

**GAO**

Report to the Chairman, Subcommittee  
on Commerce, Consumer, and Monetary  
Affairs, Committee on Government  
Operations, House of Representatives

December 1989

# THE FEDERAL RESERVE

## Information on the System's Check Collection Service





United States  
General Accounting Office  
Washington, D.C. 20548

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General Government Division

B-236067

December 15, 1989

The Honorable Doug Barnard, Jr.  
Chairman, Subcommittee on Commerce,  
Consumer, and Monetary Affairs  
Committee on Government Operations  
House of Representatives

Dear Mr. Chairman:

In your June 1, 1987, letter, you asked us to respond to five groups of questions about the Federal Reserve's check collection service. Three of the five areas you asked us to study deal with aspects of how Federal Reserve banks and private banks operate their respective check collection services (the process whereby a check deposited in one bank is brought back or presented for payment to the bank from which it was written). The remaining two areas in your request deal with the cost recovery experience of Federal Reserve banks and the adequacy of costs imputed by the Federal Reserve to make their cost base more comparable to private sector firms (an adjustment called the private sector adjustment factor [PSAF]).

After the Subcommittee's request, a study of presentment issues was mandated under the Competitive Equality Banking Act of 1987. As you are aware, we designed the legislatively mandated study, which resulted in a May 1989 report,<sup>1</sup> to incorporate most of the presentment questions and issues you raised. This report summarizes those points made in that report and addresses the questions raised by the Subcommittee that were not covered in the May report. As requested, we have also included several relevant portions of the May report. (See app. I.)

All of the questions you asked us to study relate to provisions of the Monetary Control Act of 1980 requiring the Federal Reserve to charge for its check collection services, recover costs fully, impute costs incurred by private sector firms, and make its services available to all depository institutions.<sup>2</sup> Because private banks also offer check collection services to other banks, the Monetary Control Act has resulted in

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<sup>1</sup>Check Collection: Competitive Fairness is an Elusive Goal (GAO/GGD-89-61, May 12, 1989).

<sup>2</sup>Before the Monetary Control Act of 1980, the Federal Reserve did not charge for its check collection service. The service, however, was generally available only to commercial banks that were members of the Federal Reserve System.

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## Objectives, Scope, and Methodology

For calendar years 1984 through 1988, we reviewed how much revenue the Federal Reserve System and each of the 12 Reserve banks actually collected for check collection services. We compared the revenue to that needed to recover costs, including that portion of the PSAF allocated to check collection.

The PSAF is difficult to analyze because no private sector firms provide the same priced services that Federal Reserve banks provide. The Monetary Control Act also did not specify how imputed costs are to be calculated, and therefore a number of judgments must be made in establishing the PSAF.

In preparing this report, we did not review the entire PSAF calculation. As requested, we looked only at new developments affecting the adequacy of the Federal Reserve's allowance for its imputed return on capital that have changed materially since our 1985 report that found the PSAF calculation generally to be reasonable.<sup>3</sup> The principal change since our report was issued is that the Federal Reserve System and other bank regulatory agencies (Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation [FDIC]) established standards for the minimum amount of capital as a percent of assets that must be held by banks and bank holding companies. We concentrated on the possible check collection inequities that could occur because the Federal Reserve does not follow the minimum capital rule that banks must follow. We extended our analysis to another aspect of the PSAF—deposit insurance premiums—in which the Federal Reserve also has been following a different procedure than that required of private banks.

The Subcommittee also asked about the cost recovery for different kinds of check collection services offered by Reserve banks. We therefore examined the records kept by the Federal Reserve System to determine whether individual Federal Reserve banks were using revenues from profitable check collection services to subsidize unprofitable ones, thus providing itself with a competitive edge.

As discussed with the Subcommittee, because the Federal Reserve does not maintain detailed cost data at the individual services level, we were unable to determine whether such cross-subsidization was occurring beyond that reported in our May 1989 report. (See app. I.) In commenting on this report, the Federal Reserve Board correctly pointed out that

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<sup>3</sup>An Examination of Concerns Expressed About the Federal Reserve's Pricing and Check Clearing Activities (GAO/GGD-85-9, Jan. 14, 1985).

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In a July 1989 letter, the Board defined the steps it was taking to promote competition in response to our recommendations. (See app. IV.) The Board said it was pursuing the development of a workable same-day payment proposal in association with representatives of payment system participants. Additionally, in accordance with our other recommendations, the Board said it was clarifying and refining procedures for reviewing price and service changes and expanding procedures to address private sector assertions of harm caused by a conflict between the Federal Reserve's roles as provider of services and regulator, supervisor, and lender.

Two topics in the Subcommittee's request require additional comment. You asked us specifically to evaluate the direct settlement service proposed at one time by the California Clearinghouse Association. During the course of our work, it became clear that direct settlement was just one way of trying to equalize presentment rights. Under this proposal, banks could present directly to one another but only if they were, in essence, "deputized" by the Federal Reserve. Thus, this proposal would create another Federal Reserve service that was free from competition and would continue private bank dependency on the Federal Reserve to make check presentments to other banks. Because extending the right to same-day payment would eliminate these shortcomings, we recommended that the Federal Reserve work to eliminate the differences in presentment abilities between Federal Reserve and private banks.

We were also asked to examine the argument that presentment fees may improve efficiency in check processing if they are graduated in some fashion to assess a higher fee for presentments later in the day that allow the paying institutions a shorter time for processing. Some banking officials have told us that presentment fees are higher later in the day and that such variations encourage earlier presentment of checks. Bankers generally consider the early receipt of checks (about noon or earlier) to be an important factor in processing checks efficiently. For example, banks offering cash management services to corporations want to receive checks as early in the day as possible to advise customers on the fund balances available for investment that day. Smaller banks also want to receive checks early enough so that all operations that either require the same equipment or personnel as check processing or depend upon information obtained from processing checks can be completed within the regular working day.

