FEDERAL RESERVE BANK OF DALLAS
Station K, Dallas, Texas 75222

Circular No. 84-89
August 29, 1984

TO: All depository institutions in the Eleventh Federal Reserve District

ATTENTION: Chief Executive Officer

SUBJECT: **White Papers approved by Board of Governors of the Federal Reserve System -- "The Federal Reserve in the Payment System" and "Standards Related to Priced Services Activities of the Federal Reserve Banks"**

SUMMARY: Recently, the Board of Governors of the Federal Reserve System approved the attached copies of two policy statements known as White Papers. "The Federal Reserve in the Payment System" sets forth the rationale for Federal Reserve participation in the payment mechanism and "Standards Related to Priced Services Activities of the Federal Reserve Banks" details standards for Reserve Bank personnel to follow to ensure that conflicts of interests between the System's priced service activities and its other responsibilities are avoided.

ATTACHMENTS: Board's press release and White Papers

MORE INFORMATION: Tony J. Salvaggio, Extension 6224

ADDITIONAL COPIES: Public Affairs Department, Extension 6289

FEDERAL RESERVE press release

For immediate release

August 14, 1984

The Federal Reserve Board has approved the two attached policy papers regarding the Federal Reserve System's role in the nation's payment mechanism and the System's policies and procedures designed to carry out provisions of the Monetary Control Act respecting providing services to depository institutions.

One paper, entitled "The Federal Reserve in the Payment System" sets forth the rationale for the Federal Reserve's participation in the payment mechanism, describes the System's procedures for evaluating Federal Reserve priced services to depository institutions and states the System's objectives, including cost recovery, for the pricing of such services as directed by the Monetary Control Act.

The other paper -- "Standards Related to Priced Services Activities of the Federal Reserve Banks" -- is concerned with System safeguards for avoiding any internal conflict of interest between the exercise of the Federal Reserve's responsibilities for the provision of priced services to depository institutions, and its other principal responsibilities in the fields of monetary policy, bank supervision and lending to depository institutions.

The primary responsibility for assuring that the standards are applied is entrusted to the management of each Reserve Bank. The Board exercises oversight over standards for provision of priced services through review and approval at Board level of changes in the level of pricing and services, and through frequent on-site reviews by Board staff of Reserve Bank activities. In addition, the Board specified in approving its policy statement that the Board member serving as chairman of the Board's Federal Reserve Bank Activities Committee is responsible for overseeing investigation and responses to complaints in this area. Vice Chairman Martin is the current chairman of this committee and inquiries may be directed to his attention.

The policy statements are attached.

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Attachments.

August 14, 1984

THE FEDERAL RESERVE IN THE PAYMENT SYSTEM

This paper defines the mission and role of the Federal Reserve in the payment system. The objective of the paper is to clarify the Federal Reserve's purpose and role in the payment system in order to encourage closer cooperation among all participants in improving the payment system and to facilitate the business planning of users and providers of payment mechanism services. The paper also outlines the procedure the Federal Reserve will use in reviewing its service offerings.

In summary, the mission of the Federal Reserve in providing payment services is to promote the integrity and efficiency of the payment mechanism and to ensure the provision of payment services to all depository institutions on an equitable basis. Given the size, speed, and interdependencies of payments, this mission is, and will likely continue to be, even more important than it was when the Federal Reserve was established in 1913.

I. Role of the Federal Reserve

Background

For 70 years, active involvement by the Federal Reserve in payments processing has been an integral part of the development of the nation's financial system. Congress, responding in part to the breakdown of the check collection system in the early 1900s, established the Federal Reserve in 1913. At that time the Congress envisioned that the Federal Reserve would play a dual role as an operator and a regulator of the payment mechanism. The Congress has, as recently as 1980, reaffirmed its commitment to this dual role for the Federal Reserve.

The Federal Reserve has a wide ranging role in the payment system. Reserve Banks process about 35 percent of the checks written in this country and provide a nationwide network for the collection of items ineligible for processing through normal check collection channels, such as matured coupons, bonds, and bankers' acceptances. The Federal Reserve assisted in developing the Automated Clearing House (ACH) system and now provides a nationwide electronic ACH network. Depository institutions transfer billions of dollars in payments each day over the Federal Reserve's nationwide wire transfer system (Fedwire). The Federal Reserve also operates a book-entry securities service for the safekeeping and transfer of United States government and agency securities. Finally, through its nationwide network of account relationships, the Federal Reserve provides net settlement for a variety of clearing arrangements.

