BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
MEMBER OF THE BOARD

December 7, 2015

David Walker, President & CEO
Electronic Check Clearing House Organization
3710 Rawlins Street, Suite 1075
Dallas, Texas 75219

Dear Mr. Walker:

This letter is in response to your letter regarding the Reserve Banks' check image services. In consultation with Governor Brainard, my colleague on the Board's Committee on Federal Reserve Bank Affairs, I have reviewed your concerns regarding the Reserve Banks' competitive position in today's electronic environment and have considered your request for a de novo competitive impact analysis with opportunity for public comment. As described more fully in the attached staff analysis, I have reviewed the issues raised by ECCHO using the framework of the Board's policy *The Federal Reserve in the Payment System*, which calls for an analysis of changes to a Reserve Bank price or service, if the changes 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 due to differing legal powers or the Federal Reserve's dominant market position deriving from such legal differences.

As noted in the attached staff analysis, overall, the industry's shift to a virtually all-electronic check collection environment has not materially increased any competitive advantages the Reserve Banks have in the provision of their check collection services, and has not increased the Reserve Banks' market share from what it was in the pre-Check 21 environment. As you know, it is difficult to create total parity between the Reserve Banks and correspondent banks with respect to check collection services. Although the Monetary Control Act and the Board's same-day settlement rule both made important progress in leveling the playing field, legal differences remain that affect the competitive landscape for check services. Certain differences may facilitate the Reserve Banks' provision of competitive priced services, such as their use of autocharge, while other legal differences provide competitive advantages to private-sector collecting banks. For example, although correspondent banks generally have the flexibility to individually negotiate with their customers and do not publish their fees, the Monetary Control Act requires that fees for Reserve Bank priced services be published and transparent to competitors and customers alike.

The Board is committed to maintaining an efficient and effective payment system that provides maximum feasible parity between the Reserve Banks and private sector banks. Although I do not believe that a full competitive impact analysis of the Reserve Banks' check image services would be fruitful at this time, I have asked staff to review further (1) the Reserve Banks' anti-money laundering compliance expectations and costs, and (2) certain Reserve Bank pricing practices related to electronic checks, to determine whether any changes to Federal Reserve policies, procedures, products, or fee structures are warranted. In addition, Board staff would welcome discussion of any specific proposals that you would like the Board to consider.

Sincerely,

Jerome H. Powell
Chair
Committee on Federal Reserve Bank Affairs

Enclosure

cc: Robert C. Hunter, The Clearing House
David Pommerehn, Consumer Bankers Association
Stephen Kenneally, American Bankers Association

ATTACHMENT

STAFF ANALYSIS FOR THE COMMITTEE ON FEDERAL RESERVE BANK AFFAIRS OF THE ELECTRONIC CHECK CLEARING HOUSE ORGANIZATION'S REQUEST FOR A DE NOVO COMPETITIVE IMPACT ANALYSIS OF RESERVE BANK CHECK OPERATIONS

I. Background

In a May 20, 2015, letter ECCHO requested that the Board undertake a de novo competitive impact analysis of the Reserve Banks' check services to determine whether any changes are necessary to Federal Reserve policies, procedures, products, or regulations in light of the competitive advantage that ECCHO argues the Reserve Banks experience in today's electronic check processing environment. Specifically, ECCHO requested that the Board consider changes to Regulation CC, Regulation J, Operating Circulars 1 and 3, Reserve Bank services and pricing practices, and the private sector adjustment factor.

Under the Board's policy *The Federal Reserve in the Payment System*, a competitive impact analysis is conducted when considering an operational or legal change, if that 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 due to differing legal powers or the Federal Reserve's dominant market position deriving from such legal differences.[1] ECCHO believes that a competitive impact analysis is warranted at this time—independent of any proposed new services or operational and legal changes on the part of the Reserve Banks—as a result of the industry achieving a virtually all-electronic check environment. ECCHO also requested that the Board provide an opportunity for public comment on the competitive impact analysis because it believes that the Reserve Banks have competitive advantages that have significant longer-run effects on the nation's payment system.[2] ECCHO's request was supported separately by the American Bankers Association, The Clearing House, and the Consumer Bankers Association.

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[1] *The Federal Reserve in the Payments System*, Fed. Res. Reg. Serv. 9-1558, http://www.federalreserve.gov/paymentsystems/pfs_frpaysys.htm.

[2] The Board will seek public comment when changes in fees and service arrangements are proposed that would have significant longer-run effects on the nation's payments system. *See Principles for Pricing Federal Reserve Bank Services*, Pricing Principle 7, Fed. Res. Reg. Serv. 9-1568, http://www.federalreserve.gov/paymentsystems/pfs_principles.htm.

