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CHECK COLLECTION

Competitive Fairness Is an Elusive Goal





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The Honorable Donald W. Riegle
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking, Finance
and Urban Affairs
House of Representatives

This report discusses private banks' ability to compete with Federal Reserve banks in providing check collection services. The report was undertaken in response to the requirement included in the Competitive Equality Banking Act of 1987.

We are also sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System, Chairman of the Federal Home Loan Bank Board, other interested congressional committees and subcommittees, and officials of clearinghouses and trade associations involved in the subject of this report.

This report was prepared under the direction of Craig A. Simmons, Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix XII.

A handwritten signature in cursive script, reading 'Richard L. Fogel'.

Richard L. Fogel
Assistant Comptroller General

the check collection system would be damaged if the differences in basic check presentment abilities of collecting and Reserve banks were narrowed or eliminated. In fact, the system might be improved by such a change. However, GAO believes that to develop a practical proposal that successfully accounts for the interests of all participants in the check collection system, the Federal Reserve will have to develop an explicit policy on competitive fairness and develop more specific criteria to guide its decisions on competitive fairness issues.

GAO's Analysis

Need for Same-Day Payment

To advance the efficiency of the check collection system, the Federal Reserve has used its authority to deviate from state laws governing private banks. In particular, Reserve banks require paying banks (1) to make payment on the same day the Reserve banks present checks and to do so without charging fees, (2) to make such payment on checks that Reserve banks have not endorsed, and (3) to make such payment on checks presented by Reserve banks up to 2:00 p.m.—a time later than is customary for collecting bank check presentments. These payment terms enable Reserve banks to make low-cost funds available quickly to banks that use Reserve banks for check collection. (See p. 26.)

To be competitive, collecting banks need to be able to match Reserve bank collection terms. In part, collecting banks can do this by choosing which customers they will serve. Unlike Reserve banks, however, collecting banks do not have the authority to unilaterally vary from state laws governing check collection. Since these laws do not provide collecting banks with a practical entitlement to same-day payment, collecting banks need to negotiate agreements with other banks covering the terms of check presentment and payment. (See pp. 27-29.) When presentment and payment agreements can be worked out, they customarily entail collecting banks paying fees (presentment fees) to the paying banks. According to bankers that provided GAO with estimates, these fees increased their check collecting costs from 18 to 40 percent. (See p. 30.)

To lessen the effects of the same-day payment difference, collecting banks join clearinghouses, local associations of banks formed to facilitate the exchange of checks among banks. However, member banks must still negotiate arrangements in order to present checks to banks outside the clearinghouse. (See pp. 37-39.)

Agency Comments

The draft report was sent to the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board, and seven trade associations. The Board of Governors agreed with the overall theme of the report and said it would work “further to formalize procedures for evaluating regulatory, service, and pricing proposals, and to articulate the relative importance of competition in evaluating these proposals.”

Though the Board did not directly comment on GAO’s recommendation to adopt a specific policy statement of competitive fairness, it said that publicly disclosing its mark-ups and rationale for decisions to change check collection was an unnecessary encumbrance since its current review procedures are adequate to ensure competitive fairness. The Board also said that extending Reserve banks’ abilities to collecting banks may not enhance competition or efficiency or be in the public interest. In GAO’s opinion, the recommendations made are valid and should be pursued. (See pp. 63-66.)

The Federal Home Loan Bank Board commented that the role of its banks should be further defined and also suggested a different recommendation. GAO believes its characterization of home loan banks is sufficient and that the suggested recommendation is not the best way to equalize competition. (See pp. 66-67.)

Generally, all the trade associations that commented agreed with GAO’s conclusions and recommendations. Some suggested additional recommendations, and the New York Clearing House did not agree with the GAO recommendation calling for a revised same-day payment proposal. Two trade associations did not respond. (See pp. 67-69.)

Chapter 5 summarizes comments received and GAO’s response. Appendixes V through XI contain the individual letters with GAO’s specific responses.

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Reserve System. In 1913, when passing the Federal Reserve Act, Congress saw a need for, among other things, a central bank role in the payments system. The central bank supports the management of the Nation's monetary affairs, in part, through its provision of check collection services. The private network that existed at the time, although it did provide a nationwide system for collecting on checks, was subject to non-par check collection and delays in funds transfers.² Accordingly, the Federal Reserve Act established 12 Federal Reserve district banks under the supervision of the Board of Governors of the Federal Reserve System.³ These 12 Reserve banks, among their other fiscal responsibilities, were authorized to serve as check collection centers that, under section 13 of the act, are exempt from bank charges for the collection and payment of checks.

The Federal Reserve's unique nationwide network of banks and offices provided it with strong market powers. For example, banks that wanted their customers' checks to be generally accepted by the public had to comply with payment terms set by Reserve banks collecting on checks. In this manner, the Federal Reserve in effect regulated the check collection system.

The 1980 Monetary Control Act reaffirmed the Federal Reserve's continued role in the check collection process by expanding the number and kind of depository institutions for which it would directly provide services. Reserve banks were required to make their check collection services available to member and nonmember banks alike in exchange for a fee. The Federal Reserve's nationwide presence was deemed necessary in order to ensure the maximum reliability and availability of check collection services to all financial institutions on an equal basis. The Federal Reserve has since asserted that the basic purpose to be served by its continued presence in the payment service area is to contribute to the efficiency and integrity of the payments mechanism.

In 1987, the Expedited Funds Availability Act made the Federal Reserve responsible for expediting the collection on checks and making further improvements in the check collection system. Accordingly, it was provided broad regulatory and enforcement authority to carry out its

²Non-par payment was the practice of paying less than the face value of the check presented for payment. Such a practice provided compensation to paying banks for expenses and risks associated with the payment of checks.

³The Federal Reserve district banks are in Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. The 12 banks operate through 48 offices in 34 states.

Federal Home Loan banks are limited to providing check collection services to thrift institutions. Reserve banks and collecting banks may service thrifts as well as banks.

We cannot precisely determine market shares of Federal Reserve and collecting banks from the available data. However, as discussed in chapter 2, information on the number of checks handled is available for Reserve banks. That data indicate that, in 1987, Reserve banks handled about 17 billion checks, or about 55 percent of the checks written on one bank and deposited in another.⁷ No similar data are kept on the number of checks collecting banks are hired to collect on or the number of checks banks collect on their own, for example through local clearinghouse associations.⁸

How Checks Are Collected

The check collection process commences at the close of the business day when a bank's deposited checks are sorted between those checks drawn on the bank and those drawn on other banks. Checks drawn on other banks may be presented for payment in several ways. (See fig. 1.1.)

Sorting is usually done by high-speed machines that read, endorse, and sort the checks into compartments representing either a single paying bank or a group of paying banks.⁹ The checks from each compartment are then packaged in bundles with a listing (a cash letter) that shows the total value and number of the checks.

For checks drawn on other banks, the bank of first deposit may choose one or more of the following options for collecting payment:

- send the checks to the bank on which the check is written (paying bank),
- send all or some of the checks to a Federal Reserve bank,
- send all or some of the checks to a regional or national collecting bank,

⁷Checks handled by two Federal Reserve banks are counted as one check. Also, an undeterminable number of those checks have also been handled by collecting banks and then deposited with a Reserve bank for collection. Details of total check work load are shown in appendix II.

⁸Clearinghouses, of which there are about 145 formally established around the country, are local associations of banks that arrange for the exchange of checks, drafts, and notes among members. The operations of clearinghouses are explained in more detail in chapter 2.

⁹The machines sort checks by reading the sorting instructions printed in magnetic ink characters along the bottom of checks. These numbers indicate where in the country the check is drawn; what bank the check is drawn on; and usually what account it is drawn on, the check number, and the dollar amount.

If the checks are deposited with a collecting bank, that bank in turn has the same choices about how it will undertake the next step of the collection process. When checks are deposited with a Reserve bank, however, the Reserve bank exercises only two choices: either present the check for payment or deliver the check to another Reserve bank for collection.

The method a bank chooses to collect on a check depends on a number of factors. Chief among these are the relative price of the service and how quickly funds are made available. In short, prospective customers are looking for a low-cost check collector that, in most instances, provides funds the day checks are deposited for collection. Table 1.1 lists the primary reasons given by some banks for choosing among collectors.

Table 1.1: Reasons for Choosing Among Check Collectors

Reason	Small banks ^a	Large banks ^b
Lower per-check price	35%	39%
Quicker funds availability	20	28
Efficiency through consolidation of business	12	3
Other ^c	32	31
Total^d	100%	100%

^aSmall banks have assets of \$750 million or less.

^bLarge banks have assets greater than \$750 million.

^cOther includes reasons such as higher quality of services at comparable costs and preference for one collector over another.

^dColumns do not add due to rounding.

Source: Survey conducted by the Association of Reserve City Bankers, January 1988.

Returned Check Process

Checks may be returned for a variety of reasons: improper endorsement, insufficient funds, forgeries, nonexistent accounts, stop payment orders, or improper date. Of the returned checks, over half are returned for amounts less than \$100 and over 60 percent of these are paid when presented for payment the second time.

Before September 1988, the return process was much slower than the forward collection process. Returned checks were sent back through each intermediary that handled the check during the forward collection process. The checks were handled manually instead of through the high-speed machines, and there was no requirement to send them back in the same way they were sent forward. For example, a bank's responsibility could have been met by mailing the returned check to a collection intermediary.

required all depository institutions to meet the same reserve requirements as Federal Reserve members. To reduce the burden on banks, the act also lowered the amount of reserves required to be held. This lower reserve requirement reduced the general revenues of the U.S. Government because the profits the Federal Reserve earns from investing bank reserves are turned over to the U.S. Treasury.

To compensate for a large part of the revenue shortfall that otherwise would have resulted from the reduced reserves, Congress required the Federal Reserve to explicitly price its services. As part of this change, Federal Reserve services were made available to all depository institutions. Check collection, the subject of this report, is the most significant of these services in terms of revenues, accounting for about 77 percent of the \$650 million of total priced service revenues earned in 1987.¹¹

For check collection services, implementation of the pricing mandate marked a transition from a complementary Federal Reserve-collecting bank relationship to a more competitive one: Federal Reserve member banks that once were provided with free services now had to pay, and their nonmember bank customers were now eligible for Reserve bank services and thus had a broader choice of collectors.

In adopting the Monetary Control Act, Congress considered the various benefits that would accrue from the explicit pricing of Federal Reserve services. During the floor debate on the Senate version of the bill that became the Monetary Control Act, the then-Chairman of the Senate Banking Committee, Senator William Proxmire, explained

“the efficiency of the banking and payments system will be enhanced through pricing of Fed services and through the greater degree of competitive equality that will result from the legislation. These benefits will accrue to the public generally in the form of lower prices for banking services.”¹²

¹¹Other services provided by Reserve banks include special cash services, electronic funds transfers, automated clearinghouse, securities transfers and safekeeping, and noncash collection services.

¹²Congressional Record, p. S274, January 18, 1979.

We testified before the Senate Committee on the results of our work in April 1984 and issued a report in January 1985. Our report pointed out that the Federal Reserve had taken steps to eliminate the subsidies that characterized the initial phases of pricing.¹⁵ On the broader question of competitive equality, we noted that collecting banks and Reserve banks each had advantages. In particular, we noted how the Federal Reserve's nationwide presence and the Federal Reserve's exemption from certain costs of doing business had enabled it to undertake actions that could not be done by its competitors. We also noted collecting banks' flexibility in selecting customers and using other services outside check collection to attract customers. The report pointed out that problems requiring congressional attention might well arise from time to time due to the pricing provisions of the Monetary Control Act.

The two House Committee reports reaffirmed the value of both Federal Reserve and private sector participation in check collection and the payments system in general. The reports discussed competition in terms of achieving a balance between the two sectors. The report of the House Committee on Government Operations included the following statement:

"It is clear that the priced services operations of the Fed can never be an exact copy of a private enterprise, and to hold that idea up as the ultimate objective is a mistake. There will always be significant differences, and the objective of public policy must be, among other things, to strike a balance that provides a fair and full opportunity to compete to both the Fed and the private sector suppliers."¹⁶

In a similar vein, the House Subcommittee on Domestic Monetary Policy stated that

"The Monetary Control Act did not envisage, nor does the Subcommittee accept, the creation of a theoretically pure and perfect competitive setting if the result is to drive the Federal Reserve out of the payments system and thus weaken the safety, security, and accessibility of the system. However, the Subcommittee would also not accept, nor did the Monetary Control Act intend, a situation in which the Federal Reserve through its actions drives the private clearing banks out of check clearing. Thus, [the specific findings of this report] do not seek to measure the actions of the Federal Reserve in the implementation of the Monetary Control Act against some ideal model of competitive markets, but against the practical test of whether those

¹⁵An Examination of Concerns Expressed About the Federal Reserve's Pricing of Check Clearing Activities (GAO/GGD-85-9, Jan. 14, 1985).

¹⁶Committee on Government Operations, Federal Reserve Competition With the Private Sector in Check Clearing and Other Services (H.R. 98-676, 98th Cong., 2d sess., Apr. 11, 1984), pp. 30-31.

same day that checks were presented for payment. In addition, extended deposit deadlines for same-day payment were established for presorted checks and checks drawn on city banks and certain high-dollar-volume regional banks. Additionally, in 1987, the Board of Governors authorized Reserve banks to collect on checks drawn on banks in foreign nations.

In 1987, the Expedited Funds Availability Act expanded the Federal Reserve's responsibility for payments system efficiency. In addition to overseeing the check collection operations of Reserve banks, the Federal Reserve was authorized to regulate the collection on checks by private sector banks. With its newly acquired authorities, the Federal Reserve, through Regulation CC, established expedited availability deadlines and procedures for the speedier return of unpaid checks. The Federal Reserve also developed a concept paper discussing measures that would enable private sector banks to obtain speedier payment on checks than provided under existing laws.

The 1987 act further mandated that, to improve the efficiency of check collection, the Board of Governors consider requiring the electronic transmission of the information on checks in lieu of forwarding paper checks and that consideration be given to implementing an electronic clearinghouse. After studying the matters, Board staff concluded that while mandated electronic presentment would not be appropriate at this time, voluntary uses of electronic payments should be pursued. As electronic payments become more popular, the impetus for switching from nonelectronic to electronic payments may be provided.

Objectives, Scope, and Methodology

As a compromise to a bill provision adopted by the Senate that would provide for Reserve banks to pay bank fees incidental to the presentment of checks (presentment fees), the Competitive Equality Banking Act of 1987 required that we, in coordination and consultation with the Board of Governors of the Federal Reserve System, study certain issues relating to the ability of collecting banks to compete with Reserve banks for the check collection business of other banks. Specifically, the act required us to report on

- the Federal Reserve System's exemption from the imposition of presentment fees,
- the impact of the imposition of presentment fees on the efficiency of the check collection system, and

bank services. Banks that we interviewed were not randomly selected but were taken from lists provided by Reserve banks and clearinghouses on the basis of size, relationship with local clearinghouses, and whether they provide or use check collection services. Users of services were further differentiated by whether or not they had made a change in their choice of providers or use of a clearinghouse within the past 2 years. We also met with officials from the Federal Home Loan Bank Board and three of their member banks to gain insight on the interaction between two competitors that share similar characteristics.

In total, we spoke to officials of the Federal Reserve System; the Federal Home Loan Bank Board; 16 small-to-midsize community banks and representatives of their trade association; the Independent Bankers Association of America (IBAA); 28 large commercial banks from Federal Reserve cities and representatives from their trade association; the Association of Reserve City Bankers (ARCB); and officials of the American Bankers Association (ABA) who represent the interests of 90 percent of the Nation's banks, both large and small. We also met with a group of bankers, referred to as the National Payments System Coalition, who have been vocal in their complaints of being competitively disadvantaged.

During our interviews with banks, we requested price and funds availability schedules currently offered, and collection fees paid, so as to obtain a sense of the cost banks incur as a result of presentment fees and the comparability of price and funds availability offered by collecting and Reserve banks. This information was supplemented by data taken from surveys done by the ABA, ARCB, Bank Administration Institute, and other private organizations. We also used data obtained from the Federal Reserve System's Planning and Control System, Cost Revenue Reporting System, and the Lagged Float Reporting System. Finally, we reviewed comments submitted by banks we interviewed on proposed expedited funds availability regulations to gain further insight on competitive issues and practical problems faced by banks offering commercial check services.

Advocates of change to the current structure of the payments system have made proposals to equalize competition among providers of check collection services. We considered the proposals in view of their potential to resolve any competitive differences and provide both Reserve and collecting banks a full and equal opportunity to compete; the possible effects on the speed, cost, and availability of services; the potential risk

Agency Comments

A draft of this report was sent to the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board, the American Bankers Association, the Association of Reserve City Bankers, the Independent Bankers Association of America, the California Bankers Clearing House, the Chicago Clearing House Association, the Houston Clearing House Association, and the New York Clearing House. Comments were received from all groups except the Independent Bankers Association of America and the Chicago Clearing House Association. The major points raised in the comment letters and our responses are summarized in chapter 5. Each letter and our full response is contained in appendixes V through XI.

A nationwide same-day payment requirement for presentments by Reserve banks was set out in a revision to Regulation J in 1972. Without that regulatory change, Reserve banks could not effectively require all banks to make same-day payment. Before the regulatory change was adopted, the Federal Reserve Bank of San Francisco, for example, was attempting to convince all 406 banks within the district to make same-day payment. However, 95 banks refused.

According to Federal Reserve Board officials, all banks now conform to the Federal Reserve's terms and conditions of check collection. According to them, a bank cannot afford to (1) turn down check presentments from a Reserve bank, (2) refuse to make same-day payment in full to a Reserve bank, or (3) deny a Reserve bank the right to automatically charge an account maintained at a Reserve bank for check collection purposes.² In short, if a bank did not comply, its checks would not be handled by the Reserve banks. In turn, according to Federal Reserve officials, delays and difficulties in obtaining payment would cause the public to lose confidence in the checks drawn on that bank and move checking accounts to other banks.

Additionally, Reserve banks make no payments to paying banks to cover expenses incidental to their participation in the collection. Section 13 of the Federal Reserve Act specifies that banks may not charge Reserve banks fees associated with the act of collection or payment on checks. The general intent of the act's prohibition was to establish a nationwide system for collecting checks at "par" or face value. Previously, many paying banks paid less than the face value of checks presented by collecting banks. The legislative history indicates that such a practice compensated paying banks for expenses and risks associated with collection. However, recouping another bank's check collection expenses from a Reserve bank was viewed as an undesirable policy. The act did not, however, rule out banks charging other banks a fee.

Collecting Banks Pay Fees to Obtain Same-Day Payment

Unlike Reserve banks, collecting banks do not have the authority to unilaterally vary from the terms of the U.C.C., and its terms do not give banks the practical authority to effectively demand that other banks make same-day payment. For example, under the terms of the U.C.C., collecting banks may

²The account may be the bank's reserve account, separate clearing account, or the account of another bank provided that the other bank agrees to allow a Reserve bank to automatically charge the account.

Therefore, to obtain same-day funds, collecting banks may, under the terms of the U.C.C., enter into individual agreements that may require the payment of presentment fees.⁴ For example, when a collecting bank finds a paying bank willing to provide same-day funds, a collecting bank may open an account at the bank and deposit checks written on the paying bank into the account. The paying bank would then transfer funds from the checkwriters' accounts to the collecting bank's account.⁵ These proceeds may then be wired to the collecting bank's account at a Reserve bank. For these services, a paying bank typically charges a presentment fee, which includes per-check charges for each check deposited in the collecting bank's account and charges for maintaining the account, reporting balances, and transferring funds.

The payment of presentment fees is an accepted and prevalent business practice in the banking industry. According to collecting bank officials, the payment of fees is necessary because that induces paying banks to accept checks directly from collecting banks. Moreover, without compensation, a paying bank does not have an incentive to make same-day funds available on terms more favorable than the minimum standards required by the U.C.C. One banker noted that

"initially, collecting banks experienced some resistance from paying banks to the idea of allowing collecting banks to direct deposit a paying bank's own items. The resistance was related to bookkeeping and return item handling cost issues. In order to overcome this resistance, collecting banks offered to pay the paying banks for the privilege of direct deposit."

Another collecting bank that deposited checks directly with 49 other banks in 21 states during 1987 provided us with more detailed information on the presentment fees it paid. Table 2.1 displays the range of per-check fees that the bank says it was charged by the 49 banks for accepting deposits into the collecting bank's account and for providing same-day payment on checks drawn on those banks. Of the 49 banks, only 1 did not charge a per-check fee for checks drawn on itself. On the basis of other bank fee schedules obtained during our work, Federal Reserve studies, and industry surveys, the charges accrued to this collecting bank appear to be representative of industry practices.

⁴Alternatively, banks may obtain same-day payment through clearinghouse agreements. This alternative is discussed on pages 37-39.

⁵Beyond facilitating payment on checks, a demand account arrangement also enables paying banks to protect themselves against checks they return instead of paying. The minimum balances maintained in the collecting banks' accounts provide a source of funds to cover returned checks.

Even if collecting banks are willing to pay presentment fees, paying banks can refuse to enter into agreements to allow same-day payment. For example, one banker described a bank's refusal to accept presentment:

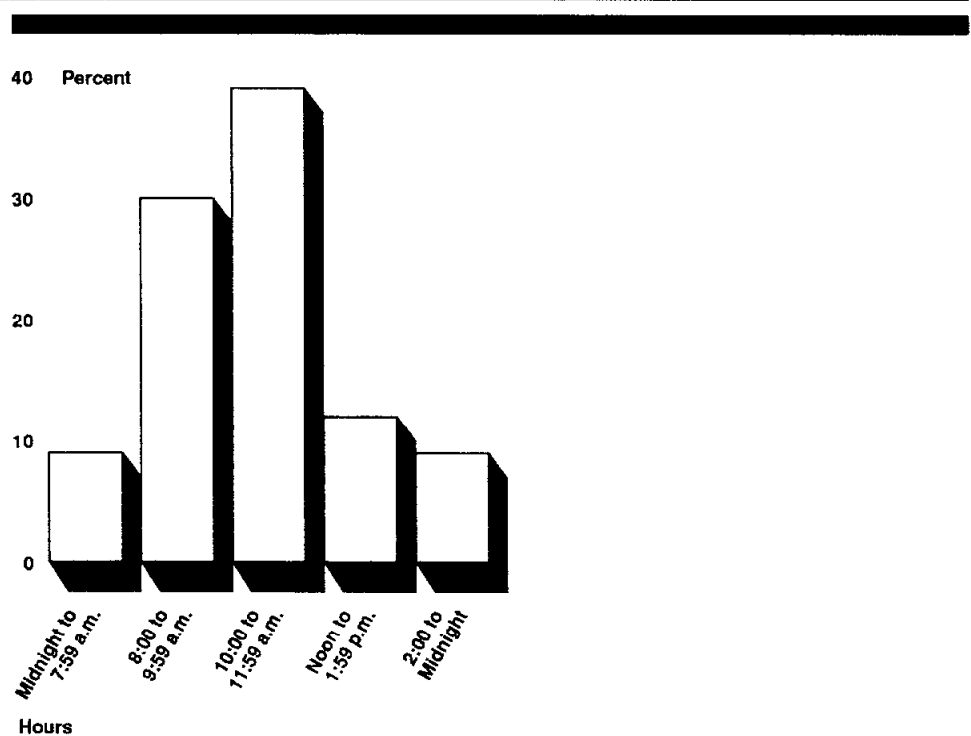
"[the bank] will not accept any items from the private sector, even though they are the largest [non-city] paying bank in this District in terms of items presented. [The bank's] position is that it is more appropriate for it to receive all their incoming items from the Fed . . . than to earn income through presentment fees."

In a similar vein, we were also provided with a copy of a letter from a paying bank that announced it was bringing its account relationship with a collecting bank to an end. Even though this collecting bank preferred to continue presenting checks and paying for the privilege, the letter—without further elaboration—stated that the paying bank would no longer accept deposits from collecting banks for same-day funds availability. In another instance, a small bank turned down a proposal from another local bank to exchange checks for no charge. The other bank decided that the volume was too small to justify the administrative expense of setting up a demand account and that it did not want to accept checks from sources other than a Reserve bank. The bank prefers to have its incoming checks come from one bank owing to the bookkeeping requirements involved in accepting checks from multiple collecting banks.

In our opinion, given the provisions of the U.C.C., the practice of paying presentment fees represents a reasonable and necessary expense of operating a check collection business in competition with Reserve banks. However, the same fees that enable collecting banks to provide expeditious check collection service also adds another expense to their basic cost of doing business—an expense the Reserve banks do not incur. We cannot, however, measure the extent of this competitive disadvantage because of the variation in the charges among banks and the lack of certainty that the offer to pay fees will even result in receiving same-day payment. Nonetheless, the inability to obtain same-day payment without charge constrains collecting bank abilities to operate a check collection business.

lessen its costly float problem. However, collecting banks also incur float costs but cannot unilaterally adopt noon as the time of presentment to reduce such costs. Or, as described by another banker, Reserve banks are the only check collectors that can miss privately set presentment deadlines, such as those imposed on members of a clearinghouse, and still demand same-day payment.

Figure 2.1: Check Presentment Hours of Clearinghouses Nationwide



Source: The Rand McNally Bankers Directory, 1987.

High Dollar Group Sort

The Federal Reserve developed the high dollar group sort product as another means for providing customers with same-day funds on more checks. As in the noon presentment change, Reserve banks changed the time at which they present checks to high-dollar, high-check-volume banks outside Federal Reserve cities. This change in presentment timing enabled the Reserve banks to adjust their deposit deadlines to give their customers more time to get checks to the Reserve banks and provide the

According to collecting bank officials we interviewed, there is little opportunity for a collecting bank to sell a product like payor bank services. Each individual bank does not have all the information. However, to the extent a controlled disbursement bank receives checks from only one bank—one that provides account totals early—it can provide the disbursement service. Because no bank may turn down presentments from a Reserve bank and since it provides the information early, the Reserve bank becomes the preferred source.

Fine Sort

The Federal Reserve developed the fine sort product as another means for providing customers with same-day funds on more checks. To use this product, banks deposit presorted, prepackaged bundles of checks—a separate bundle per paying bank—with a Reserve bank. The Reserve banks then present the checks without first processing them through high-speed reader-sorters for endorsement and recordkeeping purposes. By eliminating much of the processing work and expenses, Reserve banks are able to provide later deposit deadlines yet retain enough time to present prepackaged checks for same-day payment and charge a relatively low collection price.

The Federal Reserve developed the fine sort product by setting terms and conditions for same-day payment that are not specifically provided for under the U.C.C. Regulation J and Reserve bank operating circulars specify that Reserve banks may

- present unendorsed checks for same-day payment;
- warrant that they have good title to the checks or are authorized to obtain payment;
- keep no records on unendorsed checks: it is the responsibility of the sender;
- have no responsibility to describe a lost or stolen check that is to be charged back to a sender; and
- return checks unpaid that are sent to them unendorsed.

Lacking similar abilities to unilaterally establish terms and conditions for same-day payment, officials from collecting banks told us that they cannot offer a similar collection product. As a practical matter, collecting banks endorse checks to meet the U.C.C. ground rules for assigning liability should something go wrong in the collection process—a process that can involve a number of banks. The ground rules hold banks responsible for maintaining records that identify each bank that handles a check from first deposit to final presentment and provide that

Table 2.2: Comparison of Prices and Floor Costs for 1987 In-City Check Collection Products

Location	Product	Price ^a	Floor cost	Net markup	Percent markup
Chicago	Fine sorted	.0149	.0069	.0080	116
	Unsorted	.0251	.0169	.0082	49
New York	Fine sorted	.0151	.0094	.0057	61
	Unsorted	.0368	.0310	.0058	19
San Francisco	Fine sorted	.0076	.0031	.0045	145
	Unsorted	.0235	.0113	.0122	108

^aPrices represent the per-check fee charged by Reserve banks adjusted to prorate the cash letter and package deposit fees on a per-check basis.

The higher percentage markup does not appear to be justified by the amount of capital or other resources used to provide the fine sort product. Because little processing is required, the fine sort product should need less support on a per-check basis than other products that involve more processing. This is demonstrated by the fact that the Federal Reserve Bank of New York is planning to move its check-processing equipment and personnel from Manhattan to Long Island and New Jersey. But even without the processing equipment or additional personnel to operate it, the Reserve bank will continue to offer the fine sort product out of the Manhattan office. Depositing banks will drop off prepackaged checks and paying banks will pick them up. The Reserve bank will debit and credit the appropriate accounts.

We are not in a position to know why the Federal Reserve applies a higher percentage markup to its fine sort product than to other products. The higher markup for fine sort products is, however, consistent with pricing that would be expected to occur when there is an absence of competing products from which customers may choose.

Collecting Bank Membership in Clearinghouses and Same-Day Payment

A collecting bank, by joining a local clearinghouse association, may obtain same-day payment from other members of the association at little expense. In Houston and New York, however, the difference between Reserve and collecting bank abilities to obtain same-day payment from nonmember banks has led to complaints from the local clearinghouses as representatives of the collecting banks.

Clearinghouse Operations and Collecting Banks

Nationwide, about 20 percent of all U.S. banks are members of clearinghouses. In total, about 145 clearinghouses have members ranging in number from 2 to 632 banks. In general, each clearinghouse is a local,

ways to collect on checks and receive same-day payment. For example, one large collecting bank member of the San Francisco clearinghouse provided the following breakdown on how it collects on checks:

- 44 percent are sent to Reserve banks,
- 34 percent are sent to the clearinghouse, and
- 22 percent are sent directly to nonmember banks.

According to the collecting bank officials, for the checks that the bank needs to collect on outside of the clearinghouse arrangement, all are subject to either presentment fees or collection fees.

Houston Complaints

As with other clearinghouses throughout the country, the Houston Reserve bank presents checks without charge to the Houston clearinghouse members in general conformity with clearinghouse rules. Nonetheless, the Houston clearinghouse has complained that its member collecting banks are at a competitive disadvantage relative to the Houston Reserve bank.

Since the Reserve bank sends checks to clearinghouse members through the clearinghouse exchange without charge, clearinghouse officials believe its members should be able to send checks to nonmember banks through the Reserve bank without charge or, alternatively, the Reserve bank should pay fees to the clearinghouse. In the clearinghouse's opinion, either alternative is warranted because the clearinghouse member banks provide a service to the Houston Reserve bank. This service is in the form of additional processing work done after the checks are presented for payment by the Reserve bank. In short, the Reserve bank—as instructed by clearinghouse member banks—presents a package of checks to each of the 13 members of the clearinghouse. These 13 members, in turn, sort and further process the checks on to the clearinghouse's 250 associate members.¹² (App. III provides more detailed information on the interaction between the Houston Reserve bank and the clearinghouse member banks.)

In the opinion of Federal Reserve officials, there is no reason for the Reserve bank to pay the clearinghouse for any work performed by the member collecting banks. From the Federal Reserve's viewpoint, the member banks are providing a service to the associate member banks

¹²The Houston clearinghouse is somewhat unique in that most clearinghouses have substantially fewer, if any, associate members.

New York City Complaints

Commencing in early 1988, the Federal Reserve Bank of New York started moving check collection operations out of New York City to New Jersey and Long Island. Regardless of the location, collecting bank members of the New York clearinghouse need access to Reserve bank services to obtain same-day payment from nonmember banks. Accordingly, when learning of the move, the clearinghouse complained that the increased costs and difficulties its member collecting banks will have in getting checks to the Reserve bank will put member collecting banks at a competitive disadvantage. Specifically, in a letter sent to the Reserve bank, the clearinghouse said:

“The most recent stage of relocation process . . . effectively change(s) [Federal Reserve Bank of New York] deadlines for the delivery of checks and it will result in a decided competitive advantage for [Federal Reserve Bank of New York] at the expense of our member banks. . . . Our members . . . simply cannot meet the [deposit] deadlines . . . for City unsorted checks without (i) establishing significantly earlier cut-off times for their own processing of City Work, (ii) setting much earlier deadlines for the receipt of City work from their correspondents and (iii) incurring large expenses.”