This participatory role has served the United States well--contributing directly and indirectly to widespread public confidence in a payment system that is quick, sure, and efficient. The Federal Reserve's participatory role is well-suited to the structure of the United States financial industry. This country has a highly fractionalized banking system spread over wide areas with different types of institutions--commercial banks, savings institutions and credit unions--having differing payments needs. No one private banking organization holds more than four percent of total deposits or offers deposit services in all regions.

If and when generalized structural changes such as interstate banking are authorized, the underlying public policy rationale for a Federal Reserve operational presence in the payment mechanism will continue to be as important a consideration as it is today. Then, as now, the Federal Reserve can be expected to bring to payments markets an overall concern for safety and soundness, promotion of operating efficiency, and equitable access. Indeed, those considerations relating to integrity, efficiency and access to the payment mechanism will remain at the core of the Federal Reserve's role and responsibilities regarding the operation of the payment mechanism.

Integrity of the Payment System

A reliable payment system is crucial to the economic growth and stability of the nation. The smooth functioning of markets for virtually every good and service is dependent upon the smooth functioning of banking and financial markets, which in turn is dependent upon the integrity of the nation's payment mechanism. History tells us--all too vividly--that fragility of a country's payment system can precipitate or intensify a general economic crisis. The breakdown of the payment machinery in the United States during the panic of 1907--which helped to precipitate the creation of the Federal Reserve System--is a case in point. More recently, the 1974 failure of a relatively small German financial institution, Bankhouse I.D., Herstatt, and the consequent uncertainty regarding payments through private clearing networks, temporarily caused substantial disruption in the United States payment system. This clearly demonstrated that financial failures can have a dramatic rippling effect, via the payment system, to financial institutions in all parts of the world.

The value of funds transferred is so large that no private concern is perceived as able adequately to ensure the integrity and reliability of the system. The Federal Reserve's direct and ongoing participation in the operation of the payment mechanism enhances its integrity and reliability. For example, the Federal Reserve's final irrevocable Fedwire transfer service reduces the risk that failure of one institution could be rapidly transmitted to other institutions. The current effort to control intraday risk on large dollar payment networks is another example of a Federal

Reserve initiative, in conjunction with the private sector, to enhance the integrity of the payment system.

Efficiency of the Payment System

Federal Reserve involvement in the payment system promotes efficiency for a variety of reasons.

The Federal Reserve has a public interest motivation in seeking to stimulate improvements in the efficiency of the payment mechanism. The Federal Reserve has worked closely with other providers of payment mechanism services to develop and utilize advancements in technology and procedures. Because of its day-to-day operating presence in the payment mechanism, it has the know-how to contribute to such advancements as well as the ability to help promote their implementation. This is particularly true in the case of significant payment mechanism advancements that involve substantial resources, such as the ACH. Federal Reserve involvement may also be particularly appropriate for advancements that require widespread cooperation among depository institutions (for example, introduction and implementation of MICR encoding of checks). Moreover, Federal Reserve involvement as a neutral and trusted intermediary may facilitate acceptance of innovations that improve the efficiency of the payment mechanism. Additional efficiencies result from the scope of the Federal Reserve's participation in the payment mechanism.

As Congress anticipated in the Monetary Control Act of 1980, competition between the Federal Reserve and other providers of payment services has resulted in a more efficient payment system. Both the Federal Reserve and other service suppliers have been prompted by competition during the last three years to trim the cost of processing payments and to improve the quality of the services offered.

It is recognized that further gains in payment efficiency are most likely to come from the application of advances in electronic technology. These gains will become more widespread as the new technology becomes available to all depository institutions regardless of size or location. An impediment to the conversion of paper-based payments to electronic payments, however, is the significant float advantage enjoyed by some initiators of paper-based payments. To eliminate part of this advantage and thus help spur the shift to electronic payments, the Federal Reserve has during the past two years accelerated the collection of checks, including checks drawn on institutions at relatively remote locations. As a result of these efforts, more than $3 billion in checks daily are now being collected and paid one day quicker than was the case previously.