II. Analysis

ECCHO identified several legal, operational, and business factors that it believes affect competition between the Reserve Banks and private-sector collecting banks in today's electronic check environment. We understand that ECCHO worked closely with its members to identify potential steps that would improve the competitive position of the private sector providing check collection services, but—with limited exceptions discussed below—members were unable to identify recommendations that were not overly burdensome on the industry. We will continue our dialogue with ECCHO and other members of the industry on steps to improve competition and the efficiency of the check system.

A. *<u>Same-Day Settlement</u>*

ECCHO argues that the Reserve Banks have competitive advantages when presenting electronic checks to paying banks.

ECCHO states that because the Board's same-day settlement rule applies only to paper checks, private-sector collecting banks are unable to obtain same-day settlement agreements from many paying banks for checks presented electronically, whereas the Reserve Banks are able to obtain such agreements. We believe that the Reserve Banks' ability to obtain same-day settlement for checks presented electronically is due, for the most part, to the Reserve Banks' policy of direct presentment, as discussed in section B below, coupled with most paying banks' desire to receive presentment electronically, and not the result of Regulation CC's same-day settlement rule for paper checks.[3]

The Board has requested comment on modifications to Regulation CC with respect to the application of the same-day settlement rule to electronic checks twice since 2011.[4] In neither instance did such a modification receive significant support from commenters.[5] Commenters also did not propose alternatives that would create an

[3] Regulation CC's same-day settlement rule requires paying banks to settle same-day for paper checks presented by 8 AM. 12 CFR 229.36(f).

[4] 76 FR 16862 (2011); 79 FR 6674 (2014). The Board also requested public comment in 1998 on whether to reduce or eliminate remaining legal differences between the Reserve Banks and the private sector with respect to the collection of checks. 63 FR 12700 (1998). Based on comments received, the Board determined that changes would create significant additional burdens and costs with only marginal benefits. 63 FR 68701 (1998). We continue to believe that this is the case, even with the widespread adoption of electronic checks.

[5] In response to both requests, ECCHO provided comments as part of a joint comment letter submitted by

effective means of applying the same-day settlement rule to electronic checks while alleviating the Reserve Banks' perceived competitive advantage.[6]

B. *Direct Presentment*

ECCHO questions the Reserve Banks' practice of presenting checks directly to paying banks rather than collecting checks through subsequent intermediary collecting banks.

ECCHO argues that the Reserve Banks' practice of presenting directly to paying banks, either electronically or via paper, unfairly encourages paying banks to enter electronic check presentment arrangements with the Reserve Banks to avoid paper check presentments, leaving them less likely to set up electronic connections with other banks, as discussed in section C below. ECCHO believes that a potential solution would be for the Reserve Banks to collect checks through subsequent intermediary collecting banks rather than presenting the checks directly to paying banks.[7]

Using subsequent intermediary banks for presentment or return as ECCHO suggests would introduce additional complexity by adding parties to the process, providing additional opportunities for potential delays in presentment or return, and creating additional counterparty risks. We believe that this would reduce the overall efficiency of the nation's check collection system.

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industry trade groups. In response to the first request, the joint comment letter stated that an electronic same-day settlement rule raised substantial policy and operational issues that should be considered in greater detail. In response to the second request, the joint comment letter did not reach a consensus about extension of the same-day settlement rule to electronic checks and did not suggest any alternative approaches. ECCHO did not separately submit comments to either request for comment.

[6] Applying the same-day settlement rule to electronic checks raises a number of issues, such as the potentially significant costs and security burdens that paying banks may incur in order to maintain connections with multiple presenting banks (which were not necessary for paper check presentments). In addition, an electronic same-day settlement rule may need to address responsibility for communication or technical failures (e.g., if a paying bank experiences system failures due to a significant volume of check images presented shortly before a presentment deadline).

[7] ECCHO has previously argued that the Reserve Banks would not have authority to pay fees in such a scenario. *Letter to Louise Roseman Regarding the Reserve Banks' Choice Receiver Product* (September 13, 2013).

C. Complexity and Costs of Electronic Connections

ECCHO argues that the complexity and costs of electronic connections necessary to present electronic checks create incentives for paying banks to maintain a single connection with the Reserve Banks.

