Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Unbundling: The Next Step

The Federal Reserve last weekend unveiled a proposed schedule of prices for check-processing and automated-clearinghouse services, as part of its comprehensive plan to improve the workings of the U.S. financial system. This latest move adds significant detail to the package submitted to Congress last July, when the Fed outlined proposals for interest payments on member-bank reserves, universal reserve requirements, and nonmember access to Fed services—as well as pricing for those services.

Pricing represents an attempt to use the marketplace to help determine the ultimate role of both the public and private sectors in the nation's payments mechanism. The Fed's action thus parallels the movement in the commercial-banking sector towards "unbundling"—that is, the explicit pricing of each bank service at market prices. And on a broader scale, this action parallels the actions taken by other regulatory agencies, such as the Civil Aeronautics Board, to make the economy run more efficiently through greater use of the market mechanism.

Why unbundling?
For commercial banks, the motivation for unbundling stems from the pressures generated by a prolonged period of high interest rates, which has led economically-rational corporations and households to improve the return on their assets through such means as reduced utilization of noninterest-bearing demand deposits. Today, the public's transactions balances are increasingly held in interest-bearing form. Corporations led the way more than a decade ago, and households later followed suit—for example, through the development of NOW (negotiable orders of withdrawal) accounts in the Northeastern states, and beginning this month through the adoption of AFT (automated funds transfers) programs at banks throughout the nation. But with banks now paying interest (more or less directly) on transactions balances, they have come under pressure to price checking and other services more nearly in line with costs—and to improve their return on funds in other ways as well.

For many Federal Reserve member banks, this has meant a decision to drop out of the System, because their reserves earn no explicit interest when held with the Fed. The decline in membership (like other recent developments) can be traced to the rising trend of market interest rates, which has increased the implicit cost of assets frozen in the non-earning reserves required of memeber banks (in contrast, state-chartered banks which are not members of the Federal Reserve System can hold reserves in interest-earning form.). Altogether, 551 banks

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have withdrawn from the System over the past decade, and the proportion of commercial-bank deposits held by member banks has declined from 83 percent in 1965 to about 73 percent today.

To combat that problem, the Fed last July proposed a formula of interest payments on reserves that would have yielded roughly a 6-percent return on banks' 1977 reserves. But as a companion measure, it also announced the proposal to unbundle its services through individual pricing. By the same token, however, it won't start charging for services until some program to stem membership attrition is implemented. In no case will charges be levied before July 1, 1979.

Pricing payments services

The tentative pricing schedule has been developed by the Board of Governors and the twelve Reserve Banks to cover prices for Federal Reserve check-clearing and automated-clearinghouse (ACH) services. These payment-mechanism services account for about 60 percent of the total expenses incurred by Reserve Banks in providing services to financial institutions. The system is still developing pricing schedules for other services, such as the processing of coin and currency, wire transfer of funds, and safekeeping of securities.

The Fed expects that the imposition of service charges will encourage more efficient use of payments facilities and will provide incentives for innovations that reduce bank costs. Pricing also could foster the transition from a paper-based payments system to a less costly electronic-based payments system. Altogether, there should be expanded opportunities for the private sector to compete with and improve upon Federal Reserve services.

Charges for check collection and ACH services probably would total about $257 million annually. However, these costs should be analyzed only in the context of the overall plan designed to reduce the cost of Federal Reserve membership. After deduction of service charges, most member banks would experience a gain in earnings under terms of the membership legislation recently considered (but not passed) by Congress.

The Fed has published its pricing schedule on a District-average basis—

that is, with a different schedule for each of the twelve Districts in the country. It has published District-average prices primarily because they provide sufficient information for the financial community to determine the impact of pricing. The final decision on the price structure will be influenced by resource-cost differences and the competitive situation existing at different Fed offices.

Proposed charges

The proposed pricing schedule for check-collection services is based on the volume of Federal Reserve check clearings during the first half of 1978. The prices are meant to recoup both the direct and indirect costs of providing such services on a District-wide basis, plus an 11-percent adjustment to reflect additional costs that would be borne in the private sector. The adjustment allows for income taxes, for a dividend on the Reserve Bank stock imputed to providing the service, and for the replacement cost of capital. It thus includes an allowance for depreciation of the Fed-owned capital assets associated with the service being priced. (The costs of leased facilities—such as computers—already include a private cost of capital.) The 11-percent adjustment has been made to meet potential criticism from the private sector, arising from the fear that the Fed could monopolize the clearing function through low-cost services.

The proposed ACH processing charges represent a special case. These prices were set to approximate the estimated unit price of mature ACH service—the level of service expected to be achieved by the mid-1980's. The Fed has established ACH prices at this level to encourage banks and their customers to take advantage of the potentially lower cost of electronic funds transfers, while still affording room for competing ACH services to develop in the private sector.

Altogether, pricing represents a useful step in the gradual process of unbundling that is affecting the entire financial industry. Again, the Fed's pricing proposals constitute only one part of a comprehensive program designed to help solve the membership problem. But as that program takes hold, it should enhance competitive equity among all depository institutions and, through greater competition, improve the overall effectiveness of the payments mechanism.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/8/78	Change from 11/1/78	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	121,158	+ 676	+ 16,355	+ 15.61
Loans (gross, adjusted)—total	98,153	+ 478	+ 16,795	+ 20.64
Security loans	2,339	+ 346	− 398	− 14.54
Commercial and industrial	28,418	− 22	+ 3,731	+ 15.11
Real estate	34,013	+ 159	+ 7,537	+ 28.47
Consumer instalment	18,132	+ 44	+ 4,034	+ 28.61
U.S. Treasury securities	8,386	− 9	− 67	− 0.79
Other securities	14,619	+ 207	− 373	− 2.49
Deposits (less cash items)—total*	115,608	+ 388	+ 14,953	+ 14.86
Demand deposits (adjusted)	32,023	+ 327	+ 2,265	+ 7.61
U.S. Government deposits	378	+ 23	+ 216	+ 133.33
Time deposits—total*	81,239	+ 233	+ 12,580	+ 18.32
States and political subdivisions	6,713	+ 71	+ 1,482	+ 28.33
Savings deposits	31,693	+ 65	− 34	− 0.11
Other time deposits‡	39,893	+ 124	+ 10,344	+ 35.01
Large negotiable CD's	19,293	+ 46	+ 7,792	+ 67.75

Weekly Averages of Daily Figures	Week ended 11/8/78	Week ended 11/1/78	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	+ 24	− 1	+ 19
Borrowings	50	44	+ 225
Net free(+)/Net borrowed (−)	− 26	− 45	− 206
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions Net purchases (+)/Net sales(−)	+ 707	− 218	+ 1,415
Transactions with U.S. security dealers Net loans (+)/Net borrowings (−)	+ 117	− 608	+ 575

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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