Provision of Payment Services to All Depository Institutions

Federal Reserve payment services are available to all depository institutions, including smaller institutions in remote locations that other providers might choose not to serve. Under the Monetary Congrol Act, in making payment services available to depository institutions, the Federal Reserve is to give due regard to the provision of an adequate level of services nationwide. Since implementation of the Act, the Reserve Banks have opened access to Federal Reserve services to nonmember banks, mutual savings banks, savings and loan associations and credit unions. Furthermore, the Reserve Banks currently handle paper and electronic items that are destined for over 20,000 depository institutions.

The Federal Reserve also stands ready to provide payment mechanism services to troubled depository institutions that other providers of payment services may not serve because of the risks involved. This helps to ensure that the inability of a depository institution to make or process payments will not trigger its insolvency and that the institution's problems can be resolved in an orderly fashion with minimum disruptive effects.

Fiscal Agency Functions

In addition to the payment services provided to depository institutions, the Federal Reserve, as fiscal agent, provides a variety of services on behalf of the United States Treasury and other government agencies. These include the creation, safekeeping, and transfer of book-entry records evidencing ownership of the public debt and the processing of governmental payments.

To the extent that the facilities and expertise required to provide these services can be used to produce other similar services for depository institutions, production efficiencies result. In addition, paper and electronic payment services are supplied to the Treasury and other government agencies at lower costs than would be possible if there were no opportunities for the Federal Reserve also to offer these services to depository institutions.

II. Criteria for Federal Reserve Services

In offering payment services, the Federal Reserve must satisfy the cost recovery objective of the Monetary Control Act: in the long run aggregate revenues should match costs. The Federal Reserve is currently achieving this objective.

In addition to the aggregate cost recovery objective specified in the Monetary Control Act, the pricing principles adopted by the Board of Governors in 1980 added the more stringent objective of full cost recovery (including all operating and float costs and imputed taxes and return on capital) for each service line.[1/] Based on more than two years of experience with the provision of priced services, this internal objective of cost recovery at each service line has been elaborated to provide that revenues for each service line must cover all operating costs, float costs, and certain

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1/ See Appendix for details on calculation of costs and fees.

imputed costs such as the cost of interest on short- and long-term debt as well as make some contribution to the pre-tax return on equity. Thus, each service line must be at least marginally "profitable" and all service lines combined must, in the aggregate, cover all costs, float costs, and the overall PSAF. At present, check collection, cash services, wire transfer and net settlement, and the book-entry securities service lines are meeting this secondary cost recovery objective. The commercial ACH service line is also meeting this objective, after taking into account the planned subsidy. Only the definitive securities safekeeping and noncash collection service line is not presently meeting this objective.

Federal Reserve objectives are established in terms of cost recovery rather than targeted volume. Circumstances might materialize that could jeopardize the Federal Reserve's ability to meet its cost recovery objectives. Such circumstances include changing technology and consolidation of depository institutions. If a service experiencing such developments can be improved to be more responsive to the market, it would continue to be offered. If it becomes clear, however, that the service simply cannot be expected to meet cost recovery objectives, the Federal Reserve would reassess the appropriateness of continuing to provide the service after taking into account its other objectives, including the requirement of providing equitable access and an adequate level of services nationwide. For example, several Reserve Banks have stopped offering the cash transportation service in areas where an adequate level of this service is otherwise provided by the private sector.

Failure to meet cost recovery objectives may also result from an aggressive pricing policy of other service providers. Because the Monetary Control Act directs the Federal Reserve to give due regard to competitive factors, a decision would have to be made whether the public benefits of continuing to offer the service justify the shortfall. The Federal Reserve might also continue to provide a service that did not meet cost recovery objectives if the revenue shortfall was caused by some temporary situation that could be corrected. In any event, any decision to continue to provide a service that could not reasonably be expected to meet these objectives would be made by the Federal Reserve Board only after soliciting public comment and only in circumstances in which there were clear public benefits associated with such a course of action. Similarly, any decision to withdraw from a particular service line would have to be undertaken in an orderly way giving due regard to the transition problems associated with the discontinuation of service offerings.

