



FEDERAL RESERVE BANK  
OF DALLAS

TONY J. SALVAGGIO  
FIRST VICE PRESIDENT

DALLAS, TEXAS  
75265-5906

September 11, 1995

**Notice 95-85**

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

**SUBJECT**

**Request for Public Comment on a Proposal  
to Control Third-Party and Respondent Access to the  
Automated Clearing House Service**

**DETAILS**

The Board of Governors of the Federal Reserve System has requested public comment on the benefits and costs of adopting a policy to control access to the Federal Reserve Banks' automated clearing house (ACH) service by entities other than the depository institution whose Federal Reserve account will be debited.

The proposed policy would apply to ACH credit transactions sent by third-party processors and respondent depository institutions to a Reserve Bank or to a private ACH operator that exchanges transactions with a Reserve Bank. The policy is based on the requirements of the Federal Reserve's payments system risk policy and the concepts in the Fedwire third-party access policy.

The Board must receive comments by November 9, 1995. Please address comments to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. All comments should refer to Docket No. R-0889.

**ATTACHMENT**

A copy of the Board's notice as it appears on pages 42413-17, Vol. 60, No. 157, of the *Federal Register* dated August 15, 1995, is attached.

**MORE INFORMATION**

For more information, please contact Bill Musgrave at (214) 922-6488. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely,

A handwritten signature in cursive script, reading "Tony J. Salysio". The signature is written in black ink and is positioned below the word "Sincerely,".

**FEDERAL RESERVE SYSTEM**

[Docket No. R-0889]

**Federal Reserve Payment System Risk Policy****AGENCY:** Board of Governors of the Federal Reserve System.**ACTION:** Notice; request for comment.

**SUMMARY:** The Board requests comment on the benefits and costs of adopting a policy to control access to the Federal Reserve Banks' automated clearing house (ACH) service by entities other than the depository institution whose Federal Reserve account will be debited. The controls would apply to ACH credit transactions sent by third-party processors (service providers) and respondent depository institutions directly to a Reserve Bank or a private ACH operator that exchanges transactions with a Federal Reserve Bank. Controlling access to the ACH service will help to ensure the safety and soundness of the ACH system.

The concepts underlying the proposed ACH third-party access policy are similar to the provisions of the Fedwire third-party access policy, which was originally adopted in 1987 and amended today. (See notice published elsewhere in today's **Federal Register**.) The Board requests comment on the specific provisions of the proposed policy and the cost and operational impact of providing risk monitoring capabilities for controlling access to the Federal Reserve Banks' ACH service. The risk monitoring capabilities are intended to permit the depository institutions that are

responsible for funding ACH credit transactions to control the potential credit risk and reduce the risk of fraud created by their customers and respondent depository institutions. The proposed policy provisions and monitoring alternatives do not cover ACH debit transactions.

**DATES:** Comments must be submitted on or before November 9, 1995.

**ADDRESSES:** Comments should refer to Docket No. R-0889, and may be mailed to Mr. William Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. Comments may also be delivered to Room B-2222 between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's rules regarding availability of information.

**FOR FURTHER INFORMATION CONTACT:** Florence M. Young, Assistant Director (202/452-3955), Wesley M. Horn, Manager, ACH Payments (202/452-2756), or Scott E. Knudson, Senior Financial Services Analyst, ACH Payments (202/452-3959) Division of Reserve Bank Operations and Payment Systems; for the hearing impaired *only*: Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

**SUPPLEMENTARY INFORMATION:**

**I. Background**

The ACH is a value-dated electronic payment service that supports both debit and credit transactions. In ACH debit transactions, funds flow from the depository institution receiving the transaction to the institution originating the transaction. Typical debit transactions include collection of insurance premiums, mortgage and loan payments, consumer bill payments, point-of-sale transactions, and corporate cash concentration transactions. Institutions originating ACH debit transactions are exposed to the risk that the receiving institution will return a transaction and the originating institution's customer will not have sufficient funds available to cover the returned transaction. An originating institution can control its exposure to potential losses from returned debit transactions by establishing funds availability policies that are based on the creditworthiness of each customer. That is, an originating institution can

hold all or a part of the funds collected via ACH debit transactions until returned transactions are expected to be received.<sup>1</sup>

