

FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 78-166

December 1, 1978

**TO ALL BANKS
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:**

The Board of Governors of the Federal Reserve System has released a preliminary schedule of prices for Federal Reserve check and automated clearinghouse services (a proposal containing the schedule is attached). The tentative schedule was developed by the Board and the 12 Federal Reserve Banks as part of a comprehensive plan to provide greater competitive equality among financial institutions. No price schedule will be implemented until effective steps have been taken to alleviate the burden of membership in the Federal Reserve System.

Price schedules for other services such as the provision of coin and currency; wire transfers of funds; the purchase, sale, safekeeping, and clearing of securities; and noncash collection are under consideration.

The pricing of check collection services suggested in the attached schedule is based on the volume of check clearings by the Federal Reserve in the first half of 1978. The prices are meant to recoup direct and indirect costs of providing such services. In addition, adjustments totaling 11 percent of these costs have been added to reflect additional costs that would be borne in the private sector. These adjustments include capital costs, taxes, an allowance for dividends, and provision for reserve.

Prices for automated clearing and settlement services have been calculated to be competitive with check prices. Establishment of prices for automated clearinghouse services at this level is intended to encourage banks and their customers to take advantage of the potentially lower cost of electronic fund transfers as compared to the cost of payments by check, while still affording opportunity to develop competing automated clearing and settlement services in the private sector.

Before a final decision is made on pricing, the Federal Reserve will consider the advisability of establishing different prices for each zone in some Federal Reserve districts.

Please send any comments on the attached proposal to me in care of this Bank, Station K, Dallas, Texas 75222. In addition, I would be pleased to discuss this matter with any interested banks.

Sincerely yours,

Ernest T. Baughman

President

Attachment



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

Proposal for pricing of Federal Reserve
Check Collection and Automated Clearing and Settlement Services

November 17, 1976

In connection with legislation to enhance competitive equity in banking, to improve monetary policy and to relieve the burden borne by Federal Reserve member banks, one of the issues under discussion during the recent session of Congress was pricing of Reserve bank services. Service charges were one element of the comprehensive plan addressing these issues that the board submitted to the Congress last summer. In addition, many of the bills under consideration by the Congress required the Federal Reserve to publish a price schedule for its services to financial institutions. At hearings on the bills, members of Congress and other interested parties commented that a price schedule for Reserve bank services was needed in order to evaluate fully the effects of the proposed legislation.

In response to these comments, the System has prepared a preliminary proposal for charging for Reserve bank check collection and automated clearing and settlement services. A tentative price schedule is presented to elicit additional discussion. The System particularly hopes to receive indications of the competitiveness of the prices in relation to prices for comparable services (where available) in local markets. In addition, the system expects to receive analyses of the effects of implementing these prices on the banking industry and upon other users of payments services.

Attachment 1 to this proposal shows a tentative schedule of prices approximating those that would have been in effect in the first half of 1976 covering check collection and Automated Clearing House (ACH) clearing and settlement services. The payments mechanism services in this initial schedule account for about 60 per cent of the total expenses incurred by the Reserve Banks in providing services to financial institutions. Preliminary prices for the remaining services are in preparation and will be available later.

Implementation of Prices

Charges for Reserve Bank services could enhance the efficiency of the nation's payments mechanism. Such charges would promote both cost effective payments techniques and equity among institutions providing payments services to the public. However, the Federal Reserve System does not intend to implement service charges until effective steps have been taken to relieve the burden of membership in the Federal Reserve. Otherwise, the already very serious problem of withdrawals from the System would simply be exacerbated.

The Federal Reserve recognizes that these preliminary prices may have to be adjusted to reflect competitive realities and changing conditions in the industry and in the Reserve Banks. Furthermore, at the time of implementation, the System would monitor developments and could revise the prices to avoid disruption of existing clearing arrangements.

Objectives of Pricing

In constructing the tentative price schedule, the System has

been guided by the policies announced by the Board on July 10, 1978 in conjunction with its plan to resolve the membership problem. The Board stated that service charges should promote competitive equity among users of Federal Reserve services, encourage innovation and more efficient use of payments services, and enhance the opportunities of the private sector to compete with and improve upon Federal Reserve services. In addition, the Board announced that charges would be established with due regard to the need to assure continued efficient functioning of the payments mechanism, to avoid major disruption during the transition to a more competitive environment, and to maintain a satisfactory basic level of service nationwide.

