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STATEMENT OF

WILLIAM J. ANDERSON, DIRECTOR

GENERAL GOVERNMENT DIVISION

BEFORE THE

COMMITTEE ON BANKING, HOUSING,

AND URBAN AFFAIRS

U.S. SENATE

ON

FEDERAL RESERVE PRICING OF ITS CHECK

CLEARING SERVICES

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Mr. Chairman and Members of the Committee:

It is a pleasure to appear today to participate in your assessment of the actions the Federal Reserve has taken to price its check clearing services. Before the Monetary Control Act of 1980 was passed the Federal Reserve provided check clearing services without charge to its member banks. Following the act's enactment, the Federal Reserve was required to price its services and provide them to all member and nonmember institutions. This expanded the Federal Reserve's potential market for check services but at the same time raised a question about whether its

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check processing volume would hold up when the service was no longer free. Direct competition increased between the Federal Reserve and private check clearing institutions and this, in turn, has evoked controversy.

In your request of April 6, 1983, you asked us to provide an analysis of the progress the Federal Reserve has made to fully recover its check clearing costs since our May 1982 report on the subject. You also asked that we assess certain Federal Reserve actions that have been questioned by its private sector competitors. Since your committee and others with an interest in these subjects have been provided with a draft report on our findings, I will very briefly highlight the results of our work.

PROGRESS MADE SINCE 1982 IN RECOVERING COSTS

The Monetary Control Act sets forth the principle that over the long-run the Federal Reserve should price its services to cover three items: (1) its operational costs, (2) its costs associated with float created in the check clearing process, and (3) imputed amounts representing the taxes and the return on capital that would be paid if it were a private sector firm--known as the Private Sector Adjustment Factor or PSAF. In our May 1982 report, we expressed concern about the speed with which the Federal Reserve was approaching full cost recovery. We were particularly concerned about its failure to price or eliminate float in its check clearing operations. At the beginning of 1983 the Federal Reserve's prices were not providing enough revenue to cover operating expenses and it was still not pricing float, thereby continuing to confer a subsidy on users of its services. During 1983 the Federal Reserve began pricing check float, increased other prices, and experienced changes in its mix of services. Average revenue per check increased by 38 percent over the course of the year.[1] Our analysis indicates that as a result of these changes, total revenues are now covering all costs as well as the PSAF. There no longer appears to be a subsidy in the pricing of Federal Reserve check clearing services.

COMPETITOR'S CONCERNS

Certain competitors of the Federal Reserve have raised concerns about the way the central bank has implemented its pricing and check clearing policies under the 1980 act. These concerns fall into two general categories:

(1) Market advantages that result from the Federal Reserve's central bank status.

(2) Subsidy of check clearing operations that may continue because not all associated costs (including the imputed costs for the PSAF) have been properly identified.

I will discuss the results of our work as they relate to each of these concerns.

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[1]This figure is based on actual data for calendar year 1983 and revised volume data for 1982 that have become available since the draft report was prepared. In the draft report we estimated the comparable figure to be 41 percent.

Concerns About the Federal Reserve's National Scale of Operations

In general, the Federal Reserve does enjoy certain advantages as a result of its central bank status. Its nationwide system of check clearing facilities as compared with the fragmented nature of individual competitor operations no doubt creates advantages that accrue from scope and scale. The most recent authoritative study of the nation's check clearing system showed that in 1979 the Federal Reserve participated in clearing about 60 percent of all checks that were deposited in one bank for payment by another.

The nationwide character of the Federal Reserve System also provides it with a measure of flexibility in how it prices its services. To accomplish full cost recovery for the system as a whole, the price of each and every product the Federal Reserve System offers at each of its 48 locations need not--and probably as a practical matter cannot--be set to recover the estimated fully allocated costs (including the imputed taxes and cost of capital) associated with that particular product. The Federal Reserve System sets its prices with the expectation that excess revenues generated by some products in some locations will be sufficient to offset revenue shortfalls associated with some products offered in the same or other locations. Federal Reserve policies and the discipline of generating enough system-wide revenues to cover system-wide expenses do, however, limit the flexibility which Federal Reserve banks have in setting product prices. In our view, limited flexibility in setting some prices below fully allocated costs, if done in furtherance of legitimate statutory and regulatory objectives, is consistent with the provisions of the 1980 act.

We think it is also important to point out that the Federal Reserve does not enjoy all the competitive advantages. It must, for example, be prepared to serve all financial institutions regardless of how costly serving some may be. Private institutions on the other hand, have a greater ability to influence the services they will provide. Thus, a private bank can, but a Federal Reserve bank cannot, charge very high prices to discourage demand for services the bank feels do not represent the best use of the bank's resources. Furthermore, unlike its private competitors, the Federal Reserve is not in a position to market its check clearing services as part of a broader array of service lines that would define a total business relationship between respondent and correspondent banks. In this sense the Federal Reserve may have less flexibility in its pricing and in its ability to compete than private sector counterparts. From our perspective, it is unclear how these comparative advantages balance out.