In ACH credit transactions, funds flow from the institution originating the transaction to the institution receiving the transaction. Typical ACH credit transactions include direct deposit of payroll, annuity payments, dividend payments, and corporate payments to vendors and suppliers. When ACH credit transactions are transmitted to a Reserve Bank, the depository institution originating ACH credit transactions or its designated correspondent is obligated to fund the transactions on the settlement day, whether or not the institution's customers fund the payments.<sup>2 3</sup>

ACH transactions are processed in batches one or two days before they are scheduled to settle. The use of value-dating exposes an originating institution to interday credit risk that can extend from one to two business days, depending upon when transactions are transmitted to an ACH operator and when a depository institution's customer funds the payments it originates. To address this exposure, as of January 3, 1995, *The Guide to the Federal Reserve's Payment System Risk Policy* requires depository institutions performing self assessments in order to

<sup>1</sup> In Regulation CC (12 CFR Part 229), an ACH debit transfer is excluded from the definition of electronic payment, which is subject to next-day funds availability, because the receiver of an ACH debit transfer has the right to return the transfer. Thus, an ACH debit transfer is more like a check than a wire transfer of funds.

<sup>2</sup> The Federal Reserve Banks' Uniform Operating Circular on Automated Clearing House Items, paragraph 11(c) states "by sending an item to a Reserve Bank, the sending institution authorized the Reserve Bank holding the institution's account to debit the amount of a credit item to the sending institution's account on the settlement date." Paragraph 38 states "a sending institution or prior party may not amend or revoke an item after it has been received by a Reserve Bank, except as otherwise provided in the applicable ACH rules." The ACH Rules (Article Seven, Section 7.1), promulgated by the National Automated Clearing House Association (NACHA), state that "neither an originator nor an ODFI (originating depository financial institution) has the right to recall an entry or file, to require the return of or adjustment to an entry, or to stop the payment or posting of an entry, once the entry or file has been received by the originating ACH operator."

<sup>3</sup> The Uniform Operating Circular on Automated Clearing House Items, Appendix 4, Settlement Agreements, states that a sending or receiving institution (or its correspondent account holder) may terminate a settlement agreement by providing written notice to a Reserve Bank. A Reserve Bank may terminate a settlement agreement by providing written notice to the institution (or correspondent account holder). In either case, the termination notice is effective on and after the banking day following the banking day of receipt by the institution of the notice, or on and after a later date specified in the notice.

obtain daylight overdraft caps to (1) evaluate the creditworthiness of each customer that originates ACH credit transactions, (2) establish for each customer an interday credit limit, and (3) monitor compliance with credit limits across all processing cycles for a given settlement day. For customers in weak financial condition, real-time monitoring is required.<sup>4</sup> In addition, the Board has issued an *Overview of the Federal Reserve's Payments System Risk Policy* for use by depository institutions that use only minimal amounts of intraday Federal Reserve credit, that is, institutions that are exempt from filing or that qualify for a *de minimis* cap. The *Overview* indicates that institutions should perform credit assessments and establish credit or exposure limits for customers originating large dollar volumes of ACH credit transactions and that compliance with the limits should be monitored across all processing cycles for a given settlement day.<sup>5</sup> In both documents, depository institutions are encouraged to require customers in weak financial condition to prefund or collateralize ACH credit transactions.

Many depository institutions originating ACH transactions do so through third-party service providers. There are a variety of third-party processing arrangements that result in a service provider's transmitting ACH transactions directly to a Federal Reserve Bank or a private ACH operator, which may ultimately transmit the transactions to a Federal Reserve Bank.<sup>6</sup> For example, a depository institution may contract with another depository institution, acting as a service bureau, or with a non-depository institution service provider to create ACH transactions on its behalf. In some cases, companies create ACH transactions on behalf of their account-holding institution and transmit the files to third-party service providers. Service providers may also create ACH transactions directly for corporate customers, such as payroll payments. In these cases, service providers consider the contracting companies, not the depository institution, to be their clients. In addition, respondent depository institutions may send ACH credit transactions for which settlement will be made through a correspondent

<sup>4</sup> *Guide to the Federal Reserve's Payment System Risk Policy*, Section VII, p. 57, January 1995.

