IS THE PAYROLL INDUSTRY AT RISK DUE TO ACH SYSTEM USED FOR DIRECT DEPOSIT?

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAX, FINANCE, AND EXPORTS

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

WASHINGTON, DC, APRIL 9, 2002

Serial No. 107–52

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE

79–639 WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON SMALL BUSINESS

DONALD MANZULLO, Illinois, *Chairman*

LARRY COMBEST, Texas
JOEL HEFLEY, Colorado
ROSCOE G. BARTLETT, Maryland
FRANK A. LoBIONDO, New Jersey
SUE W. KELLY, New York
STEVE CHABOT, Ohio
PATRICK J. TOOMEY, Pennsylvania
JIM DeMINT, South Carolina
JOHN R. THUNE, South Dakota
MICHAEL PENCE, Indiana
MIKE FERGUSON, New Jersey
DARRELL E. ISSA, California
SAM GRAVES, Missouri
EDWARD L. SCHROCK, Virginia
FELIX J. GRUCCI, Jr., New York
TODD W. AKIN, Missouri
SHELLEY MOORE CAPITO, West Virginia
BILL SHUSTER, Pennsylvania

NYDIA M. VELAZQUEZ, New York
JUANITA MILLENDER-McDONALD, California
DANNY K. DAVIS, Illinois
BILL PASCRELL, Jr., New Jersey
DONNA M. CHRISTENSEN, Virgin Islands
ROBERT A. BRADY, Pennsylvania
TOM UDALL, New Mexico
STEPHANIE TUBBS JONES, Ohio
CHARLES A. GONZALEZ, Texas
DAVID D. PHELPS, Illinois
GRACE F. NAPOLITANO, California
BRIAN BAIRD, Washington
MARK UDALL, Colorado
JAMES R. LANGEVIN, Rhode Island
MIKE ROSS, Arkansas
BRAD CARSON, Oklahoma
ANIBAL ACEVEDO-VILA, Puerto Rico

Doug Thomas, *Staff Director*
Phil Eskeland, *Deputy Staff Director*
Michael Day, *Minority Staff Director*

Subcommittee on Tax, Finance, and Exports

PAT TOOMEY, Pennsylvania, *Chairman*

STEVEN J. CHABOT, Ohio
DARRELL ISSA, California
EDWARD SCHROCK, Virginia
TODD AKIN, Missouri
FRANK LoBIONDO, New Jersey
JIM DeMINT, South Carolina
JOHN THUNE, South Dakota

JAMES LANGEVIN, Rhode Island
GRACE F. NAPOLITANO, California
ANIBAL ACEVEDO-VILA, Puerto Rico
DANNY K. DAVIS, Illinois
ROBERT A. BRADY, Pennsylvania
MIKE ROSS, Arkansas

Sean M. McGraw, *Staff Director*

CONTENTS

IS THE PAYROLL INDUSTRY AT RISK DUE TO ACH SYSTEM USED FOR DIRECT DEPOSIT?

TUESDAY, APRIL 9, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS,
Washington, DC.

The committee met, pursuant to call, at 2:04 p.m. in room 2360, Rayburn House Office Building, Hon. Pat Toomey (chairman of the committee) presiding.

Chairman TOOMEY. At this time I would like to call the hearing to order and ask the witnesses to take their seats at the witness table, please, if they would.

[Pause.]

Thank you. This afternoon the Small Business Committee on Tax, Finance and Exports convenes to hear from some of our nation's small payroll processing providers and third-party vendors about the problems they are encountering with the automated clearinghouse system that is used for direct deposits. The purpose of this hearing is to learn about the concerns of small payroll processing companies as they endure often significant financial liabilities as a result, in part, of the existing ACH system.

The ACH system, and that stands for the automated clearinghouses, began operating about 30 years ago in response to the increased complications associated with a large volume of paper checks. In an effort to reduce both the number and cost of paper checks, banks in California began experimenting with ACHs. After much success, banks in different regions across the country began similar programs, and in 1974, the regional ACHs coordinated nationally under the National Automated Clearinghouse Association, which goes by the acronym NACHA. NACHA is now the private regulatory organization that oversees ACHs and the direct deposit payroll system.

It should be noted that NACHA was offered an opportunity to testify today, but due to previous commitments they are not able to participate. They have, however, submitted testimony for the record.

A quick description of the ACH system I think is in order here. ACH is basically a batch processing system. A payroll processing company will calculate and develop a file with all the relevant payroll information each pay period for each employee that they process.

These files are forwarded to the company's bank, which will initially sort of any internal accounts to identify employees that use the same bank as the company. The remaining files are then forwarded to the ACH, sorted by destination, and then forwarded to the appropriate bank.

As a result of federal banking regulations, should there be an occasion of nonsufficient funds in an employer's account on payday the payroll company, which is often held liable for these situations, is not allowed to do a reversal transaction to collect the funds back from the employee's account, and herein lies a major part of the problem.

If a client of a payroll processing company, namely, an employer, has insufficient funds to cover a payroll, the payroll processing company can be made to cover the shortfall.

The subcommittee will hear several small payroll providers and third-party vendors who are experiencing problems with the existing system, and I trust any corrections if my account of how the systems works is in any way in error.

But I want to specifically thank a number of folks, starting with Mr. Nick Antich from AD Computer; Ms. Dena Brunskill, the president of Independent Payroll Processors Association; Mr. Chip Dawson from Payroll 1; Mr. Gene Krause with ACH Direct; and Ms. Rita Zeidner with the American Payroll Association for their participation in this hearing.

I look forward to the testimony of the witnesses before us today, and I want to particularly thank my constituent and a member of the panel, Mr. Nick Antich, for bringing this concern about this issue to my attention.

At this time I will be happy to yield to my good friend, the subcommittee's ranking member, Mr. Bill Pascrell, for his opening comments.

Mr. PASCRELL. Thank you, Chairman Toomey, and good afternoon.

Today, no one can doubt the wide saturation of computers and information technology in business. Small businesses led the way during the 1990 economic boom. The numbers speak for themselves. Contributed new technology, software and services that capitalized on emerging information super highway we call the internet.

Even outside the technology sector computers are pervasive. Our one recent survey said 80 percent of small firms use computers for business purposes. Offices today have moved away from paper toward completely electronic business communications and transactions from e-mail to e-commerce, and we persuaded them, we have encouraged that. All the subcommittees of small business have encouraged that movement away from massive paperwork that we still are swimming in.

One survey reported that 27 percent of small firms use the internet for sales, and 44 percent of small firms used the internet for purchasing. Employees too are becoming more computer savvy. More than half of all employees regularly use a PC, and they are frequently taking advantage of electronic services such as internet banking, online bill payments, and shopping on the web. Clearly, we are living through a revolution in the basics of how we do business.

One of the paperless transaction systems that evolved steadily during the last 15 years is direct deposit. It has evolved during the eighties as a novelty, and then flourished during the nineties when the mantra of better, faster and cheaper pushed information technology to new limits and capabilities.

Capitalizing on the new revolution in electronic commerce direct deposit systems now offer substantial savings and money and time by cutting bank processing fees, paper costs, check replacement charges and delays in a time that employees once wasted in line just to deposit their own checks.

However, as useful as direct deposit is to thousands of corporations and millions of their employees, there are significant barriers to these time and cost saving systems. Small businesses often simply do not have the resources to take full advantage of direct deposit, and as a consequence they waste more time and waste more money with older methods of paying their employees.

One of the barriers they face is the prefunding requirement that many direct deposit automated clearinghouse services require. This is a demand that small businesses keep their payroll account flush with cash prior to payday. Unfortunately, many small business simply cannot spare that kind of seat saver money. So they don't take advantage of the service.

Another problem is the fees for direct deposit services. Many of those fees are outlandish. Many banks charge more for their service than small businesses can afford, and if the small businesses cannot fulfill the prefunding requirement the fees charged by the clearinghouses to cover the risk usually push the cost even higher out of range, so that is why we are having this hearing.

When transaction systems are automated and paperless, small businesses can concentrate on what they do best. This constant push for new ways of doing things is one of the reasons American workers are the most productive in the world.

I look forward to hearing from our witnesses today, Mr. Chairman, and I thank you for bringing this problem to our attention.

Chairman TOOMEY. I thank the gentleman from New Jersey.

At this time let me just explain very briefly the way the process will work from here. I will recognize each of the five panelists. If you could please keep your remarks to five minutes. There will be a light system which will be green at the beginning, it will go to yellow when there is one minute left, and go to red when your time has expired.

And after each of the panelists have had a chance to make their presentation, then I will ask a series of questions, followed by ranking member Pascrell, and then any other members of the committee who join us will get their chance at that point.

So at this time I would like to welcome and invite to share with us his testimony, Mr. Chip Dawson.

STATEMENT OF CHIP DAWSON, CO-FOUNDER AND CHAIRMAN, PAYROLL 1, INC.

Mr. DAWSON. Good afternoon, Chairman Toomey and Mr. Pascrell.

Chairman TOOMEY. If you could take the microphone and bring it right up to your mouth, please, that will enable us all to hear you.

Mr. DAWSON. How is that?

Chairman TOOMEY. I think that is going to work.

Mr. DAWSON. Okay. Good afternoon. My name is Chip Dawson. I am co-founder and chairman of Payroll 1. I would like to do three things today: Provide a brief background, frame the problem, and conclude by offering two solutions, one short term and one long term.

Our firm is headquartered in Michigan. We provide payroll processing for 10,000 businesses across the country. We operate from eight states. A few among them are Pennsylvania, Illinois, Missouri, and California.

Payroll 1 serves small businesses from one to several hundred employees, and our average size payroll is 15 to 20 people. Among our services is direct deposit, and we do that utilizing NACHA.

We are testifying today on behalf of our clients and the hundreds of thousands of clients of other payroll processors across the country for whom this system of moving money presents potential hardship.

Direct deposit is a smart way to get paid. It is safe, it is confidential, it is convenient, and we continually look for the most cost-effective and efficient way to provide that service to our clients. NACHA statistics indicate that more than 80 percent of large companies offer direct deposit, but 100 plus employee companies represent a mere fraction, less than two percent in fact, of American businesses.

Among smaller businesses direct deposit has not grown significantly until recently despite being available for many years. That is changing as demand for direct deposit picks up momentum in our ever-expanding electronic age.

But the fees many banks charge for originating direct deposit transactions have increased over the years, to the point that they are just too high for small businesses to bear. These high bank fees have compelled payroll companies to search out alternatives for direct deposit processing.

Now, one method we found is to consolidate direct deposits for multiple employers through a single ACH originator, such as one bank. That way a payroll company is able to create enough volume to attract third-party vendors to provide services at substantially lower fees than banks will offer. However, the single source is not the employer's bank, and therefore will not bear the risk of insufficient payroll funds, so it is up to the payroll company to make that choice.

The ACH system of today is a batch processing system that relies on overnight transmissions, and consequently the payroll company, the way we operate, is the initial receiver of the funds and cannot be certain in some cases that sufficient funds were transmitted until after employees have already been paid and receive their monies.

As a result of this uncertainty, small businesses are frequently disadvantaged in obtaining direct deposit services because they must choose from a series of unattractive options. A small business has three basic choices:

It can have its payroll company send direct deposit files directly to the employer's bank. As I have said, that results often in high bank fees and likely diminished use of direct deposit by small businesses.

It can have its payroll company use a third-party vendor to send direct deposit files. This alternative is unacceptable to a responsible payroll company because it puts them at risk of NSFs.

Now, this risk can be mitigated by the employer either by prefunding the account well in advance of payday or executing a letter of credit in favor of the payroll company, but arguably neither is the most efficient use of capital in a small business.

It can choose one of the largest payroll processors who may accept the NSF risk, but then the employer is losing the individualized attention and personal service that is often the fundamental reason for choosing the smaller payroll company in the first place.

I would conclude by offering two possible solutions. For the short term, change the NACHA rules to permit payroll companies to reverse entries from employee bank accounts in the event that the employer does not fund the payroll. And for the long term, to utilize a different system. Take advantage of newer technology as the funding source for direct deposit in the ACH network.

For example, automated teller machine or point of sale network operates in real time, and thus could enable an ACH originator to verify funds at the time a transaction is initiated rather than finding out later that the funds are insufficient.

I thank you for the opportunity to testify here today on this important issue, and I will be glad to try and answer any questions you might have.

[Mr. Dawson's statement may be found in appendix.]

Chairman TOOMEY. Thank you very much, Mr. Dawson.

At this time I would like to welcome and recognize Mr. Nick Antich, AD Computer in Center Valley, Pennsylvania. Welcome.

STATEMENT OF C. NICHOLAS ANTICH, PRESIDENT, AD COMPUTER CORPORATION

Mr. ANTICH. Good afternoon, Chairman Toomey, and members of the subcommittee.

My name is Nick Antich. I am president of AD Computer Corporation in the Lehigh Valley, Pennsylvania. We are a payroll processing company.

I am here today to alert you to the fact that when the automatic clearinghouse is used for payroll direct deposits, the small independent payroll computer company is put in peril and at great risk when there is a nonsufficient funds situation.

With the advent of automated electronic bill payments, ATM machines, the internet, and debit cards, the public has become accustomed to electronic funds transfer. This has resulted in a great increased demand for payroll direct deposit over the last few years. There has been a switch from just the largest companies offering direct deposit to their employees to the very smallest companies. We are talking about companies with two to three to five to ten employees.

Small companies want to have the same efficiencies as the larger businesses. In addition, they have to offer similar options to their employees to retain them.

In the U.S., there are three major public national payroll companies, and there are several behind them, and then there are approximately 3300 small independent payroll computer processors.

The problem I am bringing to light is really a problem for the small, independent payroll computer processors. As was already stated, when direct deposit is offered, the small payroll processor must offer direct deposit to be competitive with the large payroll companies, a file is created of which there are multiple transactions. There is one debit from the employer's account and a credit to each of the employee's account.

This file is then sent to an originator that originates or sends it through the ACH system. In the past that has always been the bank that the employer dealt with, that he had his accounts with. And if there were multiple companies dealing with the same bank, the payroll company would put all of the companies on one file, send that to the bank once a day, and then those transactions would be processed.

The bank had determined particular limits that the direct deposit file could have for each customer based on their risk assessment and their relationship with the customer. Therefore, there was very, very minimal risk of an NSF. Should that direct deposit exceed their limit, they would not originate the funds until they contacted their customer to make sure there would be funds or made other arrangements.

Third-party ACH vendors were established. This has eliminated the sending of the files to the banks, and therefore have put the small payroll companies on a level playing field with the large national public payroll companies.

The big problem is that banks are more dependent on fee income today than they ever have been for their earnings, and they are charging sometimes five and ten times what they charge for the exact very same service that we had in the eighties and early nineties, and some of the consolidation in the banking industry is responsible for this.

That is the bottom line of the problem. The fees are too high. The small companies cannot afford to go that route. Therefore, we had to use the third-party ACH vendors in order to offer an affordable direct deposit system for small companies which eliminate bank fees.

The problem is we do not have any financial relationship with that customer, neither does the third-party vendor. Therefore, if there is a nonsufficient funds, it is the payroll company who by default is looked to to make good for the funds.

In summary, the ACH system has not been updated to utilize today's technology. It was developed in the seventies when Richard Nixon was president, before PCs, before companies had fax machines, when typewriters were used instead of word processing. Can you imagine doing today's business with the tools of the seventies?