Derivation of the Prices

The schedule in Attachment 1 shows prices approximating those that would have been in effect if service charges had been implemented in the first half of 1978. The check collection prices are based upon the cost accounting data recorded by the Planning and Control System (PACS) for the Reserve Banks. A markup of 11 per cent was applied to the total of direct and indirect PACS cost of providing the check collection service, after certain minor adjustments were made to refine the raw data.

The markup covers imputed costs similar to the capital costs and taxes that a private business firm providing the service would have borne. This markup or private-sector adjustment was calculated under the assumption that the Reserve Bank assets used in providing check collection services were financed one-half by debt and one-half by equity. The cost of servicing the debt

was assumed to be 9 per cent annually. The after tax cost of imputed equity was set at 7 per cent, equal to the 6 per cent statutory dividend that the System pays on Reserve Bank stocks held by member banks plus an added 1 per cent for reserve. The method used to construct the private-sector adjustment is described in Attachment 2.

No charge for Federal Reserve float is included in the check collection prices. There are alternative strategies for dealing with float that might be more desirable and should be considered. In addition there are uncertainties in measuring the value of float to society or to individual banks which cloud the issue of charging for float.

Tentative prices for ACH clearing and settlement services have been based upon projections of the estimated unit processing cost associated with probable future volumes of electronic payments items. Because of the inherent uncertainties, however, the preliminary ACH prices are set comfortably above the estimated long-run cost. The price for intra-ACH items equals the lowest District price for RCPC check items. These prices will permit banks, businesses, and consumers to reduce costs by converting to this new, highly efficient and secure electronic payments medium.

Level of Detail of Prices

The tentative price schedule presents the prices at the level of the Federal Reserve District. Service level differences, regional wage and transportation cost differentials, and other factors contribute to the differences among the District prices shown. Such differences may exist among offices within a District. Before a final decision is made on pricing, the System will consider the advisability of establishing different prices

for each zone in some Reserve Districts. For this reason, the System particularly hopes to receive indications of the competitiveness of the tentative price schedule compared with prices charged by others in those cases where comparable services are available in a local market. Disparities between the District average price and prices for comparable services in individual office zones could lead to inefficient volume shifts or have other undesirable effects on the payments mechanism. In such a case, adjustment of the prices may be necessary.

PRELIMINARY

Price Schedule

for

Federal Reserve

Check Collection

and

Automated Clearing and

Settlement Services

PRELIMINARY
 PRICE SCHEDULE
 FOR FEDERAL RESERVE CHECK COLLECTION AND ACH SERVICES
 (cents per item)

Federal Reserve District	<u>Cash Letters Deposited Directly at Processing Fed Office*</u>								<u>Cash Letters Consolidated with Shipments Sent from Other Fed Offices to Processing Fed Office</u>			<u>Automated Clearing and Settlement Services Items Deposited Directly at Processing Fed Office</u>	
	City	Country	RCPC	Mixed	Other Feds	Non-Mach.	Package Sort	Group Sort	City	Country	RCPC	Intra-ACH	Inter-ACH
Boston	1.5	--	1.5	1.9	3.7	3.9	.3	1.4	1.9	--	1.9	1.4	2.0
New York	2.2	2.4	2.0	2.0	4.5	5.6	.6	1.9	2.6	2.8	2.4	.3	1.5
Philadelphia	1.4	1.9	1.9	1.9	3.6	4.2	.6	1.5	1.8	2.3	2.3	1.4	2.0
Cleveland	1.3	--	1.9	2.0	3.5	4.1	--	--	1.7	--	2.3	1.4	2.0
Richmond	1.3	2.3	1.6	1.8	3.6	3.1	.2	--	1.7	2.7	2.0	1.4	2.0
Atlanta	1.3	--	1.5	1.6	3.4	3.9	.7	--	1.7	--	1.9	1.4	2.0
Chicago	1.5	2.3	1.6	--	4.0	3.4	.8	--	1.9	2.7	2.0	1.4	2.0
St. Louis	1.4	2.2	2.0	2.7	3.5	3.3	.5	--	1.8	2.6	2.4	1.4	2.0
Minneapolis	1.2	2.0	1.4	1.8	3.6	4.6	.6	1.2	1.6	2.4	1.8	1.4	2.0
Kansas City	1.2	1.9	1.4	2.2	3.4	3.5	--	--	1.6	2.3	1.8	1.4	2.0
Dallas	1.4	2.1	1.7	1.8	3.8	5.0	.7	1.6	1.8	2.5	2.1	1.4	2.0
San Francisco	1.3	--	1.4	--	3.6	4.2	.3	--	1.7	--	1.8	1.4	2.0
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)