## In 1988, the Federal Reserve Did Not Fully Recover Its Check Collection Costs

As you know, the Monetary Control Act required that the Federal Reserve calculate the PSAF to reduce pricing disparities between Reserve banks and private banks offering similar services. The PSAF covers the imputed value of taxes, return on capital, and other adjustments (such as FDIC insurance premiums), each of which must be paid by private banks but not Federal Reserve banks. To form its cost base, the Federal Reserve adds imputed costs to its actual costs. This cost base determines the amount of revenue that will have to be recovered through Reserve bank prices. Each Reserve bank is expected to recover its allocated portion of the cost base. In 1988, the Federal Reserve estimated that its imputed costs would be \$76.2 million, of which 77 percent was allocated to check collection.<sup>5</sup> For that year, the PSAF represented about 15 percent of the total check collection cost base. (See app. II for a fuller description of how the Federal Reserve calculates its PSAF.)

In 1988, the System as a whole and 7 of its 12 Reserve banks did not fully recover all check collection costs primarily because of unanticipated expenses incurred by Reserve banks in providing a new service for processing returned checks to meet the mandate of the Expedited Funds Availability Act. For the System as a whole, the shortfall in 1988 was \$9.0 million, or 1.8 percent of its cost base.<sup>6</sup> (See table 1.) Table 1 shows the amount of recovery by each Reserve bank from 1984 through 1988.

The Expedited Funds Availability Act of 1987 required the Federal Reserve System, among other things, to improve the process by which paying banks return unpaid checks to the bank of first deposit. The Federal Reserve System responded to this requirement by offering a new service to all banks—called the direct return service. When the Federal Reserve System first introduced this service, it based its prices on cost and volume estimates that later experience proved were optimistic. The System then raised its prices in May 1989. According to the Federal Reserve, this price increase was necessary to cover the additional processing of the many poor quality returned checks received by the Reserve banks. The five banks that fully recovered costs in 1988 were

<sup>5</sup>Check collection is the largest of the priced services, accounting in 1987 for \$500 million or 77 percent of the \$650 million in revenues received by the Federal Reserve for its priced services.

<sup>6</sup>In commenting on the report, the Federal Reserve noted that it strives to match costs and revenues for each calendar year. The Board believes that an overrecovery or underrecovery of the costs of providing the check service is suboptimal in that an overrecovery results in the collection of excessive fees from the users of the service and underrecovery may adversely affect other providers of the service. According to the Board, it matched costs and revenues more closely in 1988 than in any other year since pricing began.

## The Deposit Insurance and Equity Capital Component of the PSAF

We have reviewed two elements of the PSAF that could potentially give the Federal Reserve a cost advantage over private banks—the handling of deposit insurance premiums and of minimum capital rules imposed by federal regulators. In both cases, the Federal Reserve PSAF methodology has involved using accounting rules that differ from those that federal agencies impose on private banks. We found that the only material difference in costs was associated with the deposit insurance premiums. However, a change in the PSAF methodology adopted in June 1989 has eliminated cost differences in this area.

## Deposit Insurance Premiums

Banks pay deposit insurance assessments to FDIC on the basis of their depositors' demand account balances.<sup>7</sup> These balances include deposits arising from checks that have not yet been collected. In imputing its deposit insurance premium cost, the Federal Reserve has not been counting all checks deposited with it for collection. Instead, it has counted only those checks for which credit has been passed to the depositor before the funds are collected. Because the Federal Reserve did not count all checks in process of collection, its 1988 FDIC assessment calculation was \$1.9 million instead of a potential \$4.3 million.

On June 16, 1989, the Board of Governors of the Federal Reserve Board adopted a revision to the PSAF methodology that provided for counting checks in the Federal Reserve banks' collection process in a way that is comparable to the way in which private banks count checks in process. The Board stated, however, that the amount of this asset would be reduced by any checks counted on the books of more than one Federal Reserve bank, credits passed to government agencies (which is a non-priced item), and credits associated with their direct and consolidated shipments.<sup>8</sup>

In our opinion, the deductions made are reasonable. The first two deductions provide a more accurate count of checks in process. The third deduction takes into account that the Federal Reserve does not actually receive the checks as deposits until they are received by the processing

<sup>7</sup>Assessments are computed twice each year on the basis of an average of two end-of-quarter balances. Total demand account balances are reduced by 16 2/3 percent to reflect that checks that have not yet cleared are counted as deposits by both collecting and paying banks. FDIC annual assessments amount to 1/12 of 1 percent of the adjusted balances.

<sup>8</sup>In this service, private banks ship presorted packages of checks to out-of-district Reserve banks for processing. The banks may or may not use Federal Reserve transportation to ship the checks. Before the checks are received, the banks receive credit from their own Reserve bank based on an "advice" of the amount of checks sent to be collected.

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increase in the imputed equity capital component of the PSAF. We estimate that the amount of equity capital reflected in the PSAF calculation for 1986 through 1988 would meet the regulatory minimum capital adequacy standard. Appendix III provides additional information on how equity capital is affected by the old and new approaches to calculating checks in process of collection.

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## Agency Comments

A draft of this report was sent to the Board of Governors of the Federal Reserve System. In responding to the report, the Federal Reserve raised no concerns with the message of the report but provided some clarifying information. The letter and our response is contained in appendix V.

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As arranged with the Subcommittee, we are sending a copy of this report to the Board of Governors of the Federal Reserve System and other interested parties.

The major contributors to this report are listed in appendix VI. If you have any questions or need additional information, please call me at 275-8678.

Sincerely yours,



Craig A. Simmons  
Director, Financial Institutions  
and Markets Group

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**Abbreviations**

FDIC      Federal Deposit Insurance Corporation  
PSAF      Private Sector Adjustment Factor



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Executive Summary

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the check collection system would be damaged if the differences in basic check presentation abilities of collecting and Reserve banks were narrowed or eliminated. In fact, the system might be improved by such a change. However, GAO believes that to develop a practical proposal that successfully accounts for the interests of all participants in the check collection system, the Federal Reserve will have to develop an explicit policy on competitive fairness and develop more specific criteria to guide its decisions on competitive fairness issues.