Additionally, the clearinghouse complained about the lack of early notification of the proposed move and its exclusion from any planning, particularly planning for potential disruptions to the existing competitive balance.

To lessen the move’s impact on its New York City competitors, the Federal Reserve Bank of New York decided to allow the New York City clearinghouse members to continue depositing checks at the Reserve bank’s offices in New York City at approximately the same deadlines—at least temporarily—and will share in the costs of transporting the checks to New Jersey, including the cost of the helicopter service needed to meet the tight processing time frames. However, should that transportation fail to deliver the checks in time, float expenses are to be charged back to the depositing member banks.

Accordingly, for checks drawn on New York City banks that are not clearinghouse members, the move will increase New York City collecting bank costs of transportation and increase the risk of float expense. If the collecting banks had the same right to same-day payment as Reserve banks, the collecting banks could better determine whether it was more efficient or economical to present checks directly to paying banks or use Reserve bank collection services.

endorsing and microfilming checks by processing them through reader-sorters. Accordingly, before collecting banks could offer a competitive fine sort service, a scheme for maintaining records of the chain of banks that is satisfactory to the banking industry and mandatory industry-wide would need to be devised. Also, any costs that collecting banks are required to incur should also be required of Reserve banks. According to Federal Reserve officials, eliminating the use of endorsements was considered when Regulation CC was being developed.¹⁴ However, the Federal Reserve's industry advisory group indicated that the industry resisted such a change at this time because it found endorsement information useful for identifying the banks that handled the checks during the course of collection.

Until a new endorsement scheme can be devised so that all collecting banks face similar costs and constraints, or other measures are taken to introduce competition, close attention should be paid to how fine sort and other products with a monopoly element are priced.

Conclusion

The difference between Reserve banks' and collecting banks' abilities to effectively obtain same-day payment has constrained the degree of competition that may take place in the market. By limiting the collection options available to collecting banks, the difference has also constrained the efficiencies that those banks could bring to the check collection marketplace. Moreover, this competitive difference has led to disagreements between Reserve banks and collecting banks or their clearinghouse associations.

The Federal Reserve has requested public comment on a concept paper for regulatory change that, if adopted, could enable collecting banks to obtain same-day payment without charge. Although such a step will not guarantee equality of competition because of other differences described in this and the following chapters, providing similar presentment abilities to collecting banks would remove some constraints that limit their competitiveness.

¹⁴Regulation CC, effective September 1, 1988, implements the Expedited Funds Availability Act of 1987.

not bundle them together.¹ As such, the Federal Reserve's ability to compete for check collection business is based on the collection services and funds availability it offers and the collection prices it charges.

Price and funds availability, however, are not always sufficient to attract business. For example, one banker explained that his bank would not use the Reserve bank for collection services because it cannot do anything but collect on checks. Another banker explained that the Reserve bank's price advantages are not enough to compensate for the products the Reserve banks do not offer, such as cash management and loan syndications.

Collecting Banks Negotiate to Meet Needs

Collecting banks have the flexibility to negotiate so that no two customers necessarily pay the same price for the same service. Private banks may publish price lists but, according to bank officials, the lists are simply starting points for negotiation.

The price a collecting bank customer will ultimately pay for collection services may depend on what other business the customer brings to the bank, the number and mix of checks deposited, and funds availability. One banker explained that his bank usually receives deposits of checks drawn on about 15 to 20 banks, including itself. Therefore, it bases prices on this type of collection service. However, in some instances, the bank only receives checks drawn on itself and in those instances usually gives a price break to the depositing bank. Another banker that provided us with price schedules noted that, by waiving fees for checks drawn on that bank, the prices of one service had been set as low as possible.

Beyond pricing flexibility, collecting banks may also negotiate for late presentments with same-day funds availability. In one city we visited, some banks accepted their own checks as late as 8:30 or 10:00 p.m. for same-day availability. Similarly, at one Federal Home Loan bank we visited, institutions could make some deposits as late as 5:30 p.m. and still receive same-day availability. In contrast, 10:00 a.m. is the latest a deposit may be made for same-day funds availability with the Federal Reserve Bank of San Francisco.

¹These activities include Reserve banks' check collection, wire transfer, securities settlement and safekeeping, automated clearinghouse, noncash collection, coin and currency delivery, and coin wrapping services.

Selling check collection services can help a bank get full use of resources that might otherwise remain idle. Much of the processing done as part of the collection business can be done between midnight and 6 a.m., generally off-hours for the bank's own processing. Accordingly, a collecting bank can expand its check collection business to a certain point without incurring additional fixed costs related to plant and equipment.

Selling lock box services to corporations is another way banks attain fuller utilization of existing plant, equipment, and personnel. Under a lock box arrangement, a corporation will typically have all incoming checks sent to a post office box where they are picked up by the bank. For a fee, the bank, as part of its check collection business, provides the corporation with clerical and other services. This arrangement enables corporations to deposit checks more quickly with the bank and obtain better funds availability. The bank benefits from the fees earned from the corporation and from economies of scale that may be gained by processing additional checks.

Reserve banks, however, cannot compete for corporate customer business. They are authorized to sell collection services only to depository institutions. Even with the processing of about 700 million government checks and postal money orders—the closest equivalent of processing its own checks—Reserve banks' equipment sits idle during parts of the day.

Unique Abilities of Reserve Banks

The Federal Reserve gains certain check collection benefits from its status as the Nation's central bank. As the central bank, it may quickly and inexpensively transfer funds held in reserve accounts to collect on checks. Also, it is the only bank that may operate nationwide. The 12 Reserve banks operate out of 48 offices in 34 states and are linked by a nationwide transportation network. This national presence enables Reserve banks to maintain a market influence so far unattained by private sector competitors. Because of federal and state branch banking restrictions, no private bank has yet had the opportunity to establish a national presence similar to the Federal Reserve's.

Automatic Access to Bank Accounts

In general, U.S. banks meet reserve requirements through (1) funds in an account maintained at a Reserve bank or (2) funds in an account maintained with another bank, which in turn passes the balances on to an account maintained at a Reserve bank. In addition to their role in

connection. Also, each receiver is charged for each wire transfer received and for a telephone notification of each transfer, if desired.

Nationwide Transportation Network

The Federal Reserve's national presence offers opportunities for economies of scale. For example, Reserve banks have created a nationally coordinated hub-and-spoke transportation network that connects the 48 Federal Reserve banks' check processing offices, enabling them to function as one system.

The Federal Reserve's Interdistrict Transportation System connects five designated hub cities—New York, Cleveland, Chicago, Atlanta, and Dallas—with spoke cities around the Nation. The spoke cities, in turn, have created transportation arrangements that link banks into the hub-and-spoke arrangement. For example, for the convenience of banks within the Philadelphia Federal Reserve district that use their Reserve bank's check collection services, the Reserve bank has established nine relay points in a three-state area to accept check deposits. According to the Philadelphia Reserve bank, by depositing checks by the specified deadlines at the relay points, depositors can take advantage of the full range of products offered. Because the Reserve bank's deadlines are also coordinated with interdistrict transportation schedules, the bank will handle all sorting and transportation needs for checks drawn on both in-district and out-of-district banks. According to promotional literature on the service, the deposit hours and attractive funds availability will enable banks to convert checks into cash faster than ever.

Market Influence

Because the Federal Reserve is the dominant market participant and sole presenter to some paying banks, Federal Reserve actions can affect the competitive status of others.

The market dominance of the Federal Reserve was apparent from the discussions we held with both users and competitors of the Federal Reserve's collection services. The bankers who voiced an opinion generally viewed the Reserve banks as setting the industry benchmark for product prices. Users we talked to said Reserve bank prices are used to evaluate terms offered by collecting banks and, in some instances, as negotiating instruments to obtain better terms from collecting banks. Competitors use Reserve bank products and prices as a reference point to decide whether or not they should compete for business, offer a particular collection product, make investments to expand their check collection business, or offer new products. Moreover, competitors depend

improvements have added to the business pressures experienced by collecting banks as their collection products need to be competitive with those offered by Reserve banks. A more detailed discussion of changes in Reserve banks' check collection volume, profitability, and products is contained in appendix II.

Less is known about the condition of collecting banks. Respondents of two recent surveys reported that smaller user banks (assets less than \$500 million) have increased their use of Reserve banks over time and decreased their use of collecting banks.⁵ The surveys therefore suggest that over the past several years, collecting banks have experienced an erosion of business from smaller banks. Of the banks offering check collection services, responses were about evenly divided between those that said volume had decreased and those that said it had not.

The ARCB survey shows a mixed picture in terms of profitability. About half of the banks reported that profit margins either had not changed or had increased over the past 5 years, while the other half reported that profit margins had declined. Most expected the existing trend in profit margins to continue. The surveys did not, however, provide enough information to determine additional characteristics of collecting banks whose business had suffered from those whose business was continuing to be profitable. Appendix II contains more detailed information from these surveys.

In summary, from the data available, we saw no clear signal that one competitor is being driven out of the market by the other. Since the Monetary Control Act, however, Reserve banks have more actively competed for business; they have developed specialized products and reduced the costs of check collection for their customers. In this environment, collecting bank officials believe they are at a disadvantage when competing with the Federal Reserve and would like to improve their competitive position. Federal Reserve officials, however, point out that the overall competitive balance is unknown because collecting banks have advantages of their own and, in their opinion, the advantages are sizable.

⁵In January 1988, the ARCB released the results of a bank survey that was designed to provide information on the competitive situation of collecting banks. This study, in part, followed up on the results of the 1986 ABA National Operations/Automation Survey. Because only 24.3 percent (930 of 3,824 banks contacted) responded to the ARCB survey and only 20.8 percent (706 of 3,400 banks contacted) responded to the ABA survey, the results cannot be statistically projected to the universe of all banks. Although it is not possible to make statistical projections, an analysis and comparison of the survey data does shed some light on competitive conditions as seen by the responding banks.

First is the Federal Reserve's ability to unilaterally take actions that have the potential for changing the competitive balance, such as the Federal Reserve's announced move out of New York City and its potential effect on competitors' costs and access to Reserve bank services. To minimize the potential for disruptions, Reserve banks could be required to (1) assess how their proposed actions promote competitive equality and (2) present such an assessment to the Board of Governors. In our opinion, requiring such assessments would be consistent with Federal Reserve System policy statements pledging a commitment to competitive fairness in the priced services area. A detailed discussion of these policies and the conflicts of interest to be avoided are discussed in the following chapter.

The second issue that emerges as potentially limiting competition involves the time of presentment. Reserve banks, to date, have been confined to presenting checks before 2:00 p.m., even though, for a price, some banks routinely accept checks from other banks later in the day.

In our opinion, Reserve banks should be in a position to make a decision as to whether or not it is advantageous to present checks after 2:00 p.m., provided that banks are willing to accept such checks. This later presentment may be warranted when the costs of making such presentments, including the payment of presentment fees, are less than the costs of carrying the checks overnight. Benefits from this change include

- competitive equality: collecting banks engage in such activities;
- cost efficiency: determinations can be made as to whether it is less expensive to make late presentments than to hold checks overnight; and
- speed efficiency: checks may be collected 1 day earlier.

Moreover, in our opinion, problems associated with the Federal Reserve paying presentment fees would be avoided since the amount would be limited to what the Federal Reserve would be willing to pay and the fee would only be paid when Reserve banks determined it was worthwhile.

Conclusion

Both collecting banks and Reserve banks have abilities that are unavailable to the other to further the attractiveness of their check collection business. Through use of these abilities in a competitive environment, their customers have enjoyed improved services at lower costs; benefits that users would not like to give up to eliminate what some competitors view as a competitive inequality. However, without having equal rights of presentment as discussed in chapter 2, collecting banks are not in a

Observations, Conclusions, and Recommendations

This chapter discusses the goal of competitive fairness in the context of other goals such as the promotion of payments system safety, soundness, and efficiency. It makes recommendations for ensuring that collecting banks have the opportunity to participate fully in the check collection system.

Need to Clearly Define Competitive Fairness

According to Federal Reserve policy statements, its payments system mission, in summary, is to promote the integrity and efficiency of the system and to ensure that services are equitably provided to all depository institutions. With recent legislation—most notably the Expedited Funds Availability Act—promoting efficiency has become increasingly important.

In policies adopted in 1984, the Board of Governors stated a willingness to cooperate with other service providers in improving the payments mechanism and expressed a “fundamental commitment to competitive fairness.” Competitive fairness was considered an extension of Federal Reserve responsibilities for improving the payments system and preserving its safety and soundness.

However, the Federal Reserve’s competitive fairness policy has not been further defined beyond this general statement of policy. According to Federal Reserve officials, relevant legislation provides little guidance on defining competitive fairness. The Monetary Control Act—without further elaboration—specified that Federal Reserve pricing principles should give due regard to competitive factors.

Because the Board’s policy is vague, and because there are no specific criteria by which to evaluate its actions, differentiating between Federal Reserve actions taken to improve the payments system as a whole and those taken to maintain the profitability of its check collection services can be difficult. For example, several program changes have simultaneously

- furthered the efficiency or integrity of the payments system,
- improved the competitive position of Federal Reserve bank check collection services, and
- diminished the competitive position of private collecting bank check collection services.

Such simultaneous effects have been present in several of the Federal Reserve’s service changes discussed in this report: (1) the high dollar

- disclosure is not made on how proposals for service, price, and payments system changes promote competitive fairness given the differences in abilities between collecting and Reserve banks and the extent to which competitive fairness was considered.

It has become increasingly important that policies and procedures be established to ensure that competitive fairness is fully considered along with other payments system goals. With passage of the Expedited Funds Availability Act, the Federal Reserve has the authority to regulate all checks regardless of whether they are collected by a collecting bank or a Reserve bank. Without policies and procedures for evaluating competitive fairness, Federal Reserve actions could unnecessarily constrain private sector institutions' opportunities to compete in the payments system. Such an effect would appear to be contrary to direction given by Congress. As discussed in chapter 1, the legislative history of the Monetary Control Act and subsequent oversight of payments system issues shows congressional interest in maintaining both public and private participation in the payments system.

The need to fully consider competitive fairness is reinforced by the heightened potential for conflicts of interest resulting from increased Federal Reserve responsibilities under the Expedited Funds Availability Act. Federal Reserve check collection officials responsible for overseeing the activities of Reserve banks are now also responsible for developing regulations that govern the activities of their competitors. Furthermore, these Federal Reserve officials are increasingly involved in changing the characteristics of the industry to promote efficiency. For example, to meet the requirements of the act, Federal Reserve check collection officials developed regulations that overhaul the processing and collection of returned checks. Simultaneously, they announced the adoption of check truncation and data capture products, which may result in the Reserve banks selling data processing and account services.³ Reserve banks have not previously competed with collecting banks in these service areas.

³The check truncation and data capture products were adopted to improve the check collection system. Check truncation reduces the number of times the paper check is handled by capturing the data contained in the magnetically encoded line of information printed on every check and electronically transmitting these data to the paying bank. The paper check is retained by the presenting bank. Data capture is quite similar to check truncation; however, rather than halting the flow of paper, checks are delivered to the paying bank several days after the data are transmitted using a less time-critical mode of transportation.

Reserve banks has led industry participants to take their disagreements to Congress.

Attaining Fairness by Eliminating Same-Day Payment Difference

The most important competitive difference that we found involves the Federal Reserve's unique ability to collect from any bank on the same day checks are presented and not pay for such a privilege. In our work, we did not see evidence that maintaining this difference is essential to the safety, soundness, or efficiency of the payments system. Furthermore, we think there are potential gains associated with narrowing the difference between Federal Reserve and private sector banks. Should same-day payment be extended to collecting banks, the payments system could potentially be improved because banks could choose the most efficient method of presentment on the basis of cost, funds availability, or other market forces; efficiency could increase by reducing the need for a "middleman" as a check collector; the transition to efficient electronic check presentments could be promoted; and competition would be enhanced.

Near the end of our work, the Federal Reserve requested public comment on the operational effects of requiring paying banks to make same-day payment without charge on any number of checks presented by Reserve banks or other banks up to 2:00 p.m. The Board may develop a specific regulatory proposal for public comment before final adoption of formal rules, depending on the comments received. December 1, 1988, was set as the deadline for submitting comments.

Most of the comments received as of mid-October 1988 were from paying banks and their customers opposed to the concept of same-day payment as presented for comment. The primary objections dealt with the 2:00 p.m. cut-off for presentment of checks. Paying bank customers—nonbank corporations accounted for about 75 percent of the respondents—were mostly concerned with the detrimental effect of late presentment on corporate cash management practices. Corporate cash managers say that late presentments would subject banks to additional risks and force corporations to guess at their cash positions in order to make investment decisions. Paying banks commented that later presentment will create operational problems and that if a later cut-off is adopted as regulation, they would lose cash management business. Other factors reinforcing this opposition include the potential loss of revenue from charging collecting banks for making presentments and the potential increase in check processing costs associated with receiving and processing checks from additional banks.

banks to continue their cash management business but also gave Reserve banks a product that is free from competition.

We see no compelling reason why the Federal Reserve should not be able to develop specific arrangements that recognize paying bank interests while at the same time narrow the differences between Federal Reserve and collecting banks. Developing the specific arrangements that should be considered was outside the scope of our work. However, examples of what these arrangements could entail include requiring collecting banks to notify paying banks of their intent to present checks for payment or requiring collecting banks to provide paying banks with a service similar to the Federal Reserve's payor bank services.

Conclusion

Instituting payments system changes that promote competitive fairness poses a difficult challenge to the Federal Reserve for a number of reasons. First, beyond a generally stated commitment to competitive fairness, the Federal Reserve does not have policies or procedures that provide explicit criteria for acting on changes that can promote competitive fairness or ensure that competitive fairness issues are adequately considered. Second, there can be significant opposition from some banks to changes that would promote competitive fairness. Third, the deliberations on competitive issues create conflicts of interest for the Federal Reserve because of its role as competitor, dominant provider, and payments system regulator.

In our opinion, to ensure that competitive fairness issues are appropriately considered, the Federal Reserve needs to (1) better define what is meant by its policy commitment to competitive fairness as a means of providing clear decision-making criteria and (2) establish better procedural controls to further payments system changes that promote competitive fairness while providing strengthened safeguards against potential conflicts of interest. It should then apply those policies and procedures to the development of a same-day-payment regulation.

The most important competitive difference that we found involves the Federal Reserve's unique ability to collect from any bank on the same day checks are presented and not pay for such a privilege. In our work we saw no evidence that perpetuating all differences between Federal Reserve banks and collecting banks is essential to the safety, soundness, or efficiency of the payments system. Therefore, we think the Board of Governors should apply the more specific policy on competitive fairness in developing a revised proposal on same-day payment.

Summary of Comments and GAO Response

This chapter summarizes the major points raised by the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board, and the banking associations we consulted and our response to those comments. Each comment letter and our full response are contained in appendixes V through XI.¹

Comments From the Board of Governors of the Federal Reserve System

The Board of Governors of the Federal Reserve System, while agreeing with some of our conclusions, believed that our overall message should be further developed by discussing two major points: the importance of balancing the interests of collecting banks with the interests of other payments system participants and the necessity of keeping the Federal Reserve free from unnecessary procedures that could reduce rather than enhance competition.

Under the first major point, the Board of Governors commented that

- simply providing collecting banks with the same presentment rights as Reserve banks may not promote competition or payments system efficiency since collecting banks will continue to have advantages not shared by Reserve banks;
- achieving competitive equity without tempering it with a prudent balancing of the interests of all affected parties is not in the public interest; and
- pursuing a same-day-payment proposal in which benefits to collecting banks are outweighed by inefficiencies to the other parties would not be in the public interest.

Although the Board did not endorse our recommendation that an explicit policy on competition be adopted, it did agree to work further to formalize procedures for evaluating regulatory, service, and pricing proposals and to articulate the relative importance of competition in evaluating those proposals.

Under their second major point, the Board stated that

¹The American Bankers Association, the California Bankers Clearing House, and the New York Clearing House included in their letters their responses to the Board of Governors' request for comment on the same-day-payment concept. As these comments do not directly pertain to our conclusions and recommendations, they have not been reprinted in the appendixes. But the comments are part of the public record—docket number 0631.

payment while others disagreed with the proposal as forwarded by the Board. In fact, many suggested modifications to the proposal.

We agree that it is important for the Board to take into account the interests of all users of the payments system in any decisions made. In our opinion, however, the Board does not have policy guidance in place that makes it clear why it is permissible for Reserve banks but not for other banks to present checks up to 2 p.m. If the Board followed our recommendation and adopted an explicit policy on presentment, then it would have an explicit basis for making such decisions. We recognize that a consequence of our proposal is that the Board might have to modify its own presentment practices and develop a system under which the abilities of all banks to collect checks are more equal.

Another comment in the Board's letter also shows why an explicit policy is needed. In commenting on competitive aspects of its fine sort product, the Board stated that

"Although the Federal Reserve's fine sort services do not enjoy as active competition as some other check collection services, there are indications that some collecting banks provide similar services. For example, United Banks of Colorado, Inc. discussed in its comment letter on proposed amendments to Regulation CC . . . 'the treatment of checks that typically are not indorsed by the collecting bank, such as those forwarded for collection under the Federal Reserve's fine sort program or through package-forward or endpoint sort arrangements between commercial banks.'"

The Board provided no further discussion of this point, but by using the quote from United Banks of Colorado, it seems to imply that the Reserve banks do not operate a monopoly product and that the Board is pursuing competition by inviting private banks to process or present checks they do not endorse. Many commercial bank officials told us that endorsement by them was necessary for the safety of the system, and thus, they cannot offer a product similar to fine sort. In the past, the Federal Reserve, too, has chosen safety and soundness over competition. Now, however, with this comment, the Federal Reserve appears to say that at times competition can override safety and soundness. We think a more explicit policy statement about competitive and safety concerns in the check collection area would help clarify this comment in the Board's letter.

With respect to the Board's comments on procedures, we appreciate its concerns about not being overburdened with unnecessary requirements. However, as a public entity, we think it is also reasonable for the Board

As to the recommendation, we do not believe that recommending that the Federal Reserve Board impute presentment fees is the best way in which to equalize competition because of the drawbacks discussed in appendix IV. Instead, by opening up competition through extending similar presentment rights to all participants, competitive pricing should occur.

Comments From Trade Associations

The American Bankers Association supported our recommendations and guidelines to the Federal Reserve Board to achieve competitive fairness. The Association believed, however, that the recommendations should have been defined more specifically. It would have preferred that we recommend the Board “establish procedural controls to assure that future payments system changes promote competitive fairness and conform to Board policy.” It also agreed that the Federal Reserve should balance the interests of paying and collecting banks and consider the differences in presentment abilities when developing the revised same-day-payment proposal. The Association stated, however, that it opposes any proposal that signals aggressive movement by the Federal Reserve into private sector business relationships.

The Association of Reserve City Bankers endorsed the report and the specific recommendations.

The California Bankers Clearing House agreed with our recommendation that presentment parity between collecting banks and the Federal Reserve is the most direct way to ensure competitive fairness. The Clearing House also provided some information on what it believed were some technical inaccuracies.

The Houston Clearing House Association agreed fully with the findings in our report. It also supported our recommendation for action by the Federal Reserve. The Association provided us with some ideas for achieving the goal of competitive equity. Specifically, it believed that a standing group should be established to deal with competitive equity issues. The Association also believed that a timetable should be set for the Federal Reserve to complete and implement the recommendation.

The New York Clearing House agreed with our recommendation that the Board clarify existing policies and procedures covering its commitment to competitive fairness. It believed, however, that the recommendation should have encompassed a commitment to all payments systems, not just check collection. It also wanted us to recommend that the Board

We agree that the principles of competitive fairness established in check collection could easily apply to other payment system issues, especially those involving electronic fund transfer systems. Those other issues were beyond the scope of our work but would be appropriate topics for congressional oversight in the future.

Federal Reserve and Collecting Bank Competitive Positions

This appendix summarizes the available data on the competitive positions of Reserve and collecting banks. The lack of comprehensive data on the private check collection market limits any definitive analysis of the commercial success of collecting banks. However, survey data compiled by the American Bankers Association and the Association of Reserve City Bankers, though not statistically projectable to the universe of banks, give some indication of the status of some competitors in the check collection business.

Commercial Success of the Federal Reserve

The Federal Reserve, in recent years, has improved existing collection products and introduced new ones at the same time it has reduced the real costs of its products to the banking system. In our opinion, the commercial success of the improvements is evidenced by the steady growth in Reserve bank collection business and earnings that exceed targets. Correspondingly, these improvements add to the business pressures experienced by collecting banks as their collection products need to be competitive with those offered by Reserve banks.

Check Collection Volume

When the Monetary Control Act of 1980 was adopted, the Federal Reserve did not keep comprehensive statistics on the number of checks handled by its banks. Available data, although incomplete, show that Federal Reserve check volume for 1981, the first year pricing was implemented, had declined about 6 percent from the preceding year. As shown in figure II.1, however, the Reserve banks' check collection volume has grown steadily since the initial decline. The annual growth rate ranged from 3.7 percent to 5.5 percent, with an average of 5.2 percent over the time period.

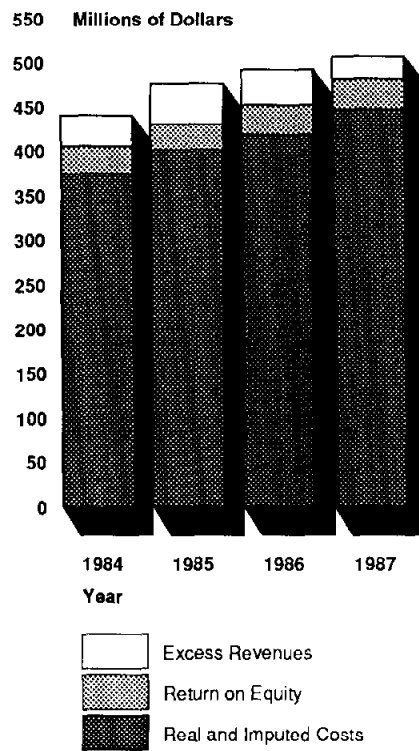
The increase in volume has not been equal among all collection products sold by Reserve banks. For example, during that entire period, fine sort volume increased about 48 percent to about 4 billion checks while the volume of processed checks—checks sorted and packaged by Reserve banks—increased about 21 percent to almost 15 billion checks.

Federal Reserve System officials believe that the growth in the number of checks handled by Reserve banks is approximately equal to or slightly greater than what they estimate to be the overall growth rate of checks. This constancy seems to suggest that the competitive position of Reserve and collecting banks has been stable for the past 5 years.

**Appendix II
Federal Reserve and Collecting Bank
Competitive Positions**

and a return on equity. As shown in figure II.2, during 1987, check collection revenues exceeded the costs of producing those revenues and targeted return on equity by about 5 percent, or \$25 million.

Figure II.2: Analysis of Federal Reserve Check Collection Revenues, 1984-87

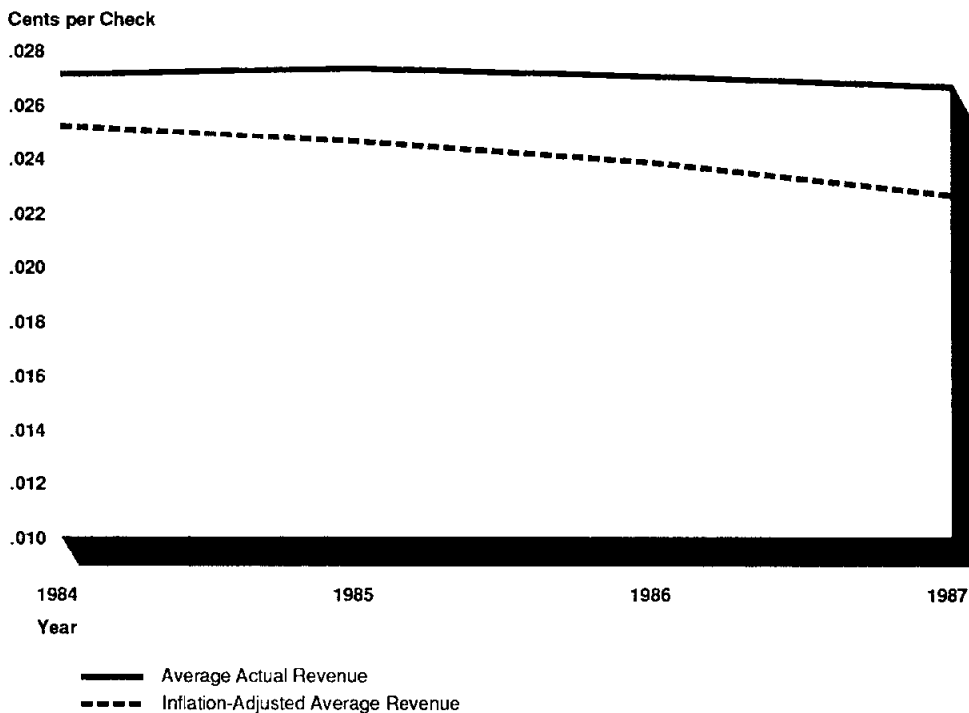


Source: Federal Reserve Annual Reports for Priced Services.

We were told by Federal Reserve officials that the practice of earning excess revenues is discouraged so that profits will not be unnecessarily extracted from the banking industry. This objective is reflected in the reduction of excess revenues between 1985 and 1987. Yet, as shown in table II.1, each Reserve bank earned revenues in excess of costs, including the cost of float and return on equity in 1987.

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Figure II.3: Average Federal Reserve
 Per-Check Revenue



Source: Federal Reserve Cost Revenue Reporting System.

Prices charged by Reserve banks for collecting on checks drawn on banks surrounding cities with Reserve banks follow a similar trend. From 1985 through 1988, prices were stable at \$0.025 per check in San Francisco; in Chicago, prices have dropped from \$0.036 per check to \$0.034.¹

Another factor contributing to the decline in real revenues per check is the increased use of low-priced products. For example, use of the fine sort product increased at a rate more than twice that of the higher priced processed work. The 10-percent decline in real revenues per check has important implications on private sector competitors of Reserve banks. To attract and retain business and yet still earn profits, collecting banks must compete successfully in an environment where a major competitor's average price per check is declining in real terms.

¹No equivalent banks are served by the New York City office of the Federal Reserve Bank of New York.

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Federal Reserve and Collecting Bank
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1984.² By 1987, the cost was reduced to about \$21 million. Table II.2 compares the change in costs for Federal Reserve collection services between 1984 and 1987. This comparison shows that the main cost components of Reserve banks' check collection activities are personnel, overhead, shipping, and equipment. Over the past several years, the cost components of Reserve bank activities have not changed substantially.

Table II.2: Cost Components of Federal Reserve Check Collection Services, 1984 and 1987

Service	1984^a	1987^a	Percent increase
Personnel	\$112.0	\$131.6	17.5
Overhead	86.2	102.7	19.1
Shipping	49.3	49.0	(0.6) ^b
Equipment	26.8	34.0	26.9
Imputed return on equity	29.6	33.4	12.8
Imputed interest on float	26.3	21.1	(19.8) ^b
Other imputed costs	13.3	25.0	88.0
Data processing	16.9	21.1	24.9
Data systems support	5.5	7.2	30.9
Building operations	12.8	15.9	24.2
Materials	8.2	9.9	20.7
Other	17.4	29.6	70.1
Total	\$404.3	\$480.5	18.8

^aDollars in millions.