* Includes Direct Send Cash Letters. Prices of other special deposit services will be available from each Federal Reserve office. Prices indicated are applicable at locations offering these services.

Attached to this schedule is a description of each of the services for which prices are shown in columns 1 through 13.

Description of Services

Cash Letters (Checks) Deposited Directly at the Processing Federal Reserve Office

The prices shown for the eight types of cash letters apply both to checks deposited by financial institutions located in the processing Federal Reserve office territory and to those checks sent directly by institutions located in other Federal Reserve office territories. (The latter institutions provide the required transportation to meet the deposit deadlines at the processing Federal Reserve office.)

The Federal Reserve intends to discontinue direct send transportation reimbursements with implementation of pricing.

City

City checks are drawn on financial institutions located in the same city as the processing Federal Reserve office. City check services are available at 43 Federal Reserve offices. Credit for city checks is available on the day of deposit at the processing Federal Reserve office if timely deposit is made (i.e., prior to the established cut-off hour. (Column 1)

Country

Country checks are drawn on banks that are geographically located outside a Federal Reserve office city and outside the area served by Regional Check Processing Center (RCPC) operations. Presentment of checks to country banks usually is made through the U.S. Postal Service. Country check services are available at 13 Federal Reserve offices. Credit for country checks is available one day after timely deposit at the processing Federal Reserve office. (Column 2)

RCPC

RCPC checks are drawn on financial institutions located in geographic areas designated as RCPC zones. Checks drawn on RCPC financial institutions are usually transported by courier for presentment. There are 44 Federal Reserve offices that offer RCPC check services. Credit for RCPC checks is available the same business day if the items are deposited by 12:01 a.m. (Column 3)

Mixed

Mixed cash letters contain checks drawn on financial institutions located in city, country, RCPC and in other Federal Reserve office territories. At present, only those member banks with less than 5,000 items to be cleared each day are eligible to deposit mixed cash letters. Mixed cash letter services are available at 27 Federal Reserve offices. Credit for checks deposited in mixed cash letters normally is available the day after deposit if the deposit is made before the processing Federal Reserve office "city check cut-off hour". (Column 4)

Other Feas Other feas cash letters contain checks drawn on financial institutions located in all Federal Reserve office territories other than the processing Federal Reserve office territory. Prices for collecting these checks reflect the resources required to sort the checks at two Federal Reserve offices and to transport the items between these offices. All 46 Federal Reserve offices offer this service. Credit for Other Feas cash letters is available 1 or 2 days after timely deposit at the processing Federal Reserve office. Such credit is dependent on the availability of overnight transportation and the type of item (city, country or RCPC). (Column 6)

Non-machineable Non-machineable cash letters contain checks which have been rejected from the computer sorting equipment of the depositing financial institution, and those checks which are mutilated and cannot be computer processed. Prices for non-machineable checks reflect the additional manual handling required to process these exception items. Credit for non-machineable checks is deferred one day beyond normal for the same type check (e.g., credit for a city non-machineable check would be available the day after timely deposit to the processing Federal Reserve office). (Column 6)

Package Sort Package sort cash letters contain only checks that are drawn on one financial institution and are packaged for delivery. Federal Reserve service is limited to presentment and settlement. The package sort service is currently offered at 24 Federal Reserve offices. Later cut-off hours are applicable to package sort cash letters and credit is available on the same schedule as for city, country, and RCPC items. (Column 7)