ECCHO argues that the complexities and costs of multiple electronic check presentment arrangements create incentives for paying banks to accept presentment only from the Reserve Banks. We believe that the Reserve Banks' practice of presenting checks to all endpoints, with the option to receive presentment electronically or via paper, has allowed the Reserve Banks to successfully encourage paying banks to accept electronic presentment.[8] Although most large banks accept presentment from other large banks and the Reserve Banks, some paying banks have indicated that they prefer to accept electronic presentment only from the Reserve Banks for operational simplicity. Paying banks may not have an incentive to accept electronic presentment from presenting banks that do not have the capacity to present checks directly in either paper or electronic form like the Reserve Banks.

We recognize that correspondent banks have generally not made the same investments in printers to create substitute checks as have the Reserve Banks, but believe they could easily do so, individually or collectively, to make paper presentment a realistic option without incurring a significant expense. We agree with ECCHO that it would not be desirable to materially increase the proportion of checks presented in paper form, and believe that correspondent banks' *ability* to present paper checks would likely create a sufficient incentive for paying banks to accept checks electronically. The Reserve Banks have dismantled their air and truck transportation networks and now rely solely on regular or overnight mail to present substitute checks to paying banks that do not accept electronic presentments. Similarly, correspondent banks would not need to invest in physical transportation infrastructure to have the capability to present paper checks.

In addition, we believe that correspondent banks have options for presenting checks to paying banks electronically without the paying banks having to establish new

[8] Most paying banks agree to electronic presentment to avoid higher costs of handling paper. Since passage of the Check 21 Act, the Reserve Banks made significant investments in equipment for printing paper substitute checks to facilitate the implementation of Check 21. The Reserve Banks continue to use these capabilities, particularly in the case of check returns, which nearly 2,900 endpoints still refuse to receive electronically.

electronic connections. Many medium-to-small banks, representing approximately one-third of the Reserve Banks' presentment volume, designate a third-party processor or aggregator as their electronic presentment location. These paying banks could similarly designate a third-party processor or aggregator as their electronic presentment location for private-sector banks, thus avoiding the need to establish an additional electronic connection.

D. *Compliance Costs*

> *ECCHO argues that the Reserve Banks are not subject to the same compliance obligations as private-sector collecting banks, including AML/BSA compliance obligations, and therefore the Federal Reserve should impute those compliance costs when setting prices for Reserve Bank payment services.*

The Board sets prices for Reserve Bank services to fully recover over the longer run the actual costs of those services as well as the imputed costs that would have been incurred and profits that would have been earned if the services were provided by a private firm, referred to as the private sector adjustment factor (PSAF). ECCHO argues that private-sector collecting banks that serve as intermediaries in the check collection system have experienced increasing costs and burdens associated with regulatory requirements and supervision that the Reserve Banks do not incur, in particular regarding compliance with federal anti-money laundering (AML) laws such as the Bank Secrecy Act (BSA), and therefore that the Federal Reserve should impute those costs when establishing prices.

The Reserve Banks' priced services are not in all cases subject to the same regulatory regime as similar services provided by private-sector banks, but are subject to Board supervision. The cost of that supervision is included in the PSAF, and calculated in the costs that must be recovered through the services' revenue.

If private-sector banks incur material BSA/AML costs related to their correspondent check collection services that the Reserve Banks do not, it may be appropriate for Reserve Banks to impute such costs as part of the PSAF. Making such a determination would be challenging, given that such costs are not publicly available (as other inputs to the PSAF are). Moreover, correspondent banks have informed us that they would have significant difficulty determining the proportion of BSA/AML costs that relate to correspondent check services specifically, because they do not allocate compliance costs directly. ECCHO has acknowledged that it was unable to obtain such information from its member banks. We believe the Federal Reserve would likely encounter similar difficulties and would welcome any additional insights or suggestions that ECCHO may have.

We also believe that this issue should be reviewed in the context of the remaining inherent differences between private-sector collecting banks and the Reserve Banks in the provision of priced services. Certain differences may facilitate the Reserve Banks' provision of competitive priced services, such as the Reserve Banks' later presentment deadline for paper check presentments (which has become less meaningful in today's electronic environment), the ability to autocharge paying banks for the amount of the settlement, and the lack of counterparty credit risk that respondent banks bear when holding balances with the Reserve Banks. However, certain other differences provide private-sector collecting banks important competitive advantages. For example, correspondent banks can be more selective in the customers they serve, can negotiate prices with individual customers, and do not generally publish their fee schedules in the public domain. The Reserve Banks, in contrast, publish their fee schedules, providing transparency to both customers and competitors, and generally make their services available to all depository institutions.

E. *Intellectual Property Costs*

ECCHO argues that the Reserve Banks do not incur intellectual property costs, including costs for licensing or defending against infringement claims.