^bPercent decrease.

Source: Federal Reserve System income statements, Planning and Control System reports, and Cost Revenue Reporting System data.

Service

The Reserve banks' ability to compete successfully for check collection business can also be partly attributed to the attractiveness of the products offered by Reserve banks, an attractiveness that has been enhanced by the introduction of new products and the expansion of products that were not significant in 1980. These include

- implementation in 1979 of a nationwide late-deposit fine sort product,
- implementation in 1983 of a noon presentment deadline for making checks available for dispatch to banks in Federal Reserve cities,
- implementation in 1984 of a high dollar group sort product to further accelerate the collection of checks,

²A portion of this reduction is attributable to a drop in the average federal funds rate. The average federal funds rate was 12.26 percent in 1982 and 10.22 percent in 1984.

Appendix II
Federal Reserve and Collecting Bank
Competitive Positions

A detailed analysis of the change in Reserve bank customers and the destination of the deposited checks is shown in table II.4.

Table II.4: Federal Reserve Check Collection Volume, 1984 and 1987

Destination of check	Checks deposited by customer ^a							
	Local banks		Banks out of district		Other Federal Reserve banks		Total ^b	
	1984	1987	1984	1987	1984	1987	1984	1987
Federal Reserve processing of cash letters drawn on								
In-district								
City banks	597	689	1,264	1,190	422	516	2,283	2,395
Regional banks	3,838	4,232	2,910	3,233	673	905	7,421	8,370
Country banks	455	373	351	312	84	79	890	764
Out-of-district banks	856	1,124					856	1,124
Mixed-district banks	1,542	2,045					1,542	2,045
Other	39	18	3	1	17	13	59	32
Total processed checks	7,327	8,481	4,528	4,736	1,196	1,513	13,051	14,730
Federal Reserve handling of fine-sorted packages of checks drawn on								
In-district								
City banks	1,067	919	209	246	103	139	1,379	1,304
Regional banks	1,229	2,145	198	270	77	136	1,504	2,551
Country banks	77	141	10	35	6	10	93	186
Total fine-sorted checks	2,373	3,205	417	551	186	285	2,976	4,041
Total checks handled	9,700	11,686	4,945	5,287	1,382	1,798	16,027	18,771

^aIn millions.

^bChecks handled by two Federal Reserve banks are counted twice. Totals can be adjusted by subtracting the number of checks deposited by other Federal Reserve banks.

Source: Federal Reserve System Cost Revenue Reporting System.

Check Collection Market Share of Collecting Banks

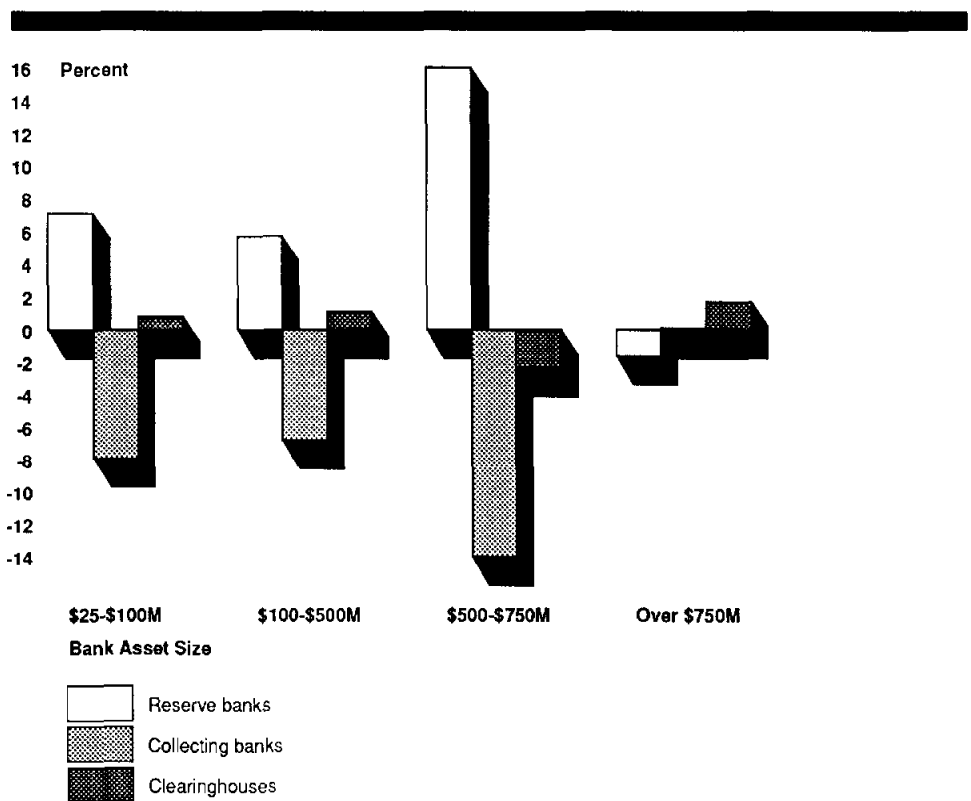
In January 1988, the Association of Reserve City Bankers (ARCB) released the results of a survey designed to provide information on the competitive situation of collecting banks. This study, in part, followed up on the results of the 1986 American Bankers Association (ABA) National Operations/Automation Survey.³ Because only 24.3 percent (930 of 3,824 banks contacted) responded to the ARCB survey and only 20.8 percent (706 of 3,400 banks contacted) responded to the ABA

³Both studies refer to collecting banks as correspondent banks. For consistency, in this report we refer to these banks as collecting banks.

A Shift in Customers by 1985

A comparison of ABA data for year-end 1983 with year-end 1985 shows that collecting banks lost between 7 and 14 percent of the check collection business of smaller banks participating in the survey while retaining their market share of the business with banks having over \$750 million in assets. (See figure II.6.)

Figure II.6: Net Change in Percent of Market Share by Bank Asset Size, Year-End 1983-85



Source: Unpublished data from the 1986 American Bankers Association National Operations/Automation Survey. Data were obtained to coincide with data categorizations by the Association of Reserve City Bankers January 1988 study

Trend Continues From 1985 Through 1987

Figure II.7 shows the market share of the check collection business that was held by Reserve banks, collecting banks, clearinghouses, and others as reported by banks that responded to the ARCB questionnaire. The data were accumulated during December 1987.

**Appendix II
Federal Reserve and Collecting Bank
Competitive Positions**

collecting banks. However, the banks also reported using the check collection services of holding company affiliates for 10 percent of their checks in 1987. Since the holding company affiliates may or may not be collecting banks, the loss of market share would be in the range of 6-16 percent. For the largest banks, those with assets over \$750 million, the loss in collecting bank market share may range from 2 to 7 percent.

Table II.5: Net Change in Check Collection Market Share, Year-End 1985 to Year-End 1987

Asset size of bank ^b	Percentage gain or loss ^a		
	Private banks ^c	Federal Reserve	Clearinghouses
\$ 25 to 100	(2) to (8)	2	0
100 to 500	(6) to (16)	2	3
500 to 750	2 to (4)	(1)	0
750 and over	(2) to (7)	0	0

^aLoss in parentheses.

^bIn millions.

^cRange of gains and losses results from whether or not check collection through affiliates is categorized as collecting bank business.

Although the industry studies are open to interpretation as to the amount of collecting bank loss of market share, the data indicate that collecting banks have experienced a continuing erosion of business, particularly from smaller banks.

10:00 a.m. At noon the Federal Reserve Bank of New York makes its final check presentment. At the exchange, full members present separately packaged checks to other full members. The full members may also present separately packaged checks to the 176 banks. However, the 176 banks may not directly present to the 12 full members. Instead, they contract with a full member to have their checks presented.

San Francisco

San Francisco has 8 full members and 21 associates and affiliates. The full members pay a \$50,000 membership fee, \$5,000 in dues, and a \$4,000 annual check presentment fee. There is also a fee based on the volume of checks presented. Five exchanges occur: 2:00 a.m., 8:00 a.m., noon, 9:30 p.m., and 11:59 p.m. At the exchange, full members present up to four check packages to other full members. One package contains checks drawn on the full member, one drawn on a designated associate of the full member, one with checks drawn on another designated associate, and one drawn on the member's remaining associates. Associate members contract with full members for check presentment and receipt.

While the specific mechanics of the exchange differ by clearinghouse, the net settlement and default procedures are similar. Under the net settlement procedures, the clearinghouse tallies the net amount due or owed to member banks. These net amounts are called into the local Reserve bank and credited to or charged against the member banks' accounts. If the transaction cannot be completed because of default by a member, the net settlement procedure is reported without the defaulting member. When the defaulter is the paying bank, either the other members recoup their losses from their customers or the clearinghouse brings a claim against the defaulting bank on behalf of the other members. When the defaulter is the depositing bank, a paying bank attempting to return a check would bring a claim against the depositing bank's customers or the last collecting bank in the chain.

Reserve Bank Interaction

In general, Reserve banks interact with local clearinghouses without becoming full members of the associations. The Reserve banks may sort the checks in the form desired by the clearinghouse members (group or fine sort, for example); provide some monetary and nonmonetary support; and for the most part, follow the time schedule set for the clearinghouse exchange.

The support provided to clearinghouses is decided on an individual basis, with each Reserve bank determining (with the consent of the

Alternatives for Reducing Differences in Banks' Abilities to Collect on Checks

Numerous alternatives may be considered to reduce differences between Reserve and collecting banks' abilities to collect on checks. In general, these alternatives may be approached in two ways. Either the Federal Reserve's unique check presentment abilities can be reduced to resemble those of collecting banks or collecting banks could be provided additional powers so that their presentment abilities resemble those of Reserve banks.

Reserve Banks Could Pay Presentment Fees

One way to make the Reserve banks more comparable to collecting banks would be to require Reserve banks to pay presentment fees. Such a requirement would cause the competing parties to face similar types of costs. Also, it would give those banks that receive checks from Reserve banks a new source of revenue.

There are, however, associated drawbacks to consider. First, there is no assurance that the fees paid by Reserve banks would be comparable to those paid by collecting banks. Because private banks may act as either paying or collecting banks, they both charge and pay fees. For this reason, to the extent they are involved in reciprocal relationships, paying banks are constrained in the amounts they may charge because of the potential for retaliation the next time they act as a collector. The Federal Reserve, however, acts solely as a collecting bank. Therefore, it would never be in a position to charge as a paying bank. Hence, the constraint would not exist and Reserve banks may incur higher charges than those incurred by collecting banks. Accordingly, while requiring Reserve banks to pay presentment fees may seemingly reduce differences between competitors, the change would not, in our opinion, eliminate constraints on competition or promote competitive equality.

Second, if Reserve banks were required to pay fees imposed by paying banks, the change could foster increased check collection prices. Because the Reserve banks would be paying, but not charging presentment fees, their check collection costs would increase. Accordingly, Reserve banks may be forced to increase their collection prices to offset the additional expense of paying the fees. Since Reserve bank prices are considered an industry benchmark, it seems likely that an increase in Reserve bank prices would be followed by collecting bank price increases.

Third, requiring Reserve banks to pay presentment fees would remove a constraint on the amount of those fees charged by paying banks. Currently, paying banks may set their presentment fees to compete with

Associated drawbacks exist here as well. First, because of the range in presentment fees, determining an appropriate fee to impute would be difficult. Second, there would not necessarily be any relationship between services provided by paying banks and the costs imputed by Reserve banks. Third, the Reserve banks' prices would increase but paying banks would have no commensurate increase in revenues. Fourth, this alternative does not provide collecting banks with the right to present checks and obtain same-day payment. Accordingly, the alternative, in our opinion, neither removes constraints on competition nor promotes competitive equality.

Exempt Private Banks From Fees

The Federal Reserve's exemption from bank charges could be extended to private banks. Such an exemption could result in greater cost comparability between all parties. However, such an approach risks slowing the current speed of check collection at a time when expedited funds availability has been specifically mandated.

In the private sector, fees can further the collection on checks in two ways. First, they can provide paying banks the incentive to make funds available sooner than what is minimally required by law, potentially accelerating the collection process by 2 days. Second, they can provide collecting banks incentive to deposit checks early in the day to avoid higher presentment fees charged on deposits made later in the day. According to some bankers, early deposits allow for more efficient use of paying bank resources by distributing the work associated with incoming checks throughout the day rather than concentrating the work at a later time of day. Therefore, while exempting collecting banks from paying bank fees might contribute some additional measure of cost comparability into the payments system, the prohibition of such fees could disrupt the work flow and reduce incentives for expediting funds availability. Accordingly, banks could be further disadvantaged when competing on the basis of funds availability.

Restrict Reserve Banks' Abilities to Deviate From Standard Practices

Differences could also be reduced by requiring Reserve banks to follow local banking customs and not exercise its abilities to invoke collection terms that vary from those provided under the Uniform Commercial Code (U.C.C.). For example, if local clearinghouse presentments are made at 10:00 a.m., such as in New York City, the local Reserve bank would have to comply. In effect, the Reserve banks would be forced to operate under constraints similar to a collecting bank.

Opportunities for Competing Products

Extending Reserve bank presentment abilities to collecting banks through direct presentment would introduce some competition to Reserve banks' fine sort and high dollar group sort products and payor bank services but, as discussed in chapter 2, would not remove all barriers.

If adopted, the proposal could add some pricing pressure to the Federal Reserve's fine sort product. By authorizing collecting banks to present checks directly to other banks for same-day payment, there would be an economic choice of either presenting directly to the paying bank or using a Reserve bank's fine sort product. As a result, even though collecting banks might still be unable to sell competing products, by having an alternative to purchasing products, the Federal Reserve could not establish a fine sort price that exceeds the value of the products provided and still maintain a steady volume of business.

The introduction of pricing pressure could help alleviate concerns that the lack of competitive alternatives to the Reserve banks' fine sort product allows for higher markups in the fine sort price than are justified by the capital and other resources used to provide the product. In our opinion, by extending the right of presentment and same-day payment to collecting banks, the maximum price Reserve banks could charge could be influenced by the market; that is, by Reserve banks' competitors.

Drawbacks Appear to Be Surmountable

Although providing collecting banks the choice to present directly to paying banks has the potential to benefit the payments system, the proposal is not without drawbacks. However, in our opinion, these drawbacks appear to be surmountable.

Specifically, we are aware of six. They are the

- increased costs to the payments system owing, in part, to the expenditure of real resources to reduce check collection float;
- potential losses from bank insolvencies before checks can be paid;
- increase in paying banks' work load owing to an increase in the number of check packages requiring reconciliation;
- increase in paying banks' work load owing to an increase in the number of bank-to-bank relationships that would need to be developed and maintained;
- losses incurred because of erroneous funds transfers; and

Appendix IV
Alternatives for Reducing Differences in
Banks' Abilities to Collect on Checks

containing no fewer than 100 checks.³ Such a limit could be continued. Therefore, paying banks would probably not experience a big increase in the number of check packages they receive under this proposal. However, the check packages will probably arrive from more banks instead of being funneled through a Reserve bank.

Developing and maintaining relationships with more banks will probably increase the amount of work paying banks will have to undertake. (With the acceptance of check presentments from a bank, there are associated bookkeeping operations. These operations are duplicated for each new customer.) However, since banks may now return checks outside the normal forward collection network, as authorized under Regulation CC, more bank-to-bank relationships, including making provisions for same-day settlement, should develop. Therefore, we do not believe this proposal will add substantially to paying banks' burdens.

As to funds transfers, mistakes conceivably could result from erroneous billing of paying banks. However, funds transfers are currently made, seemingly without problem, according to information provided by the collecting banks under Federal Reserve consolidated shipment and fine sort services. As under these services, Reserve banks and paying banks would maintain the right to correct errors through offsetting transfers. Therefore, we believe any additional risk posed by the funds transfer would be minimal.

However, extending collecting bank privileges to 2:00 p.m.—the existing cut-off for Reserve bank presentments—risks overturning the existing balance among the disparate interests of paying banks, the Federal Reserve, and collecting banks. This is because paying banks are interested in obtaining checks as early in the day as possible to meet customer needs for account information and post the checks to customer accounts; Reserve banks are interested in preserving the efficiencies achieved from the change to a noon to 2:00 p.m. presentment time frame; and collecting banks are interested in obtaining quick funds availability at a low cost.

While Reserve banks present checks later than is customary or desired by some paying banks, they have accommodated the information needs of these banks through payor bank services. The Reserve banks provide

³Federal Reserve prices for the fine sort service generally make it uneconomical for banks to present fewer than 100 checks to another bank.

Comments From the Board of Governors of the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

January 27, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

The Board is pleased to have this opportunity to comment formally on the draft report of the General Accounting Office (GAO) entitled Check Collection: Competitive Fairness is an Elusive Goal, which was prepared by the GAO pursuant to the Competitive Equality Banking Act of 1987 (Section 1202 of P.L. 100-86). The Competitive Equality Banking Act directed the GAO to study: (1) the Federal Reserve System's exemption from the imposition of presentment fees; (2) the impact of the imposition of presentment fees on the efficiency of the check collection system; and (3) whether the Federal Reserve System requires check clearinghouses to provide services to Federal Reserve Banks, and whether Federal Reserve Banks should pay check clearinghouses for any such services. The draft report states that because each of these issues involves specific aspects of collecting banks' abilities to compete with Reserve Banks, the report addresses the overall issue of competitive fairness.

While the Board welcomes the broader scope of the GAO inquiry, we believe that the presentment fee and clearinghouse issues are important. In this regard, we note that in Appendix IV of the draft report the GAO concludes that requiring Reserve Banks to pay presentment fees would neither eliminate constraints on competition nor promote competitive equality. In its analysis, the GAO determines that requiring Reserve Banks to pay presentment fees would provide no assurance that the fees paid by Reserve Banks would be comparable to those paid by collecting banks, would likely foster increased check collection prices, and would remove a constraint on the amount of those fees charged by paying banks. For similar reasons, the analysis also determines that limiting the amount of presentment fees the Reserve Banks are authorized to pay or imputing the cost of presentment fees in Reserve Bank priced services would neither remove constraints on competition nor promote competitive equality. The Board strongly supports these conclusions.

See comment 1.

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Comments From the Board of Governors of
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See pp. 58 and 60.

appropriate. First, as demonstrated by the comments to the Board's same-day payment proposal, the interests of the providers and users of check collection services are often in conflict, and eliminating differences in the abilities of correspondent banks and Reserve Banks, without carefully balancing these interests, may result in undesirable consequences for the check collection system or the payments system generally. Second, encumbering the Federal Reserve with unnecessarily rigid procedures in offering payments services could reduce rather than enhance competition, and is likely to result in the less efficient provision of these services.

See pp. 65-66.

The Interests of Correspondent Banks Must be Balanced with the Interests of Other Payments System Participants

See comment 3.

As the draft report notes, it is difficult to weigh the advantages enjoyed by the different providers of check collection services, and to determine which competitor has a net advantage. The draft report recommends, however, that the Federal Reserve should, to the extent possible, ensure that correspondent banks have the same abilities as Reserve Banks. The draft concludes that this will enhance competition in the check collection service. It is unclear that changes made simply to provide correspondent banks with the same abilities as Reserve Banks will promote competition or payments system efficiency. Correspondent banks will continue to enjoy many advantages not shared by the Reserve Banks.

See comment 4.

Further, efforts to achieve competitive equity untempered by a prudential balancing of the interests of the affected parties is not in the public interest. It is often difficult to weigh the public benefits of removing particular differences between the abilities of Reserve Banks and correspondent banks. While the report acknowledges that differences between the abilities of the Reserve Banks and correspondent banks should not be eliminated if "the continuation of those differences are necessary to promote the safety, soundness, or efficiency of the payments system," it should be made clear that the concept of efficiency encompasses the interests of all users of and participants in the check collection system.

See comment 5.

The comments received on the Board's same-day payment proposal highlight the issue of whether the Board should adopt a rule that may benefit a small number of correspondent banks, while disadvantaging a large number of depository institutions and their customers. Although the commenters to the proposal have an interest in a competitive environment that allows users to choose a service provider so as to obtain the best service at the most advantageous price, an overwhelming proportion of

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that have no direct or material effect at all, and thus need not be subject to a competitive impact analysis. For example, the Federal Reserve Bank of New York moved its check operations out of the Head Office to the Jericho and Cranford offices as an interim step in its long-term plan to meet space needs. A number of the New York Clearing House member banks had previously taken similar steps to move their check operations out of Manhattan. Only about 3 percent of the volume deposited by the New York City collecting banks was affected, and the Federal Reserve and the collecting banks worked cooperatively to address the concerns raised with respect to these items. (A further discussion of the New York move is included in Appendix A.) The ability to take such actions is not a power unique to the Federal Reserve; correspondent banks routinely take similar actions designed to enhance the efficiency of their operations. The Federal Reserve should not be unduly constrained in making these business decisions.

See comment 7.

Similarly, while the Board agrees with the recommendation in the draft report that the pricing of services that do not enjoy active competition deserves particular attention, accounting procedures that conform to generally accepted accounting principles should not be an issue of public debate. For example, as is discussed in Appendix A, while the report questions the allocation of overhead costs in the Federal Reserve's fine sort prices, the allocation of overhead costs is not a precise science. The allocation methodology used by the Federal Reserve has been subject to prior review by the GAO and found to be acceptable. The GAO has acknowledged that "there is room for judgment" in cost allocation methodology. Federal Reserve costs, as reported in the System's Planning and Control System, are in the public domain. The Federal Reserve should have the discretion to set fees within its established pricing principles and guidelines. Requiring public disclosure of the overhead allocated to particular products within the check service would only invite unproductive debate over discretionary accounting issues.

See comment 8.

Finally, the CAO recommends that the Board develop a forum for hearing disagreements raised by private sector participants pertaining to Reserve Bank actions that are perceived to hinder competition that cannot be resolved locally. Although informal mechanisms already exist for resolving these problems, the Board agrees that it may be in the public interest to inform the industry further of the mechanism for hearing industry concerns regarding the competitive impact of Reserve Bank actions.

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Appendix A

**Further Information on the Response to the
Board's Same-Day Payment Proposal; Federal Reserve
Price and Service Policies; the Move of the Federal
Reserve Bank of New York's Check Operations; and
the Federal Reserve's Fine Sort Service**

The draft report raises a number of issues pertaining to Federal Reserve check collection services, procedures, and actions. We believe that the following information is necessary for a full evaluation of these issues. ^{1/}

Comments Received on the Board's Proposed Same-day Payment Concept

Now p. 59.

The GAO found (p.76) that the "most important competitive difference" between the Federal Reserve and private sector collecting banks involves the Federal Reserve's unique ability to obtain payment from any bank on the same day checks are presented and not pay presentment fees. The report concludes (p.80) that instituting changes to the payments system to promote competitive fairness poses a difficult challenge to the Federal Reserve. The report recommends (p.82) that the Board develop a revised, comprehensive same-day payment proposal that both balances the interests of paying and collecting banks and eliminates differences between Reserve Bank and collecting bank presentment abilities that are not necessary for the safety, soundness, or efficiency of the payments system.

Now p. 61.

Now p. 62.

In April 1988, the Board issued for public comment a same-day payment concept which encompasses the same characteristics as discussed in the draft report (FR Docket No. R-0631, 53 Fed. Reg. 11911). Under the Board's proposed concept, paying banks would be required to pay for checks presented by collecting banks prior to 2:00 p.m. in same-day funds, without the imposition of presentment fees. The Board proposed this concept to seek comment on improvements which could speed the forward check collection process, consistent with the purposes of the Expedited Funds Availability Act. The Board noted in its request for comment that "same-day payment has the potential to accelerate the collection of some checks by encouraging more direct presentments by private sector collecting banks." The Board also noted that "Nevertheless, same-day payment may impose unwelcome burdens and operational difficulties on paying banks."

^{1/} The information in this appendix is presented in the order in which it is discussed in the Board's comment letter on the draft report.

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function as correspondent banks. The U.S. League of Savings Institutions, a trade association representing over 3,000 savings and loan associations and savings banks, indicated that presentment fees are self-serving and impede the collection of checks, but that the Federal Reserve ought not promulgate regulations to abolish the private sector's right to assess presentment fees. The U.S. League stated that the "competitive nature of the check processing marketplace and the Federal Reserve's active role in the clearing system tempers the private sector's ability to impose unreasonable economic barriers." The U.S. League recommended that the same-day payment concept not be pursued because the sparse availability gains do not warrant the operations and settlement nightmares. The Credit Union National Association, a trade association representing over 15,000 credit unions, was concerned with the effect of the proposed concept on credit unions that issue share drafts, and concluded that the costs and risks to the paying bank far outweigh the benefits of the proposal.

Commercial banks, which might be expected to favor an enhanced ability to "compete," were divided in their opinion of the same-day payment proposal. The responses of commercial banks may best be illustrated by the response submitted by the American Bankers Association (ABA), a trade association representing banks comprising about 95 percent of the total industry assets. The ABA concluded that the "consequential disadvantages of the proposal outweigh . . . anticipated benefits." While the New York Clearing House, an association of 12 large New York City commercial banks, "strongly opposed" the same-day payment proposal, the California Bankers Clearing House Association, an association of large California commercial banks, favored the concept and offered suggestions to modify it. The Association of Reserve City Bankers (ARCB), an association of senior executives from the nation's major banking institutions, including a number of major correspondent banks, indicated that it is still reviewing the proposal. The ARCB does not support the proposal as drafted because "it is not clear that it would allow private correspondent banks to remain competitive in the nation's check collection system."

The comments highlight the fact that banks have different views of what constitutes "competitive fairness." Even the most adamant proponents of change to promote competitive fairness have suggested that modifications are necessary to the same-day payment proposal to make the concept workable. Although the users of the check collection system favor competition because a choice of service providers enables them to receive better service at lower cost, users do not see this particular proposal as furthering this objective.

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major enhancements to existing services, which include analyses of the public benefits and the potential for the private sector to provide the service. New services and major service enhancements are expected to yield clear public benefits, including, for example, promoting the integrity of the payments mechanism, improving the effectiveness of financial markets, reducing risks associated with payments and securities transfer services, improving the efficiency of the payments mechanism, or reducing the use of real resources such as through the introduction of new technology. Further, the service should be one that other service providers cannot be expected to provide with reasonable effectiveness, scope, and equity. (FRRS 7-145).

To ensure conformity with these policies, all price and service level changes are reviewed by Board staff. Non-routine changes, such as structural changes in prices or changes that raise significant policy issues, are reviewed by the Board. In addition to reviewing changes, all fees and service levels are reviewed annually, and priced services financial statements are published on a quarterly basis. Inherent in this review process is consideration of the effect that price and service changes have on private sector correspondent banks.

Under these procedures, private sector correspondent banks have an ability to participate in this process by commenting on price and service changes that will have a substantial longer-run effect on the payments system, as well as on all regulatory changes. In addition, Federal Reserve staff meets periodically with representatives of these institutions to discuss changes and the effect such changes have on the banking industry.

See comment 11.

Move of Federal Reserve Bank of New York's Check Operations

The draft report cites the relocation of certain check processing operations by the Federal Reserve Bank of New York from its New York City Head Office to its Cranford and Jericho offices as an example of the Federal Reserve's ability to make unilateral changes in Reserve Bank services that can affect competition in the check collection market. The ability to relocate operations facilities, however, is not unique to the Federal Reserve; in fact, many of the New York Reserve Bank's competitors also have moved check processing and other payments operations from New York City to outlying areas.^{2/}

See comment 12.

^{2/} The majority of the member banks of the New York Clearing House have established check processing and/or other payment operations outside of New York City, including Chase Manhattan Bank, Citibank, Chemical Bank, Morgan Guaranty Trust Company, National Westminster Bank, Irving Trust Company, and European American Bank. The Federal Home Loan Bank of New York also maintains check processing operations in New Jersey.

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of depository institutions that the relocation may cause a degradation in availability or quality of service.

Given the concerns raised by five New York City collecting banks, a number of discussions and meetings were held to resolve competitive issues. Based on those discussions, a cooperative and mutually agreeable solution was developed that retained the Head Office deadlines that had existed prior to the move. As indicated in the report, a helicopter service has been arranged to transport checks to Cranford without a change in the New York City deposit deadline.

Federal Reserve Fine Sort Service

The draft report questions the allocation of overhead costs to the Federal Reserve's fine sort service -- a product the report describes as having "a monopoly element." In addition, the report indicates that the Board should publish more detailed cost information about the pricing of such products. The Board agrees that particular attention should be paid to pricing of services that do not enjoy active competition; however, accounting procedures that conform to generally accepted accounting principles should not be an issue of public debate.

Allocation of overhead costs is not a precise science. There is no single "right" way to allocate such costs, as recognized in a 1985 GAO study (An Examination of Concerns Expressed About the Federal Reserve's Pricing of Check Clearing Activities, January 14, 1985) that stated that "there is room for judgment in defining costs, which could have an effect on prices." Further, this study indicated that the methodology used by Reserve Banks to allocate costs and to price for services is in accordance with generally accepted accounting principles. In reference to allocation of overhead costs within the Federal Reserve's cost accounting system (PACS), which is in the public domain, the GAO reported "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." The Federal Reserve should have the discretion to set fees within its established pricing principles and guidelines. Requiring public disclosure of the overhead allocated to particular products within the check service would only invite unproductive debate over discretionary accounting issues. Technical comments regarding the draft report's statements about cost allocation are contained in Appendix B.

The draft report's discussion of the Federal Reserve's fine sort service as a monopoly product relies heavily on volume

See comment 13.

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Appendix B

Detailed Staff Comments on the Draft Report

Page

Executive Summary

3 Last paragraph. The report states that the Federal Reserve "uses its authority to deviate" from state law. This is misleading. The Federal Reserve has varied, by agreement, certain state law provisions in accordance with section 4-103 of the Uniform Commercial Code.

4 Second paragraph. The report asserts that "collecting banks do not have the authority to unilaterally vary from state laws governing check collection." Section 4-103(2) of the Uniform Commercial Code provides that "Federal Reserve regulations and operating letters, clearing house rules, and the like, have the effect of agreements under subsection (1), whether or not specifically assented to by all parties interested in items handled."

Chapter 1

11 Footnote 2. The last sentence should read "Such a practice provided compensation to paying banks for expenses and risks associated with the payment of checks" rather than "check collection."

12 First paragraph. The report states that "In this manner, the Federal Reserve regulated the check collection system." This sentence is misleading and should be deleted. As the report recognizes, while the Federal Reserve's actions in the past have had a substantial impact on the check collection system, prior to the Expedited Funds Availability Act the Federal Reserve did not regulate check collection practices that did not involve Federal Reserve Banks.

13 Footnote 6. The report indicates that Federal Home Loan Banks must "make services equally available to all thrift institutions". This appears to be inconsistent with the statement on page 14 that the Federal Home Loan Banks "may only offer check collection services to their member thrift institutions."

14 Footnote 8. The report indicates that there are 145 clearinghouses in the U.S. While this may approximate the number of formal associations that have chosen to publicize their existence by establishing formal by-laws and procedures, it may understate the number of groups of banks

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decline, such that fees do not cover costs, the act requires the Federal Reserve to reduce Reserve Bank budgets."

Now p. 20.
See comment 29.

24 The first sentence of the last indented paragraph should read "The Federal Reserve encouraged the use of a standard machine readable code, called Magnetic Ink Character Recognition (MICR)."

Now p. 21.
See comment 30.