Group Sort Group sort cash letters contain checks of a specific type (i.e., city, country or RCPC) which have been partially processed by the depositing financial institution. For example, the first pass through a check sorter of a multiple-pass sorting process would constitute a group sort. Seven Federal Reserve offices offer this service. Later cut-off hours are also applicable to group sort cash letters and credit is passed to depositing institutions on the same schedule as for city, country and RCPC items. (Column 6)

Cash Letters Consolidated with Shipments Sent from Other Federal Reserve Offices to the Processing Federal Reserve Office

The consolidated shipment service consists of consolidating direct send check shipments with regularly scheduled Federal Reserve inter-office check shipments. The cash letter types listed (city, country and RCPC) are the same as those described earlier. The price for these items reflects the costs associated with receiving, sorting, reconciling, settling, and presenting checks by the processing Federal Reserve Office, and the price

for transporting the checks between Federal Reserve offices. Those financial institutions authorized to use the consolidated shipment service are also authorized to direct send checks to processing Federal Reserve offices. (Columns 9, 10 and 11)

Automated Clearinghouse Services -- Items Deposited Directly at the Processing Federal Reserve Office

The prices shown, except at New York, are applicable at all Federal Reserve operated clearing and settlement facilities and include receiving, sorting, reconciling, settling and delivery of either debit or credit automated clearing house (ACH) transactions. New York prices reflect the provision of ACH clearing operations in the private sector and settlement by the Federal Reserve.

Intra ACH

Payment transactions received from local originating financial institutions for delivery to financial institutions located in the same ACH area. (Column 12)

Inter ACH

Payment transactions received from local originating financial institutions and from private sector ACH facilities for delivery to financial institutions in areas served by other ACHs. (Column 13)

Derivation of Private Sector Adjustment

The Federal Reserve System's cost accounting includes depreciation of buildings, furniture, and equipment (at historical cost) but does not include any of the costs which the System implicitly incurs to finance these or other asset acquisitions. To reflect these implicit financing costs as if the Federal Reserve System were a privately owned enterprise, an adjustment factor was developed which has been added to the direct and indirect costs recorded in the Federal Reserve cost accounting system.

In computing the adjustment factor, a determination had to be made of the assets employed in providing services. It was assumed that such assets were financed in a way similar to the way the private sector finances assets. Total System assets to be financed were assumed to include existing net book value of buildings and equipment and other "working capital" assets. Assets solely identified with central bank functions, such as holding Gold Certificates, SDR's, Acceptances and Treasury and agency securities were not included because such assets are not used in providing services. Because there are alternative strategies for dealing with Federal Reserve float that may be more desirable, float was excluded from the computation of working capital assets. Also excluded were Federal Reserve assets associated with the foreign function and any premium on securities derived from not reflecting securities in the portfolio at cost on the balance sheet. Based on the average of six month end balance sheet reports for the twelve Federal Reserve Banks during the first half of 1978, total System assets to be implicitly financed were calculated to be \$752 million as shown in Table 1.

The capital structure which was assumed to finance the \$752 million in assets included 50% equity and 50% debt.

The return on equity was assumed to be 7% after tax or 13% before tax, given an income-tax rate of 45%. The interest rate on debt was assumed to be 9%.

Not all of the imputed \$752 million in assets would be required to provide the services to financial institutions that would be priced. Therefore, a calculation was made to exclude assets supporting such functions as monetary and economic policy, supervision and regulation, and services to the Treasury as fiscal agent. Service charges for these functions are not included in this pricing proposal. Capital assets were allocated to priced services based upon ratio of the cost incurred for such services during the first half of 1978 to the total cost of all System services during that period. Because shipping services are contracted from the private sector, the cost of shipping was subtracted from both the numerator and denominator of the ratio. During the first half of 1978 the cost of services to be priced less shipping expense represented about 54% of total System costs minus shipping expense. A total of \$402 million in assets was therefore allocated to the services to be priced.

On an annualized basis, the cost of the imputed debt of \$201 million, at a 9 per cent annual rate, would be \$18 million. At a 13 per cent annual pre-tax rate of return, the cost of the imputed equity would be \$26 million. The \$44 million resulted in a markup of 11 per cent on the \$402 million of direct and indirect cost of providing the services to be priced. This calculation is illustrated in Table 2. If the System had priced its services during the first two quarters of 1978 to recover direct and

indirect cost plus an adjustment of 11% for private sector costs, it would have generated revenues of \$223.1 million during this period.