There is a solution, and that can be automatic electronic authorization prior to originating the file, and those tools can be developed with the software companies who develop the ACH and the electronic authorization today, for example, with debit cards.

Thank you very much for the opportunity to testify here today, and I will be very happy to answer any questions you may have for me regarding this important issue affecting all small business.

[Mr. Antich's statement may be found in appendix.]

Chairman TOOMEY. Thank you very much, Mr. Antich.

Next, I would like to welcome and invite Ms. Dena Brunskill, the president of IPPA from Palm Desert, California.

STATEMENT OF DENA L. BRUNSKILL, PRESIDENT, INDEPENDENT PAYROLL PROVIDERS ASSOCIATION; CEO, COMPUTER PAYROLL COMPANY

Ms. BRUNSKILL. Thank you. Good afternoon, Chairman Toomey, and to your committee.

My name is Dena Brunskill, and I am president of the Independent Payroll Providers Association.

Chairman TOOMEY. Excuse me, Ms. Brunskill. Could you bring the microphone closer?

Ms. BRUNSKILL. It will not go.

Chairman TOOMEY. That is all it will go. Okay. Well, then we will just listen carefully.

Ms. BRUNSKILL. Sorry.

[Pause.]

Ms. BRUNSKILL. How is that?

Thank you. Would you like me to start over?

Chairman TOOMEY. If you could, please.

Ms. BRUNSKILL. Okay. Good afternoon, Chairman Toomey, and to your committee.

My name is Dena Brunskill.

Chairman TOOMEY. A little closer still. Sorry. We are going to get this just exactly right.

Ms. BRUNSKILL. My name is Dena Brunskill, and I am president of the Independent Payroll Providers Association, IPPA.

Our organization represents 107 independent payroll service bureaus across the United States. Our members service approximately 50,000 small, medium and large employers, with an estimate of two million employees nationwide.

IPPA's primary focus is to provide forms and resources to assist our members in advancing their respective organizations by facilitating the exchange of best practices and top business resources. IPPA's board of directors come from Kansas, Virginia, California, and Minnesota. Our executive offices are located in Kansas City, Kansas.

My comments today will focus on how our members provide direct deposit service to their clients and the liability to which they are exposed to. For some members that exposure occurs 200 times plus a day. We are here before you to seek your guidance and support in creating a solution to this crisis, both short term and long term.

Many of our members have been directly impacted by this exposure and all feel as if this is a land mine waiting to be stepped on.

There are several different software packages our members use to send their direct deposit files for input into the fed line. The software is dictated by the automated clearinghouse, ACH originator they have chose to do business with.

Banks are the more prevalent choice for an ACH provider. However, third-party vendors are becoming a viable consideration when our members reevaluate their current vendors.

Regardless of the software they use, the ACH originator converts and/or transmits the files into a format required by the National Automated Clearinghouse Association, NACHA, for ACH to the fed line. It appears every region and every ACH originator have differing windows of time in which the payroll provider has to transmit its data. Fees for these services are just as regional.

Our members have implemented in-house procedures and processing steps along with checks and balances to ensure the accuracy of these transactions. Believe me, in our business it really does pay to do it right the first time.

Because this is a repetitive set of steps, it is fairly easy to perfect the procedure as long as the audits are performed within the prescribed time frame. Audits need to be performed by the ACH provider, the payroll provider and the employer. It is the ethical obligation of each to inform the other parties of any problem that would hinder the successful completion of this task.

The most crucial element of the whole equation is timing. Each party has a different timing requirement.

The employer has to know how much and when to make certain the funds are in his account to cover his payroll obligations. He also needs to notify his payroll provider within 24 hours if there is a problem with his service.

The payroll provider has to create schedules based on the client's check dates and the ACH originator's windows to ensure that all the necessary calculations are done by all parties in time to fund the employee's account. The providers are totally dependent upon the employer for the accuracy of the input dates they agreed to during the start-up process. They are also responsible for correctly inputting the employer's information into their software, calculating the data, and completing all segments of the payroll process.

The ACH originator must follow its mandated procedures to ensure all of its checks and balances for its outside auditors and to fulfill the features of its service contract with the payroll provider. They have total control of the NSF information. The timing of furnishing this information to the provider varies. It can be anywhere from 24 hours to seven days. I have been told by my ACH originator a dispute can be submitted up to 30 days after settlement date. In reality, anything longer than four hours is too late.

Payroll providers and ACH originators need to know if the employer has enough money to fund the employees' pay checks electronically before the credit is sent to the employee, bottom line.

The real significance of the situation is who really has control of this process. The employer dictates which employees to pay, how much to pay, when to pay, and what to do with the pay. The ACH originator dictates when the transactions go into the system and when the payroll provider is notified of a problem. The only responsibilities of the payroll provider are the accuracy of the data and to complete the steps of the process.

We believe the technology is available today in some already proven format for a real time solution.

My time is over so I will go ahead and sum up.

Chairman TOOMEY. Finish your thought if you would like, sure.

Ms. BRUNSKILL. As my colleagues have stated, payroll providers need to offer direct deposits to their clients in order to compete with the big guys—end of the story. We have lost hundreds of thousands of dollars paying someone else's employees, not to mention the time and effort expended to collect those losses.

I would like to thank you for this opportunity to present the views of our membership and we look forward to working together to solve this most urgent problem.

Thank you.

[Ms. Brunskill's statement may be found in appendix.]

Chairman TOOMEY. Thank you very much.

At this time I would like to welcome and introduce Mr. Gene Krause from ACH Direct.

Mr. Krause.

STATEMENT OF GENE P. KRAUSE, DIRECTOR OF BUSINESS DEVELOPMENT, ACH DIRECT, INCORPORATED

Mr. KRAUSE. Mr. Chairman, Congressman Pascrell, good afternoon, and thank you for granting the opportunity to appear before this subcommittee, hearing recommendations pertaining to the ACH network as it relates to credit transactions, specifically the impact on companies performing payroll processing and those that process the direct deposit payroll transactions.

My name is Gene Krause, and I am the director of business development for ACH Direct, Incorporated, a California-based company.

My profession and the company I work for evolves centrally around the Federal Reserve's ACH system. We are a company that is commonly referred to as a third-party ACH processor, a company that develops value-added technologies and services for the users of the ACH network, as well as performing ACH transaction processing.

Approximately one month ago, I received correspondence from a company who performs payroll processing, in turn, providing direct deposit via the AHC network for their clients' employees. This correspondence came at an interesting point in time as this topic has been central to our company focus in recent time.

Relayed in the correspondence were frustrations and limitations pertaining to the ACH system as well as thought of alternative solutions to the issues they were faced with. We have known for some time that many share those same frustrations as they are voiced regularly to our staff.

As many end-user companies view it, the electronic distribution or deposit of their company's payroll should not be a difficult task. On the surface, most anyone would draw the same conclusion. These personal theories are borne from the basic principal of thought that because funds must first be debited from the client company's account before being credited to the employees' accounts, there should be no risk or problem in doing so.

Unfortunately, for this industry the ACH network does not provide for real time settlement finality. This operating limitation of a 72-hour risk of return window is then made significant because it requires various levels of collateral or risk alleviation measures to be utilized.

Additionally, the industry or the payroll processing service providers have time constraints brought about by their clients, most of which cannot provide data four days in advance of the deposit credits to employees or for one reason or another do not want their company's operating account debited four days before deposit credits are issued.

The ACH network operates effectively and efficiently under most operating environments. Unfortunately, in the case of credit transactions for the purpose of direct deposit payroll it does not provide the ultimate solution. The central limiting factor, being the lack of real time settlement finality for the debit or funding transaction from where the credit dispersements come from. This limitation creates a severely unbalanced risk-to-reward scenario for any company performing ACH transactions assuming a 72-hour hold of funds has not been imposed.

Without a 72-hour hold of funds, our company would be exposed to a potential loss that is 14,000 times greater than the profit received.

While the ACH network does have operating limitations, the alteration of any rules governing its use would most probably not alleviate the issue of settlement finality. Any alteration to or adaptation for the ACH network that might provide for real time settlement would, in essence, be the creation of a new transaction network.

It is most probable that a solution be found from one of the following areas: One, adaptation of a merging technology that can provide for funding settlement finality; or two, integrated use of additional transaction methodologies for funding settlement with the ACH network being used for credit dispersement transactions.

Either one refers to the use of ATM networks and recent advancements made to them. Over the past year our company has dedicated a good percentage of resources towards the integration to ATM networks which would provide for company growth in the area of debit transactions. To utilize these systems for direct deposit purposes, a few things are still needed:

One, rules adaptation for business account debits; two, increased participation from financial institutions which currently is growing.

Item two refers to the supplemental use of other existing transaction methods such as wire transfers which could eliminate the processor's risk for funding, ideally reverse wires would be used with the origination notification provided by the transaction processor, leading to a more automated solution. This potential solution also has limitations, including the availability. Not all financial institutions are capable of handling reverse wires, (b) increased costs. Wire transfers are much more expensive than ACH transactions. Risk exposure, with reverse wire risk exposure is not eliminated, but rather is transferred to the funding party.

In summary, the current system makes for an unfavorable risk-to-reward scenario which, in turn, makes it difficult for payroll service providers, particularly small companies, to acquire a transaction processing that is flexible enough to meet their needs, and in turn, their clients' needs. There is no doubt that the larger of the payroll processing companies have less difficulty in acquiring and providing for this service, but no matter who is the company or how large they are the risk of exposure is a constant. Only the management thereof can be an effective variable.

And in an effort to be efficient with time, I have limited my oral testimony. I welcome your questions pertaining to it or to my more detailed written testimony.

I thank this subcommittee for allowing our voice to be heard. Thank you.

[Mr. Krause's statement may be found in appendix.]

Chairman TOOMEY. Thank you, Mr. Krause.

At this time I would like to welcome and introduce Ms. Rita Zeidner from the American Payroll Association here in Washington.

STATEMENT OF RITA ZEIDNER, MANAGER, GOVERNMENT RELATIONS, AMERICAN PAYROLL ASSOCIATION

Ms. ZEIDNER. Thank you so much for having me, and I apologize for coming up here and squirming. I injured my knee in a ski accident about a month ago, and I am anxiously awaiting surgery which will speed up the recovery. So if you see me a little squirmy up here, I apologize.

On behalf of the American Payroll Association, I am pleased to address the issues related to the automated clearinghouse system.

The APA is a nonprofit professional association representing nearly 21,000 companies and payroll professionals in all 50 states and Canada. Our membership includes all employees as well as large firms and spans virtually ever sector of the economy, including financial services, retail manufacturing, restaurants, educational institutions, and state and local government. We represent payroll software developers and several hundred third-party payers, including all of the large firms, and hundreds of small and independently owned payroll service providers.

As an organization, we represent our members' interests in a broad range of areas, including the administration of federal and state wage and hour laws, employment tax withholding, remittance reporting and garnishment administration, and needless to say the efficient and cost effective running of the electronic banking system is an integral part of our members' success.

The overwhelming—the majority of our members favor direct deposit as a method of paying workers. In general, they find the system eliminates many of the administrative problems associated with traditional paychecks.

While the savings that can be directly attributed to direct deposit vary from company to company, and are often difficult to quantify, respondents to a 1999 APA direct deposit survey reported that they could save as much as $5 per payment.

Because most states don't allow employers to require their workers to be paid by direct deposit, many of our members conduct elaborate direct deposit campaigns during the workday offering prizes and other incentives to induce their workers to abandon their allegiance to paper checks.

When all other direct deposit marketing efforts fail, some employers adopt policies that make it cumbersome for workers to receive a paper check. For instance, they might insist that paper checks be mailed to the workers' homes with the accompanying risk of late or lost payment, or they may charge an employee for a replacement check, or they may refuse to issue advance payments to workers who will be away on business or on vacation on payday.

Some employers have even looked into the legality of making direct deposit a condition of employment for new hires. Employers in 16 states have succeeded in convincing their state lawmakers to allow mandatory direct deposit. In all of these 16 states the employer can require workers to receive their pay via direct deposit so long as the worker is permitted to choose the financial institution.

And I give you that introduction just to give you an idea of how popular direct deposit is among our members.

My detailed testimony gives some explanation about how employers work with the ACH system, and I think most of the witnesses have already given that presentation, so I will skip over that. But I wanted to talk a little bit about the relationship of employers with payroll processors.

Information circulated by this subcommittee suggests that there are more than 3,000 independent payroll processors handling payroll for U.S. employers. Many of these processors, along with the larger public companies, are members of the American Payroll Association. Both the independents and the large processors vie aggressively for business among APA's 21,000 employer members. These payroll processors market to our members by buying advertising in our magazines, exhibiting in our conferences, and sponsoring payroll-related events, such as National Payroll Week.

In fact, several hundred of these vendors will be leasing space in our exhibit hall during our annual meeting next month in San Antonio.

The active marketing presence of so many payroll processors suggests that competition is stiff, and the fact that about half of our members use a payroll processor to assist in all or part of the payroll administration suggests that business in this industry is thriving.

An informal survey we conducted of our membership in preparation for this hearing supported that premise. As part of this informal survey, we sent an e-mail to several hundred American payroll association members, asking about the fees they pay to originated direct deposit.

And I see I am running a little bit long to. Should I summarize our may I continue?

Chairman TOOMEY. Finish the thought you are on. You have a little time left.

Ms. ZEIDNER. Okay. I received a broad array of answers, and in some instances the banker service bureau processing the payroll charge to flat fee. In other arrangements the employer was charged a flat fee per transmission, plus a fee per direct deposit transaction.

Responses to our informal survey suggested that fees generally range from about three cents to 10 cents per transaction. Some companies paid only per transaction, and in these instances the fee seemed slightly higher, around 15 cents per transaction.

I asked our members whether loss of float figured into their decision to offer direct deposit or not. Information circulated by this subcommittee suggests that at least one smaller payroll processor believes—he or she believes she is at a disadvantage because he or she must ask employer clients to prefund their payroll to ensure that the employer has the funds on hand on payday.

The vendor suggested that the larger service bureaus generally do not have the prefunding requirement. The majority of respondents, including APA's own payroll director, said that prefunding was not an issue for them. Rather, they understood it to be part of the cost of doing business. Companies that were concerned with lose of float took that into consideration when negotiating other fees with their service provider and/or their bank.

And what I would like to do is quickly summarize. I was asked to respond to three proposals, and I would like to quickly go over those.

May I have the time?

Chairman TOOMEY. Okay, if we could do that briefly.

Ms. ZEIDNER. Okay. You asked us how we felt about regulating the fees that banks can charge for direct deposit or via the fed wire system. We do strongly oppose this proposal. Regulation is generally seen as a way to correct market imbalances or stop abuses, and our members don't feel that that's taking place. If they felt that they were being abused, then I think we wouldn't see direct deposit as popular as we see it today.

You also asked us to comment about proposal to allow payroll companies to do reversals from employee accounts when an employer doesn't fund its accounts.

I think it's important to note that NACHA has very specific rules spelling out when an electronic payment can be reversed, and an employer's failure to fund the payroll doesn't seem to fit in with this rule. Reversals for ACH items can be only carried out within five days of the originating settlement date for the item, and they are allowed for only two reason: duplicate payments or erroneous payments.