25 Next to last sentence of indented paragraph. "Presorted" commonly refers to check deposits of various types, one of which is "fine sorted". Use of the term "fine sorted" appears more appropriate in this context.

Now p. 21.
See comment 31.

Second paragraph. The reference to "minimum availability deadlines" is unclear. The Expedited Funds Availability Act established a maximum availability schedule but that reference appears to be irrelevant to the discussion.

Chapter 2

Now p. 26.
See comment 32.

31 First paragraph. The draft report states "To operate a check collection business a collector . . . must provide same day funds . . ." See comments to page 17, regarding the need for a collecting bank to provide "same-day" funds on most checks it collects.

Now p. 26.
See comment 32.

Last paragraph. The terms and conditions under which the Reserve Banks require payment are specified in Regulation J and the Reserve Bank operating circulars; Regulation CC applies to all banks.

Now p. 27.
See comment 33.

33 Second paragraph. The provision in the Federal Reserve Act restricting the payment of presentment fees by Reserve Banks was enacted as a 1917 amendment to the Act.

Now p. 30.
See comment 34.

37 First paragraph. The report provides ranges of fees imposed by collecting banks for account maintenance, balance reporting, and funds transfers, as indicated in banks' price lists. The report should note that these prices are typically negotiated, rather than assessed at the level stated in the price list.

Now p. 30.
See comment 35.

Second paragraph. In discussing the presentment fees paid by collecting banks, the report should note what percentage of checks collected by these banks are presented through a clearinghouse arrangement, and thus are not subject to presentment fees. The report cites examples of what portion of a collecting bank's collection costs are represented by presentment fees. It is not clear whether these percentages represent the cost to collect only those checks for which presentment fees are imposed, or the cost to collect all

Appendix V
Comments From the Board of Governors of
the Federal Reserve System

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Reserve Bank has dispatched the checks. In many cases, banks receiving payor bank services receive such services via magnetic tape that is transported to the institution via the same courier as the checks. In other cases, information may be transmitted and received by the institution before receipt of the physical checks but generally not before dispatch of the checks by the Reserve Banks.

Now p. 35.
See comment 40.

44 Second indented item. This item should be revised to state "warrant that they have good title to the checks or are authorized to obtain payment." (12 CFR 210.6(b))

45 The last two lines on the page repeat language on the top of page 46.

Now p. 37.
See comment 41.

46 Table 2.2 compares fine sort fees to processed fees at three Reserve Banks. This table is inaccurate in that: 1) It reflects obsolete fees and should be updated to reflect price changes implemented in September 1988. 2) Per item fees have been adjusted to prorate cash letter fees and fine sort package fees on a per item basis. Cash letter fees and fine sort package fees have varying effects on the cost of cash letters or packages containing different volumes of checks, and thus cannot be effectively demonstrated in tabular form. 3) The inclusion of the percent mark-up column implies that overhead costs should be allocated as a percentage of floor costs for each check product. As discussed in Appendix A, there is no single right way to allocate overhead costs. This column should be deleted from the table and related discussions rewritten to reflect actual increases above the floor costs on a per item rather than a percentage basis.

Now p. 37.
See comment 42.

Second paragraph. The example of the amount of overhead support required for fine sort is erroneous. The report cites the fact that fine sort will continue to be deposited in the New York Head Office, even after the bulk of that office's check operation is moved to Jericho or Cranford, and the Head Office no longer has "the equipment or personnel to operate" a full-scale check collection operation. The equipment and personnel referred to are considered direct costs, not overhead costs. We also note that personnel and equipment have been retained at the Head Office to handle fine sort arrangements.

Now p. 38.
See comment 43.

48 Second paragraph. The report cites the 1988 San Francisco city fine sort per item fee as \$0.05. The correct per item fee is 5 mills (\$0.005). The current fee is 4 mills.

Appendix V
Comments From the Board of Governors of
the Federal Reserve System

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Now p. 49.
See comment 49.

Now p. 50.
See comment 50.

See comment 51.

63 Third paragraph. San Francisco is not considered an ITS hub although it is connected to the ITS network.

65 First paragraph. Effective September 1, 1988, the city unsorted per item fee in New York was reduced from 3.5 cents to 2.7 cents, or 23 percent. The fine sort per item fee was reduced from 1.0 cents to 0.8 cents, or 20 percent.

67 First paragraph. The draft report includes an analysis of interbank balances, which the GAO states provides "another indication of the condition of collecting banks." The draft report concludes that banks are "now less willing to maintain balances," as demonstrated by the decline of average balances held by U.S. banks at other banks "from \$68.7 billion in 1983 to about \$31.5 billion in 1984." The average aggregate balances cited for these two years represent different deposit types, and therefore are not comparable. Prior to 1984, the Federal Reserve published, in Table 1.25 (Assets and Liabilities of Commercial Banking Institutions), the "balances with depository institutions" (line 10). Beginning in 1984, the Federal Reserve published this information as two separate data elements -- "demand balances at U.S. depository institutions" (line 46) and "other cash assets", i.e., savings and time balances at U.S. institutions (line 47). It appears that the GAO compared 1983 total deposits with 1984 demand deposits. In addition, there is a break in the time series for this data between 1983 and 1984. The 1984 revised series differs from the previous series because of a change in the universe of institutions covered and a change in estimation method. (See explanation of the revisions in the Federal Reserve Bulletin, vol. 71 (March 1985), pp. 160-162.)

On a more general note, we do not believe that an analysis of trends in the level of interbank balances, absent an analysis of trends in explicit fee income received by banks for correspondent services, would provide valid insights to the condition of collecting banks. Correspondent banks generally permit their respondents to pay for services received either through compensating balances or explicit fees. Respondent banks may shift between balances and fees based on the prevailing interest rate, which determines the level of balances that must be held. Therefore, the significance of a change in the level of interbank balances can only be determined by also analyzing the change in fee income from respondent institutions received by correspondents.

Further, a decline in interbank balances/fee income would not necessarily reflect a change in the competitive balance

Appendix V
Comments From the Board of Governors of
the Federal Reserve System

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Now p. 73.
See comment 56.

Appendix II

86 Last sentence. The report should clarify that the 1987 excess revenue of \$25 million represents only a 5 percent overrecovery.

Now p. 74.
See comment 57.

90 The discussion of the stability of Reserve Bank check prices should note the productivity gains made by the Reserve Banks during this period. An analysis of "Productivity at the Federal Reserve Banks" was published in the Annual Report: Budget Review 1986-87 of the Board.

Now p. 75.
See comment 58.

93 Last paragraph. The per item fees referenced in the report for the Chicago office have been reduced by \$0.001 effective September 1, 1988. The current fee for unsorted regional checks is 3.3 cents, and the premium fee for regional checks is 4.0 cents.

Now p. 78.
See comment 59.

94 Table II.3. The "premium group sort" product should include a footnote indicating that the HDGS program did not begin until April 1984.

Now p. 79.
See comment 60.

95 Table II.4. The total check volume statistics in the last two columns of Table II.4 are overstated because of the inclusion of "other Federal Reserve Bank" volumes.

Now p. 84.
See comment 61.

Appendix III

101 Second indented paragraph. The description of the operation of the Houston Clearing House is confusing. The report states that the clearinghouse's 2:00 p.m. exchange "is for full members only (they may not present associate members' checks.) At the exchange, the full members present commingled check packages to other full members (the bundles contain checks drawn on the full member and its associate members)." The report should clarify whether commingled checks are presented at this exchange.

Now p. 88.
See comment 62.

Appendix IV

107 Second paragraph. In describing how a paying bank may "set its presentment fees to compete with Reserve Bank prices," the report should state that the presentment fee may be set slightly below Reserve Bank fine sort prices, not check collection prices.

Now p. 92.
See comment 63.

113 Last paragraph. The report states that "In July 1986, Federal Reserve officials rejected a proposal substantially similar to the same-day payment concept now out for comment." Board staff offered to recommend that the Board issue a concept proposed by several banks -- a direct settlement service -- for public comment, if they wished to have this concept further pursued. The proponents of this

GAO Comments

1. The finding that Reserve banks should not pay presentment fees or impute such fees was reached in our analysis of ways in which to equalize competitive abilities between collecting banks and Reserve banks. In our opinion, the check collection system could benefit more from collecting banks achieving presentment abilities similar to those held by Reserve banks than it could from increasing the costs incurred by Reserve banks.
2. We agree that the Federal Reserve must provide services to all depository institutions and deliver to all end points. Such a responsibility does not mean, however, that the Federal Reserve alone should have the right to same-day payment.
3. Despite the difficulties in ascertaining which competitor has a net advantage, we were able to determine that collecting banks' inability to obtain same-day payment without charge constrains their abilities to operate a competitive check collection business. We found no similar constraints placed upon the Federal Reserve banks even though they do not share in all collecting banks' abilities. Furthermore, as pointed out in the report, when collecting banks cannot negotiate for direct presentment, no alternative to the Federal Reserve currently exists. If the right to presentment did not have to be negotiated, the speed of collection on checks could be quickened since the checks would not have to be routed through Reserve banks and users of collection services would be given additional choices.
4. In the report, we say that collecting banks should have the same abilities as Reserve banks "unless there are compelling safety, soundness, or efficiency reasons for Reserve banks to take on unique abilities." We recognize that balancing the costs and benefits of any change can be difficult; that is why we call for complete disclosure of the rationale for decisions reached on competitive fairness. We further recognize that the Federal Reserve, when deciding what actions to take, must consider what would most benefit the payments system as a whole. Such recognition resulted in our recommendation that the Federal Reserve adopt criteria and procedures for ensuring competitive fairness. By implementing the recommendation, the Federal Reserve would be in a better position to demonstrate that its decisions are in the best interest of the payments system, thus allaying fears by payments system participants that the Federal Reserve has blurred its dual role as regulator and competitor.

other banks. Because clearinghouse member banks often receive commingled checks from their customers, they would have to change business arrangements with their customers in order to respond to a Reserve bank's change affecting even a small percentage of checks.

7. Our prior report discussed the methodology used to allocate direct and indirect costs to priced services—not the allocation of costs within each service. Also, we do not suggest that the Federal Reserve should lose its discretion to set prices. Rather, we state that the establishment of the fine sort price resembles that of a monopoly product. At this time, competitors cannot offer a similar product, and they are the major users of the fine sort. Thus, costs should not be loaded onto a low-cost product. Public disclosure of the markup should help ensure that it remains reasonable.

8. In our opinion, informal mechanisms are not sufficient since they do not necessarily require problem resolution.

9. In our opinion, the report does not suggest that the Federal Reserve issued its same-day payment concept for comment in response to our study. The report only states the chronological sequence of events. We have, however, slightly modified the text to further clarify this point.

10. Footnote 5 of chapter 1 has been amended to clarify that banks often function as both paying and collecting banks though some perform more of one function than the other.

11. As noted in the report (see p. 56), public comment is not sought on all changes that can materially affect Reserve bank competitors. Also, without a competitive impact assessment, the effects of change on the payments system or its participants cannot, in our opinion, be fully assessed.

12. While some New York banks have moved their processing centers out of New York City, the banks are still receiving checks at the same place—the New York Clearing House. Therefore, their move does not affect their users. Also, unlike the Reserve banks, these New York banks are not the clearer of last resort. Thus, no bank is compelled to use them should they become too inconvenient—there is always another alternative.

13. This point is covered in comment 7 of our response.

23. In our opinion, clearinghouses constitute a collection intermediary since they serve as one vehicle through which depository banks can get checks to paying banks. Furthermore, they function like an intermediary by providing settlement services.

24. The statement is correct as written. For purposes of this report, the term bank, as defined in footnote 1 of chapter 1, includes any and all depository institutions. Therefore, the bank of first deposit might be a thrift. Also, even if the bank of first deposit is technically a bank, some or all the checks might be drawn on a thrift that has designated its local Federal Home Loan bank as the official point of presentment.

25. Text amended to clarify that the account number, check number, and dollar amount are not necessarily present in the Magnetic Ink Character Recognition line but are typically present.

26. The paragraph only discusses the prices and services sought by prospective customers as a means of discussing collecting banks' basis for competition. The result of this search (higher prices owing to higher interest rates, next day availability, and so on) is not relevant to this particular discussion.

27. We believe that the suggested revision could mislead the reader into thinking that banks must return checks directly to the depository bank. As demonstrated by the Federal Reserve's intermediary return service, we understand that the standard is to use the most expeditious means of return.

28. Text amended to more clearly restate the requirements of the act.

29. Text amended as suggested.

30. Text refers to more than fine-sorted checks, for example group-sorted checks. Therefore, no change has been made.

31. "Minimum" changed to "expedited."

32. Text amended to show that same-day availability of funds is necessary to offer a competitive check collection business. See also comment 26. The reference to regulation CC has been deleted.

33. Text does not specify that this was part of the original law. It simply attributes the provision to section 13 of the act.

42. Text revised to show that the fine sort product requires less support in general rather than specifically focusing on overhead. The paragraph has also been amended to clarify that the Manhattan office now operates without processing equipment and with a reduced level of personnel.

43. Text corrected to report \$0.005.

44. Text revised as suggested.

45. Text amended to include the Reserve bank's offer to present the Houston member banks with fine-sorted checks.

46. We agree that the Federal Reserve has a mandate to present to all end points. This point has been added to the chapter. (See p. 46.)

47. Regardless of what the Competitive Equality Banking Act will or will not allow, the statement is currently true because no bank has yet had an opportunity to develop a nationwide scale of operations.

48. Our prices reflect 1987-88 data.

49. Text corrected to report five hub cities.

50. This was resolved with Federal Reserve Bank of New York staff who now agree with our computations.

51. Paragraph has been deleted.

52. See comment 6.

53. See the definition of the services in footnote 3 on page 57.

54. In our opinion, the statement does not imply that competition is the most critical factor to be considered. On the contrary, concerns for payments system safety, soundness, and efficiency are discussed as factors that could override concerns for competitive fairness. Competition is but one critical factor among others that warrants appropriate consideration. Therefore, we believe it reasonable that "compelling" remain to ensure that competition is appropriately weighed against other factors.

55. Text corrected as suggested.

Comments From the Federal Home Loan Bank Board

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Federal Home Loan Bank Board



1700 G Street, N.W.
Washington, D.C. 20562
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

15 FEB 1989

Mr. Stephen C. Swaim
Group Director
United States General
Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Swaim:

The Federal Home Loan Bank Board appreciates the opportunity to comment on the General Accounting Office's (GAO) study of competitive equity issues, especially as it concerns the Federal Reserve's proposed regulation of direct presentment, and the study's description and analysis of the check collection industry. In preparing this response, representatives of the twelve district Federal Home Loan Banks, hereinafter referred to as "the FHLBanks", were interviewed and their combined commentary is summarized here.

Besides reiterating the FHLBanks' position on direct presentment, two basic issues are discussed here. They include the following:

- the need for further definition of the FHLBanks' role in the payments system, rather than including them in the broad category of "private collecting banks"; and
- the idea that the Federal Reserve add imputed costs for presentment fees to its Private Sector Adjustment Factor (PSAF) model

First, the FHLBanks wish to state that their position on the Federal Reserve's direct presentment proposal have remained unchanged, despite the competitive equity concern. If the Board of Governors elects to take GAO's advice and pursue a regulation, we hope that the FHLBanks' initial commentary letters will be reviewed.

Second, in dealing with the broad issue of competitive equity, the GAO draft attempts to compare the operational abilities and constraints of the Federal Reserve with those of all other collecting entities. In this comparison, the study includes a brief description of the FHLB System as neither entirely like the Federal Reserve nor entirely like the private sector (p.13). We would encourage the GAO to expand upon this description.

The FHLBanks feel strongly about this issue since the GAO study suggests that the Board of Governors sincerely seek to understand and address the needs of all affected groups when it proposes future regulations. To that end, the GAO study lists groups from the private sector that were interviewed concerning this issue (p.28). Conspicuous by

See p. 66.

Now pp. 12-13.

See comment 1.

Now p. 23.

Appendix VI
Comments From the Federal Home Loan
Bank Board

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Now p. 12.

B. The FHLBanks must, like the Federal Reserve, satisfy a PSAF requirement and all of their resources (capital, hardware, software, staff) must be recovered through fees for these services.

Now p. 46.

C. Private sector banks can operate a check collection business purely as an aid to paying for the resources it must already have to process its own checks (p.60).

Further, thrifts have historically made radically different decisions concerning the commitment of resources to internal check processing compared to commercial banks of similar size. The majority of thrifts, including many large thrifts, continue to clear payor bank items through an intercept bank and use a third party data servicer for individual account maintenance. The following restatement of the FHLBanks' original commentary on the Federal Reserve's direct presentment proposal will expand upon the concerns of thrifts given these relationships.

See pp. 87-88.

Finally, we would ask the GAO to reconsider its position on its recommendation that the Federal Reserve System adjust its PSAF model to include imputed presentment fees. Since the FHLBanks, like the Federal Reserve, justify the competitive equity of their pricing through the use of a PSAF, they are in a position to appreciate the drawbacks to this solution as the study enumerates in Appendix IV. But we do not necessarily agree that they are sufficient to dismiss the idea.

In addition to this intimate understanding of what the PSAF is designed to justify, check processing professionals in the FHLBank System are in a position to communicate routinely with the private sector peers within their check collecting communities. The FHLBanks feel that the industry's criticism of the Federal Reserve does indeed center around competitive pricing. The issue does not necessitate that the Federal Reserve actually pay presentment fees or that it bar presentment fees by regulatory mandate, but that it set its collection fees as if it pays them.

Because of the FHLBanks' simultaneous identification with the Federal Reserve and the private sector and their obvious differences from both groups, it sometimes places the FHLBanks in a somewhat ambiguous position. Regarding this issue, the FHLBanks identified with and shared the concerns of private collecting banks when the Federal Reserve announced under Regulation CC the unbundling of return items from its forward collection fees. This effectively forced Federal Reserve pricing, already at competitive challenge, lower still. Consequently, the FHLBanks feel strongly that adding imputed presentment fees to the Federal Reserve's PSAF would go a long way toward satisfying this concern.

GAO Comments

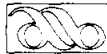
1. The objectives, scope, and methodology section should have included the Federal Home Loan Bank Board in the list of groups interviewed. This section has been amended.
2. In our opinion, the Federal Home Loan banks, acting as consolidated presentment points for a number of institutions, mirror other collecting banks, such as those in the Houston Clearinghouse discussed in chapter 2.
3. With the establishment of a same-day-payment requirement, the existing practice of maintaining accounts in other banks may no longer be needed and costs may be further reduced. See discussion on page 90.
4. The Home Loan banks' limited market appears on page 12. The point has also been added to page 46.

**Appendix VII
Comments From the American
Bankers Association**

**AMERICAN
BANKERS
ASSOCIATION**

CONTINUING OUR LETTER OF
January 27, 1989

SHEET NO. 2



Committee, Wholesale Operations Committee, Payment Systems Policy Board) to review the draft report and provide comments on the:

- o Accuracy and completeness of factual and interpretive material in Chapters 1-3 and the Appendices,
- o Conclusions and recommendations in Chapter 4.

This letter reports the results of this review.

* * *

The draft report describes fairly and accurately the current check collection environment. However, we feel that some clarifications are required in the discussion of competitive advantages held separately by the Federal Reserve System and by the private sector. The Association supports the recommendations to the Federal Reserve Board to achieve competitive fairness, but believes those recommendations should be defined more specifically. The Board should establish procedural controls to assure that future payments system changes promote competitive fairness and conform to Board policy.

The Federal Reserve possesses a special market power through its operation of a national transportation network for its check collection system. Private sector providers can afford transportation costs on a selective basis to only the largest end points. Member banks report that Reserve banks' carrier contracts bar these carriers from transporting private banks' work. This reported exclusion from sharing the Reserve banks' transportation system would be inconsistent with the goal of an efficient payment system, and would provide the Federal Reserve with an unfair leverage in transportation scheduling and costs because of its unique national distribution.

Chapter 3 identifies unique abilities of collecting banks to attract prospective customers to check collection services. These include the abilities to:

1. use cross product subsidies to attract check collection business through other services provided to banks;
2. tailor services and prices to meet individual bank needs;
3. limit business to lucrative customers, and
4. use existing bank resources to conduct the check collection business.

The competitive realities of the marketplace make cross product subsidies difficult to support. All main line correspondent products must be priced competitively, i.e., at or below Federal Reserve prices. As a

See comment 1.
Now p. 49.

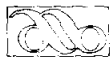
See comment 2.

Appendix VII
Comments From the American
Bankers Association

AMERICAN
BANKERS
ASSOCIATION

CONTINUING OUR LETTER OF
January 27, 1989

SHEET NO. 4



- o Monitor and provide public disclosure for price mark-ups on products which cannot be offered by collecting banks on an equal basis.
- o Develop a forum to hear disagreements by the private sector on any changes which effectively preclude the private sector from offering a competing service.

Although we agree with the overall recommendations to achieve competitive fairness stated on pp. 81-82 of the draft report, the complete text of these recommendations should be restated in the Executive Summary to reflect more accurately the intent of the draft report. Further, we believe that the Federal Reserve should define in specific terms its policy commitment to competitive fairness. The Board should establish procedural controls to assure that future payments system changes promote competitive fairness and conform to Board policy. Several of our members have suggested that an oversight group, which would include private sector representatives, be established to deal with issues of competitive equity between the Federal Reserve and those providing check clearing services.

Finally, the draft report recommends that the Board develop a revised, comprehensive same-day payment proposal that balances the interests of paying and collecting banks, and considers the differences in presentment abilities between Reserve and collecting banks. Although we agree that the Federal Reserve should incorporate these considerations in a revised private sector presentment proposal, the Association remains opposed to any proposal that signals aggressive movement by the Federal Reserve into private sector business relationships. The Association's position on this proposal is contained in a December 20, 1988 comment letter to the Board (attached). In summary, we expressed our concerns that the proposal as presented intrudes into private sector business judgments concerning customer relationships and pricing, poses additional risks to paying banks, disrupts cash management services, shifts processing schedules with attendant increases in personnel and equipment costs, increases the incidence of daylight overdrafts and pressures Fedwire capabilities. Our comment letter recommended specific modifications for a revised proposal impacting private sector presentment.

Thank you for the opportunity to comment on the draft report
Check Collection: Competitive Fairness is an Elusive Goal.

Very truly yours,

Frank P. Curran

Now p. 62.
See comment 4.

See comment 5.

Comments From the Association of Reserve City Bankers

1710 RHODE ISLAND AVENUE, N.W.
SUITE 500
WASHINGTON, D.C. 20036
202 296 5789
FAX 202 785 2605

ASSOCIATION OF RESERVE CITY BANKERS



January 31, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

The Association of Reserve City Bankers (ARCB) appreciates the opportunity to comment on the draft report entitled Check Collection: Competitive Fairness is an Elusive Goal. ARCB is an association of the highest-ranking executives of the nation's major banking organization.

The Association of Reserve City Bankers endorses the report of the General Accounting Office and the specific recommendations to the Board of Governors of the Federal Reserve System found on pages 81-82 of that report.

The issue of competitive fairness between private participants and the Federal Reserve in the nation's check collection system is an extremely important one. ARCB believes the General Accounting Office has done an outstanding job in addressing this issue in its report and it stands prepared to work with all parties in assuring that the action steps recommended in that report are achieved.

Sincerely,

Carl E. Reichardt

OFFICERS

PRESIDENT
CARL E. REICHARDT
CHAIRMAN AND
CHIEF EXECUTIVE OFFICER
WELLS FARGO BANK, N.A.
SAN FRANCISCO

VICE PRESIDENT
BENNETT A. BROWN
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CHIEF EXECUTIVE OFFICER
THE CITIZENS AND
SOUTHERN CORPORATION
ATLANTA

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CHIEF EXECUTIVE OFFICER
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DETROIT

ANTHONY T. CLUFF
EXECUTIVE DIRECTOR

MARGUERITE A. COX
ASSISTANT DIRECTOR

Now p. 63.

CALIFORNIA BANKERS CLEARING HOUSE

Mr. Richard L. Fogel
January 12, 1989
Page 2

See comment 2.
Now p. 38.

We would also like to take this opportunity to correct our misunderstanding regarding your inquiries on the specifics of our own operations (page 48). Your field personnel asked us to estimate our members' cost to clear items using the clearing house. We estimated a penny per check. As your report makes clear, our service is comparable to the San Francisco Fed's city fine sort product. In reading the draft report, it is clear what you wanted was an estimate of the clearing house cost to compare to the Fed cost. We apologize for misunderstanding the question. We thought you wanted an estimate of total cost to members, not marginal cost of clearing house services.

Here are the correct figures. In 1987, our association cleared 1,060,000,000 checks statewide; 400,000,000 in San Francisco and 660,000,000 in Los Angeles. Statewide check clearing costs (including overhead, salaries and all direct costs to the association) were \$337,500. Our average cost per check was \$0.00032 statewide, and \$0.00038 in the San Francisco office.

See comment 3.

The subject matter is extremely complex and in our view, a number of minor flaws have crept into the final report. We have detailed a few of them here. While we concur with the general conclusions of the report, we disagree with the way in which some of the details are presented. For example, there is no doubt that the Congress created some payments and collection functions for Reserve Banks in 1913 and enhanced them over time. However, the clear Congressional intent in 1913 was to create a source of bank liquidity through discount window operations, not a nationwide payments processor. The remaining Fed powers, including payments collection, were in our view, incidental. The casual reader of your report might get the mistaken notion that the Fed's prime purpose was to collect checks and provide payments services to banks.

See comment 4.

The notion of eliminating non-par collection as a payments policy goal is a traditional Federal Reserve reinterpretation of Congressional action. Another interpretation would appear to strike closer to the facts, e.g. if Congress intended eliminating non-par, why did it specifically authorize banks to charge discounts and merely exempt reserve banks from paying them? Federal Reserve reinterpretations notwithstanding, Congress specifically granted authority to paying banks to charge fees, a fairly clear indicator that Congress intended continued market negotiation of fees between competitors.

GAO Comments

1. Although we agree that measurable goals for evaluating the Federal Reserve's progress in promoting efficiency and competition in the payments system are desirable, the lack of consolidated and comprehensive market data on private check collection activities limited our ability to develop such measurements. To date, the Federal Reserve neither has access to, nor is voluntarily provided with, private banks' proprietary market information. Appendix II of our report, however, summarizes the data that was available on the competitive positions of Reserve and collecting banks.
2. Text amended as suggested.
3. The paragraph referred to has been revised slightly to clarify that payment and collection functions of the Federal Reserve are not the sole responsibility of the Reserve banks.
4. In our opinion, the report does not suggest that the elimination of non-par banking was a specific goal of Congress, rather that it existed in the earlier part of the century. However, the text has been revised to clarify that the belief that non-par check collection resulted in circuitous routing was held by some individuals.
5. According to our research of the Monetary Control Act's legislative history, the act was not intended by Congress to be revenue-neutral with respect to reserves. During the January 18, 1979, Senate floor debate, Senator Proxmire indicated that the revised revenue requirements of the Monetary Control Act would cost the Treasury \$60 million in after-tax revenue losses. Accordingly, despite the actual effect of the law, in our opinion we have accurately characterized the historical concerns of a revenue shortfall resulting from a reduced reserve requirement.

Appendix X
Comments From the Houston Clearing
House Association

Mr. Richard L. Fogel
January 25, 1989
Page 2

We also strongly support the GAO's recommendations for action by the Federal Reserve and offer the following thoughts as to how the goal of competitive equity can be more readily achieved.

See comment 1.

We believe that a standing group should be established to deal with issues of competitive equity between the Federal Reserve and major private sector financial institutions providing check clearing services. This Competitive Equity Issues Committee should be comprised of the Federal Reserve, major city clearing house associations and representatives of other major city banking communities where clearing house association representation is not available. The Committee should be limited to 10 participants. It should be supported administratively by the Federal Reserve. This Committee should report on an annual or biennial basis to the Banking Committees of the Senate and the House of Representatives, the GAO, and the Board of Governors of the Federal Reserve.


See comment 2.

We believe that a time table should be set for the completion of the implementation of the recommendations included in this report and our response. Such a time table will allow the GAO, the Federal Reserve and the private sector to work together in a productive and timely fashion to implement the recommendations.

With the cooperative efforts of GAO, the Federal Reserve and of private sector organizations, we are confident a more equitable competitive environment can be established, one that will better serve the needs of the American public.

Sincerely,

HOUSTON CLEARING HOUSE ASSOCIATION


Fred J. Redeker
President

FJR/lac

Comments From the New York Clearing House

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

NEW YORK CLEARING HOUSE

100 BROAD STREET, NEW YORK, N. Y. 10004

JOHN F. LEE
EXECUTIVE VICE PRESIDENT

January 26, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States
General Accounting Office
Washington, D.C. 20548

Re: General Accounting Office Draft Report Entitled
"Check Collection: Competitive Fairness is an
Elusive Goal"

Dear Mr. Fogel:

The New York Clearing House Association* appreciates this opportunity to comment on the above-referenced draft report prepared by the General Accounting Office.

We have long sought to remind the Federal Reserve that it should not use its regulatory authority to enhance its competitive position. Therefore, we agree with the GAO's recommendation that the Federal Reserve Board clarify existing policies and procedures covering its commitment to competitive fairness in the check collection system. However, we believe that the GAO's recommendation should be broader. The GAO should recommend that the Federal Reserve Board commit to competitive fairness in all the payments systems, not just the check collection system. The GAO should also recommend that the Board consult the private sector participants in the payments systems in developing its policies and procedures on competitive fairness.

We also believe that the GAO should not recommend that the Board make any changes to the payments systems to promote competitive fairness until (i) the Board's commitment to competitive fairness is fully developed and (ii) procedural controls and adequate safeguards are created

* The members of the New York Clearing House Association are The Bank of New York, The Chase Manhattan Bank, N.A., Citibank, N.A., Chemical Bank, Morgan Guaranty Trust Company of New York, Manufacturers Hanover Trust Company, Irving Trust Company, Bankers Trust Company, Marine Midland Bank, N.A., United States Trust Company of New York, National Westminster Bank USA and European American Bank.

See comment 1.

See comment 2.

See comment 3.

See comment 4.

GAO Comments

1. While we agree that the principles of competitive fairness could apply to other payments system issues, we did not include this as part of our recommendations because these other issues were outside the scope of our work.
2. Similar comments were also raised by other associations. However, we believe that the Board of Governors should be given the opportunity to implement our recommendations before an outside party is called in to participate in check collection deliberations.
3. We believe that one way the Federal Reserve can demonstrate its commitment to competitive fairness is to further revise and develop a same-day-payment proposal that both equalizes competitive abilities and balances the interests of Federal Reserve, net paying, and collecting banks.
4. In our opinion, our recommendation that Board staff be required to either (1) provide the Board of Governors with proposals to eliminate practical and legal differences between Reserve and collecting bank abilities to compete or (2) publicly explain why continuation of such differences is necessary to the safety, soundness, or efficiency of the payments system in essence establishes procedural controls and safeguards against conflicts of interest.
5. The revised and comprehensive same-day-payment proposal that we have recommended the Board of Governors develop would not necessarily resemble the same-day-payment concept paper the Federal Reserve issued for public comment. Consistent with the policy and procedural changes we have recommended, the revised proposal would consider the concerns raised by those who have commented on the concept and balance the interests of all affected parties. Appendix IV provides our analysis of potential drawbacks identified during the review.

Related GAO Products

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

An Examination of Concerns Expressed About the Federal Reserve's Pricing of Check Clearing Activities (GAO/GGD-85-9, Jan. 14, 1985).