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## GAO's Analysis

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### Need for Same-Day Payment

To advance the efficiency of the check collection system, the Federal Reserve has used its authority to deviate from state laws governing private banks. In particular, Reserve banks require paying banks (1) to make payment on the same day the Reserve banks present checks and to do so without charging fees, (2) to make such payment on checks that Reserve banks have not endorsed, and (3) to make such payment on checks presented by Reserve banks up to 2:00 p.m.—a time later than is customary for collecting bank check presentations. These payment terms enable Reserve banks to make low-cost funds available quickly to banks that use Reserve banks for check collection. (See p. 26.)

To be competitive, collecting banks need to be able to match Reserve bank collection terms. In part, collecting banks can do this by choosing which customers they will serve. Unlike Reserve banks, however, collecting banks do not have the authority to unilaterally vary from state laws governing check collection. Since these laws do not provide collecting banks with a practical entitlement to same-day payment, collecting banks need to negotiate agreements with other banks covering the terms of check presentation and payment. (See pp. 27-29.) When presentation and payment agreements can be worked out, they customarily entail collecting banks paying fees (presentation fees) to the paying banks. According to bankers that provided GAO with estimates, these fees increased their check collecting costs from 18 to 40 percent. (See p. 30.)

To lessen the effects of the same-day payment difference, collecting banks join clearinghouses, local associations of banks formed to facilitate the exchange of checks among banks. However, member banks must still negotiate arrangements in order to present checks to banks outside the clearinghouse. (See pp. 37-39.)

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Executive Summary

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Agency Comments

The draft report was sent to the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board, and seven trade associations. The Board of Governors agreed with the overall theme of the report and said it would work "further to formalize procedures for evaluating regulatory, service, and pricing proposals, and to articulate the relative importance of competition in evaluating these proposals."

Though the Board did not directly comment on GAO's recommendation to adopt a specific policy statement of competitive fairness, it said that publicly disclosing its mark-ups and rationale for decisions to change check collection was an unnecessary encumbrance since its current review procedures are adequate to ensure competitive fairness. The Board also said that extending Reserve banks' abilities to collecting banks may not enhance competition or efficiency or be in the public interest. In GAO's opinion, the recommendations made are valid and should be pursued. (See pp. 63-66.)

The Federal Home Loan Bank Board commented that the role of its banks should be further defined and also suggested a different recommendation. GAO believes its characterization of home loan banks is sufficient and that the suggested recommendation is not the best way to equalize competition. (See pp. 66-67.)

Generally, all the trade associations that commented agreed with GAO's conclusions and recommendations. Some suggested additional recommendations, and the New York Clearing House did not agree with the GAO recommendation calling for a revised same-day payment proposal. Two trade associations did not respond. (See pp. 67-69.)

Chapter 5 summarizes comments received and GAO's response. Appendixes V through XI contain the individual letters with GAO's specific responses.

**Appendix I**  
**Excerpts From Check Collection: Competitive**  
**Equality Is an Elusive Goal (GAO/GGD-89-61)**

**Chapter 2**  
**Differences in Ability to Obtain Payment on**  
**Checks Affect the Competitive Balance**

A nationwide same-day payment requirement for presentments by Reserve banks was set out in a revision to Regulation J in 1972. Without that regulatory change, Reserve banks could not effectively require all banks to make same-day payment. Before the regulatory change was adopted, the Federal Reserve Bank of San Francisco, for example, was attempting to convince all 406 banks within the district to make same-day payment. However, 95 banks refused.

According to Federal Reserve Board officials, all banks now conform to the Federal Reserve's terms and conditions of check collection. According to them, a bank cannot afford to (1) turn down check presentments from a Reserve bank, (2) refuse to make same-day payment in full to a Reserve bank, or (3) deny a Reserve bank the right to automatically charge an account maintained at a Reserve bank for check collection purposes.<sup>2</sup> In short, if a bank did not comply, its checks would not be handled by the Reserve banks. In turn, according to Federal Reserve officials, delays and difficulties in obtaining payment would cause the public to lose confidence in the checks drawn on that bank and move checking accounts to other banks.

Additionally, Reserve banks make no payments to paying banks to cover expenses incidental to their participation in the collection. Section 13 of the Federal Reserve Act specifies that banks may not charge Reserve banks fees associated with the act of collection or payment on checks. The general intent of the act's prohibition was to establish a nationwide system for collecting checks at "par" or face value. Previously, many paying banks paid less than the face value of checks presented by collecting banks. The legislative history indicates that such a practice compensated paying banks for expenses and risks associated with collection. However, recouping another bank's check collection expenses from a Reserve bank was viewed as an undesirable policy. The act did not, however, rule out banks charging other banks a fee.

**Collecting Banks Pay Fees**  
**to Obtain Same-Day**  
**Payment**

Unlike Reserve banks, collecting banks do not have the authority to unilaterally vary from the terms of the U.C.C., and its terms do not give banks the practical authority to effectively demand that other banks make same-day payment. For example, under the terms of the U.C.C., collecting banks may

<sup>2</sup>The account may be the bank's reserve account, separate clearing account, or the account of another bank provided that the other bank agrees to allow a Reserve bank to automatically charge the account

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Therefore, to obtain same-day funds, collecting banks may, under the terms of the U.C.C., enter into individual agreements that may require the payment of presentment fees.<sup>4</sup> For example, when a collecting bank finds a paying bank willing to provide same-day funds, a collecting bank may open an account at the bank and deposit checks written on the paying bank into the account. The paying bank would then transfer funds from the checkwriters' accounts to the collecting bank's account.<sup>5</sup> These proceeds may then be wired to the collecting bank's account at a Reserve bank. For these services, a paying bank typically charges a presentment fee, which includes per-check charges for each check deposited in the collecting bank's account and charges for maintaining the account, reporting balances, and transferring funds.

The payment of presentment fees is an accepted and prevalent business practice in the banking industry. According to collecting bank officials, the payment of fees is necessary because that induces paying banks to accept checks directly from collecting banks. Moreover, without compensation, a paying bank does not have an incentive to make same-day funds available on terms more favorable than the minimum standards required by the U.C.C. One banker noted that

"initially, collecting banks experienced some resistance from paying banks to the idea of allowing collecting banks to direct deposit a paying bank's own items. The resistance was related to bookkeeping and return item handling cost issues. In order to overcome this resistance, collecting banks offered to pay the paying banks for the privilege of direct deposit."

