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Statement by

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Federal Reserve Bank of Minneapolis

before the

Committee on Banking, Housing

and Urban Affairs

United States Senate

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Mr. Chairman, I am pleased to have this opportunity to review developments over the past three years regarding the priced services activities of the Federal Reserve Banks. My prepared statement is divided into four parts: the first provides an overview of the role of the Federal Reserve in the provision of payments services to depository institutions; the next section provides a general review of our experience with the pricing of such services as required by the Monetary Control Act of 1980; the third section comments on the draft report on such activities prepared by the General Accounting Office at the request of members of this Committee; and, the last section contains some brief remarks on the subject of delayed availability of funds associated with some check deposits.

I. THE ROLE OF THE FEDERAL RESERVE IN THE PAYMENTS MECHANISM

The operation of the nation's payments mechanism is a vast and complex undertaking which daily--directly or indirectly--affects virtually every citizen, every business, and every financial institution in this country and millions of others abroad. For most of us, the act of making or receiving payment is as routine as getting out of bed in the morning. However, because literally hundreds of billions of dollars change hands daily with such reliability and efficiency we should not take for granted the smooth workings of the payments mechanism. The safe, efficient, and trusted operation of the payments system is clearly a matter of high public interest here in the United States and around the world. Indeed, these very considerations relating to the safety and efficiency of the payments mechanism were a central element in the decision of the Congress to create the Federal Reserve more than 70 years ago.

Reflecting in part the legacy of 70 years of experience, I believe there is virtually unanimous agreement that the Federal Reserve, as the nation's central bank, has a natural and continuing interest in the efficient and safe functioning of the payments mechanism. In part, that natural interest arises from the fact that disruptions in the payments mechanism--regardless of their origins--can threaten the safety and soundness of financial institutions, financial markets and, in the extreme, the smooth functioning of the economy at large. However great those concerns may have been 70 years ago, they take on even greater importance in the context of today's highly interdependent domestic and international banking and financial markets.

The point should also be made that transactions balances at depository institutions and the associated reserve balances held at the Fed are, at one and the same time, the vehicle through which most payments are made, the bedrock upon which all other financial flows rest, and the mechanism through which monetary policy is conducted. This trilogy of unique functions is one of the reasons that banks have, in effect, had an exclusive franchise on the operation of the payments mechanism and it is one of the reasons why I believe that banks are special. That trilogy points, in my judgment, to the imperatives of strong banks, strong financial markets, and a strong and efficient clearing system.

To put it more pointedly, the payments system demands the highest degree of public confidence. It simply would not be possible to make hundreds of billions of dollars in payments daily if public confidence in the certainty of payments and the payments process were shaken or undermined. While perhaps

not of the same order of importance, the operation of the payments mechanism inevitably involves other public policy considerations relating, for example, to the ease and terms with which smaller economic entities and more remotely located institutions and individuals have access to the payments system.

The question, therefore, is not whether the central bank has a responsibility to promote the safety and efficiency of the payments mechanism, but rather it is one of how that responsibility can be most effectively discharged. More particularly, should the Fed seek to achieve these public policy objectives by regulation alone; should it act as a processor of last resort, taking on only those functions that others are unwilling to provide or unable to provide at reasonable fees and conditions; or should it maintain an operational presence in the payments mechanism along the broad lines that have prevailed for the past 70 years? From my perspective, the dictates of public policy point strongly in the direction of preserving the operational presence of the Fed in the payments mechanism--recognizing, of course, that the exact configuration of that presence need not, and probably will not, remain as it is today. In saying this I should also stress that an operational presence for the central bank along the general lines of the Fed's current activities is by no means unique among central banks in the industrialized countries of the world.

The processor of last resort concept is deceptively appealing but, in my judgment, is not workable. The Federal Reserve Banks could not maintain the standby facilities, equipment and personnel that would be needed to function on an on-again, off-again basis or to step into those situations in which an

adequate level of payments services might not be available nationwide at reasonable costs and terms. Moreover, even the simplest aspects of the payments mechanism require a continuity of expertise and working knowledge that would be very difficult to maintain in such an environment. Even if feasible, the cost to the taxpayers would be high. Therefore, assigning to the Fed a role as processor of last resort is simply not viable.

In my opinion the United States has--taking account of the size of our economy and the size of our country--the most efficient payments system in the world. That fact cannot be attributed to technological superiority; it surely cannot be attributed to the presence of a neat and clean banking and financial structure. While many factors may be involved, I would suggest that the side-by-side presence of the Federal Reserve and the private banking system in the operation of the payments mechanism has been one of the primary factors that has permitted and encouraged the payments system in the United States to achieve this lofty status.

One can speculate as to whether the result would have been different had the historic role of the Fed been confined to that of a regulator of the payments system. That speculation--however interesting--cannot alter 70 years of experience and it cannot alter the fact of where we are today. Let me cite a few examples that may help to illustrate my point.

-- Is it reasonable to conclude that the book-entry system for U.S. government securities would have been developed as quickly as it was--if at all--if the Fed had been only a regulator rather than a participant in the payments mechanism?

- Is it reasonable to assume that one or more private entities could, or would even want to, fully displace the Fed's funds transfer network?

- Is it reasonable to assume that absent a Federal Reserve operational presence 99 percent of the checks written in this vast country with its 40,000 depository institutions would be collected in two days or less?

- On the other side of the coin, as late as 1979, the Federal Reserve attempted, in the form of a Board policy statement, to put a halt to delayed disbursement of checks. However, we probably have more delayed disbursement of checks today than we did in 1979. The Federal Reserve--through the so-called "high dollar group sort program" which will be implemented on April 23 of this year--is now seeking to achieve through its operations what it could not achieve through "regulation."

The point, of course, is that the payments mechanism is so complex, legally and operationally, that it is far from clear that public policy objectives could be achieved simply by writing regulations. Moreover, it is quite possible that absent the "hands on" working knowledge gained through operations, regulatory efforts would quickly take on an ivory tower character that would be ineffective or impair the efficiency of the payments mechanism or both. There is no doubt in my mind the Fed's operational presence in the payments mechanism is a better alternative than what otherwise would be a cumbersome and very costly regulatory apparatus.

While I am skeptical that regulation alone could provide a cost-effective and efficient method of ensuring that the public policy objectives associated with the operation of the payments mechanism would be well served, there are other aspects of the Fed's operational presence that would be very difficult to duplicate if it were simply a regulator of the payments system. For example, the Fed can be thought of as something of a neutral and trusted intermediary in the payments process. Its only interest is bringing together collectors and payors in the fastest and safest manner possible. It has no particular interest in whether a check is large or small, whether the collecting or paying institution is large or small, or whether the writer of a check is an otherwise valued customer. Indeed, the fact that the Federal Reserve has no relationships with bank customers that are not depository institutions is a feature that makes it an attractive source of payments services for many depository institutions.