Table 2 also shows the markup for the check collection services which accounts for 58% of the \$402.2 million in costs incurred by the Federal Reserve for all operations to be priced. Given a markup of 11%, \$128.6 million in revenues would be derived from check collection services at the 1978 volume for the first half of 1978.

TABLE 1

Implicit System Balance Sheet
 Underlying Private Sector Adjustment
 (\$ millions, Based on the Average of Six
 Month End Balance Sheets for First Half of 1976)

bank Premises, net	\$ 384.3	Debt	\$376.0
Difference & Suspense Accounts	192.5	Equity	<u>\$376.0</u>
Furniture and Equipment, Net	49.0		
Deferred Charges, Other	43.9		
Other Real Estate	42.2		
Overdrafts	38.2		
Deferred Charges, Leaseholds	<u>1.9</u>		
Total Assets Financed	<u>\$ 752.0</u>	Total liabilities	<u>\$752.0</u>

TABLE 2

Estimated
Implicit Revenue Statement
Underlying Private Sector Adjustment
Annualized, based on
First Half 1970
(50% debt; 50% equity)
(\$ millions)

	<u>All Operations to be Priced</u>	<u>Allocation* To Check Services</u>
Revenues	\$446.2	\$257.2
Less		
PACS Cost of Service	402.2	231.8
Debt Service (@ 9%)	18.0	10.4
Equals: pre-tax income	26.0	15.0
Less: income tax	12.0	6.6
Equals: return to Equity (@ 7%)	14.0	8.2
Implied Markup	11%	11%

MEMO: Assets have been allocated to Reserve Bank operations to be priced in the same ratio that the PACS expense of providing those services bears to total expenses. For the first half of 1970 this ratio approximated 54%, and \$402 million in assets were allocated to priced operations. In addition, it was assumed that one-half these allocated assets are financed by debt and one-half represent equity.

Debt	\$201.0 million
Equity	<u>201.0 Million</u>
Total	\$402.0 million

* based on ratio of check collection PACS costs to PACS costs for all operations to be priced.

QUESTIONS AND ANSWERS ON PRICING

POLICY DECISIONS ON PRICING

1. Is the proposal to charge for Federal Reserve services tied to the membership problem?

Yes. If actions are not taken to relieve the burden of Federal Reserve membership, the Federal Reserve will not proceed to implement any pricing schedule.

2. Why is the Federal Reserve proposing to charge for its payments services?

The Federal Reserve is considering charging for its payments services as part of its comprehensive plan to enhance competitive equity among depository institutions and encourage competition to improve both the effectiveness and cost of the payments mechanism.

Service charges are expected to encourage more efficient use of payments facilities and to provide incentives for innovations that reduce costs. For example, pricing of check collection services will provide an incentive for banks to do more check processing themselves and to set up additional local clearing arrangements. Therefore, the opportunities for the private sector to compete with and improve upon Federal Reserve services would be enhanced. Moreover, service charges will provide the System with additional revenues to minimize the impact of the membership plan on the Treasury.

3. When will charging for Federal Reserve services be made effective:

The exact date when charges will be effective depends on implementation of a plan to resolve the problem of attrition of membership in the Federal Reserve. In no case will charges be levied before July 1, 1979.

4. Does the publication of a District average price schedule mean that the Federal Reserve is going to implement pricing on a District average basis?

The Federal Reserve has not yet reached a final determination on what level (national, district, or office) prices will be implemented. There is little sentiment for national average check collection prices at this time. District average prices are being published because they provide sufficient information for the financial community to determine the impact of pricing. The final decision on the price structure will be influenced by resource cost differences and the competitive situation existing at different offices.

5. Will the Reserve Banks be changing the levels of service they now provide once pricing is instituted?

Prices published are based on the levels of service currently provided by Federal Reserve Offices. The Federal Reserve feels that the level of service now provided is appropriate and does not intend to change when pricing is initially implemented. The Federal Reserve does, however, recognize its responsibility to insure an efficient and effective payments system, which might require future service level changes, as it has in the past. Increased expenditures to meet service demands or reductions in resource requirements associated with technological or productivity improvements will be reflected in prices charged. Likewise, any change in availability schedules will be related to the System's ability to collect funds.