Some of the service bureau members we interviewed suggested that reversals wouldn't even help them solve the problems they face by underfunded employers. These respondents noted that by the time the service bureau would attempt to recoup the misappropriated funds it's likely that the payee would already have withdrawn the money and therefore the funds would no longer be available to debit.

Because of the problems inherent in initiating a proposal, including the questionable legality under the NACHA rules, and the fact that the money wouldn't be available anyway, several of the service bureaus that responded stressed that risk management was a far more effective means of limiting exposure.

And lastly, regarding the ATM debit network, we don't necessarily have any position on this proposal, but we do support innovative ways of administering payroll, and have been positively impressed by the rollout of payment card systems such as the Visa Payroll Card, and I think Mr. Dawson spoke a little bit about the expansion and use of ATM debit systems as a means of paying folks, so I won't go over that.

I would like to thank you so much for the opportunity to testify here and for your interest in this interesting issue.

[Ms. Zeidner's statement may be found in appendix.]

Chairman TOOMEY. Thank you very much, and I will begin with some questions. I have a number of questions. I would like to first make sure I understand the nature of the problem a little bit better.

First of all, it strikes me that a business model that is all about providing the service of computing the payroll and administering and preparing the payroll need not necessarily also have with it the credit risk component of whether or not an employer has sufficient funds on hand. I do not see why those two features need to go together.

And I guess I want to make sure I understand exactly why they do, so correct me if I am wrong here. But prior to the advent of ACHs, this really was not a problem; is that correct?

Mr. ANTICH. [Nodding.]

Mr. DAWSON. [Nodding.]

Chairman TOOMEY. But since the advent of the ACH system the problem occurs. Now, perhaps Mr. Antich could address this. Others feel free to as well.

Does the problem occur because the payments actually are run through your accounts of your company, and you have an obligation, you have made a credit, and you are waiting for a credit on the other side?

Can you help us with mechanically how is it that you are out of cash when there is nonsufficient funds?

Mr. ANTICH. Well, first of all, we have been doing direct deposits since 1980, and in many cases, and we still do also send files to the bank where the customer has their accounts. There is not a problem in that scenario because the bank has a financial interest with their customer. The bank has the credit limit that they have ascertained because of their risk management and so forth, and they electronically check that file. They know what the funds are for the company that has their account with that bank, so that is not where the issue is.

The issue is really when, because of the extremely higher fees, and as I mentioned, five to ten times as much now as they were in the eighties for the exact same service, when you have a small company with two to five employees they can be charged $100 a month to $125 in order for them to just electronically send this file through the system. That is as much or more than our entire service.

The problem is that there is no real time authorization. The file is now sent to a third party ACH vendor. Neither one of us has any knowledge whatsoever of what the employer has, whether he has funds or not.

There is a date for the credits to hit the employees accounts. This is sent through. Now, sometimes you might debit the account a day or two ahead of time, but still you may not find out for three days after that that there were nonsufficient funds.

So since it is not real time, it is just done, the credits are just sent out. You then find out there is a nonsufficient funds, and if it is after the fact, even if it is the same day as the credits, they are already there, and that is where the transaction has to be made whole. Somebody has got to make good for those credits that went into those accounts.

Chairman TOOMEY. So who is the enforcer on this? Is it one of the banks? Is it a bank employee or is it the bank for the employer, and when they come to you, and they call you up and say this is how much we were short, write us a check? Is that what happens?

Mr. ANTICH. Well, it is going to be in this case the third-party ACH vendor, and Gene might be able to add on to this, they are going to be looking to the company who sent that file, which is the payroll company.

The payroll company is certainly going to try to get the money from the employer, but they may be belly-up. They might be out of business. And if the payroll company goes out of business, then it seems to me it's the third-party ACH vendor who is going to have to make good.

Chairman TOOMEY. So Mr. Krause, in this scenario the first, in the information that there is insufficient funds comes to your firm, and then you, in turn, turn to the payroll processing company; is that what your company does?

Mr. KRAUSE. Correct. In our model of business, ultimately the risk lies with us. However, I mean, if we cannot get the money from Nick's company, we are assuming the risk, and so whatever payroll has not been funded that comes out of our pocket.

Really the whole issues lies around one central point, and that is the lack of settlement finality from the funding of the client company's payroll. The RDFIs have by law 72 hours to respond.

Chairman TOOMEY. Excuse me. What is an RDFI?

Mr. KRAUSE. Receiving financial institution.

Chairman TOOMEY. Okay.

Mr. KRAUSE. In this case the client company's bank is an RDFI because the funding for the payroll is actually a debit from their account. Then we in turn send out credits to the employees.

Chairman TOOMEY. Right.

Mr. KRAUSE. So theoretically, and I will refer you to page 4 of my written testimony, theoretically a company could deposit a paper check on Friday, which is when they send off a file for the ACH transactions to us. They fund their bank account with a paper check. It shows up on the ledger as there being money in there.

We go on Monday and debit that account, send the funds out. We are able to do that because the ledger says there is money there. A day later they come back to us and say, hey, there is no money there. Well, that company all of a sudden is out of business or for whatever reason we cannot get the money. That is where the risk lies and that is why these companies are having a hard time.

Chairman TOOMEY. And given the technology that we have and we talked briefly about other kinds of electronic transfers, ATM, debit cards, mechanism that are in widespread use, seem to work very well as far as I can see, what is preventing a more modern way of solving this problem so that you can look in real time and know that there is money there or there is not, and you have that finality you are talking about? What is the obstacle here?

Mr. KRAUSE. We need a few more good programmers and a little bit more money.

Chairman TOOMEY. I do not understand.

Mr. KRAUSE. We are working on a solution.

Chairman TOOMEY. I mean, the technology exists, right?

Mr. KRAUSE. Yes, it does.

Chairman TOOMEY. Has it not been adopted by this network? Is that the problem?

Mr. KRAUSE. Exactly. We are the first company in the country that is integrated with the Star ATM network which may be a solution to this problem. There are a couple of limiting factors in that the rules are yet to be clarified as to what you can do with this network.

At this moment we are able to look into a DDA or a bank account and find out if there is money there. We are able to do that right now. By the end of this year we will be able to debit in real time, or actually capture or freeze funds, and then the account will be funded the next day. So that is real close to being accomplished.

We have got a couple of issues. Number one, how many participating financial institutions are there to make this worthwhile for this particular industry; and number two—I lost my train of thought here. Oh, the rules pertaining to the business debits. The network essentially was set up for business to consumer, yes, business to consumer transactions.

Chairman TOOMEY. Well, I am going to yield to my colleague, Mr. Pascrell, but then I am going to go back and ask some more questions, and I am going to try to follow up with a question about whether there is existing legislation that in any way impedes the development of this network that would be more efficient or whether there is a need for new legislation to facilitate it, but at this time I will yield to the gentleman from New Jersey.

Mr. PASCRELL. I just have a quick question, Mr. Chairman. I have to run to the other end of the campus for another meeting.

My question to Mr. Dawson is, I mean, we're talking about a lot of money here. Last year, I am looking at the, there was eight billion ACH payments worth over $22 trillion. That is pretty mind-boggling, so we are not talking about nickel and dime stuff here. We are talking about something very critical. And assessing risk is not an easy task. You know, I understand that.

What exactly—I mean, we know that processing a check actually cost the originating bank more than processing any ACH transaction. Just very briefly, how do we assess risk in terms of trying to answer what the Chairman just concluded with?

In order to answer his questions, we are going to have to decide how to assess this risk. How do you assess it?

Mr. DAWSON. Someone might have a better answer than this, but we assess it as we do not want it at all.

Mr. PASCRELL. That is the bottom line, is it not?

Mr. DAWSON. We are not a banker.

Mr. PASCRELL. Right.

Mr. DAWSON. We are not a lender. We are not a credit provider. We are a transaction processor. We get a small fee, six-seven dollars——

Mr. PASCRELL. Right.

Mr. DAWSON [continuing]. For initiating a file, and I think someone made the mention that the risk associated with that, if we choose to accept it, is 14,000 times or something the rewards, that six or seven dollars.

In our case at our company we choose not to accept that risk. We require prefunding, which is an obstacle to ask a small company four or five days ahead of its payroll to fund its entire payroll.

Mr. PASCRELL. So then how would you react, what is your response, what is the answer in your mind?

Mr. DAWSON. The answer to which question? I am sorry.

Mr. PASCRELL. The one you just very—you clarified, you crystallized. I mean, what is our response? Is it legislation? Is it something we need that is already on the books to enforce? What are you suggesting? Less regulation? More regulation?

Mr. DAWSON. You know, actually, I am not certain with the technology being where it is today, that is, it looks like it could provide the solution, I am not really sure what the obstacle is, but it appears to be somewhere embedded in either NACHA or the banking system, or there is a lot of resistance to this occurring, and I really do not know where it is.

Mr. PASCRELL. Yes, sir.

Mr. DAWSON. Nick does.

Mr. PASCRELL. Mr. Antich?

Mr. ANTICH. No, I do not.

Again, just a possible solution, and I know Gene mentioned they are working on something. But number one, we have gotten feedback that banks are not interested whatsoever in making any change because they do not see the risk, and that is number one. So this is really like a problem of moving mountains here.

But I do believe that the technology is available with the software vendors today to come up with a solution. There are various payment types in the ACH NACHA format, and there could be, and this is just an idea, a new payment type, that if that payment type is used, it would automatically interface into a yet undesigned, electronic authorization system designed for commercial accounts. If the account has the funds, the company still has the use of those funds for earnings credit until settlement date, which might be two-three days later, the electronic authorization system would put a memo hold or a reserve on those funds with the date of settlement, knowing that this electronic debit is coming through on that date. To me, that is certainly a potential solution, but we would have to get the banking industry to embrace this. I know we could get the software vendors to do it, and there would have to be some changes in the NACHA rules as well, and formats and payments.

Chairman TOOMEY. Thank you. I have a bill that is on the House floor momentarily, and I am going to have to run down and manage the floor debate on my bill. But I wanted to wrap up with a couple of maybe questions and thoughts.

The changes that we have discussed, the potential solution that Mr. Antich just referred to, and the idea of an alternative, which is real time ability to evaluate whether the money is here or not, is anyone of the opinion that that requires actual legislation to make that happen, or is there a legislative obstacle?

Mr. KRAUSE. Depends on the rules that will come about. This is new, this is new technology.

Chairman TOOMEY. Okay. At the moment is it fair to say that the existing system and methodology and the rules for participating in this network are designed by NACHA and they are within the authority of NACHA, which is, I assume, a voluntary association of members? Is that correct? Is it really?

Mr. KRAUSE. For the AMT networks, I am not sure that all the rules reside within NACHA's operating.

Chairman TOOMEY. I am not referring for the ATMs. I am talking about for payroll processing and settlements, current system.

Mr. KRAUSE. For the current system, yes, correct.

Chairman TOOMEY. Yes. Okay. And there is nothing that—there is no legislation that anyone is aware of that governs or regulates NACHA? I mean it is not—even the reversibility of credits, for instance.

Mr. KRAUSE. There are some FCC rules that——

Chairman TOOMEY. Okay.

Mr. KRAUSE [continuing]. Taken into account, yes.

Chairman TOOMEY. Okay. Is there legislation that precludes reversing out a credit to an account in the event that there is insufficient funds, or is that just a rule of NACHA?

Mr. KRAUSE. I believe that is just a rule of NACHA.

Chairman TOOMEY. Okay. Okay. All right, did anybody have any closing thoughts, if they could be brief, that are important that we have not touched on yet?

Okay, I would like to actually continue for some time with questions, but I have to—unfortunately, leave and get down to the House floor. But I want to thank you all very much for your testimony. This has been very informative, and you have raised some very interesting issues. And if you have any further thoughts on this, please submit them to the committee. We will take them under consideration.

Thank you very much. The hearing is adjourned.

Mr. KRAUSE. Thank you.

[Whereupon, at 3:00 p.m., the hearing was adjourned.]

Remarks of Subcommittee Chairman Patrick J. Toomey

"Are Small Payroll Processing Providers at Risk Due to ACH System Used for Direct Deposit"

April 9, 2002; 2:00 PM

This afternoon, the House Small Business Subcommittee on Tax, Finance, and Exports convenes to hear from some of our nation's small payroll processing providers and third party vendors about the problems they are encountering with the Automated Clearinghouse System used for Direct Deposit.

The purpose of this hearing is to learn about the concerns of small payroll-processing companies as they face increasing costs of operation at the hands of large banks that hold them liable for the transacted funds. The Subcommittee will examine alternatives and solutions to this problem, including the promotion of real-time automated clearinghouse services, regulation of bank fees, and relaxing regulations on payroll processors.

The Automated Clearinghouses (ACH) began operating about thirty years ago in response to the increasing complications associated with paper checks. In an effort to reduce both the number and cost of paper checks, banks in California began experimenting with ACHs. After much success, banks in different regions across the country began similar programs. In 1974, regional ACH's coordinated nationally under the National Automated Clearing House Association (NACHA).

NACHA is now the private regulatory organization that oversees ACHs and the direct deposit payroll system. It should be noted that NACHA was offered an opportunity to testify today, but due to previous commitments, they are not able to participate.

ACH is basically a batch processing system. A payroll-processing company will calculate and develop a file each pay period for each employee that they process, including the amount to be paid, the bank and account number to which the money is being deposited, the account number from which the employer is paying, and the date upon which this transaction is to take place.

These files are forwarded to the company's bank, which will initially sort out any internal accounts to identify employees that use the same bank as the company. The remaining files are then forwarded to the ACH, sorted by destination, and then forwarded to that bank. As a result of federal banking regulations, should there be an occasion of non-sufficient funds (NSF) in an employer's account, the payroll company, which is often held liable for these situations, is not allowed to do a reversal transaction to collect the funds back from the employees' accounts.

Unfortunately, it seems technology and the current economic times may have passed this system by. This process is changing now as banks, looking for revenue, begin to increase fees to companies for direct deposit. This hurts small businesses and payroll processors because the fees are often very high, making it unfeasible for them to take advantage of direct deposit. Consequently, the payroll processing industry is examining ways to alleviate this burden for small businesses so that they may offer their employees similar benefits to larger companies.

The Subcommittee will hear several small payroll providers and third party vendors who are experiencing these problems first hand. I want to specifically thank Mr. Nick Antich, from AD Computer, Ms. Dena Brunskill, President, Independent Payroll Processors Association, Mr. Chip Dawson, from Payroll 1, Mr. Gene Krause, with ACH Direct, and Ms. Rita Ziedner, with the American Payroll Association, for their participation in this hearing.

I look forward to the testimony of the witnesses before us today. I want to particularly thank my constituent, and a member of the panel, Mr. Nick Antich, for bringing his concerns about this issue to my attention.

At this point, I now yield to my good friend, the Subcommittee's Ranking Member, Bill Pascrell, for his opening comments.

Testimony of

Chip Dawson, Co-Founder and Chairman
Payroll 1, Inc.

Before the

Subcommittee on Tax, Finance, and Exports
Of the
House Committee on Small Business
On April 9, 2002

Payroll Industry Seeks to Expand Direct Deposit Usage Among Small Businesses

Introduction

Good afternoon Chairman Toomey. My name is Chip Dawson. I am co-founder and chairman of Payroll 1. Our firm is headquartered in Michigan and provides payroll processing and payroll tax filing services for more than 10,000 clients across the country. We operate from seven branch offices and one licensed office in Pennsylvania, Illinois, Missouri, North Carolina, California, Georgia, Colorado and Michigan.