This role as a trusted and neutral intermediary is reinforced by the fact that the Fed is also the bankers' bank whose solvency is never in question. This feature permits the Fed prudentially to assume risks such as the intra-day credit exposure on Fedwire or to act as a correspondent for problem banks when others may be unable or unwilling to accept such risks. In tandem, the neutral intermediary and the ever-solvent bankers' bank are aspects of the Fed's role in the payments mechanism which contribute, in no small way, to that essential public confidence in the payments system.

None of the above should be construed to mean that the Fed's operational presence should remain exactly what it is today. Technological developments, the advent of interstate banking, the creative efforts of individual

banks and a host of other factors, no doubt, will change that role over time. Moreover, the Congress may wish to provide different direction to the Federal Reserve asking that we do more, that we do less, or that we do nothing. At this juncture, however, I personally would urge that we retain the legislative status quo.

The bottom line, as I see it, Mr. Chairman, is that the financial system, the business community, and the public at large have been the clear beneficiaries of the Fed's role--in partnership with the banking community--in promoting the highly efficient and safe payments system that we enjoy in the United States. Alternative configurations are easy to conceive but may not be so easy to operate in a way that is appropriately sensitive to those public interest considerations I spoke of earlier.

Much of what I have said about the role of the Federal Reserve is germane to one of the most basic issues raised by the GAO draft report. Namely, whether there is a conflict of interest between the Fed's role as a service provider and a regulator of the payments mechanism. I will readily concede that there is a potential conflict of interest between the Fed's role as a regulator and as a provider of payments services in a competitive environment. However, there are powerful forces which seem to me to more than adequately insure that potential conflicts will never become actual conflicts. These powerful countervailing forces include the generalized public scrutiny of Fed actions, the oversight and general supervisory role of the Board of Governors, the public comment process, the activities of the GAO, and the oversight by the Congress itself.

Moreover, I think the point should be stressed that removal of the Fed from an operational role in the payments system will not eliminate potential conflicts of interest--it will in fact create or intensify other potential sources of conflict. That is, private suppliers of payments services legitimately look first to their customers' and their shareholders' interests in determining the operational posture they will take in providing such services. That is wholly appropriate, but at times it may not yield results that are in the public interest. The payments process is, inevitably, one that entails collisions of interests: payors want to slow it down; collectors want to speed it up; large economic agents have more clout and flexibility than do the small ones. These potential conflicts are subtle and not easy to detect or resolve. The potential conflicts associated with Fed activities--to the extent they are real--are highly visible and readily subject to remedy if abuses were to develop.

Having said all of that, I should hasten to add that there will always be situations in which operational activities of the Federal Reserve Banks impinge on "regulatory" considerations and vice-versa. Let me cite a couple of very contemporary examples:

- Just two weeks ago, the Federal Reserve Board requested public comment on a wide variety of possible measures for reducing risk in the operation of large-dollar wire transfer systems, including FedWire itself.

- Beginning on April 23, the Federal Reserve will commence an operational program designed to accelerate the collection of checks

drawn on certain institutions located outside of Federal Reserve cities. In certain instances, the practice of drawing checks on such institutions could undermine the efficiency of the check collection system, raises questions of equity and, in the extreme, also raises questions of safety and soundness.

-- Later in this statement I will make reference to a possible operational change by the Fed that could provide a major step forward in coping with the delayed availability problem on certain check deposits.

In all of these areas, and in others I could mention, we must very carefully weigh operational and policy considerations. In the final analysis, our actions should have a powerful public interest motivation. However, even when the case for a particular action makes overwhelming sense on both operational and public policy grounds some market participants may object to our initiatives on the grounds that our action may be harmful to them or to their customers. I do not think we can or should avoid those problems, but I do believe that the system of checks and balances I referred to earlier provides more than adequate protection against the misuse of regulatory power by the Federal Reserve. Indeed, as I see it those checks and balances may be so tilted that there is the danger of the Federal Reserve not doing things that would serve the public interest simply to avoid "rocking the boat."

II. EXPERIENCE WITH THE PRICING PROVISION OF THE MONETARY CONTROL ACT

During 1983, the Federal Reserve essentially completed the transition to pricing of its payments services to depository institutions as called for in

the Monetary Control Act of 1980. Specifically, the Act required that the Federal Reserve begin by September 1981 to price its payments services so that over the long-run, fees would be established based upon the full costs of providing such services including the cost of float, taxes, and capital the Federal Reserve would incur if it were a private firm.

Within little more than two years of the date which the MCA required the Federal Reserve to commence pricing:

- all payments services provided to depository institutions have been priced and are now generating sufficient total revenues to cover the full costs of providing such services, including the costs of float, taxes, and capital the Fed would incur if it were a private firm.
- Federal Reserve services have been opened to all depository institutions regardless of size and location.
- operational improvements by the Federal Reserve have dramatically reduced the daily average amount of Federal Reserve check float from \$4.5 billion in 1980 to a daily average of \$1.2 billion in the fourth quarter of 1983. Of the latter amount, \$500 million was recovered through "as of" adjustments and explicit fees and the cost of \$700 million in "residual" check float was added to the cost base subject to recovery through per-item fees. A major thrust of the Federal Reserve's activities over the past two years was to reduce float to the extent possible through operational

improvements that added only modestly to operating costs. This approach serves both equity and efficiency. If the value of all check float as of 1982 and 1983 had simply been added--across the board--to costs and prices, sizable incentives to increase float--particularly by the writers of large dollar checks--would have been created and the costs of such float shifted to the collection system generally, rather than being borne by those who create and benefit from float.

The transition to the priced services environment was managed not only with a view toward satisfying cost-recovery objectives, but also with a view toward seeking to enhance and improve the efficiency of the payments mechanism. The goal of greater efficiency was served in a number of important respects including, but not limited to, the following:

- Federal Reserve pricing served as a further catalyst for moving in the direction of electronic payments.
- Federal Reserve pricing spurred the re-emergence of local clearing arrangements among private depositories. This tended to remove one step in the processing cycle for many local checks, thereby resulting in faster and cheaper clearing services.
- Changed deposit deadlines, processing cycles, and presentment times at many Federal Reserve offices permitted the shift of checks valued at about \$2 billion per day from two-day collection to one-day collection.

-- It would appear that the amount of society's real resources devoted to the payments mechanism has declined.

