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BY THE COMPTROLLER GENERAL
Report To The Chairman Committee On Banking, Housing, And Urban Affairs United States Senate
OF THE UNITED STATES

An Examination of Concerns Expressed About The Federal Reserve's Pricing Of Check Clearing Activities

The Federal Reserve System and some of the Nation's larger commercial banks play major roles in clearing the billions of checks written each year in the United States. The Monetary Control Act of 1980 requires that the Federal Reserve charge fees for checks that it clears. But private banks competing for this service with the Federal Reserve complained that it undercharges for its services and takes advantage of its status as a central bank.

GAO's investigation of the private bank complaints showed that the Federal Reserve has eliminated the undercharges that had previously existed. GAO believes the procedures the Federal Reserve now uses for allocating costs and setting prices generally are reasonable.

The Federal Reserve System is the largest provider of check clearing services, and concerns about competition are understandable. However, GAO found no evidence that the Federal Reserve is abusing its central bank status. When fully implemented, recent changes in Federal Reserve policies, including more complete disclosure of financial and program information, should help reduce concerns of its competitors. The Federal Reserve and others who commented on a draft of this report did not take issue with GAO's major conclusions.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-211855

The Honorable Jake Garn
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

In your April 6, 1983, letter you asked us to update our May 1982 report on how the Federal Reserve prices its check clearing services pursuant to the Monetary Control Act of 1980. You also asked us to address specific questions that have an effect on Federal Reserve prices and on how it competes in the market place. In addition to updating our previous report, we focus on the general topic of competition between the private sector and the Federal Reserve and on whether the taxpayer is subsidizing the Federal Reserve's check clearing services. The report identifies actions the Federal Reserve took in 1983 to bring revenues into line with costs, and provides other information which should assist the Committee in monitoring Federal Reserve pricing activities. We are also issuing a supplement to the report which provides additional information on Federal Reserve operations.

A draft of this report was the subject of hearings before your Committee on April 11, 1984, at which you received statements of the Federal Reserve and of interested parties from the private sector. The report also addresses their comments.

As arranged with your office, we are sending copies of this report to the members of this Committee; other interested committees; Director, Office of Management and Budget; the Chairman, Board of Governors, Federal Reserve System; American Bankers Association of America; The National Payments System Coalition, and the Independent Bankers Association. Copies will also be made available to other interested parties who request them.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CHAIRMAN OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

AN EXAMINATION OF CONCERNS EXPRESSED ABOUT THE FEDERAL RESERVE'S PRICING OF CHECK CLEARING ACTIVITIES

One reason checks serve the commercial needs of the public so well is that any check written is brought back quickly to the writer's bank for payment (called "presentment"). The system works because the Federal Reserve System, which functions as the Nation's central bank, and the Nation's commercial banks devote considerable resources to sorting checks, organizing their transportation between banks, making presentment, and transferring balances from one bank to another.

The Monetary Control Act of 1980 required the Federal Reserve to offer its check clearing services--at a fee--to all depository institutions, i.e., member and nonmember commercial banks, savings banks, savings and loan associations, and credit unions. Before that act, these services were available (without a fee) only to members of the Federal Reserve System. The act also set forth the principle that over the long run the prices charged by the Federal Reserve for check clearing and other priced services should be based on all expenses attributable to those services. In 1982, GAO reported that the Federal Reserve's prices were not sufficient to recover the related costs, including the cost of Federal Reserve float.[1,2]

Because of the requirement to set prices and of the expanded market the Federal Reserve was

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[1] The Federal Reserve Should Move Faster to Eliminate Subsidy of Check Clearing Operations (GAO/GGD-82-22, May 7, 1982).

[2] Federal Reserve float is created if a Federal Reserve bank credits the reserve account of a bank for a deposited check before the Federal Reserve bank has collected the check. This represents an advance to the depositing bank. The Monetary Control Act of 1980 requires the Federal Reserve to begin charging interest to recover the costs of such advances. In the early spring of 1982, these advances were averaging about $2.5 billion.

required to serve, the Monetary Control Act placed the Federal Reserve in more direct competition with some of the Nation's larger commercial banks. These banks, known as correspondent banks, also compete to provide check clearing and other services to smaller or out-of-town financial institutions. Many correspondent banks believe that the actions taken by the Federal Reserve to implement the provisions of the Monetary Control Act, particularly those associated with changes in service that occurred in and after February 1983 to speed the collection of checks, have adversely affected the profitability of the correspondent bank business. Representatives of some of the correspondent banks, therefore, raised two concerns with the Senate Banking Committee. The concerns are that the Federal Reserve (1) because of its size and the law enjoys certain advantages that are unavailable to commercial banks and (2) is not recovering all costs for its check clearing services. The Committee asked GAO to find out if these concerns are valid.

GAO found that the Federal Reserve took actions during 1983 that by the beginning of 1984 eliminated the revenue shortfall that previously existed. (See pp. 12 to 15.) GAO also found that the Federal Reserve, as a result of its central bank status, does enjoy some advantages in competing with correspondent banks. These advantages, however, are consistent with the authority the Federal Reserve has under the Monetary Control Act and other provisions of law. (See pp. 18 to 21.) In addition, correspondent banks have advantages not available to the Federal Reserve, such as pricing some activities to intentionally discourage demand for services that represent an unprofitable use of bank resources. (See pp. 36 and 37.)

ADVANTAGES THE FEDERAL RESERVE HAS AS A RESULT OF ITS SIZE

Through its 12 banks, the Federal Reserve operates check processing centers in 48 American cities. These centers are linked by telecommunications and extensive air and ground transportation facilities for moving checks. Nationally, over half of the checks cleared between banks pass through the Federal Reserve. Even though some of these checks may also have been processed first by a correspon-

dent bank, the Federal Reserve has by far the largest market share of any single institution. This dominant position no doubt results in large part from its central bank status and its ability to operate throughout the Nation.

The Federal Reserve sets prices with the expectation that excess revenues generated by some products in some locations will be sufficient to offset revenue shortfalls associated with products offered in the same or other locations. In the first quarter of 1984 check clearing revenues at the Reserve banks of Chicago, New York, and Boston were from 7.1 to 15.2 percent below fully allocated costs. At the other extreme, check clearing revenues at the Reserve banks of Atlanta, San Francisco, and Richmond were from 15.2 to 24.9 percent above costs.

Some correspondent bank competitors expressed concern that Federal Reserve pricing policies, which enable some Reserve banks to set check clearing prices below costs, provide too much flexibility for the Federal Reserve, making it difficult for the correspondents to compete. Although data were not available from the private sector to enable GAO to compare Federal Reserve check clearing profitability with that of the private sector, it would be reasonable to expect that private sector institutions almost certainly have a more difficult time competing with the Federal Reserve in locations in which the Federal Reserve does not recover fully allocated costs. GAO did not, however, observe instances in which the Federal Reserve cut prices below costs in order to take business away from particular competitors.

Factors present in Federal Reserve operations also limit the possibility that the Federal Reserve could abuse the flexibility it has in setting prices. Now that the Federal Reserve has achieved full cost recovery on a nationwide basis for its check clearing services, it can only subsidize a particular service by charging more than full costs for other services. However, as the Federal Reserve raises some of its prices above its costs, this increases the chance that it will lose market share to private competitors in these areas and thereby lose the means of financing service subsidies.

In addition, pricing guidelines adopted by the Federal Reserve's governing body, the Board of Governors, tend to limit the flexibility the Federal Reserve System has in setting prices of particular services below the costs of those services. Correspondent institutions competing with the Federal Reserve, on the other hand, have no special restrictions on how they price their services and, therefore, are free to price any way they wish so long as they do not violate anti-trust or other provisions of law. (See pp. 20 to 21.)

Noon presentment program made possible in part by Federal Reserve System advantages

Two of the factors that correspondent banks believe give the Federal Reserve an advantage--noon presentment of checks to payor banks and immunity from presentment fees--are associated with service improvements which the Federal Reserve began to offer in February 1983. Prior to these changes the Federal Reserve abided by local clearinghouse (voluntary associations of local banks) rules which generally required presentment of checks to payor banks for payment between 8 a.m. and 10 a.m. each day. By custom, correspondent banks presenting checks for payment after normal clearinghouse hours are often subject to special fees, called presentment fees, which typically are per item charges not related to the value of the check. Presentment fees may remove the economic incentive from presenting all but larger valued checks at later times. The Federal Reserve, however, is prohibited by law from paying presentment fees. Therefore, the Federal Reserve did not have to worry about how presentment fees would affect its costs (and therefore the prices it would have to charge its customers) when it presented some checks for payment at a later time of day.

When the Federal Reserve moved the time for check presentment to noon, it had more time to present checks for payment at many paying banks. The result has been an increased ability of the Federal Reserve to collect checks in 1 day that had previously taken 2 days. Because of this, banks using the Federal Reserve to collect checks for them can often obtain useable funds 1 day earlier than was previously the case and perhaps 1 day earlier

than a competing correspondent could have done without paying presentment fees. In June 1983 later presentment of checks by the Federal Reserve to payor banks, located in the 48 cities where the Federal Reserve has check processing offices, amounted to 31 percent of the total dollar value and 16 percent of the total number of checks the Federal Reserve presented.

GAO cannot say precisely how much of an advantage the Federal Reserve gained from noon presentment because data are not available to determine the effect that the Federal Reserve's improved service has had on the revenue and volume of correspondent banks. In the second quarter of 1983, after the noon presentment program began, the number of checks transported by the Federal Reserve System between offices and districts was 16 percent higher than in the same quarter in the previous year, while the total number of checks written increased at an estimated rate of only 5 to 6 percent for the year. This increase in Federal Reserve transportation volume could not have occurred unless the volume of privately arranged check courier services used by correspondent competitors and perhaps other correspondent bank services declined. However, most of this increase in transportation volume occurred before the noon presentment program was implemented and thus appears to be primarily the result of the transportation improvements that were implemented in August 1982. The volume of interoffice and interdistrict check transportation has actually fallen slightly since the quarter in which the noon presentment program began. (See pp. 21 to 26.)

The Federal Reserve's decision to abandon its long-standing policy of following local clearinghouse rules was legal. Therefore, to offset this advantage, some clearinghouses have changed their rules to more closely correspond to the noon presentment time used by the Federal Reserve.

Some correspondent banks, believing that Federal Reserve banks should pay "reasonable and nondiscriminatory" presentment fees, have proposed that legislation be passed permitting such payments. In GAO's opinion, several questions need to be resolved before assessing

the proposed legislation's merits. These include the level of fees that should be permitted; whether Federal Reserve payment of such fees could lead to significant increases in all presentment fees; and whether it would be administratively burdensome to assure that the fees paid by the Federal Reserve were fair. (See pp. 26 to 29.)

Federal Reserve will eliminate the advantage associated with clearing balances

A bank using the check clearing services of the Federal Reserve or a correspondent bank can pay for such services by fee or by maintaining deposits, known as clearing balances, with the service provider. GAO was asked to determine whether the Federal Reserve enjoys an advantage over correspondent banks because of the way it imputes value to clearing balances.

Federal Reserve and correspondent banks both use the interest earned from investing clearing balances to help pay the costs of check clearing services. When a correspondent bank accepts a clearing balance, however, it must forward 12 percent of the amount received to its reserve account at the Federal Reserve, on which the Federal Reserve pays no interest to the correspondent. On the other hand, when the Federal Reserve accepts a clearing balance to help pay for check clearing services, it has no reserve requirement and earns interest on the full amount deposited. The Federal Reserve, for the purpose of pricing its services, imputes a value on the full amount of a clearing balance, while most correspondents deduct the 12 percent reserve requirement from the amount they receive as a clearing balance.

Correspondent banks, having less investable funds as a result of the reserve requirement, can be at a disadvantage compared to the Federal Reserve in quoting the clearing balance required for a given level of service. This may be offset by the fact that correspondent banks can earn more than the Federal Reserve on the funds they do invest. The Federal Reserve can only invest in U.S. Treasury securities whose yields generally are lower than other investment opportunities open to commercial banks.

In March 1984, the Board of Governors approved a policy change which will remove any price advantage the Federal Reserve banks have had due to the way the Federal Reserve handled clearing balances. As previously stated, to determine the size of the balance which the Federal Reserve requires as compensation for a given level of priced services, a value is imputed to clearing balances. In the past, the interest rate used to calculate this value has been the federal funds rate. Under the new policy, the Federal Reserve will reduce the effective interest rate it uses. This rate reduction in turn will increase the effective cost of Federal Reserve Services, in some cases by as much as 13.6 percent. (See pp. 29 to 34.)

APPARENT END TO FEDERAL RESERVE'S UNDERCHARGING FOR CHECK CLEARING SERVICES

At the beginning of 1983, Federal Reserve prices for clearing checks were significantly below average net costs. By the end of the year, the Federal Reserve had increased revenue per check processed by 38 percent. Data for the first quarter of 1984 suggest that the new prices cover all identified expenses. (See pp. 12 to 15.)

Representatives of correspondent banks have suggested that even with the price increases for check clearing operations, the Federal Reserve System is still undercharging for its services. They argue (1) operating expenses distributed to check clearing by the Federal Reserve's accounting system are too low, and (2) the return on capital that the Monetary Control Act requires the Federal Reserve to compute should be raised. GAO does not agree with the position of the critics, although it recognizes that there is room for judgment in defining costs, which could have an effect on prices.

No significant understatement of operating expenses found

For 1983, the Federal Reserve System incurred $1.03 billion in operating expenses for all of its activities. Of this total, about $322 million or 31 percent was distributed to check clearing expenses. Part of the $322 million

assigned to check clearing represents the direct expenses of check clearing; the remainder represents allocation of support and overhead activities. GAO believes that these operating expenses were being distributed in a reasonable manner. (See pp. 38 to 42.)

Amounts for capital expenses and taxes adequate

The Monetary Control Act required the Federal Reserve to include in its prices for check clearing an allocation for taxes and return on capital that would be incurred by a private firm. The Federal Reserve refers to this as the private sector adjustment factor (PSAF). For 1984, the Federal Reserve's proposed PSAF was $56 million.[3] This constitutes about 10 percent of the revenue the Federal Reserve expects to recover from check clearing and its other priced services. Some critics of the Federal Reserve believe that the PSAF should be much higher--as high as $180 million. They are of the view that the Federal Reserve underestimates both the amount and cost of capital that would be associated with a private sector organization providing the same services the Federal Reserve does.

Because there is not a set of firms exactly like the Federal Reserve, several judgment factors are associated with calculating the PSAF. Therefore, GAO cannot state exactly what the PSAF should be. However, after reviewing all factors in the PSAF and the Federal Reserve's methodology, GAO sees no reason to propose a higher PSAF. The Federal Reserve made reasonable assumptions about both the value of assets devoted to priced services and

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[3]In March 1984 the Federal Reserve approved a revised PSAF calculation which increased the amount to $58.8 million. Most of the discussion in this report is directed toward the earlier proposal which, in all essential respects, is calculated by using the same methodology as the one ultimately adopted by the Federal Reserve. The proposal adopted in 1984 used more recent data for the calculation, took account of the added cost of FDIC insurance banks have to pay on clearing balances, and made other minor changes.

the imputed rate of return used to finance them. GAO's analysis shows that the Federal Reserve's proposal for a PSAF of $56.2 million falls within the range of $56 million to $64 million that GAO believes to be reasonable. (See pp. 43 to 45.)

FEDERAL RESERVE EFFORTS TO ELIMINATE CONFLICTS WITH CORRESPONDENT BANKS

By law, the Federal Reserve must function both as a competing institution and as a central bank with regulatory authority. This unique statute creates some problems for the Federal Reserve System in its relations with correspondent banks.

Most correspondent banks are owned by bank holding companies, which are regulated and supervised by the Federal Reserve. Some banks believe that if they compete too hard for check clearing business, they might be adversely affected by Federal Reserve supervisory decisions in other areas. GAO found no instances where the Federal Reserve abused its central bank powers.

However, some banks have complained that the Federal Reserve has not provided appropriate information to the public about its check clearing operations. These banks contend that without better knowledge of the Federal Reserve's intended presence in the market over the long run, they face increased risks in making their own long-range plans. They believe that in the future the Federal Reserve could effectively preempt private banks from any share of the market the Federal Reserve wanted to serve.

The Federal Reserve System plans to draw up a set of policies for determining the type of actions that are and are not appropriate for Reserve banks to take when competing with private sector institutions. When fully implemented, these policies, including more complete quarterly disclosure of financial and program information, should help reduce concerns of its competitors. (See pp. 61 to 64.)

AGENCY AND OTHER COMMENTS

Federal Reserve officials and others who commented on a draft of this report did not take

issue with GAO conclusions but rather stated their respective views about the Federal Reserve's role in the check clearing process. The Federal Reserve expressed the opinion that the Congress intended for it to have a unique role. The Federal Reserve believes the Monetary Control Act is working as the Congress intended and has resulted in increased competition. This increased competition has resulted in increased efficiency which has benefitted consumers, businesses, and other users of the payments system. The Federal Reserve also expressed the view that presentment fees should be banned for all banks. GAO has not taken a position on this issue.

Officials representing various groups of commercial banks who commented on the draft report agreed that continuing oversight of Federal Reserve check processing activities is needed. Representatives of a coalition of correspondent banks stressed the importance of having the Federal Reserve set forth more clearly its intentions about the share of the check clearing market it is seeking. GAO and the Federal Reserve agree with this because it would help the banks to make more rational investment decisions. Representatives of the Independent Bankers Association, representing small banks, tended to agree with the Federal Reserve's actions since the Monetary Control Act of 1980 was passed because they have benefitted from improvements made by the Federal Reserve in the payments system. Comments received have been reprinted in appendixes II through IV.

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CHAPTER 1

INTRODUCTION

On April 6, 1983, the Chairman and eight other members of the Senate Banking Committee asked us to update our 1982 report on the Federal Reserve System's implementation of provisions in the Monetary Control Act of 1980 that required the System to price its check clearing and certain other services.[1] Before passage of the Monetary Control Act, these services were provided at no charge to those commercial banks that were members of the Federal Reserve System.[2] The act required the Federal Reserve to offer its check clearing and other services--at a fee--to all such institutions, i.e., member and nonmember commercial banks, savings banks, savings and loan associations, and credit unions.[3] The act also set forth the principle that over the long-run the fees charged for priced services were to be based on all expenses attributable to these activities.

The Committee's request, contained in appendix I, also asked us to respond to specific questions that focused on

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[1]The Federal Reserve Should Move Faster to Eliminate Subsidy of Check Clearing Operations, GAO/GGD-82-22, May 7, 1982. The other services to be priced were wire transfer; net settlement; automated clearinghouse; purchase, sale, safekeeping, and transfer of securities; noncash collection; coin and currency delivery; coin wrapping; and any new services that the Federal Reserve System offers, including but not limited to payment services to effectuate the electronic transfer of funds. See the glossary for an explanation of each of these services.

[2]Although the Federal Reserve did not explicitly charge for check clearing services, member banks were required to leave a certain amount of interest-free reserves on deposit at the Federal Reserve resulting in an indirect cost or charge for using Federal Reserve services.

[3]This extension of eligibility to all institutions was associated with changes the Monetary Control Act made in the reserve requirements applicable to depository institutions. The act reduced the percentage of deposits that had to be kept in reserve. On a phased-in basis it also extended reserve requirements to all depository institutions, not just member banks. Check clearing services were therefore made available to all institutions now subject to reserve requirements and the revenue derived from charging for these services helped to offset the decline in revenues that the Federal Reserve would otherwise have experienced as a result of lower reserve requirements.

concerns raised by some private banks and by air courier firms working with these banks. Their concerns center on two issues--whether the Federal Reserve enjoys special advantages in competing with private sector institutions and whether the Federal Reserve is charging enough for its check clearing services to cover associated costs. In keeping with the Committee's main interest, this report focuses on the general topic of competition between the private sector and the Federal Reserve and on whether the taxpayer is subsidizing the Federal Reserve's check clearing services. More detailed discussions of topics raised in the request are contained in the supplement to this report. (See The Federal Reserve System Pricing of Check Clearing Activities, (GAO/GGD 84-71A).)

The report is organized as follows. This chapter contains background information on the Federal Reserve's role in the Nation's check clearing system.[4] Chapter 2 describes actions the Federal Reserve has taken through 1983 to increase the revenues that it receives for check clearing services it provides. Chapter 3 discusses those concerns raised by the Federal Reserve's competitors that have to do with subjects other than whether the Federal Reserve is subsidizing its check clearing services. Subsidy issues are discussed in chapter 4. Issues concerned with how the Federal Reserve discloses information about its check clearing operations to the public and administers its priced services activities are discussed in chapter 5.

HOW THE FEDERAL RESERVE CLEARS CHECKS

Checks provide a safe and inexpensive way for transferring funds from one person or business to another. In 1979, Americans wrote about 31.4 billion nongovernment checks valued at almost $24 trillion. In the late 1970s, the number of checks written each year was increasing at a rate of 5.6 percent per

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[4]The Federal Reserve System was established by the Federal Reserve Act of 1913 (12 U.S.C. 221). The Federal Reserve serves as the Nation's central bank and is charged with administering and making policy for the Nation's credit and monetary affairs. It also performs other functions, such as supervising and regulating commercial banks to help maintain a banking system that is responsive to the Nation's financial needs and objectives. As part of these banking functions, the Federal Reserve provides check clearing services to commercial banks, which is the subject of this report. The Federal Reserve is governed by its Board of Governors and carries out its activities through 12 Federal Reserve Banks, 25 branches, and other facilities situated throughout the country.

year.[5] At some time in the future the number of checks written may begin to decline as electronic means of payment substitute for paper checks.

The check collection process involves the transfer of account balances--i.e., bookkeeping entries--from one account to another. In the instances of concern to this report the accounts involved are in different banks. The report also focuses on one key aspect of the check collection process--the transfer of balances from the bank on which a check was written to the bank in which the check was deposited or cashed.

The Nation's checking system works well because the millions of checks written each day can be presented promptly for payment by the banks on which they were drawn. Although much of the check clearing activity takes place entirely within the private sector, the Federal Reserve System plays an important part in the check clearing system by providing a reliable nationwide system for clearing checks. The Federal Reserve operates 48 check processing centers, 1 at each of the 12 District banks, 1 at each of 25 branch banks, and 11 where no bank or branch is located. (The locations can be found in table 47, section 9, of the supplement to this report.) Each processing center serves a given geographical area. Except by permission, banks using the Federal Reserve's services must deposit checks for collection with the processing center in their respective zone. Each center is linked by air courier and wire services.