Payroll 1 serves small and medium-size businesses such as medical offices and other professional services firms, schools, municipalities, restaurants, manufacturers and non-profit institutions. The advantage of using our service is the time that business owners, managers and employees gain to devote to their businesses.

Clients range in size from one employee to several hundred and include start-up and long-established businesses, with one location or several, and multi-state enterprises. Our average client employs 15 to 20 people.

During our 16 years in business, Payroll 1 has grown to meet the needs of clients in all 50 states. Among our services is direct deposit of payroll, utilizing the system provided by the National Automated Clearing House Association (NACHA).

We're testifying today on behalf of our clients and the hundreds of thousands of clients of other payroll processors across the country for whom this system of moving money presents potential hardship.

Direct deposit is a smart way to get paid.

NACHA promotes direct deposit as a smart way to get paid. We subscribe to that view. We have encouraged the use of direct deposit by our clients and have continually looked for the most cost effective and efficient way to provide the service. Direct deposit is safe, confidential, and convenient. Typically, employees who use direct deposit have their pay available to them on the morning of payday, and there is no waiting for checks to clear. NACHA statistics indicate that the chance of having a problem with a live, negotiable check is 20 times greater than with direct deposit. And, if a problem ever does occur, it is typically easy for a company to rectify. Many financial institutions also offer free checking or reduced account fees to consumers who use direct deposit. NACHA figures indicate that 71 percent of employees who have direct deposit available use it, and 97 percent of those who use direct deposit are very satisfied with it. Companies can save up to $1.25 per payment by using direct deposit instead of checks. As a result of the many benefits of direct deposit, more than 80 percent of large companies with 100+ employees offer direct deposit, and it has become a staple in today's employee benefits packages. But 100+ employee companies represent a small fraction, less than 2 percent, in fact, of American businesses.

The rising expense of direct deposit

Among smaller businesses, direct deposit has not grown significantly until recently, despite being available for many years. As the public's use of the Internet and all forms of electronic payments and funds transfers has grown, however, so too has the demand by small businesses for direct deposit of payroll. Like other payroll companies, we historically provided the service by sending direct deposit files to each client's bank. That bank would then originate the direct deposit transaction through the ACH system, but only after determining that the client's funds were either present in the client's account or did not exceed the client's credit line with the bank. With the employer's bank acting as the originating bank, the risk of there being insufficient funds available on payday was greatly reduced. This system works and is in use today. The fees many banks charge for originating direct deposit transactions, however, have increased over the years to the point that they are just too high for small businesses to bear. A recent sampling of bank rates in seven of our operating regions found, for example, that a 10 person company with two payrolls per month could expect to pay fees ranging from nearly $50 to as high as $110 per month for a bank merely originating the customer's direct deposit transactions. This compares with the same company's total cost of $80 per month for a fully comprehensive payroll service including the calculating, processing, and printing of all required checks, reports and tax returns.

A less expensive but risky solution

This high expense of originating direct deposit through many banks has compelled many payroll companies to search out alternatives for direct deposit ACH processing. By consolidating the direct deposits from multiple employers through a single ACH originator (such as one bank), a payroll company is able to create enough volume to attract third-party ACH vendors to provide services at substantially lower fees than most banks will offer. This has allowed payroll companies to offer direct deposit services to small businesses at a reasonable price. This method of providing direct deposit service, however, comes with a substantial risk. Since the originating ACH vendor is not the employer's bank, the vendor does not know whether the employer has sufficient funds to cover the transaction and thus the vendor will not agree to bear the risk of an NSF (non-sufficient funding of the payroll) by the employer. In order to provide direct deposit to its clients under this method of operation, a payroll company must choose whether to bear the risk of an employer's NSF.

The ACH System of Today

The ACH system is a batch processing system designed in the 1970s that relies on overnight transmission and is governed by NACHA operating rules. Consequently, the receiver of the funds (the payroll company) can not be certain that sufficient funds were transmitted until, in some cases, after the employees have been paid.

Small businesses are disadvantaged by limited direct deposit options

As a result of the uncertainty of funds availability that is inherent in the way the ACH system currently works, small businesses are frequently disadvantaged in obtaining direct deposit services because they must choose from a series of unattractive options. The direct deposit options available to a small business employer are these:

1) Have its payroll company send direct deposit transmissions directly to the employer's bank. This however, often results in high bank fees and likely diminished use of direct deposit by small business in general.

2) Have its payroll company use a third party ACH vendor to send direct deposit transmissions, which puts the payroll company at risk of NSF. This risk can be mitigated by either pre-funding the bank account well in advance of payday or executing a letter of credit in favor of the payroll company. But, arguably, neither is the most efficient use of capital for a small business.

3) Choose one of the largest payroll processors who may accept the NSF risk, but then the employer is losing the individualized attention and personal service that is often the fundamental reason for choosing the smaller payroll company in the first place.

4) Have its payroll company accept the NSF risk, but the risk (potentially hundreds of thousands of dollars) so far outweighs the reward (typically a $6 or $7 file transmission fee) that this alternative is unacceptable to a responsible payroll company.

We believe that these potentially costly hardships can be avoided and that all businesses interested in offering direct deposit to their employees can benefit by applying new, existing technologies.

Solutions

Short term

Permit payroll companies to reverse entries from employee accounts when the employer does not fund its payroll account.

Long term

Utilize a different system, such as the ATM/POS (Automated Teller Machine/Point of Sale) Network, as the funding source for direct deposit in the ACH system. The ATM/POS Network is a real-time – not a batch processing – system, and could enable an ACH originator to verify funds at the time the transaction is initiated and put a hold on those funds prior to an ACH transmission being sent through the ACH system. If funds are not available, the originator would be notified that the file was not being sent through the ACH system.

Thank you for the opportunity to testify here today on this important issue. I will be glad to try to answer any questions you may have.

Testimony of

C. Nicholas Antich, President
A D Computer Corporation

Presented before

The United States House of Representatives
House Small Business Committee
Subcommittee on Tax, Finance and Exports
The Honorable Patrick J. Toomey, Chairman

April 9, 2002

"Direct Deposit of Payroll Puts Small Independent Payroll Processors at Risk"

Introduction

Good afternoon Chairman Toomey and members of the subcommittee. My name is Nick Antich and I am president of A D Computer Corporation, a payroll processing company in the Lehigh Valley, PA. I would like to make you aware that the Automated Clearing House system, known as ACH, which is used for direct deposit of payroll, puts small payroll processing companies at risk when there is non sufficient funds (NSF).

Background

With the advent of electronic bill payments from consumers' bank accounts, the increased use of debit cards, ATM machines and the Internet, the public has become accustomed to electronic banking. This change in the public perception concerning electronic transfers of funds has dramatically increased the demand for direct deposit of payroll. With direct deposit, funds are electronically credited to an employee's bank account for their net pay and the total of all employees' direct deposit is electronically debited from the employer's bank account. The use of direct deposit is expected to greatly increase over the next few years and into the foreseeable future.

More than one million businesses, large and small, outsource their payroll functions to third party vendors. There are approximately 3300 independent payroll processors in the United States. The payroll industry collects and remits billions of tax revenues for the federal government through payroll deductions each year.

With the increased demand for direct deposit, small independent payroll processing companies have had to offer direct deposit services to their clients to stay competitive with the large national payroll companies. There has been a definite shift from only large employers offering direct deposit to now the very smallest of businesses offering direct deposit to their employees. Small businesses have to become more efficient just like large corporations and also must offer similar options to retain their employees. In the past, payroll companies would send direct deposit files to each client's bank and the bank would originate the direct deposit transaction through the Automated Clearing House (ACH). In this scenario the bank would check the total direct deposit debit for the company against the limit that they established for that client, based on their risk assessment, before the ACH credits would be released. This would reduce the possibility of non-sufficient funds (NSF) from the company on the day of settlement. However, should an NSF occur, the bank funds the debit and then uses the leverage they have with the client to take appropriate action to collect NSF funds from the employer and charge fees to collect those funds. This system has been utilized for 30 years and is still used today. Unfortunately, now many banks are looking to increase revenues through increased fees to clients for direct deposit. In many cases the fees are so high, it is not feasible for small businesses to take advantage of direct deposit.

This forced payroll companies to look elsewhere for ACH processing. The need was recognized and third party ACH vendors were created. This allowed payroll companies to offer direct deposit to smaller companies and to circumvent onerous bank fees. The independent payroll companies create ACH transactions for the employer and send the file to a third party ACH vendor who originates the file through the ACH System. The file has a credit transaction to each employee's account and one debit transaction to the employer's account. Neither the payroll company nor the third party ACH vendor, under the present system, knows whether the employer has the funds to cover the transaction. They are just providing a service and have no financial interest connected with their customer. If the employer does not fund its account, the transaction has to be made whole. The payroll company becomes liable for the funds that were transferred to the employees' accounts. In addition, under the present rules governing ACH transactions, the payroll company, who is just providing the mechanism for the employer to transfer payroll funds, is not allowed to do a reversal transmission to collect the funds back from the employees' accounts in the case of an NSF from the employer.

The present problem stems from the fact that the ACH system, designed in the 1970's, has no real time clearing and settlement. It is a batch system with overnight transmission, meaning ACH is basically a handshake and a promise between sender and receiver. The unfortunate realities of business today is that NSF's are occurring more frequently than in the past. While the banks have additional leverage due to the fact that they can check account balances and usually hold liens and have other options available to them to collect funds and some very large public payroll companies have large reserves of cash to cover losses, most independent payroll processors do not. Thus a large direct deposit NSF could put a payroll company out of business.

With the way the present system is designed there are only three options for independent payroll companies. The first is to stop offering direct deposit, which would put them at a competitive disadvantage with the larger payroll companies and impede the growth of electronic funds transfers. The second would be to go back to sending transmissions to each employer's individual bank. This would preclude many small employers from using direct deposit due to many banks charging onerous bank fees. In addition, some banks do not want to deal with multiple payroll processing companies and others don't originate ACH files. The final option is to continue to use the third party ACH vendors to transmit direct deposit for the clients. This creates a level playing field for all the independent payroll companies to compete with the largest payroll companies but puts each organization at risk of NSF's from employers.

The non real-time nature of today's electronic payment services introduces substantial risk to small independent payroll companies. There is no relationship between the fee that payroll companies can competitively charge for providing a direct deposit service to their customers and the risk involved. The fee is $6.00 or $7.00 for creating a direct deposit file, which may have a direct deposit debit of $100,000 or more. If there was an NSF this could easily put a small payroll company out of business.

As stated, under the present system there are no viable options for the payroll industry. This is why we are looking at the other possible solutions listed below.

Possible Short Term Solution

- Regulate the fees banks can charge for direct deposit. However, this is still not a complete solution.
- Allow payroll companies to do reversals from employee accounts when an employer does not fund its account. However, the notification of an NSF is usually several days after the date the funds have been credited to the employee's account and may no longer be there. This also is not a complete solution.

Long Term Solution

- Use a system similar to the Debit Card network, with real time electronic authorization available to the ACH system. Debit Cards and electronic authorization evolved from the credit card industry. They needed a real time way to create authorizations for purchases. They could not use the ACH system because it is an overnight batch system, not real time. Debit Cards with electronic authorization became popular in the 1990's. They circumvent the federal reserve batch system and directly check the consumer's bank account balance. This type of electronic authorization would have to be expanded to commercial bank accounts and integrated into the ACH system. The electronic authorization system checks the previous night's balance and that day's credits and debits on file and if the funds are available a withdrawal memo is created. Settlement is then done that evening. With a new ACH payment type (Standard Entry Class Code), the electronic authorization system would be used by ACH originators to check for funds availability and put a memo hold, or reserve, on those funds before an ACH transmission is sent through the ACH system. The reserve would designate the debit coming through the ACH system on settlement date and would be held to satisfy that debit. If funds were not available in the amount of the debit, the file would not be sent through the ACH System and a notice would be sent to the company who created the file. NSF risk would be minimal. There is presently no incentive for the banks to change the system. The banks take advantage of ACH system inefficiencies by charging high consumer fees.

Summary

The problem is we are using a thirty year old ACH system that was developed when Richard Nixon was President, before PCs, before companies had fax machines, and when typewriters were used because there were no word processors. The ACH system has not been updated to utilize technology that is available today. Can you imagine doing today's business with only the tools available in the 1970's. If you try to buy $40 worth of groceries with a debit card, the transaction is not authorized if the funds are not available. Why then should a system send through credits to bank accounts which could amount to $100,000 or more, when that system doesn't know if there are any funds to cover those dollars. Under the present rules governing ACH transactions, the transaction cannot be reversed and it is the payroll company, who is just providing a service which facilitates the use of direct deposit by creating the ACH file, who is looked to for making the transaction whole. The present ACH system is impeding the growth of direct deposit for the customers of the small independent payroll companies, as well as putting them at great risk when an NSF occurs.

Testimony of

Dena L Brunskill
President, IPPA (Independent Payroll Providers Association)
C.E.O., Computer Payroll Company

Before the

The United States House of Representatives
Committee on Small Business
Subcommittee on Tax, Finance and Exports

Patrick J. Toomey, Chairman

April 9, 2002

Rayburn House Office Building
2:00 PM - Room 2360

Good afternoon, Chairman Toomey, and to your committee. My name is Dena Brunskill, and I am President of the Independent Payroll Provider Association, (IPPA) Our organization represents 107 Independent Payroll Service Bureaus across the United States. Our members service approximately 50,000 small, medium, and large Employers, with an estimate of 2 million Employees nationwide. IPPA's primary focus is to provide forums and resources to assist members in advancing their respective organizations by facilitating the exchange of best practices and top business resources. IPPA's current Board of Directors come from Kansas, Virginia, California, and Minnesota; our Executive offices are located in Kansas City, Kansas.

My comments today will focus on how our members provide Direct Deposit service to their clients and the liability which they are exposed to. For some members, that exposure occurs 200 plus times a day. We are here before you today to seek your guidance and support in creating a solution to this crisis, both short and long-term. Many of our members have been directly impacted by this exposure and all feel as if this is a land mine waiting to be stepped on.

There are several different software packages our members use to send their Direct Deposit files for input into the Fed Line. The software is dictated by the Automated Clearing House (ACH) Originator they have chosen to do business with. Banks are the more prevalent choice for an ACH Provider; however third party vendors are becoming a viable consideration when our members re-evaluate their current vendors. Regardless of the software they use, the ACH Originator converts and/or transmits the files into a format required by National Automated Clearing House Association (NACHA) for ACH to the Fed Line. It appears every region and ACH Originator have differing "windows" of time in which the Payroll Provider has to transmit its data. Fees for these services are just as regional.

Our Members have implemented in-house procedures and processing steps, along with checks and balances, to insure the accuracy of these transactions. Believe me, in our business it really does "pay to do it right the first time". Because this is a repetitive set of steps, it is fairly easy to perfect the procedure as long as the audits are performed within the prescribed timeframe. Audits need to be performed by the ACH Provider, the Payroll Provider, and the Employer. It is the ethical obligation of each to inform the other parties of any problem that would hinder the successful completion of this task.