6. Why is there no charge proposed for handling return items?

Charging for return item processing would impose a significant manual accounting burden on both Reserve Bank and financial institutions to bill and reconcile such charges. The probable price for return item handling, developed along the lines used for check services, would be small (5 cents to 10 cents) and would have little impact as an incentive to avoid creating return items. In light of these observations the Federal Reserve has chosen to perform return item processing as a necessary adjunct to check processing services and has priced those services accordingly.

7. When will the price schedules for Fed services other than check and ACH processing be available?

The Federal Reserve proposes to charge for other services, including the provision of currency and coin, transfers of reserve account balances, and

security safekeeping. Price schedules for these other services are being developed and will be available at a later date.

8. what impact will service charges have on Federal Reserve policy concerning access to the services?

Service charges can be implemented when, and only when, steps have been taken to relieve the burden borne by member banks of the Federal Reserve System. If the membership burden is removed, the System would be able to reevaluate the access policy.

9. how will the Federal Reserve adjust its prices over time?

The Federal Reserve is still considering the issue of how prices are to be administered. The board has stated that prices will be determined with due regard for competitive conditions and for the need to maintain a basic level of payments services nationwide.

IMPACT OF PRICING

10. what impact will service charges have on the payments mechanism?

The anticipated impact on the payments mechanism will be to increase its efficiency by providing the private sector with greater opportunities to compete with and improve upon Federal Reserve services. Pricing should stimulate the development of more efficient means of making payments. It may also roster the transition from a paper-based payments system to a less costly electronic-based payments system.

11. what will be the cost of service charges to the banking sector?

Service charges for check collection and automated clearing house services will total about \$225 million. However, these costs can be imposed in the context of a general membership plan that will reduce the cost of Federal Reserve membership. After service charges are deducted, most member banks will have a gain in earnings from the membership legislation under consideration in the last Congress when compared with nonmember banks that do not incur the burden of sterile reserves.

12. What effect will pricing have on the volume of payments processed by the Federal Reserve?

We are uncertain at this time as to the changes in total volume of payments processed by the Federal Reserve that may occur as a result of pricing. There is a possibility of volume decline at some offices if pricing is implemented as the private sector begins to provide services in competition with the Federal Reserve.

MECHANICS OF DETERMINING PRICES

13. Do the announced prices include any allowance for imputed costs that take into account the taxes that would have been paid and the returns on capital that would have been provided had the services been provided by a private business firm?

The tentative prices include an allowance for depreciation of the capital assets associated with the service being priced. The costs of leased facilities (e.g., computers, transportation contracts) already have a private cost of capital imbedded in them. In addition, the prices include an adjustment to cover the cost of financing the assets employed in providing the services. The adjustment also allows for income taxes, for a dividend at the statutory rate on the Reserve bank stock imputed to providing the service, and for the replacement cost of capital.

14. Do the prices include the value of float?

The value of float is not included in the prices for check services. Float usually is not included by the private sector in unit prices for payment services. Instead, the private sector often allows for float by adjusting the availability of funds to their customers. It would be difficult to allocate the cost of float among different types of checks and to determine which financial institution should be charged in this early experimental stage of pricing.

15. Are these tentative prices based on costs?

The tentative prices are designed to recoup total Reserve Bank direct and indirect costs associated with providing check collection services as well as an adjustment for capital, taxes and dividends. Thus, the average prices shown are not precisely related to costs at any office.

To. The proposed charges for ACH processing are clearly lower than current costs would indicate. How is this consistent with the Federal Reserve policy of recouping costs?

ACH prices were set to be competitive with prices for comparable check collection services. These prices also approximate the estimated unit price of a mature ACH service. (Mature operating levels are expected to be attained by the mid-1980's.) These prices should assist banks and their customers to take advantage of this potentially lower cost way of transferring funds while still affording considerable opportunity to the private sector to establish competing automated clearing and settlement facilities. Operating costs and ACH prices will be reviewed as the ACH concept develops, and private initiatives will be encouraged.