<sup>5</sup> *Overview of the Federal Reserve's Payments System Risk Policy*, Section VI, p. 22, October 1993.

<sup>6</sup> There are currently one national private ACH operator—Visa, U.S.A.—and two regional private ACH operators—the New York Automated Clearing House and Deluxe Data Systems, which is the service provider for the Arizona Clearing House Association.

depository institution's account directly to a Federal Reserve Bank or a private ACH operator. In other cases, a respondent depository institution might transmit transactions to a third-party service provider, which would in turn transmit the transactions to a Federal Reserve Bank or private ACH operator. The Board believes that there may also be other types of third-party arrangements that have not been identified.

As noted above, depository institutions are required to fund ACH credit transactions on the settlement day once they have been transmitted to a Federal Reserve Bank. Therefore, the transmission of ACH credit transactions to a Federal Reserve Bank by a third-party service provider or respondent institution without the explicit review and consent of the originating institution or correspondent, whose Federal Reserve account will ultimately be charged for the transactions, can expose the originating institution or correspondent to credit risk. For example, if a depository institution's customer that uses a third-party service provider to originate payroll payments declares bankruptcy before transactions have settled, the depository institution would be required to absorb any loss. Similarly, if a third-party service provider originated fraudulent payments, a depository institution could, at a minimum, be exposed to liquidity risk and the safety and soundness of the ACH service could be undermined.

## II. Risk in ACH Third-Party Processing Arrangements

During the mid-1980s, the Board became concerned about the credit exposure faced by depository institutions entering into arrangements with service providers to send and receive Fedwire funds transfers. To address the credit exposure inherent in these arrangements, as part of its risk reduction policy, in 1987 the Board approved a set of conditions under which Fedwire-third-party access arrangements could be established. The Board has adopted revisions to the Fedwire third-party access policy. (See notice published elsewhere in today's *Federal Register*.)<sup>7</sup>

At the time the Fedwire controls were adopted, they were not applied to the ACH because it was considered a small-dollar payment system. As a result, there was little concern about the risks

created when third parties originated and transmitted ACH transactions to ACH operators on behalf of depository institutions. Although the average value of individual ACH credit transactions is relatively small—\$2,600 compared with \$3 million for Fedwire funds transfers in 1994—the aggregate value of ACH transactions originated by a customer of an institution can be significant. Moreover, the volume and value of commercial ACH credit transactions has increased rapidly. In 1987, when the Fedwire policy was adopted, 206.8 million ACH credit transfers, with a value of approximately \$410.7 billion, were processed by the Federal Reserve Banks. In 1994, 955 million transfers, with a value of almost \$2.5 trillion, were processed by the Federal Reserve Banks. Thus, over the last seven years, the volume of ACH credit transactions has grown at an average annual rate of nearly 25 percent and the value of these transactions has increased at an average annual rate of nearly 30 percent. A number of factors indicate that continued rapid growth is likely.

To assess the level of risk depository institutions face due to ACH transactions originated through third-party service providers, the Board's staff surveyed the Reserve Banks to obtain information on the value of ACH credit transactions that are processed for depository institutions that have agreements with service providers.<sup>8</sup> The potential credit exposure was measured by dividing the dollar value of the daily average and peak-day ACH credit transactions originated by service providers for each depository institution by the amount of the institution's total capital. In general, the survey results indicated that the amount of risk faced by institutions in third-party processing arrangements is a small percentage of capital. Peak-day exposure averaged approximately 5 percent of the total capital of institutions using third-party processors. Although the average risk exposure, as measured by the survey, was not significant, for some institutions significant exposure existed. Of the 5,020 institutions that permitted service providers to originate ACH transactions, the peak-day exposure for seven institutions exceeded 150 percent of capital and, for one institution, it exceeded 250 percent of capital. As ACH volume continues to grow, the potential risks created by the use of service providers is likely to increase.