The most crucial element of the whole equation is timing. Each party has a different timing requirement. The Employer has to know how much and when to make certain the funds are in his account to cover his payroll obligations. Also he needs to notify his Payroll Provider within 24 hours if there is a problem with any element of his service. The Payroll Provider has to create schedules based on the clients check dates and the ACH Originator's windows to ensure all the necessary calculations are done by all parties in time to fund the Employee's account. The Providers are totally dependent on the Employer for the accuracy of the input dates they agreed to during the start up process. They are also responsible for correctly inputting the Employer's information into their software, calculating the data and completing all segments of the payroll process. The ACH Originator must follow its mandated procedures to ensure all of its checks and balances for its outside auditors and fulfill the features of its service contract with the Payroll Provider. They have total control of NSF information. The timing of furnishing this information to the Provider varies. It can be anywhere from 24 hours to 7 days and I have been told by my ACH Originator a dispute can be submitted up to 30 days after settlement date. In reality, anything longer than 4 hours is too late! Payroll Providers and ACH Originators need to know if the Employer has enough money to fund the Employees paychecks electronically **before** the credit is sent bottom line!

The real significance of the situation is, ***Who Really Has Control Of This Process?***. The Employer dictates which employees to pay, how much to pay, when to pay, and what to do with the pay. The ACH Originator dictates when the transactions go into the system and when the Payroll Provider is notified of a problem. The **only** responsibilities of the Payroll Provider are the accuracy of the data and to complete the steps of the process! We believe the technology is available today in some already proven format to allow for a real time solution. It may need to be adapted to meet the needs of this application; we need to think out of the box. Naturally, the Employers and the ACH Originators are not as interested in making changes as fast as payroll providers are, but they're not the ones exposed to the liability. However, my experience with them has been one of support, because ultimately the changes will benefit everyone.

We requested feedback from our Members as to how this has affected their business. Some of the responses were "Boy did you hit a sore spot with me. I am dealing with this issue right now with the banks. Their ACH department's cooperation and attitude has changed in the past few months. They have forgotten who the customer is". And this one; "I receive my client's funds 2 days in advance; this should be plenty of time to notify me if we have a problem before it gets out of hand. In this day and age of automation, I would think we would be able to find out before the file is processed if there is a problem." Another said "our big concern is the amount of time it takes to receive notification from our client's bank of an NSF problem. It can take 4 or 5 days after effective date that we receive this notice. We have had several problems where the client was not able to cover its payroll and then we have to go back to the employees and try to recover the funds. As you know, most people start spending their pay the day they get it, sometimes before payday. Going to the employees has not proven to be a successful way for us to recover our money. The other steps are to file a civil suit or wait our turn in Bankruptcy Court. We don't have much success going this route either". One more point regarding Direct Deposit NSF's, "When clients enter into bankruptcy and the Payroll Provider is involved because they bounced a direct deposit, we are treated as a general creditor. Our opinion is that we should be given preferential priority because we have paid ***their*** employees".

As my colleagues have stated Payroll Providers need to offer Direct Deposits to their clients in order to compete with the big guys - end of story! Payroll Providers have lost hundreds of thousands of dollars paying someone else's Employee, not to mention the time and effort expensed in trying to collect those losses. If the Payroll Provider is fortunate enough to recover some or all of the funds, the compensation never equals the exposure. It's the equivalent of getting a loan interest free. I know of no other organization in the United States who is forced to accept this exposure.

I would like to thank you for this opportunity to present the views of our membership. We look forward to working together to solve this most urgent problem. I will be pleased to try to answer any questions you might have.

Hearing on the Automated Clearing House System
As related to credit transactions for the payroll processing industry

Testimony Presented before
The United States House of Representatives
Committee on Small Business
Subcommittee on Tax, Finance and Exports
The Honorable Patrick J. Toomey
Chairman

Tuesday April 9, 2002

Testimony Presented by
Gene P. Krause
Director of Business Development
ACH Direct, Inc.

Supplemental Testimony Presented by
John Zieglgansberger
ACH Direct, Inc. Advisory Board Member

Contents

ACH Direct, Inc.

ACH Direct, Inc. is a privately held California corporation located in the Coachella valley near Palm Springs. Our company's focus is the creation of value added systems, technologies and tools for the processing of electronic financial transactions, primarily ACH transactions. ACH Direct, Inc. is a "third party" ACH processor. As such, we gain access to the Federal Reserve ACH system through a sponsor ODFI (Originating Depository Financial Institution). Our ODFI relationship affords ACH Direct, Inc. the ability of total risk management and associated underwriting duties, making all financial transactions the fiscal and regulatory risk of ACH Direct, Inc.

ACH Direct, Inc. was founded in 1998 and it continues to grow and prosper. The client list includes such companies as DirecTV, Verizion and Cingular, as well as many payroll processing companies, the like of those testifying before this subcommittee today. For additional information on ACH Direct, inc. please visit our website: http://www.achdirect.com.

Present Issue and Current Environment

ACH credit transactions for the purpose of direct deposit payroll present a number of restrictive characteristics, all of which are central to the issue of assumed financial risk for the dollar volume of the corresponding transactions, and how that risk is managed. On the surface it appears that ACH "credit" transactions would be nearly free of risk. Certainly that is how the vast majority of our clients and prospective clients view it. Their observation is that "if we are sending out money, there is no risk because it must come out of our account first, before being credited to the receiving account." This statement is far from reality.

In order to better understand these restrictive characteristics, it is appropriate to examine ACH Direct's typical risk exposure and loss from a single company who is originating payroll credit transactions:

In this example, 'ABC Company' has contracted with ACH Direct, Inc. for the processing of direct deposit payroll. ABC Company has 500 employees with an average net salary of $40,000 annually. Their payroll processing period is bi-weekly, thus ABC Company transmits an electronic file every two weeks to ACH Direct, Inc. having a total dollar volume of

$769,230.00. ACH Direct, Inc. has assumed the risk for these transactions from the time they were submitted by ABC Company to the time of settlement finality, 72 hours after the debiting of ABC Company's operating account for the funding and delivery to ABC Company's employees. ABC Company has been a client of ACH Direct for nearly two years, but unbeknownst to ACH Direct, ABC Company has recently become fiscally unstable. For this current payroll period, ABC Company had to deposit a paper check from a different company account the same day (Friday) that the electronic payroll file was delivered to ACH Direct. Once ACH Direct receives the file we then debit ABC Company's account and fund their employees. All goes well until Monday. On Monday it is found out that while ABC Company's bank account ledger reflected a balance sufficient to fund the payroll volume, the paper item that was deposited on Friday resulted in a returned item. ABC Company's bank will then demand funds from ACH Direct to cover the loss. ACH Direct as the originator for ABC Company bears the risk of the payroll transaction until the time of finality of the funding debit transaction.

Given the potential financial loss ACH Direct can incur from payroll transactions it makes sense to utilize every precaution available.

Additionally, ACH transactions are typically priced per transaction, with transaction dollar volume playing no role in fees or profit. A typical payroll transaction provides for approximately $0.10 profit per transaction. So, ABC Company was providing ACH Direct about $50.00 pre tax profit for each two-week payroll period, while being exposed to the potential loss of $700,000+ for that same payroll period. To charge fees based on dollar volume of transactions would quickly place an end to direct deposit payroll. Companies would simply not allow for a percentage of a direct deposit transaction to be charged to them. Thus we are left to seek other protections, of which we will examine here:

1. To have the client company provide an irrevocable letter of credit from their bank in the amount of their company's payroll volume per payroll period. *Quite simply, many companies are not going to use a sizable portion of their available credit just to enable electronic deposit of employees' payroll.*
2. To provide ACH Direct with a security deposit in the amount of their company's payroll volume per payroll period. *Once again, too restrictive to the client company.*
3. Impose a 4 day "hold of funds" allowing the 72 hour risk window to close before funding the employee accounts. *On the surface this*

seems like a logical method and choice for the elimination of risk while providing the low cost direct deposit transaction to take place. Unfortunately, client companies are not able to supply the required data file far enough in advance to enable the 4 day hold. This industry expects that when a data file is delivered for payroll processing, that the funding takes place immediately.

4. Employ strict underwriting criteria to any company applying for ACH credit transaction services. *This option is a given, but the simple fact is we can not predict the future. One needs to look no further than recent corporate failures to see that no matter what criteria and guidelines are employed, the risk is there and a resulting loss is possible.*

Effects of Current Environment on ACH Direct, Inc.

As mentioned in the introduction, ACH Direct continues to prosper; even though ACH credit transactions from payroll deposit plays only a small role within our company. Currently, ACH Direct's transaction processing volume is comprised largely of debit type transactions. The percentage of credit transactions from payroll deposits accounts for less than 5% of our monthly transaction volume. While I can not ever foresee the potential for credit transactions to equal that of the debit transaction volume, it certainly could account for a greater percentage than 5%. Because of the overall positive economic environment that ACH Direct currently enjoys, we have not put forth the resources to analyze the specific fiscal impact to ACH Direct.

The current environment for direct deposit transactions certainly hinders ACH Direct's growth within that sector. However, this also presents a potential opportunity for companies like ACH Direct, to discover or develop methods and technologies to overcome or mitigate existing obstacles related to direct deposit transaction processing.

In summary, the enormous risk far outweighs the profits of direct deposit ACH transactions. As in the ABC Company demonstration, a \$100.00 per month profit is far outweighed by the constant risk exposure of \$700,000.00. While the Federal Reserve and NACHA market and push for more companies to participate in direct deposit payroll, the very system they tout for this purpose has hindering qualities that retard such growth. Under the current operating environment, ACH Direct has no interest in marketing for, or acquiring new payroll transaction business. In fact, I would estimate that our lost opportunity costs from explaining risks to prospective clients outweighs our existing profits from direct deposit payroll clients.

Effects of Current Environment on Companies Providing Payroll Services.

While neither I nor anyone from ACH Direct can offer complete testimony from the viewpoint of a payroll processing company, we do have such clients and do hear their issues on a frequent basis. When discussing the existing restrictive characteristics pertaining to ACH credit transactions, our clients and prospects echo what we have already put forth, and depending on the particular company have additional thoughts and concerns.

Some of these payroll processing companies' enjoy a similar ODFI bank relationship as ACH Direct. However, as before stated, this type of relationship brings the risk for each companies transactions. Given the fact that these payroll processing companies are not first and foremost an ACH processing company, they are less likely to effectively manage and underwrite the risks incurred. There is no doubt that the small and mid-sized payroll companies want to incur such risk. Should a loss from exposure occur, from just one company, it could very well doom the payroll company.

Some payroll processing companies will have a third party such as ACH Direct assume the risk. I have already provided examples relating to the safeguards that we impose for such clients. This makes it necessary for these payroll processing companies to adhere to our restrictive policies, curtailing their ability to offer direct deposit payroll in the same fashion as the larger of the payroll processing companies.

The large payroll processing companies have the resources, funds and banking relationships that allow for a more streamlined acceptance procedure for direct deposit payroll. The very fact that their risk is spread-out due to the larger mass of client companies is helpful in the management of their risk. With that said, these larger companies share the same pit-falls as the rest of us, and would welcome methods to eliminate risk relating to their payroll deposit transactions.

Improvements to Existing ACH System

While the ACH system has certain restrictive characteristics pertaining to the Payroll processing industry and payroll related credit transactions, it does function quite well for other uses.

So, the question must be asked "can improvement be made to the ACH system that will better accommodate the payroll processing industry?" The ACH network itself can not be altered to accommodate one industry. To do so would in essence be creating a new network in itself. Rules could be looked at for amendment, but the risk responsibility will still be evident in any system where funds settlement finality is anything short of real-time.

It is this person's opinion that solutions to the payroll processing sector of ACH credit transactions are to be found from other methods than improvements to the existing ACH system or rules.

Solutions Using Emerging Real-time Technology

Over the past year various enhancements have been made to the existing ATM networks. One of which now allows for verification of funds from a consumer DDA, without the use of a PIN normally associated with an ATM transaction. In its present status, this technology does not present a solution to our issue before us, but the ongoing evolution of this technology does have great promise in this area.

ACH Direct has dedicated a great percentage of its resources in the development and integration of this technology. Today ACH Direct offers the services ATMverify™ and ATMcheck™. ATMcheck presents the ability to look into DDA's in real-time and capture *or reserve* funds for settlement.

In the most basic terms, what ATMcheck does is route electronic debit transactions through our nation's ATM network rather than the ACH network. By utilizing this method, ACH Direct not only is able to know with absolute guarantee that the funds necessary to process a particular company's payroll are present, but we are also able to immediately debit those funds from their company's business account without delay.

The ATMcheck process is completely automated and does not require any manual interaction which is required for wire transfer or reverse wire transfer transactions. The cost for the ATMcheck debit transaction is slightly more in cost (about ten cents more) to an ACH debit transaction.

Credits to the employee's accounts would take place in the same manner in which Direct Deposit takes place today- over the ACH network. Because funding for the dispersement(s) has finality, credits may be issued by virtually any method a client would care to use. If on the other hand, a payroll processing company needed the funds to credit to the employee's account immediately, then the ATMcheck could be utilized. Some of the advantages of using the ACH network for sending the credits rather than the ATM network are:

- The most cost effective method available today for moving money.
- No need to change receiving bank's procedures.
- No change required by consumer (no new forms or contracts to fill out, no new account numbers, nothing new to learn)
- Extremely large participation – Over 95% of financial institutions in the US are able to receive electronic credits via the ACH network.

The ATMcheck service was initially designed as a method for merchants to perform real-time electronic check conversion for *consumers* at the point of sale. With some minor changes to the legal framework in which we perform these electronic debits, the ATMcheck service could easily be used to process our nation's Direct Deposit transactions.

Limitations

Although this sounds like the ultimate solution, there is one limitation. Currently there are only a few major banks that are participants in the ATMcheck service. The current list includes: BB&T, First Union, and Union Bank of California. Scheduled for 3rd and 4th quarter of this year is:

- Bank of America
- Citibank
- US Bank
- Wells Fargo (early in 2003)

Although the current list of participants is small, the interest and list is growing very rapidly. Connectivity can be achieved to almost any financial institution via one of the participating ATM network providers: STAR, NYCE, and PULSE. Implementation can be achieved at rates which are well within reach of all but the smallest institutions and typically takes around 3 months to complete.

Because the vast majority of the transactions will occur over the existing ACH network, massive participation (and major infrastructure upgrades) is not required. The only requirement will be that the company who wishes to offer Direct Deposit payroll services to their employees will have to bank at one of the participant's banks.

Requirements to facilitate

The only item remaining to facilitate this solution is to establish the operating rules between the financial institutions and the ATM networks. These operating rules provide the legal framework for performing the ATM debits, and must be modified in order to address the unique aspects of processing Direct Deposit payroll transactions.

Conclusion

The infrastructure is building, the technology is proven, the solution is very cost effective, the risk is eliminated, and the solution requires no changes for the employees or to the institutions receiving the Direct Deposit transactions.

By employing this method for the processing of Direct Deposit, payroll companies can provide the absolute highest level of service at the best possible cost structure.

Solutions Using Existing Alternative Infrastructure

An alternative solution to the utilization of ACH to process the Debit portion of a payroll transaction is by the supplemental use of Reverse Wires. Reverse Wires allow the Processing Vendor to initiate a wire to fund the Direct Deposit of Payroll. The process guarantees the processing vendor collected and available funds for the Direct Deposit to employee's accounts using the ACH Network, thus eliminating the risk of a return due to unavailability of funds. It is also the fastest method of funding a payroll transaction.