-- The Federal Reserve has deployed almost 3,000 low-cost terminals in small- and medium-sized depository institutions, thus providing these institutions with convenient and inexpensive access to a wide range of payments and related services.

These achievements and the rapid transition to a "profitable" base of operations did not come easily. Indeed, I believe it is entirely fair to suggest that the transition to the priced services environment was more difficult and complex--and more contentious--than most of us anticipated at the time the MCA was enacted. Speaking for myself, I think I can also say that if I had to do it over again, there are some things I would have done differently. On balance, however, I believe that the net effect of Fed pricing has been good for the Fed, good for the banking industry, and good for the public at large.

I also believe that with the difficult initial transition to pricing now largely behind us, we in the Federal Reserve are better positioned to turn our attention to the more important questions of what we can do--in cooperation with the banking industry--to foster still further improvements in the efficiency, safety, and integrity of the payments mechanism. These issues loom all the more important in the face of the financial interdependencies that are now such a prominent feature of contemporary financial institutions and markets.

III. THE GAO REPORT ON FED CHECK CLEARING ACTIVITIES

At the request of members of this Committee, the General Accounting Office has prepared a comprehensive draft report regarding the pricing of Federal Reserve check clearing services. The draft report covers a wide range of issues raised by members of the Committee and still others raised by a few commercial banks. The Committee, I believe, is also aware that the Federal Reserve engaged the services of a major accounting firm to take an even more detailed look at other aspects of our priced service activities. That report is a couple of months away from completion, and we will submit the conclusions of the report for the record at that time.

Based on my reading of the GAO report, it seems to me that steps already taken by the Federal Reserve respond to most of the report's major suggestions or recommendations. We will, of course, submit a detailed response to the overall GAO report. There are, however, several areas in which I would offer some further comments at this time.

-- First, we fully agree with the need for more and better disclosure on the part of the Federal Reserve regarding its priced services activities. Toward that end, we have recently issued a "Report on Priced Service Activities for 1983" and contemplate that a similar report--augmented by abbreviated quarterly reports--will be prepared annually. A copy of the 1983 report is appended to my statement (Appendix A).

-- Second, the GAO report strikes me as somewhat cautious on the question of presentment fees and on the specific question of

whether--in some situations--the Federal Reserve should be required to pay presentment fees. This is an area, Mr. Chairman, in which I have very strong views. I believe it would be a mistake to subject the Federal Reserve to presentment fees. If there is a case for legislative action regarding presentment fees, I would argue that such fees should be banned altogether for any check presented to a payor institution in advance of the 2:00 p.m. cut-off hour established in the Uniform Commercial Code. I have also appended to my statement some supplementary comments on this subject (Appendix B).

-- Third, the GAO suggests several areas in which our internal procedures for allocating certain overhead costs to specific priced services might be improved. We are looking closely at these suggestions and others made by our own staff and our accounting firm. Some changes in these procedures have already been made and others will be made but--like the GAO--I do not believe such changes will have a material effect on costs or prices.

While these and other issues raised in the GAO report are important, there are two questions raised in the chapter of the report on "Competitive Issues" which I believe are central. The first is the question of how to assure that the Federal Reserve--with its central bank status and ability to influence the market it serves--continues to exercise its authority responsibly. I have spoken to that issue earlier. The second of these central questions is what response the Federal Reserve should make if it becomes clear that the price the

market will be ultimately willing to pay for a service the Federal Reserve provides is less than what the Federal Reserve must charge to recover its full costs. That latter question comes down to what should the Fed do if it cannot cover its costs in a particular operation? In one sense, the answer to that question is very easy but in another sense it is very difficult. Not every service we provide or might provide has the same degree of public interest considerations associated with it. For example, in considering the efficiency, safety, and integrity of the payments mechanism, nobody would seriously argue that there are great public policy considerations associated with coin wrapping. On the other extreme, I think most everyone would readily concede that there are significant public policy considerations associated with the electronic transfer of reserve balances and securities by the Federal Reserve.

Given these differences in the public interest content of our various services, our response to the question can, in some instance, be rather straightforward. Absent some strong public purpose, a failure to cover costs in a particular service area must lead to the discontinuation of the service in question by the Federal Reserve. Indeed, we may have to face that very situation with respect to certain of our paper securities safekeeping operations. In those circumstances, we are quite prepared to discontinue particular operations but in the process we will have to face some very difficult questions of how and with what speed such services are phased out.

In the case of a service which does not cover costs but is perceived as having a clear public purpose it seems to me that we would have no choice but to consult with the Congress. In the near term, I do not see that situation

arising but over time it certainly could, particularly in the face of the sweeping changes in the structure of our financial system that are almost certain to occur over the next several years. Indeed, the potential for that situation arising is all the greater in a context in which we perceive a strong and continuing interest on the part of the Congress in ensuring that an adequate level of payments services are available to all institutions regardless of their size and location.

There is one other point implied by the GAO report which is relevant to the preceding discussion and warrants a few words. We in the Federal Reserve need to articulate a clear statement of our future role in the operation of the payments system in a priced environment. It was not possible to develop a statement of this nature until the initial transition to pricing had been accomplished. Now that the transition is behind us, we are well positioned to proceed with that task and I would hope that such a statement would be adopted by the Federal Reserve Board by mid-year.

IV. DELAYED AVAILABILITY

Mr. Chairman, I am keenly aware that there is acute interest in this Committee and elsewhere in the Congress in finding ways to stop the practice of excessive delays by some depository institutions in passing credit to their customers on some check deposits. Allow me, therefore, to close with a few brief comments on this subject. My comments are as follows:

- First, the incidence of abuse in delaying customer availability on check deposits varies considerably from market to market--and from institution to institution--and unfortunately in some cases is far too lengthy.

- Second, efforts by some states, efforts by depository institutions and their trade associations, interest on the part of the Congress and the recently issued policy statement of Federal financial institutions regulators represent constructive steps in dealing with the problem.

- Third, I have reservations about efforts to legislate availability schedules in part because there is a danger, however remote, that such legislated schedules could have the perverse effect of encouraging banks that do not delay availability to do so and in part because I believe our objectives should be more ambitious than current procedures and technology would permit. For example, under recently adopted state regulations and as contemplated in some versions of proposed Federal legislation, delays in availability on some checks of up to eight days are authorized. I believe we can do much better and would not, therefore, want to institutionalize delays of that duration.