Another collecting bank that deposited checks directly with 49 other banks in 21 states during 1987 provided us with more detailed information on the presentment fees it paid. Table 2.1 displays the range of per-check fees that the bank says it was charged by the 49 banks for accepting deposits into the collecting bank's account and for providing same-day payment on checks drawn on those banks. Of the 49 banks, only 1 did not charge a per-check fee for checks drawn on itself. On the basis of other bank fee schedules obtained during our work, Federal Reserve studies, and industry surveys, the charges accrued to this collecting bank appear to be representative of industry practices.

<sup>4</sup>Alternatively, banks may obtain same-day payment through clearinghouse agreements. This alternative is discussed on pages 37-39.

<sup>5</sup>Beyond facilitating payment on checks, a demand account arrangement also enables paying banks to protect themselves against checks they return instead of paying. The minimum balances maintained in the collecting banks' accounts provide a source of funds to cover returned checks.

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Even if collecting banks are willing to pay presentment fees, paying banks can refuse to enter into agreements to allow same-day payment. For example, one banker described a bank's refusal to accept presentment:

"[the bank] will not accept any items from the private sector, even though they are the largest [non-city] paying bank in this District in terms of items presented. [The bank's] position is that it is more appropriate for it to receive all their incoming items from the Fed . . . than to earn income through presentment fees."

In a similar vein, we were also provided with a copy of a letter from a paying bank that announced it was bringing its account relationship with a collecting bank to an end. Even though this collecting bank preferred to continue presenting checks and paying for the privilege, the letter—without further elaboration—stated that the paying bank would no longer accept deposits from collecting banks for same-day funds availability. In another instance, a small bank turned down a proposal from another local bank to exchange checks for no charge. The other bank decided that the volume was too small to justify the administrative expense of setting up a demand account and that it did not want to accept checks from sources other than a Reserve bank. The bank prefers to have its incoming checks come from one bank owing to the bookkeeping requirements involved in accepting checks from multiple collecting banks.

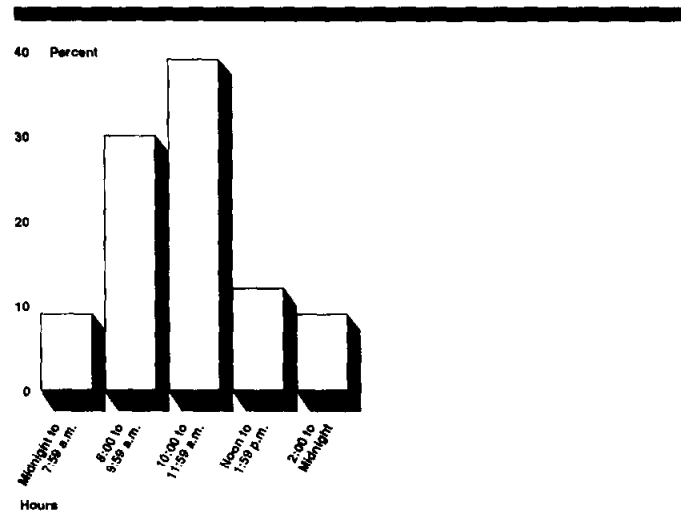
In our opinion, given the provisions of the U.C.C., the practice of paying presentment fees represents a reasonable and necessary expense of operating a check collection business in competition with Reserve banks. However, the same fees that enable collecting banks to provide expeditious check collection service also adds another expense to their basic cost of doing business—an expense the Reserve banks do not incur. We cannot, however, measure the extent of this competitive disadvantage because of the variation in the charges among banks and the lack of certainty that the offer to pay fees will even result in receiving same-day payment. Nonetheless, the inability to obtain same-day payment without charge constrains collecting bank abilities to operate a check collection business.

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lessen its costly float problem. However, collecting banks also incur float costs but cannot unilaterally adopt noon as the time of presentment to reduce such costs. Or, as described by another banker, Reserve banks are the only check collectors that can miss privately set presentment deadlines, such as those imposed on members of a clearinghouse, and still demand same-day payment.

**Figure 2.1: Check Presentment Hours of Clearinghouses Nationwide**



Source: The Rand McNally Bankers Directory, 1987

**High Dollar Group Sort**

The Federal Reserve developed the high dollar group sort product as another means for providing customers with same-day funds on more checks. As in the noon presentment change, Reserve banks changed the time at which they present checks to high-dollar, high-check-volume banks outside Federal Reserve cities. This change in presentment timing enabled the Reserve banks to adjust their deposit deadlines to give their customers more time to get checks to the Reserve banks and provide the

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According to collecting bank officials we interviewed, there is little opportunity for a collecting bank to sell a product like payor bank services. Each individual bank does not have all the information. However, to the extent a controlled disbursement bank receives checks from only one bank—one that provides account totals early—it can provide the disbursement service. Because no bank may turn down presentments from a Reserve bank and since it provides the information early, the Reserve bank becomes the preferred source.

**Fine Sort**

The Federal Reserve developed the fine sort product as another means for providing customers with same-day funds on more checks. To use this product, banks deposit presorted, prepackaged bundles of checks—a separate bundle per paying bank—with a Reserve bank. The Reserve banks then present the checks without first processing them through high-speed reader-sorters for endorsement and recordkeeping purposes. By eliminating much of the processing work and expenses, Reserve banks are able to provide later deposit deadlines yet retain enough time to present prepackaged checks for same-day payment and charge a relatively low collection price.

The Federal Reserve developed the fine sort product by setting terms and conditions for same-day payment that are not specifically provided for under the U.C.C. Regulation J and Reserve bank operating circulars specify that Reserve banks may

- present unendorsed checks for same-day payment;
- warrant that they have good title to the checks or are authorized to obtain payment;
- keep no records on unendorsed checks: it is the responsibility of the sender;
- have no responsibility to describe a lost or stolen check that is to be charged back to a sender; and
- return checks unpaid that are sent to them unendorsed.

