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# PRICING AND ACCESS TO FEDERAL RESERVE SERVICES


Remarks by

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Pricing and Access to Federal Reserve Services

The Monetary Control Act of 1980 requires two fundamental changes in the way the Federal Reserve provides its payments services. First, our doors must be open not just to member banks, but to all financial institutions offering transactions accounts. The number of such institutions will soon increase sharply. Second, prices must be charged by the Federal Reserve for services rendered. These changes, along with the numerous technological innovations that are occurring in the financial world, may well have a profound and dramatic impact on our nation's payments mechanism.

None of us can foresee with any clarity what the payments mechanism will look like 10 years from now, or what the Federal Reserve's role in it will be. I certainly will not try to make any forecasts of that trend this morning. What I would like to do is to discuss with you briefly what the Federal Reserve's responsibilities are under the Act, as we see them; why the Board made some of its decisions embodied in the pricing schedule released recently; and some of the potential problems that we will all have to be alert to as the effects of the changes stimulated by the Act begin to unfold.

The changes in payments services mandated by the Act were motivated by Congressional and Federal Reserve concerns over the System's membership and related problems. Historically, only member banks have had

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direct access to Federal Reserve services. While there has been no explicit charge for these services, member banks certainly believe that they pay for them by maintaining non-interest bearing reserves. The Federal Reserve invests these reserves in Treasury securities and transfers the interest earned, net of operating expenses, back to the Treasury. The Congress did not believe, however, that this revenue transfer should be considered compensation for services received by member banks at no explicit cost.

The Federal Reserve was also concerned about the lack of explicit charges for services rendered. Implicit charges, unrelated to the quantity of services used, can lead to inequities and, more importantly, to serious economic inefficiencies. It was difficult to do anything about that situation, however, when only member banks were required to hold reserves at the Fed, particularly in light of the erosion of membership that had been occurring.

The Monetary Control Act of 1980, by requiring explicit pricing, open access, and universal required reserves at lower reserve ratios, responds to the concerns of both the Congress and the Federal Reserve. Explicit pricing should ensure that payments services are used more efficiently. We all recognize that goods and services that are free--or more generally, priced below cost--tend to be utilized in ways that are wasteful. Artificially cheap gasoline promotes too much driving; similarly, cheap payments services encourage wasteful use of resources.

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The law opens up new opportunities for the private sector to compete with the Fed, which will also help to increase efficiency. We anticipate, and indeed welcome, competition--not only from commercial banks, but from a variety of private sector suppliers of payments services. This competition will provide additional encouragement for innovation and will help to ensure that payments services are produced at the lowest possible cost.

As you know, we will begin pricing in January 1981, starting with our wire transfer and net settlement services. In April 1981 charges will be levied for check clearing and collection, and for automated clearinghouse services. Purchase and sale of securities, safekeeping and transfer of securities, and non-cash collection will be priced in October 1981. Pricing is being phased in, rather than introduced all at once, to facilitate as orderly a transition as possible to the requirements of the Act. Float will be handled through a three phase program that I will discuss shortly.

The only services exempted from pricing are those that fall into the category of public goods. These are services that benefit the public collectively, so that explicit prices would not serve a useful economic function. National defense is an often cited example of a public good. In the payment area, the storage, issue and retirement of currency and coin are examples.

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The announcement of proposed prices released recently includes a discussion of the principles governing the implementation of our fees. I would like to review these principles with you to provide some insight into how we designed our fee schedule and how we intend to improve the efficiency of the payments mechanism through pricing.

The Act and its legislative history give us considerable direction as to how to implement pricing. For example, the Act not only requires that we recover the full cost of providing services, but also that we include in our costs an allowance for taxes and a profit markup. This adjustment factor is designed to put our costs in line with what they would be if we were a privately owned corporation. We had previously estimated an adjustment factor of this kind in November 1978, when we issued for comment a proposed schedule of prices for Federal Reserve check and ACH services. We received very detailed and thoughtful comments on that schedule from the ABA. In light of those comments, we revised our method of calculating this private sector adjustment.