- Fourth, in a context in which we are willing to provide some reasonable time for voluntary initiatives to take hold, the Federal Reserve is actively considering a phased in approach to a universal system of wire or telephonic advice of larger dollar return items. With such a system in place, the case for a depository institution delaying funds availability on all checks to protect against the risk of loss on the tiny fraction of items that are returned would be greatly diminished, particularly as the dollar cut-off for wire

advice is reduced over time. This is a good example of how advancing technology can work to produce better results than might be gained through legislatively imposed availability schedules which--to some extent--are captive to current procedures and techniques.

While these steps can help solve or minimize the delayed availability problem, the only solution to the practice--and to the larger problems associated with the mountains of paper payments made daily--is to continue and to accelerate the move toward electronic payments. I said earlier that I believe that one of the benefits of the MCA was that it helped reduce some of the barriers to the more widespread use of electronics in banking for consumers and businesses alike. The technology is certainly there and our younger people--to say nothing of our school-age children--are less intimidated by computer terminals than are many of us. Similarly, the relative costs of paper versus electronic payments continue to shift in a direction that is favorable to electronics. Yet, the current paper-based system provides real or perceived advantages to many--advantages that in substantial ways grow out of the inefficiencies of the paper based system including the substantial amounts of non-Federal Reserve float associated with its operations. Thus, seizing the opportunities associated with electronic payments will require a dual effort pushing the efficiency of the paper system to its limit while at the same time developing and exploiting the benefits of electronics.

We in the Federal Reserve are strongly committed to those efforts and to the larger goal of promoting the safety and efficiency of the payments mechanism. We look forward to working closely with the banking industry and others in the furtherance of that goal.

FEDERAL RESERVE press release

For immediate release

April 9, 1984

The Federal Reserve Board today issued a report summarizing developments in the priced services areas for 1983 and providing detailed financial results of providing those services.

A report on priced services is expected to be issued annually and a financial statement consisting of the Federal Reserve's priced service balance sheet and income statement will be issued quarterly. The pro forma financial statements are designed to reflect standard accounting practices, taking into account the nature of the Federal Reserve's activities and its unique position in this field.

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Attachments

REPORT ON PRICED SERVICES ACTIVITIES FOR 1983

I. OVERVIEW

During 1983, the Federal Reserve essentially completed the transition to pricing of its payments services to depository institutions as called for in the Monetary Control Act of 1980. Specifically, the Act required that the Federal Reserve begin by September 1981 to price its payments services so that over the long-run fees would be established to cover the full costs of providing such services including the cost of float, taxes, and capital costs the Federal Reserve would incur if it were a private firm.

Within a little more than two years of the date which the MCA required the Federal Reserve to commence pricing:

- All payments services provided to depository institutions have been priced and are now generating sufficient revenues to cover all costs and the private sector adjustment factor (PSAF).
- Federal Reserve services have been opened to all depository institutions regardless of size and location.
- Operational improvements by the Federal Reserve have dramatically reduced the daily average amount of commercial check float from \$4.5 billion in 1980 to a daily average of \$1.2 billion in the fourth quarter of 1983. Of the latter amount, \$500 million was recovered through "as of" adjustments and explicit fees and the cost of \$700 million in "residual" check float was added to the cost base subject to recovery through per-item fees. A major thrust of the Federal Reserve's activities over the past two years was to reduce float to the extent possible through operational

improvements that added only modestly to operating costs. This approach serves both equity and efficiency. If the value of all check float as of 1982 or 1983 had simply been added--across the board--to costs and prices, sizable incentives to increase float--particularly by the writers of large dollar checks--would have been created and the costs of such float shifted to the collection system generally.

The transition to the priced services environment was managed with a view toward satisfying cost-recovery objectives, but also with a view toward seeking to enhance and improve the efficiency of the payments mechanism. The goal of greater efficiency was served in a number of important respects including, but not limited to, the following:

- Federal Reserve pricing served as a further catalyst for moving banking in the direction of electronic payments.
- Federal Reserve pricing spurred the re-emergence of local clearing arrangements among private depositories. This tended to remove one step in the processing cycle for many local checks thereby resulting in faster and cheaper clearing services.
- Changed deposit deadlines, processing cycles, and presentment times at many Federal Reserve offices permitted the shift of checks valued at about \$2 billion per day from two-day collection to one-day collection.
- The dramatic reduction in Federal Reserve float, in effect, largely eliminated one of the barriers to more widespread acceptance and use of electronic funds transfers.

-- The Federal Reserve has deployed almost 3,000 low-cost terminals in small- and medium-sized depository institutions, thus providing these institutions with convenient and inexpensive access to a wide range of payments services.

II. FINANCIAL RESULTS

In considering the Federal Reserve's financial performance in its priced service activities for 1983, four important qualifications should be kept in mind:

- o First, the PSAF methodology used for 1983 has been revised for 1984. Thus, the PSAF recoveries targeted by the Federal Reserve in 1983 are modestly different in composition and amount than those targeted for 1984.
- o Second, early in 1983, the Federal Reserve accelerated its float reduction and pricing efforts with a view toward eliminating or pricing all check float by the fourth quarter of 1983 rather than in early 1984 as had been contemplated earlier. Thus, the cost/revenue figures for 1983 include the value of all "residual" float for the fourth quarter ^{1/} but do not include the value of such float for the first three quarters of the year. During the first three quarters of 1983, the amount of check float that was not priced or otherwise recovered amounted to \$1.4 billion and was valued at \$98.5 million. During 1984, all residual check float will be priced.

^{1/} The data for 1983 include the cost of all check float in the fourth quarter and any holdover check float in excess of one percent of the total dollar value of checks received for the period February 24 to June 30 and any holdover check float in excess of 0.5 percent of the total dollar value of checks received for the period July 1 to September 30.

- o Third, the processing of securities transfers, ACH entries, and coupons from definitive securities can also result in modest amounts of float. Book-entry securities transfer float was added to the cost base as of January 1, 1984; coupon collection float will be added to cost base as of May 1, 1984, and ACH float will be phased in during 1984.
- o Fourth, during 1983, the cost/revenue comparisons were influenced by the presence of modest and designed subsidies that have been approved by the Federal Reserve Board for ACH and cash transportation services. The cash transportation subsidy--which was terminated as of December 31, 1983--amounted to \$1.6 million in 1983 and the ACH subsidy, which will be phased out by 1985, amounted to \$8.1 million in 1983.

With those qualifications in mind, overall fee-generated income for Federal Reserve priced services in 1983 amounted to \$496.2 million (see Table 2). Total production costs, net of approved subsidies, amounted to \$432.4 million thus yielding \$63.8 million in income from operations. Imputed costs, including the value of "residual" check float and the interest cost on short-term and long-term debt associated with the 1983 PSAF, amounted to \$40.2 million, while the net interest income from clearing balances amounted to \$13.1 million. Thus, the income before allowance for imputed income taxes was \$36.8 million. Given the income tax assumption in the PSAF, estimated after-tax income was \$22.8 million.