The Federal Reserve's operational presence in the payment system can be expected to change as the payment system evolves. Technological developments are likely to be the most important influence, but changes also can be expected from increased interstate banking, the creative efforts of individual depository institutions, the entry of new participants in the payment system, and developments in law and regulation accommodating these and other changes.

As the Federal Reserve introduces new services or major service enhancements in the future, all of the following criteria must be met:

(1) The Federal Reserve must expect to achieve full recovery of costs over the long run.

(2) The Federal Reserve must expect its provision of the service to yield a clear public benefit, including, for example, promoting the integrity of the payment mechanism, improving the effectiveness of financial markets, reducing the risk associated with payments and securities transfer services, improving the efficiency of the payment mechanism or reducing the use of real resources such as through the introduction of new technology.

(3) The service should be one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity. For example, it may be necessary for the Federal Reserve to provide a payment mechanism service to ensure that an adequate level of the service is provided nationwide or to avoid undue delay in the development and implementation of the service.

The Federal Reserve recognizes that its unique position carries with it unique responsibilities, including a willingness to cooperate with other providers in improving the payment mechanism and a fundamental commitment to competitive fairness. These unique responsibilities must, in the final analysis, be viewed as an extension of the Federal Reserve's underlying responsibility for preserving the safety and soundness of, and improving, the payment system.

III. Possible Payment System Improvements

The Federal Reserve is committed to improving the payment mechanism. In this regard, interest has been expressed by some depository institutions and others in having the Federal Reserve introduce major enhancements to existing services and offer new services that will improve the payment system. In all such cases, further study will be required before such enhancements and services could be offered for public comment or for implementation.

Among other things, such study will focus on technical feasibility, cost and benefits, the compatibility of the particular initiative with the Federal Reserve's mission regarding the payment mechanism, and the compatibility of the initiative with the three criteria for new service offerings and major service enhancements specified in this paper. These services might best be developed by the Federal Reserve independently or acting jointly with depository institutions and other providers of payment services, as was the case with MICR encoding of checks and the introduction of ACH. With this in mind, there are several service areas that the Federal Reserve believes warrant particular attention over the next year or two. They include:

- Minimization of the costs and the time associated with the handling and processing of return items. Initiatives in this area may entail certain short term efforts such as notification of the institution of first deposit of large dollar return items along the lines proposed by the Board in June 1984. Long term efforts may require the application of new and higher technology to return item processing as well as continued efforts to accelerate the collection of checks more generally.

- In part related to improvements in the return item process, efforts to speed up the collection of checks as well as eliminate some of the physical handling of paper by applying electronic technology to the existing paper-based system. Some form of check truncation, for example, appears to be a logical step in the progression toward electronic payments.

- Book-entry service for selective and limited classes of securities not presently held in book-entry form, such as municipal securities, might offer attractive economies while improving security and the payment flow. The Federal Reserve could provide access to a number of institutions that might not have access to existing alternatives.

- Enhancements to existing electronic services, including improved electronic delivery and security of payments.

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The payment system will continue to evolve, adopting new technologies and creating new risks and opportunities. The Federal Reserve has an important role as a participant in that evolution. As such, the Federal Reserve will seek opportunities to improve existing services or offer new services within the framework of satisfying its responsibilities to promote the integrity and efficiency of the payment system, providing an adequate level of services nationwide, and serving the long range interests of the economy.

Methodology for Computing Federal Reserve Bank Costs and Fees

In accordance with the Monetary Control Act, the Federal Reserve establishes prices for its payment services in order to recover costs and a private sector adjustment factor (PSAF). The PSAF is an allowance for the taxes that would have been paid and the return on capital that would have been provided had the Federal Reserve's priced services been furnished by a private sector firm.

Costs for providing services are derived from the Federal Reserve's Planning and Control System (PACS). PACS is the uniform financial accounting system Reserve Banks use for determining the full costs of fulfilling their four basic areas of responsibility: Monetary Policy, Supervision and Regulation, Treasury, and Financial Institutions and the Public (the latter includes both priced and non priced services). The system was developed in the mid-1970's to serve as a cost accounting system, similar to systems used in the private sector, and also to serve as a vehicle for evaluating the cost-effectiveness and relative efficiency of Reserve Banks.