The private sector adjustment now incorporated in our proposed prices adjusts all our costs upward by 12 percent. This figure was obtained by conceiving of our operations as if they were performed by a large commercial bank. The value of the assets to be financed was set at the historical cost of the assets actually employed by the Federal Reserve in the production of priced services. However, it was assumed that the maturity of our assets and the maturity of liabilities issued

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to finance them are approximately equal--that is, long-term assets were assumed to be financed with long-term liabilities and short-term assets with short-term liabilities. Estimates of the costs of the liabilities--debt and equity--and the taxes we would incur if we were a private firm were derived from the actual costs of a sample of large commercial banks.

The decision to use a large bank model as the basis for the private sector adjustment followed a lively debate in the Federal Reserve. There were some who favored using a public utility model, on the grounds that the Federal Reserve's operations closely approximate those of a public utility. That view did not prevail, but we have not ruled out altogether the use of a public utility model at some time in the future, at least for some of our services. In any case, we expect changes to be made in the size of the adjustment over time, since it will vary with changes in taxes and the cost of financing.

The Act leaves us free to decide whether prices should be established on the basis of costs measured at the District or national level. We have been guided by efficiency considerations in making that decision. For example, it makes sense to use local or District prices for services where costs differ significantly across Federal Reserve Districts (or across offices within the District), and where the market is local in scope. A nationwide price for such services might make us the low cost provider in high cost areas and uncompetitive in low cost

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areas. That would contribute to inefficient resource use. Therefore, District fees are proposed for coin wrapping, securities and noncash collection services; for currency and coin shipping services, prices are set at individual Federal Reserve offices. Fees for check collection services may be set at the District or office level, whichever would better reflect regional cost differences. Services that are nationwide in scope will be priced uniformly across the Federal Reserve System.

Although this general method of differentiating our fees seems appropriate, we know that problems will occur that we have not foreseen. By retaining the flexibility to adjust fee schedules and respond to information gained from careful monitoring of the markets for these services, we will attempt to ensure that our fee schedule is working as intended.

Situations may arise where institutions desiring direct access to Federal Reserve services do not maintain a reserve balance with us, or one that is too small to permit direct payment for services. We felt it appropriate to accommodate the needs of such institutions by giving them two payment options. They can arrange to have their credits, debits and charges posted to the account of another institution that is maintaining an adequate balance and is agreeable to the arrangement; alternatively, they can maintain a clearing balance. These clearing balances would be in addition to any required reserves, and would earn an interest credit that could be used solely to offset charges for services received.

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The Act requires that we price Federal Reserve float. Elimination of float--through operational improvements, changes in availability schedules, or other ways--is, we believe, consistent with the requirements of the Act. We intend to do this in ways that will discourage remote disbursement and other practices that are economically wasteful from the standpoint of the nation as a whole. Moreover, in dealing with float, we hope to promote increasing use of electronic technology. To accomplish these objectives we have announced a three phase program for float as part of our pricing schedule.

The first phase calls for improvements in Federal Reserve operations that can be cost justified. We have no intention of spending sums on operational improvements that exceed the value of the float reduction that they would promote. Rough estimates suggest that a 50 percent reduction in float can be achieved by a less than 10 percent increase in the costs of check collection. Our Interdistrict Transportation System is undergoing improvement already and further steps are scheduled. Far more cost-effective improvement can be achieved, we believe, through the use of telecommunications. We are exploring carefully the legal and operational problems of electronic check presentment, particularly for large dollar value checks. Implementation of electronic check presentment may prove to be a feasible transition to electronic initiation of both debit and credit items.

The second phase will begin in September 1981, when availability schedules will be increased by fractions of days to reflect actual collection

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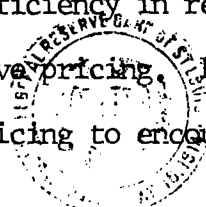
times more accurately. We expect these changes to amount to no more than 2%-4% for local items and 6%-10% for inter-District items. In order that the link between availability and collection times be strengthened, we are exploring the possibility of using wire advice of credit along with fractional availability.