For the year 1983, the Federal Reserve's targeted recoveries for the PSAF were \$60.3 million including \$20.5 million in interest costs and \$39.8 million in pre-tax income. Results for the year as a whole were in line with

the operating targets particularly in the light of the decision to accelerate float pricing. Of course, as noted earlier, since 1983 was the second and last full year in the transition to pricing, the value of float for the full year was not reflected in the cost base or the operating targets.

III. SERVICE-BY-SERVICE RESULTS

As a matter of policy, the Federal Reserve Board adopted in 1980 a pricing principle requiring each of the Federal Reserve's seven service lines ^{2/} to be managed with a view toward cost/revenue matching for each such service line. This performance standard is a very rigorous one, and it is also one for which financial yardsticks are more difficult to develop. That is, in addition to all the judgments that must be made to arrive at an aggregate pro forma income statement, the service-by-service analysis requires, among other things, that clearing balance income and expense be allocated to specific services. Moreover, since there is no reasonable method for allocating income taxes among service categories, the financial results for each service line are taken to the level of estimated income before tax. With this in mind, however, it can be said--allowing for designed subsidies--that all Federal Reserve service lines (see Table 3) except definitive securities and noncash collection had pre-tax income in 1983 which was in line with operating targets and, as noted earlier, the aggregate pre-tax income was slightly below the overall PSAF recoveries targeted for the year. In the case of definitive securities--which account for only about four percent of Federal Reserve revenues and which were not repriced until mid-1983--the deficit before taxes is about \$2.7 million.

^{2/} The service lines are: (1) commercial check collection; (2) wire transfer of funds and net settlement; (3) commercial automated clearinghouse operations; (4) safekeeping of definitive securities and the collection of noncash items such as interest coupons on municipal securities; (5) the safekeeping and transfer of book-entry securities; (6) cash transportation; and (7) coin wrapping.

Major developments in each service line are discussed below.

Funds Transfers and Net Settlements

Funds transfer and net settlement services were first priced in early 1981 and were repriced in the spring of 1982. Thus, this service has been operating with unchanged prices for almost two years. During 1983, the daily average volume of transfers increased by 7 percent--a very modest increase relative to the pre-pricing trend growth rate of almost 20 percent. Total income for the wire transfer service in 1983 was \$57.4 million--up 16 percent from 1982--while production costs rose by 2 percent to \$48.8 million. During 1983, the net income before taxes associated with wire transfer and net settlement services was \$7.2 million.

Commercial Check Operations

Commercial check operations were originally scheduled to be repriced in August 1982. The 1982 repricing was delayed until late February 1983 due to the controversy surrounding the Federal Reserve's changes in deposit deadlines and presentment times. Those service level changes and corresponding increases in check prices took effect on February 24, 1983. The decision was also made in early 1983 to accelerate the Federal Reserve's float reduction and pricing efforts with a view toward completing that task by the fourth quarter of 1983. The decision to accelerate the float pricing/reduction efforts also required the annual check repricing scheduled for early 1984 to be moved up to December 1983 since the value of "residual" float was built into the cost base earlier than initially

anticipated. Thus, in December 1983, check prices were raised by about seven percent on average with the expectation that such prices would carry through the full year 1984.

Federal Reserve check processing volume grew at a modest rate of 2 percent during 1983. Such growth was, in all likelihood, smaller than the growth in overall check volume during 1983, such that the percentage of all checks cleared by the Federal Reserve continued to drop modestly in 1983 following the sharp decline registered in late 1981 and early 1982. However, the modest growth in volume, together with the service enhancements made by the Federal Reserve and the February and December price increases, yielded a sharp 32 percent increase in revenues for check services to \$372.9 million for the year. Reflecting in part the cost of float reduction initiatives, operating expenses for check processing rose by 5 percent to \$320.0 million. For the year, pre-tax net income for commercial check operations amounted to \$27.8 million.

Commercial ACH

The Board of Governors has adopted a policy to phase out the subsidy for ACH operations over a three-year period ending in 1985. ACH prices were established in early 1983 with a view toward generating revenues that would cover 40 percent of costs and the PSAF with the understanding that the cost recovery targets would be raised annually in increments of 20 percentage points. Commercial ACH volume grew by a robust rate of 48 percent in 1983 and revenue increased by 407 percent to \$6.6 million. Commercial ACH operating costs rose by 40 percent to \$13.5 million in 1983 and--reflecting the move to the 40 percent recovery rate--ACH costs subject to recovery

rose by \$3.5 million to \$5.4 million in 1983. Pre-tax net income--after allowance for the designated subsidy--was \$1.2 million in 1983.

Definitive Safekeeping and Noncash Collection

Definitive safekeeping and coupon collection is the one area in which the Federal Reserve has not yet been able to generate financial results that are in line with the pricing principles developed by the Board of Governors. These activities were initially priced in late 1981 and were repriced in the fall of 1983. The safekeeping operation in particular experienced sharp volume losses following the advent of pricing, and in many locations volume attrition continues. Coupon collection activities, on the other hand, have recently experienced a sharp rise in volume. Nevertheless during 1983, the service line had an overall pre-tax loss of about \$2.7 million. Thus, for 1983, the service line fell well short of the goal of full cost recovery.

Over the course of the year, the combination of (1) the implementation of revised priced schedules in October; (2) rigorous cost containment measures; and (3) the sharp turnaround in coupon collection volume yielded some improvement in the cost recovery picture such that fourth quarter results were markedly better than first quarter results. Pending results during 1984, the role of the Federal Reserve in these activities will be re-appraised.

Book-Entry Securities

The Federal Reserve's book-entry safekeeping and securities transfers services were first priced in late 1981 and were repriced in early 1983. For the year 1983, the daily average volume of securities

transfers rose by 1 percent--a very modest increase relative to the repricing experience. Income from book-entry operations rose by 40 percent to \$18.6 million. Operating costs declined to \$15.3 million or by 5 percent. Net income before taxes was \$2.9 million.