Lacking similar abilities to unilaterally establish terms and conditions for same-day payment, officials from collecting banks told us that they cannot offer a similar collection product. As a practical matter, collecting banks endorse checks to meet the U.C.C. ground rules for assigning liability should something go wrong in the collection process—a process that can involve a number of banks. The ground rules hold banks responsible for maintaining records that identify each bank that handles a check from first deposit to final presentment and provide that

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**Table 2.2: Comparison of Prices and  
Floor Costs for 1987 In-City Check  
Collection Products**

Location	Product	Price*	Floor cost	Net markup	Percent markup
Chicago	Fine sorted	.0149	.0069	.0080	116
	Unsorted	.0251	.0169	.0082	49
New York	Fine sorted	.0151	.0094	.0057	61
	Unsorted	.0368	.0310	.0058	19
San Francisco	Fine sorted	.0076	.0031	.0045	145
	Unsorted	.0235	.0113	.0122	108

\*Prices represent the per-check fee charged by Reserve banks adjusted to prorate the cash letter and package deposit fees on a per-check basis.

The higher percentage markup does not appear to be justified by the amount of capital or other resources used to provide the fine sort product. Because little processing is required, the fine sort product should need less support on a per-check basis than other products that involve more processing. This is demonstrated by the fact that the Federal Reserve Bank of New York is planning to move its check-processing equipment and personnel from Manhattan to Long Island and New Jersey. But even without the processing equipment or additional personnel to operate it, the Reserve bank will continue to offer the fine sort product out of the Manhattan office. Depositing banks will drop off prepackaged checks and paying banks will pick them up. The Reserve bank will debit and credit the appropriate accounts.

We are not in a position to know why the Federal Reserve applies a higher percentage markup to its fine sort product than to other products. The higher markup for fine sort products is, however, consistent with pricing that would be expected to occur when there is an absence of competing products from which customers may choose.



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### Opportunities to Promote Competition

Differences in Reserve bank and collecting bank abilities to obtain same-day payment for check presentments could be reduced through a variety of alternatives. (A description of these alternatives and their merits are discussed in app. IV.) In our opinion, requiring paying banks to make funds available to Reserve and collecting banks on equal terms could best alleviate constraints on competition caused by differing rights of presentment. Furthermore, such a requirement has the potential to hasten the speed of collection and provide users of collection services additional choices of collection products as the opportunity for marketing collection products increases.

One way the requirement could be developed, and the one we think is most promising, would be to amend Regulation CC and authorize collecting banks to present checks directly to paying banks and receive same-day payment. Regulation CC already provides a precedent for such a change: To speed the return check process, banks are authorized to return checks directly to the bank of first deposit and obtain same-day payment without charge.

After we briefed Federal Reserve officials on the results of our work showing the differences in rights of presentment—but not necessarily because of this—the Federal Reserve issued a release requesting public comment on the concept of same-day payment. Specifically, the Federal Reserve concept paper provides for paying banks to make same-day funds available for checks presented by any collecting bank without charge. Furthermore, paying banks would be required to accept any number of checks until 2:00 p.m.

Although we do not endorse all the specifics of the Board's same-day payment proposal, we commend the Federal Reserve for issuing the concept paper for consideration. We encourage efforts to continue accepting comments and refining the concept to find a viable way to eliminate unnecessary differences leading to unequal competition. Nevertheless, a direct presentment proposal would not remove all barriers to equal competition discussed in this chapter.

Dealing with the difference involving the need for endorsements would require changes affecting commercial code provisions covering assignment of financial liabilities. These changes may introduce new complications with unknown consequences. As noted previously, the U.C.C. provides the ground rules for determining liability should something go wrong in the collection process. Currently, the record showing the chain of banks handling a check is maintained, in part, by collecting banks

Chapter 4

## Observations, Conclusions, and Recommendations

This chapter discusses the goal of competitive fairness in the context of other goals such as the promotion of payments system safety, soundness, and efficiency. It makes recommendations for ensuring that collecting banks have the opportunity to participate fully in the check collection system.

### Need to Clearly Define Competitive Fairness

According to Federal Reserve policy statements, its payments system mission, in summary, is to promote the integrity and efficiency of the system and to ensure that services are equitably provided to all depository institutions. With recent legislation—most notably the Expedited Funds Availability Act—promoting efficiency has become increasingly important.

In policies adopted in 1984, the Board of Governors stated a willingness to cooperate with other service providers in improving the payments mechanism and expressed a “fundamental commitment to competitive fairness.” Competitive fairness was considered an extension of Federal Reserve responsibilities for improving the payments system and preserving its safety and soundness.

However, the Federal Reserve’s competitive fairness policy has not been further defined beyond this general statement of policy. According to Federal Reserve officials, relevant legislation provides little guidance on defining competitive fairness. The Monetary Control Act—without further elaboration—specified that Federal Reserve pricing principles should give due regard to competitive factors.

Because the Board’s policy is vague, and because there are no specific criteria by which to evaluate its actions, differentiating between Federal Reserve actions taken to improve the payments system as a whole and those taken to maintain the profitability of its check collection services can be difficult. For example, several program changes have simultaneously

- furthered the efficiency or integrity of the payments system,
- improved the competitive position of Federal Reserve bank check collection services, and
- diminished the competitive position of private collecting bank check collection services.

Such simultaneous effects have been present in several of the Federal Reserve’s service changes discussed in this report: (1) the high dollar

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**Chapter 4  
Observations, Conclusions,  
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- disclosure is not made on how proposals for service, price, and payments system changes promote competitive fairness given the differences in abilities between collecting and Reserve banks and the extent to which competitive fairness was considered.

It has become increasingly important that policies and procedures be established to ensure that competitive fairness is fully considered along with other payments system goals. With passage of the Expedited Funds Availability Act, the Federal Reserve has the authority to regulate all checks regardless of whether they are collected by a collecting bank or a Reserve bank. Without policies and procedures for evaluating competitive fairness, Federal Reserve actions could unnecessarily constrain private sector institutions' opportunities to compete in the payments system. Such an effect would appear to be contrary to direction given by Congress. As discussed in chapter 1, the legislative history of the Monetary Control Act and subsequent oversight of payments system issues shows congressional interest in maintaining both public and private participation in the payments system.