Unfortunately, this is a stop gap solution which does not function for all payroll companies, nor their client base. The limitations include:

1) Increased cost; the cost to process the reverse wire can be as high as $70.00 per transaction as opposed to $0.10 for an ACH transaction.

2) Availability; Today not all depository institutions are capable of initiating or processing a reverse wire. This limits the solution to those clients who maintain relationships with depository institutions which allow for reverse wires.

3) Risk exposure; With Reverse Wires, risk is not eliminated, but

rather the risk is transferred to the Funding Party, and potentially exposes the funding party to unauthorized transfer of funds using this process. This potential risk causes many Businesses's to be reluctant to enter into this agreement. It should be noted that the Depository institutions require all parties to enter into a Drawdown / Reverse Wire agreement, which holds the Banks that are involved in the transaction, harmless for losses incurred due to the use of a Reverse Wire.

Ultimately, this solution does solve the problems of expeditious movement of funds and the risk to the processing vendor, but it does have its limitations. ACH Direct utilizes the Reverse Wire solution when the opportunity is available, and it is appropriate.

Gene Krause

Director of Business Development, ACH Direct, Inc.

Gene Krause serves ACH Direct, Inc. in the development of future products, services and strategic relationships. Additionally, Mr. Krause's expertise is put to use solving complex client configuration requests, with focus on high-volume and high-exposure accounts.

Mr. Krause has long been aware of the issues presented before this subcommittee today. Part of his present duties are the development of processes that would eliminate the inherent risks of direct deposit payroll transactions.

Prior to Joining the ACH Direct, Inc. team, Mr. Krause was President of Intellefunds, Inc., a marketing and support company serving the ACH client marketplace. His prior experience comes in the form of sales and product management for technologies and hard goods.

Mr. Krause is a resident of Maryland Heights, Missouri. His family consists of his wife Denette, daughter Kirsten and son Eric. Mr. Krause is civically active, coaching multiple youth sports and serving on city government boards.

John Zieglgansberger

Member, ACH Direct, Inc. Advisory Board

John Zieglgansberger has more than 9 years experience as a relationship banker to successful businesses and affluent individuals. He is currently a Vice President with City National Bank; a Beverly Hills based financial institution with a special emphasis on the Entertainment Industry. His expertise includes business development, commercial lending, cash management and complex depository relationships.

He currently heads up the Sun Valley Office for City National. In this capacity, he manages a team of business development officers and bankers that are heavily networked in the San Fernando Valley business community. John has many contacts within this group on both personal and professional levels. His prior experience with United California Bank, formerly Sanwa Bank of California, as the primary relationship manager for ACH Direct, a specialist in third party electronic processing has given John exposure and perspective in electronic banking and processing.

Thank You

We thank this subcommittee for extending the opportunity to us to help shed light on the current ACH system as it relates to direct deposit payroll transactions and the affiliated industries. We are truly honored to play a small yet significant part in the shaping of our country's financial transaction(s) systems.

Respectfully submitted,

Gene Krause

John Zieglgansberger

Testimony of Rita Zeidner
U.S. House of Representatives
Small Business Subcommittee on Tax, Finance and Exports
April 9, 2002

Presented by Rita Zeidner
Manager, Government Relations
American Payroll Association

On behalf of the members of the American Payroll Association, I am pleased to address issues relating to the Automated Clearinghouse (ACH system).

The APA is a non-profit professional association representing nearly 21,000 companies and payroll professionals in all 50 states and Canada. Our membership includes small employers as well as large firms and spans virtually every sector of the economy, including retail, manufacturing, restaurants, educational institutions, state and local government, and banking. We also represent payroll software developers and several hundred third-party payors, including all of the large firms and hundreds of small and independently owned payroll service providers. As an organization, we represent our members' interests in a broad range of areas including the administration of federal and state wage and hour laws, employment tax withholding, remittance and reporting, and garnishment administration. Needless to say, the success of our members depends on a smoothly running, efficient, and cost effective electronic banking system.

The overwhelming majority of our members favor direct deposit as a method of paying workers. In general, they find the system eliminates many of the administrative problems associated with traditional paper paychecks, including:

secure storage of blank checks;
replacement of lost or stolen checks;
distribution of checks to multiple work sites;
storage of cashed checks and related documents;
early preparation of vacation checks; and
reconciliation of unclaimed or uncashed checks

In addition, the system allows employers to cut costs relating to bank check processing, bank stop-payment charges, check reissue costs, and paper.

While the savings that can be directly attributed to direct deposit vary from company to company and are often difficult to quantify, respondents to a 1999 APA direct deposit survey reported the following savings:

26 percent said they were saving \$.01 - \$.10 per payment
16 percent said they were saving \$.11 - \$.25 per payment
12 percent said they were saving \$.26 - \$.50 per payment
13 percent said they were saving \$.51 - \$1.00 per payment
25 percent said they were saving \$1.01 - \$5.00 per payment
8 percent said they were saving \$5.01 - \$12.00 per payment

Because most states don't allow employers to require their workers to be paid via direct deposit, many of our members conduct elaborate direct deposit promotional campaigns during the work day, offering prizes and other incentives to workers to induce them to abandon their allegiance to paper checks. As part of their marketing efforts, employers often will invite local banks to the workplace to market their products to those workers who don't already have bank accounts. In addition, many employers have invited banks to install ATMs on-site.

When all other direct deposit marketing efforts fail, some employers adopt "get-tough" strategies that make it cumbersome for workers to receive a paper check. For instance, they might insist that paper checks be mailed to the workers' homes — always a risky proposition. Or an employer may charge to replace a lost or stolen check. Or an employer may refuse to issue advance payments to workers who will be away on business or vacation on payday. Some employers have even looked into the legality of making direct deposit a condition of employment. Employers in 16 states have succeeded in convincing their state lawmakers to allow mandatory direct deposit. (In nine of these 16 states, the employer can require workers to receive their pay via direct deposit so long as the worker is permitted to choose the financial institution. The other seven states have the additional requirement that the employee must not incur any additional costs.)

As further proof of employers' growing interest in direct deposit, APA's *Guide to Successful Direct Deposit* is one of our perennial bestsellers. The 15th edition of this guide, intended to help employers promote direct deposit, is now in the final stages of production.

How Direct Deposit Works - The Employer's View

For those employees being paid through direct deposit, the employer prepares an automated file of direct deposit records indicating where the employees' pay is to go. This file is then sent to a financial institution that has the ability to process the file. In the language of the banking industry, this institution is known as the Originating Depository Financial Institution (ODFI).

The ODFI makes sure the file has been prepared correctly, checks for any exceptions and entries for employees' accounts maintained by the ODFI, and processes the file utilizing the Automated Clearing House (ACH) system. The ACH network, operating under the rules developed by *NACHA — The Electronic Payments Association*, processes electronic payments between the ODFI and the financial institutions designated by the employees to receive the payments. The ODFI also coordinates the financial settlement between the participating financial institutions.

To process the file through the ACH network, the ODFI delivers the file to the ACH operator, which provides the actual data processing services for distribution of the financial transactions to the financial institution the employees have selected. The financial institution that receives an employee's money is known in banking parlance as the Receiving Depository Financial Institution (RDFI). Many types of institutions may function as an RDFI, including a bank, credit union or investment house. Funds can generally be deposited into any type of account the RDFI offers, a checking, savings or money market vehicle.

The RDFIs designated by the employees accept the electronic payments, post them according to ACH rules and settle with the ACH operator for their value. They also post the direct deposits to the employees' accounts and provide periodic statements reflecting the deposits. Most employers provide their workers with a paper pay stub containing the same data that would have been shown on the pay stub attached to their paycheck. This information includes date of payment, pay-period dates, gross and net wages, hours worked, taxes, and other deductions. It is interesting to note, however, that increasing numbers of employers are looking to automate the pay process further by doing away with traditional paper pay stubs and providing employees the same information electronically.

Mistakes can occur with direct deposit as they can with any payroll function. In 1994, the ACH rules were changed to make it easier to correct errors such as duplicate payments, payments made to the wrong employee or to a terminated employee, or payments issued in the wrong amount. ACH rules now allow employers to simply generate a "single entry reversal" through the ACH network within five banking days from the date of the original entry. No debit authorizations are necessary from employees for single entry reversals made in the exact amount of the original payment and executed within the specified time frame for corrections. However, the rules do require that the employee be notified of the reversal no later than the settlement date of the reversing entry.

Employers and the ACH process

As stated earlier, direct deposit is an extremely popular method of payment among the members of the American Payroll Association. More than 90 percent of the organizations responding to our 1998 pay media survey said they offered direct deposit for wage disbursements while only seven percent paid employees exclusively by check.

When asked why they offered direct deposit, 89 percent of the respondents cited benefits to employees, while 38 percent noted cost savings for the employer. (The total is greater than 100 percent because many respondents chose more than one possible reason.)

It is, however, important to note that direct deposit is not without direct costs to the employer. Like any other business decisions, however, employers must way these costs against the benefits. There are two key areas where employers are most likely to incur costs:

1) through loss of interest ("float") on payroll funds from the time a payment is issued until the employee's bank clears it; and

2) through the ODFI's charges for its processing services.

Information circulated by this subcommittee suggest that there are more than 3,000 independent payroll processors handling payroll for U.S. employers. Many of these processors, along with the larger public companies, are members of the American Payroll Association. Both the independents and the large processors vie aggressively for business among APA's 21,000 employer members. These payroll processors market to our members by buying advertising space in our magazines, exhibiting at our conferences, and sponsoring payroll-related events such as National Payroll Week. In fact, several hundred of these vendors will be leasing space in our exhibit hall during our annual meeting next month in San Antonio. **The active marketing presence of so many payroll processors suggests that competition is stiff. The fact that about half of our members use a payroll processor to assist in all or part of payroll administration suggests that business in this industry is thriving.**

An informal survey we conducted of our membership in preparation for this hearing supported that premise. As part of this informal survey, we sent an e-mail to several hundred American Payroll Association members asking about the fees they pay to originate a direct deposit. I received a broad array of answers. In some instances the bank or service bureau processing the payroll charged a flat fee. In other arrangements, the employer was charged a flat fee per file transmission, plus a fee per direct deposit transaction. Responses to our informal survey suggested that fees generally range from about $.03 to $.10 per transaction. Some companies paid only per transaction, and in these instances, the fees seemed slightly higher — around $.15 per transaction.

I also asked our members whether loss of float figured into their decision to offer direct deposit or not. Information circulated by this subcommittee suggests that at least one smaller payroll processor believes s/he is at a disadvantage because s/he must ask employer clients to prefund their payroll to ensure that the employer has the funds on hand on payday. The vendor suggested that the larger service bureaus generally do not have the prefunding requirement.

The majority of respondents, including APA's own payroll director, said that prefunding was not an issue for them. Rather, they understood it to be part of the cost of doing business. Companies that were concerned with loss of interest float took that cost into consideration when negotiating other fees with their service provider and or their bank.

The subcommittee has asked for APA's response to several recommendations:

Proposal: Regulate the fees banks can charge for direct deposit or via the FedWire system.

APA Response: The APA strongly opposes this proposal. Regulation is generally seen as a way to correct market imbalances or to stop abuses. Our members do not feel they have been abused by financial institutions in the administration of direct deposit. They are free to offer direct deposit if they feel it serves their business interests. And as stated earlier, the vast majority of our employer members feel that the benefits of direct deposit far outweigh the costs. Employers who process their own payroll, as well as service providers, have seemingly endless opportunities to compare prices charged by ODFIs. If the costs charged by ODFIs were overshadowing the benefits of direct deposit, businesses would not see it in their interest to offer direct deposit. We see no evidence suggesting that this is the case. On the contrary, use of direct deposit among employers appears to be increasing.

Proposal: Allow payroll companies to do reversals from employee accounts when an employer does not fund its account.

APA Response: APA has no position on this proposal. It is our understanding that at least some service providers routinely ask their clients' employees to sign an authorization form that would allow the service bureau to debit an employee's account in the event that an employer didn't make payment (or if the payment was in error.) The problem for the service bureau, it appears, is that by the time the service bureau attempts to recoup the misappropriated funds, the employee has already withdrawn the excessive payment and the funds are no longer available to debit.

In interviews with service bureau administrators of various sizes agree that risk management is an integral part of their business operations. To protect themselves against underfunded employers, they make it a practice to perform elaborate credit checks before engaging the employer in a direct deposit arrangement. Likewise, they may limit their direct deposit services if the client doesn't appear credit worthy.

In our informal survey, a few employers said they would not want to give a service bureau authority to debit employees' accounts.

Proposal: Utilize the ATM/Debit network.

APA Response: APA has no position on this proposal. We do, however, support innovative ways of administering payroll and have been positively impressed by the roll-out of payment card systems such as the Visa Payroll Card. This system has been particularly beneficial for employers looking to automate payments for workers who don't have bank accounts.

Employers using this kind of payment system establish a central funds pool with a financial institution. The employer then establishes separate accounts within the pool. On payday, each employee's net pay is credited to his/her account. Employees can access the money through an ATM or use the card like a debit card to make purchases.

NACHA
The Electronic Payments Association

DIRECT DEPOSIT

A Success Story for America's Employees and Businesses

APRIL 9, 2002

U.S. House of Representatives
Committee on Small Business
Subcommittee on Tax, Finance, and Exports

Elliott C. McEntee
President and Chief Executive Officer

13665 Dulles
Technology Drive
Suite 300
Herndon, VA 20171
Phone: 703/561-1100
Fax 703/787-0996
www.nacha.org

DIRECT DEPOSIT

A Success Story for America's Employees and Businesses

Summary

NACHA – The Electronic Payments Association is pleased to submit this written testimony to the House Committee on Small Business, Subcommittee on Tax, Finance and Exports. As requested, NACHA is providing information on the ACH Network and Direct Deposit, and providing feedback and recommendations on specific proposals contained in the paper we received from the Subcommittee staff.

Direct Deposit is the most secure and reliable way to get paid, and offers numerous benefits to both employees and employers. The marketplace for Direct Deposit and payroll services is healthy and highly competitive, as evidenced by the large number of banks and payroll service companies that offer these services, the numerous processing options available to companies, and by decreasing prices for Direct Deposit.

In this testimony, we point out several market practices in use today that payroll service companies could adopt to reduce the risk associated with clients not funding their payroll. For reasons explained in this testimony, NACHA opposes the proposals to regulate prices for payment services and to allow payroll service companies to revoke employees' Direct Deposits.

Introduction

Mr. Chairman and distinguished members of the Subcommittee, my name is Elliott McEntee. I am the President and Chief Executive Officer of NACHA – The Electronic Payments Association. Thank you for this opportunity to submit this testimony on Direct Deposit and the Automated Clearing House (ACH) payments system.

NACHA is a not-for-profit association. We represent more than 12,000 financial institutions through our 21 regional payments associations, and more than 600 other companies and organizations through our industry councils and Affiliate Membership program.

NACHA administers the operating rules for the ACH Network. We also develop payment products and business practice standards in the areas of electronic bill payment, e-commerce, e-checks, electronic data interchange, and international payments. In addition, NACHA's Electronic Benefits Transfer Council administers the Quest operating rules, which are now used by 31 states for the delivery of electronic benefits.