<sup>8</sup> Data were provided by all Reserve Banks, except the Federal Reserve Bank of New York, for the month of December 1993. The New York Automated Clearing House provides essentially all commercial ACH service in the New York District.

Further, anecdotal evidence suggests that many depository institutions are not fully aware of the extent to which third parties originate ACH transactions on their behalves.

The potential exposure created by the use of third-party service providers to institutions originating ACH transactions, led the Board of Directors of the National Automated Clearing House Association to pass a resolution addressing system controls for third-party processors in November 1993. That resolution, among other things, recommended that ACH controls include: ". . . a review and release function capability for originating depository financial institutions with respect to all files sent directly to ACH Operators by third parties and respondent depository financial institutions. . . ." The purpose of this resolution was to provide originating depository institutions a mechanism to control the risks created by third-party service providers and respondent depository institutions.

The New York Automated Clearing House (NYACH) has implemented a voluntary mechanism that permits originating institutions to set limits on the aggregate amount of ACH credit transactions that can be originated against their accounts by third-party processors. If the credit limit is exceeded, NYACH will hold the files and contact the originating institution. Based on its instructions, NYACH will either reject the file or permit the institution to adjust the credit limit. Visa, U.S.A. and the Arizona Clearing House Association are considering instituting third-party controls.

## III. Proposed ACH Access Policy

The Board is concerned about the potential lack of control in third-party arrangements and believes that appropriate measures should be taken to ensure the safety and soundness of the ACH service by enabling originating institutions to control the risks created by the use of service providers. Thus, the Board requests comment on the benefits and costs of adopting a policy to control access to the Federal Reserve's ACH services. In particular, the Board requests comment on the scope of the proposed policy, risk monitoring capabilities for implementing ACH credit controls, and several other controls.

### A. Scope

The proposed ACH policy would apply only to ACH credit transactions. As noted above, a depository institution is able to control its credit risk from ACH debit transactions by delaying the

<sup>7</sup> The policy requires depository institutions to impose prudent controls over Fedwire transfers initiated, received, or otherwise processed on their behalf by a third-party service provider.



availability of funds to the originators of the transactions. The Board, therefore, believes that limiting the policy to the origination of ACH credit transactions avoids imposing unnecessary burdens on the industry while addressing the most significant risk.

The policy would cover all of the following types of arrangements:

- Service providers (service bureaus, information processors, and depository institutions that act as service bureaus for other institutions) that transmit ACH credit transactions directly to a Federal Reserve Bank or to an ACH operator that exchanges payments with a Federal Reserve Bank;
- Companies that transmit their ACH credit transactions directly to a Reserve Bank or private ACH operators that transmit transactions to the Federal Reserve; and
- Institutions that transmit ACH credit transactions directly or indirectly to a Federal Reserve Bank and designate a correspondent depository institution for the settlement of the transactions.

#### B. Credit Controls

In its payments system risk policies, the Board has indicated that depository institutions should establish procedures to protect themselves from the risk created by their corporate customers when they originate ACH credit transactions. In particular, the Board has indicated that depository institutions should perform credit assessments and establish credit limits for corporate customers that originate ACH credit transactions. That policy applies whether ACH credit transactions are originated by a depository institution itself or by a service provider.

In addition to the requirements currently included in the payment system risk policy, the Board requests comment on the following credit controls.

- Institutions that outsource their own ACH processing would be required to establish an interday limit on the value of ACH credit transactions that a service provider can originate on their behalf.
- Correspondent depository institutions would be required to establish interday credit limits for each of their respondent institutions that originate ACH credit transactions.