A Supplement to An Examination of Concerns Expressed About the Federal Reserve's Pricing of Check Clearing Activities (GAO/GGD-85-9A, Jan. 14, 1985).

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Appendix XI
Comments From the New York
Clearing House

Richard L. Fogel

-2-

January 26, 1989

to insure that competitive fairness would result from the change. Any changes made before these two steps are accomplished would be premature and could create or exacerbate competitive imbalances.

In particular, we believe that the GAO should not recommend that the Board develop a same-day payment proposal, especially one that resembles the private sector presentment concept that it recently published for comment (Docket No. R-0631). We object to any such proposal because of the detrimental effects it would have on "net paying banks" (*i.e.*, banks that pay more checks than they collect) and their customers. The major detrimental effects of such a proposal on paying banks and their customers are:

(i) it would significantly reduce the ability of corporations, the federal government, and state and local governments to obtain the maximum returns on investments of funds made possible through cash management and other services provided by paying banks;

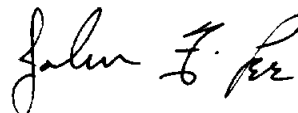
(ii) it would disrupt the flow of work to paying banks and increase their check processing costs;

(iii) it would delay the presentment of many checks; and,

(iv) it would increase the risk of loss to paying banks.

The detrimental effects of such a proposal are discussed in detail in our comment letter dated December 1, 1988 on the Board's private sector presentment concept. A copy of our letter is attached.

Very truly yours,



Attachment

(0680V)

See comment 5.

GAO Comments

1. A similar suggestion for a joint private sector-Federal Reserve oversight group was raised by the American Bankers Association. However, in light of the number of relatively newly appointed Governors of the Federal Reserve Board, we believe it reasonable to first give the Board of Governors the opportunity to implement our recommendations. In our opinion, the number of relatively newly appointed Governors makes this an ideal time for the Board to obtain a fresh insight into the concerns of both providers and users of check collection services.

2. In our opinion, it is more important that the Federal Reserve carefully consider and work toward the recommendations suggested in our report than to implement the recommendations without fully balancing the interests of all payments system participants. However, we agree that swift action could help demonstrate the Federal Reserve's commitment to the goal of competitive fairness.

Another reason we did not include a specific date by which recommendations should be implemented is because the Legislative Reform Act of 1970 (31 U.S.C. 720) requires the Board of Governors to submit to Congress a written statement of the actions taken on our recommendations before the 61st day after the date of the report. OMB Circular A-50 further requires the Board of Governors to report to the Office of Management and Budget the date corrective actions are planned to be completed and again after corrective actions are completed.

Comments From the Houston Clearing House Association

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

HOUSTON CLEARING HOUSE ASSOCIATION

ORGANIZED OCT. 1891

511 RUSK, SUITE 200

HOUSTON, TEXAS

77002

(713) 223-3836

January 25, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Programs
General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

We would like to commend the GAO for their diligent efforts in conducting their study dealing with competitive equity in the payments system and for their analysis of the complex issues involved. We believe the GAO did an excellent job of identifying the major issues and of examining both sides of each issue. Our role in the shaping of the Competitive Equality Banking Act of 1987 clearly demonstrated our intense interest in the topic and the GAO report.

The GAO report includes the following findings:

1. "Collecting bank inability to match Reserve bank collection terms, especially obtaining same-day payment without incurring bank fees, has constrained the collection options open to collecting banks; the collection services they may sell; and, in turn, the potential efficiencies they may bring to the market."
2. "GAO found no evidence that the check collection system would be damaged if the differences in basic presentment abilities of collecting and Reserve banks were narrowed or eliminated."

We fully agree with these findings.

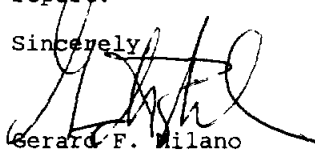
CALIFORNIA BANKERS CLEARING HOUSE

Mr. Richard L. Fogel
January 12, 1989
Page 3

In that same vein, your report references pricing of reserve bank services as a method of making up a revenue shortfall from reduced bank reserves under the Monetary Control Act. Temporary reserve conditions during the phase-in period notwithstanding, the Monetary Control Act was intended by Congress to be revenue neutral with respect to reserves. A simple average of reserve balances in the seven years since the MCA and for the seven prior years would make that point clear to the most casual observer. In fact, looking at recent levels of reserves, the Monetary Control Act was slightly positive with respect to total reserve balances on which the Fed earns a return. Clearly, the intent of Congress in explicitly pricing Fed services was to permit an orderly market determination of the usefulness of Fed services, not to create some gimmick to make up a temporary revenue shortfall to Treasury. Congress envisioned reduced Fed participation in a vigorous competitive payments market. Since the Federal Reserve has not yet (through 1987) recovered the cost of its services through explicit fees, relying on "earnings credits" to produce the "profits" it reports to Congress each year, it is clear that the Fed does not wish the market to decide to change suppliers too quickly.

In conclusion, despite some minor flaws, we believe your report accurately documents the Federal Reserve's failure to define achievable goals for competitive fairness in payments. We concur with your conclusion that presentment parity is necessary to achieve competitive fairness. We appreciate the opportunity to work with your fine professional staff and to review the draft report prior to publication. We look forward to seeing the final report.

Sincerely,



Gerard F. Milano
Executive Director

GFM:ls
Enclosure

See comment 5.

Comments From the California Bankers Clearing House

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

**CALIFORNIA
BANKERS
CLEARING
HOUSE**
established 1876

January 12, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
UNITED STATES GENERAL ACCOUNTING OFFICE
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to review the draft of "Check Collection: Competitive Fairness is an Elusive Goal".

We believe it is important for the Congress to understand the nature of competition in the check collection business. We were pleased to cooperate with your investigation during the field research stage, and are pleased to be able to review and comment on the report in draft form prior to its publication.

In general, we share the view set forth by GAO in this report that the Federal Reserve Board has failed to develop measurable goals for the U.S. payments system in terms of efficiency and competitive fairness. Absent such goals (for the payments system in general or check collection in particular) it is difficult to know whether any progress has been made as a result of Federal Reserve policies and practices since the 1980 Monetary Control Act. Frankly, we had hoped GAO would use its resources to supply some measurable goals which the Congress could use to evaluate the Federal Reserve's performance. We are disappointed that GAO did not choose to define some measurements of efficiency and competitiveness on its own initiative.

As is apparent from our comment letter to the Federal Reserve on Private Sector Presentment (Docket No. R-0631), we also concur with GAO's specific recommendation that presentment parity between collecting banks and the Federal Reserve is the most direct way to ensure competitive fairness. A copy of our November 22, 1988 comment letter is enclosed for your reference. We would be happy to supply additional information regarding our association's views on presentment should you or your associates be interested in studying the subject further.

388 Market Street • Suite 1200 • San Francisco, California 94111 • (415) 392-2570 • FAX (415) 392-0106

See comment 1.

GAO Comments

1. In chapter 3 we discuss how the Federal Reserve's nationwide transportation network provides it with unique opportunities to advance its check collection business.
2. We acknowledge that the ability to use cross-product subsidies may not be great; however, the ability is unique to private banks since they do not have legal constraints. Also, some products offered by collecting banks, such as loan participation, are not subject to competitive pressure from Reserve banks. Thus, at least for those products, the ability to attract prospective customers is not, in our opinion, limited by the market presence of the Federal Reserve.
3. Although our work with specific district banks was necessarily limited, our work with representatives from clearinghouses and trade association spokespersons, such as those from the ABA, enabled us to consider the interests of a much larger number of banks than we were able to deal with individually.
4. For brevity, the Executive Summary only highlights the major points discussed in the report. In our opinion, the reader can attain an accurate understanding of the recommendations from the summary.
5. We have not eliminated the idea of a private sector-Federal Reserve oversight group to deal with issues of competitive fairness. However, in light of the number of relatively newly appointed Governors to the Federal Reserve Board, we believe it reasonable to give this group an opportunity to implement our recommendations before asking that they form an oversight group to look at the fairness of actions taken by Reserve banks in competing for business.

**Appendix VII
Comments From the American
Bankers Association**

**AMERICAN
BANKERS
ASSOCIATION**

CONTINUING OUR LETTER OF
January 27, 1989

SHEET NO. 3



result, product lines whose profit margins can support subsidies to other products do not exist.

Collecting banks do gain some marketing flexibility in price negotiation to meet a customer's specific situation. This advantage is tempered however, by the market presence of the Federal Reserve. The draft study acknowledges that Federal Reserve prices define the market standard against which private sector prices are measured. In effect, the Federal Reserve sets the price levels in the market. The negotiating abilities of private sector collecting banks are generally limited to bidding prices at or below the level of competing Federal Reserve prices.

Private sector banks do gain some advantage from the allocation of already available resources to the check collection business. This advantage is generally limited to equipment sharing, while personnel, software, transportation, and supply costs cannot necessarily be shared.

In considering the climate of competitive fairness throughout the system, the GAO should have analyzed activities in each Reserve territory. Reserve check collection services and prices, as well as sales and marketing policies and techniques, differ from district to district. The competitive environment between Reserve banks and private sector banks fluctuates according to the policies of the district.

A key factor in the draft report is the specific emphasis that any Federal Reserve action to improve the payment system must be based on the principle of providing the same ability to collecting banks as those enjoyed by the Federal Reserve. As stated, the only exceptions to this principle should be those changes which involve the safety, soundness, and in certain cases dictated by Congress, the efficiency of the payment system.

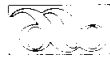
The report appropriately provides guidelines on how the Federal Reserve should deal with future payment systems changes including the pressing issue of same day presentment. These guidelines include requirements that the Federal Reserve:

- o Identify practical and legal differences which limit collecting bank capabilities versus those of the Federal Reserve when considering regulatory, pricing and service changes.
- o Eliminate or justify differences to the Board on those changes which are not necessary to promote safety, soundness or efficiency of the payment system.
- o Publicly disclose the rationale for decisions not related to safety, soundness, and operating efficiency.

See comment 3.

Comments From the American Bankers Association

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

GOVERNMENT
RELATIONS/
RETAIL BANKING

DIRECTOR
Frank P. Curran
202/663-5436

January 27, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

The American Bankers Association appreciates the opportunity for advance review and comment on the General Accounting Office draft report entitled Check Collection: Competitive Fairness is an Elusive Goal.

The Competitive Equality Banking Act of 1987 directed the General Accounting Office (GAO) in coordination and consultation with the Board of Governors of the Federal Reserve System, to study competitive issues in the payments mechanism relating to the ability of collecting banks to compete with Reserve banks for the check collection business of other banks. Specifically, the Act required the GAO to conduct a study on:

- o the Federal Reserve System's exemption from the imposition of presentment fees;
- o the impact of the imposition of presentment fees on the efficacy of the check collection system, and
- o whether the Federal Reserve System requires check clearing houses to provide services to the Federal Reserve banks and whether Federal Reserve banks should pay check clearinghouses for any such services.

Since each of the issues raised involves specific aspects of collecting banks' abilities to compete with Reserve banks, the report addresses the overall issue of competitive fairness.

The draft report is organized into an Executive Summary, four chapters and four appendices. Chapters 1-3 (pp. 10-70) contain historical background, narrative description of the check collection system and assessments of banks and Federal Reserve competitive capabilities. Chapter 4 (pp. 71-82) contains conclusions and recommendations, and the Appendices contain supporting data and analysis. We invited four groups of bankers (Operations and Automation Executive Committee, Transaction Processing

Now pp. 11-54.


Now pp. 55-62.

Appendix VI
Comments From the Federal Home Loan
Bank Board

-4-

The Bank Board sincerely hopes that the GAO accepts these comments as the FHLBanks intend them: given in a spirit of helpfulness and a desire to promote understanding of themselves and the thrift industry they serve. Further, the FHLBanks stand ready to assist or provide information to both the GAO and the Federal Reserve Board of Governors at any time.

Sincerely,



Gregory D. Rothwell
Executive Director
Administration and
Human Resources

cc: M. Danny Wall
James E. Boland, Jr.
S. G. Frank Haas, III

Appendix VI
Comments From the Federal Home Loan
Bank Board

-2-

their absence from the list were thrift industry representatives, the U.S. League of Savings Institutions, and the Federal Home Loan Bank System. Since the thrift industry is a major provider of retail accounts, the FHLBanks play a major role in the check collection process on behalf of savings institutions. Both groups are unique within and/or from the private sector, and we think the study should explore that distinction more fully.

Specifically, we believe the GAO should consider amplifying its Chapters Two and Three "differences" sections to more fully differentiate the FHLBanks and thrift industry's uniqueness from the Federal Reserve and the generic "Private Collecting Banks". Specific examples that illustrate these differences might be helpful.

1. SAME DAY SETTLEMENT ISSUES

Beginning on page 34, the study describes settlement procedures between paying banks and collecting banks. We feel that the following facts about the FHLBanks are relevant to this issue:

- A. The FHLBanks, being the check processor for most of their member institutions, are very attractive presentment points for collecting banks. It is far more efficient to present commingled cash letters (multiple endpoints) to the FHLBanks than to present individual cash letters to each FHLBank member.
- B. The FHLBanks cannot use the most expeditious and least costly settlement arrangement for direct presentment, as described by the study, since legally only thrifts and other FHLBanks are permitted clearing accounts.
- C. Presentment fees seem appropriate given the added cost inherent with additional direct presentments and the more time-consuming and costly manual settlement arrangements that must be used by the FHLBanks.

2. ANCILLARY ABILITIES OF COLLECTING BANKS

Beginning on page 56, the study describes the advantages collecting banks have in advancing their check collection business. We believe that the following facts are relevant to this issue:

- A. Generally, both the Federal Reserve and private sector banks have an unlimited market, while the FHLBanks may only market their services to thrift institutions. Specifically, this study reports that the private sector can limit its customers to only those financial institutions that are lucrative within its market while the Federal Reserve may not. Neither may a FHLBank.

Now p. 28.

See comment 2.

See comment 3.

See p. 66.

Now p. 46.

See comment 4.

56. Text revised to reflect the percent of total costs plus the return on equity.
57. In our opinion, the discussion on page 76 of reduced average real collection costs and reduced Reserve bank float adequately addresses the issue of increased productivity.
58. Since all numbers are 1987 and information is purely for illustrative purposes, a change seems unnecessary.
59. Note added to acknowledge that some of the increase can be attributed to the product's initial start-up period and to the partial-year data included in the 1984 volume.
60. Note added to show that checks handled by two Federal Reserve banks are double-counted in the totals column and that the totals can be adjusted by subtracting checks deposited by other Federal Reserve banks.
61. Paragraph clarified to show the amount of sorting conducted for each exchange.
62. Text revised as suggested.
63. Text revised so as not to suggest the proposal was flatly rejected by Board staff.
64. This drawback is not listed because it is not, in our opinion, a drawback to same-day payment but a drawback to the Federal Reserve's proposed 2:00 p.m. presentment time. In fact, the effect of an afternoon presentment time was acknowledged earlier by the Federal Reserve when it moved to noon presentment and then provided payor bank services. In our opinion, 2:00 p.m. presentment is not an essential part of the same-day-payment proposal.
65. The text does not state that private presentments should occur simultaneously with those of Reserve banks but rather that they occur by the time period in which the Reserve banks generally make their presentments or provide automated account information.

34. As noted in the text, the amounts are ranges that can be charged, depending on the relationship that exists between the two banks.

35. The statistics cited refer to fees paid by collecting banks to paying banks, and therefore, a discussion of checks collected through a clearinghouse does not enhance this discussion. Collecting bank use of a clearinghouse is discussed on pages 37-39. Therefore, no changes to the text have been made.

36. The report does not state that presentment fees provide a “significant source of income” because no data are available to support such a statement. Also, while we agree that banks can earn money from charging presentment fees, these earnings are from acting as a payor bank, not as a collecting bank. Therefore, we see presentment fees as a disincentive or impediment and not as a benefit to banks that are seeking to operate a check collection business in active competition with Reserve banks.

37. In our opinion, the suggested change would not enhance the clarity or accuracy of the statement. The result is the same, the Federal Reserve quickened the collection of some checks by adopting noon presentment.

38. The paragraph does not seek to show motivation in offering or purchasing this service. It merely defines the product and discusses the effect on Reserve banks and their customers. Therefore, no change has been made to the text.

39. Text changed to show that information is usually received before the physical check is received rather than before the checks are dispatched.

40. Text revised as suggested.

41. At the time our calculations were made, the 1989 fees were not published. We have since rerun the calculations, and even with the 1989 fees, our observation has not changed. In our opinion, the cost of the cash letter is appropriately factored into the price since customers must pay cash letter fees in addition to per-item fees in purchasing the service. We disagree that reporting the difference between the fine sort price and floor costs implies anything about how overhead costs should be allocated for all check products.

14. The fact that the fine sort product is primarily used by large banks, including collecting banks—and thus Reserve banks' competitors—is why we recommend disclosure of the product's markup. While the fine sort may help collecting banks provide services to their customers, paying unnecessarily more for the product because no competing product is available does not appear beneficial.

15. In our discussions with banks and their trade associations, we were told that no bank offers a fine sort product similar to the Federal Reserve because checks must be endorsed and presented for payment. If a bank has no negotiated arrangement with the paying bank, then basically the checks are undeliverable through direct presentment. We would also suggest that the statement forwarded to the Federal Reserve by the Colorado bank and used as an example is inaccurate since, according to the Federal Reserve's operating circulars, checks packaged under the fine sort program must be endorsed by the bank.

16. We agree that fine sort prices were reduced with the removal of return costs and implementation of a separately priced return item product. However, the disparity in markups still exists. Therefore, no change has been made.

17. Because the U.C.C. (sec. 4-103) authorizes the Federal Reserve to vary from state law whether or not assented to by all parties, in our opinion the statement is not misleading.

18. Because collecting banks can vary the terms of the U.C.C. only through clearinghouse or individual arrangements and all parties must agree, we do not believe that this constitutes unilateral variation.

19. Text amended as suggested.

20. The text has been slightly modified to better indicate that the Federal Reserve's strong market presence had the effect of regulation.

21. The Federal Home Loan banks must make collection services equally available to all thrifts. Subsequent mention has been corrected accordingly.

22. Text amended to clarify that the 145 include only those clearinghouses that have been formally established.

5. While many respondents did indeed oppose the same-day payment concept, we believe the opposition stemmed from the 2:00 p.m. presentment and the banning of presentment fees. As many respondents noted, by implementing the Federal Reserve's suggested 2:00 p.m. presentment time, cash management services would be severely disrupted. Many respondents also believed that presentment fees did not have to be banned completely. Furthermore, they provided suggestions for changing parts of the same-day proposal, such as requiring an earlier presentment time or establishing two presentment times, while retaining the basic concept of same-day payment. Because of these comments, we have recommended that the same-day payment concept be reintroduced once all interests have been considered and balanced.

6. In our opinion, disclosing the rationale for decisions reached is not an unnecessary encumbrance for a public entity. Since the competitive impact of any major changes made is already considered by the Federal Reserve, disclosing this information should not require considerable effort or impede the Federal Reserve from reacting to a changing environment. Furthermore, while we do recognize the review procedures currently in place at the Board, we also believe that the procedures do not go far enough to alleviate concerns that changes are made to enhance the Reserve banks' competitive position. In our opinion, the review procedures should also incorporate a requirement that all changes be analyzed for the potential competitive impact. Without such a requirement, the Board cannot ensure that public comment is being sought "on all regulatory proposals affecting priced services, as well as significant price and service proposals."

We do not recommend that all changes be submitted for public comment—only those that can materially affect collecting banks' ability to compete. In our opinion, the New York move is one such example. As first proposed to the New York clearinghouse banks, the move would have caused these banks to back up their customers' deadlines in order to meet the Reserve banks new deadlines. Such a move could have affected their ability to compete. As noted earlier in the report, customers look for attractive deadlines when searching for a check collector.

The move out of Manhattan by individual banks differs from that of the Reserve bank primarily because individual banks do not require other clearinghouse members to change when, where, or how they present checks. Therefore, their move does not affect the check operations of

**Appendix V
Comments From the Board of Governors of
the Federal Reserve System**

- 24 -

proposal did not ask that it be subject to the public comment process. Under Federal Reserve policies, the Board would not have approved this proposal without public comment, because it would have significant longer-run effects on the nation's payments system.

The list of drawbacks to the same-day payment concept should include that it impedes the ability of corporate customers to obtain early in the day account balance information for investment purposes.

- 116 Fourth paragraph. The draft report states that "check presentment cutoff times could be set to coincide with existing Federal Reserve practices." This would be impractical because Federal Reserve presentment times vary widely from institution to institution based on courier arrangements.

Now p. 91.
See comment 64.

Now p. 94.
See comment 65.

Appendix V
Comments From the Board of Governors of
the Federal Reserve System

- 22 -

between correspondent banks and Reserve Banks. For example, due to the decline in the cost of check processing equipment in the 1980s, a number of depository institutions that previously relied on correspondent banks for check processing and accounting services are now performing these services in-house.

Now p. 50.
See comment 52.

- 69 Second paragraph. The report cites "the Federal Reserve's ability to unilaterally take actions that have the potential for changing the competitive balance such as the Federal Reserve's announced move out of New York City" as an ability that is not shared by collecting banks and one that potentially limits competition. The report should note that the ability to relocate operations is not an ability unique to the Federal Reserve. In fact, the majority of New York Clearing House member banks have already taken similar actions to move their check processing and/or other payment operations out of New York City, to take advantage of the lower cost structure in the surrounding suburbs.

Now p. 57.
See comment 53.

Chapter 4

- 74 The last sentence notes the adoption, by the Board, of check truncation and MICR-capture services (described in the report broadly as data capture products), and states that this may result in the Reserve Banks "selling data processing and account services." Data processing and account services imply the provision of demand deposit accounting services, which the Reserve Banks do not now offer, nor contemplate offering in the future.

Now p. 58.
See comment 54.

- 75 Second paragraph. The report notes that the Federal Reserve should develop a policy that "collecting banks will have the same abilities as Reserve banks to collect on checks unless there are compelling safety, soundness, or efficiency reasons for Reserve banks to take on unique abilities." The Federal Reserve must balance all of these considerations, as well as others, such as ensuring an adequate level of service to all depository institutions, in considering regulatory and service changes. The statement implies that competition is the most critical of all of these factors, and should be given the greatest weight. It is also inconsistent with the report's recommendation. The word "compelling" should be deleted.

Now p. 70.
See comment 55.

Appendix I

- 83 Footnote B. The reference should be to "Automated Clearing House", not "automatic clearinghouse."

Appendix V
Comments From the Board of Governors of
the Federal Reserve System

- 20 -

Now p. 39.
See comment 44.

50 First line. Clarify that "member" means clearinghouse member.

Now p. 40.
See comment 45.

Second paragraph. In the discussion of the concerns of the Houston Clearing House, the report should note that the banks that are members of the clearinghouse have the choice to receive checks drawn on their respondents separately sorted or commingled. The clearinghouse members find it more efficient for their own operations to receive these checks commingled. Associate members of the Houston Clearing House pay the members for accepting and outsorting the associate's checks.

55 The first two lines on the page repeat language at the bottom of page 54.

Chapter 3

Now p. 46.
See comment 46.

56 Second paragraph. The discussion of collecting bank advantages in providing check collection services should also note that correspondents can choose those endpoints to which they present, and can give higher cost items to the Federal Reserve, which must present to all endpoints.

Now p. 49.
See comment 47.

61 First paragraph. The report cites, as one of the Federal Reserve's unique abilities, the fact that "it is the only bank that may operate nationwide." This is not accurate. Section 612 of the Competitive Equality Banking Act amended section 11A of the Federal Reserve Act to state that "all depository institutions . . . may receive for deposit and as deposits any evidences of transaction accounts . . . from other depository institutions . . . or from any office of any Federal Reserve bank without regard to any Federal or State law restricting the number or the physical location or locations of such depository institutions." Correspondent banks sought this provision to equalize their abilities to provide check collection services nationwide. In addition, the report should acknowledge that thrift institutions, which may provide correspondent service to other thrift institutions, have the ability to operate nationwide, and that an increasing number of bank holding companies are gaining this ability as they acquire affiliates in different states.

Now p. 48.
See comment 48.

62 Table 3.1. The following information updates Table 3.1 in the draft report to reflect current (1989) fees for originating wire transfers:

Basic transfer originated	\$0.50
Off-line origination surcharge	6.00
Telephone advice surcharge	4.00

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checks, including those presented through clearinghouse arrangements.

Now p. 31.
See comment 36.

38 Last paragraph. The report notes that collecting banks incur the cost of presentment fees, which is an expense the Reserve Banks do not incur. The report fails to note, however, that presentment fees provide a significant source of income to banks as well, whereas the Reserve Banks do not obtain revenue from presentment fees.

Now p. 32.
See comment 37.

40 Footnote 7. The draft report states that "these changes [noon presentment], in part, enabled Reserve banks to reduce the amount of their check float from about \$2.2 billion a day in 1982 to about \$0.3 billion a day in 1984." It would be more accurate to state that "as a result of the program, in 1984 checks with a total daily average value of approximately \$2 billion were being collected one day earlier than they were being collected previously." While this in part resulted in reductions in Federal Reserve float as stated in the footnote, it also contributed to reductions in float for other payment system participants, including depository banks and collecting banks.

Now p. 33.
See comment 38.

41 The discussion of the High Dollar Group Sort (HDGS) program in the first paragraph is incomplete. The HDGS program was implemented to speed the collection of large-dollar checks drawn on certain non-city institutions. The program was also designed to deter delayed disbursement practices by reducing the payor's investment return associated with these activities. The program, as a supplement to existing deposit programs, offers later deposit deadlines at higher fees. The later deadline allows depositing banks additional processing time to identify large-dollar checks destined for certain endpoints and deposit such checks for collection. The higher fees reflect the additional resources required to process such checks within shorter processing windows, and the additional transportation required to present such checks to the non-city institution after the usual presentment. Because of the higher fee, depositing institutions typically use the service to collect only those large-dollar checks where the opportunity cost of one day's later availability would be higher than the fee. HDGS volume accounts for only about .5 percent of total Federal Reserve check volume.

Now p. 34.
See comment 39.

42 Last paragraph. The draft report states that "Banks purchasing this service [payor bank services] are able to obtain information . . . before Reserve banks dispatch checks." Generally, information provided through payor bank services is not available to the institution until after the

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that agree to exchange checks. Although the Federal Reserve does not maintain a list of clearinghouses, a Federal Reserve study, published in the Jan/Feb 1984 Business Review of the Federal Reserve Bank of Philadelphia, estimated that 95 additional clearinghouses were established following the implementation of pricing for Federal Reserve check collection services. Previous estimates, by Littlewood-Shain & Co., put the number of clearinghouses at about 900.

Now p. 14.
See comment 23.

- 15 Figure 1.1. Clearinghouses are incorrectly included in the list of "collection intermediaries" in Figure 1.1. Clearinghouses are not intermediaries; rather, they are arrangements whereby participants exchange checks directly.

Now p. 14.
See comment 24.

- 16 Second paragraph. In describing the collection options available to a bank of first deposit, the alternative of sending checks to a Federal Home Loan Bank should be limited by stating "provided the sending bank is a thrift institution."

Now p. 13.
See comment 25.

Footnote 9. We suggest that footnote 9 be revised to read: "The machines sort checks by reading the routing number printed in the MICR (magnetic ink character recognition) line along the bottom of the check. The routing number indicates the location and identity of the paying bank. The MICR line usually also contains the account number on which the check is drawn, the check number, and the dollar amount."

Now p. 15.
See comment 26.

- 17 First paragraph. The report states that banks look for a low-cost check collector that, in most instances, "provides funds the day checks are deposited for collection." Collecting banks generally receive checks from their respondents late on the day of deposit at the depository bank or early the next day and provide credit on that next day on most of the checks received. The report should also note that, particularly in a high interest rate environment, some banks incur higher costs to collect high-dollar checks, or checks drawn on high-dollar endpoints, in a more expeditious manner than other checks.

Now p. 16.
See comment 27.

- 18 Third paragraph. The last sentence should read "Since the regulation's effective date of September 1, 1988, banks are required to make funds available to their depositors in accordance with specified schedules, and returned checks are routed directly to the depository bank."

Now p. 18.
See comment 28.

- 21 Third indented item. The last sentence should read "However, if check volume declines or is projected to

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growth statistics and the perceived inability of collecting banks to provide similar services. Prior to the implementation of pricing for check services in August 1981, the Federal Reserve received fine-sorted volume in only a few offices. Depositors had no financial incentive to sort checks by endpoint because they paid no explicit fees for Federal Reserve collection services. To mitigate the impact of Federal Reserve fees on depositing banks and to offer more choices to depositors, the Federal Reserve expanded its fine sort service, requiring each Reserve Bank office to provide multiple fine sort products. As a result, checks deposited at Reserve Banks in fine sort packages have increased from very low volume in 1981, to about 24 percent of total volume in 1988.

See comment 14.

The fine sort service is used primarily by large banks, including correspondents that provide check collection services in competition with the Federal Reserve. The fine sort option enables correspondent banks to accept mixed deposits from respondent banks, sort the checks by endpoint, and deposit with the Federal Reserve at lower fees and later deposit deadlines than for checks deposited unsorted, thus lowering the costs to correspondent banks of providing competing mixed deposit services. Thus, the fine sort service better enables correspondent banks to compete with the Federal Reserve's mixed deposit program.

See comment 15.

Although the Federal Reserve's fine sort services do not enjoy as active competition as some other check collection services, there are indications that some collecting banks provide similar services. For example, United Banks of Colorado, Inc. discussed in its comment letter on proposed amendments to Regulation CC (FR Docket No. R-0649, 53 Fed. Reg. 44343) "the treatment of checks that typically are not indorsed by the collecting bank, such as those forwarded for collection under the Federal Reserve's fine sort program or through package-forward or endpoint sort arrangements between commercial banks."

See comment 16.

In addition, the report should recognize the recent reductions made in fine sort prices at all Federal Reserve offices. These reductions were prompted by the removal of return costs from forward collection prices effective September 1, 1988, when returned checks were explicitly priced. At that time, fees for processed checks were reduced by an average of 7 percent and fees for fine-sorted checks were reduced by an average of 20 percent.

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The New York Reserve Bank's relocation of certain check operations out of the Head Office to its Jericho and Cranford offices is an interim step in the Bank's plan to meet longer term space needs, address large-dollar transfer processing contingency concerns, and address operational inefficiencies stemming from inadequate existing physical facilities.

Before relocating the check operations, the New York Reserve Bank assessed the effects of the move on various depository institutions. This analysis, based on detailed customer deposit profile data, suggested that of the approximately 3.3 million items handled daily at the Head Office, approximately 3.2 million of the total volume would be largely unaffected by the move or subject to improved deadlines. Specifically, 1.8 million items, representing fine sort and outgoing consolidated shipments, would remain at the Head Office. These items constitute the vast majority of checks deposited by Manhattan-based collecting banks. About 1.1 million items represent incoming city items from depository institutions located in other Federal Reserve districts. These items would be processed at the Cranford Office and presented to paying banks in a manner generally consistent with presentment schedules that existed prior to the move. Approximately 300,000 items, which would be processed at the Jericho office, would be subject to improved (i.e., later) deposit deadlines.

The Reserve Bank determined that only a small residual number of checks, perhaps 100,000 per day, would initially have been subject to an earlier deposit deadline. Included in the 100,000 were approximately 35,000 items (approximately 1 percent of total volume) deposited by five New York City collecting banks that perceived that the Reserve Bank's move would have a negative impact on their ability to collect these checks. The earlier deposit deadline for the remaining 65,000 items did not pose a problem for collecting banks, because these items are generally available for deposit at the earlier deadline. Within the context of the total check volume handled at the Head Office, however, the New York Reserve Bank's analysis showed that the move would not have a major impact on depository institutions because the vast majority of check volume would be unaffected.