The ACH Network is an all-electronic payments system that is used by 20,000 financial institutions, more than 3.5 million businesses, and at least 115 million consumers to make and receive electronic payments. The Federal Reserve and three private-sector organizations – the American Clearing House Association, the Electronic Payments Network, and Visa U.S.A. – act as ACH Operators, which are clearing houses among financial institutions that route ACH payments to their proper destinations.

The ACH Network is commonly used for Direct Deposit of payroll and government benefits such as Social Security, Direct Payment of consumer bills, business-to-business payments, federal tax payments, and, increasingly, e-check and e-commerce payments. In 2001 there were almost 8 billion ACH payments made worth over $22 trillion dollars.

The NACHA Operating Rules standardize payment formats for the ACH Network and define the rights, obligations and warranties of parties involved with processing ACH payments. Operating rules provide a uniform business and legal framework for the exchange of payments, which enhances participants' confidence in the safety and reliability of the payments system.

All ACH participants are required to follow the NACHA Operating Rules. Financial institutions enter into contractual agreements with ACH Operators, and companies enter into contractual agreements with their banks, obligating their adherence to the rules. These contractual agreements allow the NACHA Operating Rules to be enforced through the legal system. By entering into an agreement to comply with the NACHA Operating Rules, ACH participants also become subject to ACH Network rule enforcement mechanisms.

Participants in today's ACH Network use the latest technology to achieve efficient and reliable payment processing. Companies, financial institutions and ACH Operators are linked together by secure telecommunications connections. All ACH payment files are delivered by electronic transmission, and processing by financial institutions and ACH Operators is automated. Banks are enabling their customers to originate ACH payments on their desktop computers and connect to the banks via secure web sites.

A history of NACHA, the ACH Network and Direct Deposit is attached to this testimony as Appendix 1. A more detailed explanation of ACH Network operations is attached as Appendix 2.

Federal Government Use of the ACH Network

The Federal Government is the largest single user of the ACH Network. In 2001, the Federal Government originated more than 910 million ACH payments. The vast majority were Direct Deposit payments made to federal employees, retirees and beneficiaries. The U.S. Department of Treasury's Financial Management Service (FMS) estimates that the Federal Government saves over 40 cents for every Direct Deposit, resulting in savings of $340 million in 2001 to U.S. taxpayers.

FMS also reports that 98 percent of federal payroll payments, 92 percent of federal retirement payments, and 79 percent of Social Security payments are made by Direct Deposit.

The Federal Government also uses the ACH Network for federal tax collections. In 2001, the Internal Revenue Service collected more than $1 trillion through the ACH Network, and reported 3.5 million companies enrolled in the Electronic Federal Tax Payment System.

NACHA has a long history of working closely with the Federal Government on electronic payments. For example, the U.S. Treasury has adopted the NACHA Operating Rules to govern Federal ACH payments, which means that the government and the private sector now use a common set of rules. We also work every year with the Social Security Administration, the Treasury Department, and the Federal Reserve to promote Direct Deposit for Federal payments.

Direct Deposit

Direct Deposit is the electronic transfer of a payment from a company or the government into the checking or savings account of an employee, consumer or government beneficiary. Direct Deposit is used for payroll, expense and travel reimbursement, pension and annuity payments, interest payments, retirement and mutual fund distributions, Social Security, Veterans and other government benefits, and tax refunds. Banks and credit unions receive their customers' Direct Deposits through the ACH Network.

In 2001 there were 3.7 billion Direct Deposit payments made worth more than $4 trillion. The average Direct Deposit was for $1,110. Use of Direct Deposit is increasing by approximately 10 percent per year. NACHA estimates that at least 115 million people nationwide rely on Direct Deposit to receive their pay or government benefits. NACHA also estimates an economic savings in the United States of more than $8 billion in 2001 through the use of Direct Deposit.

Employee Benefits of Using Direct Deposit

Direct Deposit is simply the most secure and reliable way to get paid. Direct Deposit is safe, confidential, and convenient. It has a proven, 30-year track record of success. In a recent market research study, the Federal Reserve found that the satisfaction rate among consumers for Direct Deposit is 97 percent.

Payments made by Direct Deposit are extremely secure. In fact, an employee is much more likely to have a problem with a paper check being lost or stolen. Direct Deposit is more confidential. A check passes through many more hands than a Direct Deposit. Problems with Direct Deposit are rare, and are quickly resolved. By contrast, problems with checks may take much longer to correct.

By using Direct Deposit, an employee may save the equivalent of three workdays each year by not having to deposit paper checks. The employee doesn't even have to be at work to get paid. If an employee is traveling on business, on vacation, or even out sick, they still get paid on time, every time.

Direct Deposit can give employees access to their funds one to four days earlier than a check. There is no waiting for a paper check to be deposited and cleared. NACHA's rules require Direct Deposit funds to be made available at the opening of business on payday, as long as the payment information was delivered to the employee's financial institution by 5:00 p.m. on the previous day. The U.S. Treasury Department has followed this practice for approximately 25 years in making Federal salary and benefit payments. Also, under NACHA's rules, once an accurate Direct Deposit payment has been made to the employee, it cannot be revoked.

Many financial institutions waive checking account fees or minimum balance requirements for customers that use Direct Deposit. With Direct Deposit, an employee may even be able to divide his or her pay among several accounts, including savings and investment accounts, and have it done automatically each payday. Financial planners recommend Direct Deposit as one step towards gaining control of personal finances.

Employer Benefits of Using Direct Deposit

Direct Deposit may save a company up to $1.25 per payment instead of issuing a paper check. Direct Deposit eliminates the cost of delivering checks to employees at different locations. Direct Deposit eliminates the chance of lost or stolen checks and the resulting charges for stop payment and check replacement. Direct Deposit also eliminates employee "lost time" – depositing a check on company time.

Direct Deposit saves a company time by making payroll reconciliation easier and streamlining tax reporting at the end of the year. With Direct Deposit, there is no need for special check handling when employees are on vacation or out of the office. Direct Deposit reduces time spent storing and securing check stock.

As noted above, while payroll is the most widely used application of Direct Deposit, it can also be used for many other types of payments, such as expense reimbursements, which can save a company even more time and money.

The greatest benefit for an employer, however, is that Direct Deposit benefits its employees, and is perceived as a substantial employee benefit.

Business Continuity

Recent events have demonstrated that the flow of paper checks, including payroll checks, can be interrupted without warning and for reasons beyond the control of any company or individual. By using Direct Deposit, people can ensure that they get paid on time, even when they are unable to make it to work. Businesses can ensure that they meet their payroll obligations, even when paper checks cannot be distributed.

Direct Deposit Processing

There are a variety of ways that an employer can process its Direct Deposit transactions. It can process its payroll directly with its bank, or outsource part or all of its payroll function to a payroll processor. There are many choices available in the marketplace, and companies make choices based on their needs. The very fact that there are 3,300 independent payroll service companies and thousands of banks that offer Direct Deposit services strongly suggests that the market is healthy and that competition is vigorous.

ACH processing schedules have been substantially enhanced over the years, and many financial institutions send and receive ACH payments several times a day. The capability now exists to conduct same-day ACH payments. NACHA continues to investigate ways to improve processing schedules for all ACH participants.

The capability in the ACH Network of originating large numbers of payments in advance of the settlement date is an advantage for many types of payments, including Direct Deposit. While companies can choose to originate their Direct Deposit transactions on payday, most choose to do so 1 or 2 days in advance. The primary reason is to provide their employees with the earliest possible access to their money. This is a significant benefit that companies provide to employees. Companies are also able to learn about and correct errors in advance of payday, which helps prevent delays in paying employees.

Direct Deposit and Small Business

While historically the use of Direct Deposit by small businesses has lagged behind adoption by larger businesses, there are several reasons to think that this is changing. First, decreasing prices charged by banks for ACH payments are making Direct Deposit even more competitive when compared to paper checks. According to the Phoenix-Hecht Blue Book of Bank Prices, the average price charged by a bank to an employer for a Direct Deposit payment has fallen by more than 23 percent since 1995. Second, as employees have come to expect Direct Deposit, more employers will offer it as a benefit. Third, a new national consumer advertising campaign to promote Direct Deposit is being undertaken. By focusing on consumer education, the campaign will reach employees of both large and small business regarding the benefits of Direct Deposit. Fourth, every year consumers and businesses of all sizes are becoming more familiar and comfortable with making and receiving payments electronically.

Response to Proposals

The Subcommittee staff asked NACHA for its views on several legislative or regulatory proposals.

Proposal: *Regulate the fees banks can charge for Direct Deposit. Regulate and reduce fees charged to use the FedWire system.*

NACHA Response

NACHA opposes the proposals to regulate prices for payment services. First, competition in the provision of payment services by financial institutions and other companies has driven the price of payment origination to a very low level. For example, according to the Phoenix-Hecht Blue Book of Bank Prices, the average price charged by a bank to a corporate customer to originate a Direct Deposit payment is less than 10 cents. An ACH file fee of several dollars, spread among all of the individual Direct Deposit payments within the file, adds only a few cents more to the cost of each transaction. Second, any company or payroll processor that is not satisfied with the services offered by its bank can comparison shop in what is a highly competitive market. Third, price regulation may cause many banks to stop offering

Direct Deposit origination services in favor of paper checks, which presumably are not being considered for price regulation. Fourth, payment prices reflect an assessment of the credit risk associated with particular users. Regulating these prices would compromise a bank's ability to account for and manage risk.

Proposal: *Allow payroll companies to do reversals from employee accounts when an employer does not fund its account.*

NACHA Response

NACHA opposes the proposal to allow payroll companies to revoke Direct Deposits from employee accounts. This would constitute a rollback of a basic consumer right. A primary benefit to employees receiving Direct Deposit of their pay is the irrevocability of a properly made wage payment. In the event an employer, a payroll service provider or a bank fails to honor its funding commitments, Direct Deposits that have already been settled via the ACH Network are safe and accessible by employees.

Proposal: *Utilize the ATM/Debit networks.*

NACHA Response

NACHA has no position regarding the proposal for payroll companies to utilize ATM/debit networks. Use of real-time debit networks may not address the concerns expressed, however, because most companies will still want to originate their payroll 1 or 2 days in advance in order to provide their employees the earliest possible access to their money and to prevent errors in payroll processing. The payroll service company would need to use one or more of the risk management practices described below in our recommendations.

NACHA Recommendations

Instead of government price regulation, NACHA recommends that payroll service companies that have difficulty with clients funding their payroll consider a few commonplace business practices to protect themselves from risk.

The first is to examine the creditworthiness of clients and establish credit limits based on this analysis. With credit limits in place, the payroll service company would not originate any payroll files on behalf of the client in excess of this limit without obtaining funds in advance.

The second is to require pre-funding of payroll before originating payroll files. Instead of the payroll service company originating a debit to a client's account, which could be returned for insufficient funds, the client would ensure by an established deadline that sufficient funds are available or remitted in advance. This is a common practice in the payroll service industry.

The third is to charge fees commensurate with the amount of risk one is assuming. A common approach is to not assume risk for which you cannot get paid. A fourth is to require companies to put up collateral to offset the credit that is being extended.

It should be noted that any or all of these options could be considered prudent, depending on the creditworthiness of the client.

Conclusion

Direct Deposit is a successful electronic payment product that benefits both employees and employers, and I hope this hearing raises the awareness among small businesses of Direct Deposit and its many benefits. There is no need for government regulation when it is clear that a healthy competition exists in the marketplace for Direct Deposit and payroll services, a marketplace that keeps quality high and costs low.

Additional information about NACHA is available on our web site at www.nacha.org. More information about Direct Deposit can be found at www.directdeposit.org.

NACHA would be glad to answer any questions the Subcommittee has on the ACH Network and Direct Deposit.

Appendix 1

History of NACHA, the ACH Network and Direct Deposit

The ACH Network was developed in response to the growth of check payments and the many technological advances in the 1970s, and functions as an efficient, electronic alternative to paper checks.

The ACH movement began in the early 1970s when a group of California bankers formed the Special Committee on Paperless Entries (SCOPE). In direct response to the rapid growth in check volume, the Committee was chartered to explore the technical, operational, and legal framework necessary for an automated payments system.

SCOPE laid the groundwork for the first Automated Clearing House (ACH) association, which began operation in 1972. The establishment of this ACH association led to the formation of similar groups in other parts of the country. Agreements were made between the emerging regional ACH associations and the regional Federal Reserve Banks to provide facilities, equipment, and staff to operate regional ACH networks. Two notable exceptions to this type of arrangement occurred in New York and Chicago, where private clearing houses were formed to handle ACH transactions.

In 1974 a task force created by the American Bankers Association concluded that a national organization was needed to establish uniform operating rules for the exchange of ACH payments. The task force recommended that the banking industry establish the National Automated Clearing House Association to carry out this responsibility. In 1974, NACHA was incorporated in the State of Delaware as a non-profit association. The association was originally located in Washington, DC in the ABA's offices and stayed there during the first 11 years of its existence.

The first set of operating rules were developed later that year, and NACHA began to negotiate with the Federal Reserve to have one set of national ACH rules. The Federal Reserve agreed that it would rely on the private sector to develop and maintain detailed operating rules.

It was during this same year, 1974, that the first true nationwide ACH application was implemented – the Direct Deposit of the United States Air Force's payroll. The success of the Air Force program resulted in the Treasury Department accelerating development of plans to offer Direct Deposit to Social Security recipients, and two years later the availability of Direct Deposit for Social Security benefits was a reality.

The success of these two government programs encouraged the Federal Reserve to move ahead with the development of a nationwide exchange of commercial ACH payments using NACHA's rules. The nationwide network was completed in 1978, and it was then possible for two institutions located anywhere in the United States to exchange ACH payments under a common set of rules and procedures.

In 1981, the Federal Reserve began pricing for its ACH services, as required by the Monetary Control Act of 1980. This opened the door to the introduction of competition from the private sector for interbank ACH processing. Today, four ACH Operators – the American Clearing House Association, the Federal Reserve, the Electronic Payments Network (a subsidiary of the New York Clearing House) and VisaNet ACH Services – compete nationwide for ACH services.

In 1985, NACHA separated from the American Bankers Association. Many members of the regional ACH associations were credit unions and savings and loans, while ABA members were commercial banks. The ACH was also growing in importance. For these reasons, it was decided that NACHA could best service its members as an independent entity.

In 1988 NACHA's Board of Directors approved the first major national campaign to promote Direct Deposit to consumers. This campaign was conducted in 1989, and consisted primarily of television and radio advertising, and a national public relations campaign. NACHA has conducted an annual national campaign ever since with partners at the regional ACH associations, the Federal Reserve, the Social Security Administration, the Treasury Department, and other interested associations and private organizations. Before the annual campaigns began, use of Direct Deposit by employees in the private sector was 8 percent; it is now well over 50 percent. The Federal Government has also seen substantial growth in the use of Direct Deposit by both employees and benefit recipients.

Appendix 2

ACH Network Operation

The ACH Network is a batch processing, store-and-forward system. Transactions received by the financial institution during the day are stored and processed later in a batch mode. Rather than sending each payment separately, ACH transactions are accumulated and sorted by destination for transmission during a predetermined time period. This provides significant economies of scale. It also provides faster processing than paper checks, which must be physically handled. Instead of using paper to carry necessary transaction information, ACH transactions are transmitted electronically between financial institutions through data transmission.