Specific Concerns

Specific concerns have been raised by the Federal Reserve's competitors as evidence of the central bank's competitive advantage. They include its move to noon presentment, its prohibition from paying presentment fees, its treatment of clearing balances, and the way it has chosen to price some of its float.

Noon Presentment and Presentment Fees. In February 1983, the Federal Reserve began presenting checks for payment as late as 11 a.m., and in June the time was moved to noon. Before the move to noon presentment, the Federal Reserve generally had abided by the earlier presentment deadlines prescribed by clearinghouses in major cities, normally 8 a.m. to 10 a.m. Checks presented after customary clearinghouse deadlines are often subject to fees called presentment fees, that the Federal Reserve, by law, is prohibited from paying. The move to noon presentment, in combination with improved transportation arrangements and later deposit deadlines, was designed to speed the collection of checks thereby facilitating the functioning of the nation's payment system. But it also represented a significant improvement in the Federal Reserve's ability to compete. We found no basis to conclude that the Federal Reserve's change to noon presentment constituted improper regulatory action, but do believe it would have been beneficial if public comment had been invited earlier in the process.

Data that would allow a comprehensive analysis of the effect noon presentment has had on the Federal Reserve's competitors are not available. There is some evidence, however, that the changes in the Federal Reserve's service have adversely affected at least some of its competitors' activities. The best evidence is that the rate of increase in the number of checks transported by the Federal Reserve after noon presentment began to be implemented was greater than the rate of increase in the number of checks thought to have been written during the period after Federal Reserve policies changed. This result logically implies a reduction in checks transported by other means. Although local clearinghouses could change their rules to permit later presentment times, to our knowledge they have not found it advantageous to do so.

Because a correspondent bank competitor cannot do what the Federal Reserve did without suffering the repercussion of paying presentment fees, the concerns raised about the move to noon presentment are understandable. The practice of charging presentment fees has been in existence for a long time and is viewed by the banks levying such fees as compensation for costs incurred in paying checks after normal clearinghouse hours. We were asked to comment on the advisability of authorizing Federal Reserve banks to pay presentment fees. In principle, subjecting the Federal Reserve System to the same arrangements competitors face has merit. Data unfortunately does not exist that permit a complete description of how presentment fees fit into the overall check collection picture. As indicated in our draft report, however, we believe a number of unanswered questions exist about how authorizing or requiring payment of presentment fees would affect the role and responsibility of the Federal Reserve System and about how a fee system would be administered.

Presentment fees currently vary according to local custom and in many cases seem to be the result of arrangements negotiated on a case by case basis between banks. In light of this, it is unclear what level of fees would constitute nondiscriminatory charges, and it is also unclear who would decide the level of such fees. If a standard fee were set for the Federal Reserve, would that become the standard for all banks? If the fee the Federal Reserve paid were allowed to vary according to local custom, what opportunities exist for clearinghouses to change the procedures and the costs associated with the check clearing process? Furthermore, because the Federal Reserve is strictly a presenter and not also a payer of commercial checks, would imposition of fees place it at a disadvantage relative to competitors that both pay and charge presentment fees? In deciding whether to authorize or require the Federal Reserve to pay presentment fees we think it would be appropriate to answer as many of these questions as possible to be certain that subjecting the Federal Reserve to such charges would not adversely affect the functioning of the nation's payments system.

Clearing Balances. Under policies soon to be changed, the Federal Reserve's treatment of clearing balances appears, in most cases, to give it an advantage over private check processors. Other things being equal, balances whose earnings help pay for check clearing services are worth more at a Federal Reserve bank than at a correspondent bank. This is because the correspondent bank has to place 12 percent of all such deposits in a noninterest bearing reserve account. Clearing balances maintained with the Federal Reserve are not subject to this requirement. The Federal Reserve's advantage is, however, to some extent offset because correspondents earn more on the portion of their clearing balances they invest than can the Federal Reserve. Nevertheless, everything considered, it seems appropriate for the Federal Reserve to change its method of calculating the value of its clearing balances to eliminate the apparent advantage that stems from its central bank status.

On March 7, 1984, the Federal Reserve Board approved a proposal to accomplish this change, and this will take effect later on this year. This proposal will increase effective prices to some degree for most of the institutions eligible to deposit checks with the Federal Reserve System for collection. The maximum effective price increase for any one institution that wants to pay for its check clearing services entirely by clearing balance earnings credits is about 13 percent, but the overall effect of the change on average Federal Reserve effective prices will be much less than this amount.

