing settlement services. Private-sector providers of settlement services would have to hold account relationships with both parties to the settlement. In addition, a presenting bank would be more likely to agree to participate in a bilateral settlement service if the service could be provided with respect to multiple bilateral relationships, increasing the number of account relationships that a private-sector service provider might have to maintain. Attaining these account relationships for the explicit purpose of providing settlement services would likely be difficult.

Thus, a potential private-sector provider of bilateral settlement services would be adversely affected if the Federal Reserve Banks offered a bilateral settlement service. It is unclear, however, whether such adverse effects would be material. Settlement participants may choose to function entries from the Federal Reserve's bilateral settlement service through accounts held at correspondent banks, which are the primary private-sector service providers of settlement services. If this option is chosen by service users, the adverse effects of a bilateral settlement service on private-sector providers might be minimized. The Board requests comment on whether the potential effects of a bilateral settlement service are material.

If the effects are determined to be material, the Board must determine whether the adverse effects are due to legal differences or due to a dominant market position deriving from such legal differences. Because the Federal Reserve has account relationships with most banks in its roles both as central bank and payments system service provider, the adverse effect would be both due to legal differences between the Federal Reserve Banks and private-sector service providers and due to a dominant market position deriving from legal differences.

The objective of a bilateral settlement service would be to provide banks an alternative means of settlement for checks presented by private-sector presenting banks. Provision of an alternate means of settlement should facilitate direct presentments in cases where the direct presentment and the settlement service are less costly or more efficient than collection through intermediaries. The Board believes that provision of a settlement service through Fedwire, and possibly also through a bilateral settlement service, may enhance competition in the provision of check collection services by making it easier for private-sector presenting banks to obtain settlement for checks presented to paying banks. The Board requests comment on whether the provision of a bilateral settlement service, in addition to a Fedwire settlement alternative, would provide greater incentives for direct presentments to occur.

It does not appear that the service can be modified to lessen or eliminate any adverse effect on private-sector providers of settlement services. The

service would allow paying banks and presenting banks to have their entries made through a correspondent settlement agent. Because correspondent banks are the primary private-sector providers of settlement services, the fact that such providers can participate within the context of the service should lessen the potential adverse effects of the proposal. The Board requests comment on whether any other modifications can be made to the service to lessen or eliminate the adverse effect on private-sector providers of settlement services.

By order of the Board of Governors of the Federal Reserve System, March 6, 1991.

Jennifer J. Johnson,

Associate Secretary of the Board.

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