In addition, the New York Reserve Bank consulted with banking community representatives regarding the relocation and was prepared to accommodate any unforeseen problems. Formal discussions, including a seminar regarding the move, were held in October 1987 with all Manhattan-based depository institutions. A formal announcement was mailed to all depository institutions in the Second District one month before the first stage of the move. Follow-up discussions were held with all Head Office depositors, including New York Clearing House banks, to address the concerns

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The Federal Reserve will continue to analyze the comments received on the proposed same-day payment concept, and will work with industry groups and others to formulate plans and programs to increase the efficiency and effectiveness of the check collection system.

Federal Reserve Price and Service Policies

The draft report recommends that: (1) the Board adopt the principle that collecting banks should have the same abilities as Reserve Banks to collect checks unless fulfillment of payments system safety, soundness, or efficiency objectives indicates Reserve Banks should take on unique abilities; and (2) Federal Reserve officials, when deliberating on regulatory, price, and service changes, identify any practical or legal differences between Reserve Banks and collecting banks that hinder collecting banks' ability to offer effectively competing check collection services and to provide proposals for eliminating the differences, or explain why continuation of those differences is necessary to promote safety, soundness, or efficiency of the payments system.

Since the introduction of pricing, the Federal Reserve has been sensitive to the relationship between services provided by the Federal Reserve Banks and those provided by the private sector correspondent banks. Federal Reserve price and service changes and regulations affecting the payments system are subject to Board policies designed to ensure their fairness. In addition, regulatory changes are subject to the Administrative Procedure Act requiring public comment.

After enactment of the Monetary Control Act (MCA), the Federal Reserve Board adopted seven pricing principles to carry out the intent of MCA. These principles provide for public comment whenever changes in fees or service arrangements would have a significant longer-run effect on the nation's payments system. (Federal Reserve Regulatory Service "FRRS" 7-134). Shortly thereafter, the Board emphasized the importance of a private sector role in the payments system, stating that the Federal Reserve "should be prepared to remove itself from the provision of services that can be supplied more efficiently by the private sector, unless there are overriding public interest considerations for maintenance of an operational presence by the System." (FRRS 7-191).

In 1984, the Board established explicit standards to address potential conflicts between the Federal Reserve's role as provider of services and its role as a regulator, supervisor, and lender. (FRRS 7-136-138). Also in 1984, the Federal Reserve established explicit standards for evaluating new services and

See p. 62.

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While the Federal Reserve's primary objective in seeking comment on the same-day payment concept was to determine whether the concept would improve the efficiency of the check system, the draft report suggests that the proposal was issued in reaction to the GAO's study and considers the proposal primarily in the context of enhancing the competitive environment in the check collection system. The proposed same-day payment concept would provide a regulatory framework for presentment by private collecting banks equivalent to that available to the Federal Reserve.

See comment 9.

The report's analysis of the same-day payment concept categorizes banks as either "paying" or "collecting" banks, implying that a bank is either one or the other. In fact, all depository institutions that offer transaction accounts function in both the paying and collecting roles. Depository institutions receive checks deposited by their customers that must be collected, and receive checks for payment drawn on their customers' accounts. Correspondent banks engage in the check collection business as a service to other banks.

See comment 10.

Over 1,000 comments have been received by the Board on the proposed concept of same-day payment. The responses illustrate how the competitive goals expounded in the report, and sought by the Federal Reserve, can indeed be "elusive." Nearly 90 percent of the respondents expressed concern regarding the ramifications the proposal would have on the payments system if implemented. The most common theme expressed by the commenters was that the costs of the proposal outweigh the anticipated benefits.

More than one half of the comments received were from nonfinancial companies, primarily larger corporations. These responses indicate that corporations are very concerned that the check collection system function efficiently and that the banking industry continue to be able to provide cash management services, i.e. controlled disbursement, to corporate customers. Corporations are particularly concerned about the timeliness of payment data they now receive as part of cash management services provided by banks. The National Corporate Cash Managers Association, a trade group of cash management professionals, urged the Board to allow current presentment practices to remain in place, affording corporations the ability to manage their cash balances in a timely, efficient manner.

Comments also indicate that the thrift industry, (i.e. savings & loan associations, savings banks, and credit unions) is generally satisfied with the current competitive environment in the check collection system. These institutions believe that the proposed changes benefit only those large commercial banks that

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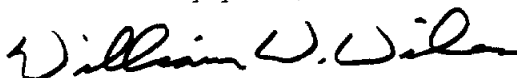
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Conclusion

In conclusion, the Board believes that competition in the check collection system is important to promoting the system's efficiency. Attempts to "equalize" competition, however, must consider the interests of depository banks, collecting banks, paying banks, and their customers, and the need to ensure that an adequate level of service is available to all depository institutions. The Board must consider the impact of regulatory, price, and service proposals on all payments system participants, not solely on competitors. In addition, imposing unnecessary procedural burdens on Reserve Banks that impede their ability to react quickly to market needs does not further the goal of competitive equity. In this context, the Federal Reserve will work further to formalize procedures for evaluating regulatory, service, and pricing proposals, and to articulate the relative importance of competition in evaluating these proposals.

We appreciate this opportunity to comment on the draft report. Additional detailed staff comments are included in Appendix B.

Sincerely yours,



William W. Wiles
Secretary of the Board

Enclosures

See pp. 63-66.

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commenters opposed the same-day payment concept. Commenters viewed the proposal from a broader perspective of overall payments system efficiency, rather than the more narrow objective of promoting the efficiency in the check collection process. The commenters argued that the efficiency of the check system as a whole would be reduced, rather than enhanced, by the proposal. Appendix A includes further information pertaining to the comments received on the same-day payment proposal.

It would not be in the public interest to pursue a same-day proposal such that any benefits to correspondent banks would be outweighed by the inefficiencies to other parties. Similarly, the interests of all parties must be weighed in considering the elimination of other differences between the Reserve Banks' and correspondent banks' abilities to offer services.

**Encumbering the Federal Reserve with Unnecessary Procedures
Could Reduce Rather than Enhance Competition**

In order for competition to work effectively, all participants, both correspondent banks and Reserve Banks, must have the ability to respond quickly to market needs. The draft report recommends that the Board analyze the competitive impact of regulatory, price and service changes, and fully disclose the basis for its decisions to the public. The Federal Reserve should not be encumbered with unnecessary procedural requirements that would impede its ability to modify services in response to a changing environment.

The Board has developed comprehensive review procedures, under which service proposals are evaluated with respect to a number of criteria, including the impact on service users and competitors. The Board requests public comment on all regulatory proposals affecting priced services, as well as significant price and service proposals, and includes competitive impact analyses with these proposals. Appendix A describes more fully the Federal Reserve's review process. Board and Reserve Bank staff also meet periodically with industry representatives to discuss the manner in which the Reserve Banks provide payment services and other issues of mutual interest.

This review process, however, should not be extended to changes that do not have a direct and material competitive effect. Actions affecting monetary policy or bank supervision and regulation are carefully separated from priced services activities under Federal Reserve policies. Further, even in areas more closely related to priced services, Reserve Banks regularly undertake initiatives designed to foster more efficient operations that have only an incidental competitive impact or

comment 6.

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See p. 40.

Concerning the Federal Reserve's relationships with check clearinghouses, the Board would like to emphasize its position as reported in the GAO study. While the Federal Reserve benefits from the existence of check clearinghouses through reductions in transportation costs, the Federal Reserve does not receive services from the clearinghouses. These cost reductions result from actions taken by the clearinghouse members and their associates for their own benefit, rather than a service requested by the Federal Reserve.

With regard to the broader issue of competitive fairness, in general the Board agrees with the underlying theme of the report that viable competition in the provision of check collection services is important to both banks and their customers. We believe that competition is a means of promoting the efficiency of the payments system, and not an end in itself. Generally, a competitive environment provides additional incentives for payment service providers to increase the quality of their services, while minimizing their costs, and thus serves to promote payments system efficiency. We believe that the payments system has benefited from the enhanced competition resulting from the adoption of the Monetary Control Act. Because of the positive effect of a competitive environment on the efficiency of the check collection system, the Federal Reserve strives to ensure the maintenance of a competitive market in the development of its services and policies.

See comment 2.

Although active competition tends to promote payments system efficiency, attempting to eliminate differences between service providers does not always achieve that result. As the draft report notes, in certain respects Reserve Banks have abilities in the provision of check collection services not equally shared by correspondent banks. For example, the Federal Reserve can obtain same-day payment on checks presented to paying banks without separately negotiating individual agreements, and has a nationwide network of offices not equaled by the correspondent banks at this time. In other respects, however, correspondent banks have abilities not shared by the Reserve Banks. For example, correspondent banks have the flexibility to tailor services and prices to meet individual needs, and unlike the Federal Reserve, which must provide services to all depository institutions and deliver to all endpoints, can limit business to profit-generating customers and endpoints. Further, correspondent banks can bundle check collection services with other services not offered by Reserve Banks.

We believe that it is important that the analysis, conclusions, and recommendations contained in the GAO report be considered in this context. In this regard, we believe that further development of certain aspects of the report may be

information to paying banks on the amount of the checks before delivering them.

In our opinion, additional accommodations can be made to preserve the existing balance among interests of Reserve, collecting, and paying banks. For example, to ensure that paying banks would not receive checks any later than they do now, check presentment cut-off times could be set to coincide with existing Federal Reserve practices. This would also preserve the collection efficiencies achieved by the Federal Reserve from adopting the noon to 2:00 p.m. presentment policy. To meet the needs of banks purchasing automated account information totals from the Reserve banks, a provision could be phased in whereby collecting banks, as a precondition to making check presentments, could be required to provide the same kind of information on the same terms as the Reserve banks. This electronic presentment should ensure that eliminating constraints on competition is not attained at the expense of commercial bank customers who need timely information for investment purposes.

Also, by accommodating all parties, inroads can be made to achieving the efficiencies envisioned by a change from a paper-based system to electronic presentments. Currently, check collection schedules are based on banks' ability to ship bundles of paper, typically by truck or plane. This method is inefficient when compared to the speed achievable through the electronic transmission of similar information. In the current environment, however, where there are obstacles to direct presentment, collecting banks do not see a market for selling automated account information like Reserve bank payor bank services. By establishing a requirement for offering automated account information services as a precondition for making direct presentments, the Reserve would bring the payments system one step closer to an electronic system.

- risk of a uniform 2:00 p.m. presentment time, which would upset the existing balance among the interests of collecting, paying, and Reserve banks.

In July 1986, Federal Reserve officials considered, but did not support, a proposal substantially similar to the same-day-payment concept now out for comment. According to Federal Reserve correspondence, the primary benefit of the proposal would be float reduction. Since float reduction was considered a transfer payment between collecting and paying banks rather than a savings in real resources, it was not considered a social benefit. Also, Federal Reserve officials were concerned that collecting banks would incur increased costs to reduce float and that paying bank costs would increase. In our opinion, the ability of collecting banks to reduce float—that is, accelerate the collection on checks they handle much like Reserve banks do—would also promote payments system efficiency, a goal of the Federal Reserve and the Expedited Funds Availability Act. That act mandated improving the check collection system by promoting quicker check collection and availability of funds. Moreover, it is reasonable to expect that collecting banks would make prudent business decisions regarding the costs versus benefits of reducing check float. Also, as discussed in the following paragraphs, the demands placed on paying banks need not be burdensome.

The risk from banks becoming insolvent before checks can be paid appear to be no greater under direct presentment than in the current method of check collection. Under either method, procedures are in place for banks to receive their funds. Should the paying bank fail before checks can be presented for payment, depositing banks could recoup funds from its customers. Similarly, should the bank of first deposit fail before a check can be returned to it for payment, the paying bank could make a claim against the customer at the bank of first deposit. Alternatively, the paying bank has the option of recouping the funds from the collecting bank that presented the checks. That collecting bank could make a claim against the customer at the bank of first deposit.

The burden placed on paying banks because of a substantial increase in the number of check packages would seem to be small. It is likely that only banks with sufficient capacity to sort checks to individual paying banks will take advantage of new authorities to present checks directly. The banks that currently have this capability already present presorted packages of checks through the Federal Reserve in bundles typically

Restricting the Federal Reserve's abilities to vary from collection terms provided in the U.C.C. is, in our opinion, undesirable and impractical. The Federal Reserve has used those abilities to fulfill its responsibility of improving the efficiency of the payments system. Restricting those abilities would eliminate a number of efficiency gains. For example, by removing the ability to offer a fine sort service, the banking system would be denied a low-cost check collection option that maximizes the amount of time available for getting checks to a Reserve bank for same-day collection. Also, by requiring Reserve banks to adhere to locally set presentment times, the banking system would potentially lose the efficiencies gained from the Federal Reserve's nationally coordinated deposit deadlines, check processing schedules, and transportation arrangements.

Require Funds Be Made Available to All Collecting Banks on Equal Terms

As discussed in chapter 2, requiring paying banks to make funds available to collecting banks, private or public, on equal terms would in our opinion best alleviate constraints on competition caused by differing rights of presentment. This requirement could hasten the speed of collection by eliminating unnecessary intermediaries. Furthermore, it provides new opportunities for collecting banks to market certain products previously sold only by Reserve banks.

Extending the right of direct presentment increases the alternatives available to banks for choosing the fastest and least costly means of collecting on checks. Because banks can receive same-day funds on checks only when paying banks consent to provide such availability, in some instances collecting banks with the capacity and desire to present directly to the paying bank are left no alternative but to use Reserve banks as an intermediary. This circuitous routing seems to occur frequently with controlled disbursement banks because these are the banks that tend to deny access.

Direct presentment could also introduce opportunities to reduce or eliminate fees associated with current bank-to-bank arrangements. Because collecting banks would be entitled to same-day funds without negotiation, the per-check fee paid to induce expedited funds availability may no longer be warranted. Furthermore, since funds could be made available through transfers of reserve account balances, banks could determine whether it was in their financial interest to maintain accounts with other banks.

Reserve bank prices. For example, a paying bank may set its presentment fee slightly below Reserve bank fine sort prices, attract checks from other banks, and earn revenues from the presentment fees charged. Conversely, setting an uncompetitive fee would eliminate a source of income because Reserve banks—which do not pay fees—would become the more attractive collection option. However, if Reserve banks were required to pay presentment fees, paying banks could increase their presentment fee charges without fear of losing revenue. Since presentment fees can affect Reserve bank and collecting bank prices, any increases could also raise the costs of check collection to the banking system.

As a means of controlling presentment fees, one banker suggested that the Federal Reserve could be empowered to limit the amount of a presentment fee that its banks would be authorized to pay. The amount could be set to approximate the bookkeeping expenses paying banks incur when presented with checks.¹ In this way, Reserve banks would, in this banker's opinion, incur costs similar to those incurred by collecting banks.

Limiting the amount Reserve banks may pay, however, does not eliminate constraints on competition nor promote competitive equality. Limiting the amount would not guarantee that Reserve bank and collecting bank costs would be equal, nor would it guarantee collecting bank access to paying banks, and the issue of access—the right to present checks and obtain same-day payment—is, in our opinion, the basic dilemma faced by collecting banks.

Federal Reserve Banks Could Impute Presentment Fees

Instead of paying presentment fees each time it presents checks for collection, the Federal Reserve could estimate and impute the costs of such fees and set its prices to recover those costs. Precedent for such a proposal exists in the Federal Reserve's current method of imputing certain other costs that it does not incur because of its governmental status.² Such a change would tend to negate the cost avoidance difference in presenting checks but, at the same time, allow the Federal Reserve System to control the amount of fees it would pay.

¹This banker suggested that these bookkeeping expenses could be estimated by deducting the Federal Reserve's transportation costs from its fine sort service price.

²The Monetary Control Act requires that Federal Reserve banks set their prices high enough to recover, among other things, the taxes that would have been paid and the profits that would have been earned had the services been provided by a private sector firm. This recovery is known as the private sector adjustment factor.

**Appendix III
Clearinghouse Operations and Interaction
With Reserve Banks**

Board of Governors of the Federal Reserve System) how much it should be. In a policy statement, the Federal Reserve said that

“Since the Federal Reserve believes that it benefits from the participation of Reserve banks in local check exchanges and is interested in their growth and viability, Reserve Banks will, where appropriate, support the exchanges through assistance with the provision of space, equipment, personnel or equivalent fees to facilitate the clearing process.”

Nationwide, the most frequently provided benefit is free net settlement and space. The specific way in which the Reserve banks interacted with the clearinghouses at the time of our field visits is shown in table III.1.

Table III.1: Interaction of Reserve Banks With Local Clearinghouse

Location ^a	Support provided	Time of exchange	Sort pattern
Chicago	Net settlement; \$2,000 per year plus free workspace ^b	11:00 a.m.	Provides a check package to both full and associate members.
Houston	Net settlement	11:15 a.m.	Presents a package of commingled checks to each full member. Associate members receive checks from full members. ^c
New York	\$65,000 per year plus net settlement	80-85 percent by 10:00 a.m. and 15-20 percent at noon	Presents a check package to both full and city collection members.

^aThe Federal Reserve Bank of San Francisco does not support the San Francisco clearinghouse. The clearinghouse purchases net settlement services from the Federal Reserve bank for about \$5,000 a year.

^bThe clearinghouse is located in the Federal Reserve Bank of Chicago.

^cCommingled checks are those drawn on a variety of banks.

The Reserve banks generally present more checks at the clearinghouse than do other members. Table III.2 compares, for 1987, the percentage of check volumes presented by the Reserve banks and the largest presenting members at the clearinghouses we visited.

Table III.2: Clearinghouse Check Volume, 1987

Clearinghouse ^a	Largest clearing member	Federal Reserve bank
Chicago	13.8%	38.0%
Houston	19.4%	25.3%
New York	13.8%	38.6%

^aThe San Francisco clearinghouse is not included because the local Reserve bank does not participate in the clearinghouse exchange.

Clearinghouse Operations and Interaction With Reserve Banks

This appendix summarizes the operational characteristics of clearinghouses in four U.S. cities and how they interact with Federal Reserve banks.

Clearinghouse Operations

Chicago

Chicago has 13 full members and about 144 associate members.¹ The full members pay a \$200,000 initiation fee and make an annual contribution based on check volume, with a minimum contribution of \$5,000. The time of check presentment at the exchange is 11:00 a.m. Each full member then presents separately packaged checks to all members. Associate members contract with full members for check presentment services but not necessarily for receiving checks.

Houston

Houston has 13 full members and about 250 associate members. The full members pay approximately \$250,000 in initiation fees and make an annual contribution based on check volume to cover the cost of clearinghouse operations. Houston has three check exchanges: The first exchange—a “courtesy” exchange—occurs between 2:00 and 7:00 a.m. The second exchange occurs at 11:15 a.m. At this exchange, the full members present commingled check packages to other full members (the bundles contain checks drawn on the full member and its associate members). The associate members contract with full members for check presentment and receipt services. The third exchange is at 2:00 p.m. and is for full members only (they may not present associate members’ checks).

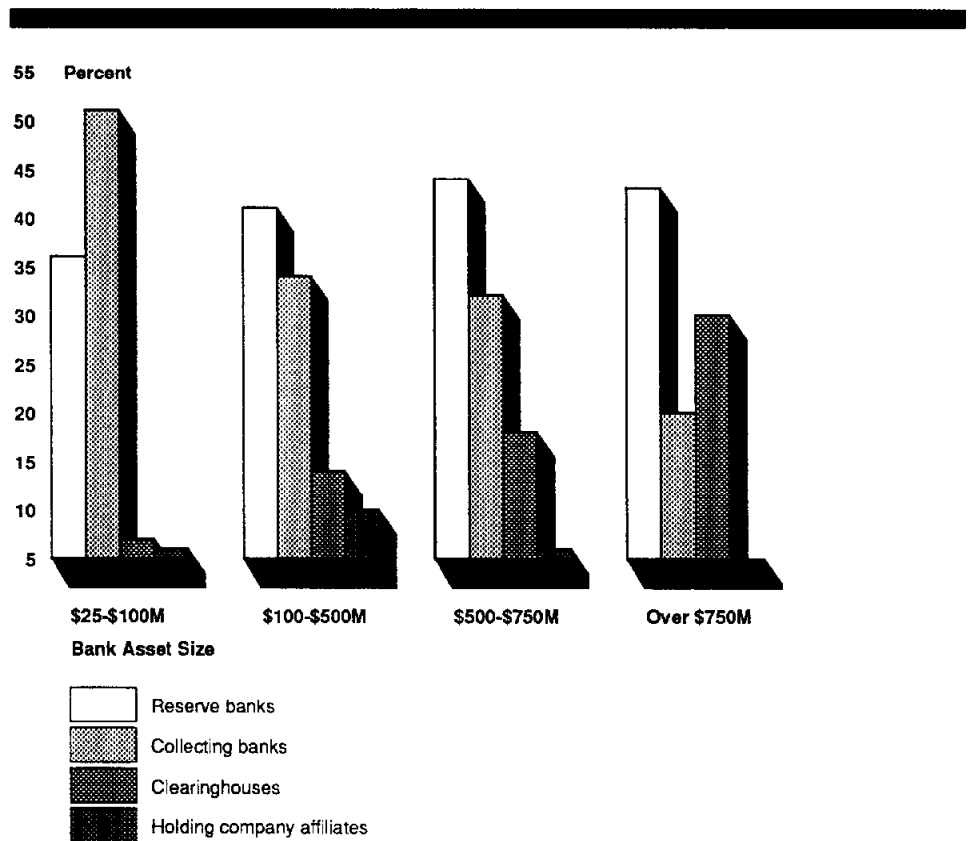
New York

New York has 12 full members and no associate members. The clearinghouse does have a subset called the City Collection Department that is made up of 176 foreign banks. Full members pay a \$100,000 admission fee and a \$5,000 annual fee. There is also a prorated fee based on asset size and check and dollar volume cleared, with a minimum contribution of \$25,000. New York has several exchanges: 6 a.m., 8:00 a.m., and

¹One significant difference between full and associate members is that full members present checks at the clearinghouse exchange while associate members contract with the full members for performing this service. Associate members may also contract with a full member to serve as a receipt point for its checks, such as in Houston and San Francisco.

Appendix II
 Federal Reserve and Collecting Bank
 Competitive Positions

Figure II.7: Check Collection Market Share by Bank Asset Size, Year-End 1987



Note: An additional 2-percent market share for banks with assets over \$750M is attributable to "other."
 Source: Association of Reserve City Bankers Check Clearing Study, January 1988.

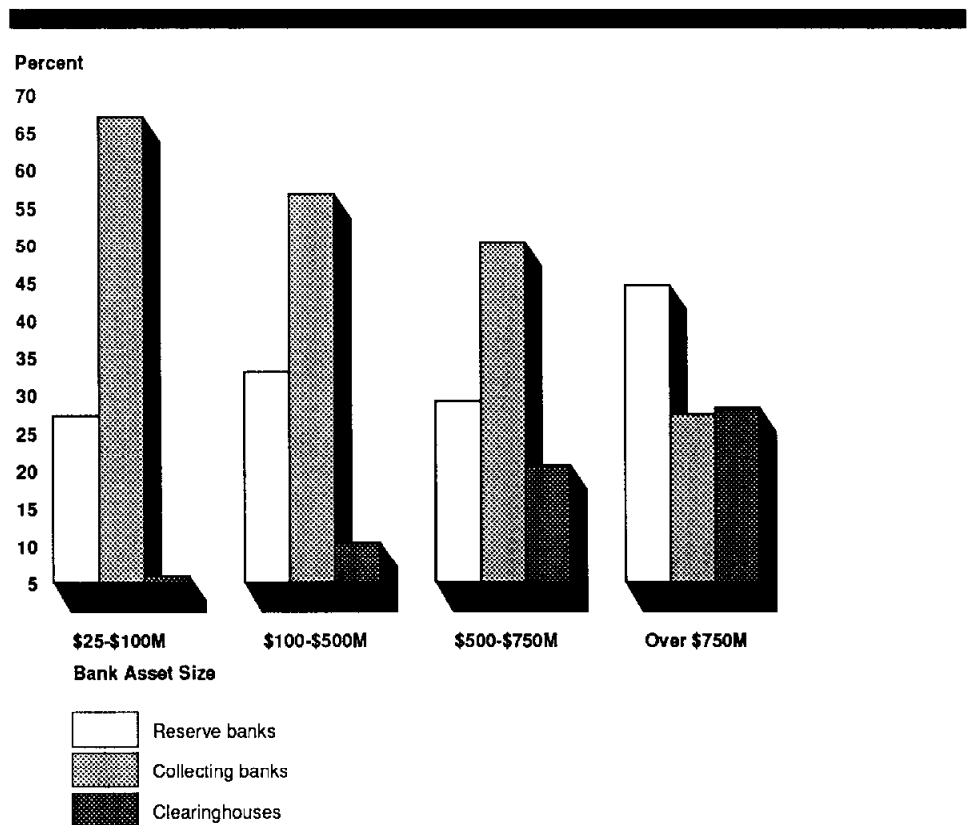
A comparison of the year-end 1985 ABA data with year-end 1987 ARCB data, although somewhat inexact, suggests that a decline took place in collecting banks' check collection business, which continues a trend set during the period 1983-85. Making the comparison is difficult because of differences in the way each study collected data—the ARCB study asked banks to factor in the extent to which holding company affiliates were used to clear checks, while the ABA study did not. These affiliates may or may not be collecting banks. Accordingly, table II.5 shows the range over which collecting bank market share may have changed from year-end 1985 to year-end 1987. For example, banks with assets between \$100 and \$500 million that responded to the two surveys reported using collecting banks for 50 percent of their checks in 1985 and 34 percent in 1987. This drop would indicate a market share loss of 16 percent for

survey, the results cannot be statistically projected to the universe of all banks. Although it is not possible to make statistical projections, an analysis and comparison of the survey data do shed some light on competitive conditions as seen by the responding banks.

Market Share in 1983

ABA data indicate that of the banks participating in the survey, the smaller banks sent a greater proportion of their checks to collecting banks for collection than did larger banks. As shown in figure II.5, these smaller banks are an important segment of the collecting banks' business: Banks with assets between \$25 and \$100 million cleared about 67 percent of their checks through collecting banks, while the largest banks, those with assets over \$750 million, cleared about 27 percent of their checks through collecting banks.

Figure II.5: Check Collection Market Share by Bank Asset Size, Year-End 1983



Source: Unpublished data from the 1986 American Bankers Association National Operations/Automation Survey. Data were obtained to coincide with data categorizations by the Association of Reserve City Bankers January 1988 study.

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- implementation in 1984 of “payor bank” services, and
- implementation of other premium products where depositing banks may take advantage of later deposit deadlines by paying a higher price.

An example of the efforts made by Reserve banks to improve their products and meet market demand can be seen in the choices a bank has in obtaining same-day funds from banks in the Chicago region. Among its options, a bank may use the Federal Reserve Bank of Chicago’s

- basic collection product and deposit regional checks unsorted by 12:01 a.m. at a cost of 3.4 cents per check and a \$2.00 deposit fee;
- premium basic collection product and deposit regional checks unsorted by 1:00 a.m. at a cost of 4.1 cents per check and a \$2.00 deposit fee;
- fine sort collection product and deposit regional checks sorted and prepackaged according to the institution on which they are drawn by 3:00 a.m. at a cost of 1.4 cents per check and a \$3.75-per-package deposit charge; or
- high dollar group sort collection product and deposit regional checks sorted into one group, provided that the checks are drawn on qualifying institutions by 8:30 a.m., at a cost of 9 cents per check and a \$7.00 deposit charge.

The importance of the new or expanded products for Reserve banks’ total check collection activity is summarized in table II.3. This table shows that the sale of fine sort, premium group sort, and other premium collection products has been increasing at a faster rate than regular collection products. By 1987, the fine sort and premium products together accounted for about 29 percent of total volume.

Table II.3: Change in Banks’ Use of Reserve Bank Products Between 1984 and 1987

Collection product	1984^a	1987^a	Percent increase
Fine sort product	2,937.3	4,041.3	37
Premium group sort	21.2	142.4	381 ^b
Other premium products ^c	1,071.0	1,304.8	23
Regular collection products	12,022.4	13,282.5	11
Total	16,051.9	18,771.0	17

^aChecks in millions.

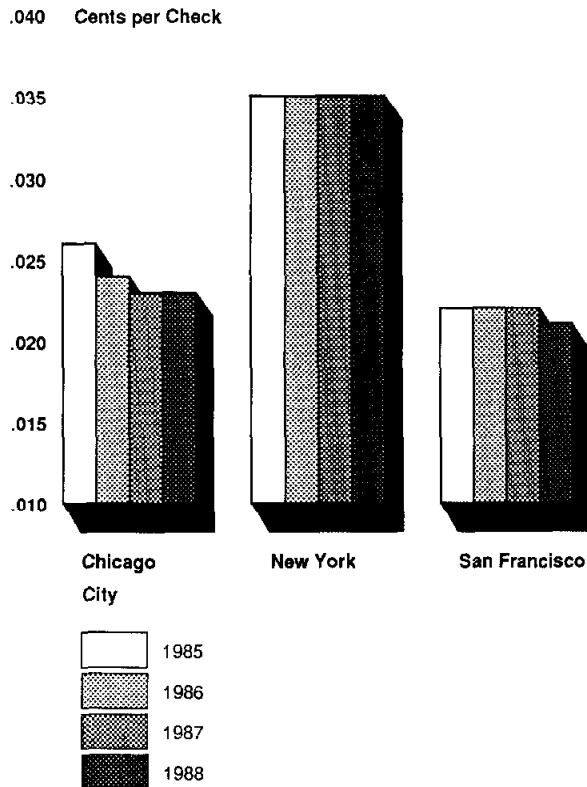
^bBecause the high dollar group sort product was not offered until April 1984, some of this increase can be attributed to the product’s initial start-up period and to partial-year data included in the 1984 volume.

^cIncludes premium fine sort products.

Source: Federal Reserve Cost Revenue Reporting System.

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Figure II.4: In-City, Unsorted Check
 Collection Per-Check Prices, 1985-88



Note: There is also a deposit fee, referred to as a cash letter fee, of approximately \$2.00.
 Source: Federal Reserve bank price announcements.

Cost

Between 1984 and 1987, Reserve banks' check collection costs rose from \$404.3 to \$480.5 million. In inflation-adjusted terms, this change represents about a 9-percent cost increase. This increase, however, is less than the increase in work load. (The volume of checks handled during that same time period increased by about 17 percent.) Therefore, the average real cost of collecting on each check was reduced.

Also, Reserve banks' check float has been reduced from 1982 levels. According to Federal Reserve statistics, the amount of check float was reduced from about a \$2.2-billion daily average in 1982 to about a \$0.3-billion average in 1984. The interest costs of carrying this check float was reduced from about \$266 million in 1982 to about \$26 million in

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Table II.1: Check Collection Volume and Profitability of Each Federal Reserve Bank, 1987^a

Bank	Revenue^b	Cost^c	Revenue as a percent of cost
Boston	\$35.0	\$34.9	100
New York	65.6	64.8	101
Philadelphia	24.0	21.1	114
Cleveland	29.2	28.3	103
Richmond	45.6	43.4	105
Atlanta	58.4	53.6	109
Chicago	67.9	64.0	106
St. Louis	23.4	22.9	102
Minneapolis	28.6	27.1	106
Kansas City	32.1	31.8	101
Dallas	35.4	34.8	102
San Francisco	55.4	48.7	114
Total	\$500.6^d	\$475.4	105

^aWith implementation of Financial Accounting Standards Board Statement No. 87, Employer's Accounting for Pensions, effective January 1, 1987, Reserve banks recognized an \$18.7-million credit to expenses and an equivalent increase in long-term assets. For financial reporting purposes, the \$18.7 million was not allocated among banks' priced services nor among the individual banks. Accordingly, it is not reflected in these totals.

