Research Department
Federal Reserve
Bank of
San Francisco

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FRB SF Weekly Letter

Fed Pricing

The implementation of Federal Reserve pricing is now largely behind us. Thus far, users of various Fed services—wire transfer, net settlement, check collection, automated clearinghouse (ACH), securities handling, and coin and currency transportation—are being charged for their use. The only remaining area to be priced is Federal Reserve float—Fed credit for checks whose processing requires more than one or two days. Whatever float is not eliminated may also be priced in late 1982.

The transition has occurred on schedule with relatively few problems, although it has required the Fed to implement an accounting and billing system for a widely expanded set of potential users—all depository institutions rather than the much smaller group of member banks. As expected, the Fed generally (but not universally) has experienced a decline in service volume. Revenues for most major services generally have fallen short of costs, placing upward pressure on Reserve Bank fees. Ultimately, Fed pricing and rising fees are certain to bring about major changes in correspondent-banking relationships, including a diminished role for the Fed in the nation's payments mechanism. More importantly, explicit pricing will greatly enhance the efficiency of the payments system by providing an incentive for users to shift to lower-cost alternatives.

Monetary Control Act

The Depository Institutions Deregulation and Monetary Control Act of 1980 (MCA) altered the payments mechanism fundamentally by changing required reserves, making them universal for depository institutions, and requiring the Fed to price its services and to make them directly available to all depository institutions. In changing the structure of required reserves, the Act also lowered aggregate required reserves and hence the Fed's payments to the Treasury. (Federal Reserve portfolio earnings, less operating costs and stock dividends, are remitted directly to the Treasury.) As a revenue offset, the MCA required Reserve Banks to price their nongovernmental services at cost plus a private-sector adjustment factor—that factor to include a markup for taxes and the full cost of capital that normally would have been incurred by a private supplier. (For 1981 and 1982, the private-sector markup is 16 percent.) The MCA also required the Fed to eliminate its net float subsidy—the average discrepancy between the stated "availability schedule" on which the Fed credits a collecting bank's account (usually one or two days) and the actual check-clearing time on which it debits a paying bank's account. On the basis of potential-revenue studies, Fed staff estimated that Fed pricing and the elimination of the float subsidy would more than offset the Treasury revenue lost through lower aggregate required reserves. Subsequent calculations have borne out this expectation.

The decision to price Fed services is enhancing the efficiency of the nation's payments network. By directing the Fed to price at full cost plus an implicit return to capital, the Act assures that prices of such services at least approximate true resource costs. This requirement is heavily affecting Fed check-clearing services, where costly sorting, bundling and transportation operations had been provided free of direct charges. But that isn't all; pricing is significantly affecting *all* Fed services. Banks and thrifts are now producing more payments-related services in-house, while using more direct sends, local clearinghouses, and correspondent banks. But some of the Fed's volume decline is being offset by added *direct* business from nonmember banks and thrifts, which were prohibited direct access to most Fed services prior to the MCA. (They purchased their services from correspondent banks, which in turn relied on the Fed as well as other service providers.)

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The Act specifically provided exceptions to full-cost pricing for Fed services of a governmental nature (such as handling Treasury securities)—and further stated that "pricing principles shall give due regard to competitive factors and the provision of an adequate level of such services nationwide." This stipulation enables the Fed to deviate from cost-plus pricing, in some respects. Indeed, the Fed currently is pricing its ACH services below current total costs, in order to promote the use of this declining-cost technology. No one yet knows how soon ACH pricing will move toward the full-cost concept.

Industry reactions
As a consequence of pricing, a dramatic reshuffling of marketing strategies and banking relationships is occurring throughout the financial-services industry. The ultimate prices and market shares are far from certain, as institutions adjust to the transition from free Fed services to priced services. Institutions will continue to examine the relative costs and benefits of purchasing services from Reserve Banks, correspondents, or service bureaus—or of producing the services internally.

The Federal Reserve's 48 operating centers are seeing overnight changes in their service volumes. Indeed, the Fed anticipated such uncertainty when it opted for pricing with regional-cost differentials. Less flexible pricing would have resulted in a situation like that faced by the U.S. postal system, and would have made no more sense for the Fed than for any other institution providing payments services in a competitive market.

Service volume down
It is still premature to assess the long-term effect of pricing on the Fed's service volume, but some initial patterns are discernible. Volume trends in the important service areas of check processing and wire transfers (interbank electronic-funds transfers) reveal definite patterns in response to pricing.

Check processing, which consumes by far the largest portion of the Fed's payments-related costs, has been priced only since last August 1. For the six-month period through January, overall check volume declined 9 percent from the comparable year-earlier period. Actually, annual growth would have been roughly 5 percent without pricing, so the overall effect of this shift was a 14-percent volume decline.

The lion's share of check volume (94 percent before pricing) is in "processed" checks—those that are not presorted or prepackaged according to receiving institution. "Processed" volume declined by an average of 19 percent across Federal Reserve Districts, with individual district declines ranging from 3 percent to 43 percent. In contrast, "package sort" volume jumped 159 percent over the year-earlier figure, offsetting part of the reduction in processed volume but not increasing revenues accordingly. (Already sorted according to the receiving institution, "package sorts" need only to be shipped to the paying institution.) As a consequence of pricing, institutions are doing more presorting in-house before presentment to the Fed. The marginal sorting step is less costly when appended to the collecting bank's processing than when done as a separate step at the Fed. Such shifts in the payments industry exemplify the efficiency gains that result from explicit pricing.