IV. OUTLOOK FOR 1984

In the wake of the almost breakneck pace of developments over the past two years, 1984 should provide the Federal Reserve and the banking industry a period for some consolidation regarding the Federal Reserve's payment services activities. For one thing, at this juncture, it seems likely that the frequency of changes in Federal Reserve prices or service levels in 1984 will be greatly reduced compared to 1982 and 1983. Indeed, barring the unforeseen, the only major changes now slated for 1984 are the repricing of ACH services, the possible adoption of changes in the fee structure for wire transfer, and the implementation of the program to accelerate the collection of checks drawn on non-city institutions. The Federal Reserve is studying the feasibility of adopting steps in 1984 designed to expedite the processing of return items. The Federal Reserve is also studying a proposal for the direct exchange of checks by collecting and paying banks. However, except for selective price changes that might occur from time to time, no major price changes are now planned for check, book-entry securities, definitive securities, noncash collection, and cash transportation services during 1984. Similarly, it is also expected that volume trends in 1984 will be very much in line with 1983 results, except for the possibility of diminished growth in ACH activities.

The Federal Reserve expects that 1984 revenues for priced services will cover all costs, all elements of the PSAF, and the value of "residual" float. For the year as a whole, service income should rise by 10 to 15 percent, reflecting in large part the full year impact of 1983 price increases.

Production costs are projected to rise by five to seven percent while imputed costs will rise by approximately \$20 million, or about 50 percent. The sharp rise in imputed costs reflects the cost of a full year of "residual" float and the addition to the PSAF recoveries of an allowance for sales taxes and FDIC insurance. Assuming net clearing balance income in 1984 is similar to 1983, the Federal Reserve's income and after-tax return on equity should meet that contemplated by the PSAF methodology adopted by the Board of Governors for 1984.

Table 1

Pro Forma Balance Sheet
For Priced Services
Federal Reserve Banks
December 31, 1983
(in millions)

Short-term assets		
Imputed reserve requirements on clearing balances	\$147.4	
Investment in marketable securities	1,080.6	
Receivables	49.0	
Materials and supplies	4.4	
Prepaid expenses	2.3	
Net items in process of collection (float)	<u>720.7</u>	
Total short-term assets		\$2,004.4
Long-term assets		
Premises	168.7	
Furniture and equipment	91.9	
Leases and leasehold improvements	<u>2.5</u>	
Total long-term assets		<u>263.1</u>
Total assets		<u>\$2,267.5</u>
Short-term liabilities		
Clearing balances	\$ 1,228.0	
Balances arising from early credit of uncollected items	720.7	
Short-term debt	<u>55.7</u>	
Total short-term liabilities		\$2,004.4
Long-term liabilities		
Obligations under capital leases	0.4	
Long-term debt	<u>83.5</u>	
Total long-term liabilities		<u>83.9</u>
Total liabilities		2,088.3
Equity		<u>179.2</u>
Total liabilities and equity		<u>\$2,267.5</u>

Accompanying notes are an integral part of these financial statements.

Pro Forma Income Statement for Priced Services
Federal Reserve Banks
For the year ended December 31, 1983
(in millions)

Income:		
Services provided to depository institutions		\$496.2
Expenses:		
Production expenses	\$442.1	
Less: Board approved subsidies	<u>9.7</u>	<u>432.4</u>
Income from operations		63.8
Imputed costs:		
Interest on float	19.7	
Interest on short-term debt	10.4	
Interest on long-term debt	<u>10.1</u>	<u>40.2</u>
Income from operations after imputed costs		23.7
Other income and expenses:		
Investment income	84.9	
Earnings credits	<u>71.8</u>	<u>13.1</u>
Income before income taxes		36.8
Imputed income taxes		<u>14.0</u>
<u>Net income</u>		<u>\$22.8</u>
Memo:		
Targeted return on equity		<u>\$24.6</u>

Details may not add to totals due to rounding.

Accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

Balance Sheet (Table 1)

Federal Reserve assets are classified as short- or long-term. Short-term assets represent assets such as cash and due from balances, marketable securities, receivables, materials and supplies, prepaid expenses, and items in the process of collection. Long-term assets are primarily fixed assets such as premises and equipment.

The imputed reserve requirement on clearing balances and investment in marketable securities reflect the Federal Reserve's treatment of clearing balances maintained on deposit with Reserve Banks by depository institutions. For balance sheet and income statement presentation, clearing balances are reported comparable to reporting of compensating balances held by respondent institutions with correspondents. That is, respondent balances held with a correspondent are subject to a reserve requirement as determined by the Federal Reserve. This reserve requirement must be satisfied with either vault cash or with non-earning balances maintained at a Reserve Bank. Following this model, clearing balances maintained with Reserve Banks for priced service purposes should also be subject to reserve requirements. Therefore, a portion of the clearing balances held with the Federal Reserve are identified on the balance sheet as imputed reserve requirements on clearing balances, representing vault cash and due from balances. The remaining amount would be available for investment. For these purposes, the Federal Reserve assumes that all such balances would be invested in three-month Treasury bills.

Other short-term assets reflect the total of: 1) assets directly used in providing priced services, or 2) an allocation of the portion of joint assets used in providing priced services. Receivables primarily reflect

amounts due the Reserve Banks for priced services which have been provided to institutions for which payment has not yet been received. Receivables also include that share of suspense account and difference account balances related to priced services.

Materials and supplies reflect short-term assets necessary for the ongoing operations of priced service areas for which payment has been made. Prepaid expenses represent other prepaid items such as salary advances and travel advances for priced service personnel and the portion of priced service leasehold improvements which will be amortized to current expense during the year.

Net items in the process of collection is the amount of float which will be added to the cost base subject to recovery. Thus, it is the difference between cash items in the process of collection and deferred availability cash items. Therefore, the asset item on the balance sheet corresponds to the amount of float that the Federal Reserve must recover through fees to satisfy the Monetary Control Act. Conventional accounting procedures would call for the gross amount of cash items and deferred availability items to be included on a balance sheet. However, because the gross amounts have no implications for income or costs and no implications for the PSAF calculation, they are not reflected on the pro-forma balance sheet.

Long-term assets that are reflected on the balance sheet have been allocated to priced services using a direct determination basis. This approach was adopted along with other changes in calculating the PSAF for 1984. The direct determination method utilizes the Federal Reserve's Planning and Control System (PACS) to directly associate single-purpose assets and to

apportion assets used jointly in the provision of different services to priced and non-priced services. Additionally, also resulting from changes to the PSAF methodology, an estimate of the assets of the Board of Governors related to the development of priced services will be included in long-term assets in the premises account in 1984.

Long-term assets also include an amount for capital leases. In accordance with generally accepted accounting principles, the Federal Reserve in 1984 will begin to capitalize leases that qualify for capitalization. Leases had not been shown previously on Federal Reserve balance sheets due to immateriality. While the impact in the future is also likely to be immaterial, procedures have been established in order to disclose these assets on a basis consistent with accounting and disclosure practices of private sector firms. These assets also include leasehold improvements. The current portion of leasehold improvements has been included in prepaid expenses.