The majority of checks processed by a center are for collection within that center's territory. Although the processing centers work around the clock, the busiest time is after midnight, when checks are sorted according to paying banks and prepared for dispatch. The sorting process is highly mechanized, using high-speed sorting and data processing equipment. This is made possible through the use of machine-readable magnetic encodings on checks showing amount of the check, the Federal Reserve zone in which the paying bank is located, and the specific paying bank on which the check is drawn.

Federal Reserve System involvement in the check collection process is set in motion when a bank, called a depositing or collecting bank, turns checks over to the Federal Reserve for collection. Collecting banks must encode the amount of the check in magnetic ink and prepare a listing, called a cash letter, of the individual checks with each grouping of checks being deposited.

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[5]Estimates are from the last comprehensive study performed on this subject: A Quantitative Description of the Check Collection System, co-sponsored by the American Bankers Association, Bank Administration Institute, and the Federal Reserve System. The study analyzed 1979 check processing data.

Presentment and settlement

Presentment of checks refers to the procedure whereby a bank brings checks deposited with it back for payment to the banks on which they were written. When a Federal Reserve bank presents checks to a bank, it subtracts the amount of funds to be collected from an account that the paying bank (or a bank acting as the agent of the paying bank) maintains with that Federal Reserve bank. The depositing bank receives its funds when the account it maintains at a Federal Reserve bank is credited for the amount of the checks deposited with the Federal Reserve System. The day on which the funds will be credited to the depositing bank's account varies according to the length of time it usually takes to achieve collection. Generally, funds drawn on banks located close to the check processing center are credited on the same day of deposit, while those located further away are credited 1 or 2 days later.

Throughout the day, banks' accounts at the Federal Reserve banks are debited for the value of checks presented to them for collection and credited for amounts that they are due from others. At the end of a day's transactions, banks are given a status report of the net settlement results, which includes adjustments made as a result of returned checks, errors, and disputed items. In the same manner, the Federal Reserve banks and branches settle among themselves on a daily basis using their wire services.

Float

The Federal Reserve provides banks an assured collection schedule of no more than 2 days, the number of days depending on the locations of depositing and paying banks. The Federal Reserve is not always able, however, to present checks to the paying bank before it has credited the account of the depositing bank. Crediting the depositing bank's reserve account before debiting the paying bank's reserve account creates Federal Reserve float within the check clearing system. Federal Reserve float arises for a number of reasons--peak workloads that exceed processing capacity, delays in transportation, or unusual weather conditions. In essence, Federal Reserve float is an advance provided to depositing institutions by a Federal Reserve bank. The nature of Federal Reserve float and its cost are discussed more fully in section 3 of the supplement to this report.

The Federal Reserve's market share

In 1983, the Federal Reserve collected about 14.3 billion checks, which represented an estimated 37 percent of all checks written in the United States. However, a study of 1979 data by the Atlanta Federal Reserve Bank indicated that about 30 percent of all checks are deposited directly in the bank on which they were written. Assuming that this percentage has not changed

since 1979, if these checks are excluded, the checks handled by the Federal Reserve represent more than half of all checks deposited in one bank for payment by another. It may, however, be an overstatement to say that the Federal Reserve has a majority share of the market for checks that clear between banks. This is because many of the checks received by the Federal Reserve have first been processed and possibly transported to it by correspondent banks.[6] Nevertheless, it is clear that the Federal Reserve is the dominant single institution in the check clearing market.

The market in which the Federal Reserve is competing represents the revenue potential for third party check processing. If a bank has deposited with it a check drawn on an account of one of its customers, no third party revenue potential exists because the check does not have to leave the bank of original deposit. Also, no revenue potential exists when two local banks agree to exchange checks drawn on each other. The market that is relevant for this report comprises only instances where banks find it advantageous to use third parties--generally either Federal Reserve or correspondent banks--to clear checks on their behalf.[7]

Unfortunately, it is not possible to measure accurately either the total size or the Federal Reserve's share of this third party market in which the Federal Reserve competes with correspondent banks. Reliable and comprehensive data on the volume and value of check processing done by correspondent banks are not available.

OBJECTIVES, SCOPE, AND METHODOLOGY

To find out whether the Federal Reserve enjoys certain competitive advantages or is subsidizing its check clearing operations, we undertook an examination of the Federal Reserve's check clearing services and of the costs associated with it. Our principal objective in each area we examined

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[6]Correspondent banks are generally large, urban, commercial banks that provide check clearing and other services to other depository institutions. A correspondent bank may find it more economical to clear some checks through the Federal Reserve System than to process the checks through its own system.

[7]In addition to the Federal Reserve and correspondent banks, third party check clearing services are provided by Federal Home Loan Banks, by state central credit unions, and by special bankers' banks that can be chartered by the Comptroller of the Currency. At present, the volume of checks processed by institutions other than the Federal Reserve and correspondent banks is relatively small.

was to determine if there were major problems that required attention from the Federal Reserve Board or from the Congress.

To assess the progress made by the Federal Reserve in meeting the pricing objectives of the Monetary Control Act, we analyzed Federal Reserve accounting and program data for individual Reserve banks and for the System as a whole. We discussed pricing issues with officials at the Board of Governors and at the Reserve Banks of Richmond, Chicago, New York, and San Francisco. We selected the New York, Richmond, and San Francisco banks because of their proximity to GAO staff available for this assignment, and the Chicago bank because at the time it was responsible for managing the Federal Reserve's Interterritory Transportation System.

We met with a number of private bank and trade association officials to discuss the range of issues covered in this report. Section 10 of the supplement to this report lists those contacted. We also met with representatives of a coalition of several institutions who are critical of Federal Reserve pricing policies to discuss their July 1983 report Recommendations of the National Payments System Coalition for the Modification of the Monetary Control Act of 1980 to Assure a More Efficient and Competitive Payments System.

The Monetary Control Act of 1980 required the cost basis for the Federal Reserve's prices to include imputed costs for taxes and return on capital that would have been incurred if the services had been provided by a private business. These imputed costs are referred to as the private sector adjustment factor (PSAF). We obtained the views of three consultants with respect to the PSAF.

Our PSAF calculations were based upon data supplied by the Federal Reserve in 1983. In 1984 the Federal Reserve published revised data for calculating the PSAF. Although we note the changes which the Federal Reserve made, our detailed analysis of the PSAF is still based upon the earlier Federal Reserve proposal which is very similar to the version eventually adopted. Unless otherwise noted all other data in this report are based upon actual figures available to us in early 1984. Several limitations on our work are discussed in the following paragraphs.

Our review was performed in accordance with generally accepted government auditing standards and is based on data for the period 1980 through 1983.

Limitations

Our analysis, which concentrated on check clearing and not on electronic payment or other priced services, is based on available Federal Reserve System Revenue, cost, volume, and other pertinent data. The System was cooperative in supplying

information but does not routinely keep some of the data that we would like to have had, such as separate accounting for all priced and non-priced expenses. In some cases we had to rely on estimates developed by or in consultation with Board staff.

In concentrating on Federal Reserve pricing actions, we did not attempt to provide a comprehensive economic analysis of the market for various check clearing services. Although such a study would be useful, little data are available on private sector check clearing operations, and it was outside the scope of what the Committee asked us to do.

Our work relied heavily on the Federal Reserve's cost accounting system, known as the Planning and Control System (PACS). Although certain aspects of PACS, which predates the Monetary Control Act of 1980, have been continually refined, certain cumbersome manual adjustments to PACS must be made to completely separate expenses associated with all priced services from those that are not priced. Fortunately, the direct costs of check clearing services provided to commercial banks are adequately segregated from other activities in PACS.

Our review concentrated on the data that PACS contains about check clearing costs and did not constitute a review of how well PACS serves the accounting needs of the Federal Reserve System. We did not attempt to verify the accuracy of the Federal Reserve's ability to account for transactions, but we did review the procedures PACS uses in distributing expenses and also reviewed how the Federal Reserve Board and Federal Reserve Bank officials in San Francisco try to ensure adherence to those procedures. We also visited three other Federal Reserve locations, New York, Baltimore, and Cranford (New Jersey), to observe how building, overhead, and data processing costs were allocated, but our work in these three locations was not extensive. At these three locations we selected six specific categories of data, such as number of personnel for particular services, and traced the data from office records to the PACS report for the second quarter of 1983.

Allocating joint costs between different activities, applying cost information to pricing decisions, and imputing taxes and a return on capital to activities operating outside of a market setting always involve judgment. Our analysis of cost and pricing questions concentrated on assessing the reasonableness of judgments made by the Federal Reserve System, not on the independent development of cost allocation or pricing procedures. We recognize that a reasonableness test inevitably involves subjective elements, but, to the extent possible, we have assessed objective factors relevant to a particular situation. Complex, detailed audits would have been required to try to resolve matters that contain significant judgment issues, such as the allocation of the cost of centrally managed computer facilities, or the market value of the assets employed by the Federal Reserve in its priced service operations. We did not

attempt to perform such audits because they were outside the scope of our work.

Check clearing involves an unusual feature of the economy in that the Nation's central bank competes actively with private sector institutions. It was not possible to address all aspects of this situation because of time constraints and the expressed interest of the Committee in having us concentrate on the specific questions contained in the request letter. Thus, we do not, for example, attempt to assess whether the Monetary Control Act adequately addressed all of the issues associated with the Federal Reserve's check clearing responsibilities. Nor did we assess inherent economic advantages of the Federal Reserve System or how the dynamics of competition are likely to affect the Federal Reserve, private banks, and clearinghouses. Similarly, we make no attempt to define public interest aspects of the Federal Reserve System's check clearing or other payment functions or whether organizational changes, such as establishing the Federal Reserve's check clearing operations as a separate subsidiary, would be appropriate.

AGENCY AND OTHER COMMENTS

A draft of this report was the subject of hearings before the Senate Committee on Banking, Housing, and Urban Affairs on April 11, 1984. At the direction of the Committee, copies of the draft were provided to the Federal Reserve, the American Bankers Association, the Independent Bankers Association of America (IBAA), and by a representative of a group of private institutions called the National Payments System Coalition (the Coalition) all of whom gave statements at that time. We subsequently received written comments on the draft report from the Federal Reserve, IBAA, and the Coalition, which are included as appendixes II through IV of this report. The American Bankers Association did not submit written comments to us but did testify about the report at the hearings. Officials that commented on the draft report did not take issue with any of our conclusions. The comments consisted primarily of statements of views concerning the Federal Reserve's role in check clearing.

In their comments, Federal Reserve officials said that the increased competition resulting from the Monetary Control Act had resulted in a more efficient payments system as intended by the Congress. They highlighted the actions they have taken to eliminate check clearing subsidies on a phased-in basis in compliance with that act and stressed the importance of their services to the Nation. We did not review the rationale for the Federal Reserve's presence in check clearing services because it was outside the scope of our work.

The IBAA supports the Federal Reserve's performance under the Monetary Control Act. However, they believe and we agree that Federal Reserve activities in check clearing need continuing review.

The Coalition expressed concern over the uncertainity surrounding the Federal Reserve's future market intentions. It stated that this uncertainty complicates the investment decisions that banks must make at a time when the payments system is increasingly based on electronic transactions. We think this concern is understandable. The Coalition also highlighted advantages which it believes the Federal Reserve enjoys, particularly in the highly competitive interdistrict check clearing market. We agree that it is proper to focus attention on this market, but our report does show that many of the advantages cited by the Coalition have been or will soon be eliminated by relatively recent Federal Reserve actions. Our discussion of Federal Reserve advantages in chapter 3 also points out that the Federal Reserve does not have all of the advantages.

CHAPTER 2

IN 1983 THE FEDERAL RESERVE INCREASED PRICES AND REVENUE SUBSTANTIALLY

As required by the Monetary Control Act, the Federal Reserve took a number of actions in 1983 that by the beginning of 1984 helped bring revenues in line with costs. These actions increased average revenue per check processed by about 38 percent and improved service quality. The effect on private banks' market share of certain aspects of check clearing services was uncertain. Lack of private sector data made it difficult for us to say for sure that private banks had lost market share.

MONETARY CONTROL ACT PRICING PROVISIONS

The Monetary Control Act provides that over the long run the Federal Reserve System should establish prices for check clearing and other priced services on the basis of three factors:

(1) all direct and indirect expenses (including overhead) actually incurred in providing priced services;

(2) a charge representing the financing cost of float;[1] and

(3) a charge, referred to as the private sector adjustment factor (PSAF), that takes into account taxes and return on capital that would be incurred if the Federal Reserve were a private business firm.[2]

The Federal Reserve System has a great deal of flexibility under the act in deciding how the pricing principles are to be carried out. The act does not state a fixed date when full cost recovery should be achieved. Furthermore, in setting prices the Federal Reserve is also required to "give due regard to competitive factors" and to provide for "an adequate level of services nationwide." These latter requirements could conflict with full cost recovery and affect the way that the Federal Reserve sets its prices.

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[1]The Monetary Control Act provides that interest on float is to be charged at the federal funds rate (the interest rate charged by a commercial bank for short-term loans to another bank). Float is described more fully in chapter 3 and in section 3 of the supplement to this report.

[2]See section 8 of the supplement to this report for an explanation of the private sector adjustment factor.

Before the Monetary Control Act was passed, Federal Reserve check clearing services were available without cost to member banks, which were the only institutions then required to maintain non-interest bearing reserve balances with the System. After August 1981, when the Federal Reserve began charging for its services, the number of checks handled by the Federal Reserve declined about 10 percent. Most Federal Reserve and private bank officials we talked with believed that the Federal Reserve lost volume to local clearinghouses[3] and that this loss has improved the efficiency of the check processing system.[4] The decrease in volume was also not surprising, since the System was charging for services that had previously been available without charge.

THE FEDERAL RESERVE HAS CORRECTED PROBLEMS DISCUSSED IN GAO'S 1982 REPORT

In our 1982 report, we recognized that the Federal Reserve faced a difficult task in moving to a priced environment and we found many of the actions taken by the Federal Reserve to be reasonable. We recommended, however, that to achieve a situation in which a taxpayers' subsidy was no longer provided, thereby making it more possible for private sector institutions to compete, the Federal Reserve needed to adopt policies to eliminate the revenue shortfall of about $350 million per year that was then occurring. The shortfall resulted primarily from the Federal Reserve's decision to delay pricing float until the amount of float had been reduced substantially by operating improvements. Some revenue shortfall was also attributable to delays in bringing check clearing costs and revenues into balance after the volume of cleared checks dropped. Although float was 44 percent lower in the early spring of 1982 than it was when the Monetary Control Act was passed, pricing the $2.5 billion in float that was still outstanding at the then-prevailing 15 percent federal funds rate would have about doubled the average price of the Federal Reserve's check clearing services.

During 1982 and 1983 the Federal Reserve took a number of steps, described in the following paragraphs, to bring its costs

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[3]A clearinghouse is essentially a voluntary association of depository institutions in a city that facilitates the clearing of checks through direct exchange between members.

[4]Federal Reserve officials and commercial bankers told us that new local clearinghouses have been formed and more banks have joined existing clearinghouses in order to avoid paying Federal Reserve charges. As no third party is involved when checks are presented directly, the total market potential for third party check processing may thus have decreased as a consequence of pricing Federal Reserve services.

and revenues into balance. These steps were responsive to our concerns about the revenue shortfalls that were occurring in the Federal Reserve's check clearing operations. During calendar year 1982 the average revenue per check handled by the Federal Reserve was less than half of its full average cost, but the revenue gap was nearly closed during 1983. This is shown in figure 1. At the end of 1983, average revenue and cost were both about 2.9 cents per check. (The average cost includes both the cost of float and the imputed cost of capital.) For the first quarter of 1984, preliminary data show the average revenue per check exceeded the average cost per check.

STEPS TAKEN BY THE FEDERAL RESERVE TO ELIMINATE REVENUE SHORTFALLS

By the fourth quarter of 1982, the excess of costs over revenue had already fallen from an annual rate of about $350 million at the beginning of the year to a rate of about $230 million, primarily because the amount of float had been reduced and the cost of float was lower due to lower interest rates.[5] The major steps the Federal Reserve took during 1983 to close the revenue gap were to (1) simultaneously raise its check clearing prices and improve the quality of service in early 1983, (2) include the cost of float in its check processing prices starting in July 1983, and (3) raise prices an average of 7 percent in December 1983.[6]

The change in service quality that began to take effect in February 1983 coincided with a new price schedule that generally increased the Federal Reserve's prices.[7] The quality

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[5]In the fourth quarter of 1982, the Federal Reserve's $79 million in direct and indirect check clearing expenses (exclusive of float and the PSAF) exceeded its revenues by $5 million. Had the System also recovered the cost of the PSAF and priced float, its fourth quarter revenues would have been $132 million--$58 million or 78 percent greater than the funds actually collected.

[6]In assessing the actions the Federal Reserve took to bring revenues and costs into balance it is important to note that the System can administratively control costs and prices but the revenue obtained from any given price depends upon market conditions--i.e., how existing and potential customers respond to prices. A major factor in such response is quality of service--reliability and how soon deposited funds are available.

[7]Although the prices were higher in nominal terms, they might not have been higher in real terms because the service improvements implemented by the Federal Reserve have value.

improvement resulted from the combination of later deposit deadlines, later presentment times (daily cutoff time for a collecting institution to present a check for payment at a paying institution), and improved transportation. These changes enabled the Federal Reserve to accelerate the availability of funds to many depositing banks (the change in the quality of service is discussed in more detail in the next chapter).[8] As a result of the new prices and improved services, the Federal Reserve's revenues in the second quarter of 1983 were about 32 percent higher, and costs were about 7 percent higher compared to the same quarter of 1982. Most of the increase in revenue was due to the higher prices because the number of checks processed by the Federal Reserve increased by only 2 percent over a comparable period. In the second quarter of 1983 revenues exceeded the amount of costs and the PSAF, exclusive of float, by about 8 percent. Because float was still not priced, however, the level of subsidy was still running at an annual rate of about $100 million.[9] The increase in average revenue per item handled between the last quarter of 1982 and the second quarter of 1983 is evident in figure 1.

The Federal Reserve's float pricing strategy

The Federal Reserve's 1983 float pricing strategy, together with another increase in prices that took effect in December 1983, closed the remaining revenue gap. In July, the System began to charge depositing banks for "interterritory float" (float arising from check clearing between two Federal Reserve districts). Interterritory float was the largest category of the various types of float, and averaged about $1 billion at the beginning of the third quarter of 1983. Pricing interterritory float helped to reduce the revenue gap because it generated

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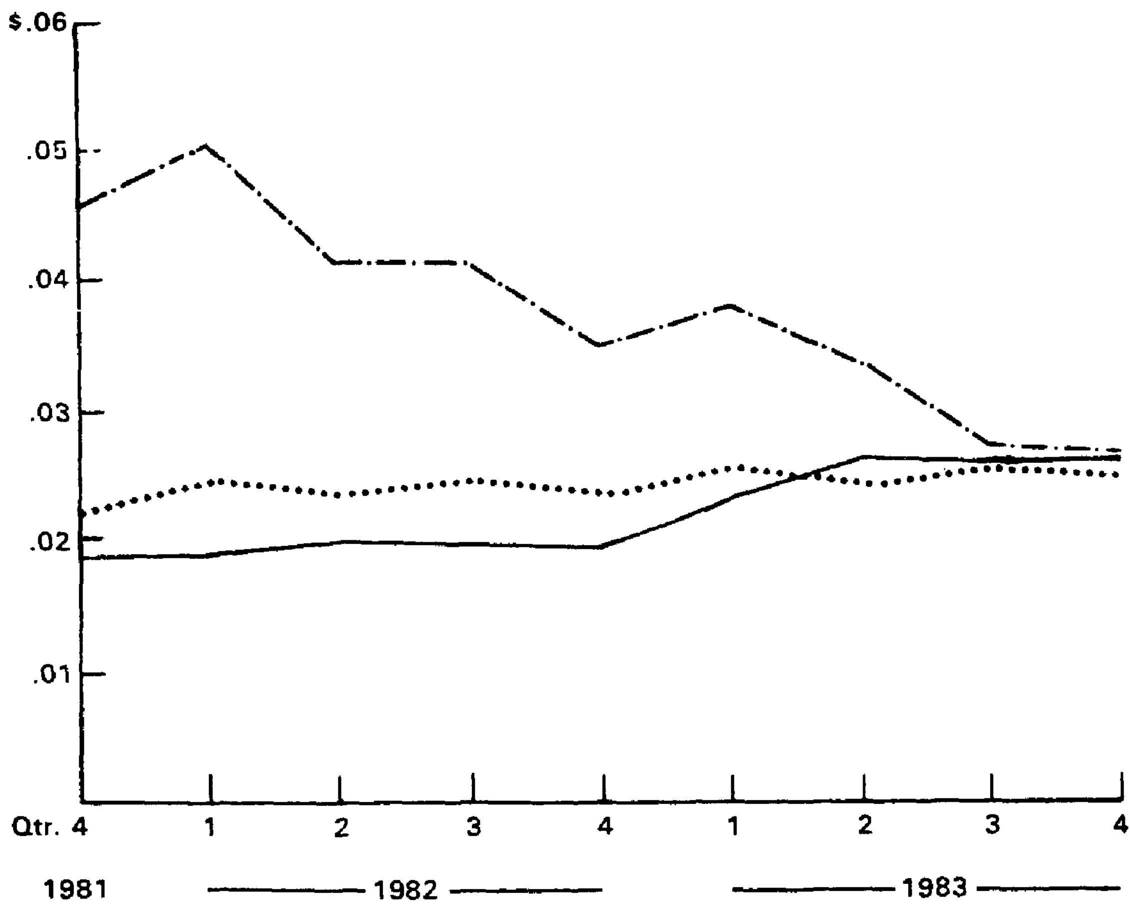
[8]Several other steps were also taken. On February 24, 1983, the Federal Reserve began phasing in a price schedule for holdover float (float resulting when a Federal Reserve office is unable to process for collection check deposits that had been received on a timely basis). At the end of July 1983 an additional surcharge averaging $0.001 was added to each check transported by the Federal Reserve's Interterritory Transportation System, which could result in annual increased revenue of about $3 million (the surcharge times the number of checks transported by the Interterritory Transportation System).

[9]For the second quarter of calendar year 1983, the $96 million in revenue received from check clearing services would have been $27 million or 28 percent higher had the System recovered full costs--operating costs plus the PSAF and interest on $1.5 billion in check float prevailing at that time. On an annual basis, the shortfall would be $108 million ($27 million times 4).

FRS Cost and Revenue Per Item Comparison For Commercial Check Service Fourth Quarter 1981-1983

(calendar years)



Note: Quarters 3 and 4 are GAO projections (1983)

Legend: Operating Cost & PSAF/Item •••••••
Operating Cost & PSAF & Float/Item —·—·
Revenue/Item ———

income and because the Federal Reserve and private banks were able to take steps to reduce costs by eliminating a considerable portion of this type of float. Interterritory float dropped by more than half when pricing began. (This is discussed further in chapter 3.) Problems in developing reliable billing procedures delayed the full realization of revenue from interterritory float until October 1. At that time the cost of all remaining check float was added to the Federal Reserve's cost base.