Through a nationwide telecommunications network, each ACH Operator is able to communicate with other ACH Operators to exchange entries quickly and efficiently, regardless of geographic distances involved. The ACH Network offers an assortment of technical formats that can be used for a variety of payment applications, products and services. The ACH Network is governed by operating rules and guidelines, which are developed by the actual users of the system, and is administered through a series of agreements among financial institutions, customers, trading partners, and ACH Operators.

A. Participants

Typically, five participants are involved in an ACH transaction:

1. The Originator is usually a company directing a transfer of funds to or from a consumer's or another company's account.
2. The Originating Depository Financial Institution (ODFI) is the financial institution that receives payment instructions from Originators and forwards the entries to the ACH Operator.
3. An Automated Clearing House (ACH) Operator is the central clearing facility operated by a private organization or a Federal Reserve Bank on behalf of depository financial institutions, to or from which participating institutions transmit or receive ACH entries.
4. The Receiving Depository Financial Institution (RDFI) is the institution that receives ACH entries from the ACH Operator and posts the entries to the accounts of its depositors (Receivers).
5. A Receiver is a person or an organization that has authorized an Originator to initiate an ACH entry to the Receiver's account with the RDFI. A Receiver may be either a company or a consumer, depending on the type of transaction.

B. ACH Transaction Flow

In ACH terminology, Originator and Receiver refer to the participants that initiate and receive the ACH entries rather than the funds. Unlike a check, which is always a debit instrument, an ACH entry may be either a credit or a debit entry. By examining what happens to the Receiver's account, one can distinguish the difference between an ACH credit and an ACH debit transaction. If the Receiver's account is debited, then the entry is an ACH debit. If the Receiver's account is credited, then the entry is an ACH credit.

ACH credit entries occur when an Originator initiates a transfer to move funds into a Receiver's account. ACH credit transactions involve both consumer and corporate payments with separate rules and regulations for each. The most typical consumer ACH application is Direct Deposit of Payroll.

In an ACH debit transaction, funds flow in the opposite direction. Funds are collected from a Receiver's account and transferred to an Originator's account, even though the Originator initiated the entry. For example, the Originator of a preauthorized debit is the company to which the amount is owed. Consumer acceptance is highest in the area of pre-authorized transfers involving regular, recurring payments, such as a mortgage.

C. Settlement and Posting

Settlement is the actual transfer of the value of funds between financial institutions to complete the payment instruction of an ACH entry.

The Federal Reserve provides settlement services for ACH entries processed by the Federal Reserve and for private sector ACH Operators that process ACH entries. The Federal Reserve ACH Operator calculates the net credit and debit positions of financial institutions and applies those credits or debits to the reserve accounts of the financial institutions (or their correspondent banks) that are maintained on the books of the Federal Reserve.

In addition to the Federal Reserve, there are also three private sector ACH Operators that provide settlement services for participants in the ACH Network: (1) the American Clearing House Association, (2) the Electronic Payments Network, and (3) VisaNet ACH Services. These private sector ACH Operators have entered into an agreement, called Private Sector Exchange or PAX, in which they exchange ACH entries among themselves, bypassing the Federal Reserve ACH system.

NACHA Operating Rules require that credit entries must be available for withdrawal or cash withdrawal by the customer no later than the settlement date of the entry. Further, according to NACHA Operating Rules, each Direct Deposit that is made available to an RDFI by its ACH Operator by 5:00 p.m. (RDFI's local time) on the banking day prior to the settlement date must be made available to the Receiver for withdrawal or cash withdrawal at the opening of business on the settlement date.

D. Legal Framework

The ACH process operates from beginning to end through a series of legal agreements. Before any transaction is initiated, the Originator and ODFI execute an agreement to use the ACH Network to originate payments. Among other things, the agreement should bind the originating company to the NACHA Operating Rules, define the parameters of the relationship between the two parties, identify processing requirements for the specific application(s), and establish liability and accountability for procedures related to certain application(s). The NACHA Operating Rules govern interregional ACH transactions and also cover intraregional ACH transactions unless a regional ACH association has implemented a local rule to supersede a provision of the NACHA Operating Rules.While the NACHA Operating Rules are the primary document addressing the rules and regulations for the commercial ACH Network, Federal Government ACH payments are controlled by the provisions of Title 31 Code of Federal Regulations Part 210 (31 C.F.R. Part 210). The Financial Management Service (FMS) of the U.S. Department of the Treasury is the agency responsible for establishing Federal Government ACH policy. In 1999, 31 C.F.R. Part 210 was revised by FMS to adopt the provisions of the NACHA Operating Rules as the regulations governing the transmission and receipt of Federal Government ACH entries, with certain exemptions to address matters of Federal law. FMS also publishes The Green Book, a procedural manual for Federal Government ACH payments.

Other laws that have a direct bearing on ACH operations are the Uniform Commercial Code Article 4, which governs check transactions, and Article 4A, and the Electronic Funds Transfer Act as implemented by Regulation E. Certain other activities related to ACH payments are affected by The Right to Financial Privacy Act, Regulation D regarding reserve requirements, Regulation CC regarding funds availability, and other regulatory agency directives. Agreements are also required between RDFIs and the ACH Operators for ACH Operator services. Relationships between the consumer as Receiver and the RDFI are generally governed by Regulation E and the NACHA Operating Rules. In some cases, agreements exist between the RDFI and the Receiver, particularly if the Receiver is a corporate or government entity.

Testimony of Rita Zeidner
U.S. House of Representatives
Small Business Subcommittee on Tax, Finance and Exports
April 9, 2002

Presented by Rita Zeidner
Manager, Government Relations
American Payroll Association

On behalf of the members of the American Payroll Association, I am pleased to address issues relating to the Automated Clearinghouse (ACH system).

The APA is a non-profit professional association representing nearly 21,000 companies and payroll professionals in all 50 states and Canada. Our membership includes small employers as well as large firms and spans virtually every sector of the economy, including retail, manufacturing, restaurants, educational institutions, state and local government, and banking. We also represent payroll software developers and several hundred third-party payors, including all of the large firms and hundreds of small and independently owned payroll service providers. As an organization, we represent our members' interests in a broad range of areas including the administration of federal and state wage and hour laws, employment tax withholding, remittance and reporting, and garnishment administration. Needless to say, the success of our members depends on a smoothly running, efficient, and cost effective electronic banking system.

The overwhelming majority of our members favor direct deposit as a method of paying workers. In general, they find the system eliminates many of the administrative problems associated with traditional paper paychecks, including:

secure storage of blank checks;
replacement of lost or stolen checks;
distribution of checks to multiple work sites;
storage of cashed checks and related documents;
early preparation of vacation checks; and
reconciliation of unclaimed or uncashed checks

In addition, the system allows employers to cut costs relating to bank check processing, bank stop-payment charges, check reissue costs, and paper.

While the savings that can be directly attributed to direct deposit vary from company to company and are often difficult to quantify, respondents to a 1999 APA direct deposit survey reported the following savings:

26 percent said they were saving $.01 - $.10 per payment
16 percent said they were saving $.11 - $.25 per payment
12 percent said they were saving $.26 - $.50 per payment
13 percent said they were saving $.51 - $1.00 per payment
25 percent said they were saving $1.01 - $5.00 per payment
8 percent said they were saving $5.01 - $12.00 per payment

Because most states don't allow employers to require their workers to be paid via direct deposit, many of our members conduct elaborate direct deposit promotional campaigns during the work day, offering prizes and other incentives to workers to induce them to abandon their allegiance to paper checks. As part of their marketing efforts, employers often will invite local banks to the workplace to market their products to those workers who don't already have bank accounts. In addition, many employers have invited banks to install ATMs on-site.

When all other direct deposit marketing efforts fail, some employers adopt "get-tough" strategies that make it cumbersome for workers to receive a paper check. For instance, they might insist that paper checks be mailed to the workers' homes — always a risky proposition. Or an employer may charge to replace a lost or stolen check. Or an employer may refuse to issue advance payments to workers who will be away on business or vacation on payday. Some employers have even looked into the legality of making direct deposit a condition of employment. Employers in 16 states have succeeded in convincing their state lawmakers to allow mandatory direct deposit. (In nine of these 16 states, the employer can require workers to receive their pay via direct deposit so long as the worker is permitted to choose the financial institution. The other seven states have the additional requirement that the employee must not incur any additional costs.)

As further proof of employers' growing interest in direct deposit, APA's *Guide to Successful Direct Deposit* is one of our perennial bestsellers. The 15th edition of this guide, intended to help employers promote direct deposit, is now in the final stages of production.

How Direct Deposit Works - The Employer's View

For those employees being paid through direct deposit, the employer prepares an automated file of direct deposit records indicating where the employees' pay is to go. This file is then sent to a financial institution that has the ability to process the file. In the language of the banking industry, this institution is known as the Originating Depository Financial Institution (ODFI).

The ODFI makes sure the file has been prepared correctly, checks for any exceptions and entries for employees' accounts maintained by the ODFI, and processes the file utilizing the Automated Clearing House (ACH) system. The ACH network, operating under the rules developed by *NACHA — The Electronic Payments Association*, processes electronic payments between the ODFI and the financial institutions designated by the employees to receive the payments. The ODFI also coordinates the financial settlement between the participating financial institutions.

To process the file through the ACH network, the ODFI delivers the file to the ACH operator, which provides the actual data processing services for distribution of the financial transactions to the financial institution the employees have selected. The financial institution that receives an employee's money is known in banking parlance as the Receiving Depository Financial Institution (RDFI). Many types of institutions may function as an RDFI, including a bank, credit union or investment house. Funds can generally be deposited into any type of account the RDFI offers, a checking, savings or money market vehicle.

The RDFIs designated by the employees accept the electronic payments, post them according to ACH rules and settle with the ACH operator for their value. They also post the direct deposits to the employees' accounts and provide periodic statements reflecting the deposits. Most employers provide their workers with a paper pay stub containing the same data that would have been shown on the pay stub attached to their paycheck. This information includes date of payment, pay-period dates, gross and net wages, hours worked, taxes, and other deductions. It is interesting to note, however, that increasing numbers of employers are looking to automate the pay process further by doing away with traditional paper pay stubs and providing employees the same information electronically.

Mistakes can occur with direct deposit as they can with any payroll function. In 1994, the ACH rules were changed to make it easier to correct errors such as duplicate payments, payments made to the wrong employee or to a terminated employee, or payments issued in the wrong amount. ACH rules now allow employers to simply generate a "single entry reversal" through the ACH network within five banking days from the date of the original entry. No debit authorizations are necessary from employees for single entry reversals made in the exact amount of the original payment and executed within the specified time frame for corrections. However, the rules do require that the employee be notified of the reversal no later than the settlement date of the reversing entry.

Employers and the ACH process

As stated earlier, direct deposit is an extremely popular method of payment among the members of the American Payroll Association. More than 90 percent of the organizations responding to our 1998 pay media survey said they offered direct deposit for wage disbursements while only seven percent paid employees exclusively by check.

When asked why they offered direct deposit, 89 percent of the respondents cited benefits to employees, while 38 percent noted cost savings for the employer. (The total is greater than 100 percent because many respondents chose more than one possible reason.)

It is, however, important to note that direct deposit is not without direct costs to the employer. Like any other business decisions, however, employers must way these costs against the benefits. There are two key areas where employers are most likely to incur costs:

1) through loss of interest ("float") on payroll funds from the time a payment is issued until the employee's bank clears it; and

2) through the ODFI's charges for its processing services.

Information circulated by this subcommittee suggest that there are more than 3,000 independent payroll processors handling payroll for U.S. employers. Many of these processors, along with the larger public companies, are members of the American Payroll Association. Both the independents and the large processors vie aggressively for business among APA's 21,000 employer members. These payroll processors market to our members by buying advertising space in our magazines, exhibiting at our conferences, and sponsoring payroll-related events such as National Payroll Week. In fact, several hundred of these vendors will be leasing space in our exhibit hall during our annual meeting next month in San Antonio. **The active marketing presence of so many payroll processors suggests that competition is stiff. The fact that about half of our members use a payroll processor to assist in all or part of payroll administration suggests that business in this industry is thriving.**

An informal survey we conducted of our membership in preparation for this hearing supported that premise. As part of this informal survey, we sent an e-mail to several hundred American Payroll Association members asking about the fees they pay to originate a direct deposit. I received a broad array of answers. In some instances the bank or service bureau processing the payroll charged a flat fee. In other arrangements, the employer was charged a flat fee per file transmission, plus a fee per direct deposit transaction. Responses to our informal survey suggested that fees generally range from about $.03 to $.10 per transaction. Some companies paid only per transaction, and in these instances, the fees seemed slightly higher — around $.15 per transaction.

I also asked our members whether loss of float figured into their decision to offer direct deposit or not. Information circulated by this subcommittee suggests that at least one smaller payroll processor believes s/he is at a disadvantage because s/he must ask employer clients to prefund their payroll to ensure that the employer has the funds on hand on payday. The vendor suggested that the larger service bureaus generally do not have the prefunding requirement.

The majority of respondents, including APA's own payroll director, said that prefunding was not an issue for them. Rather, they understood it to be part of the cost of doing business. Companies that were concerned with loss of interest float took that cost into consideration when negotiating other fees with their service provider and or their bank.

The subcommittee has asked for APA's response to several recommendations:

Proposal: Regulate the fees banks can charge for direct deposit or via the FedWire system.

APA Response: The APA strongly opposes this proposal. Regulation is generally seen as a way to correct market imbalances or to stop abuses. Our members do not feel they have been abused by financial institutions in the administration of direct deposit. They are free to offer direct deposit if they feel it serves their business interests. And as stated earlier, the vast majority of our employer members feel that the benefits of direct deposit far outweigh the costs. Employers who process their own payroll, as well as service providers, have seemingly endless opportunities to compare prices charged by ODFIs. If the costs charged by ODFIs were overshadowing the benefits of direct deposit, businesses would not see it in their interest to offer direct deposit. We see no evidence suggesting that this is the case. On the contrary, use of direct deposit among employers appears to be increasing.

Proposal: Allow payroll companies to do reversals from employee accounts when an employer does not fund its account.

APA Response: APA has no position on this proposal. It is our understanding that at least some service providers routinely ask their clients' employees to sign an authorization form that would allow the service bureau to debit an employee's account in the event that an employer didn't make payment (or if the payment was in error.) The problem for the service bureau, it appears, is that by the time the service bureau attempts to recoup the misappropriated funds, the employee has already withdrawn the excessive payment and the funds are no longer available to debit.

In interviews with service bureau administrators of various sizes agree that risk management is an integral part of their business operations. To protect themselves against underfunded employers, they make it a practice to perform elaborate credit checks before engaging the employer in a direct deposit arrangement. Likewise, they may limit their direct deposit services if the client doesn't appear credit worthy.

In our informal survey, a few employers said they would not want to give a service bureau authority to debit employees' accounts.

Proposal: Utilize the ATM/Debit network.

APA Response: APA has no position on this proposal. We do, however, support innovative ways of administering payroll and have been positively impressed by the roll-out of payment card systems such as the Visa Payroll Card. This system has been particularly beneficial for employers looking to automate payments for workers who don't have bank accounts.

Employers using this kind of payment system establish a central funds pool with a financial institution. The employer then establishes separate accounts within the pool. On payday, each employee's net pay is credited to his/her account. Employees can access the money through an ATM or use the card like a debit card to make purchases.