Monitoring capabilities would enable institutions to ensure that the credit limits established by the originating institution for each corporate customer and for its own transactions are not exceeded. If monitoring capabilities only enabled a depository institution to monitor the aggregate value of ACH credit transactions transmitted to a

Reserve Bank or a private ACH operator by a third-party, the responsible depository institution would not be able to control the risk that it faces from its corporate customers. The Board believes that it is important for depository institutions to be able to control the credit exposure that they face from each of their corporate customers and respondent institutions. As a result, the Board requests comment on the benefits and costs of adopting risk monitoring capabilities that differ from the approach recommended by the NACHA's Board of Directors and implemented by one private operator, which establishes controls over the total exposure an institution faces due to transactions originated through third-party service providers. Additionally, more than one third-party service provider may originate ACH credit transactions on behalf of a depository institution's customers. Therefore, a depository institution would be expected to ensure that its internal procedures enable it to monitor all ACH credit transactions originated for each of its corporate customers through third-party service providers.

The following discussion describes the requirements of the ACH risk monitoring capabilities. The Board requests comment on whether the Reserve Banks and private ACH operators and/or third-party service providers, at the option of depository institutions, should provide the risk monitoring capabilities.

The institution's management would set credit limits to reflect the total amount of *unsettled* ACH credit transactions that the institution's management had determined was acceptable based on the customer's or respondent institution's financial condition. The institution would provide these credit limits to the entity providing the monitoring capabilities. Upon receipt of a file from a third-party service provider or respondent institution, the dollar value of the ACH credit transactions in each batch would be combined with the amount of other *unsettled* ACH credit transactions that had previously been processed for the same company or respondent institution. The resulting aggregate amount of *unsettled* credit transactions would be compared to the pre-established credit limit. If this total were below the credit limit established for the customer or respondent institution, the transactions would be processed. If the credit limit for the customer or respondent institution were exceeded, the batch(es) would be held and the originating depository institution and/or the correspondent institution would be

notified. The depository institution would have the option to reject the batch or set a new credit limit for its corporate or respondent customer.

If an originating institution of ACH credit transactions uses a third-party service provider to originate ACH transactions and uses a correspondent institution for settlement, the respondent institution would be expected to establish credit limits for its customers and to instruct the provider of the monitoring mechanism regarding the action to be taken if a batch(es) of ACH credit transactions exceeded its customer's credit limits. In addition, the correspondent institution would be expected to establish credit limits for its respondent institutions and to instruct the provider on the action to be taken if a batch(es) of transactions originated on behalf of its respondent institution exceeded the respondent's credit limit.

These risk monitoring requirements would apply if the Reserve Banks and private ACH operators or third-party service providers provided the monitoring capabilities. Specifically, the Board is requesting comment on whether the monitoring capabilities could most effectively be provided by the Reserve Banks and private ACH operators, third-party service providers, or some combination selected by depository institutions.

If the Reserve Banks provided the monitoring capabilities, the Board believes that the capabilities for this alternative could be implemented within approximately 12 to 18 months following approval of the ACH third-party policy. Developing and operating such a monitoring system would be costly, and the benefits of the system would accrue to institutions using third-party service providers and correspondent institutions. Therefore, it is likely that the Reserve Banks would assess some fee to institutions originating ACH credit transactions through third-party service providers and to institutions acting as ACH correspondent settlement agents if they were to provide monitoring capabilities. The Board is interested in knowing the amount of time that private ACH operators and service providers would need to implement the proposed monitoring capabilities.

The Board believes that the risk monitoring capability may require users of ACH services to make changes that may result in increased costs. For example, in many instances batches of ACH credit transactions could be pending after normal business hours. Thus, originating institutions and correspondent institutions would need to make personnel with credit-granting

authority available during these off-hours. Finally, if service providers provided the monitoring capabilities, originating depository institutions or correspondent institutions that permit customers or respondents to transmit ACH credit transactions directly to a Reserve Bank may not be able to rely on the service provider to provide effective controls over such transactions.

#### C. Other Controls

To ensure the integrity of ACH third-party and respondent access arrangements, the following provisions, which are generally consistent with those required in the Fedwire third-party access policy, would apply.