Wire transfers are experiencing a similar shift in the type of service demanded. Off-line transfers—those originated by telephone from an institution without direct access to the Fed's wire network—have declined in volume because of the relatively high cost and associated high price. Likewise, telephone confirmations of completed transactions have declined in number. But there has been a dramatic shift to lower cost (and lower priced) on-line transfers—those originated directly by institutions with computer or terminal access. In short, Fed prices now reflect the high cost of off-line telephone service, and institutions therefore have re-

MONETARY POLICY OBJECTIVES

Federal Reserve Chairman Paul Volcker presented a report on "Monetary Policy Objectives for 1982" at the February 10-11 meetings of the House and Senate Banking Committees. The report includes a summary of the Federal Reserve's monetary-policy plans for 1982, along with a review of economic and financial developments in 1981. Single or multiple copies of the report can be obtained upon request from the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco CA 94120. Phone (415) 544-2184.

sponded by shifting to more efficient on-line access, or by purchasing these services from correspondents with on-line access. In fact, the heavy demand for on-line access has made it impossible for some Federal Reserve districts to add terminal capacity fast enough.

Proposed prices up

The Fed's Board of Governors this January released for comment the proposed 1982 fee schedule for wire transfers and net settlement services. The proposed wire-transfer fees are designed to increase revenues by one-third in order to meet the cost-plus criterion. They are sharply higher than the initial fees imposed in 1981, and incorporate two major changes in pricing structure. First, the proposal calls for a fee of 65 cents per transfer, to be levied on both the originating institution (sender) and the *receiving* institution, as opposed to the 1981 practice of levying 80 cents only on the sending institution. This practice of charging both institutions more closely resembles the pricing structure employed by the private sector—and also encourages the sending institution to direct its payments through the wire, thereby speeding up payments and reducing float.

A second proposed change would involve a 15-cents-per-transfer surcharge for interdistrict transfers. In addition, the Fed is proposing to raise its surcharge for off-line originators—institutions not directly linked by computer or terminal to the Fed's wire network—from $2.70 to $3.50 per transfer. Also, it would increase the added surcharge for off-line institutions requiring telephone advice (notification) of transfers from $1.80 to $2.25. Besides raising revenues to cover these costly activities, the latter increases should encourage institutions to come "on-line," thereby promoting a more efficient technology.

The Fed has also proposed significant increases in fees for net settlement services—that is, the debiting and crediting of institutions' Federal Reserve accounts for transactions generated by ACH's, private clearinghouses, and credit-card clearing associations. The proposal envisions steep fee hikes as well for off-line telephone service related to net settlement.

In all Federal Reserve Districts the dramatic shift in check clearing from processed volume to package sorts has caused significant revenue shortfalls. Processed checks generate about three times as much revenue per check as do package sorts. In the San Francisco (Twelfth) District, the difference amounts to about 1.7 vs. 0.6 cents per check. In light of revenue shortfalls, increased operating costs, and altered scales of operation, Reserve Bank fees for all types of check services probably will have to increase in 1982 if revenues are to approximate expenses (plus 16 percent). Although not part of the Board of Governors' January proposal, price increases may occur on a local basis across the twelve Reserve Banks and their branches. Indeed, some check prices are scheduled to rise by a substantial margin on April 1, with the imposition of a per-package fee for package sorts ranging from $1.00 to $4.51 in addition to the existing per-check fee. While the increase will slow the growth of the package-sort service, this low-cost service will continue to increase in importance. Other check prices probably will be modified in August.

In short, Federal Reserve pricing is dramatically affecting the Fed's involvement in the payments industry, and the ultimate outcome is far from certain. But pricing also presents an interesting real-life "experiment"—one in which we can observe industry responses to price changes, substitutions among types of services, rapid acceptance of lower-cost technologies, and consequent increases in economic efficiency.

Jack Beebe and Gary Zimmerman

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

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/24/82	Change from 2/17/82	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	157,795	− 204	11,055	7.5
Loans (gross, adjusted) — total #	136,552	− 161	12,228	9.8
Commercial and industrial	42,142	− 589	5,597	15.3
Real estate	56,328	62	5,192	10.2
Loans to individuals	23,492	− 52	− 110	− 0.5
Securities loans	2,399	458	1148	91.8
U.S. Treasury securities*	6,328	75	− 369	− 5.5
Other securities*	14,915	− 118	− 783	− 5.0
Demand deposits — total#	37,664	−3,877	− 1,660	− 4.2
Demand deposits — adjusted	26,053	− 483	− 1,806	− 6.5
Savings deposits — total	30,073	− 367	802	2.7
Time deposits — total#	92,072	2,146	14,636	18.9
Individuals, part. & corp.	82,276	1,664	14,301	21.0
(Large negotiable CD's)	36,099	1,216	6,263	21.0

Weekly Averages of Daily Figures	Week ended 2/24/82	Week ended 2/17/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	73	151	33
Borrowings	155	63	67
Net free reserves (+)/Net borrowed(−)	− 82	88	− 34

* Excludes trading account securities.
\# Includes items not shown separately.

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