A price increase in December 1983 eliminated the remaining revenue shortfall

The Federal Reserve expected that an average price increase of 7 percent that took effect on December 1, 1983, would bring it to the point where the revenues it received for its check clearing services covered its full costs including the cost of float and the imputed costs for capital and taxes that are decribed below. But the revenues received in December were still about 10 percent below its identified costs, due to a large increase in float that month. Preliminary data for the first quarter of 1984 suggest, however, that the new prices are generating the revenues needed to cover all identified expenses.

Average revenue per check processed in December 1983 was about 38 percent higher than in the last quarter of 1982. Cost, revenue, and volume data for Federal Reserve check clearing services and for all priced services are contained in sections 6 and 9 of the supplement to this report.

THE EFFECT OF FEDERAL RESERVE ACTIONS ON PRIVATE BANKS' MARKET SHARE IS UNCERTAIN

As noted, the number of checks handled by the Federal Reserve in the second quarter of 1983 was only 2 percent greater than in the comparable quarter of 1982. Since the total number of all non-government checks written is believed by the Federal Reserve to be increasing at the rate of 5 or 6 percent annually, it might appear that the Federal Reserve actually lost some market share after the changes were made in February 1983. However, this conclusion may not be valid with respect to the third party check processing market that is of most relevance to this report.

In principle, correspondent bank competitors could be losing a significant share of the volume and revenue from third party checks due to the Federal Reserve's action even though the Federal Reserve's statistics show little change in volume. For example, a bank might have been depositing checks with a correspondent bank that in turn used the services of the Federal Reserve System in collecting the checks. If the bank stopped using the correspondent and began to send checks directly to the Federal Reserve, the Federal Reserve would show little increase in check processing volume, because previously it would have

received the checks but at a later stage in the collection process. The correspondent bank, however, would lose all its volume and revenue. Unfortunately, as indicated on p. 5, the necessary information does not exist to determine what has happened to the Federal Reserve's share of the third party check processing market since February 1983.

Some evidence exists, however, that the improvements the Federal Reserve instituted in its services have reduced the private sector's share of certain aspects of the check clearing market. In the second quarter of 1983 the number of interoffice and interdistrict checks transported by the Federal Reserve increased by about 16 percent from the same quarter of the previous year. Given the much slower rate of growth for the check clearing market as a whole, this rate of increase seems to imply some reduction in the private sector share of check transportation services.

The increase in check transportation volume seems, however, to be more attributable to improved transportation that was put in place in August 1982 than to the noon presentment program that was implemented in 1983. Most of the increase occurred in the last half of 1982, before the noon presentment program actually went into effect, and transportation of checks actually dropped slightly during 1983. (Federal Reserve data show that the volume of checks transported in the 4th quarter of 1983 was 2 percent less than in the 4th quarter of 1982.)

Additional financial institutions also appear to be taking advantage of Federal Reserve services. From December 1982 to April 1983 the System as a whole experienced a 9 percent gain in the number of institutions depositing checks directly with the System. (Most of the gain, however, was in the San Francisco and Minneapolis reserve districts, and some districts experienced a decrease, so that the evidence on the number of institutions using the Federal Reserve is mixed.)

Bank officials also told us that correspondent banks, in order to maintain their volume, have reduced their charges in response to the Federal Reserve's improved services. We have no basis for commenting on what has happened to the level of correspondent bank check processing revenues since the Federal Reserve improved the quality of its services.[10] We believe, however, that it is probable that the correspondent share of the total revenue that banks pay either to the Federal Reserve or to correspondent banks must have declined during 1983. From December of 1982 to December 1983 the Federal Reserve's revenue for

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[10]Correspondent bank revenues from check clearing operations would consist of fees paid for services rendered plus revenues derived from the investment of compensating balances maintained at correspondent banks.

clearing checks increased by 34 percent. This was due primarily to actions designed to bring revenues in line with costs. Unless correspondent bank revenue increased at a comparable rate--which is unlikely since they were presumably already pricing to cover costs and there is no evidence of a significant change in volume--it follows logically that the correspondent share of the total revenue decreased. The increase in Federal Reserve revenues need not, of course, imply an actual reduction in revenues obtained by correspondent banks. Whether this is the case depends upon what happened to the total size of the market when the Federal Reserve increased its charges. The long-run effects on the Federal Reserve's share of the revenue and volume in the relevant market resulting from improved services and higher prices are difficult to estimate at this point.

CHAPTER 3

ANALYSIS OF POSSIBLE ADVANTAGES THE FEDERAL RESERVE HAS AS THE NATION'S CENTRAL BANK

We were asked to examine several Federal Reserve policies of concern to its competitors to see whether these policies gave the Federal Reserve special advantages. The policies, each of which will be discussed in this chapter, are noon presentment, presentment fees, clearing balances, and Federal Reserve float. These policies and the Federal Reserve's size and its ability to operate nationwide, when combined with the Federal Reserve's position as the Nation's central bank, do give it advantages that other institutions do not possess. However, the Federal Reserve does not have all of the advantages because private banks have some advantages not available to the Federal Reserve.

THE FEDERAL RESERVE SYSTEM'S SIZE AND FLEXIBLE APPROACH TO PRICING INDIVIDUAL SERVICES

Federal Reserve officials and competitors both agree that the Federal Reserve's size and nationwide presence are an important element in helping it compete for check clearing services. It is widely recognized that one reason for establishing the Federal Reserve System was to provide a reliable nationwide system for clearing checks.

To the extent that the Federal Reserve has an advantage because of its size, the options that are available for modifying the Federal Reserve's competitive position are fairly limited. If the Congress wanted to limit the advantage the Federal Reserve has due to its size, the Congress would have to either alter the character of the Federal Reserve System or place restrictions on how it sets prices, which might make competition difficult with correspondent banks. How this might be done was outside the scope of our review.

One of the consequences of the nationwide character of the Federal Reserve System is that this provides an opportunity for spreading check clearing costs that may not be available to its competitors to the same degree. The Monetary Control Act gives the Federal Reserve flexibility to charge some users of its services more than full costs and others less, so long as total revenues for all its priced services cover total costs. This flexibility in pricing, typical in business, also occurs in the Federal Reserve System. For example, in the second quarter of 1983 before float pricing began, some Reserve banks (especially San Francisco, Atlanta, Chicago, and Dallas) were recovering check clearing revenue in excess of check clearing operating

costs plus the Private Sector Adjustment Factor (PSAF),[1] and others (New York, Boston, and Philadelphia) less. During the first quarter of 1984 after float had been priced, all banks except three recovered check clearing revenue in excess of costs. The three banks that recovered less than costs (and the percent that revenue fell below costs) were Boston (7.1 percent), New York (9.0 percent), and Chicago (15.2 percent). Those banks that recovered considerably more check clearing revenue than costs and the percent that revenue exceeded costs were Atlanta (24.9 percent), San Francisco (17.7 percent), Richmond (15.2 percent), and Kansas City (13.8 percent). When cost and revenue for all priced services--not just check clearing--were considered for the first quarter of 1984, the deficit at New York was eliminated and it was almost eliminated at Boston, but Chicago's deficit increased to 16.9 percent.

The Federal Reserve's competitors have expressed concern that the flexibility the Federal Reserve has in setting prices, when combined with its preeminent market position and unique access to funding as the Nation's central bank, gives the Federal Reserve the opportunity to drive out any competitor. We recognize that the problem suggested by the Federal Reserve's competitors could occur. Although data do not exist to compare the profitability of private sector competitors with that of Federal Reserve banks, it would be reasonable to expect that private sector institutions almost certainly have a more difficult time competing with the Federal Reserve in locations in which the Federal Reserve does not recover fully allocated costs. We did not, however, observe abuses in the sense of the Federal Reserve cutting prices below costs in order to take business away from particular competitors. If the Federal Reserve raised those prices that are below its fully allocated costs, it cannot be determined whether private sector institutions would also raise their prices.

In the absence of specific problems needing correction we also believe it would not be easy to come up with rigorous safeguards that do not themselves raise administrative or other problems. For example, a rule could be adopted to require each price to be based on costs but it would be difficult to administer. This is because the problems involved in trying to allocate fixed and joint costs are compounded as the categories to which costs need to be allocated become more and more detailed. As we shall describe, we found it challenging enough to determine whether costs were being fairly allocated to the whole activity of check clearing.

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[1]The PSAF is a factor required by the Monetary Control Act that the Federal Reserve is to add to its prices to reflect the taxes and return on capital that would have been incurred if the Federal Reserve were a private sector supplier.

Another practical problem to consider is that an effort to restrict the Federal Reserve's flexibility in pricing also has competitive implications for the Federal Reserve. The institutions with which the Federal Reserve competes are free to price however they want to so long as they do not violate antitrust or other provisions of law.

Several factors limit the possibility that the Federal Reserve would consciously or unconsciously abuse the flexibility it has in setting prices. One is interest in the Congress and elsewhere in evidence that actual abuses may be occurring. Another is that the Federal Reserve's procedures for obtaining public comment on proposed changes in the price schedule affords an opportunity for formal public scrutiny of prices. Another is provided by the discipline of having to recover all of its costs from pricing in a competitive environment. So long as the Federal Reserve does not subsidize its priced activities taken as a whole, it can only charge some customers less than actual costs if it charges others more. The ability of competitors to take business away from the Federal Reserve whenever certain prices get too high thus restricts the revenue available to the Federal Reserve to subsidize certain activities.

One step the Federal Reserve has taken to prevent abuses is to require that Reserve banks set no individual price below that needed to cover all costs except overhead, float, and the PSAF.[2] In San Francisco, where we tested implementation of system pricing policies at the Federal Reserve Bank (discussed in section 4 of the supplement to this report), we observed that this guideline was followed. This guideline does, however, permit a great deal of flexibility in that it permits some prices to be set that are at least 40 percent below the estimates of full costs. Federal Reserve officials said that in practice most prices are considerably closer to full costs than the 40 percent difference the guideline allows. The officials point out that the effect of the Board of Governor's procedures for reviewing the price schedules proposed by individual banks is to assure that market prices have a reasonable relationship to full costs.

In commenting on this section in a draft of this report where we state that the cost recovery experience is different for different Reserve banks, the Federal Reserve emphasized that it should only be evaluated as an integrated system rather than by individual banks. Their reasoning is that the Federal Reserve's payments system is national in scope and private businesses generally are evaluated by the market place as an integrated whole. However, the Federal Reserve said that fee schedules have been established in 1984 for each Reserve bank to cover all costs and the costs of float and to make at least some contribution to the PSAF recovery.

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[2]With the advent of float pricing, all float costs not charged to depository institutions are included as production costs.

We have not taken a position that the Federal Reserve should or should not be evaluated on a local or national scale, but we do note that the Federal Reserve is attempting to fully recover costs at each Reserve bank. The competitive implications of using revenues in one Federal Reserve bank to offset costs in another is an area of legitimate concern to correspondent banks competing for business against the subsidized Federal Reserve bank. We believe, however, limited flexibility in setting some prices below fully allocated costs is consistent with the 1980 act. Also, placing restrictions on the Federal Reserve's pricing flexibility could restrict its ability to provide the full range of services it now makes available to all financial institutions while still recovering full costs mandated by the Monetary Control Act.

Pricing of transportation services

The flexible approach to pricing individual services that the Federal Reserve uses is evident in the transportation area. This conclusion emerges from the examination we were asked to make of the way the Federal Reserve charges for the air transportation of checks. Our analysis of transportation pricing is contained in section 5 of the supplement to this report.

The Federal Reserve has established an interterritory transportation system, made up of ground and air couriers, to transport between districts checks that have been placed with the Federal Reserve for collection. It adds a surcharge to its check processing prices for each check transported by this system. Although the Monetary Control Act does not require the Federal Reserve to establish a price that identifies specific charges for air transportation services, the Federal Reserve has chosen to do so.

Air transportation revenue did not cover costs in 1982 and was short of costs by about $8.5 million in 1983. In 1983 the Federal Reserve spent about $37.3 million and received about $28.8 million in revenue to transport checks between districts. The $8.5 million shortfall in transportation revenue is about 23 percent of transportation costs and must be made up from other components of the price structure. When new air transportation contracts were awarded in November 1983, the Federal Reserve was able to cut its contract costs by about $7.3 million per year. Assuming air transportation revenue continues at the 1983 level, it appears that 1984 revenue will not cover costs.

NOON PRESENTMENT OF CHECKS AND NONPAYMENT OF PRESENTMENT FEES GIVE THE FEDERAL RESERVE AN ADVANTAGE

This section will discuss the Federal Reserve's program to improve its check clearing services in competition with major correspondent banks. Some of the banks believe that the program constitutes unfair, though not necessarily illegal, competition. What the Federal Reserve has done is to present checks to paying banks later in the day than has been customary and still receive

payment that day. For reasons to be explained, competitors have not been able to do the same thing at the same cost. The unilateral way in which the Federal Reserve initially proposed in 1982 to implement these service improvements caused sharp concern among some competitors. While the program appears to be operating successfully, its effect on the Federal Reserve's share of the check clearing market is not clear.

Clearinghouse members customarily agree to a rule that checks will normally be presented to one another for payment not later than a certain hour each morning. Such rules are made to suit the mutual convenience of the members; they can smooth the workload of operating departments and can also act to defer payment of checks being presented by banks in other cities when the checks cannot be delivered to them by the presentment deadline. The clearinghouse deadline in many cities is between the hours of 8 a.m. and 10 a.m.

Until February 24, 1983, the Federal Reserve generally followed the daily check presentment deadlines established by local clearinghouses. This meant that checks would be presented for payment to banks in the 48 cities with Federal Reserve check processing offices by or before 10 a.m. each day. To improve the quality of its check clearing services and to speed the collection of checks, on February 24 the Federal Reserve departed from local clearinghouse rules by moving the latest time it would present checks in the 48 cities and some others to 11 a.m. (local time). On May 2, 1983, the Federal Reserve moved the latest presentment time to noon. While this move was unilateral, it was in conformance with the Uniform Commercial Code. The code allows institutions to present checks for payment as late as 2 p.m., regardless of clearinghouse rules, and permits banks to make arrangements among themselves (as many do) to present checks at any mutually agreeable hour. But practical reasons make it unlikely that any institution other than the Federal Reserve System could move unilaterally to establish a later presentment time nationwide.

Federal Reserve officials and their correspondent bank competitors agree that this later presentment of checks each day, combined with the Federal Reserve's accelerated transportation of checks deposited with it, has improved the Federal Reserve's competitive position in seeking check processing activity from respondent banks.[3] The Federal Reserve now has additional time to receive, process, and present checks to payor banks. The effect of these improvements is that respondent banks can often obtain useable funds from the Federal Reserve 1 day earlier than was previously the case because some checks that previously were

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[3]An institution that sends checks to correspondent banks or the Federal Reserve for collection.

held unpresented overnight can now meet a later deadline during the day. Many small banks indicate that this service is attractive. In contrast to the Federal Reserve's noon presentment program, correspondent bank competitors located in Reserve cities are still bound by the presentment time rules of the local clearinghouses to which they belong. The clearinghouses could change their rules to be more competitive with the Federal Reserve, and as of January 1984, at least 12 have done so.

Neither the Federal Reserve nor correspondent banks maintained data that enabled us to determine the effect noon presentment has on correspondent check clearing revenue and volume. As noted on page 16, the number of interdistrict checks transported by the Federal Reserve System in the quarter after the noon presentment program was put into effect was significantly greater than the number transported a year earlier. This increase cannot, however, be attributed solely to the noon presentment program because most of it occurred in the last half of 1982, after transportation agreements were improved.

Why banks could not do what the Federal Reserve did

A major bank seeking to collect a significant volume of local checks (some of which it may be collecting as an agent for other banks) will also likely be responsible for paying a large number of checks written by its own customers. If it is a member of a local clearinghouse, the bank benefits from membership both as a paying bank and as a collecting bank. If the bank wanted to try to establish a later presentment time for presenting checks, it would have to face one of two adverse consequences that are not applicable to the Federal Reserve System. One way a bank could present checks later to other banks would be to withdraw from the clearinghouse membership. However, if the bank chooses to leave the clearinghouse and thus not be bound by clearinghouse rules, other banks could present checks later to it--possibly up until 2 p.m., as authorized by the Uniform Commercial Code. This would offset much of the benefit obtained by the later presentment it was seeking from others. Since commercial checks are not presented to the Federal Reserve for payment, the Federal Reserve does not have to consider this drawback.

If, on the other hand, the bank wanted to present checks later but remain a member of the clearinghouse, it would then most likely be faced with having to pay special fees to the paying banks. These fees, called presentment fees, are charges that presenting institutions commonly pay when they present checks to certain banks, generally larger banks belonging to clearinghouses in Federal Reserve cities. Presentment fees are typically flat, per item charges unrelated to the amount of the check. (Presentment fees are discussed further in section 1 of

the supplement to this report.) One instance in which presentment fees are often charged is when checks are presented for payment after normal clearinghouse hours. In the case of checks for small amounts, this would effectively remove the economic incentive for presenting checks at a later time in the day. This is true when the cost of the presentment fee is greater than the value of obtaining payment for a check 1 day sooner. Formerly, when the Federal Reserve presented no checks later than the normal clearinghouse hours, correspondent competitors could arrange to present high value checks after such hours, pay the presentment fees, and still offer their customers a benefit from faster availability of funds. It is important to note that the Federal Reserve does not, and believes it cannot, legally pay presentment fees even in cases when it presents checks for payment after the normal clearinghouse hours.

We agree with the Federal Reserve's judgment that it is prohibited by law from paying presentment fees. This is based upon our interpretation of section 342 of Title 12, U.S. Code, which codified section 13 of the Federal Reserve Act, as amended, and also upon our review of its legislative history. (A discussion of this issue appears as section 1 of the supplement to this report.) This immunity from presentment fees gives the Federal Reserve a competitive advantage that it applied in moving to noon presentment; it can now present checks for payment later in the day than its correspondent bank competitors and not have to pay the fees those competitors have to pay.

Better procedures could have been used

We were asked to consider the Federal Reserve's "unilateral regulatory action" of changing to noon presentment and how it affected banks competing with the Federal Reserve. We assume by "unilateral regulation" the Committee means a form of administrative action on the part of the Board that would violate proper administrative rulemaking procedures. We found no basis to conclude that the Federal Reserve's action on changing to noon presentment was carried out improperly. However, the Federal Reserve could have used its established procedures for inviting public comment on this change earlier in the process rather than announcing it after it had already entered into transportation contracts (to move checks between districts) that were essential for the success of improved check processing. Following the announcement, because of concern expressed by the public, comment was then invited. The Federal Reserve found that the reaction of banks to noon presentment was mixed.

Opposition to noon presentment centered mainly in some large eastern and midwestern correspondent banks and their check couriers, who believed they would lose profitable check processing activity to the Federal Reserve. Some of these parties indicated to us that because the Federal Reserve did not

initially invite public comment, it caused concern as to the Federal Reserve's competitive intentions in the long run. On the other hand, noon presentment was favored by many small banks, particularly those located outside the 48 Federal Reserve cities, because they expected to receive payment earlier on some of the checks the Federal Reserve was collecting for them. The noon presentment program that the Federal Reserve phased in beginning in February 1983 reflected some modifications that resulted from the comment process. The transportation contracts went into effect in August 1982 as initially planned.

Effect of noon presentment not yet known

In June 1983, the Federal Reserve presented checks to private institutions located in the same cities as Federal Reserve offices at later than customary clearinghouse hours. This later presentment amounted to 31 percent of the total dollar value and 16 percent of the total number of checks presented by the Federal Reserve to these institutions during that month. It is not clear how much of the later presentment actually represents checks that are clearing 1 day earlier than they otherwise would have because it is not possible to know what would have been the case if noon presentment had not been implemented. When the noon presentment program was first announced, some banks expressed concern that their receipt of a large volume of checks to be paid at a later than customary hour in the morning would cause significant operational problems. However, commercial bank officials we have talked to since noon presentment was implemented said that they have been able to cope with this change without significant additional costs.

Private institution officials critical of the Federal Reserve's move to noon presentment in Reserve cities have said that the later presentment of corporate disbursement checks makes it more difficult for cash managers to monitor their daily cash position. Cash managers prefer to know early in the day the amount of their corporations' checks presented for payment so that optimal arrangements can be made to manage their cash position. The earlier in the day that managers can determine their cash needs, the more flexibility they have in borrowing or investing their funds on a daily basis. In response to this criticism, the Federal Reserve is attempting to reduce the delay of information reporting caused by noon presentment; they are developing procedures to notify banks before the noon deadline of the amounts the banks will be expected to pay at noon that day on selected checking accounts. Banks can then notify their corporate customers that morning. This Federal Reserve program began on April 23, 1984. Federal Reserve officials believe the service has been well received, but we were not able to assess how successful this may be in meeting the concerns of corporate cash managers.

In recent years many large corporations have moved their disbursement checking accounts to banks located outside major cities. This was done so that checks would not clear as quickly, thus giving corporations the use of their funds for a longer period of time. This practice is often referred to as remote disbursement, and the Federal Reserve has for some time attempted to discourage it because it tends to slow down the Nation's payment system.

Many large corporate disbursement checking accounts are now maintained in banks located outside reserve cities. It is typical that all the checks presented for payment at such banks will be received by them at an early morning hour. To accelerate the payment of checks drawn on these corporate accounts, the Federal Reserve implemented a plan on April 23, 1984, to present checks as late as noon to selected payor banks located outside Reserve cities. This is known as the high dollar group sort program. The purpose of the program is to identify the payor banks having a high volume of disbursement account activity and to accelerate the collection of checks drawn on them. Under this program, remotely located banks to which noon presentment will be applied are primarily those that pay an average of $10 million or more of nonlocal checks each day. The program was initiated at 120 banks. Some commercial bank officials are skeptical whether this program will succeed. Their supposition is that corporations affected by the high dollar group sort program will simply relocate their checking accounts to other banks not subject to noon presentment. We have no basis to say whether this will occur; if it does, the added check transportation costs of the program would generate few benefits. Federal Reserve officials believe that the inital response to the high dollar group sort program suggests it will not result in large scale shifts of accounts.

The Federal Reserve's move to noon presentment raises the issue of the relationship between its central bank status and its competitive operational role in the Nation's payments system. Whatever the merits of noon presentment for the long run efficiency of the payments system, the action also enhanced the Federal Reserve's competitive position by enabling it to present some checks more quickly to paying banks than in the past. It demonstrated that the Federal Reserve System has a degree of influence usually associated with a dominating firm in a market and that it is not just another competitor. The way in which noon presentment was implemented, coupled with the exemption from presentment fees, has heightened concerns of competitors over actions the Federal Reserve may take in the future as it reacts to the dynamics of market forces and changing technology in the payments area.