^bIn millions.

^cIn millions, includes all real and imputed costs and a return on equity.

^dNet income from clearing balances (\$5.1 million) are not allocated by bank. For analysis purposes, this income was offset against imputed costs before allocation to Reserve banks.

Source: Federal Reserve financial statements and Cost Revenue Reporting System.

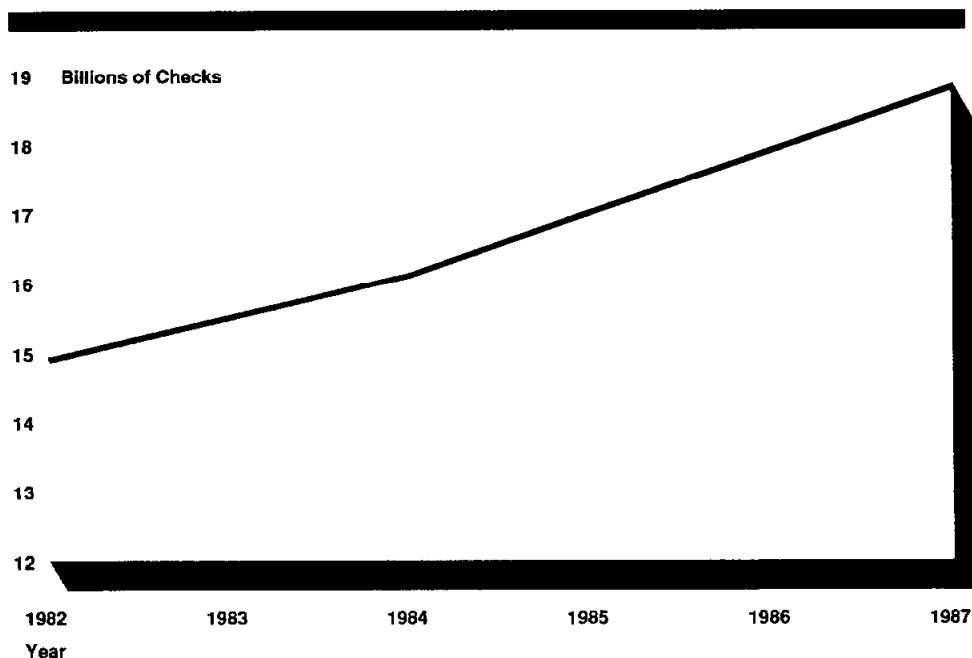
Revenue and Prices

Since 1984, Reserve banks' check collection revenues have increased at about the same rate as the increase in their total check collection volume, for an average annual growth rate of 4.9 percent and 5.6 percent, respectively. The result, shown in figure II.3, is that per-check revenues have remained relatively stable, ranging from about 2.73 to 2.66 cents over the 4-year period. However, when taking into account changes in the general price level of the economy, the average real revenue of the Reserve banks' check collection service fell by about 10 percent over the 4-year period.

The 10-percent decline in real revenues per check is attributable, in part, to keeping some prices stable in a somewhat inflationary economy and in part to decreasing some other prices. Figure II.4 shows the pricing trends for basic in-city check collection products offered by Reserve banks in the three cities where we did our field work.

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Figure II.1: Checks Collected by the
Federal Reserve, 1982-87



Source: Federal Reserve Cost Revenue Reporting System.

We cannot, however, make this conclusion by looking strictly at statistics on Federal Reserve volume. First, collecting banks do not necessarily handle all of the checks collected outside of the Federal Reserve. These checks may be exchanged directly between banks, such as in clearinghouse exchanges, or handled by Federal Home Loan banks. Data from the Federal Home Loan banks show that at the rate they were processing checks, about 1.6 billion would be handled in 1988, just 7 years after entering the business. Comprehensive statistics on clearinghouse and collecting bank volume, however, are not available.

Second, as noted in chapter 1, checks may be handled by more than one bank. Therefore, collecting bank volumes could be decreasing, increasing, or remaining stable at the same time Reserve bank volumes showed little change.

Profitability

Over the past several years, the Reserve banks earned revenues in excess of that needed to cover operating costs, including the cost of float

Estimated Volume and Value of Different Payment Instruments, 1987

Type of instrument	Volume of transactions ^a	Total value ^b
Nonelectronic		
Cash	278,600	\$1.400
Check	47,000	55.800
Credit cards	5,111	0.300
Other ^c	2,165	0.100
Electronic		
Automated clearinghouse ^d	936	3.600
Wire transfers	84	281.000
Other ^e	84	.003

^aIn millions.

^bIn trillions.

^cOther nonelectronic instruments are travelers checks and money orders.

^dA computer-based clearing and settlement system established for the exchange of electronic transactions among participating depository institutions.

^eOther electronic instruments are point of sale and bill payment by automatic teller machine.

Source: David B. Humphrey and Allen N. Berger, "Market Failure and Resource Use: Economic Incentives to Use Different Payment Instruments." Paper presented at the Federal Reserve Bank of Richmond Payment System Symposium, May 1988.

consult with private sector participants when it develops policies and procedures on competitive fairness. Lastly, the Clearing House felt the Board should not be required to make any changes to the payments system until its commitment to competitive fairness is fully developed and procedural controls and adequate safeguards are created. Specifically, the Clearing House objected to our recommendation calling for the development of the same-day-payment proposal, “especially one that resembles the private sector presentment concept that it [the Federal Reserve] recently published for comment.”

GAO Response

We appreciate the comments provided by the industry groups. We believe the recommendations to the Board of Governors, if implemented, should ensure that Reserve banks and collecting banks compete on a more equal level and that collecting banks and their associations gain a better understanding of how and why certain decisions are made by the Board of Governors that affect collecting banks’ abilities to compete. The recommendations would, in essence, establish procedural controls for the Board of Governors and a progression for making decisions. Specifically, implementation of our recommendation that the Board of Governors develop an explicit policy statement on competitive fairness would provide criteria for making decisions about private sector participation. Furthermore, if the Board of Governors adopts our recommendation for disclosure and discloses its rationale, safeguards against conflicts-of-interest will be created. We believe that the Board of Governors should be given the opportunity to implement these recommendations before calling for an outside party to participate in check collection deliberations.

As to the same-day-payment proposal, industry must recognize that with passage of the Expedited Funds Availability Act, the role of the Federal Reserve has changed. With the act came the added responsibility of governing all checks, not just those collected by the Federal Reserve. Therefore, the Federal Reserve may now affect private sector business relationships. This new responsibility makes it all the more important that the Board of Governors implements our recommendations so that any changes made by the Federal Reserve are not misunderstood. The comments forwarded providing industry’s views on the same-day-payment concept illustrate how accommodations can be made to meet the overriding needs of all participants. For example, as stated by the ABA, collecting banks could be required to notify paying banks of their intent to make direct presentment and an earlier presentment time could be established.

to have to expect to operate under more stringent requirements than private sector banks.

Given the unique situation in which a public entity is competing with private sector institutions, we see nothing unreasonable about the Board being obligated to disclose its rationale for changes made that can materially and adversely affect its competitors. With full disclosure, all participants—including the Board—can understand why changes have been made and be assured that they have not been made solely to benefit Reserve banks. Furthermore, full disclosure would ensure that the Board does not take advantage of its abilities to, at times, offer a unique service or services.

Similarly, by extending its competition analysis to all changes, in our opinion the Board would have a more complete basis on which to make decisions on whether or not changes affect or have “only an incidental competitive impact” on collecting banks. We see such analysis as part of an overall process that, taken as a whole, can result in competitive fairness. In the process, the Board first makes the policy commitment, extends the presentment rights to all where feasible, discloses why changes cannot be made, and then provides for a formal airing of disagreements over decisions made by the Board that the industry feels can adversely and materially affect them.

Comments From the Federal Home Loan Bank Board

The Federal Home Loan Bank Board had two points: The Board suggested that the report further differentiate between Home Loan banks and collecting banks and that we reconsider our position against the Federal Reserve imputing presentment fees.

GAO Response

Home Loan banks have been included in the collecting bank category because the focus of the study was the competition that exists in the check collection business. To that end, and as pointed out in the Board’s letter, Home Loan banks do compete with the Reserve banks as do private banks. While Home Loan banks and Reserve banks share some similar characteristics, they do not operate in tandem. Therefore, Home Loan banks share concerns voiced by private collecting banks. We do realize that, in some instances, Home Loan banks have unique concerns such as the need to service all thrift institutions. We believe these concerns have been sufficiently addressed in the report.

- fully disclosing the basis for decisions made to change regulation, prices, and services would be an encumbrance that would impede its ability to modify services in response to a changing environment;
- extending the public review process and the competitive impact analysis to changes that do not materially affect collecting banks' abilities to compete is unnecessary; and
- requiring public disclosure of the overhead allocated to products in which no competition exists would only invite unproductive debate over discretionary accounting issues.

GAO Response

In our opinion, the Board's response to our conclusions and recommendations provides further evidence as to why a change in its policy and procedures is necessary. The Board's letter does not adequately address the concerns that led us to make the recommendations contained in chapter 4. We recommended that the Board of Governors define its commitment to competitive fairness by explicitly adopting the principle that collecting banks have the same abilities as Reserve banks to collect on checks unless fulfillment of payments system safety, soundness, or efficiency objectives dictated otherwise. We said that without the criteria that such a policy would contain, the Board would have no basis for fairly deciding the merits of any changes that can materially affect their competitors. In other words, without specific criteria, it would be difficult for anyone to determine whether the principal basis for Board decisions was to benefit Reserve banks or the payments system.

The Board's comments to us about its same-day-payment proposal illustrate the problem that arises because it has no explicit criteria for making decisions with competitive implications. The Board said "an overwhelming proportion of commenters opposed the same-day payment concept" and went on to state that "it would not be in the public interest to pursue a same-day proposal such that any benefits to [collecting] banks would be outweighed by inefficiencies to other parties." It is interesting to note that some of the objections received to the Board's concept are similar to the objections raised when the Board moved its presentment time to later in the day (noon to 2 p.m.). With that proposal, half the banks responding (267 of 557) did not agree, voicing concerns, among other things, over disruptions to their internal processing schedules and their cash management services. In spite of these comments, in 1983 the Board moved ahead with its proposal. Also, we do not necessarily agree with the characterization of the same-day payment comments. From our review of the comments, a better characterization would be that some disagreed with the concept of same-day

Despite these changes, some Federal Reserve check collection products—such as the fine sort product—might not be made open to competition. Therefore, other procedures need to be in place to closely examine the price markups of those products to ensure the markups are not unreasonable and to safeguard against potential conflicts of interest.

Recommendations to the Board of Governors of the Federal Reserve System

We recommend that the Board of Governors clarify existing policies and procedures covering the Federal Reserve commitment to competitive fairness. Specifically, the Board of Governors should do the following:

- Define its commitment to competitive fairness by explicitly adopting the principle that collecting banks should have the same abilities as Reserve banks to collect on checks unless fulfillment of payments system safety, soundness, or efficiency objectives indicate Reserve banks should take on unique abilities.
- Require Federal Reserve officials, when deliberating on regulatory, price, and service changes, to identify any practical and legal differences between Reserve and collecting banks that may hinder collecting banks' ability to effectively offer competing check collection services. For differences that are found, Federal Reserve officials should provide the Board with proposals for eliminating the differences or an explanation of why continuation of those differences are necessary to promote the safety, soundness, or efficiency of the payments system. Full disclosure of the basis for decisions should be made to the public.
- Require Federal Reserve officials to closely oversee prices on products that cannot be offered by collecting banks on an equal basis to ensure that markups are not unreasonable and to make public disclosure of what those markups are.
- Require Federal Reserve officials to develop a forum for hearing disagreements raised by private sector participants over changes made by the Federal Reserve that may result in the private sector being precluded from effectively offering competing check collection services.

We also recommend that the Board of Governors, consistent with the recommended policy and procedural changes, develop a revised, comprehensive same-day-payment proposal that both balances the interest of paying and collecting banks and eliminates differences in presentment abilities between Reserve and collecting banks that are not necessary for the safety, soundness, or efficiency of the payments system.

The Federal Reserve faces a dilemma in deciding what actions to take that would most benefit the payments system as a whole. In general, paying and collecting banks have opposing interests in the payments system. On the one hand, paying banks (and their customers) usually favor slower payment of checks and want presentment to take place early in the day to enhance the value of cash management services offered to customers. Collecting banks, on the other hand, want to be able to obtain funds as quickly as possible so that they and their customers can make use of deposited balances. The Federal Reserve is responsible for balancing the interests of all participants so that the system is as safe, sound, and efficient as possible.

The Federal Reserve's dilemma is further complicated by its dual role as regulator and competitor. In this case, if it adopts the concept as proposed, it will be overriding the objections of the majority of the banks and bank customers that submitted comments. However, if it rejects the concept, it may appear to be making a decision to further its own interests. Paying banks, by objecting to the same-day payment concept, are in effect arguing to preserve the unique abilities of Reserve banks to present checks for same-day payment without charge. Therefore, were the Federal Reserve to decide to uphold paying bank objections, this would also continue to enhance the competitive standing of the Reserve banks.

If the Federal Reserve System adopts the criteria and procedures for ensuring competitive fairness discussed in the previous section, we think it would be in a better position to make decisions that can clearly be defended as being in the best interest of the payments system as a whole. The criteria would enable the Federal Reserve to revise the proposal to narrow or eliminate the presentment difference while considering the viewpoints of paying banks and their customers.

In the past, the Federal Reserve has shown how paying bank interests can be considered while furthering the interests of the payments system. We see no reason why this principle could not be extended to the same-day-payment proposal. For example, in 1983 when the Federal Reserve first proposed noon to 2:00 p.m. as the time period for its Reserve banks to present checks to city and certain regional banks, many paying banks objected for the same reasons they are now objecting to the same-day payment concept. Despite those comments, the Federal Reserve found that payments system efficiency improvements warranted Reserve banks' making later presentments. However, to accommodate paying bank concerns, the Federal Reserve instituted payor bank services. Such an accommodation not only allowed paying

Promoting Fairness Through Policy and Procedural Changes

In our opinion, the Federal Reserve needs to pursue two objectives to fully implement a commitment to competitive fairness. Meeting these objectives will provide criteria for balancing competing interests and reduce the appearance of conflicts of interest.

First, the Federal Reserve needs to develop a policy that provides criteria for making decisions about private sector participation in the payments system. In our opinion, the policy should explicitly state that collecting banks will have the same abilities as Reserve banks to collect on checks unless there are compelling safety, soundness, or efficiency reasons for Reserve banks to take on unique functions. With such a policy, the Federal Reserve and others will have criteria for differentiating between actions that will improve the profitability of its check collection services and actions that will improve the payments system as a whole. Moreover, the policy will promote competitive fairness by establishing a basis for limiting differences between collecting and Reserve banks.

Second, the Federal Reserve needs to implement procedures for carrying out that policy. When deliberating on changes to the payments system, Federal Reserve officials should be required to identify all differences, both practical and legal, between Reserve and collecting banks that may hinder collecting banks' ability to effectively offer competing check collection services. When they find differences, Federal Reserve officials should be required to provide the Board with either proposals for eliminating the differences or an explanation of how the differences promote the safety, soundness, or efficiency of the payments system.

We recognize, however, that some collection products, such as fine sort, might not be made open to competition because of endorsement requirements. Therefore, other procedures need to be in place to examine closely the price markups of those products to ensure that the markups are not unreasonable.

Federal Reserve procedures should also require disclosure of the rationale for decisions on competitive fairness and the price markups on those products not open to competition. The disclosure would help alleviate any concerns that proposals are developed and implemented to enhance the competitive position of Reserve banks.

As an additional safeguard against potential conflicts of interest, Federal Reserve procedures should provide a means for hearing disputes arising from private sector concerns over competitive fairness. In part, dissatisfaction with existing arrangements for negotiating disputes with

group sort and fine sort products, (2) noon presentment, and (3) payor bank services. Additionally, Reserve banks benefit from constraints on private competition through price markups on the fine sort product.¹ Therefore, when evaluating changes made by the Federal Reserve to improve the payments system, it appears that proposals are designed to enhance the competitive position of the Federal Reserve.

The Federal Reserve Board has established some procedures to avoid actual or apparent conflicts of interest. For example, to provide an external check on certain proposed actions, the public has the opportunity to comment on proposed regulations and those Reserve bank service changes deemed significant by the Federal Reserve. Internally, Federal Reserve check collection officials are responsible for assessing the effect Federal Reserve actions have on competition. Additionally, these check collection officials are not permitted to participate in making decisions about bank supervision, lending matters, and merger applications. This separation is intended to avoid the possibility of check collection matters being used to influence other bank-related decisions.

In our opinion, the established procedures do not go far enough to alleviate competitors' concerns that payments system changes are implemented to enhance the competitive position of Reserve banks. In part, this is due to the vague policy and lack of explicit criteria for evaluating the commitment to competitive fairness. Also, under Federal Reserve procedures

- public comments are not obtained on all proposed service and price changes that can materially affect collecting bank abilities to compete. For example, comments were not obtained concerning the New York move.²
- deliberations on service, price, and payments system changes do not identify the practical differences, such as those discussed in chapter 2, that may limit collecting banks' abilities to provide competing services. For example, internal decision documents covering collection service and price changes associated with the New York move did not discuss the effect on competition.

¹These service changes are discussed on pages 32-37.

²See page 41.

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position to choose between a direct presentment option and Federal Reserve services based on market economics. Therefore, they depend on the Federal Reserve to ensure that any changes to Reserve bank price and service effectively deal with all competitive implications. Our views on how to balance the interests of participants in the payments system and promote competitive fairness are presented in chapter 4.

Industry Support for Existing Federal Reserve Services

The Independent Bankers Association of America, which represents about half of the banks in the country, supports the active role taken by Reserve banks to provide what it categorizes as an efficient and cost-effective service. According to Association officials, the members, as users of the check collection service, have benefited from the competition between Reserve banks and collecting banks. They believe check collection costs are low, and to keep them low the Association should do what it can to promote the competitiveness of Reserve banks. Accordingly, the Association has opposed changes that would subject Reserve banks to increased costs.

Similar views were expressed in our meetings with officials of banks that are users, not competitors, of check collection services. In general, these banks viewed the Reserve banks as efficient, reliable, low-cost providers. They did not want to see change that would result in higher Reserve bank prices as this would increase their own banks' costs. Even banks that were using collecting banks opposed change that would increase Reserve bank prices because such increases would enable collecting banks to raise their prices commensurately.

Likewise, some bankers that offer check collection services, while believing that they are at a competitive disadvantage, favor continuation of the Federal Reserve's present role. For example, one collecting bank that serves as a collection intermediary for over 100 million checks a year has not advocated that Reserve banks pay presentment fees. In general, the bank officials are concerned that the costs incurred from increased Reserve bank prices could exceed any revenues that could be made from charging the Reserve bank for each check presented.

During our review, the American Bankers Association was, among other things, attempting to grapple with the concerns of banks that both provide and use collection services. As of September 1988, the Association was reassessing its previous position concerning whether or not Reserve banks should incur bank charges incidental to the presentment of checks, and it was trying to better define the role of commercial banks in the check collection industry.

Opportunities to Promote Competition

Federal Reserve and private competitors have different abilities to make their services competitively attractive. Among these differences, however, we found two as potentially limiting competition.

on the Federal Reserve's services to collect on checks deposited by customers and drawn on banks with which the collecting bank does not have a direct presentment arrangement.

The New York Reserve bank's move out of Manhattan illustrates how the influence may advance Reserve bank competitiveness. As discussed in chapter 2, the Reserve bank's announced relocation would reduce New York City collecting bank access to Reserve bank services or add to the collecting banks' costs of obtaining needed services. As a result, according to New York clearinghouse officials, it will be more difficult for New York City collecting banks to compete for check collection business. Also, the New York Reserve bank's repricing of check collection products—reducing prices more on products that collecting banks compete against than on products they use extensively—furthered Reserve bank competitiveness. Specifically, analysis of Federal Reserve cost-accounting data and price announcements show that the Federal Reserve Bank of New York is

- reducing the price of regular unsorted in-city collection products by about 18 percent and
- reducing the price of the in-city fine sort collection product by about 7 percent.

In view of these changes, collecting banks face the prospect of reduced check collection profit margins. The collecting banks will need to price their products competitively (potentially reducing their prices by 18 percent) while the products they traditionally used are not equally reduced. Moreover, as discussed in chapter 2, the fine sort price is already marked up at a higher rate than the regular unsorted product.

Limited Information for Comparing Competitive Positions

How the different abilities to offer check collection products have affected the competitors' relative market positions cannot be readily or definitively discerned from available data. However, some general observations can be made.

After 1980, the Federal Reserve responded to the increased competitive check collection market environment by improving existing collection products and introducing new ones while reducing the real costs of its products to the banking system. In our opinion, the Federal Reserve's check collection business can be classified as commercially successful. The success is evidenced by the steady growth in Reserve banks' collection business and earnings that exceed targets. Correspondingly, these

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implementing monetary policy, these accounts also constitute the backbone of the Nation's payments system because, at banks' requests, Reserve banks can debit and credit reserve account balances to move funds between banks. During 1987, about \$224 trillion of such payments between banks were made.³

The automatic debiting and crediting of reserve accounts is a key factor in the Reserve banks' check collection business. Reserve banks have designed an automated system whereby, as checks are processed by high-speed reader-sorters, the accounting system picks up bank totals and posts the information to appropriate reserve accounts.⁴ The cost to the Federal Reserve banks of making such a transfer is covered through check collection fees. Data available from the Federal Reserve's cost-accounting system indicate that the cost of transferring funds between bank reserve accounts averages about 41 cents per transfer.

In contrast, private banks presented with checks typically transfer funds through interbank accounts that, in some cases, require that minimum balances be maintained. This, in part, duplicates the expense of maintaining a reserve account with the Federal Reserve. Moreover, unlike Reserve banks that control the wire transfer system, collecting banks may need to instruct paying banks to wire transfer funds for the presented checks. To wire transfer funds, a paying bank instructs its Reserve bank to debit its account and credit the collecting bank's account. Table 3.1 depicts the prices charged by Reserve banks during 1987 for originating a wire transfer.

Table 3.1: Wire Transfer Originator's Charge, 1987

Originator's automation status	Basic service	Telephone advice
On-line	\$0.50	\$3.50
Off-line	6.00	3.50

To take advantage of on-line prices, banks also pay an electronic connection fee. In 1987, these fees amounted to about \$400 a month for a dedicated leased line, \$250 for a multidrop leased line, or \$60 for a dial-up

³These transfers include the value of all transactions made over the Federal Reserve's wire transfer network.

⁴Reserve banks may also debit and credit clearing balances if maintained at a Federal Reserve bank. Maintaining clearing balances may be desirable because Reserve banks provide earnings credits on those balances—similar to paying interest but the proceeds may only be used to pay for Federal Reserve services—while no interest is paid on reserve accounts. According to a Federal Reserve Board official, however, an estimated 80 percent of checks deposited with Reserve banks are cleared through reserve accounts.

Similar negotiating abilities are not available to the Reserve banks. First, the Monetary Control Act directs Reserve banks to make their services available to all banks at their published prices. Therefore, Reserve banks do not have the flexibility to negotiate with individual customers. Reserve banks also cannot match the late deposit deadlines offered by some collecting banks because, according to Federal Reserve officials, its banks need to receive checks earlier in the day in order to present checks to paying banks by 2:00 p.m., a deadline authorized by the U.C.C. and followed by Reserve banks.

Collecting Banks Can Choose Their Customers

Collecting banks have the option of turning away less profitable customers.² One way in which they may reject customers or avoid offering certain kinds of collection services is to set high prices. For example, one New York City bank discourages collection on non-city checks by charging a higher price for those checks.

The Federal Reserve cannot carve out a market “niche” for itself because it must ensure an adequate level of check collection services nationwide and present to all end points. Moreover, Reserve banks must operate according to the Board’s Standards Related to Priced-Service Activities of the Federal Reserve Banks. One of the standards is that “All activities incident to the provision of priced services will be conducted in a manner that is fully consistent with the public role and responsibilities of the Federal Reserve.” For example, the Reserve banks do not cease collecting checks for a bank facing financial difficulties. The Reserve banks will service financially troubled institutions that other providers, because of the risks involved, might not serve.

Collecting Banks Can Use Existing Resources

Collecting banks also have opportunities unavailable to Reserve banks to make better use of check collection resources: plant, equipment, and personnel.

The investments a bank makes to internally process its own checks, those presented to it for payment from retail customers or from a Reserve bank, may be used to operate a check collection business. The high-speed reader-sorters, costing upward of \$750,000 each, can be used to sort checks and prepare cash letters for other banks.

²This option is not available to Home Loan banks since they must make services equally available to all thrift institutions.

Other Differences Enable Both Banks to Advance Their Check Collections

The differences in presentment rights discussed in chapter 2 suggest that changes are needed to enhance the state of competition. However, before dealing with the specifics of a corrective action, such as the same-day payment concept advanced by the Federal Reserve, consideration needs to be given to (1) other factors that may uniquely enable competitors to advance their check collection business, (2) the relative condition of the competitors in the marketplace, and (3) banking industry views on existing conditions.

Unique Abilities of Collecting Banks

Collecting banks have certain abilities, unavailable to the Federal Reserve, to improve the attractiveness of their check collection services to prospective customers. These include the ability to (1) attract check collection business through other services provided to banks, (2) tailor services and prices to meet individual bank needs, (3) limit business to lucrative customers, and (4) use existing bank resources to conduct the check collection business.

Collecting Banks Market Other Services

Collecting banks may offer customers more than just check collection services. They may offer loan participations, investment and safekeeping services, letters of credit, automated clearinghouse, accounting, data processing, and other services. In some instances, collecting banks may bundle services together so that customers in search of one service will purchase other services as well.

Collecting banks may benefit from bundling services; that is, sell certain services at a lower profit margin or a loss to attract customers to services with high profit margins. For example, in our discussions with an official of one bank we learned that this bank used a collecting bank whose check collection prices were higher than those of the local Reserve bank. The official said his bank's relationship with the collecting bank goes beyond check collection; it includes an outstanding loan with the collecting bank's holding company. Accordingly, it was in this bank's interest to continue with the check collection arrangement.

The Federal Reserve System, although authorized to engage in certain banking activities, is required to separately price each service; it may

Opportunities to Promote Competition

Differences in Reserve bank and collecting bank abilities to obtain same-day payment for check presentments could be reduced through a variety of alternatives. (A description of these alternatives and their merits are discussed in app. IV.) In our opinion, requiring paying banks to make funds available to Reserve and collecting banks on equal terms could best alleviate constraints on competition caused by differing rights of presentment. Furthermore, such a requirement has the potential to hasten the speed of collection and provide users of collection services additional choices of collection products as the opportunity for marketing collection products increases.

One way the requirement could be developed, and the one we think is most promising, would be to amend Regulation CC and authorize collecting banks to present checks directly to paying banks and receive same-day payment. Regulation CC already provides a precedent for such a change: To speed the return check process, banks are authorized to return checks directly to the bank of first deposit and obtain same-day payment without charge.

After we briefed Federal Reserve officials on the results of our work showing the differences in rights of presentment—but not necessarily because of this—the Federal Reserve issued a release requesting public comment on the concept of same-day payment. Specifically, the Federal Reserve concept paper provides for paying banks to make same-day funds available for checks presented by any collecting bank without charge. Furthermore, paying banks would be required to accept any number of checks until 2:00 p.m.

Although we do not endorse all the specifics of the Board's same-day payment proposal, we commend the Federal Reserve for issuing the concept paper for consideration. We encourage efforts to continue accepting comments and refining the concept to find a viable way to eliminate unnecessary differences leading to unequal competition. Nevertheless, a direct presentment proposal would not remove all barriers to equal competition discussed in this chapter.

Dealing with the difference involving the need for endorsements would require changes affecting commercial code provisions covering assignment of financial liabilities. These changes may introduce new complications with unknown consequences. As noted previously, the U.C.C. provides the ground rules for determining liability should something go wrong in the collection process. Currently, the record showing the chain of banks handling a check is maintained, in part, by collecting banks

that have contracted with them—not with the Reserve bank. Also, according to the Federal Reserve, the Houston Reserve bank is simply presenting checks at the place and in the form designated by the member banks. Moreover, the Reserve bank would, if requested, present fine-sorted checks or bypass the member banks altogether and present directly to the associate member banks.

Though they do not believe they receive services from the member banks, Federal Reserve officials believe they benefit from the Houston clearinghouse operations. In a worst-case situation, without the clearinghouse the Houston Reserve bank could be sorting checks into 250 packages and transporting them to 250 places. In recognition of these benefits, Reserve bank officials offered to contribute \$2,000 per month to support clearinghouse operations—similar arrangements have been made in other cities—and made other proposals for reducing member bank collection expenses.

The clearinghouse member banks have accepted some of the proposals. For example, the clearinghouse is now receiving \$2,000 a month from the Reserve bank. The clearinghouse does not view the matter closed, however. In the clearinghouse's view, its member banks are competitively disadvantaged and will remain so until, at a minimum, the Federal Reserve incurs the same costs as member banks or reciprocates with free services.

To help resolve the issue, the Houston Reserve bank has offered to serve as a pick-up point for presorted packages of checks drawn on local banks that are not members of the clearinghouse. These nonmember banks would pick up their checks at the Reserve bank and settle their accounts through the clearinghouse. Through this arrangement, the Reserve bank would not charge the member collecting banks a fee for dropping off the checks.¹³

However, for the proposal to work, nonmember banks would have to agree to accept the packages of checks from the clearinghouse members for same-day payment. Clearinghouse officials were not optimistic that such agreements are obtainable.

¹³Under such an arrangement, the clearinghouse would take responsibility for bookkeeping and handling adjustments while the Reserve bank would provide settlement by debiting and crediting reserve accounts as instructed by the clearinghouse.

nonprofit association of banks that promotes the efficient collection of checks among its member banks. Each clearinghouse adds to check collection efficiency by

- helping its member banks hold down shipping costs by establishing one central location for banks to drop off and pick up checks,
- helping its member banks control and coordinate their check processing work by establishing scheduled hours for the exchange of checks, and
- providing its member banks with same-day funds on the exchanged checks.

In general, when a bank joins a clearinghouse, it agrees to adhere to certain rules promulgated by clearinghouse member banks such as

- establishing how and when it will present and settle checks through the exchange,¹⁰
- not charging presentment fees to other members who have clearinghouse presentment privileges, and
- paying a pro rata share of clearinghouse operating expenses.

Appendix III provides a detailed description of the operational characteristics of the four clearinghouses we visited.

In general, membership in a clearinghouse association provides a collecting bank with a low-cost alternative to paying a “middleman” for check collection services or paying presentment fees when presenting checks directly to other banks. For example, about 400 million checks are presented annually through the San Francisco branch of the California Bankers Clearing House. According to a clearinghouse official, the cost to the member banks to present checks and obtain same-day payment is about \$0.0004 per check. In comparison, the cost of using the Federal Reserve Bank of San Francisco during 1987 was \$0.005 per check plus a \$3.00 deposit fee, while presentment fees charged by large banks in the area range from almost \$0.005 to \$0.12 per check.¹¹

Obtaining same-day payment through a clearinghouse is, however, limited to checks drawn on the membership of the local clearinghouse. As a result, banks wanting to present to nonmember banks need to seek other

¹⁰The clearinghouse may establish different classes of members with different check presentment privileges, rules governing how checks are to be presented at the exchange, and the time at which the exchange will take place.