Check Float. Concerns have been expressed that the Federal Reserve has the ability to sustain higher levels of check float than any private institution and thereby enjoys a competitive advantage. While this may have been an important competitive factor when $4.5 billion in unpriced float existed following passage of the 1980 Act, we question whether it is still a significant cause for concern. Because check float is now priced, the Federal Reserve has every incentive to keep it low in a competitive environment.

The Federal Reserve's strategy, which succeeded, was to reduce float before pricing it, thereby minimizing the effect that float pricing would have on the Federal Reserve's customers. As a result of operating improvements and the implementation of pricing, commercial check float fell to an average of $1.2 billion in the fourth quarter of 1983.

Concerns have been raised about the Federal Reserve's policy of charging banks for float that arises in connection with clearing interterritory checks. In this case the Federal Reserve charges depositing banks for the float arising from their actual deposits. This strikes us as being more equitable than incorporating these costs into the unit check clearing prices charged to all banks because some banks in some regions have a larger dollar value of float per check processed than those in other regions. Though this system may be more administratively burdensome than the alternative, this disadvantage is more than offset by its fairness and its tendency to discourage abuse of the payments system.

Operating Costs and the Private Sector Adjustment Factor

I now turn to the issue of whether the Federal Reserve is continuing to subsidize its check clearing operations. As requested by your committee, we analyzed the system the Federal Reserve uses to allocate costs to its check clearing operations. In 1983, the Federal Reserve had an estimated $1.02 billion in total operating expenses. Of this total, the Federal Reserve's Planning and Control System (PACS) allocated about $320 million to check clearing. Part of this amount represents direct expenses; the remainder represents an allocation of support and overhead expenses. We paid particularly close attention to the reasonableness of procedures used to allocate support and overhead expenses because this is an area where judgments come into play. We found that PACS rules were to a large extent reasonable and being conformed with.

However, we identified eight overhead and support accounts as well as expenses for the Board of Governors where there appears to be a basis for reconsidering the allocation rules currently followed. We then considered the effect on prices if a higher percentage of these expenses were allocated to check clearing. Based on our analysis of each category, we selected measures that we believed collectively represented the upper bound of increased allocations that might be justified. As a result of these reallocations, operating expenses associated with check clearing would increase by about $17 million and prices would rise by roughly 5 percent.

The changes we made to the allocation rules should not be construed as indicating deficiencies in the methods currently being used. Whether current methods are appropriate could only be determined by a detailed examination of how the resources in each category are actually used. Our calculations should simply be viewed as an effort to determine the significance of giving the Federal Reserve no benefit of the doubt in the most questionable allocation rules and seeing what the effect would be on prices. Because the effect is modest, we do not believe that there are glaring expense omissions or understatements that would significantly affect Federal Reserve prices.

The Monetary Control Act requires the Federal Reserve to include in its prices for check clearing an adjustment for the taxes and return on capital that would be incurred by a private firm. Determining what this adjustment should be is a very complex exercise.

In October the Federal Reserve proposed to recover $56 million through the PSAF in 1984. After carefully studying the methodology used by the Federal Reserve, we saw no reason to propose a higher PSAF. The Federal Reserve's measure of the amount of capital allocated to check clearing, the debt/equity ratio used, the effective tax rates used, and the average pre-tax return on capital of 17.2 percent all appeared reasonable. In March the Federal Reserve adopted a revised PSAF calculation of about $59 million. The revisions the Federal Reserve made also appear to be reasonable.

Some critics of the Federal Reserve's calculations take issue with all assumptions made and measures used to calculate the PSAF, arguing that it should be over 3 times higher. Because there is not a set of firms exactly like the Federal Reserve, disagreements about judgments made are bound to exist. For this reason we cannot say precisely what the PSAF should be. We do not believe, however, that anything approaching a PSAF that is roughly 3 times higher than that proposed is reasonable.

It is important to note that the way the Federal Reserve calculates its PSAF omits profit that the System makes on its clearing balances. Taking this into account would raise the excess of revenues over costs above the PSAF range that we think is needed. Procedures now being considered by the Federal Reserve may, however, reduce or eliminate the profit on clearing balances.

DISCLOSURE AND GUIDELINES ON COMPETITIVE PRACTICES

The Monetary Control Act placed the Federal Reserve in the unique and difficult position of competing directly in its check clearing and other priced services operations with many of the same institutions that it regulates. The Federal Reserve is, however, taking some steps that should help reduce the tensions that can easily be generated by its central bank status. We are encouraged by the action that the Federal Reserve is now taking to disclose more fully its financial and program information as well as its efforts to develop policies defining the bounds of its competitive actions. These steps do not, of course, deal with the basic economic concerns of the correspondent banks but they should be helpful in reducing misunderstandings about how the Federal Reserve is carrying out its responsibilities.

Mr. Chairman that concludes my prepared statement. My colleagues and I will be happy to respond to any questions the committee might have.