Changing the law to authorize the Federal Reserve to pay presentment fees raises questions that are difficult to answer

We were requested to comment on whether valid public policy reasons exist for exempting Reserve banks from presentment fees and whether this area of the law should be changed. In principle, subjecting the Federal Reserve System to the same arrangements competitors face has merit. However, proposals to authorize the Federal Reserve to pay presentment fees also raise difficult questions about the role of the Federal Reserve System and about how the fees would be determined. These questions should be examined carefully if legislation modifying the Federal Reserve's exemption from presentment fees is to be given serious consideration. Until these questions are addressed more thoroughly, we are unable to take a position on whether the law should be changed.

One problem with authorizing payment of presentment fees is that it is difficult to know how much the Federal Reserve could eventually end up being charged. An estimate of the initial effect of a legislative change can be derived from current presentment patterns. In June 1983, the Federal Reserve banks processed about 241 million checks drawn on Reserve city banks. Of these, about 39 million checks were presented after normal clearinghouse hours but not later than noon. Some or all of these 39 million checks might have been subject to presentment fees if the Federal Reserve were paying such fees. For each penny per check charged for presentment, the Federal Reserve could incur a monthly cost of $390,000 or $4.7 million per year if all 39 million were charged. To recover this cost, the Federal Reserve in turn would have to increase its average prices on all checks it clears by about 1 1/4 percent for each penny of average presentment fee. The percentage increase in prices would be much higher if only the prices of checks presented later were raised. We understand that presentment fees vary widely and are often at a level of several cents per check.

If the Federal Reserve began to pay presentment fees, payor banks might increase per item presentment fees or institute earlier clearinghouse hours, after which the Federal Reserve would have to pay presentment fees on a larger volume of checks. Both of these changes would increase payor bank revenue at the expense of the Federal Reserve and of banks depositing checks in the Federal Reserve for clearing. Also, banks not currently charging presentment fees could begin to do so; it would be difficult for the Federal Reserve to justify paying fees to some banks and not to others. As the Federal Reserve is only a presenter and not a payor of commercial checks, the cost to it of presentment fees that would have to be passed back to depositing banks could become significant. In contrast to correspondent banks, the Federal Reserve would obtain no offsetting revenue from charging other banks presentment fees. We have no basis for estimating how probable it is that such changes in current practices might occur.

Some banks suggest changing the law to permit the Federal Reserve to pay "reasonable and nondiscriminatory charges." It

is difficult to assess the actual effect of such a proposal because it would affect the intricate and constantly changing relationships between the Federal Reserve System, local clearinghouses, and individual banks. The proposal does, however, raise significant questions for consideration. If the Federal Reserve is given discretion to make payment, how is the discretion to be exercised? For example, would such language have the practical effect of allowing the Federal Reserve to approve or disapprove the rules of local clearinghouses? If, as a practical matter it will be difficult for the Federal Reserve to justify its disapproval of locally accepted custom, then would clearinghouses have considerably greater power to change the circumstances under which checks are cleared? How are the respective roles of the Federal Reserve System and of local clearinghouses to be delineated? In addition, would the changes of the type described in the preceding paragraph have the affect of inhibiting the Federal Reserve's ability to improve the Nation's payment system?

Another concern is whether a system prescribing reasonable and nondiscriminatory presentment fee charges to the Federal Reserve would be difficult to administer. Would the highest fee schedule for any bank become the standard for all banks? Also, would it be possible to demonstrate that presentment fees paid by the Federal Reserve were by comparison reasonable and nondiscriminatory? Any resolution of such issues poses the potential for additional regulation of private banks or possible litigation between those institutions and the Federal Reserve. Therefore, we believe that these administrative matters would also have to be dealt with if consideration is to be given to changing the law to allow the Federal Reserve to pay presentment fees.

The Federal Reserve, in commenting on a draft of this report, said that presentment fees for any check presented to a payor institution in advance of the Uniform Commercial Code's 2 p.m. cut-off time should be banned altogether. According to the Federal Reserve, payment of presentment fees can cause inefficiencies in the payments system to the extent that collecting institutions attempt to avoid paying such fees through circuitous routings or by holding checks until the next day so that they can be presented through a clearinghouse exchange. The Federal Reserve also believes that any costs incurred by a payor bank for paying a check should be borne by the payor bank or its customer (the check writer). They say that transferring payor bank costs to a collecting bank reduces the payor bank's incentive to minimize expenses.

While the Federal Reserve's position on letting the payor bank and ultimately the check writer bear as much of the cost of writing checks as possible has merit, the effect of banning presentment fees altogether would be difficult to predict. We have not attempted to assess the effect on the Nation's check collection system if presentment fees were banned on checks presented

up to 2 p.m., but it could be significant for some payor banks in terms of both lost revenues and greater operational work loads. As stated earlier the information available about the existing arrangements between individual institutions regarding presentment fees and presentment times is very limited.

FEDERAL RESERVE POLICY ON CLEARING BALANCES HAS CHANGED

A bank depositing checks with the Federal Reserve System must either have an account at its district Reserve bank or designate the account of a correspondent bank which itself has an account with a Reserve bank that can be used to handle its transactions. For a bank that has an account with the Federal Reserve, the balance that must be maintained is set by the Federal Reserve; it is set at a level which is thought, in the light of a bank's size and the size of its normal daily paying and receiving transactions, to be sufficient to avoid overdrafts. For larger banks, the reserve accounts maintained at the Federal Reserve on deposit liabilities are often large enough to accommodate check clearing transactions. All other banks must place funds at the Federal Reserve to use the Federal Reserve facilities for check clearing purposes. These funds are known as clearing balances. We were asked to determine whether the Federal Reserve's handling of these clearing balances creates an advantage for the Federal Reserve in competing with correspondent banks.

Although clearing balances are non-interest bearing deposits, the Federal Reserve now accrues what are called earnings credits that can be used by the banks to pay for check clearing services. This reflects the fact that the Federal Reserve System earns interest by investing clearing balances in Federal debt obligations. To pay for services entirely by earnings credits, many banks establish clearing balances at a level above that required to conduct transactions. They do this because this higher balance allows them to pay for Federal Reserve services without paying a cash fee. In commercial banking, it is also common practice for respondent banks to keep sufficient balances at correspondent banks to generate earnings credits to pay for services rendered.

In June 1983, 3,240 financial institutions maintained clearing balances with Federal Reserve banks. For 1983 the Federal Reserve System estimates that only about 13 percent of its revenues for check clearing services were generated by earnings credits on clearing balances. The other check clearing services were paid for through direct billing.

In assessing the equities involved in clearing balances we found the evidence to be mixed. On the one hand, the Federal Reserve is granting earnings credits at an effective rate that appears to be higher than is typical in comparable banking practices and that can involve some hidden subsidy by the taxpayers. On the other hand, restrictions on how the Federal Reserve can

invest its funds means the Federal Reserve probably earns less on its clearing balances than is typical of a private bank. On balance, however, for reasons explained below, we concluded it would be appropriate for the Federal Reserve to change its policies to eliminate competitive advantages and sources of subsidy that result from its central bank status. The Federal Reserve recently agreed to make these changes later in the year.

<u>It is questionable whether the Federal Reserve should benefit from reserve requirements imposed on private banks</u>

Given a certain amount of check clearing services to be paid for, the Federal Reserve in most cases will enjoy an advantage over correspondent banks when banks pay by a clearing balance arrangement. There is no such advantage when the services are paid for by cash.

The Federal Reserve's advantage arises because clearing balances maintained at a correspondent bank are, like any other demand deposit, subject to Federal Reserve bank reserve requirements. Thus, in accordance with the terms of Regulation D of the Federal Reserve, a percentage of the clearing balance received from a customer must be included in the correspondent's reserve account at the Federal Reserve. Because no interest is earned on this amount, the correspondent does not normally give earnings credits on the full amount of the clearing balances. Instead, the typical business practice seems to be that a correspondent bank gives earnings credits at a money market rate, such as the federal funds rate, on only that portion of the balance in excess of the reserve requirement. Clearing balances at a Federal Reserve bank are, by contrast, not subject to reserve requirements, and therefore earnings credits accrue on the full amount of required clearing balance deposits. (No earnings credits are given for deposits that are the greater of 2 percent or $25,000 in excess of required balances.) Assuming that both the Federal Reserve and the correspondent banks allow earnings credits at the federal funds rate, a respondent bank will, because of the difference in reserve requirements, usually have to maintain a balance at a correspondent bank that is as much as 13.6 percent more than the balance at a Federal Reserve bank to pay for the same amount of check clearing service.[4]

If Federal Reserve and correspondent banks were able to earn the same return as a result of investment activity resulting from balances on deposit with them, the present treatment of Federal Reserve balances without question would provide an advantage to

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[4]Large banks that are members of the Federal Reserve System would not be at a price disadvantage if they used a private correspondent bank because their reserve requirements are at the same level as those of the correspondent. This is explained in section 2 of the supplement to this report.

the Federal Reserve when check clearing services are paid for by clearing blances. The Federal Reserve is not, however, a profit making institution in the usual sense, and its earning potential associated with clearing balances is more limited than the earnings potential of balances on deposit with commercial banks.

The earning assets that the Federal Reserve has associated with its clearing balance liabilities consist principally of short-term U.S. securities purchased on the open market, which typically are at the lower end of yields available on money and credit markets.[5] Commercial banks, on the other hand, have a wide variety of earning opportunities associated with the clearing balances deposited with them.[6] Thus, it is possible that on average the greater earnings potential available to commercial banks could offset some or all of the effects of the disadvantage that they experience due to different reserve requirements.

The Federal Reserve can essentially follow two courses with its treatment of clearing balances. One course is to leave things as they are on the assumption that banks on average can earn more on balances than the Federal Reserve can, and that this difference is reflected in lower prices that correspondent banks charge their customers. Unfortunately the validity of this assumption cannot be verified because data do not exist on either the earnings generated by clearing balances or on the cost and profit components of the prices charged by correspondent banks. The other course is to disregard the relative earnings potential of clearing balances and to change Federal Reserve policies so

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[5]Strictly speaking, the Federal Reserve does not have to take action to invest the funds associated with a clearing balance. When a clearing balance account is established, there are offsetting entries on the liability side of the Federal Reserve's balance sheet. An increase in clearing balance liabilities is offset by a decrease in reserve account liabilities because transferring a reserve account balance (or federal funds) is the way that a bank would normally pay the Federal Reserve to set up the account. By itself, this transaction makes no difference in the amount of U.S. Treasury securities owned by the Federal Reserve. If, however, the level of bank reserves that existed before the new clearing balance was established was felt by the Federal Reserve to be the level most appropriate for monetary policy reasons, the Federal Reserve would restore that previous level of reserves by purchasing additional U.S. securities in an amount equal to the increase in clearing balances.

[6]Banks can invest funds in the federal funds market, purchase securites, or use them as a basis for making new loans. The use made of a balance by a bank at any one time depends upon its particular situation with respect to investment opportunities open to it and whether or not it has excess reserves.

that potential advantages accruing from its central bank status are eliminated.

Obviously, elements of judgment are involved in deciding which course of action is preferable. We believe, however, that it would be reasonable for the Federal Reserve to change its policies to eliminate the advantages it has even though it is not possible to do anything to equalize the earnings potential between the Federal Reserve and commercial banks. We believe this course is appropriate because it deals in the most straightforward way with the everyday decisions that respondent banks must make in deciding whether to use the services of the Federal Reserve banks or a correspondent bank.

A correspondent bank and a Federal Reserve bank will each quote prices for providing a set of services. If the cash prices are similar, we question whether it is appropriate for the Federal Reserve to be in a position to tell potential customers that, due to lack of reserve requirements, a lower level of clearing balances can be deposited at a Federal Reserve to pay for that same level of service. In our opinion, it is better to run the risk of having correspondent banks use their potential to generate higher earnings from clearing balances to reduce their prices than it is to permit the Federal Reserve to be in a position where it can use its lack of reserve requirement to attract customers. The reserve requirement is, after all, a requirement imposed on the banking system as a matter of law for reasons that have nothing to do with the provision of services such as clearing checks. Furthermore, eliminating the Federal Reserve's reserve requirement differential will provide added incentive for institutions to pay cash for the services they receive. This is consistent with the trend toward explicit pricing of services that is occurring throughout the banking industry.

On October 3, 1983, the Federal Reserve invited public comment on a plan to modify its treatment of clearing balances by reducing its earnings credit to reflect the same adjustment for required reserves that would occur if the clearing balance were placed instead with a correspondent bank. The Federal Reserve adopted this proposal in March 1984. The System expects to implement the procedures in late October 1984. We believe the change adopted by the Federal Reserve is a reasonable way to adjust for its cost advantage that potentially affects most of the institutions eligible to deposit checks with the Federal Reserve System.

A different interest rate would allow earnings credits to correspond more closely to the Federal Reserve's actual earnings

The Federal Reserve gives earnings credits at a different interest rate than it actually earns on such balances. This practice can result in a problem whenever the federal funds rate currently used by the Federal Reserve to calculate earnings

credits is higher than the Treasury bill rate the Federal Reserve actually earns on its investment of short-term funds. For most of the past 5 years the more volatile federal funds rate has been above the Treasury bill rate, which suggests that on balance the Federal Reserve is likely to be giving earnings credits that are higher than its related investment income. At times in 1983, however, the federal funds rate has been slightly lower than the comparable Treasury rate so that the Federal Reserve has been obtaining a benefit from earnings credits.

Irrespective of the spread between the federal funds and Treasury bill rates, the Federal Reserve (and ultimately the taxpayers) are profiting from the present clearing balance arrangement in a major way. This occurs because many institutions keep clearing balances in excess of the higher level of reserves required by the Federal Reserve when a bank pays for all of the services it receives by earnings credits on clearing balances. The Federal Reserve provides no earnings credit on the excess balances but does earn interest on the investment of these funds in Treasury securities. For 1984 the Federal Reserve estimates that institutions will keep on deposit with the Federal Reserve about $250 million more in clearing balances than the total of $1 billion that they require. This will result in a gain to the Treasury of almost $22.5 million, assuming a 9 percent Treasury bill rate. Federal Reserve officials are planning to develop a service to facilitate the withdrawal of excess clearing balances so that respondents can invest them. The service is to be implemented in 1984.

The proposal that the Board of Governors approved for public comment on October 3, 1983, accepted the principle of granting earnings credits at the Treasury bill rate rather than the federal funds rate. The Federal Reserve plan would make this switch only if it begins to incur a net loss as a result of granting credits at the federal funds rate, a situation that would occur only when most of the excess clearing balances disappeared and the Treasury bill rate was lower than the federal funds rate. Making the adjustment whether or not this contingency occurs would match stated revenue figures with actual earnings of the System. If the adjustment is not made, however, it would seem reasonable that net profits or losses created by the interest rate spread (the difference between the amount the Federal Reserve receives from investing clearing balances at the Treasury bill rate and the amount it provides as earnings credit on clearing balances at the federal funds rate) be incorporated into cost recovery calculations for check clearing services.

In commenting on a draft of this report the Federal Reserve said that the federal funds rate is the more appropriate rate to use as long as the overall Federal Reserve income generated by clearing balances is not below the value of earnings credits given on clearing balances because (1) at times the federal funds rate is below the Treasury bill rate and (2) when the federal funds rate is above the Treasury bill rate, any advantage

is generally offset by the disadvantage of Federal Reserve current procedures for calculating earnings credits. The Federal Reserve said the disadvantage occurs because it calculates earnings credits only on required clearing balances, not on excess balances. Correspondent banks, on the other hand, generally calculate earnings credits on the full amount of a bank's clearing balances (after deducting the amount that must be placed in reserve). The Federal Reserve has not indicated whether the cost accounting adjustment suggested in the preceding paragraph will be made.

FEDERAL RESERVE FLOAT IS NOW PAID FOR BY BANKS, BUT SOME CRITICISM CONTINUES

A principal view expressed in our 1982 report was that the Federal Reserve should move expeditiously to price or eliminate float. This view was based on the competitive advantage given to the Federal Reserve when it was absorbing the cost of all float and on the high cost of float to the taxpayer.[7] From August 1981, when pricing began under the Monetary Control Act, until October 1, 1983, when the cost of float was incorporated fully in the priced services cost base, we estimate that the cost of unpriced check float was $512 million. (Check float is discussed in greater detail in section 3 of the supplement to this report.)

Float is somewhat seasonal; it is highest during winter months because of delays in check transportation due to inclement weather. But the average level of float has declined to one-quarter of its 1979 level. In the 4th quarter of 1983 gross check float averaged about $1.3 billion, down from about $2.2 billion in the same quarter of 1982. Thus, with the advent of pricing, the level of float has fallen. Of the $1.3 billion of float, $460 million represents interterritory check float compensated for by "as of" adjustments. (Interterritory check float is float caused by transportation delays for checks shipped between Federal Reserve districts). In the 4th quarter of 1983, net check float after "as of adjustments" averaged a little less than $900 million,[8] of which about 20 percent or $172 million represented interterritory float. The Federal Reserve anticipates that net check float will be further reduced in 1984 to an estimated level of $450 million.

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[7]Funds made available to depositing institutions as float reduced the interest-bearing Treasury securities the Federal Reserve otherwise would have owned. Since the Federal Reserve pays all of its surplus revenues to the U.S. Treasury, the lost investment income caused by float ultimately represents a cost to the taxpayer.

[8]See section 3 of the supplement to this report for additional information on "as of adjustments."

Although the Federal Reserve is now pricing all check float, some public criticism of the Federal Reserve float program continues. One criticism is that the Federal Reserve chose to charge the cost of interterritory float back to the depositing banks on an actual basis rather than by including that cost in its unit prices for processing all checks, as is being done with the other categories of float described in section 3 of the supplement to this report.

Some correspondent bank competitors contend that this procedure is burdensome to administer and may confuse banks, especially small ones, as to the full amount of Federal Reserve charges because they will receive two bills for check clearing services--one for operating expenses and one for interterritory float. While we agree that the system is complex, it has important advantages. First, it recognizes that float is not randomly spread throughout the System and thus matches the cost of float to the depositing institution that benefits from it. About 40 percent of all float occurs in two Federal Reserve offices--New York and Chicago--that together clear only 25 percent of the checks.[9] Second, it tends to discourage abuse of the payments system: Any institution depositing checks of higher than average value will not benefit disproportionately from float and thus have an incentive to create it. They would have such an incentive if float were unit priced. We found little evidence that respondent banks will be unable to identify charges for float on deposits they make at the Federal Reserve.

Representatives of a coalition of private institutions called The National Payments System Coalition for the Modification of the Monetary Control Act of 1980 to Assure a More Efficient and Competitive Payments System have argued that the existence of persistent levels of Federal Reserve float gives the Federal Reserve a competitive advantage. Correspondents do not have the resources to make advances to respondents on the same scale as the Federal Reserve. The critics argue that the Federal Reserve should establish a system whereby it makes funds available to depositing banks only upon actual collection of each deposited check by the Federal Reserve. This argument had more force when the levels of Federal Reserve float were higher than they are now and float was not priced. Now that the cost of float must be paid by the depositing banks, the Federal Reserve no longer has an advantage over the correspondent banks.

In considering how to respond to the float pricing mandate of the Monetary Control Act, the Federal Reserve in 1980 proposed a plan that would give availability on the basis of

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[9]A primary reason float is higher at these two Reserve offices is that the average value per check in these two locations is higher than the System average.

average performance. For instance, under this plan, known as fractional availability, if 97 percent of the amount of checks deposited by a bank were collected in 1 day, the depositing bank received credit for 97 percent of the deposits 1 day after the deposit and the remaining 3 percent on the second day. The Federal Reserve withdrew this plan as a result of criticism that this approach to float reduction created bookkeeping burdens for private banks. Since July 1, 1983, however, fractional availability has been reintroduced as one of the alternatives a bank may select to eliminate the subsidy that was associated with interterritory float.

Some correspondent bank competitors believe that the existence of float hid operational inefficiencies at the Federal Reserve. In the current fully priced competitive environment, however, the Federal Reserve has an incentive to perform efficiently. Although we are not sure why the reduction occurred, float in the third quarter of 1983, when some but not all of it was being priced, was about half of the level prevailing in the third quarter of 1982. Furthermore, a significant amount of Federal Reserve float is actually created by private sector banks rather than by the Federal Reserve. When a private bank sends checks directly to Federal Reserve offices outside its home district, it notifies the Federal Reserve office within its district and receives credit on the assumption that the checks are delivered in a timely manner. As such, float can arise from transportation delays beyond Federal Reserve control and should not be ascribed to Federal Reserve inefficiency. In July 1983, the average daily float created by private institutions sending checks in an untimely manner to out-of-district Reserve banks was $268 million. This represents 32 percent of total interterritory check float during the period. With the effect of float pricing that occurred following July 1983, float of this type declined sharply.

In addition, correspondent banks also have a certain degree of check float. Although we have no way to quantify the amount of this float, a survey of bank check clearing expenses prepared by the coalition of banks critical of the Federal Reserve's policies showed evidence that float does arise in conjuction with clearing services of some correspondent banks.

Noncheck float is float arising from financial transactions, such as electronic funds transfers or the purchase and sale of securities between member banks, that do not involve paper checks. Net noncheck float, averaging about $190 million in the last quarter of 1983, has not been priced. The Federal Reserve plans to price noncheck float in 1984. Noncheck float is also discussed in section 3 of the supplement to this report.

FEDERAL RESERVE DOES NOT HAVE ALL THE ADVANTAGES

While the Federal Reserve's advantages raise concerns among competitors, the Federal Reserve does not have all of the advantages. A commercial bank can, but a Federal Reserve bank cannot, charge very high prices to discourage demand for services it feels do not represent the best use of its resources. Also, unlike its correspondent bank competitors, the Federal Reserve is not in a position to market its check clearing services as part of a broader array of service lines that would constitute a total business relationship between respondent and correspondent banks. In this sense, the Federal Reserve may have less flexibility in its pricing and in its ability to compete than private sector counterparts. From our perspective, it is unclear how these comparative advantages balance out.

If the Federal Reserve's share of the Nation's check clearing market began either to increase or decrease sharply as a result of competition, an assessment of the public interest aspects of Federal Reserve participation in the Nation's payment system might be warranted. However, in our opinion such an assessment would have to consider that legislatively restraining the Federal Reserve's ability to compete could be cumbersome to administer and may have adverse effects upon Federal Reserve attempts to improve the economy and efficiency of the Nation's payment system.