The need to fully consider competitive fairness is reinforced by the heightened potential for conflicts of interest resulting from increased Federal Reserve responsibilities under the Expedited Funds Availability Act. Federal Reserve check collection officials responsible for overseeing the activities of Reserve banks are now also responsible for developing regulations that govern the activities of their competitors. Furthermore, these Federal Reserve officials are increasingly involved in changing the characteristics of the industry to promote efficiency. For example, to meet the requirements of the act, Federal Reserve check collection officials developed regulations that overhaul the processing and collection of returned checks. Simultaneously, they announced the adoption of check truncation and data capture products, which may result in the Reserve banks selling data processing and account services.<sup>3</sup> Reserve banks have not previously competed with collecting banks in these service areas

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<sup>3</sup>The check truncation and data capture products were adopted to improve the check collection system. Check truncation reduces the number of times the paper check is handled by capturing the data contained in the magnetically encoded line of information printed on every check and electronically transmitting these data to the paying bank. The paper check is retained by the presenting bank. Data capture is quite similar to check truncation; however, rather than halting the flow of paper, checks are delivered to the paying bank several days after the data are transmitted using a less time-critical mode of transportation.

Chapter 4  
Observations, Conclusions,  
and Recommendations

Reserve banks has led industry participants to take their disagreements to Congress.

**Attaining Fairness by  
Eliminating Same-Day  
Payment Difference**

The most important competitive difference that we found involves the Federal Reserve's unique ability to collect from any bank on the same day checks are presented and not pay for such a privilege. In our work, we did not see evidence that maintaining this difference is essential to the safety, soundness, or efficiency of the payments system. Furthermore, we think there are potential gains associated with narrowing the difference between Federal Reserve and private sector banks. Should same-day payment be extended to collecting banks, the payments system could potentially be improved because banks could choose the most efficient method of presentment on the basis of cost, funds availability, or other market forces; efficiency could increase by reducing the need for a "middleman" as a check collector; the transition to efficient electronic check presentments could be promoted; and competition would be enhanced.

Near the end of our work, the Federal Reserve requested public comment on the operational effects of requiring paying banks to make same-day payment without charge on any number of checks presented by Reserve banks or other banks up to 2:00 p.m. The Board may develop a specific regulatory proposal for public comment before final adoption of formal rules, depending on the comments received. December 1, 1988, was set as the deadline for submitting comments.

Most of the comments received as of mid-October 1988 were from paying banks and their customers opposed to the concept of same-day payment as presented for comment. The primary objections dealt with the 2:00 p.m. cut-off for presentment of checks. Paying bank customers—nonbank corporations accounted for about 75 percent of the respondents—were mostly concerned with the detrimental effect of late presentment on corporate cash management practices. Corporate cash managers say that late presentments would subject banks to additional risks and force corporations to guess at their cash positions in order to make investment decisions. Paying banks commented that later presentment will create operational problems and that if a later cut-off is adopted as regulation, they would lose cash management business. Other factors reinforcing this opposition include the potential loss of revenue from charging collecting banks for making presentments and the potential increase in check processing costs associated with receiving and processing checks from additional banks.

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banks to continue their cash management business but also gave Reserve banks a product that is free from competition.

We see no compelling reason why the Federal Reserve should not be able to develop specific arrangements that recognize paying bank interests while at the same time narrow the differences between Federal Reserve and collecting banks. Developing the specific arrangements that should be considered was outside the scope of our work. However, examples of what these arrangements could entail include requiring collecting banks to notify paying banks of their intent to present checks for payment or requiring collecting banks to provide paying banks with a service similar to the Federal Reserve's payor bank services.

## Conclusion

Instituting payments system changes that promote competitive fairness poses a difficult challenge to the Federal Reserve for a number of reasons. First, beyond a generally stated commitment to competitive fairness, the Federal Reserve does not have policies or procedures that provide explicit criteria for acting on changes that can promote competitive fairness or ensure that competitive fairness issues are adequately considered. Second, there can be significant opposition from some banks to changes that would promote competitive fairness. Third, the deliberations on competitive issues create conflicts of interest for the Federal Reserve because of its role as competitor, dominant provider, and payments system regulator.

In our opinion, to ensure that competitive fairness issues are appropriately considered, the Federal Reserve needs to (1) better define what is meant by its policy commitment to competitive fairness as a means of providing clear decision-making criteria and (2) establish better procedural controls to further payments system changes that promote competitive fairness while providing strengthened safeguards against potential conflicts of interest. It should then apply those policies and procedures to the development of a same-day-payment regulation.

The most important competitive difference that we found involves the Federal Reserve's unique ability to collect from any bank on the same day checks are presented and not pay for such a privilege. In our work we saw no evidence that perpetuating all differences between Federal Reserve banks and collecting banks is essential to the safety, soundness, or efficiency of the payments system. Therefore, we think the Board of Governors should apply the more specific policy on competitive fairness in developing a revised proposal on same-day payment.

Appendix IV

## Alternatives for Reducing Differences in Banks' Abilities to Collect on Checks

Numerous alternatives may be considered to reduce differences between Reserve and collecting banks' abilities to collect on checks. In general, these alternatives may be approached in two ways. Either the Federal Reserve's unique check presentment abilities can be reduced to resemble those of collecting banks or collecting banks could be provided additional powers so that their presentment abilities resemble those of Reserve banks.

### Reserve Banks Could Pay Presentment Fees

One way to make the Reserve banks more comparable to collecting banks would be to require Reserve banks to pay presentment fees. Such a requirement would cause the competing parties to face similar types of costs. Also, it would give those banks that receive checks from Reserve banks a new source of revenue.

