Federal Reserve Notes

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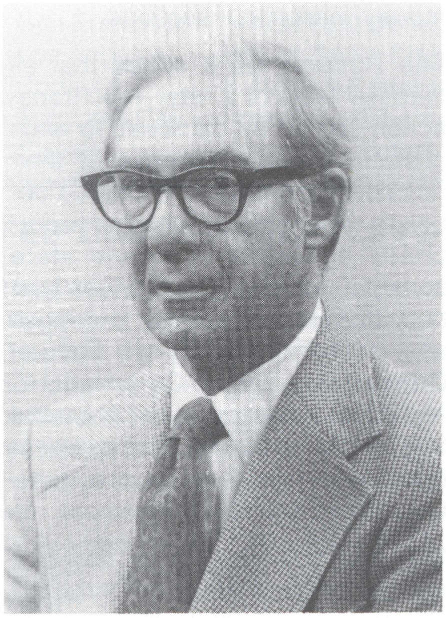
FED TO PHASE-OUT ACH INCENTIVE PRICING

The Federal Reserve plans to phase-out its incentive pricing for Automated Clearinghouse (ACH) services by 1985, but it plans to continue operating ACHs as long as it processes direct-deposit payments for the Treasury Department. Announcement of the change came in a letter from Federal Reserve Governor Lyle Gramley to Senator John J. Chafee, Chairman of the Subcommittee on Consumer Affairs of the Senate Banking Committee.

Governor Gramley said that the Fed will raise its prices for ACH services in four steps. New ACH prices, to be announced later this year, will amount to 40 percent of the current cost plus the "private-sector adjustment factor." (This factor is an adjustment for costs that would have been incurred if the services had been provided by a private business firm.) The ratio will rise to 60 percent in 1983, 80 percent in 1984, and 100 percent in 1985.

Describing the reason for the change, Gramley said that automated clearinghouses were still in a developmental stage and needed encouragement to grow at the time the Board established its pricing policies in accordance with the Monetary Control Act of 1980. "Consequently, the Board established an incentive-pricing policy for ACH operations to encourage this growth to the point where economies of scale could be realized. We believe that this is still the proper decision, but we also recognize that the development of business plans in the private sector would benefit from knowledge of when full-cost pricing of ACH services by the Federal Reserve will begin."



Lyle Gramley

The Fed governor cited several reasons why incentive pricing should be phased-out rather than ended abruptly. The present ACH prices of one cent for local ACH items and 1½ cents for interregional items are quite low—according to some estimates, only about one-fifth of the Fed's actual cost to provide this service. If fully-costed prices were implemented immediately, these substantial price increases could cause many users of the service to revert to paper checks. "Since commercial ACH volume is growing at a rapid pace, although it still constitutes only a small fraction of total payments, we believe such an action would jeopardize the future of a cost-effective and efficient service."

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FED BOARD DEFERS RESERVE RULES

The Federal Reserve Board of Governors has again deferred reserve requirements for an estimated 17,500 financial institutions (mostly credit unions) in anticipation of Congressional action to exempt those small institutions permanently. By this action, the fourth deferral of this type, the Board allowed non-member depository institutions with less than $2 million in deposits as of December 31, 1979, to avoid reporting deposits and posting reserves until December 31, 1982. At the same time, the board subjected currently-deferred institutions to reserve requirements if their total deposits had reached $15 million as of December 31, 1981.

Institutions with less than $2 million in deposits represent about 42 percent of all depository institutions, but they hold only about four-tenths of one percent of total deposits (about $9 billion). For that reason, exempting these institutions from reserve requirements would not create problems for the Federal Reserve in controlling the nation's money supply.

The Monetary Control Act imposes reserve requirements on transaction (checkable) accounts and non-personal time deposits of all depository institutions. However, when the Federal Reserve amended its Regulation D to implement the Act, it deferred for six months the requirements of small non-member institutions. The Board felt that requiring such institutions to comply immediately would pose significant opera-

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ACH INCENTIVE PRICING

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In addition, the Federal Reserve's ACH unit costs should be lower than those of the private sector because of the economies of scale inherent in ACH operations, and also because of the large volumes of transactions processed for the U.S. Treasury. The Treasury Department originates more than 60 percent of all payments processed through the ACH system, and the Federal Reserve is obligated to disburse those payments in its role as fiscal agent for the U.S. Government. "Because of this responsibility, we would continue to operate ACH facilities regardless of our policy towards commercial payments," said Gramley in his letter to Chafee.

Gramley added that the private sector would not offer ACH services unless it could do so profitably. "At present, however, commercial volume appears to be too low for anyone to produce ACH services and sell them profitably."

Corporations and consumers still find checks more efficient than ACH payments despite the security, convenience and potential cost savings available from ACH services. For example, the value of float resulting from the check-collection process is lost to originators when payments are initiated electronically—and that value can be substantial at today's interest rates.