ECCHO argues that private-sector collecting banks incur significant intellectual property costs, including costs related to licensing or defending against infringement claims, which the Reserve Banks do not incur. ECCHO argues that the PSAF should be reevaluated to impute these costs. The Reserve Banks' priced services do incur direct and material intellectual-property costs, including litigation costs associated with alleged infringement. These costs are among the costs that are recovered through the fees set for those services. Therefore, there is no need to impute these costs as part of the PSAF.

F. *Pricing Practices*

ECCHO argues that the Reserve Banks unfairly provide discounts, impose fees for receipt of check images, tier fees, and bundle services.

ECCHO argues that the Reserve Banks engage in pricing practices with which private-sector collecting banks cannot compete, specifically (1) providing discounts to encourage use of electronic check services, (2) imposing fees on paying banks for electronic presentments, (3) using tiered pricing structures unrelated to costs or operational burdens, and (4) offering bundled discounts based on use of other Reserve Bank services, such as ACH.

Providing discounts and offering bundled services are common industry practice. Although private-sector collecting banks may be unable to bundle check and ACH operator services specifically, ECCHO acknowledges that these banks have opportunities to bundle check services with services not provided by the Reserve Banks.

We are currently working with the Reserve Banks' Retail Payments Office to review certain other aspects of electronic check pricing to determine whether any changes to Federal Reserve policies, procedures, products, or fee structures are warranted.

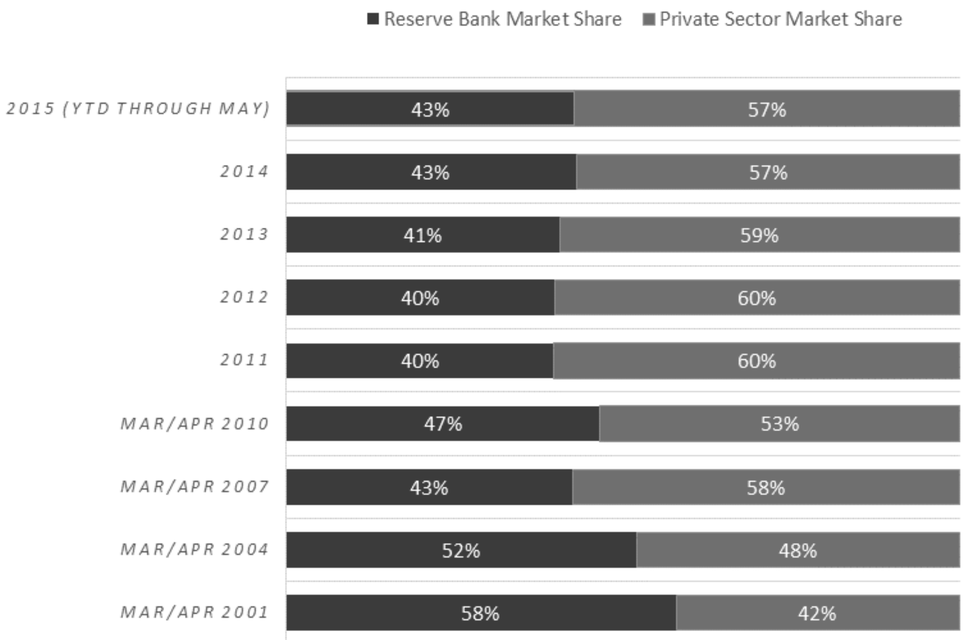
G. *Shift in Electronic Check Volume*

ECCHO argues that the Reserve Banks' competitive advantages, discussed above, have resulted in a material increase in the Reserve Banks' market share for check collection.

ECCHO indicated that between 2012 and 2014, the private sector's electronic check volume fell by 2.1 billion (21.8%), while during the same time period the Reserve Banks' volume fell by only 0.65 billion (10.2%). ECCHO states that electronic check volume shifting from the private sector to the Reserve Banks is due, in part, to the competitive advantages that the Reserve Banks have over the private sector in today's mostly electronic collection environment.

We believe that reviewing the relative market shares of the Reserve Banks and private sector over an extended period of time is more appropriate for assessing the impact of any alleged competitive advantages. As shown in the table below, although the Reserve Banks' market share has increased modestly since in 2012, it remains materially lower than it was before the implementation of the Check 21 Act in 2004.

MARKET SHARE OF INTERBANK CHECKS PRESENTED
2001-2015



Data through March/April 2010 is based on Federal Reserve Triennial Payments Survey and Federal Reserve data. Data from 2011 to 2015 was provided by ECCHO.