In commenting on a draft of this report the Federal Reserve said that the draft report suggests that the Federal Reserve enjoys an advantage because of its nationwide operational presence. The Federal Reserve agreed but stated that the advantage is not as large as it may first appear. For example, it points out that correspondent banks also service a wide geographic area by working in tandem with their own processing centers, subsidiaries of the parent company, or unaffiliated processors located throughout the country and that correspondent banks compete on a nationwide scale through couriers that pick up checks nationwide for delivery to the institutions' main office for processing. The Federal Reserve also stated that its nationwide presence is related to the unique role that the Congress intended the Federal Reserve to have. The Federal Reserve believes it must ensure that all depository institutions, regardless of location, have access to the check collection system--a system that is reliable, timely, and provided at a reasonable cost. Evaluation of the features of the Federal Reserve's current operations that uniquely serve the public interest was outside the scope of this assignment.

CHAPTER 4

THE FEDERAL RESERVE IS NOW RECOVERING ITS COSTS

Since the Federal Reserve increased prices and started pricing float in 1983, we believe the Federal Reserve is now meeting the full cost recovery objective for its check clearing services as envisioned in the Monetary Control Act. We have no basis for recommending substantial changes in either the amount of direct expenses or the imputed taxes and return on capital that the Federal Reserve applies to priced services.

ANALYSIS OF OPERATING EXPENSES

We were asked to update our past work that discussed the presence of operating subsidies that existed in 1981 and early 1982. We were also asked to determine how realistic the Federal Reserve's estimates were of future revenues and costs given the pricing schedules and services it has proposed. In addition, private institution officials expressed concern that the Federal Reserve was subsidizing its priced services, particularly check clearing operations. For the above reasons, and the fact that the treatment of operating expenses affects competition, the private sector adjustment computation, and compliance with the Monetary Control Act, we reviewed the Federal Reserve's operating expenses for the period 1980 through 1983. Our effort focused on check clearing operations.

Cost accounting system reasonably identifies expenses

If the Federal Reserve's check clearing operations are being subsidized, then its cost accounting system must be failing to associate a proper share of expenses with check clearing, causing costs and therefore prices to be too low. This is because, as shown in chapter 2, prices are now set to provide enough revenue to cover all check clearing expenses identified at the reserve banks including float and the PSAF. The question that is most relevant for whether operating subsidies exist is therefore whether the system used by the Federal Reserve provides a reasonable basis for identifying its operating expenses.

One way to establish whether the Federal Reserve's identified check clearing costs are too low would be to compare Federal Reserve costs with those of comparable private sector institutions to see if differences exist that can be explained because the Federal Reserve did not identify all of its expenses. Unfortunately, there is enough difference between the services provided by the Federal Reserve System and the private sector that comparisons provide little insight into the validity of Federal Reserve cost data. Representatives of a coalition of banks critical of Federal Reserve policies shared with us the results of their survey of bank costs, but we found the survey

to be inconclusive because of the great range in private bank check processing costs (some of which were less than the Federal Reserve's) and in the types of services provided. Our review of the Federal Reserve's accounting for check clearing costs therefore relied on an analysis of the Federal Reserve's cost accounting system. This analysis, including a discussion of how the Federal Reserve's Planning and Control System works, is described in section 7 of the supplement to this report.

The unique situation in which part of the Nation's central banking system competes on a full-cost basis in the private sector places a great responsibility on the Federal Reserve's cost accounting system. For institutions wholly in either the private or public sectors, it is not as crucial to have a cost accounting system that precisely allocates shared expenses among different activities because the main purpose served by those systems is better information for internal decisionmaking. The Federal Reserve's allocation of expenses between priced and nonpriced services has special implications for competitors. Costs allocated to a priced service must be recovered through prices, but those allocated to a nonpriced area are paid for out of Federal Reserve investment income that would otherwise be returned to the U.S. Treasury.

Total operating expenses of the Federal Reserve System for 1983 were $1.03 billion. Check clearing accounted for $322 million or 32 percent of the total. Check clearing expenses increased by $38 million or 14 percent from 1980 to 1983, but the percentage increase in check clearing expenses is considerably less than the 37 percent increase for all other priced and nonpriced services that occurred during the same period.

About one half of all expenses are directly assigned to activities within four output service lines.[1] The other half, representing data processing, building, and other support and overhead functions, are indirect expenses allocated to the four output services on the basis of either actual or estimated use, such as percentage of total personnel or other expenses

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[1]PACS, which is the Federal Reserve's centralized accounting system, segregates all expenses by service line--four output service lines (Monetary and Economic Policy, U.S. Treasury and Government Agencies, Financial Institutions and the Public, and Supervision and Regulation), one support, and one overhead. The support and overhead expenses are then reallocated to the four output services on the basis of some standard or usage criteria, such as square footage or machine time. For example, check clearing could be assigned expenses related to security based on the amount of square footage in the security office, or computer expenses could be assigned to check clearing based on the amount of machine time used to run programs for check clearing.

associated with the services. After analyzing how PACS worked, we decided that check clearing direct expenses were those most likely to be accurately identified, and we therefore focused upon the reasonableness of the various allocations of indirect expenses to check clearing.

Indirect check clearing expenses seem reasonable

One feature of the Federal Reserve's cost structure of concern to us was that the percentage of total Federal Reserve direct expenses attributed to check clearing is significantly higher than the percentage of total indirect expenses so allocated. In 1983, 38 percent of all directly identified expenses, but only 24 percent of all indirect expenses, are attributed to check clearing.[2] The difference in these two percentages is not necessarily significant; there is no reason why they must be the same. But we felt that concern was nonetheless warranted because since pricing began, check clearing's share of indirect expenses relative to direct expenses has fallen considerably. In 1980, when the Federal Reserve distributed to check clearing 38.2 percent of all direct expenses, check clearing was allocated 32.6 percent of all indirect expenses--about 9 percent more than in 1983. During this period, however, total support and overhead expenses for all Federal Reserve activities increased by $103.7 million or 25 percent, and the increase in such expenses for all areas other than check clearing was 41 percent.

We pursued several lines of reasoning in assessing the reasonableness of the Federal Reserve's allocation of indirect costs to check clearing. One was examining reasons for the decline of indirect expenses allocated to check clearing that has occurred since 1980. In addition we examined the reasonableness of the procedures the Federal Reserve is now using in allocating indirect expenses. Since there is an element of judgment involved in any cost accounting system, we also attempted to identify those areas in which the Federal Reserve's judgments concerning the allocation of indirect expenses to check clearing were most susceptible to challenge.

Several explanations can be given for the decrease in overhead and support services allocated to check clearing. Changed Federal Reserve priorities provide a major one. Since the Monetary Control Act was enacted, expenses for other activities,

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[2]Based on estimated data for 1983 derived by multiplying 2nd quarter 1983 data by 4. We did not use an average of first and second quarter data to arrive at the 1983 estimate because the first quarter data did not totally reflect the new price schedules or the move to noon presentment. Data for the full year were not available at the time our analysis was done.

particularly the central bank functions of Economic and Monetary Policy and Supervision and Regulation, have increased much more rapidly than check clearing. This change in priorities, together with improved operating procedures, is evident in the changing composition of employment that has taken place. The 22,853 people employed by the Federal Reserve System in 1983 is actually 3 percent less than the number employed in 1980. There was, however, a 17 percent drop in personnel assigned to check clearing over this period. By contrast, substantial increases in personnel were experienced in economic policy, supervision, data processing, and certain administrative activities.

Another reason for the decrease in the indirect expenses allocated to check clearing is that the Federal Reserve has made changes since 1980 in its accounting procedures. One change is that a greater percentage of its support and overhead activities is now allocated according to use rather than percentages based on how personnel or total expenses are distributed to the using activity. This change in procedure has had the effect of reducing check clearing's proportion of certain support and overhead expenses. A second change is that in 1983 some expenses formerly classified as data processing expenses were reclassified as direct expenses. Since check clearing had a large share of the reclassified direct expenses, check clearing's remaining share of data processing support costs was reduced.

In principle we believe allocation rules based on use such as those the Federal Reserve now employs are preferable to more general ratios wherever there is a reasonable, cost-effective basis for making such an assignment of expenses. Our assessment of both PACS procedures and how the System tries to enforce them is that PACS provides a disciplined, logical framework that can be defended and that for the most part provides a reasonable basis for estimating the cost of check clearing services.

On the basis of our analysis of PACS, we believe significant underreporting of indirect expenses could be occurring only if there were serious breakdowns in the operation of the Federal Reserve's cost accounting system that have been undetected by audits by Board staff and Reserve bank internal auditors. Without performing detailed audits of individual transactions, of course, we cannot know the degree of compliance that is actually being achieved. Our analysis of expense patterns in the individual Reserve banks, however, does not indicate that major discrepancies exist in the way they are treating check clearing expenses. In addition, our observations at three check clearing locations, although very limited in scope, showed consistency between PACS cost allocations and the selected supporting documentation from personnel, payroll, building, data processing, and equipment records that we examined.

Analysis of the Federal Reserve's allocation of several support and overhead activity costs

We relied upon some basic criteria to identify indirect expenses allocated to check clearing that might be questioned. Our criteria included significance of dollar amounts of each support and overhead category, how the dollar amounts compare with check clearing's percent of priced service expenses, and logic of the methods used to allocate particular expenses in relation to the Federal Reserve's specific activities.

We examined all of the support and overhead categories and based on our criteria identified eight in which the procedures used to allocate expenses are most susceptible to challenge. The eight categories are data processing, bank administration, mail, budget preparation and control, files and record storage, general ledger and expense accounting, system projects, and internal audit. We added the Board of Governors to the list of expense categories to examine because none of the expenses of the Board of Governors were reflected in the prices the Federal Reserve charged for its priced services in 1983.

We examined key features of each of the categories. Then, for the sake of argument, to illustrate the sensitivity of Federal Reserve prices to the assumptions used in allocating expenses, we estimated, on a strictly judgmental basis, what the effect would have been for 1983 if assumptions leading to higher allocations of expenses to check clearing were used in allocating expenses in nine categories most open to question. Our discussion of each category is contained in section 7 of the supplement to this report. Our estimates of how amounts allocated might vary under a different set of assumptions is contained in table 27 of the supplement to this report.

Based on our analysis, an additional $17 million would have been allocated to check clearing in 1983 under the assumptions we used that were less favorable to Federal Reserve check clearing service. This increase in operating expenses equates to a 4 percent increase in prices.[3] We believe, however, that taken as a whole the increase in the example we selected is greater than that which would result from detailed examination of the expense categories. This is because in each of the categories we examined the assumption we made provided for a relatively generous increase in expenses allocated to check

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[3]Allocating a greater portion of support and overhead operating expenses to check clearing would also have the effect of increasing the amount of capital used in calculating the PSAF. Taking this effect into account we estimate that the maximum increase in prices that could result from reexamination of support and overhead expenses is 5 percent.

clearing. For example, we assumed a 50 percent increase in centrally managed data processing expenses assigned to check clearing. Taken together, we think it is unlikely that a detailed review of each category could result in increases as large as those we assumed. Thus, while we recognize that some additional allocation of support and overhead expenses to check clearing is possible, we do not believe an underallocation of these expenses to check clearing is occurring to any significant extent.

FRS is reviewing its expense allocation procedures

Because judgment factors in the allocation of support and overhead expenses can affect the prices charged, it is appropriate for the Federal Reserve to review the way it allocates these expenses even if the net effect on prices is likely to be relatively small. The more precisely it can pin down how its resources are actually used, the more confidence the public will have that all costs attributable to check clearing are included in Federal Reserve prices.

The Federal Reserve has been reviewing the procedures it uses to allocate some of the support and overhead expenses that are most subject to question. The study of PACS that a private accounting firm is now undertaking for the Federal Reserve Board, together with the work being undertaken by the Federal Reserve staff, should provide insight into the specific changes that should be made to these cost allocation rules. Federal Reserve officials said that they were reexamining allocations of some of the categories we considered and in at least one case--Board of Governors expenses--had decided to distribute expenses to check clearing in 1984 that were not counted in the 1983 cost base. In commenting on a draft of this report the Federal Reserve said that it had made some changes and anticipated that others may be made.

PRIVATE SECTOR ADJUSTMENT FACTOR

As previously noted, the Monetary Control Act sets forth the principle that the Federal Reserve's prices should reflect imputed costs for taxes and return on capital that would be incurred if the services were instead provided by a private business firm. The act does not, however, state precisely how the imputed costs are to be calculated. In keeping with the flexibility the System has in setting prices, the Federal Reserve calculated these imputed costs, which it refers to as the private sector adjustment factor (PSAF), for the System as a whole, not separately for each Reserve bank or each major service line. The PSAF is important because it affects the Federal Reserve's prices. The higher the amount calculated for the PSAF, the higher the Federal Reserve's check clearing and other prices have to be.

Because the Federal Reserve calculates the PSAF to cover all of its priced services, it is not practical to discuss only that part of the PSAF applicable to check clearing services. However, check clearing accounts for about 75 percent of the Federal Reserve's expenses for priced services.

The Federal Reserve's calculated PSAF for 1983 was $60 million. For 1984 the Federal Reserve changed some aspects of its methodology and is recommending a PSAF of $58.8 million (revised from an initial $56.2 million). Of this amount, $4.9 million represents the value of sales tax exemptions enjoyed by the Federal Reserve that have not previously been recognized in the PSAF.[4] In 1984 the PSAF is expected to represent about 10 percent of the total revenue the Federal Reserve derives from check clearing and other priced services, including that derived from the pricing of float. Certain features of the way the Federal Reserve calculates the PSAF are explained more fully in section 8 of the supplement to this report.

Representatives of the Coalition have said that the PSAF should be higher than that calculated by the Federal Reserve. For 1983, the Coalition suggests that the PSAF should have been about $180 million rather than $60 million. Applied to the 1984 PSAF, this implies that the Federal Reserve's prices for 1984 should be increased by about 20 percent.

We do not agree with the Coalition representatives. For reasons cited below, the PSAF proposed by the Federal Reserve equals or exceeds that which we feel necessary. We estimate that for 1984 it would be reasonable for the PSAF to fall within a range of from $56 million to $64 million.[5] The initial $56.2 million PSAF calculated by the Federal Reserve is within this range. In March 1984 the Federal Reserve approved a revised PSAF calculation that increased the amount to $58.8 million. Although the revised calculation is not shown in this report, in most respects it is the same as the proposal that we analyzed.[6]

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[4]The lower PSAF for 1984 also reflects a decrease in the allocation of plant and equipment to check clearing and deletion of financing for an item now included in the price of float. The change in procedure for allocating plant and equipment to priced services is explained on page 54.

[5]We made this estimate in relationship to the Federal Reserve's projections of revenues and expenses for 1984 contained in a Federal Reserve request for public comment dated October 3, 1983.

[6]The revised calculation is greater than the proposed one primarily because (1) the Board of Governor's expenses were reclassified, (2) Federal Deposit Insurance data were included, and (3) other prepaid expenses were included.

The way the Federal Reserve calculates its PSAF omits consideration of profits that the System makes on its clearing balances. Taking these into account would raise the PSAF above the range that we think is necessary. Procedures now being considered by the Federal Reserve may, however, reduce or eliminate the profits on clearing balances.

As our use of a range indicates, we believe there is no uniformly correct way for the Federal Reserve to calculate the PSAF. There will always be room for disagreement because there is no set of firms in the market place that performs only the services the Federal Reserve does or has the same financing characteristics as the Federal Reserve. The term "capital" itself can be defined in different ways, and these differences can affect how the PSAF is calculated.[7] Also, no matter what comparisons are made, some would argue that the PSAF should be set on the high side to encourage as much private sector competition as possible.

The following discussion indicates why we believe the Federal Reserve is not understating the PSAF. First, we summarize how the Federal Reserve calculates its PSAF. This discussion highlights the two main components of the PSAF calculation--the amount of capital included and the average cost of capital. Then, for each of these components, we explain the coalition's positions and our evaluation of its arguments.

How the Federal Reserve calculates the PSAF

The principal component of the PSAF is the return on capital. The Federal Reserve's calculation can be summarized by the following formula:

Return on capital component of the PSAF	=	Amount of capital	x	Average pretax return on capital

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[7]Capital often refers either to the plant, equipment, and inventories that are counted among the assets of a firm, or to combinations of equity and liabilities that are associated with the financing or ownership of the firm. Although there is a relationship between the tangible and money aspects of capital, the relationship is not exact. Capital, in the sense of combinations of equity and liabilities can be used to finance assets other than those considered to be tangible capital--such as accounts receivable. Also, over time inflation, accounting practices, and market forces can affect the various measures of capital differently, making it particularly difficult to infer underlying economic values from book values contained in financial statements.

In calculating the PSAF, the Federal Reserve defines the amount of capital as the debt and equity necessary to finance all of the assets it devotes to priced services.[8] To identify the assets, the Federal Reserve must determine which of its assets are devoted to priced services and which are not. For 1984 the Federal Reserve estimates the value of the assets devoted to priced services at $298 million, which consists of bank premises ($183 million), plant and equipment ($88 million), inventories ($2 million), and accounts receivable and prepaid expenses ($25 million). All assets are valued at book value, which in the case of plant and equipment is historical cost less depreciation.[9]

To calculate the return on capital portion of the PSAF, the $298 million in capital must be multiplied by an average cost of capital. The average cost of capital proposed by the Federal Reserve for 1984--17.4 percent--is a weighted average derived from assumptions concerning the relative proportions of debt and equity, the interest rate paid on the debt, the after tax rate of return on equity, and the tax rate. The Federal Reserve must make such assumptions because it does not actually finance its activities with the debt and equity arrangements typical of private sector enterprises and it does not pay income taxes. The Federal Reserve made its assumptions based on magnitudes computed from a survey of similar characteristics of bank holding companies. The most important assumptions the Federal Reserve makes are that its capital is financed by 64 percent equity, the after tax of return on equity is 13.7 percent, and the effective income tax rate is 35.8 percent.[10]

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[8]The Federal Reserve thus includes short-term borrowing within its definition of capital. Other commonly used definitions of capital exclude short-term borrowing so that the term capital refers to the more permanent funds available to the enterprise. A more restricted definition, which defines capital as equity, long-term debt, deferred taxes, and accumulated tax credits, is used in section 8 of the report supplement.

[9]The Federal Reserve uses straight line depreciation schedules to depreciate its assets.

[10]The Federal Reserve assumes the rest of its capital is financed by short-term and long-term debt, which are 9.1 percent and 26.5 percent of capital, respectively. It also

GAO's approach to evaluating arguments for a higher PSAF

By challenging the key assumptions that the Federal Reserve has made in estimating the amount and average cost of capital,

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assumes that the interest rates on its short-term and long-term debt are respectively 9.5 and 10.0 percent. The interest rate paid on short-term and long-term debt were also derived by the Federal Reserve from its survey of the financial char acteristics of the 25 largest U.S. bank holding companies.

As noted, the Federal Reserve's definition of capital includes short-term borrowing that is assumed to be used exclusively to finance the short-term assets it devotes to priced services--accounts receivable, inventories, and prepaid items. Other definitions of capital, such as one referred to in section 8 of the report supplement exclude short-term borrowing from capital. Whether or not short-term debt is included in capital, however, has little or no effect on Federal Reserve prices because if it is not included in capital, the interest expense enters the cost base as an operating expense.

The calculation for the weighted average cost of capital is as follows:

$$\text{Average return on capital} = \text{Reciprocal of the amount of capital} \times \left[\text{Short-term debt x the interest rate on short-term debt} + \text{Long-term debt x the interest rate on long-term debt} + \text{Equity x } \frac{\text{the after tax rate of return}}{\text{1 - the effective tax rate}} \right]$$

$$\text{Average return on capital} = \frac{1}{298} \left[\$27.1(.0948) + \$79.1(.1001) + \$191.8 \left(\frac{0.213}{1-.358} \right) \right]$$

$$\text{Average return on capital} = \frac{1}{298} \left[2.569 + 7.918 + 40.853 \right] = \frac{51.34}{298} = 17.2\%$$

arguments can be advanced that favor a higher PSAF. The Federal Reserve's estimate of the amount of capital associated with priced services is an obvious target for criticism because many Federal Reserve assets serve both priced and nonpriced activities, but other aspects of the PSAF can be challenged as well.

It is necessary, however, to make a major challenge to the Federal Reserve's PSAF calculation to have much of an effect on prices. For example, adjustments to the various components of the PSAF that resulted in a 50 percent increase in the Federal Reserve's calculated cost of capital would result in a price increase of less than 5 percent.

As noted in the opening paragraphs of the section, the Coalition representatives suggested that the PSAF should be increased by more than $100 million over the $56.2 million estimated by the Federal Reserve for 1984--an amount that would result in a price increase of about 20 percent. By assuming that the Federal Reserve should base its PSAF calculation on financial characteristics of data processing firms, these critics have challenged all of the key components of the Federal Reserve's PSAF calculation. They believe the Federal Reserve has understated the amount of capital, the proportion of equity in its capital structure, the effective tax rate, and the after tax return on equity. Coalition representatives suggested using data processing firms as a model because these firms perform types of activities similar to those performed by the Federal Reserve, and because the financial characteristics of these firms are not dominated by borrowing and lending activities unrelated to check clearing and other operations as are those of bank holding companies.

Given the vastly different conclusions that have been arrived at by the Federal Reserve and the Coalition, we concentrated on evaluating what we believe are the seven most significant challenges that have been made to the way the Federal Reserve calculates the PSAF. Four of these challenges concern the amount of capital--possible underidentification of plant and equipment, use of book value rather than market value to value System assets, showing certain leases as expenses rather than as capitalized assets, and underidentification of long-term debt and equity that would be associated with priced services if the Federal Reserve were a private business. The other three challenges, which concern the average return on capital, are arguments that the Federal Reserve has understated the proportion of equity, the effective tax rate, and the after tax cost of equity.

In evaluating the arguments, we have used reported financial information from banks, data processing firms, and other firms as well as other economic data. We recognize that using this information to compare underlying economic rates of return among different firms and industries has inherent problems.

These problems suggest caution in basing the PSAF too narrowly on only a few calculations, but we believe that this information must be used because it is the best that is available for evaluating the reasonableness of the calculation the Monetary Control Act requires the Federal Reserve to make. To the extent possible, we have directed our attention to the unique characteristics of the Federal Reserve without attempting to force fit them into a preconceived bank holding company, data processing firm, or other model.

Analysis of factors affecting the amount of capital

As noted, we believe four major issues are associated with the amount of capital used in the Federal Reserve's PSAF calculation--failure to identify all of the plant and equipment associated with priced services, use of book rather than market values for valuing assets, failure to capitalize leases, and underidentification of capital. Of the four, the last is potentially the most significant.