Moreover, depository institutions do not currently price check services on a fully-costed basis. These check-processing costs tend to range from 24 cents to 59 cents per item, whereas institutions' fees range from minimum-balance requirements to explicit fees of around 10 cents to 20 cents per check. "Because originators pay very little of the cost of making check payments, they currently do not have an economic incentive to change their payment practices," in Gramley's view.

The Fed governor said that the industry could be moderately optimistic about the future of ACHs, despite the potential initial setback to volume caused by the Fed's decision to phase-out incentive pricing. The industry's moves towards explicit pricing of services may help stimulate rapid growth of automated clearinghouses over the next several years. He said, "By that time, the marketplace should be in a position to evaluate the cost and benefits of the ACH service, and thus to decide whether competitive ACH facilities and networks would provide an adequate return on investment."

FED NOTES PROBLEMS WITH RETAIL REPOS

The Federal Reserve Bank of San Francisco has notified member institutions that they should make customers fully aware of the nature of retail-repurchase agreements (repos) involving U.S. Government or agency securities. The volume of activity in retail repos has increased dramatically in recent months, frequently involving customers who do not normally engage in large denomination money-market transactions.

The Reserve Bank stated that all material facts of a retail-repo transaction should be disclosed to each customer, partly because of their possible confusion with insured deposits. The face of all retail-repurchase agreements should state conspicuously and in bold-face type that "the oligation is not a deposit and is not insured by the Federal Deposit Insurance Corporation." Also, institutions should be careful to avoid the potential misrepresentation that retail repos are guaranteed by the U.S. Government.

The Reserve Bank also listed a number of other pieces of information that institutions should communicate to customers. These include the nature and terms of retail repos, including interest rates paid, maturities and any prepayment fees, as well as a description and the approximate market value of the underlying security (or fractional interest thereof) collateralizing the agreements.

The customer also should be advised that the interest paid is not necessarily related to the yield on the underlying collateral, that the bank will pay a fixed amount at maturity (including interest) regardless of any fluctuation in the market value of the underlying collateral, and that general banking assets will most likely be used to satisfy the bank's obligation rather than proceeds from the sale of the underlying security. The institution should state that the market value of the collateral could depreciate before the maturity of the agreement, thus making the investor an unsecured creditor of the bank for the difference between the repurchase price and the market value of the underlying collateral. In addition, the customer should be advised as to whether he or she has a perfected lien on the underlying collateral under state law and whether it is being held by an independent trustee or custodian. If not, the legal consequences should be described. The customer should expect to find this information printed on the agreement or specifically referred to in a prospectus, offering circular, or other document containing such disclosures.

The Reserve Bank noted that retail repos are in many respects equivalent to short-term borrowings at market rates of interest. Thus, it argued that "banks engaging in repurchase agreements should carefully evaluate their interest-rate risk exposure at various maturity levels, formulate policy objectives in light of the institution's entire asset and liability mix, and adopt procedures to control mismatches between assets and liabilities. The degree to which a bank borrows through repurchase agreements also should be analyzed with respect to its liquidity needs, and contingency plans should provide for alternate sources of funds in the event of a run-off of repurchase agreement liabilities."

FED ASKS FOR DATA ON LOAN TERMS

The Federal Reserve Board of Governors has asked banks to file additional information beginning in August through the quarterly survey of terms of bank lending. The Board also has approved other reporting changes, including a simplification of a survey of debits to demand- and savings-deposit accounts.

The survey provides information about the priced and non-priced terms of business loans made by commercial banks during one business week each quarter. One form obtains information on commercial-industrial construction and land-development loans from a sample of about 340 commercial banks. The second form, covering farm loans, is collected from about 250 institutions that handle a substantial amount of agricultural lending. The final form deals with prime-rate data, and is collected from all the banks in the sampling.

The reporting changes in the quarterly survey will require that banks provide the date on which a loan matures, and not just the month and year. The report also will seek information on the frequency of interest compounding.

However, the reporting burden will be reduced for banks. Specifically, the number of days for which banks must report loans will be reduced to two days for large banks, and four days for smaller banks. According to staff estimates, the reduction should decrease the reporting burden by roughly one-third.

A second survey change, affecting the survey of debits to demand- and savings-deposit accounts, will eliminate two of five reporting requirements. The Fed will continue to ask for monthly data on total monthly withdrawals from demand deposits, total savings accounts, automatic transfer accounts and negotiable order of withdrawal accounts. However, the Fed will no longer seek information on debits to, and deposit balances of, business savings accounts.

SAN FRANCISCO FED CHANGES ACH CLOSING HOURS

The Federal Reserve Bank of San Francisco has adopted new closing hours for certain ACH items in an effort to improve services to customers. Effective May 1, depository institutions in the San Francisco (Twelfth) District will have 1½ extra hours to originate local intraregional ACH items.