There are, however, associated drawbacks to consider. First, there is no assurance that the fees paid by Reserve banks would be comparable to those paid by collecting banks. Because private banks may act as either paying or collecting banks, they both charge and pay fees. For this reason, to the extent they are involved in reciprocal relationships, paying banks are constrained in the amounts they may charge because of the potential for retaliation the next time they act as a collector. The Federal Reserve, however, acts solely as a collecting bank. Therefore, it would never be in a position to charge as a paying bank. Hence, the constraint would not exist and Reserve banks may incur higher charges than those incurred by collecting banks. Accordingly, while requiring Reserve banks to pay presentment fees may seemingly reduce differences between competitors, the change would not, in our opinion, eliminate constraints on competition or promote competitive equality.

Second, if Reserve banks were required to pay fees imposed by paying banks, the change could foster increased check collection prices. Because the Reserve banks would be paying, but not charging presentment fees, their check collection costs would increase. Accordingly, Reserve banks may be forced to increase their collection prices to offset the additional expense of paying the fees. Since Reserve bank prices are considered an industry benchmark, it seems likely that an increase in Reserve bank prices would be followed by collecting bank price increases.

Third, requiring Reserve banks to pay presentment fees would remove a constraint on the amount of those fees charged by paying banks. Currently, paying banks may set their presentment fees to compete with

**Appendix IV  
Alternatives for Reducing Differences in  
Banks' Abilities to Collect on Checks**

Associated drawbacks exist here as well. First, because of the range in presentment fees, determining an appropriate fee to impute would be difficult. Second, there would not necessarily be any relationship between services provided by paying banks and the costs imputed by Reserve banks. Third, the Reserve banks' prices would increase but paying banks would have no commensurate increase in revenues. Fourth, this alternative does not provide collecting banks with the right to present checks and obtain same-day payment. Accordingly, the alternative, in our opinion, neither removes constraints on competition nor promotes competitive equality.

**Exempt Private Banks  
From Fees**

The Federal Reserve's exemption from bank charges could be extended to private banks. Such an exemption could result in greater cost comparability between all parties. However, such an approach risks slowing the current speed of check collection at a time when expedited funds availability has been specifically mandated.

In the private sector, fees can further the collection on checks in two ways. First, they can provide paying banks the incentive to make funds available sooner than what is minimally required by law, potentially accelerating the collection process by 2 days. Second, they can provide collecting banks incentive to deposit checks early in the day to avoid higher presentment fees charged on deposits made later in the day. According to some bankers, early deposits allow for more efficient use of paying bank resources by distributing the work associated with incoming checks throughout the day rather than concentrating the work at a later time of day. Therefore, while exempting collecting banks from paying bank fees might contribute some additional measure of cost comparability into the payments system, the prohibition of such fees could disrupt the work flow and reduce incentives for expediting funds availability. Accordingly, banks could be further disadvantaged when competing on the basis of funds availability.

**Restrict Reserve  
Banks' Abilities to  
Deviate From  
Standard Practices**

Differences could also be reduced by requiring Reserve banks to follow local banking customs and not exercise its abilities to invoke collection terms that vary from those provided under the Uniform Commercial Code (UCC). For example, if local clearinghouse presentments are made at 10:00 a.m., such as in New York City, the local Reserve bank would have to comply. In effect, the Reserve banks would be forced to operate under constraints similar to a collecting bank.

**Appendix I  
Excerpts From Check Collection: Competitive  
Equality Is an Elusive Goal (GAO/GGD-89-61)**

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**Opportunities for  
Competing Products**

Extending Reserve bank presentment abilities to collecting banks through direct presentment would introduce some competition to Reserve banks' fine sort and high dollar group sort products and payor bank services but, as discussed in chapter 2, would not remove all barriers.

If adopted, the proposal could add some pricing pressure to the Federal Reserve's fine sort product. By authorizing collecting banks to present checks directly to other banks for same-day payment, there would be an economic choice of either presenting directly to the paying bank or using a Reserve bank's fine sort product. As a result, even though collecting banks might still be unable to sell competing products, by having an alternative to purchasing products, the Federal Reserve could not establish a fine sort price that exceeds the value of the products provided and still maintain a steady volume of business.

The introduction of pricing pressure could help alleviate concerns that the lack of competitive alternatives to the Reserve banks' fine sort product allows for higher markups in the fine sort price than are justified by the capital and other resources used to provide the product. In our opinion, by extending the right of presentment and same-day payment to collecting banks, the maximum price Reserve banks could charge could be influenced by the market; that is, by Reserve banks' competitors.

**Drawbacks Appear to Be  
Surmountable**

Although providing collecting banks the choice to present directly to paying banks has the potential to benefit the payments system, the proposal is not without drawbacks. However, in our opinion, these drawbacks appear to be surmountable.

Specifically, we are aware of six. They are the

- increased costs to the payments system owing, in part, to the expenditure of real resources to reduce check collection float;
- potential losses from bank insolvencies before checks can be paid;
- increase in paying banks' work load owing to an increase in the number of check packages requiring reconciliation;
- increase in paying banks' work load owing to an increase in the number of bank-to-bank relationships that would need to be developed and maintained;
- losses incurred because of erroneous funds transfers; and



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containing no fewer than 100 checks.<sup>3</sup> Such a limit could be continued. Therefore, paying banks would probably not experience a big increase in the number of check packages they receive under this proposal. However, the check packages will probably arrive from more banks instead of being funneled through a Reserve bank.

Developing and maintaining relationships with more banks will probably increase the amount of work paying banks will have to undertake. (With the acceptance of check presentments from a bank, there are associated bookkeeping operations. These operations are duplicated for each new customer.) However, since banks may now return checks outside the normal forward collection network, as authorized under Regulation CC, more bank-to-bank relationships, including making provisions for same-day settlement, should develop. Therefore, we do not believe this proposal will add substantially to paying banks' burdens.

As to funds transfers, mistakes conceivably could result from erroneous billing of paying banks. However, funds transfers are currently made, seemingly without problem, according to information provided by the collecting banks under Federal Reserve consolidated shipment and fine sort services. As under these services, Reserve banks and paying banks would maintain the right to correct errors through offsetting transfers. Therefore, we believe any additional risk posed by the funds transfer would be minimal.