The Federal Reserve's procedures for allocating plant and equipment appear reasonable

Long-term capitalized tangible assets in the Federal Reserve System on December 31, 1982, had a net book value of $728 million. This was divided between bank premises ($549 million) and equipment ($179 million).[11] The Federal Reserve has been using a simple formula to estimate its capital assets allocated to all priced services. It allocated to priced services the same percentage of all tangible assets as the percentage of total operating expenses (excluding shipping) attributed to priced services. This percentage was 39 percent in 1983. For 1984, however, the Federal Reserve is proposing to directly determine assets associated with priced services. This new procedure, which identifies the assets used in the provision of priced services more precisely, reduces the percentage of assets allocated to priced services to 35 percent. The percentage of equipment (50 percent) associated directly and indirectly with all priced services under the new procedures is greater than priced service's share of total operating expenses. However, the percentage of bank premises (30 percent) so assigned is less.

The most important factor in evaluating the Federal Reserve's allocation of tangible assets is the proportion of the value of Federal Reserve premises assigned to check clearing. PACS and other data show that 21.2 percent of the staff years, 11.9 percent of the building expenses, 12.5 percent of the

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[11]This excludes $5 million in other real estate assets.

space, and 12.2 percent of the net book value of premises are associated with check clearing activities. (These figures do not count the additional staff years or space associated with support and overhead activities indirectly allocated to check clearing.) Building expenses per person are lower for check clearing than for almost any other Federal Reserve activity. This information has led the Coalition to question the validity of the Federal Reserve's allocation procedures.

Although comparisons are difficult to make because it is hard to control for all factors related to location and type of facility, it seems to us that check clearing space reflects an adequate expense. For one thing, check clearing involves shift work, which means that not everybody is working at the same time. Thus, space is used more intensively. Also, some of the space occupied by check clearing activities is in Reserve bank buildings of monumental character that were built to reflect the importance of the Nation's central bank. So long as check clearing is paying an adequate amount for space, it does not seem appropriate to overburden check clearing activities with types of expenses that are associated strictly with the central bank status of the Federal Reserve. The Federal Reserve's building expense per square foot for all check clearing operations (taking into account allocated housekeeping and guard services as well as operating and capital expenses for physical plant) was comparable to the estimated average Federal Government lease cost for office space in the Washington D.C., area (about $20 per square foot).

Our analysis also shows that in the 48 Federal Reserve locations there is consistency between the personnel, space, and building expenses assigned directly to check clearing ties.[12] In visits to three locations we were not able to uncover any significant problems with the identification and allocation of building expenses.

<u>The effect on the PSAF and on prices of using market values to value Federal Reserve assets is uncertain</u>

The Federal Reserve's historical cost basis for valuing assets that it uses in the PSAF calculation follows traditional

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[12]The percentages of all space and personnel devoted to check clearing vary considerably among the Federal Reserve offices. There is, however, a high correlation between the proportion of space and personnel that each location devotes to check clearing. This suggests that reserve banks are following a consistent set of procedures in allocating space to their various activities and that the space allocations should be reliable if the personnel ones are. Our analysis of PACS does not lead us to question the direct allocation of personnel expenses to check clearing.

financial accounting practices and builds into the Federal Reserve's cost structure a capital expense that is comparable to that incurred by the private sector organizations with which it competes. The Coalition representatives assert, however, that if the assets of the Federal Reserve System were valued in market terms, the value of the assets would also increase and the PSAF would increase. We agree that to make better resource allocation decisions it is important for the Federal Reserve to obtain the best possible estimates of the market value of the assets it devotes to priced services. But the effect that this information would have on the PSAF is uncertain.

First, it is not clear that the market value of the Federal Reserve's assets would increase if they were valued in market terms. In an environment of changing technology, equipment can become obsolete at a rate faster than normally accounted for in straight line depreciation schedules. Also, before it had to price its services, the Federal Reserve may have acquired more space or equipment than it really needed to perform efficiently the services it prices. But once having been committed to this use, the space or equipment could now have reduced value to others outside the Federal Reserve System.[13]

Even if the market value of the Federal Reserve's assets was more than the book value, this information by itself would not provide sufficient basis for raising the PSAF. This is because it cannot be assured that the appropriate measure of the cost of capital would stay the same when the basis for valuing capital is shifted from book value to market value. Thus, if a market value measure of assets was to be used in calculating the PSAF, then for consistency the Federal Reserve should also use a market value measure of income. Income calculated on a market value basis would differ from that which the Federal Reserve now calculates, in part because the depreciation component of expense would have to be based upon the market rather than the book value of assets. Once having established a rate of return on the market value of its assets, in calculating the PSAF using this information the Federal Reserve would then have to compare its rate of return on the market value of assets with those experienced by other firms. Unfortunately, information about other firms is not readily available from the financial

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[13]The Federal Reserve concedes that current book values undervalue some of the older Reserve banks, such as those in New York and Chicago. However, the System contends that the estimated market value of the space and equipment actually employed in clearing checks and performing other priced services is close to depreciated book values. We were not able to pursue this matter because it was outside the scope of our work. This is another instance where a separate study would be needed to deal definitively with a topic relevant to this overall assignment.

statements of the firms the Federal Reserve would use as a model.[14]

Capitalizing leases could increase the PSAF slightly

The Coalition has pointed out that the net book value of tangible assets included in the October 1983 PSAF proposal did not include lease arrangements that might have to be capitalized under generally accepted accounting principles. The Federal Reserve System estimates that a maximum of $25 million of existing leases affecting priced services might be in the category of leases that should be capitalized. Capitalizing leases would, however, have little effect on prices. The reason for this is that uncapitalized lease expenses are now included in the income statement as operating expenses. If the leases are capitalized, deductions from operating expenses of existing lease payments would have to be made to avoid double counting. Since examining the characteristics of each lease was outside the scope of our work, we do not know whether existing lease payments are greater or less than the depreciation and interest expenses associated with lease capitalization. However, a recent study by the Federal Reserve Board of Governor's outside auditor has concluded that expenses associated with lease capitalization are about equal to the lease payments that have been expensed. The Federal Reserve will capitalize qualifying leases entered into on or after January 1, 1984.

Capitalized leases increase the amount of long-term debt that is included in the capital structure for the Federal Reserve System. If the ratio of long-term debt to equity is kept constant, capitalized leases in the amount of $25 million result in a requirement for increased equity. Because of the

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[14]The data requirements and economic analysis involved in implementing a consistent market value approach for all aspects of the PSAF are very demanding. Such information is usually not available outside of the firm. If available at all, it is used for internal financial and economic decision making and is not published in the financial statements of firms. The Federal Reserve therefore does not have access to this information and cannot, without extensive data gathering and analysis, compare the market values of its assets and income with those of private sector firms. Although the ideal cannot be implemented at the present time, the credibility of its PSAF analysis will increase the more the Federal Reserve can develop information that approximates this ideal. A methodology utilizing economic values for income and capital that the Federal Reserve might find useful in conducting further studies is contained in The Effective Tax Rate and the Pretax Rate of Return, Martin Feldstein, James Paterba, and Louis Dicks-Mireaux, Work Paper No. 740, NBER, August 1981.

high cost of equity, this increase in the amount of equity translates into an increase of $1.9 million in the PSAF.

Although the Federal Reserve's PSAF fails to take significant assets and liabilities into account, the case for assuming that the Federal Reserve is understating its capital is not persuasive

Although the Federal Reserve's PSAF is derived from an asset base of $298 million, the Federal Reserve has assets and related liabilities of far greater magnitude than are associated with its priced services that could be taken into account when calculating the PSAF. The major categories of excluded assets and liabilities are those associated with float and clearing balances. The Federal Reserve estimates that for 1984 there will be about $480 million in float on a daily average basis to be priced and about $1 billion in clearing balances maintained by Federal Reserve customers (of which $200 million are in excess of what is needed to actually compensate the Federal Reserve for its services).

To examine the effect on the PSAF of taking account of clearing balances and float, as well as leases and an allowance for cash and liquid assets, we prepared estimated balance sheets and income statements for the Federal Reserve for 1984 that included all of those items. This information is contained in section 8. In preparing these statements we had to make what we believe were reasonable assumptions concerning the entries that would appear on the various statements.

Our analysis shows that taking account of the assets and liabilities associated with clearing balances and float results in an adjusted Federal Reserve PSAF proposal for 1984 of about $73 million, an amount about $17 million greater than that proposed by the Federal Reserve. As stated earlier, this PSAF is higher than that which we believe is necessary.

Revising the PSAF to include the effects of float and clearing balances results in an after tax return on equity of 18.4 percent as opposed to the Federal Reserve's proposed rate of 13.7 percent. The increased return on equity results primarily from the net income from excess clearing balances. Should the level of such excess balances drop, the after tax return on equity would also decline. As indicated earlier, Federal Reserve officials indicated that they are considering policy changes that would eliminate excess clearing balances. (See chapter 3 for additional discussion of clearing balances.)

To be certain that there is no misunderstanding, it should be emphasized that adjusting the PSAF to include the effects of clearing balances and float does not mean that the Federal Reserve must increase revenues and therefore prices to recover

an additional $17 million. The Federal Reserve is already earning the amounts included in the revised calculation and will continue to do so until it implements policies to do away with excess clearing balances. We have simply added what we believe to be appropriate assets, liabilities, and income to the Federal Reserve's balance sheet and income statements to see how the Federal Reserve's earnings and after tax rate of return on equity would be affected by taking clearing balances and float into account.

One of the arguments for the Federal Reserve underestimate of the amount of capital devoted to priced services put forward by coalition representatives was based on an assumption that the Federal Reserve was understating its operating expenses for check clearing. In the absence of better data, the coalition representatives first assumed that the amount of capital (apparently defined as long-term debt plus equity) the Federal Reserve was employing as a percentage of its priced services operating expenses should be the same as that experienced by six selected data processing firms. Although the Federal Reserve's capital as a percentage of its priced services revenue is not that different from the percentage experienced by many data processing firms, the Coalition then assumed that the Federal Reserve was underreporting its operating expenses--and hence also the capital estimated as a percentage of those expenses.

Our earlier conclusion that the Federal Reserve's underreporting of operating expenses is not likely to be very great effectively discounts the argument for an increase in capital based on assumed operating subsidies. In principle we also question whether the Federal Reserve's estimate of physical or financial capital should be based solely upon a financial ratio derived from a set of firms whose business differs in some important respects from that of the Federal Reserve System.

Analysis of factors affecting the average cost of capital

As noted earlier, the Coalition representatives assert that the average cost of capital for the PSAF should be significantly higher than that used by the Federal Reserve. They have suggested that the average pretax cost of capital should be about 33 percent rather than the 17.2 percent used by the Federal Reserve. They based their argument on the cost of capital experienced by six selected data processing firms that they believe provided an acceptable model for estimating the cost of capital that should be used by the Federal Reserve. Our examination of the major components of the average cost of capital--the effective tax rate, the debt/equity ratio, and after tax rates of return on equity--does not support the Coalition's position.

We agree that a case can be made for a target after tax rate of return on equity that is somewhat higher than the

13.7 percent used by the Federal Reserve. However, the 17.4 percent rate of return that the Federal Reserve expects to achieve in 1984 when account is taken of float and clearing balances exceeds what we believe to be the upper end of the range within which the Federal Reserve's target rate should fall.

A clear rationale for changing tax rate or debt/equity assumptions does not exist

The Coalition representatives have suggested that the Federal Reserve should adopt a 42 percent effective tax rate rather than the 35.8 percent rate used in the PSAF calculation and that virtually all of the plant and equipment should be assumed to be financed by equity rather than the two thirds share assumed by the Federal Reserve. If the Federal Reserve adopted both of these policies it would then have to increase its pretax rate of return by about 23.6 percent, which translates into the need to recover an additional $12.1 million from revenue. This would entail an average price increase for 1984 of a little more than 2 percent. As explained below, we see no convincing rationale for adopting the changes proposed by the critics.

Tax rates. Although the provision for taxes by the six data processing firms we examined does exceed the amount assumed by the Federal Reserve, a substantial portion of this represents deferred taxes that may, on balance, provide cash flow benefits to the firms that exceed the ultimate tax liability. The percentage of net income that the data processing firms show as actually paid in taxes--31.6 percent--is less than the percentage used by the Federal Reserve. The tax rate used by the Federal Reserve is significantly higher than the approximately 25 percent rate the Federal Reserve determined that banks paid in 1983. This is because the Federal Reserve specifically offsets the tax advantages that banks obtain as a result of their extensive holdings of tax-exempt state and local securities. In addition, the rate used by the Federal Reserve may be on the high side; the Study of 1982 Effective Tax Rates of Selected Large U.S. Corporations, prepared by the staff of the Joint Committee on Taxation, shows that the effective worldwide federal income tax rate paid by 20 large bank holding companies on a tax return basis is about 15 percent or one-third less than the 22 percent tax rate reported in this study as paid on an annual report basis.[15] Also, the 35.8 percent tax rate used by the Federal Reserve is higher than the 34.9 percent average tax rate that national income data show all financial and nonfinancial corporations paid in Federal and state income taxes for the years 1978 through 1982.

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[15] Joint Committee on Taxation, Study of 1982 Effective Tax Rates of Selected Large U.S. Corporations, JCS-57-83, November 14, 1983, p. 15.

The debt/equity ratio. High growth firms, such as the six data processing firms coalition representatives cite as a model, typically have low levels of long-term debt. We question whether it is appropriate to assume that the Federal Reserve should have the capital structure of rapidly growing firms. Except for certain of its electronic fund transfer activities, which account for a relatively small proportion of Federal Reserve expenses, Federal Reserve activities are not growing rapidly. In addition, fast growing firms are likely to have significant balance sheet liability entries for deferred taxes and accumulated investment tax credits that do not require interest payments and that provide leverage for a higher return on equity. The six data processing firms benefit from a degree of leveraging from tax items that is greater than that assumed from long-term borrowing by the Federal Reserve's PSAF.[16]

A firm seeking to minimize its cost of capital usually finds that debt is cheaper than equity because interest payments are tax deductible and equity bears more of a risk premium, and therefore there is an incentive to have as much debt as possible. If a firm tries to borrow too much, however, its borrowing rate is likely to rise, and the institution may be forced to obtain equity at a cost that becomes even higher due to the perceived riskiness of the firm. In a variety of circumstances a firm might have a capital structure with relatively little long-term debt. This would occur due to perceived high risk, limited geographic operations, large amounts of trade credit or other short-term borrowing, a significant volume of lease financing, substantial internal cash flow, particular characteristics related to the ownership of stock, or a tax position that allows a substantial amount of earnings to be sheltered.

Since the Federal Reserve does not actually operate in a market setting, it is not possible to know what its cost of capital would be. If the Federal Reserve were operating in the market, it is entirely possible that as a government entity its cost of capital would be lower than what the PSAF is intended to estimate--the cost of capital of a private sector firm performing check clearing and other services provided by the Federal Reserve System. However, we see no compelling reason why all long-term Federal Reserve assets should be financed almost entirely by equity and see no reason for changing the assumptions used by the Federal Reserve. As noted earlier, when account is taken of capitalized leases, maintaining the Federal Reserve's debt/equity assumptions results in an increase in required equity and hence the PSAF.

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[16]Leverage is the amplification in the return on the equity funds when an investment is financed partly with borrowed money. See section 8 of the supplement to this report.

There is room for judgment in setting the aftertax rate of return on equity but an increase in the rate of return is not needed

Coalition representatives raise a valid point when they suggest that to encourage a competitive environment, the PSAF should (1) represent a rate of return applicable to a going concern experiencing a reasonable degree of success and (2) reflect as much as possible the rate of return that can be expected to be achieved in the forthcoming year. Thus, as a result of both of these factors, a rate appropriate for a future period can be either higher or lower than the one based strictly on past performance.

In evaluating the Federal Reserve's proposed 13.7 percent after tax rate of return on equity we have estimated a range consistent with a successful enterprise within which we believe it would be reasonable for the rate to fall. We estimate the range appropriate for 1984 to be from 13.0 percent to 15.4 percent. The procedure we used in constructing the range is summarized in the following paragraphs and explained more fully in section 8 of the supplement to this report. We believe the rate we have estimated is consistent with what can be known about expected rates of return in 1984. This estimate avoids measures that, if followed by the Federal Reserve System, would compromise the central bank status of the Federal Reserve by requiring it to forecast interest rates or economic conditions.

Historical rates. The lower end of the range, 13.0 percent is the median after tax rate of return on equity experienced during 1983 by the 25 largest bank holding companies. The Federal Reserve has used bank holding company rates of return in calculating the PSAF because major correspondent banks owned by bank holding companies are the System's chief competitors. However, on other grounds as well we believe bank holding company rates of return on equity are defensible for the PSAF calculation. Bank rates of return are higher than the median rate of return experienced by large firms of all types throughout the U.S. economy. Bank rates are also higher than rates of return for major segments of the Nation's regulated public utilities. Public utilities provide a useful benchmark because they are established enterprises whose stock prices usually trade at prices close to book values. Since the Federal Reserve's estimated capital is based upon book values, a rate of return above that experienced by utilities would reflect a measure of market and other types of risk for operational activities of the type actually performed by the Federal Reserve.

Bank holding company rates of return are lower than those experienced by many data processing firms. We are not persuaded by correspondent bank competitor's arguments that the higher rates of return of data processing firms should be used in the PSAF calculation. The high rate of return on the book value of

equity experienced by processing firms seems to reflect a high growth rate in the activities of these firms that is inappropriate to apply to most of the Federal Reserve's activities. As noted, although data processing and check clearing operations may have certain similarities, the growth characteristics of the markets served by the data processing firms and the Federal Reserve differ considerably. Nor is there evidence that there is such a high degree of risk inherent in Federal Reserve operations that a rate as high as that experienced by data processing firms or other firms with such high rates of return is warranted.

Even if the principle of basing the PSAF on the after tax rates of return of the 25 largest bank holding companies is accepted, a case can be made for using a rate of return somewhat higher than the 13.0 percent median rate of return. One strictly judgmental argument is that, to encourage more private sector competition, the Federal Reserve's rate should be higher than the median rate.[17] The other argument for a higher rate is based upon the fact that the stocks of most bank holding companies are valued by the stock market at below book value. When the market discount is applied to bank holding company equity, the median after tax rate of return on book equity for the 25 largest bank holding companies rises to 15.4 percent.[18] Although judgment factors enter into assessing the relevance of stock price information for the PSAF calculation, we have used this 15.4 percent rate of return as the upper bound of the range we believe is appropriate for the PSAF calculation.[19]

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[17]Thus, a rate of 15.8 percent would be appropriate if a judgment were made that to foster competition the Federal Reserve's rate should be higher than three quarters of the 25 largest bank holding companies.

[18]Using median figures from the sample consisting of the 25 largest bank holding companies, the market value of stock toward the end of 1983 was about 85 percent of the book value of the stock. This means that the selling price of a share of stock was about 85 percent of the value of a share calculated by dividing the equity of the firm reported on financial statements (essentially initial par value of stock plus retained earnings) by the number of shares of stock. If we desired to reflect the market discount and to set the rate higher than three-quarters of the 25 largest bank holding companies, the rate would increase to about 18.5 percent.

[19]Although current stock prices provide insight into the value of a firm, caution must be used in applying this information to the PSAF. Stock prices reflect expected future earnings and there is not a simple, direct relationship between these prices and current reported earnings. In addition, the reasons the market is discounting the book value of large bank

Because the 13.7 percent after tax rate of return the Federal Reserve uses falls within the range we have constructed, we have no basis for concluding that a change in the target rate of return is necessary. If the Federal Reserve chose to use an after tax rate of return of 15.4 percent rather than 13.7 percent the effect on prices would be small. The higher rate would increase the PSAF by about $5 million, which translates into a price increase of only 1 percent. When account is taken of excess clearing balances, the Federal Reserve's after tax rate of return rises to 17.4 percent, which exceeds our estimated upper bound.[20]

Expected rates. In evaluating the after tax rate of return on equity appropriate for the PSAF, we considered whether the Federal Reserve should adjust its PSAF calculation to take account of inflation, interest rates, or rates of return expected in the forthcoming period. We concluded that such an adjustment was not needed for two reasons.

The first reason concerns the central bank status of the Federal Reserve. In carrying out its central bank responsibilities, the Federal Reserve System has consistently avoided predicting future economic conditions. In our opinion benefits that might result from making adjustments to the PSAF by incorporating economic forecasts would be more than offset by problems inherent in requiring the Federal Reserve to make forecasts. Such forecasts would have to incorporate the estimated effects of the Federal Reserve's future actions. This could compromise the effectiveness of Federal Reserve conduct of monetary policy.

The second reason we felt that making an adjustment was not necessary was based on our investigation of whether the relationship of bank holding company profits to either inflation or to yields on Treasury securities would provide a reliable basis for adjusting the PSAF. We concluded, however, that these relationships introduced too many judgment factors and were too unstable on a year to year basis to give additional credibility to the PSAF calculation.

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holding companies may have to do with matters such as exposure of bank investment to interest rate or credit risks that have little to do with service operations such as those performed by the Federal Reserve System. Also the market value of a bank that is determined when the firm is actually purchased by another bank or another group of investors can be different from the value reflected in current stock prices.

[20]The 17.4 percent rate is slightly below the 18.4 percent range that would be required if the market discount factor were applied and, to foster competition, the rate was also set to exceed that experienced by three-quarters of the bank holding companies.

Effect on PSAF by hypothetical increase in expence allocations not considered

This analysis of the PSAF has not taken into account any increase in the amount of capital that would be associated with an increase in operating expenses allocated to priced services following further review of the support and overhead activities discussed earlier in this chapter. For the example considered in section 7 of the supplement to this report, which estimated that an increase of $17 million could result from the use of allocation rules less favorable to check clearing services, we estimate that the increase in the PSAF that would result from such a reallocation would be approximately $3 million.

Summary

We conclude that the Federal Reserve is not under-reporting its assets associated with priced services, and we find no compelling reasons to change the Federal Reserve's assumptions regarding the ratio of equity to debt, the effective tax rate, and the after tax rate of return on equity. Although our analysis does not support most of the Coalition's arguments for a higher PSAF, we recognize that a variety of judgments are possible with respect to the rate of return on equity. Our conclusions on the individual components of the PSAF allow us to establish a range within which we believe the PSAF should fall in 1984. This range is from $56 million to $64 million.[21]

The $56.2 million PSAF proposed by the Federal Reserve falls within the range, and we therefore conclude that no increase in the PSAF is required. When account is taken of the clearing balances and float, however, the PSAF reflected in Federal Reserve assumptions rises to $72.8 million, about $9 million more than the upper bound of our calculated PSAF. If the Federal Reserve does not change its policies to reduce its clearing balance income, the PSAF is higher than it needs to be.