After phases 1 and 2 have become fully operational, we expect float to be reduced to negligible levels. Beginning in the first half of 1982, an explicit charge will be levied for any remaining float. The value of float will be assessed at the prevailing Federal funds rate, and the fee probably will be incorporated into the charge for the function creating the float.

Our program for handling float aims at minimizing real resources expended, whether by us or the private sector. As I indicated, in considering operational improvements we are weighing carefully the potential reduction in float against the cost of achieving it. If, however, our actions prompted a major unanticipated investment in real resources in the private sector, we would have to reexamine them to determine whether a more economical method of float reduction might not be available. It is the total benefits and costs of float reduction that matter most, not just the benefits and costs to the Federal Reserve.

To promote greater efficiency in resources, we also expect to resort to some forms of incentive pricing. For example, after further study we may adopt peak load pricing to encourage a more even work load



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over the day--rather than the peak periods we now observe, followed by slack times when our facilities go underutilized. Peak load pricing has been used for some time in other areas in the economy, and could be beneficial in the payments mechanism.

Also, there are electronic substitutes for paper checks that have been promoted by the Federal Reserve, with some success, that might be encouraged by incentive pricing. For example, we have made substantial commitments to the ACH program because it has the potential to reduce operating costs for the Federal Reserve, the financial industry and the public. It also offers the consumer a more reliable and efficient method of making and receiving payments. For these reasons, automated clearinghouse services will be priced from the beginning as if we had already attained a mature volume.

A complement to ACH is the greater use of electronic delivery. Currently, most ACH payments depend on messenger and courier services for delivery from the ACH to financial institutions. Using messenger and courier services to deliver electronic payments detracts from many of the operational and cost advantages that ACH offers. As a consequence, ACH funds availability schedules are generally no better than for paper checks. Courier delivery of ACH payments is also more costly than electronic delivery and more susceptible to transportation delays. A preferable delivery method depends on electronic terminals being used to transmit ACH payments items. Incentive pricing is now under consideration as a potentially useful way of encouraging the development of terminals.

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Let me turn now to some concerns that some of us in the Federal Reserve have about how the payments system might evolve under the new arrangements. Explicit pricing for services will, I have argued, promote a more efficient use of resource in the payments mechanism. It is also true, however, that competitive markets probably lead to a larger use of real resources in collecting checks than is socially desirable. That is true because payors and their banks can realize profits by using real resources to slow down the collection process, while payees and their banks benefit by using real resources to speed it up. A substantial part of the resources so utilized may be contributing nothing of value for the nation as a whole.

Social waste of this kind could become worse in a system in which the Federal Reserve and the private sector compete actively to obtain, or maintain, an operational presence in the payments mechanism. For example, what if competition led to a duplication of the Federal Reserve's transportation network by the private sector? One could hardly argue that society would benefit from this type of competition.

We firmly believe that if private financial institutions can produce and sell payments services competitively more cheaply than the Federal Reserve, the nation may well be better served if they do so. But suppose that competition resulted in less profitable markets being subjected to vastly higher charges for payments services than more profitable areas. Such an outcome might occur if private competitors

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were able to chip away the lower cost, higher profit, areas, leaving the Federal Reserve to service remote locations with high transportation costs. The prices we would have to charge to cover our higher average cost per item might rise to levels that are socially and politically unacceptable. Such a situation would almost certainly attract Congressional attention and give rise to calls for corrective action.

I do not raise these concerns because I am pessimistic about the results of pricing for our services--quite the contrary. I merely want to underscore that we are breaking new and unfamiliar ground, and we cannot be entirely sure what lies beneath. Historically, the Federal Reserve has played a large role in the operation of the payments mechanism. That role may expand or contract. We are entirely prepared to see it contract as long as the nation is provided with an adequate level of services at reasonable cost and at competitive prices. Any other outcome, however, would not be acceptable to us, to the Congress, or to the public at large.

I am confident that the new arrangements mandated by the Monetary Control Act of 1980 will be of substantial long-run benefit to the payments mechanism and to our nation's economy. Many of you in the private sector, I am sure, are anxious for the opportunity to compete with the Fed. We welcome your rivalry. We intend to give you a tough, but fair, battle. May the best and most efficient win.

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