Insight

How The Federal Reserve's Automated Clearing House Informs The Fed's Proposed Real-Time Payments Entry

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Executive Summary

- Since the 1970s the Federal Reserve has acted both as regulator and market participant in the provision of automated clearing house services.
- Twenty years of decreasing prices that are not matched by identified cost-savings suggest that the Federal Reserve is using its platform for non-market policy purposes that serve to undercut private providers and benefit the largest banks.
- These lessons and potential conflict of interest concerns must be considered as the Federal Reserve considers also entering the real-time payments space.

Background

The Federal Reserve (the Fed) is considering providing real-time payment services, but this move would not be the first time that the Fed has entered a market as both a regulator and participant. In the early 1970s, the Fed began providing an automated clearing house (ACH) service.

An ACH is an electronic network for financial transactions that acts as a computer-based clearing house and settlement service, processing electronic payments made by financial institutions. It is this network that underpins electronic banking as we understand it today. Administered since 1985 by NACHA (previously the North American Automated Clearing House Association), each year it moves more than $41 trillion and 24 billion electronic financial transactions.

Initially created in the late 1960s by Californian banks with the Calwestern Automated Clearing House Association, from the beginning of ACH history there has been close interaction between private industry and the Fed. ACH advances were inextricably linked with the development of computers, and in the 1960s private computing was not well developed; as a result industry relied on the Fed's computer processing capacity. By 1977 there existed four U.S. ACH providers; the Federal Reserve and three private providers. Ultimately, only one private provider survived, The Clearing House with its ACH service, the Electronic Payments Network (EPN), and the Fed, a duopoly that remains in place today.

Concerns About the Fed's Involvement

For the Fed to be both market participant and regulator is a clear conflict of interest. This combination is also highly unique construct in American economic life; while there are other instances of the private sector is being regulated or supervised by a direct competitor, it is clearly unusual and undesirable. The Fed, as a government entity, is not subject to the Sherman Anti-Trust Act or other laws designed to prevent monopolistic business practices, an exemption that does not apply to its private sector competition.

Further, to intervene in the market without having demonstrated market failure or that private industry is not providing required services contravenes the Fed's mandate under the 1980 Monetary Control Act. Such intervention affects the broader market: Government bodies entering public markets reduces competition, stopping or slowing down innovation. The Fed's provision of these services (whether ACH or real-time payments) can be expected to take years to develop and cost taxpayers hundreds of millions of dollars.

These concerns, however, are not the focus of this analysis. It is better to focus instead on perhaps the most egregious demonstration of the Fed's conflict of interest: the way it prices its services.

The Private Sector Adjustment Factor

Since the 1980 Monetary Control Act, the Fed has been required to charge for the services it provides to financial institutions, most notably ACH (although this requirement would also cover real-time payments). The Act introduced the Private Sector Adjustment Factor (PSAF), the method by which the Fed calculates the direct and indirect costs to provide a service as if it were being provided by private industry. Using the PSAF, the Fed determines the fee schedule for related services on an annual basis.

Although the Fed publishes infrequent updates to PSAF methodology, the actual calculation is not made public and, therefore, the accuracy and appropriateness of the calculation cannot be validated. The Fed does, however, publish an annual return on equity (ROE). This calculation is a percentage of total expense against revenue, which explains what the Fed would 'recover' were it a private provider (i.e. profit). The most recent figures can be seen below.

Dollars in millions

Year	Revenue	Total Expense	Net Income (ROE)	Targeted ROE	Recovery Rate after ROE (%)
	A	*B*	*C (A-B)*	*D*	*E (A/(B+D))*
2017 (actual)	441.6	419.4	22.2	4.6	104.1
2018 (estimate)	441.7	432.0	9.7	5.2	101.0
2019 (budget)	440.2	430.8	9.4	5.4	100.9

At first glance the outlook appears promising. A recovery rate so close to 100 percent indicates that fees charged are appropriate, in that the Fed is barely making a profit. This optimism, however, must be tempered by an understanding that the results say nothing about the assumptions or methodology that underpins the PSAF itself. If the Fed is not accurately assessing the cost to provide its services via the PSAF, then the fees the Fed charges could be artificially low. In that case, the Fed would be capitalizing on economies of scale and explicit taxpayer support to provide services at a price no private competitor could hope to match. It is certainly curious that the Fed has not conducted an audit of its cost-accounting processes for payment systems since 1984; although an audit was discussed in 2016 if it was conducted no results have been made public.

Also publicly available is the Fed's ACH fee schedule itself, and over its history there has been a marked reduction in price. Private industry has also had to cut prices to compete. This pattern has continued for 20 years, and it appears that the Fed is both disadvantaging smaller financial institutions and systematically undercutting private industry in pricing.

The Evolution of the Federal Reserve's Pricing

Aside from opacity around the Fed's cost-recovery practices, we do have insight into the central bank's public pricing of its ACH product. These data clearly show the Fed reduces ACH transaction fees for larger financial institutions operating on its network and charges smaller financial institutions (the vast majority of community banks and credit unions around the country where the Fed has a near monopoly) higher per-transactions costs. We see this differential treatment in practice by looking at the Fed's publicly available pricing schedule for ACH, from which a telling pattern can be readily observed of the Fed giving advantage to the largest financial institutions and disadvantaging smaller ones (and potentially its competitors as well).

The Fed's pricing appears to represent price discrimination designed to attract large customers to its ACH system and away from the private sector competitor. The impact of the Fed imposing volume-based pricing in ACH, which has been in place now for well over a decade, continues today. Looking at the latest available data from the Fed, financial institutions receiving less than 10,500 items a month or sending less than 6,000 items a month ultimately end up paying "1¢ per item received or sent," whereas the Fed charges the largest financial institutions far less. Specifically, financial institutions sending at least 1.25 million ACH items per month and receiving at least 15 million items per month are charged only a fraction of a penny per transaction: 0.22-0.23¢ to send and only 0.14-0.15¢ to receive, almost an order of magnitude less than that charged to most financial institutions.

According to NACHA's 2018 annual list of top 50 ACH originators, only 17 of the largest U.S. financial institutions are eligible for this level of discount. In sum, Fed pricing policies in ACH result in more than half of the smallest community banks and credit unions paying at least 1¢ per ACH item, and the largest financial institutions paying 75-80 percent less per item.

Should the Fed choose to enter the real-time payments market, there should be every expectation that the Fed would again engage in discriminatory pricing in real-time payments, which, through the Fed's history in ACH, does not appear based on cost differences, and which has resulted in pricing inequity between the biggest and smallest financial institutions.

Conclusions

On one level, this apparent price war is not a negative result for consumers. Increased competition drives down prices and increases the quality of services provided. Consumers no doubt have benefitted.

The problem is that it is wholly inappropriate for the Fed to be acting as private competition. The Fed's move to volume discounts that only large banks can achieve have resulted in benefits to larger financial institutions and their customers that have not accrued to small financial institutions and their customers. Providing a service that private entities also provide runs counter to the Fed's mandate. Further, the Fed is a government agency that operates outside of normal cost constraints. This allows the Fed to provide fee schedules that do not appear to be based on market or cost realities but rather to take advantage of the Fed's taxpayer backing to provide services at prices increasingly impossible to provide privately. This development runs counter to the entire spirit of

PSAF.

The lessons learned in the Fed’s provision of ACH services must be considered as the Fed debates entering the private market yet again as a provider of real-time payment services.