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[21]This range was calculated using the high and low estimates of the after tax returns on equity of bank holding companies developed in section 8 of the supplement to this report and a capital structure for the Federal Reserve as shown in table 34 which includes capitalized leases in its long-term assets.

CHAPTER 5

ANALYSIS OF GENERAL COMPETITIVE ISSUES

The Monetary Control Act placed the Federal Reserve in a unique position--competing actively with private sector institutions on the basis of price and quality of service, even though it has supervisory authority over these same institutions and has responsibility for assuring that the Nation's payments system functions properly. Before the Monetary Control Act was passed, the Federal Reserve and correspondent banks both provided check clearing services to other banks, but the competition was more limited. Specifically, although the Federal Reserve did not then charge for its services, the Federal Reserve could only provide services to commercial banks that were members of the Federal Reserve System and it did not have to try to balance the revenues and costs for the services it provided. Over the past year, competition between the Federal Reserve and the private sector has intensified, as shown by increased efforts by Federal Reserve banks to market check clearing services and by increased expressions of concern by their competitors. The nature of the competitive relationship between the Federal Reserve and private sector institutions has thus taken on more importance as a general oversight issue.

Along with how changing technology is affecting the Nation's payments system, the Federal Reserve System and the Congress have to be prepared to address two policy issues associated with oversight of the pricing provisions of the Monetary Control Act. One is how to assure that the Federal Reserve System, with its central bank status and ability to influence the market it serves, continues to exercise its authority responsibly. The other is what response the Federal Reserve should make if it becomes clear that the price the market will ultimately be willing to pay for a service the Federal Reserve now provides (or believes it should provide) is less than what the Federal Reserve must charge to recover its full costs.

These oversight issues that could arise involve matters about the nature of the Nation's payments system and the structure of the Federal Reserve System that are beyond the scope of this report. However, from our discussions with people in many private sector institutions and other work we performed in preparing this report, we believe the Federal Reserve System could be taking several procedural steps that would help the System, the Congress, and the public to deal with problems that might arise under the Monetary Control Act pricing provisions. These steps include (1) improved financial reporting and (2) adopting more explicit policies to guide its competition with private sector institutions. We support the efforts that the Federal Reserve is making in these areas.

REPORTING OF FINANCIAL AND OTHER INFORMATION

Although the Federal Reserve collects much information in its check clearing and other priced services, this information is only made public through periodic press releases, notices in the Federal Register, Reserve bank circulars, memoranda prepared for Board action, limited distribution of PACS cost accounting reports, and brief write-ups and summary tables in the Federal Reserve's annual report. While this information is often helpful, it is generally not comparable to that disclosed on a consistent, periodic basis by private sector corporations. Based on discussions with private institution officials, we believe some of the intensity of the controversy about Federal Reserve actions to improve its services in 1983 stemmed from lack of information in which the public had full confidence, and this, in turn, invited critics to assume the worst. We therefore believe the System would find it useful to follow the reporting, auditing, and disclosure practices of the private sector organizations as closely as possible. Regular reporting of financial and other information about its priced services would help to establish greater understanding of and confidence in the Federal Reserve's operations.

Federal Reserve officials said that they are reviewing the amount and types of financial information made available to the public. They are considering quarterly reporting of balance sheet and income statement data that would be similar to private sector reports. In March 1984 the Board of Governors approved a proposed plan for improved financial reporting.

In commenting on a draft of this report, the Federal Reserve stated that they had recently published a report on priced services activities for 1983, which included data that had not been published previously. They intend to publish a similar report each year as well as abbreviated quarterly reports. They are also developing public statements regarding business practices and the Federal Reserve's future role in the payments system.

A statement of the Federal Reserve's future role could be of importance to its competitors and customers alike in making their own plans for the future. The National Payments System Coalition, in commenting on our report, observed that commercial banks are making major investment decisions in the payments area in a context of uncertainty as to the Federal Reserve's long-run intentions. We agree that the unique circumstance of a market dominated by a public body warrants the fullest possible disclosure of the Federal Reserve's plans and strategies for future years. The benefits from this would include more rational investment of private sector resources and an atmosphere of improved trust.

The Federal Reserve has no obligation to have its financial reports subjected to independent external audits. Competitors, therefore, have questioned whether the financial information that is disclosed provides the most desirable degree of credibility. Each year the Federal Reserve Board's Division of Bank Operations does conduct an examination of the 12 reserve banks and their 25 branches. The procedures followed by the Board's examiners are surveyed and appraised by a private firm of certified public accountants, but neither the Board nor the private firm certifies how the financial statements relate to relevant accounting standards applied on a consistent basis. We would have no objection to the use of independent external auditors by the Federal Reserve System if this were considered an important aspect of informing the public of the results of Federal Reserve activities. On the basis of the work we have performed, however, we are not in a position to make a recommendation concerning whether the cost of having external audits is worth the benefits that would be derived.

We also support the intention expressed in the October 3, 1983, statement about the PSAF approved for public comment by the Board of Governors that the Federal Reserve System would review its procedures for acquiring assets to ensure that rigorous capital budgeting procedures are consistently applied. This is particularly appropriate in light of the fact that the Federal Reserve invested almost $300 million in new plant and equipment in the years 1980, 1981, and 1982 in all of its priced and nonpriced activities. From the end of 1979 to the end of 1982 the depreciated net book value of its tangible assets increased by $218 million or about 52 percent. We assume that the improved budgeting procedures would be based upon logical tie-ins to information on capitalized assets contained in financial statements and to the rate of return on capital assumed in setting the PSAF.

GUIDELINES CONCERNING COMPETITION WITH PRIVATE SECTOR INSTITUTIONS

The Board of Governors is considering two matters that have a bearing on how the Federal Reserve competes with private sector institutions. One concerns separation of Reserve bank operations from central bank functions. The other concerns types of competitive practices appropriate for Federal Reserve banks.

Some correspondent banks complain that the same Federal Reserve bank they are competing with is also the one responsible for regulating them. Although we have not found any instances of abuse, the potential for such abuse could be reduced by the Federal Reserve insulating its regulatory functions and personnel from those in the area of priced services. Federal Reserve officials indicated to us that they were conscious of the need to maintain the desired degree of separation. At the present time,

however, it is our understanding from Federal Reserve staff that all Reserve banks do not have written policies on how such separation is to be maintained. We support efforts that are now being made to see that each Reserve bank does adopt appropriate written policies.

Another area of concern is the extent to which Federal Reserve banks should engage in business practices that are common in the competitive market place but not in the provision of public services. In a competitive setting, firms try to influence the market in their favor by such practices as aggressive marketing, discounts to attract customers, and advertising. The Monetary Control Act is silent as to whether the Federal Reserve should engage in these practices.

It could be argued that, as a government agency, the Federal Reserve should not engage in some of the practices typical of the business world. However, such constraint on its actions could put it at a disadvantage, thereby incurring risks of losing market share and returning to subsidizing check clearing services. Federal Reserve officials informed us that the Federal Reserve Board of Governors has not adopted explicit written guidance on this subject, although a written policy on this subject is currently being developed by the Subcommittee on Business Development of the Conference of First Vice Presidents of the Federal Reserve banks. We support this effort by the Federal Reserve System to develop this needed policy guidance. The adoption of specific Board guidelines should help to ensure control over the tone of Reserve bank competitive actions and provide criteria for evaluating Reserve bank actions in the event of controversy.

GLOSSARY

Term	Definition
"As of" adjustments	A procedure whereby the Federal Reserve adjusts the reserve or clearing balance required to be maintained by a depository institution during a 7-day accounting period.
Automated clearinghouse (ACH)	An electronic clearing and settlement system comprised of 40 regional ACH facilities interconnected by the Federal Reserve's wire communication system.
City items	Checks drawn on institutions located in the same city as Federal Reserve check processing offices.
Clearing balance	A demand deposit account maintained by a financial institution at the Federal Reserve or at a correspondent bank which accrues earnings credits that are used to offset the cost of services received.
Clearinghouse	A voluntary association of depository institutions in a city that facilitates the clearing of checks through direct exchange between members.
Coin and currency delivery	Transportation services for currency and coin from Federal Reserve offices to financial institutions.
Coin wrapping	The packaging of coin into rolls, and boxing of rolls for shipment to financial institutions.
Consolidated shipments	Checks deposited by financial institutins at one Federal Reserve office for shipment to another Federal Reserve office for collection using transportation arranged by the Federal Reserve.
Correspondent banks	Generally, large urban banks which provide check clearing and other services to other depository institutions.

Term	Definition
Direct expenses	Cost of any good or service that contributes to and is readily ascribable to product or service output.
Direct sends	Checks sent by a private financial institution on its own transportation to a collecting Federal Reserve office in another district.
Due from deductions	In calculating the total liabilities which are subject to reserve requirements, an institution may deduct the amount of demand deposit balances it maintains at other depository institutions.
Earnings credit	Interest imputed to clearing balances placed with the Federal Reserve or with a correspondent bank.
Federal Reserve float	Funds made available by a Federal Reserve office to a depository institution at least one day sooner than the Reserve office receives payment from payor institutions due to unexpected delays in presentment.
Holdover float	Results when a Federal Reserve office gives credit to a financial institution for check deposits which had been received on a timely basis but the Reserve office is unable, for unexpected reasons (e.g. equipment malfunction) to present the checks and receive payment on the same day credit is given.
Indirect expenses	A functional cost not attributed to the production of a special good or service but to an activity associated with production generally, e.g. general administration.
Interdistrict checks	Checks received by one Federal Reserve office for collection through another Federal Reserve office.

Term	Definition
Interterritory float	Occurs when a Reserve office gives credit to depository institutions for deposits of interdistrict checks before payment is received because of transportation delays or other unexpected delays in presentment of checks to payor institutions.
Intraterritory float	Float resulting when a Federal Reserve office gives credit for deposited checks drawn on institutions located within its service area before payment is received from payor institutions due to unexpected delays in presentment.
Midweek closing float	Float that results when the Federal Reserve gives credit on checks drawn on banks in some states which regularly and voluntarily close midweek.
Net settlement service	The Federal Reserve offers to charge and credit the accounts of institutions which clear checks between each other where the Federal Reserve has not physically handled the checks.
Noncash collection	Receipt, collection, and crediting of accounts of depository institutions for deposits of matured municipal and corporate coupons, and called or matured municipal and corporate obligations.
Nonstandard holiday float	Float that results when a Federal Reserve office gives credit for checks drawn on banks observing nonstandard-state or local holidays and the crediting Federal Reserve office is open.
Noon presentment	Latest time during the day that the Federal Reserve will make available or present checks for payment to institutions located in cities where the Federal Reserve has offices.
Output activities	Processing or analytical operations which make possible the

	direct production of services provided by the Federal Reserve System.
Overhead activities	Activities, such as accounting operations, that are necessary to insure the continuity or efficient operation of reserve offices but are not directly connected with production.
Purchase, sale, safe-keeping, and transfer of securities	A service provided by the Federal Reserve to depository institutions owning U.S. Government securities.
Presentment of checks	A demand for acceptance or payment of checks.
Presentment fees	Fees charged to presenting institutions by commercial banks for processing checks drawn on themselves and presented to them for payment.
Private sector adjustment factor	A factor required by the Monetary Control Act, that the Federal Reserve is to add to its prices to reflect the taxes and return on capital that would have been incurred if the Federal Reserve were a private sector supplier.
Processing banks	Banks that process checks for collection or payment for other banks.
Reserve balance	Noninterest bearing funds which depository institutions must place with the Federal Reserve as required by the Monetary Control Act, in connection with the Federal Reserve's conduct of monetary policy.
Respondent	An institution which sends checks to correspondent banks or the Federal Reserve for collection.
Return item float	Occurs when the Federal Reserve gives credit to a payor bank for a returned check before the Federal Reserve charges the account of a depositing bank.

Support activities	Operations, such as security, that are necessary to continue or improve production but may not be involved in the actual production process.
Wire transfer	Provides for the immediate movement of funds between two depository institutions which maintain accounts with the Federal Reserve.

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United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

April 6, 1983

The Honorable Charles A. Bowsher
Comptroller General
General Accounting Office
441 G St., N.W.
Washington, D.C. 20548

Dear Mr. Comptroller General:

On May 7, 1982, you transmitted to the Congress of the United States a report entitled "The Federal Reserve Should Move Faster to Eliminate Subsidy of Check Clearing Operations," which presented an excellent status report on the performance of the Federal Reserve in carrying out the specific statutory mandates of the Monetary Control Act of 1980 pertaining to check-clearing services.

While this report offered favorable comment regarding some of the operational steps taken by the Federal Reserve, it also raised a number of concerns and offered some recommendations with respect to the Fed's implementation of the Act. Among other things, it recommended that the Fed review and modify the check clearing pricing structure at least semi-annually and undertake a full-scale policy review to determine the most appropriate role for the Federal Reserve in check clearing and other service activities within a modern and rapidly changing payment system. The report also criticized the Federal Reserve for its failure to move more quickly to price or eliminate the float in its check clearing operations.

Chapter 5 of the report emphasized the importance of Congressional oversight of the Federal Reserve's actions under the Monetary Control Act during the crucial formative years of that performance and this Committee expects to undertake such a review later this year. In addition, recently we have received strong criticism of actions taken by the Federal Reserve in its check clearing activities from private banks which perform processing services in competition with the Federal Reserve and from private air couriers which provide the transportation support for these processing banks. The general thrust of these complaints is that the Federal Reserve enjoys certain unique structural, legal, and operational advantages over private processors and private couriers, which, when coupled with certain marketing and regulatory actions, produce conditions in the marketplace that are anti-competitive in their impact. In order for us to review the

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official actions undertaken by the Federal Reserve and to analyze the criticisms of those actions, the Committee would appreciate a comprehensive update by the Government Accounting Office of its findings in the May 1982 report.

As we are sure you are aware, the Federal Reserve has recently taken a number of interrelated actions which alter the dynamics of its check clearing system and therefore its impact upon private sector competitors. These actions involve changes in deposit deadlines and presentment times, a restructured Interterritory Transportation System (ITS), and new price schedules for these various check clearing services. The Federal Reserve also finally approved a program to reduce and price interterritory and check holdover float, to be phased in over a period beginning on February 24, 1983 and ending on October 1, 1983.

As noted earlier, the processing banks and private couriers charge that these actions of the Federal Reserve are endangering the long-term competitive environment for check clearing services. More specifically, these private businesses allege that the Federal Reserve has undertaken these actions at a time when its check clearing services continue to be subsidized by public funds due to the failure to price float and to fully recover transportation and other related costs. Therefore, in addition to a general updating of the 1982 report and an analysis of the recent policy actions of the Federal Reserve, it would assist the Committee's review of this policy area if the General Accounting Office would address the following questions:

1. The Federal Reserve has set the private sector adjustment factor (PSAF) at 16% of all direct and indirect costs associated with its check clearing activities.

-- Is 16% an adequate PSAF?

-- Do the Federal Reserve Banks' price schedules that were effective February 24, 1983 reflect a full application of the PSAF?

2. The Monetary Control Act requires the Federal Reserve to price float created by the Federal Reserve's check clearing operation.

-- Do the price schedules that were effective February 24, 1983 reflect the full cost of float?

-- If not, do the recent policy actions taken by the Federal Reserve with respect to reducing and pricing certain types of float comport with the directive of the Monetary Control Act?

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-- Does the Federal Reserve's program for interterritory float offer users of its check clearing services a ready means of comparing the price of the Fed's services with those being offered by private processors?

-- What are the competitive implications of the timing of the Federal Reserves announced program for interterritory and holdover float and what are the implications of the delay in taking action on float resulting from large dollar interterritory returned items and intraterritory float?

-- The Federal Reserve estimated a daily level of float of $1.76 billion as of the end of 1982. What is the annual cost to the Treasury of this volume of float? What do you estimate to be the cost to the Treasury at each stage of the phase-in of the new float reduction/pricing program?

3. In its pricing of check clearing services, the Federal Reserve has included transportation surcharges for the use of the Interterritory Transportation System (ITS).

-- Were the charges for such transportation in 1982 sufficient to cover the total direct and indirect costs of the system?

-- Will the total direct and indirect costs of the ITS for 1983 be fully recovered through the transportation surcharge schedules implemented by the Reserve Banks on February 24, 1983?

-- Is the ITS system constructed in a fashion so as to require the Federal Reserve Banks to pay the costs of that system, whether or not they are using it? If so, what are the competitive implications of this?

4. How realistic are the Federal Reserve's estimates of its future revenues and costs given the pricing schedules and services it has proposed?

5. It is the Committee's understanding that Reserve Banks, when making presentment of checks to a paying bank, do not pay the "presentment fees" which are normally charged to all private processing banks; because the payment of such fees has been interpreted to represent non-par banking, and as such may not be charged against Reserve Banks under Section 342 of Title 12, U.S. Code.

-- Does the GAO agree with the interpretation that such "presentment fees" are precluded by 12 U.S.C. 342 and if so, is there any valid public policy reason why the Reserve Banks should be exempt from these fees that are uniformly paid by all private processing banks?

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-- Is there a need to change this area of the law?

6. On February 24, 1983, the Federal Reserve began to phase-in a unilateral regulatory action (popularly known as "noon presentment") under which Reserve Banks are permitted to present checks for payment at city paying banks at hours which are generally later than the presentment deadlines provided for in the collective agreements of local clearing house associations.

-- Does a private processing bank have this same ability to unilaterally impose a national system of presentment times on paying banks which are later than the times provided for in local clearing house rules?

-- Since private processing banks receive heavy volumes of checks in the reciprocal role of paying banks (a role which entails significant processing and account reconciliation activity), doesn't this regulatory action, which initially is applicable to only city banks, have the greatest workload impact on those banks which compete with the Federal Reserve in check clearing actitivies?

-- What are the competitive implications of the above two questions, particularly in view of the fact that the Federal Reserve Banks do not have to perform the reciprocal function of paying banks?

7. Banks which use either private processing banks or Reserve Banks to perform some or all of their check clearing services maintain deposits with those banks known as "clearing balances." These deposits are used both for the debiting and crediting that occur in the payments process. Private processing banks maintain reserves with Federal Reserve Banks on these "clearing balances," whereas there is no comparable reserve requirement for "clearing balances" maintained with a Reserve Bank. Is this an inequity which should be addressed by the Congress?

8. Since Reserve Banks do not bear the cost of "presentment fees" or reserves and, additionally, since the Reserve Banks do not have to cope with the production requirements of a paying bank, does this create competitive inequities that should be remedied? If so, does the GAO have any recommendations for remedial legislative or administrative action?

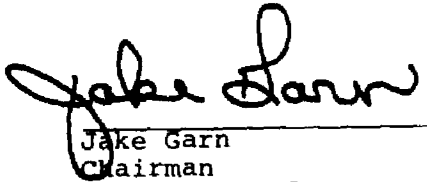
We would appreciate if the GAO would be prepared to provide an interim report and testify on these issues as early as the end of May; followed up by a formal report at a later date.

APPENDIX I

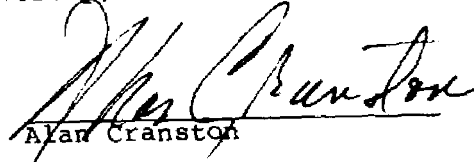
The Honorable Charles A. Bowsher
April 6, 1983
Page 5

Thank you for your prompt attention to this request.

Sincerely,



Jake Garn
Chairman



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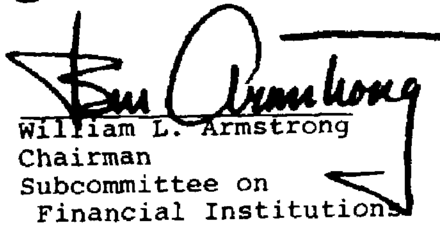
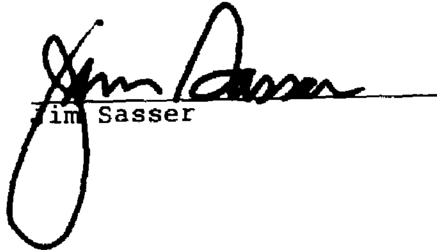


William L. Armstrong
Chairman
Subcommittee on
Financial Institutions

Donald W. Riegle

John Tower



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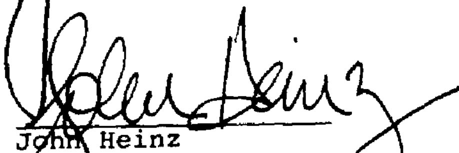
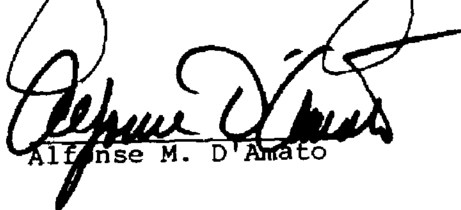


John Heinz



Alfonse M. D'Amato

Mack Mattingly

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

ADDRESS OFFICIAL CORRESPONDENCE TO THE BOARD

April 20, 1984

Mr. William J. Anderson, Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

The Board of Governors appreciates the opportunity to comment on the draft General Accounting Office report, "Federal Reserve System Pricing of Check Clearing Activities" ("report"). The Federal Reserve found the report to be constructive and comprehensive and is pleased that the General Accounting Office ("GAO") found the Federal Reserve to be in compliance with the pricing provisions of the Monetary Control Act of 1980 (Title I of Pub. L. 96-221) ("MCA") and that the policies the Board has adopted in implementing these pricing principles generally have been reasonable. As the report indicates, a number of the suggestions contained in the report have already been adopted by the Federal Reserve.

We note that the report acknowledges the Federal Reserve's unique public interest responsibilities with regard to its participation in the nation's payments mechanism generally and the check collection system specifically. We believe the MCA provides appropriate flexibility to enable the Federal Reserve to meet its public interest responsibilities while at the same time ensuring that the benefits of full and fair competition among all payments mechanism service providers are realized. It is readily apparent that the MCA has promoted competition in the provision of payments mechanism services. The Federal Reserve's check collection volume, as the report details, has declined since the implementation of pricing, and we anticipate that the percentage of checks collected by the Federal Reserve will continue to decline. We believe the increased competition resulting from the MCA has improved the efficiency of the payments mechanism and has benefitted consumers, businesses, and other users of the nation's payments mechanism. In essence, we believe the MCA is working as Congress intended.*

Against this background, we wish to comment on five areas of the report: (1) the Federal Reserve's nationwide

*See GAO notes 1 and 2 on page 81.

presence; (2) presentment fees; (3) clearing balances; (4) the costs allocated to priced services; and (5) the evaluation of overall performance.

Nationwide Presence

The report suggests that the Federal Reserve enjoys an advantage growing out of its nationwide operational presence. This characteristic is clearly related to the unique role Congress intended for the Federal Reserve in the nation's payments mechanism.