PACS provides the Federal Reserve with an important management tool for budgeting and expense control by ensuring that similar expenditures are recorded by Reserve Banks in the same way and that all Reserve Banks post and report operating expenses under a set of common and uniform definitions.

Like most expense accounting systems used in the private sector, expenses under PACS are classified by type or "object" of expense, such as salaries, supplies, equipment and travel, and the reason or "output" to which the expense is related, such as fiscal service to the Treasury or the provision of check collection services to depositing institutions. Classification of expenses by type enables the Federal Reserve to collect necessary information for external and internal financial reporting and control purposes. Classification of expenses by reason or output enables Federal Reserve management to analyze the overall costs of Reserve Bank operations in terms of on-going service responsibilities, the programs instituted to fulfill these service responsibilities, and the basic activities or processes included in the provision of each service.

Within each area of responsibility ("service line") there are subsidiary "services". The "Services to Financial Institutions and the Public" service line, for example, encompasses priced services such as commercial check, electronic funds transfer, securities and non-cash collection. Within each of these subsidiary services, PACS identifies specific "activities" which reflect the basic operations or processes within the services.

PACS classifies all costs into three categories: direct costs, support costs and overhead costs. Direct costs are those costs directly attributable to a given service. Support costs are those costs, such as computer programming and building maintenance that, although not directly used in priced service operations, are required to support such activities. All support costs are fully charged to the benefiting activities on a usage basis. Overhead costs represent all remaining Federal Reserve costs that cannot be charged directly to an output service on a usage basis. Examples of overhead functions include personnel, protection and budget control.

Overhead costs are allocated to benefiting services based upon formulas that reflect relative usage.

Each year, all Federal Reserve fees are reviewed and revised, if necessary. The annual review takes place during the third quarter of the year. Each Reserve Bank forecasts its costs and volumes for each priced service for the upcoming year. Included in the cost estimate is all direct, support, overhead, and float costs that are to be allocated to each priced service line. The cost and volume estimates are based on a combination of historical experiences and projections. At the same time, the Federal Reserve calculates a proposed PSAF for the year. Services that have Systemwide uniform prices are based upon the aggregate cost and volume estimates of the 12 Reserve Banks. Fees for other priced services (check, safekeeping, etc.) are based upon cost and volume estimates of the individual Reserve Banks.

The proposed fees of the Reserve Banks are reviewed by the System's Pricing Policy Committee and the staff of the Board of Governors. The purpose of the review is to ensure that the cost and volume estimates are reasonable, the PSAF calculation is consistent with System guidelines, and that proposed prices meet the cost recovery policies of the Board of Governors. Finally, the Board of Governors reviews the proposed prices and PSAF.

August 14, 1984

STANDARDS RELATED TO PRICED SERVICE ACTIVITIES OF THE FEDERAL RESERVE BANKS

I. Background

Since 1913, the Federal Reserve has performed a dual role as both an operator in and a regulator of the nation's payment mechanism. Over the last 70 years--and as recently as 1980--Congress has reaffirmed this role of the Federal Reserve. The Monetary Control Act of 1980 (MCA) has expanded the Federal Reserve's role by requiring the Federal Reserve to provide its services to all depository institutions on an equitable basis, taking into account the need to ensure an adequate level of services nationwide.

The Federal Reserve has exercised care to avoid actual or apparent conflict between its role as a provider of services and its role as a regulator, supervisor and lender. Further, the Federal Reserve is careful to ensure that its actions promote the integrity and efficiency of the payment mechanism. As an extension of this, the Federal Reserve exercises care to ensure that it provides payment services to all depository institutions on an equitable and impartial basis. Federal Reserve actions are also implemented in a manner that ensures fairness to other providers of payment services. Moreover, there are in place external and internal safeguards that ensure that these objectives are achieved.

Externally, the safeguards include congressional oversight, directly and through the General Accounting Office, and statutory controls. An additional level of external review is provided by the public through the opportunity to comment on all significant Board proposals. The internal safeguards include oversight by the Board of Governors and Reserve Bank boards of directors through various means, including use of the Board examiners and Reserve Bank internal auditors. Finally, the Federal Reserve itself imposes restrictions upon the conduct of its employees--restrictions intended to avoid even the appearance of impropriety.