A matched-book capital structure for those assets that are not "self-financing," has been used to determine the liability and equity amounts. Short-term assets are financed with short-term debt. Long-term assets are financed with long-term debt and equity in a proportion equal to the ratio of long-term debt and equity of the bank holding companies used in the private sector adjustment model.

Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of obligations on capital leases.

System Income Statement (Table 2)

The income statement reflects the income and expenses for priced services. Included in these amounts are Board approved subsidies, imputed

float costs, imputed financing costs, and the income and cost related to clearing balances.

Revenues reflect charges to depository institutions for priced services. These charges are paid through one of two methods: direct charges to an institution's deposit account or earnings credits. Income includes charges for per-item fees, package fees, explicitly priced interterritory check float, account maintenance fees, shipping and insurance fees, and surcharges. Production expenses include direct, indirect, and other general administrative expenses generated by priced service activities.

Board approved subsidies consist of programs established for the commercial automated clearinghouse and cash transportation services. The incentive pricing program established for the ACH service provides for fee structures designed to recover an increasing share of expenses. In 1983, ACH revenues were intended to recover 40 percent of costs plus the private sector adjustment. This incentive pricing program is being phased out with complete elimination planned in 1985. The transitional support program adopted for the cash transportation service was concluded at the end of 1983. During 1983, the subsidy on ACH operations amounted to \$8.1 million and the cash transportation subsidy totalled \$1.6 million.

Imputed float costs include the value of float that was intended to be recovered, either explicitly or through per-item fees, during the period. In 1983, imputed costs for the commercial check service included the value of holdover check float in excess of one percent of the total dollar value of checks received for the period February 24 through June 30, 1983, the value of holdover check float in excess of one-half of one percent of the value of checks received and interterritory check float recovered through

explicit charges to depository institutions for the period July 1 to September 30, 1983, and the value of all check float from October 1, 1983. In 1984, float recovery for book-entry securities, ACH, and noncash coupon collection services will be implemented. The implementation of float recovery in 1983 follows float reduction efforts in the past two years that have reduced Federal Reserve float significantly. Total imputed check float costs were \$121.7 million and float costs for all services were \$137.5 million in 1983. Had all float been intended to be recovered in 1983, the cost of all float would not necessarily have been included in imputed costs since non-monetary charges are available to recover float costs. Also included in imputed costs is the interest on short and long-term debt used to finance priced service assets through the PSAF.

Other income and expenses are comprised of income on clearing balances and the cost of earnings credits granted to depository institutions. For 1983, income represents the average coupon equivalent yield on three-month Treasury bills applied to the total clearing balance maintained. Expenses for earnings credits were derived by applying the average Federal funds rate to the required portion of the clearing balances. In 1984, both the income and expense are to be adjusted for the net effect of reserve requirements on clearing balances.

Imputed income taxes are calculated at the effective tax rate used in the PSAF calculation applied to the net income before taxes:

The targeted return on equity represents the after-tax rate of return on equity that the Federal Reserve would have earned had it been a private sector firm.

Supplemental Financial Data

Service Income Statement (Table 3)

The income statement by service reflects the revenues, operating expenses adjusted for Board approved subsidies, and imputed costs except for income taxes.

Imputed costs include float and the interest on short- and long-term debt as calculated for the private sector adjustment. Float costs are spread based on the actual float incurred in each priced service that is intended to be recovered. Interest on short- and long-term debt are spread based on the ratio of the operating costs less shipping costs in each priced service to the total cost of priced services less shipping costs.

Other income and expenses consist of income on clearing balances and the cost of earnings credits for the Federal Reserve. Since clearing balances relate directly to the Federal Reserve's offering of priced services, the income and cost associated with these balances are spread to each service based on a total income ratio.

Taxes and the after-tax targeted rate of return on equity, as shown on the aggregate income statement, have not been spread by service since these elements relate to the organization as a whole.

Revenue and Expense of Locally Priced Services (Table 4)

This table depicts the financial results for each Reserve Bank in providing locally priced services. The financial results for each Reserve Bank do not include the dollars to be recovered through the private sector adjustment factor and the net investment income on clearing balances.

As such, in order to reconcile Table 4 net revenue data with that disclosed in Table 3, adjustments must be made for the imputed interest on short- and long-term debt and for the difference between income on clearing balances and the cost of earnings credits.

Priced Service Volumes (Table 5)

This table shows the year-to-year volume and percent changes in the number of items handled by the Federal Reserve in its priced service operations. Wire transfer of funds volume is the number of basic transactions originated; ACH volume is the total number of commercial items processed; commercial check reflects the total commercial checks collected; basic transfers originated on-line represent securities transfers volume; noncash collection volume is the number of items assessed fees; and cash transportation volume is the number of armored carrier stops.

Income Statement for Priced Services
Federal Reserve Banks
For the year ended December 31, 1983
(in millions)

	<u>Total</u>	<u>Commercial Check Collection</u>	<u>Wire Transfer and Net Settlement</u>	<u>Commercial ACH</u>	<u>Definitive Safekeeping and Noncash Collection</u>	<u>Book- Entry Securities</u>	<u>Cash Trans- porta- tion</u>	<u>Coin Wrapping</u>
Income from services	\$496.2	\$372.9	\$57.4	\$6.6	\$16.3	\$18.6	\$23.1	\$1.4
Operating expenses, net of subsidiaries	432.4	320.0	48.8	5.4	18.4	15.3	23.4	1.2
Income from operations	63.8	53.0	8.5	1.2	(2.1)	3.3	(0.3)	0.2
Imputed costs	40.2	35.1	2.8	0.2	1.0	0.9	0.1	0.1
Income from operations after imputed costs	23.7	17.9	5.7	1.0	(3.1)	2.4	(0.4)	0.1
Other income and expenses, net	13.1	9.9	1.5	0.2	0.4	0.5	0.6	0.0
Income before income taxes	\$36.8	\$27.8	\$7.2	\$1.2	\$(2.7)	\$2.9	\$0.2	\$0.1

Details may not add to totals due to rounding.

Accompanying notes are an integral part of these financial statements.