The Federal Reserve's nationwide check collection service ensures that all depository institutions, regardless of geographic location, are provided check collection services. Universal access to the check collection system provides assurance that all checks will be collected in a reliable and timely manner. Furthermore, the Federal Reserve's national service results in efficiencies and enables check collection services to be provided to all depository institutions at reasonable cost.

Although the Federal Reserve's nationwide presence may provide an advantage, this advantage is not as large as it may appear at first impression. Services on a wide geographic basis are also provided by correspondent banks, which have established and participated in arrangements involving the transportation of checks from customers on an intra- and inter-state basis. Correspondent banks often work in tandem with their own processing centers, subsidiaries of the parent bank holding company, or unaffiliated processors located throughout the country. Correspondent banks have also determined that it is not even necessary to have a nationwide operating presence to compete on a nationwide basis. These institutions have established arrangements with couriers for nationwide pickup of checks and shipment to the institutions' main office for processing. We anticipate that this trend will continue and correspondent banks will increasingly offer services on a nationwide basis, particularly if and when interstate banking is authorized. It is important to note that if and when interstate banking is authorized, we believe that the underlying public policy rationale for a Federal Reserve operational presence in the payments mechanism will remain as compelling as it is today.

Presentment Fees

The GAO agrees that the Reserve Banks are prohibited by law from being charged a "presentment fee" by payor banks. Congress enacted the statutory prohibition in 1917, when nonpar payment of checks was common and was causing inefficiencies in the check clearing process. Since payor banks did not impose presentment charges uniformly on all presenting banks, collecting banks that would otherwise be subject to a presentment fee attempted to avoid such charges by routing checks sent for collection through a bank that would not be subject to a presentment fee. This circuitous routing of checks consumed unnecessary resources and extended the time period required to collect checks. Indeed, a significant objective in creating the Federal Reserve System was to eliminate this obstacle to the speedy collection of checks throughout the country.

We agree with the GAO that permitting payor banks to charge Reserve Banks presentment fees would raise very difficult problems. For example, since the Federal Reserve is essentially a collecting institution, there would be no incentive for payor institutions to maintain presentment fees charged the Federal Reserve at reasonable levels.

Rather than impose presentment fees on the Federal Reserve, we believe that presentment fees should be banned altogether. The practice of imposing presentment fees can result in inefficiency and delay in the check collection system to the extent that institutions attempt to avoid these fees through circuitous routings or by holding the check until the next day so it can be presented through a clearinghouse exchange. As the report recognizes, the presentment deadlines after which presentment fees are imposed generally are between 8 a.m. and 10 a.m. These cut-off times often were established decades ago for the institutions' own convenience and have not been reevaluated in light of the advancements in technology and business practices that have dramatically improved processing and settlement capabilities. Payor banks today clearly are able to process and settle checks received later than 10 a.m. on the day of receipt. Indeed, the report recognizes that the Federal Reserve's move to noon presentment has not resulted in significant operational problems for payor banks. In this regard, several clearinghouses have also moved their presentment times to later in the morning without encountering operational problems.

Further, any cost that the payor bank incurs in paying a check that has been presented to it for payment should normally be borne by the payor bank or its customer, the person who wrote the check. We can find no justification for transferring these costs, through a presentment fee, to the collector and ultimately to the payee of the check. In addition, transferring these payor bank costs to the collecting bank and payee eliminates the payor bank's incentive to minimize these expenses, thus undermining the market discipline that helps to assure that the costs of effecting payments will be minimized. Finally, since presentment fees are not imposed uniformly, they encourage inefficient collection arrangements as collecting banks distort their check collection patterns in order to avoid presentment fees. Accordingly, presentment fees should be banned for any check presented to a payor institution in advance of the Uniform Commercial Code's 2 p.m. cut-off. Indeed, it may be appropriate in the future to consider modifying the U.C.C.'s 2 p.m. cut-off if continued improvements in technology and operations enable payor banks to process and settle checks presented later in the day in a timely manner without the imposition of presentment fees.

Clearing Balances

We are pleased that the GAO supports the recently adopted adjustments to the method for calculating earnings credits on clearing balances that take into account the reserve requirements that would be applicable to the Reserve Banks if they were subject to reserve requirements. In view of the computer software changes that must be made, we anticipate implementation of these adjustments later this year.

In addition, the report suggests that the Federal Reserve use the Treasury bill rate, rather than the federal funds rate, to calculate earnings credits on clearing balances. We continue to believe that the federal funds rate is the appropriate rate to apply to clearing balances so long as the overall income generated by clearing balances is not below the value of the earnings credits accrued by financial institutions to pay for services and float. First, the federal funds rate is at times below the Treasury bill rate. Second, in those cases where the federal funds rate is above the Treasury bill rate, any advantage is generally offset by the disadvantages of our current procedures for calculating earnings credits. The Federal Reserve calculates earnings

credits only on required clearing balances, not on excess balances. Correspondent banks, however, generally calculate earnings credits on the full amount of a respondent's clearing balance.

As the report indicates, the use of the federal funds rate by the Federal Reserve has not resulted in any subsidy. Indeed, the Federal Reserve is carefully monitoring the revenue and expense associated with clearing balances to ensure that revenues from clearing balances exceed costs. Should costs exceed revenues, our intention is to adjust the rate we apply.

Furthermore, as the report indicates, the use of the federal funds rate does not result in an advantage for the Federal Reserve relative to correspondent banks since correspondent banks have a wider variety of investment opportunities than the Federal Reserve. Indeed, the higher returns realized on these wider investment opportunities provide a greater margin of net income to correspondent banks and thus constitute an important advantage to the correspondent banks.

Cost Allocation

The GAO recognizes that the Federal Reserve's expense accounting system provides a disciplined, logical framework for assignment of expenses. The GAO further states that it does not believe any significant underallocation of support and overhead expenses to check clearing is occurring. Nonetheless, the GAO has estimated that at most an additional $17 million of operating expenses could be allocated to check clearing were different assumptions used. The GAO recognizes that this amount was determined on a judgmental basis and that the actual increase in indirect expenses associated with check clearing would likely be less than the suggested figure.

We believe that, in most cases, the methods used in determining expense allocations have been determined objectively. We are continually refining our procedures to ensure that all costs are allocated appropriately. As part of this process and in view of the GAO's observations, we are intensively reviewing the allocation procedures in the instances where judgment is involved to ensure that appropriate amounts of support and overhead expenses are allocated, not only to check clearing, but to all other operating areas as

well. Indeed, in the process of our review, we have made some changes and anticipate that others may be made. However, we believe that such refinements would at most increase the amount of operating expenses allocated to check collection by substantially less than $17 million. We will advise the GAO as to our conclusions regarding this review in the near future.

Evaluation of Overall Performance

The report generally evaluates the performance of the Federal Reserve as a whole. However, the report does indicate that the cost recovery performance at certain Reserve Banks is better than at others.

We believe that the Federal Reserve can only be evaluated as an integrated system. Federal Reserve payments services, as well as the costs of providing these services, are national in scope. For example, more than 35 percent of the Federal Reserve's check volume and nearly 60 percent of wire transfer and ACH volume currently are interdistrict in nature. Furthermore, the experience of each Reserve Bank is in large part determined by national policies and standards. This national perspective and orientation is essential if the Federal Reserve is to meet its public interest responsibilities of ensuring the integrity, reliability and efficiency of the payments mechanism and an adequate level of payments mechanism services to all depository institutions regardless of location.

Irrespective of the unique nature and role of the Federal Reserve, business entities generally are evaluated by the marketplace as an integrated whole. For example, entities raise capital in the market based upon the strengths and weaknesses of the entity as a whole. Similarly, federal taxes paid are based upon the experience of the entity as a whole. Accordingly, we believe that it is appropriate to evaluate the performance of the Federal Reserve on a System-wide basis.

However, we are sensitive to the performance of each Reserve Bank. In this regard, fee schedules have been established for 1984 on the basis that each Reserve Bank will cover all of its costs, the costs of float, and also make at least some contribution to the PSAF recovery.

The MCA required the Federal Reserve to make the transition from providing "free" services for a limited number

of depository institutions to pricing for services potentially provided to almost 40,000 depository institutions. The Federal Reserve has implemented the pricing provisions of the MCA in a deliberate phased manner, setting objectives at each stage of the implementation of pricing. The Federal Reserve achieved its stated objectives in 1983. This year, we believe that the Federal Reserve will generate sufficient revenues to match all of our costs (including the PSAF and float) while at the same time fulfilling our public interest responsibilities to the payments mechanism.

Disclosure

Finally, we fully agree with the GAO on the need for more and better disclosure of our priced services activities. Toward this end, we have recently issued a "Report on Priced Service Activities for 1983" and intend to issue a similar report annually, augmented by abbreviated quarterly reports. Now that the initial transition to pricing has largely been completed, we are now in the process of developing a statement of business practices and a clear public statement of the Federal Reserve's future role in the payments system in the context of a priced environment.

Very truly yours,

William W. Wiles
Secretary of the Board

GAO note 1/ It was outside the scope of our review to evaluate the extent to which it is appropriate for the Federal Reserve to be involved in the Nation's payments system generally or in the check collection system specifically. Consequently, our report presents no findings or conclusions regarding the unique public interest responsibilities of the Federal Reserve.

GAO note 2/ The total volume of checks collected by the Federal Reserve declined but the major concern of large private banks is whether the Federal Reserve has increased its share of the interdistrict check clearing market. There is some evidence to suggest that the Federal Reserve's share of the interdistrict check clearing market might have increased although private sector data are not available which would enable us to say for certain that this is the case.

BANK OF BOSTON

Eugene M. Tangney
Executive Vice President

April 24, 1984

Mr. William J. Anderson, Director
General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Anderson:

The National Payments System Coalition commends the General Accounting Office on the thorough research that is demonstrated in the draft report entitled "Federal Reserve System Pricing of Check Clearing Activities."

The Coalition is particularly pleased that the Report shows that the Federal Reserve, while acting within the letter of the Monetary Control Act and other provisions of law, has benefited competitively from its central bank status.

Your Report is persuasive in showing that the Federal Reserve is not just another competitor:

- The Federal Reserve operates nationwide through 48 check processing centers in 36 states (pg. 3)
- The Federal Reserve processes 60% of all checks deposited in one bank for payment by another (pg. 5). (GAO Note 3)

The six billion inter-district checks processed by the Federal Reserve appear to provide the Fed with a 25 to 1 size advantage over the largest correspondent banks. The Federal Reserve is indeed unique in national presence and size.

We agree that the Federal Reserve has capitalized on this unique position through the six competitive advantages which you documented:

1. Presentment costs of $10.3 million annually were avoided. This sum would result if the Fed had paid an average presentment fee of 2.2¢ on the 468 million checks presented outside of clearing house hours (pg. 22) (GAO Note 4)

2. Fed check float was subsidized at an annual rate of $100 million (28% of check revenue) during the second quarter of 1983 (pg.10). Inter-district float was 34% of the total (pg. 29) resulting in approximately $34 million of subsidy. (GAO Note 5)

GAO note 3/ (This information can now be found on pp. 3 and 5 of the report.) We also pointed out in our report that many of these checks had been processed and sent to the Federal Reserve by correspondent banks. Therefore, it would be an overstatement to say that the Federal Reserve has a 60 percent share of the market for checks that clear between banks.

GAO note 4/ (This information can now be found on p. 27.) Our report pointed out that the Federal Reserve is legally prohibited from paying presentment fees. We were not able to determine what percentage of checks processed by the Federal Reserve would be subject to presentment fees or what the item charge would be. However, we estimated that if the Federal Reserve had to pay presentment fees for all checks presented to it after clearinghouse hours, each penny of presentment fee would cost the Federal Reserve $4.7 million annually.

GAO note 5/ (This information can now be found on pp. 13 and 34.) During the third quarter of 1983 the Federal Reserve began to price interdistrict check float. By the fourth quarter of 1983 no interdistrict Federal Reserve check float was being subsidized.

3. The Fed enjoyed up to a 13.6% advantage over correspondent banks in the use of clearing balances for service payment (pg. 25). (GAO Note 6)

4. Fed air transportation was subsidized by $7 million in 1983 (pg. 35). (GAO Note 7)

5. The Fed benefited from overhead allocation shortfalls of up to $17 million (pg. 40). (GAO Note 8)

<u>GAO note 6/</u> (This information can now be found on pg. 30.) During 1983 the Federal Reserve issued proposed regulations for public comment that would eliminate the advantage from clearing balances. By the first quarter of 1984 the Federal Reserve Board had formally approved procedures to eliminate the advantage. The Board staff expected to implement the new procedures in 1984.

<u>GAO note 7/</u> (This information can now be found on pg. 21.) Actual figures for 1983 show air transportation revenue to be about $8.5 million less than costs rather than the $7 million mentioned by The Coalition. However, we do not know whether there was an $8.5 million overall subsidy for interterritory checks because separate revenues and costs for processing and transportation are not available. If the Federal Reserve breaks even in 1984, any shortfall in air transportation revenue will have to be obtained from other check clearing revenue. We cannot say whether the total revenue for interdistrict checks will be greater or less than their costs. In any case, the Federal Reserve is not required to price transportation separately.

<u>GAO note 8/</u> (This information can now be found on pg. 42.) Because we did not conduct a detailed review of the Federal Reserve's overhead allocation methodology, we could not say that overhead expenses were underallocated to check clearing. However, we identified eight overhead and support accounts as well as expenses for the Board of Governors where there appears to be a basis for reconsidering the allocation rules currently followed. We then considered the effect on prices if a higher percentage of these expenses were allocated to check clearing. Based on our analysis of each category, we selected measures that we believed collectively represented the <u>upper bound</u> of increased allocations that might be justified.

The changes we made to the allocation rules should not be construed as indicating deficiencies in the methods currently being used. Whether current methods are appropriate could only be determined by a detailed examination of how the resources in each category are actually used. Our calculations should simply be viewed as an effort to determine the significance of giving the Federal Reserve no benefit of the doubt in the most questionable allocation rules and seeing what the effect would be on prices. Because the effect is modest, we do not believe that there are glaring expense omissions or understatements that would significantly affect Federal Reserve prices.

6. A Fed PSAF advantage of up to $20 million exists depending upon interpretation:

The current $56.2 million PSAF is at the low end of the GAO range of $56 million to $64 million (pg. 43).

The GAO alternative to improve competition (pg. 58) would increase the PSAF to nearly $64 million.

(GAO Note 9) Including clearing balances, float, and GAO documented subsidies would increase the PSAF to $75.8 million (pg. 60).

The 15% across the board Fed price increase resulting from these costs, while significant, is probably not decisive. However, items 1, 2, and 4 above are applicable not to the total of 14.7 billion checks processed by the Fed, but rather to the 6.0 billion inter-district checks (items 2 and 4) or to the 468 million "after-clearing-house-hours" checks (item 1) processed. (GAO Note 10) In the very competitive inter-district after-clearing-house-hours check processing market, these subsidies provide closer to an 80% price advantage.

Further, as pointed out on pg. iii of the Report, the Federal Reserve sets prices by district. This, in the competitive inter-district check processing markets of Boston, New York, and Philadelphia, the Reserve Banks lose money on check processing, while revenues exceeded costs in some southern and western markets.

The Fed's first quarter 1982 implementation of the noon presentment program capitalized on precisely the competitive advantages that the Report detailed.

GAO note 9/ (This information can now be found on pp. 44, 60, and 53.) On page 60 of the report we state that when account is taken of clearing balances and float the PSAF actually used by the Federal Reserve rises to $72.8 million, which is higher than the range of $56 million to $64 million that we believe represents a reasonable level for the PSAF. The Coalition's figure of $75.8 million means that it added $3 million to the $72.8 million for "GAO documented subsidies," apparently referring to the additional PSAF that would result from increasing the amount of support and overhead expenses allocated to check clearing. On pages 53 and 54 of the report we discuss the Federal Reserve's allocation of several support and overhead activity costs to check clearing and suggest that not more than $17 million of such expenses (which in turn would increase the PSAF by $3 million) would likely be allocated to check clearing if a rule less favorable to check clearing were adopted for certain categories. The figures are judgmental. If a detailed review is conducted of the accounts we mention, the allocations to check clearing may or may not increase and therefore the PSAF may or may not be affected.

We concluded that the Federal Reserve was not underreporting its assets associated with priced services, and we found no compelling reason to change the Federal Reserve's assumptions regarding key components of the PSAF. Our conclusions on the individual PSAF components enabled us to establish a range within which we believed the PSAF should fall in 1984. The range was from $56 million to $64 million. We also concluded that when account is taken of clearing balances and float, the PSAF rises to $72.8 million. We emphasized in the report that adjusting the PSAF to include the effects of clearing balances and float does not mean that the Federal Reserve must increase revenues and therefore prices to recover an additional $17 million. The Federal Reserve is already earning the amounts from clearing balances and float and thus no subsidy exists in this area.

GAO note 10/ Data were not available to enable us to analyze the Federal Reserve's cost and revenue from interdistrict checks either in total or segregated by before or after clearinghouse hours; therefore, we are not in a position to comment on the validity of the 80 percent price advantage. The Federal Reserve did not regularly keep data on the revenue or cost of its interdistrict checks nor was such information available from the private sector. The report points out on pages 20 and 25 that recent Federal Reserve pricing and policy changes would reduce its advantages. We agree, however, that it is proper to focus on the market for interdistrict checks.

The GAO documented well the impact of these competitive advantages:

- o The Federal Reserve increased its share of the inter-district check processing market by 16% in the second quarter of 1983 compared to 1982 (pg. 11). (GAO Note 11)

- o From December 1982 to April 1983, the Federal Reserve experienced a 9% gain in the number of institutions depositing checks with the Fed (pg. 12).

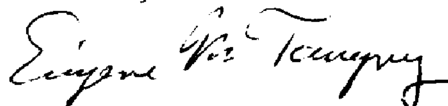
As the GAO perceptively states on pg. 20 ---

> "The Federal Reserve's move to noon presentment raises the issue of the relationship between its central bank status and its competitive operational role in the nation's payments system (emphasis added). Whatever the merits of noon presentment for the long-run efficiency of the payments system, the action also enhanced the Federal Reserve's competitive position by enabling it to present some checks more quickly to paying banks than in the past. It demonstrated that the Federal Reserve System has a degree of influence usually associated with a firm that dominates a market and that it is not just another competitor. The way in which noon presentment was implemented, coupled with the exemption from presentment fees, has heightened concerns of competitors over actions the Federal Reserve may take in the future as it reacts to the dynamics of market forces and changing technology in the payments area."

It is exactly this issue that caused the Coalition to be formed in 1982. We are pleased that the GAO has focused attention on its impact and importance.

As the nation's commercial banks make decisions about investing substantial resources in the continuing transformation of the nation's payments system from paper to electronic-based, it is imperative that the Fed's role in the payments system be clearly defined. Quick action is essential. The Federal Reserve continues to increase its market share while the debate goes on. Major banks can ill afford to expend precious resources in an environment of uncertainty as to the intentions of the dominant competitor. We thank your Agency for adding to the base of facts concerning this important subject.

Sincerely



Eugene M. Tangney, Chairman
National Payments System Coalition

GAO note 11/ (This information can now be found on pp. 16 and 26.) Our report states that the number of interdistrict checks transported by the Federal Reserve increased by 16 percent from the same quarter of the previous year. However, an increase in checks transported does not necessarily mean that the Federal Reserve's interdistrict market share increased by that amount. The report states on p. 16 that the rate of increase in transportation seems to imply some reduction in private sector market share. The basis of this assertion is that the interdistrict checks transported increased by 16 percent but the total of all checks written increased by 5 percent. Most of the 16 percent could represent a switch from private courier to Federal Reserve transportation of checks that had little to do with other aspects of check clearing services associated with correspondent bank business.

President
A.J. (JACK) KING, President
Valley Bank of Kalispell
Kalispell, Montana 59901

First Vice President
B.F. (CHIP) BACKLUND, President
Bartonville Bank
Bartonville, Illinois 61607

Second Vice President
CHARLES T. (CHUCK) DOYLE, President
First State Bank of Hitchcock
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Treasurer
CHARLES L. (BUD) VanARSDALE, President
The Bank of Castile
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WASHINGTON OFFICE

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April 24, 1984

Mr. William J. Anderson, Director
General Government Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

I am pleased to respond to your letter of March 16, 1984, to O.J. Tomson, who serves as chairman of the IBAA's Bank Operations Committee, in which you solicited our comments regarding the GAO's draft report on "Federal Reserve System Pricing of Check Clearing Activities." Mr. Tomson testified on behalf of the IBAA regarding this report before the Senate Banking Committee on April 11, 1984. His testimony was very supportive of the GAO's findings, and I will summarize his remarks in this letter.

The vast majority of community bankers view the Federal Reserve's role in the payments system as essential to the ongoing stability and improvement of this important aspect of the financial framework of our nation. The dollar volume of checks cleared through the Federal Reserve System's regional banks and related facilities in 1983 exceeded $8.4 trillion. Check volumes in 1983 exceeded 12.9 billion processed items. And this only represents a segment of the total, with the balance being cleared through the correspondent bank network.

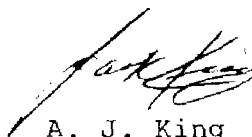
Community banks support the Fed's role because, after 70 years under the Federal Reserve Act, we still see certain abuses being promulgated by the private correspondent banks and practices being continued and inefficiencies being encouraged and marketed which we feel are contrary to the public good. For example, our customers are the victims of the so-called controlled disbursement tactics of the money center banks who have taught the corporate treasurers the profit opportunities available to their respective companies by drawing their firms' checks on branches of those large banks that are conveniently located one day outside of a money market clearing house. Of course, the correspondent bank also obtains the benefits of those delaying tactics.

2.

We need a viable alternative source where we can purchase needed services. This is what the Federal Reserve Act authorized and what the Monetary Control Act of 1980 reaffirmed. We believe that the major issue is whether the Fed in the pricing of its check clearing services competes fairly with the private sector. In this regard, the report of the GAO affirms that the Fed is doing a very conscientious job of internal cost accounting, improving its accounting techniques with time, and attempting to properly allocate overhead. We believe that Fed pricing can continue to be monitored, measured, and adjusted to comply fairly with techniques and accounting practices acceptable to the private sector. The GAO would be a fine and acceptable sounding board for this very purpose.

The IBAA supports the Fed's efforts to continue its vital, active role in the nation's payments mechanism. The nation's smaller banks are counting on the Fed to carry out its mandate to price its services properly and to improve the efficiency of the payments system. We are pleased that the GAO report confirms our belief that the Fed's check collection services are fair as regards private sector competitors.

Sincerely,



A. J. King
President

AJK/nls

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