To ensure further that its public interest role is paramount in providing priced services under the MCA, the following additional standards have been adopted.

II. Standards

A. Organization and Operations

1. No Reserve Bank personnel with responsibility for priced services, unless acting in the capacity of President or First Vice President, will also be responsible for monetary policy, bank supervision, or lending areas. Priced service personnel will not make policy decisions affecting monetary policy, bank supervision or lending matters.

2. Branch managers may administer policy decisions of a Reserve Bank in the lending area but may not make policy decisions in this area.
3. Federal Reserve actions relative to a depository institution in the monetary policy, supervisory, or lending functions involving a particular depository institution will be made without regard to whether that institution is a user of Reserve Bank services or is an alternative provider of such services.
4. Except for the President, First Vice President, branch manager, or persons acting in these capacities, Reserve Bank personnel involved in monetary policy, bank supervision or the lending function may discuss Federal Reserve priced services with a depository institution only where necessary to carry out their responsibilities. With the exceptions noted above, personnel involved in priced services may discuss matters relating to monetary policy, bank supervision, or lending with a depository institution only where the information discussed is general in nature or is public.
5. Reserve Bank personnel involved in monetary policy, bank supervision or the lending function may provide confidential information obtained in the course of their duties to Reserve Bank priced services personnel only where such action fulfills an important

supervisory objective, preserves the integrity of the payment mechanism or protects the assets of the Reserve Banks. In such cases, information will be provided on a need-to-know basis and only with the approval of senior management.

B. Business Practices

1. 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.

2. Federal Reserve services will be offered on a fair and equitable basis to all depository institutions on similar terms and conditions. The prices charged will be in accordance with the requirements of the MCA as implemented by policies of the Board of Governors.

3. Reserve Banks will provide full and accurate information regarding the provision of Federal Reserve services, including features, quality, prices and operating requirements, to enable depository institutions to make informed decisions. Comparisons of its services with those of other providers will be fair and objective.

4. When introducing or revising services, Reserve Banks will announce such changes to the public in a manner that will ensure that communications reach all

interested depository institutions in sufficient time to enable them to make appropriate adjustments.

III. Internal Oversight

The primary responsibility for assuring that the above standards are applied is entrusted to the management of each Reserve Bank. Accordingly, Reserve Bank management will ensure that these standards are clearly represented in Reserve Bank policies, procedures and controls. Consistent with its overall responsibilities, oversight of business conduct is provided by each Reserve Bank's board of directors, principally through the Bank's internal audit function. The internal audit function of each Reserve Bank maintains independence from operating management by reporting directly to the Reserve Bank's board of directors.

Oversight of Reserve Bank priced service activities is also carried out by the Board of Governors. This is accomplished through review and approval at the Board level of price and service level changes. Furthermore, Reserve Bank priced service activities are evaluated in conjunction with on-site reviews by the Board's operations review and financial examination staffs. Board oversight through these means ensures that Reserve Bank activities are consistent with the MCA and with Board policies with regard to priced services. In addition, the Board member serving as the Chairman of the Board's Federal Reserve Bank Activities Committee is responsible for investigating and responding to complaints concerning actions of Reserve Bank personnel that are alleged to be inconsistent with the standards presented above. Currently, Vice Chairman Preston Martin serves in this capacity. Accordingly, inquiries concerning Reserve Bank actions may be directed to Vice Chairman Martin's attention.

The internal audit and Board examination activities focus on Reserve Bank compliance with policies, procedures and controls, including standards of conduct related to priced service activities. Audit and examination attention also encompasses activities and functions such as organizational structure and staffing, financial accounting and reporting, allocation of costs, information flows, and associated internal controls.

IV. Conclusion

It is the policy and practice of the Federal Reserve System to conduct its affairs in a manner that will serve to maintain the integrity and credibility essential to the effective discharge of its public responsibilities. The Federal Reserve believes that these standards effectively address questions of potential conflicts while permitting the Federal Reserve to fulfill its public responsibilities in the provision of services to the nation's depository institutions.