¹¹The Federal Reserve price is for the in-city fine sort product.

endorsements placed on a check or other agreed-to arrangements between banks may serve as the source for such recordkeeping.⁹ Historically, banks have met the recordkeeping requirement by endorsing each check over to the next bank in the collection chain. In addition to meeting the U.C.C. recordkeeping requirements, those endorsements also passed on certain rights and protections to each succeeding holder of the checks. Moreover, under the terms of the U.C.C., paying banks retain the right to insist that a check be properly endorsed before making payment.

Even if a collecting bank could negotiate the presentment of unendorsed checks and decided to accept the risk of not being able to research checks on which it has advanced funds to depositors, it would still need to pay presentment fees. The amount of these fees, however, can come close to the Reserve banks' fine sort collection charge. As summarized by one collecting bank official, adding the cost of presentment fees to the cost of the product would prevent his bank from offering a competitively priced fine sort product.

The lack of competition provides Reserve banks with considerable flexibility in setting prices for the fine sort product. In general, Federal Reserve System pricing guidelines instruct Reserve banks to set prices to at least recover "floor costs"—the allocated costs of producing the product as identified by the Federal Reserve's cost-accounting system—and to make some contribution to recovering the remaining unallocated expenses. These unallocated expenses include overhead, imputed costs, shipping, and float. Nationwide, the 1987 floor costs amounted to about \$224 million while unallocated costs amounted to about \$257 million. About 45 percent of the unallocated costs nationwide (\$103 million in 1987) involved overhead expenses.

An examination of in-city collection charges by the Federal Reserve banks of Chicago, New York, and San Francisco shows that the Reserve banks charge a higher percentage markup over floor costs for fine sort products than for basic unsorted check collection products. (See table 2.2.)

⁹An endorsement signifies that a bank warrants to the next bank that it has good title to the check, has no knowledge that the signature of the maker is unauthorized, and that the check has not been materially altered. The bank is also warranting that if the check is dishonored under terms specified by the U.C.C., the bank will take back the check and return any proceeds received.

Reserve banks sufficient time to do the work necessary to present checks for payment and obtain the proceeds.

Unlike Reserve banks, collecting banks must negotiate same-day payment agreements and therefore cannot unilaterally target these high-volume banks. Moreover, according to collecting bank officials, they have been largely unsuccessful in reaching same-day payment agreements with these high-volume banks. For example, the largest of these banks in the Federal Reserve's third district only accepts checks from the Federal Reserve. In another instance, a number of collecting banks in the Northeast have arranged private transportation to fly checks daily to North Carolina. Lacking agreements with the high-volume banks in that area, the collecting banks have had to deposit the checks for collection with the Reserve bank office in Charlotte. According to the collecting bank officials, with a same-day payment requirement they would present checks directly to these banks.

Bank officials attribute the reluctance of the high-volume banks to enter into same-day payment agreements with collecting banks to the need for those banks to satisfy corporate customer demands for early-morning notification of account balances—demands that can easily be satisfied through Federal Reserve payor bank services.

Payor Bank Services

To overcome problems that paying banks and their account holders could experience as a result of the later presentment of checks, the Federal Reserve introduced an information product called payor bank services. Banks purchasing this service are able to obtain information on the value of checks for each designated account holder early in the morning, usually before the physical checks are received. By purchasing this information, banks may notify corporate customers of account balances so that cash managers may make investments early in the morning while markets are most active. Providing such services—called controlled disbursement services—to corporate customers is a profitable business for banks and a service that both banks and corporate cash managers believe needs to be continued.⁸

⁸Controlled disbursement is a cash management service sold by banks to business customers. In general, under a controlled disbursement arrangement, a corporation would open a "zero-balance" checking account at the bank. Daily, as checks drawn on the account are presented to the bank, the account would become overdrawn. Sometime in the morning, generally between 8:30 and 11:00 the bank would notify the corporation of the amount needed in the account to cover the overdraft. The account may be funded by wire transfer or other arrangement. The advantage to the corporate cash managers is that they can avoid idle funds sitting in a non-interest-bearing checking account.

Other Terms Set by Reserve Banks Have Constrained Competition

By setting other terms and conditions that are not specifically provided for under the U.C.C. for obtaining same-day payment, Reserve banks have been able to make service changes or introduce new collection products that provide its customers with same-day payment on more checks. As indicated earlier, paying banks have little choice but to comply with the change in terms; the alternative involves noncompliance with federal rules and the U.C.C. and potential loss of public confidence in the bank. However, collecting banks—lacking similar abilities to unilaterally set terms and conditions for payment—have not been able to make similar service changes or introduce comparable products. In turn, their ability to offer competitive check collection services is constrained.

Noon Presentment

To be able to provide customers with same-day funds on more checks, the Federal Reserve changed the time at which it presents checks to banks in Federal Reserve cities. Rather than present checks for payment at times set by local custom—generally in the morning—the Federal Reserve adopted the policy of dispatching checks from Reserve banks by noon with delivery to be made to the paying banks no later than 2:00 p.m.⁶ The change, called noon presentment, enabled the Reserve banks to adjust their deposit deadlines to give their customers more time to get checks to the Reserve banks and provide the Reserve banks ample time to do the necessary work to present checks for payment and obtain the proceeds.⁷ As indicated earlier, paying banks have little choice but to adjust to the changes in check collection practices implemented by Reserve banks.

Unlike Reserve banks, collecting banks do not have the ability to make banks accept checks as late as noon or 2:00 p.m. for same-day payment. Under the U.C.C., collecting banks may obtain same-day payment through agreements with other banks. However, it is customary for same-day payment agreements, like those developed by clearinghouses, to specify a presentment deadline earlier than noon. (See fig. 2.1.)

One clearinghouse president that we spoke with summarized the difference between collecting banks and Reserve banks in the following manner: One reason the Federal Reserve adopted noon presentment was to

⁶Alternatively, a paying bank may pick up its checks from a Reserve bank at the dispatch time.

⁷These changes, in part, enabled Reserve banks to reduce the amount of their check float from about \$2.2 billion a day in 1982 to about \$0.3 billion a day in 1984. Assuming a 6-percent interest rate for both 1982 and 1984, the float reduction would amount to an annual financing cost savings of over \$100 million. Without such savings, the cost of producing 1984 levels of check collection would have been about 39 percent higher.

Chapter 2
Differences in Ability to Obtain Payment on
Checks Affect the Competitive Balance

Table 2.1: Range of Per-Check Presentment Fees Paid by One Collecting Bank in 1987

State	Number of banks	Range of per item fees
1	5	\$.0100 to .0800
2	1	.0165
3	3	.0100 to .0150
4	1	.0250 to .0780
5	5	.0190 to .1200
6	2	.0050 to .0762
7	1	.0210
8	1	.1200
9	1	.0130
10	2	.0170 to .0220
11	1	.0100
12	1	.0250
13	10	.0300 to .1700
14	1	.0150
15	2	.0250 to .0600
16	3	.0120 to .0140
17	1	.0230
18	1	.0230
19	4	.0150 to .0230
20	2	.0140 to .0300
21	1	None

Given the large number of checks presented, per-check fees incurred by collecting banks—even when amounting to as little as 1/2 of 1 cent per check—may add significantly to the cost of doing business. Other charges also add to the cost of collecting checks. According to price lists we examined, charges can range from \$7.50 to \$100 per month for account maintenance, 50 to \$125 per month for balance reporting, and \$5.50 to \$16 for each funds transfer.

We were not able to examine bank records to verify the extent to which presentment fees increase collecting bank costs. However, an analysis prepared by one collecting bank regarding its presentments to other banks within the same Federal Reserve district showed that fees paid to these other banks amounted to about 18 percent of its check collection costs. Other collecting bank officials we spoke to estimated that the costs associated with presentment were much higher. They said presentment fees constituted about 40-50 percent of the cost of collecting an average check.

- present checks to paying banks through account relationships. Collecting banks may open accounts at paying banks and deposit checks into those accounts much like any bank customer. Under the terms of the U.C.C., paying banks could take up to 2 days to make funds available for withdrawal provided that the paying banks make provisional settlement by midnight of the day of deposit.
- present checks to paying banks without having established account relationships. In turn, paying banks have until midnight of the day of presentment to make payment or dishonor the checks. Payment, however, may take the form of a remittance instrument, which is, in essence, a check drawn on another bank. Such a form of payment can delay the payout of usable funds for another day or more because the instrument is subject to the same type of collection processes as the original check.
- present checks to paying banks without having account relationships but, as an alternative to accepting remittance instruments, demand cash. Accepting cash can entail hiring a courier to go to the bank and present checks one at a time to that bank's teller. Since tellers verify the authenticity of checks before releasing funds, such an "over-the-counter presentment" would amount to a time-consuming, costly undertaking without a guarantee that sufficient time would be available to cash all checks the same day. Moreover, collecting banks may need to hire armored trucks and guards to transport the cash received. The banks then would have to convert the cash to some interest-bearing asset. Furthermore, any collecting bank that participates in such a tactic could be subject to the same tactic in retaliation.

Each day's delay in obtaining payment from paying banks diminishes a collecting bank's ability to compete with Reserve banks. For example, on an average check, it would cost a collecting bank about 22 cents if it made funds available to a depositing bank 1 day before obtaining funds from the paying bank.³ In comparison, Reserve banks generally charge between 0.5 and 5 cents per check for collection services depending on the location of the banks and the level of service required. Accordingly, setting collection prices competitive with Reserve bank prices while incurring such interest costs is not a practical option available to collecting banks.

³The cost was computed using the average 1987 interest rate (federal funds rate) for interbank borrowing—6.7 percent—against the average value of checks written in 1987—about \$1,188. See David B. Humphrey and Allen N. Berger, *Market Failure and Resource Use: Economic Incentives to Use Different Payment Instruments*. Paper presented at the Federal Reserve Bank of Richmond Payment System Symposium, May 1988.

Differences in Ability to Obtain Payment on Checks Affect the Competitive Balance

To operate a competitive check collection business, a collector—either a Reserve or collecting bank—must provide same-day funds on most checks deposited by its customer banks. Providing same-day funds in a competitive market involves giving customer banks as much time as possible to get checks to the collector yet leaving sufficient time for the collector to present checks to the paying banks and obtain same-day payment. Collectors need to obtain same-day payment because float expenses—the interest cost of making funds available to customer banks before collection from paying banks—could readily exceed the earnings from collection prices in today’s competitive market.

In this chapter, we analyze differences between Reserve and collecting bank abilities to present checks to other banks for same-day payment and the effects these differences have on competition.

Only Reserve Banks Can Require Same-Day Payment Without Charge

The terms and conditions under which Reserve banks require payment are specified by the Board of Governors in Federal Reserve Regulation J and bank operating circulars. These terms are

- a paying bank must pay for all checks that it has not returned before the close of its banking day of receipt;
- payment is to be made in an amount equal to the amount of the checks;
- payment is to be made (1) by debit to an account at a Reserve bank, (2) by cash, or (3) at a Reserve bank’s discretion, by another form of payment; and
- payment proceeds are to be available to the Reserve bank before the close of its banking day.

The terms and conditions established by the Federal Reserve require quicker payment than banks are required to give other banks under the terms of the Uniform Commercial Code (U.C.C.).¹ Under certain circumstances, the U.C.C. provides that funds availability may be withheld for as long as 2 days. The U.C.C. also provides, however, that its terms, such as the timing of payment, may be varied by agreements among banks, such as in a clearinghouse arrangement, or by Federal Reserve regulation and operating circular. These Federal Reserve issuances are deemed by the U.C.C. to be agreements even if they are not agreed to by all parties.

¹The U.C.C. is a codification of commercial law established as a model for state adoption. Commercial codes patterned after the U.C.C. and governing commercial transactions such as check collection and settlement have been adopted by the 50 states and the District of Columbia. See pages 27-28 for a description of U.C.C. payment terms.

of disruption to the payments system that could result from such proposals; administrative feasibility; and the ability of competitive market forces to bring prices into line with underlying economic costs.

Our judgments were guided by assumptions we believe to be consistent with the objectives of the Monetary Control Act and the Competitive Equality Banking Act. We assumed that check collection benefits from the presence of both Federal Reserve and collecting banks in that competition contributes to the efficiency of the payments system. Moreover, we assumed that a safe, low-cost, reliable check collection system that ensures universal accessibility is necessary to avoid any possible degradation of the payments system and hence the efficient functioning of U.S. commerce and industry.

Our analysis concentrated on check collection services and not on electronic payment or other priced services. Federal Reserve staff were cooperative in providing information; however, our work was limited because some of the data we sought are not routinely kept. Also, owing to time constraints, we did not attempt to review Federal Reserve internal controls or attempt to verify the accuracy of the data supplied. However, our 1985 review of the Federal Reserve cost-accounting system for check collection provided us some assurance of the accuracy of its Planning and Control System. We are not aware of any material changes to this system that would make information less reliable than before.

Although collecting banks, clearinghouses, and other associations we dealt with were also helpful in supplying needed information, very little industrywide data had been compiled that could help describe the state of the check collection industry. Therefore, we relied on unverified data provided by those bankers.

In April 1988, after being briefed on the results of our work, the Federal Reserve Board requested public comment on a concept designed to facilitate same-day payment on checks presented to paying banks by collecting banks. This development is discussed in chapter 2.

Our work was done in accordance with generally accepted government auditing standards. As provided in the Competitive Equality Banking Act of 1987, we did this study in coordination and consultation with the Board of Governors of the Federal Reserve System. We discussed with them the proposed scope of our work on the principal issues discussed in this report and our tentative conclusions.

- whether the Federal Reserve System requires check clearinghouses to provide services to the Federal Reserve banks and whether Federal Reserve banks should pay check clearinghouses for any such services.

Each of the issues raised involves specific aspects of collecting banks' ability to compete with Reserve banks. Thus, this report addresses the overall issue of competitive fairness. To do this, we

- reviewed existing data on the present state of competition between Reserve and collecting banks,
- identified differences between Reserve and collecting banks that affect competition,
- evaluated the pros and cons of proposals that could make competition more equal, and
- considered the goal of competitive fairness in the check collection business in the context of other payments system goals.

From this information, we drew conclusions and made recommendations on ways competitive fairness can be enhanced in the check collection system.

Our work was done in Chicago, New York, San Francisco, Houston, and Washington, D.C., between August 1987 and December 1988. In Washington, D.C., most of our work was done at the Board of Governors. We selected Chicago, New York, and San Francisco on a judgmental basis to include areas of significant banking activity and to obtain broad geographic coverage. We selected Houston to look into complaints about the interaction between the Houston clearinghouse and the Houston Reserve bank. These complaints, in part, prompted the congressional mandate for this study.

In doing our work, we documented and analyzed the procedures and decision-making process followed by Reserve banks and clearinghouses in collecting on checks and the characteristics of selected pricing decisions made by the Reserve banks. We interviewed representatives from clearinghouses in Chicago, New York, San Francisco, and Houston. The number of interviews we held with individual banks was necessarily limited; however, we also interviewed spokespersons from bank trade associations that represent the interests of thousands of banks nationwide. As part of these interviews, we sought out representatives from various groups of banks that provide and use collection and clearinghouse services to determine the effects, if any, that Federal Reserve actions have had on banks' decisions to either offer or use collecting

actions have had the intent and effect of reducing competition in and creating Federal Reserve dominance of check clearing.¹⁷

Grappling with the issue of competitive fairness is made difficult by the inherent differences that exist between Federal Reserve and collecting banks. On the one hand, collecting banks have greater latitude than Reserve banks in selecting which customers they serve and the prices they charge. On the other hand, the central bank's unique status as a federal entity allows it to operate a nationwide check collection network without regard to interstate branching restrictions. The differences between the competitors and the effect these differences have on their ability to compete for customers is discussed in the following chapters.

Federal Reserve Efforts to Promote Payments System Efficiency

The Federal Reserve, besides being a competitor, is also responsible for maintaining an efficient payments system. Accordingly, over the years the Reserve banks have introduced innovative services to accelerate the collection on checks or otherwise improve the efficiency of the system. Some of the individual steps taken by Reserve banks to improve collection system efficiency include the following:

- Beginning in 1916, Reserve banks provided check collection services to members to eliminate paying banks' practice of paying some percent less than the full value of checks. This practice, known as non-par banking, was believed by some to result in the circuitous routing of checks and was thus considered a costly impediment to commerce and economic growth. According to Federal Reserve officials, by 1920 only 6 percent of U.S. banks would not remit at par, a practice that was eliminated by 1980.
- The Federal Reserve encouraged the use of a standard machine readable code, called Magnetic Ink Character Recognition. Starting in the 1970s, all checks collected by Reserve banks were required to be fully encoded before being deposited with a Reserve bank. This encoding makes possible the efficiency gained from automated check processing.
- Throughout the 1970s and 1980s, the Federal Reserve developed new programs and products to speed collection on checks and thereby enable payments to be made 1 or more days earlier. For example, the Regional Check Processing Center program sped collection by creating zones of same-day payment where availability had been deferred 1 day. Commencing in 1972, all banks were required to pay Reserve banks on the

¹⁷Committee on Banking, Finance and Urban Affairs, *The Role and Activities of the Federal Reserve System in the Nation's Check Clearing and Payments System* (Comf. Print 98-17, 98th Cong., 2d sess., Nov. 21, 1984), p. 34.

Legislation Recognized Differences Between Competitors

Congress considered some of the differences between the two competitors when it mandated the Federal Reserve to start pricing its services. Congress reduced certain price advantages held by the Federal Reserve because of its status as a government entity but also gave it the flexibility to consider other factors besides competition when setting its prices. More specifically, the Monetary Control Act requires that the Federal Reserve

- set prices high enough to recover all direct and indirect costs, including an estimate for the cost of financing any float incurred when collecting on checks.¹³
- set prices high enough to recover taxes that would have been paid and profits that would have been earned had the collection services been provided by a private sector firm.¹⁴
- give due regard to the provision of an adequate level of services nationwide as well as competitive factors when setting prices. However, if check volume declines or is projected to decline, the act requires the Board of Governors to make commensurate reductions in the operating budgets of the Reserve banks.

Also, Congress dealt with federal and state branch banking restrictions that limited the number of locations where collecting banks could receive checks. In the Competitive Equality Banking Act of 1987, banks were given the authority to pick up checks across state boundaries by operating relay points nationwide for the purpose of collecting on checks and similar instruments. The act did not, however, authorize banks to open branches nationwide.

Competitive Fairness Has Been of Continuing Interest to Congress

Congress has recognized that the topic of competitive fairness between Reserve banks and collecting banks is worthy of continued oversight. In 1983, on the basis of complaints by a coalition of banks, the Senate Banking Committee asked us to study how the Federal Reserve priced its services. In 1984, two House Committees issued reports that discussed the nature of competition between Reserve banks and collecting banks.

¹³Float arises when funds are disbursed to a depositor 1 or more days before they are collected from the paying bank. The cost to the check collector is a function of the current interest rate, that is, the financing costs of obtaining funds that are then made available to the depositor.

¹⁴The Federal Reserve refers to this recovery as the private sector adjustment factor.

According to 1985 Bank Administration Institute statistics, 42 percent of all checks took an average of 1-5 days from the date of deposit to complete the return process, 43 percent took an average of 6-9 days, and 15 percent took an average of 10 or more days. Because of these delays, banks have traditionally not made funds from deposited checks immediately available to their customers.

In response to the requirements in the 1987 Expedited Funds Availability Act, the Federal Reserve issued Regulation CC, changing the returned check process to speed the return of checks and reduce the risk caused by depositing banks making funds available to customers more promptly. Since the regulation's effective date of September 1, 1988, checks can be returned as quickly as they are forwarded and banks are required to make funds available to their depositors in accordance with specified schedules.

Legislative Oversight to Promote Competition

Before 1980, the Federal Reserve generally provided its check collection services only to member banks. Those member banks, however, could use Reserve banks' check collection services on behalf of nonmember banks. Although Reserve banks did not explicitly charge member banks for collection services, they were required to maintain relatively high non-interest-earning reserves mostly in the form of deposits at a Reserve bank.

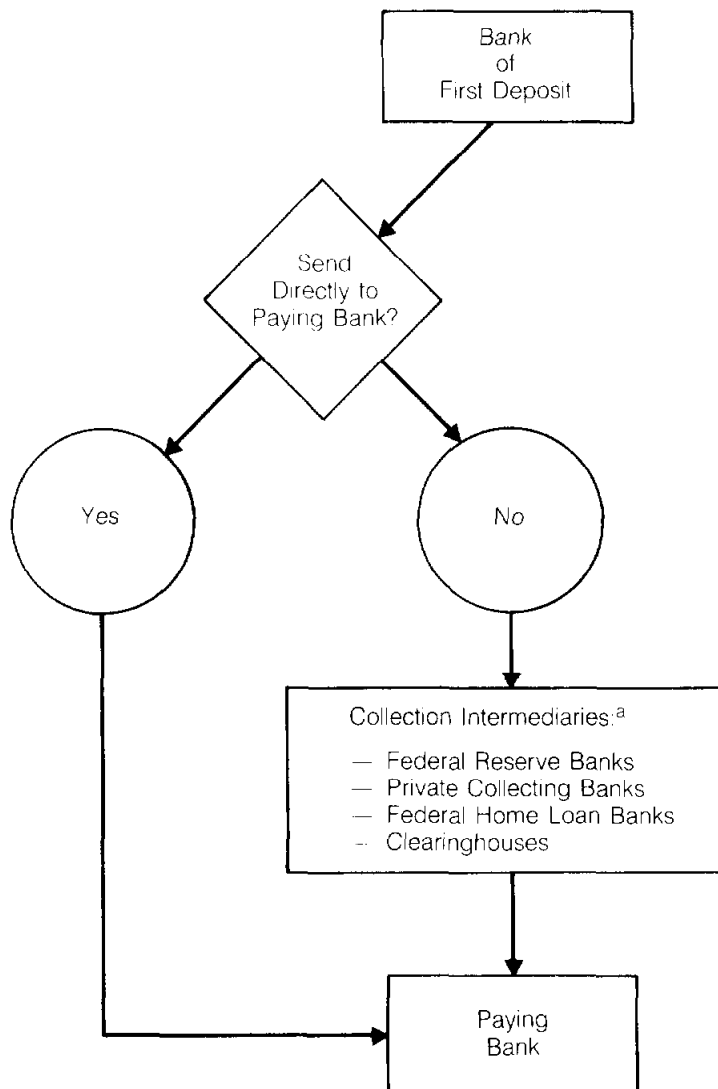
The market for check collection services was thus segmented into what amounted to a wholesale and retail market arrangement. The Federal Reserve, like a wholesaler, made check collection services available to those banks that paid to become member banks. Those member banks, in turn, could retail those collection services to nonmember banks.

The Monetary Control Act of 1980 changed this relationship between Reserve banks and collecting banks in an attempt to deal with other problems facing the Federal Reserve. During the 1970s, many banks were withdrawing from the Federal Reserve System to avoid its reserve requirements.¹⁰ The Federal Reserve and Congress believed that a reduction in membership would impair the Federal Reserve's ability to conduct monetary policy. To deal with the declining membership, the act

¹⁰National banks, which are chartered by the Comptroller of the Currency, are required by law to be members of the Federal Reserve. State-chartered commercial banks may elect to become members if they meet the requirements established by the Board of Governors.

- send all or some of the checks to a Federal Home Loan bank, or
- send the checks to a clearinghouse, provided that both the bank of first deposit and the paying bank are members of the same clearinghouse.

Figure 1.1: Path of a Check Requiring Collection



^aCollection intermediaries have the option of using another intermediary to present checks for payment.

responsibilities.⁴ Hence, the Federal Reserve's direct regulation of the check collection system was extended from those checks handled by Reserve banks to every check in the Nation.

Federal Reserve and Collecting Banks Compete for Check Collection

Three types of collecting banks compete with Federal Reserve banks for customers (other banks) in need of a check collector. These include regional collecting banks, national collecting banks, and Federal Home Loan banks.⁵

The first type, regional collecting banks, collect on checks drawn on banks in a limited, predetermined territory. They rely on either Reserve banks or national collecting banks to collect on checks drawn on more distant banks. The Federal Reserve estimates that approximately 200-300 banks fit this description.

The second type of collecting bank competes with Reserve banks on a national level. National collecting banks directly present checks for payment to as many as 200 other banks. They may act as collecting banks for regional collecting banks and others that may not be serviced by regional collecting banks. The Federal Reserve estimates that approximately 20 banks operate on a national level.

In 1981, the third type of competitor arrived on the scene. With the passage of section 311 of the Consumer Credit Checking Account Act of 1980 (Public Law 96-221), Home Loan banks were authorized to, among other things, accept deposits from member institutions (savings and loan and savings banks) and to engage in the collection and settlement of checks.⁶ Unlike the other collecting banks and Federal Reserve banks,

⁴In addition to its existing administrative enforcement powers, the act authorizes the Federal Reserve to prevent federally insured institutions from doing business with those payments system participants that are not regulated by one of the federal banking agencies and are not in compliance with the act or its implementing regulations.

⁵Together, we refer to these as collecting banks. The term collecting bank is used to refer to those banks that offer check collection services as a line of business as well as those banks that do the check collection function as part of their banking responsibilities. Acting as a collecting bank does not, however, preclude these banks from also functioning as a paying bank. The term paying bank refers to banks that provide specialized payment services as a line of business, such as cash management, and those that pay checks as part of their banking responsibilities.

⁶The Federal Home Loan banks are quasi-governmental entities that operate similarly to the Federal Reserve banks in that they are required to price services explicitly; make services equally available to all thrift institutions; recover, over the long run, direct and indirect costs that include the taxes paid and the return on capital that would have been provided if the services had been furnished by a private firm; and recover the costs of financing any float incurred when collecting on checks.

Introduction

When a check written on one bank is deposited in another, the bank in which it is deposited must initiate collection procedures to receive payment on that check.¹ To obtain payment, banks often employ the services of either Federal Reserve banks or other banks, referred to as collecting banks. This report concerns the competition that exists between Reserve banks and collecting banks providing check collection services. Collecting banks that compete with Reserve banks assert they are at a disadvantage vis a vis the Reserve banks. These assertions prompted Congress to request this study of competition in the check collection industry.

Efficient and Reliable Check Collection Is Important

The Nation's payments system is composed of nonelectronic and electronic payments. (See app. I for a synopsis of the 1987 estimated volume and value of different payment instruments.) Because of the composition of the payments system, some of the competitive issues raised regarding check collection are also relevant to electronic payments. This report, however, primarily concerns the competitive issues involving nonelectronic payments, namely checks. Checks are the largest in dollar value of nonelectronic payments and, after cash, the largest in volume of transactions. In 1987, an estimated 47 billion checks valued at about \$55.8 trillion were written.

Of all checks written in 1987, an estimated two-thirds, or about 31 billion checks valued at about \$37 trillion, were deposited in a bank other than the bank on which they were drawn. Therefore, the efficient functioning of U.S. commerce and industry depends on the ability of the domestic banking system to collect on these checks; that is, to quickly and reliably convert paper checks to funds that are usable by the recipients.

The collecting banks' ability to collect on checks and satisfy customers' needs for usable funds helps explain why checks have not lost their popularity. Although between 1986 and 1987 the number of electronic payments grew at a faster rate than nonelectronic payments, electronic payments still comprise less than 0.4 percent of total transaction volume.

The banking systems' ability to quickly and reliably convert paper checks to usable funds is also, in part, attributable to the Federal

¹Bank is used to refer to any and all depository institutions.

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Abbreviations

ABA	American Bankers Association
ARCB	Association of Reserve City Bankers
IBAA	Independent Bankers Association of America
GAO	General Accounting Office
U.C.C.	Uniform Commercial Code

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Promoting Competition

GAO found no compelling reason why differences between the collecting and Reserve banks' abilities to present checks are essential for the safety, soundness, or efficiency of the check collection system. However, the Federal Reserve faces a difficult task in changing presentment rights to try to enhance the operation of the check collection system and achieve competitive fairness. The difficulty arises because paying and collecting bank interests are in direct opposition. Also, although it has expressed a fundamental commitment to competitive fairness, the Federal Reserve has not further defined this policy or developed criteria for evaluating competitive fairness. Without such criteria, it is harder for the Federal Reserve to deal with the potential conflicts of interest between its roles as competitor and overseer of the payments system. (See pp. 55-59.)

During the course of our work, the Federal Reserve sought public comment on allowing collecting banks to present checks up to 2:00 p.m. without paying presentment fees. Many paying banks opposed the proposal because the 2:00 p.m. deadline would disrupt cash management services. However, these objections in effect argue to preserve the Reserve banks' unique check presentment ability. Since the Federal Reserve does not have specific criteria for evaluating competition, it could appear that the Federal Reserve was acting merely to preserve its competitive position if it supported the views of paying banks. (See pp. 59-61.)

GAO agrees that the interests of paying banks need to be considered when the Federal Reserve implements changes to the check collection system. However, it does not follow that the only way to do this is to preserve all the Federal Reserve's presentment advantages. For example, collecting banks could be required to notify paying banks early in the day about check presentments that would be forthcoming—a service that is now provided by the Federal Reserve. (See p. 61.)

Recommendations

GAO recommends that the Federal Reserve Board of Governors adopt a policy and implementing procedures under which collecting banks have the same abilities to provide check collection services to their customers as Reserve banks unless the safety, soundness, or efficiency of the payments system demand otherwise. (See p. 62.)

GAO also recommends that the Federal Reserve apply the new policy to develop a revised, comprehensive same-day payment proposal. (See p. 62.)

Executive Summary

Purpose

When a check written on one bank is deposited in another, funds must be collected from the paying bank, the bank on which the check was written. To collect these funds, some banks—called collecting banks—and all Federal Reserve banks provide a check collection service for a fee.

Some collecting banks have asserted that competition with the Reserve banks for check collection business is unfair because Reserve banks operate under different rules that, among other things, enable them to avoid bank fees that collecting banks incur. As part of the Competitive Equality Banking Act of 1987, Congress asked GAO to determine the validity of the assertions.

Background

In 1987, an estimated 31 billion checks, or about two-thirds of all checks written, were initially deposited in a bank other than the paying bank. The Federal Reserve handled about 55 percent of these checks, a percentage far greater than any private sector bank. (See pp. 12-15.)

The Board of Governors of the Federal Reserve System performs two different roles in the check collection system. First, the Board is responsible for overseeing the business aspects of the Reserve banks' check collection operations. Second, the Board is responsible for overseeing the operation of the check collection system as a whole. In this connection, as a result of the Expedited Funds Availability Act of 1987, the Board is empowered to regulate the collection of checks by private banks. It used this power to change the way dishonored checks are returned to the bank of first deposit. (See pp. 15-16.)

In operating their businesses, collecting banks and Reserve banks are governed by different rules. Collecting banks are governed principally by state laws that stipulate rights for accepting and paying on checks. Reserve banks operate under rules set by the Board of Governors that in many instances vary from state laws. (See pp. 26-27.)

Results in Brief

Owing to the differences in the rules under which they operate, Reserve and collecting banks each have unique abilities to attract customers. However, the inability of collecting banks to match Reserve bank collection terms, especially obtaining same-day payment without incurring bank fees, has constrained the collection options open to collecting banks; the collection services they may sell; and, in turn, the potential efficiencies they may bring to the market. GAO found no evidence that