As another benefit of the new closing hours, depository institutions will be able to include reversal files and automated-return items in the night cycle. In the past, those items had to be included in earlier cycles.

For further information on this amendment to Circular 4, Automated Clearinghouse Items, please contact the following ACH officers:

San Francisco—Robert B. O'Donoghue (415) 544-2135
Los Angeles —Robert Taylor (213) 683-8354
Portland —H. William Pennington (513) 221-5903
Salt Lake City —Robert R. Richards (801) 322-7887
Seattle —Kenneth L. Peterson (206) 442-5105

FED DROPS RESERVES FOR 3½-YEAR DEPOSITS

The Federal Reserve Board of Governors has amended its Regulation D so that depository institutions will not have to post reserves on non-personal time deposits with original maturities of 3½ years or more. The Fed thus brought its rules into line with new certificate-issuing authority granted by the Depository Institutions Deregulation Committee (DIDC).

The Committee recently authorized federally-insured commercial banks, savings banks, and S&L's to issue ceiling-free time deposits of 3½ years or more beginning May 1. However, Reg D previously had imposed a three-percent reserve requirement on non-personal time deposits of four years or less. Those with maturities of more than four years were subject to a zero percent reserve requirement.

The Fed reasoned that with the imposition of reserve requirements, institutions would have little incentive to offer the new time deposits with 3½ to four-years maturity. Under the Monetary Control Act of 1980, a negotiable time deposit is defined as non-personal, and thus subject to reserve requirements regardless of ownership. On the other hand, non-transferrable time deposits held in the name (or for the entire beneficial interest) of a natural person are not subject to reserve requirements.

The Act empowers the Federal Reserve to impose reserve requirements in order to implement monetary policy. In its announcement, the Fed said that its modification of Reg D "should not be regarded as a commitment by the Board to continue shortening the maturity of time deposits subject to this reserve requirement in line with the announced schedule of DIDC for ceiling-free deposits." It said that future decisions of this nature will depend on experience and prevailing monetary and credit conditions. Under DIDC's present deregulation schedule, the minimum maturity of a new time deposit will decrease by one year annually until March 31, 1986, when the minimum maturity for any time deposit will be that specified for any time deposit— currently 14 days.

In another action, the Board adopted a survey which will require money-market mutual funds to report every week on their holdings of overnight Eurodollar deposits. This report probably will affect less than a dozen money-market funds. In addition, the Fed liberalized the types of security used for margin requirements and also changed criteria for inclusion on the list of over-the-counter margin stocks.

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BANK BOARD GIVES S&L's BROKER ROLE

In a historic widening of the powers of savings-and-loan associations, the Federal Home Loan Bank Board has approved a plan presented last August by a consortium of four associations to offer brokerage services and investment advice to the public from offices set up in the lobbies of participating institutions. The services would be offered through a so-called Invest network, operated by a jointly-held subsidiary called the Savings Association Financial Corporation.

Associations participating in the Invest network would execute orders to buy or sell stocks and other securities through representatives registered as securities brokers with the National Association of Securities Dealers. The corporation projects a membership of 500 associations by the end of its second year, with a brokerage force of 8,000 registered representatives. Many financial analysts see the move as part of a nation-wide trend to provide one-stop supermarket-type financial services—a trend led by such enterprises as Merrill Lynch, Prudential Insurance, and Sears Roebuck.

The Bank Board's new action is in line with an earlier proposal to expand the activities of savings-and-loan service corporations. Under its proposal, S&L service corporations would be given more powers than commercial banks now have. Such powers would be even broader than those envisioned in Senate legislation to expand the powers of all financial institutions. For example, the subsidiaries would be able to offer money-market-mutual funds (as commercial banks cannot), engage in insurance underwriting activities, and participate in the manufacture of mobile homes. Also, they could engage in options trading and in securities and leasing activities.

In response to the Bank Board's initial request for comments, Federal Reserve Chairman Volcker said that any issue relating to expanded powers for thrifts should be addressed by Congress and not handled as a policy matter by a thrift agency. Moreover, the Justice Department said that the Bank Board should be "cautious and deliberate in its expansion of powers available to thrifts," so as to reduce the risk it could pose to such institutions and their depositors.

Responding to the Bank Board's move to grant brokerage services to S&L service corporations, the Securities Industries Association called for a review of the matter by the Securities and Exchange Commission as well as state securities regulators. The Wall Street trade group argued that the move would be a breach of the Glass-Steagall Act, which keeps banks out of most securities activities.

RESERVE RULES

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tional problems for both the Federal Reserve and these smaller institutions. It has extended its deferral several times because of pending legislation to exempt those institutions completely from the Act's requirements.

In another action, the Board required currently-deferred depository institutions with deposits of $15 million or more on December 31, 1981, to begin reporting their deposits beginning with the reserve computation period of May 21-26. District Reserve Banks have notified these institutions of their reserve responsibilities.