Revenue and Expense of Locally Priced Services at Federal Reserve Banks, 1983

Millions of Dollars

	Commercial Check Collection					Definitive Safekeeping and Noncash Collection			Cash Services				
	Operating Cost	Float Cost	Total Cost	Total Revenue	Net Revenue	Total Cost	Total Revenue	Net Revenue	Operating Cost	Board Approved Subsidy	Total Cost	Total Revenue	Net Revenue
Boston	20.4	0.6	21.1	20.3	-0.7	0.7	0.9	0.2	1.0	0.1	1.0	1.0	-0.0
New York	47.4	5.0	52.4	48.3	-4.1	3.6	2.7	-0.9	3.2	0.0	3.2	3.3	0.2
Philadelphia	12.7	0.0	12.7	12.4	-0.4	1.2	1.0	-0.2	1.2	0.0	1.2	1.3	0.0
Cleveland	19.2	0.1	19.3	23.1	3.8	1.6	1.5	-0.0	1.7	0.0	1.6	1.7	0.1
Richmond	27.1	1.1	28.2	31.9	3.7	0.8	0.9	0.1	1.8	0.0	1.8	1.8	-0.0
Atlanta	34.2	2.4	36.5	44.9	8.4	1.8	2.3	0.5	0.1	0.0	0.1	0.0	-0.0
Chicago	47.9	4.1	52.1	56.1	4.0	3.9	2.9	-1.0	3.6	0.1	3.4	3.1	-0.3
St. Louis	16.6	0.8	17.4	20.0	2.6	1.0	0.8	-0.2	1.3	0.2	1.1	1.2	0.0
Minneapolis	20.3	0.9	21.1	23.9	2.8	0.8	0.6	-0.3	1.5	0.2	1.3	1.4	0.1
Kansas City	23.0	1.1	24.1	27.4	3.4	1.7	1.6	-0.1	1.7	0.0	1.7	1.4	-0.2
Dallas	22.0	0.9	22.9	26.5	3.6	0.9	0.7	-0.1	2.4	0.4	2.0	2.1	0.1
San Francisco	29.1	2.7	31.8	38.0	6.2	0.4	0.4	-0.0	6.8	0.6	6.2	6.1	-0.1
System Total	320.0	19.7	339.6	372.9	33.3	18.4	16.3	-2.1	26.2	1.6	24.6	24.5	-0.1

Details may not add to totals due to rounding.

Accompanying notes are an integral part of these financial statements.

PRICED SERVICE VOLUMES

(Items in thousands)	Total			Daily Average		
	1983	1982	Percent Change	1983	1982	Percent Change
Funds Transfers	38,021.0	35,381.0	7.5 %	150.3	140.4	7.1 %
Commercial ACH	155,955.0	105,243.0	48.2	616.4	417.6	47.6
Commercial Checks	14,276,096.0	13,929,959.0	2.5	56,427.3	55,277.6	2.1
Securities Transfers	5,005.2	4,928.5	1.6	19.8	19.6	1.0
Noncash Collection	2,929.7	2,115.5	38.5	11.6	8.4	38.1
Cash Transportation Number of armored carrier stops	556.9	607.5	(8.3)	2.2	2.4	(8.3)

Accompanying notes are an integral part of these financial statements.

APPENDIX B

Presentment Fees

It has been stated that the Federal Reserve has an advantage over correspondents because, under the Federal Reserve Act, Reserve Banks cannot be charged a "presentment fee" by payor banks. The GAO draft report confirms that Reserve Banks are prohibited by law from being charged a presentment fee.

Congress enacted this statutory prohibition in 1917, when nonpar payment of checks was common and was causing inefficiencies in the check-clearing process. Since payor banks did not impose presentment charges uniformly on all presenting banks, collecting banks that would otherwise be subject to a presentment fee attempted to avoid such charges by routing checks sent for collection through a bank that would not be subject to a presentment fee. This circuitous routing of checks consumed unnecessary resources and extended the time period required to collect checks. Indeed, one of the major objectives in creating the Federal Reserve System was to eliminate this obstacle to the speedy collection of checks throughout the country by establishing a check collection system that does not permit payor banks to charge a fee for checks collected through the Federal Reserve.

In order to obtain additional information on industry practices with regard to presentment fees, the Federal Reserve retained a consultant, the ICS Group, to study the matter. The ICS Group concluded that only large correspondent banks typically charge presentment fees. They were advised that no small banks or thrifts charge presentment fees. Further, the ICS Group found that presentment fees are normally charged only on checks that are sent by the collecting bank directly to the payor bank. Presentment fees are not generally imposed upon checks presented through a clearing house to which the payor bank belongs, checks presented by the Federal Reserve, or checks presented under bilateral agreements under which each bank agrees to forego the fees. The fees were found to range from \$.01 to \$.10 per item, and cluster around the \$.015 to \$.04 range. The time of presentment (e.g., before or after 2:00 p.m.) was not found to affect whether or not a presentment fee was charged but was found to affect the size of the fee.

As we have indicated previously, rather than impose presentment fees on the Federal Reserve, presentment fees--at least for checks presented before the Uniform Commercial Code's 2:00 p.m. cut off--should be banned altogether.^{1/}

^{1/} Under the Uniform Commercial Code, a payor bank has an obligation to pay a check presented to it for payment before 2:00 p.m. by its midnight deadline. The Federal Reserve presents no checks after the U.C.C. 2:00 p.m. cut off.

The practice of imposing presentment fees can result in inefficiency and delay in the check collection system to the extent that institutions attempt to avoid these fees through circuitous routings or by holding the check until the next day so it can be presented through a clearing house exchange. This means that checks that could otherwise have been processed and settled are delayed. As the draft GAO report recognizes, the presentment deadlines after which presentment fees are imposed generally are between 8 a.m. and 10 a.m. These cut offs generally were initially set decades ago and have remained unchanged over the years. These deadlines have not been reevaluated to take account of advancements in technology and business practices that have dramatically improved processing and settlement times. Payor banks today clearly have little trouble processing and settling checks received later than 10 a.m. on the day of receipt. Indeed, the GAO draft report recognizes that the Federal Reserve's move to noon presentment has not resulted in significant operational problems for payor banks.

These early presentment deadlines, established by an institution for its own convenience, are a source of delay and inefficiency. If a check is available for presentment and the payor bank is able to process and settle for that check that

day, the check should be presented. Further, any cost that the payor bank incurs in paying a check that has been presented to it for payment (e.g., processing the check to the individual customer account) should be borne by the payor bank or its customer, the person who wrote the check. We can find no reason to transfer these costs, through a presentment fee, to the collector and ultimately to the payee of the check. In addition, transferring these payor bank costs to the collecting bank and payee eliminates the payor bank's incentive to minimize these costs, thus undermining the market discipline that helps to assure that the costs of effecting payments will be minimized. Finally, since presentment fees are not imposed uniformly, they encourage inefficient collection arrangements as collecting banks distort their check collection strategy in order to avoid presentment fees.