- An institution's board of directors would be required to approve the role and responsibilities of a service provider(s) that is not affiliated with the institution through at least 80 percent common ownership.
- A depository institution that uses an ACH third-party access arrangement would be required to have its auditors confirm compliance with the controls described in the policy at least annually.
- The service provider must be subject to examination by the appropriate federal depository institution regulatory agency(ies).
- The conditions under which these arrangements could be established would be set forth in the appendices of the Reserve Banks' uniform ACH operating circular. The uniform operating circular would serve as the legal agreement governing the arrangement between the institution and the service provider and/or correspondent and would govern arrangements of which the Reserve Banks otherwise may not be aware. The ACH Participation Agreement, which is used to document the various agreements between the Federal Reserve Banks and users of their ACH services, such as settlement arrangements and electronic connections, would serve to identify the institution and the service provider(s) or correspondent(s) in the third-party arrangement(s).

#### IV. Competitive Impact Analysis

In considering a change that has a substantial effect on payment system participants, 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 Banks 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.

The Federal Reserve Banks compete in providing ACH services to depository institutions with private-sector ACH operators. The intent of the proposed third-party access policy is to ensure the integrity of the ACH system. The proposed policy would apply equally to institutions using Federal Reserve Bank ACH services and to institutions that use the services of private ACH operators that transmit ACH transactions to the Federal Reserve Banks on their behalf. Therefore, the Board believes that although the proposal would impose requirements on private ACH operators, those requirements would not be any greater than the additional requirements the Federal Reserve would be placing on itself.

#### V. Request for Comments

The Board requests comments on all aspects of this proposal. The Board specifically requests comments on the following questions:

##### A. Current Arrangements and Controls

1. Under what types of arrangements do third parties initiate or transmit ACH credit transactions to the Federal Reserve Banks or private-sector ACH operators on behalf of depository institutions?
2. What are the unique risk characteristics of third-party processing arrangements and correspondent settlement arrangements that concern the institutions, service providers, and private ACH operators participating in such arrangements? Are the risks in these arrangements expected to increase in the future?
3. What controls are currently in place that permit institutions to control their risk in ACH third-party processing arrangements and correspondent settlement arrangements? Are these controls consistent with the type of controls required in the payment system risk policy?

##### B. Risk Monitoring Alternatives

4. How would the requirement to make personnel available after normal business hours affect institutions' ACH operating risk and costs? How would it affect the quality of the ACH service? Are there other operational issues or customer service issues associated with either risk control alternative?
5. Would monitoring capabilities provided by the Reserve Banks and private ACH operators or by the service providers be most effective in achieving the objectives of controlling risk in the ACH? Should the Board consider permitting depository institutions to

select between the two alternatives or should only one approach be adopted?

6. If only service providers were to provide monitoring capabilities, how would the activity of originating institutions' customers and respondent institutions that transmit ACH credit transactions directly to a Federal Reserve Bank or a private ACH operator be monitored?

7. What costs would be incurred by (a) private ACH operators to expand or develop their monitoring systems to permit their users to monitor ACH credit transactions at the customer level and (b) third-party service providers to develop such a monitoring mechanism?

8. How do the benefits derived from improving credit controls over access to the ACH service compare with the potential costs of implementing the proposal and the operational risk (i.e., possible untimely processing) that may be created by proposed controls?

9. Are there other monitoring alternatives that would be equally effective but pose fewer operational issues and be less costly?

10. Could depository institutions, private ACH operators, and service providers comply with the proposed policy if the final policy were effective 18 months after adoption by the Board? Could the parties comply within 12 months after adoption by the Board?

##### C. Proposed Policy Provisions

11. Do the provisions of the proposed policy address the credit risk concerns of institutions participating in ACH third-party processing arrangements? If not, explain your concerns and suggested alternative controls.

12. Could the risk monitoring controls effectively control credit risk if they were applied only to corporate customers or respondent institutions whose financial condition was considered weak? What issues might be raised if parties other than the responsible depository institution had information identifying financially weak customers or respondent institutions?

13. Should a depository institution be responsible for monitoring the financial stability of its service providers and adopting procedures necessary to ensure that the activities of the service provider were controlled appropriately?

By order of the Board of Governors of the Federal Reserve System, August 9, 1995.

William W. Wiles,

Secretary of the Board.

[FR Doc. 95-20128 Filed 8-14-95; 8:45 am]

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