However, extending collecting bank privileges to 2:00 p.m.—the existing cut-off for Reserve bank presentments—risks overturning the existing balance among the disparate interests of paying banks, the Federal Reserve, and collecting banks. This is because paying banks are interested in obtaining checks as early in the day as possible to meet customer needs for account information and post the checks to customer accounts; Reserve banks are interested in preserving the efficiencies achieved from the change to a noon to 2:00 p.m. presentment time frame; and collecting banks are interested in obtaining quick funds availability at a low cost.

While Reserve banks present checks later than is customary or desired by some paying banks, they have accommodated the information needs of these banks through payor bank services. The Reserve banks provide

<sup>3</sup>Federal Reserve prices for the fine sort service generally make it uneconomical for banks to present fewer than 100 checks to another bank.

# How the Federal Reserve Calculates the PSAF

## The Federal Reserve Models Itself After Bank Holding Companies

In calculating the PSAF, the Board of Governors of the Federal Reserve System assumes that Federal Reserve banks are most similar to bank holding companies. The Federal Reserve System therefore has adopted a procedure that combines Federal Reserve bank cost accounting information with financial characteristics of bank holding companies.

The current methodology used by the Federal Reserve to compute capital costs in the PSAF involves three steps. The first is to determine the value of Federal Reserve assets that will be used directly in producing all priced services during the coming year, including the net effect of assets planned to be acquired or disposed of during the year. The second step is to determine the financing method. Short-term assets are assumed to be financed by short-term liabilities and long-term assets are assumed to be financed by a combination of long-term debt and equity.

The third step is to impute capital costs. This is done by applying short- and long-term interest rates and a rate of return on equity derived from a sample of bank holding companies to the assumed debt and equity values. The consolidated financial data for the bank holding companies are drawn from the 25 largest (in terms of asset size), with all factors except the short-term debt rate averaged over 3 years.<sup>1</sup> (Only data for the most recent year are used for computing the short-term debt rate since by definition, short-term debt matures within 1 year.) Capital costs together with imputed estimated sales taxes, FDIC insurance assessments on clearing balances held with the Federal Reserve to settle transactions, and expenses of the Board of Governors related to priced services comprise the PSAF. Under the Federal Reserve's methodology, 77 percent of the PSAF is then allocated to the check collection service.

In 1988, the amount of the PSAF the Federal Reserve System sought to recover from all priced services was \$76.2 million. Of the PSAF amount, \$48.3 million represented the imputed cost of equity capital, based on a pretax rate of return on equity of 20.1 percent. The imputed assessment for deposit insurance in 1988 was \$1.9 million. As noted above, the Federal Reserve allocated 77 percent of this PSAF to check collection.

<sup>1</sup>As of June 1989, the Federal Reserve System's PSAF model contains consolidated financial data for the 50 largest bank holding companies in each of the last 5 years.

# July 7, 1989, Letter From the Board of Governors of the Federal Reserve Board



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE  
TO THE BOARD

July 7, 1989

Mr. Richard L. Fogel  
Assistant Comptroller General  
General Government Division  
United States General Accounting Office  
Washington, D. C. 20548

Dear Mr. Fogel:

The Board is pleased to have this opportunity to comment on the final report of the General Accounting Office (GAO) entitled Check Collection: Competitive Fairness is an Elusive Goal, which was prepared by the GAO pursuant to the Competitive Equality Banking Act of 1987 (Section 1202 of P.L. 100-86). The Board has previously commented on the report in draft form. As the report's recommendations are essentially unchanged from the draft report, our comments on the draft recommendations still apply. We would, however, like to take this opportunity to reiterate the steps the Board has taken and will take to promote competition in the provision of payments services.

As a preliminary matter, while the report prepared by the GAO goes beyond the specific issues required by the Congress, the Board welcomes the broader scope of the study, which addresses the overall issue of competitive fairness.

The Board believes, however, that the presentment fee and clearinghouse issues, which Congress directed the GAO to study, are important. The Board concurs with the conclusions of the GAO report that requiring the Federal Reserve to pay presentment fees would neither eliminate constraints on competition nor promote competitive equality. The Board believes that the Federal Reserve's payment of such presentment fees would negate the long-standing objective of the Federal Reserve Act to achieve par clearing of checks. With regard to the clearinghouse issues, the Board continues to believe that while the Federal Reserve benefits from the existence of check clearinghouses through efficiencies resulting from the delivery of checks to fewer endpoints, it does not receive services from the



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July 7, 1989, Letter From the Board of  
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ensure that private collecting banks have presentment abilities similar to those of Federal Reserve Banks.

- Since most commenters opposed some aspects of this proposal, the Board has undertaken a comprehensive analysis of the complex issues it raises. In this connection, a group consisting of representatives of banks, savings and loan associations, credit unions, clearinghouses, and corporate cash managers has been formed to assist the Board staff in analyzing alternatives and modifications suggested by the commenters to achieve the goals of the same-day payment concept. If the technical issues and concerns of the respective parties can be satisfactorily addressed, the Board will issue for comment a more specific regulatory proposal to improve the check collection system. Given the number and complexity of the issues involved, it is unlikely that a revised proposal can be developed for consideration by the Board before sometime next year.

In conclusion, the Board is refining policies and procedures in many areas recommended in the GAO report. In addition, the Board staff is soliciting input from affected parties to determine if a workable same-day payment proposal can be developed. We appreciate the opportunity to comment on the GAO's final report.

Sincerely,

(signed) William W. Wiles  
William W. Wiles  
Secretary

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the Federal Reserve System

Detailed Staff Comments on Draft Report

Page

2 The second paragraph states that because private collecting banks cannot require same-day payment for checks they present, "their options for providing a competitive service have been constrained." The report should note that private collecting banks also have certain abilities not available to Federal Reserve Banks that improve the attractiveness of their check collection services to their customers. These include the ability to: (1) tailor services and prices to individual customers and to limit business to certain customers; (2) collect checks destined only to those endpoints for which the bank derives higher profits; (3) attract check collection business through other services not provided by Federal Reserve Banks; (4) use existing bank resources to conduct the check collection business; and (5) subsidize the check collection business with profits from other service lines. The report should acknowledge that it is difficult to weigh the advantages enjoyed by the different providers of check collection services and to determine which competitor has the net advantage.

See comment 1.

The first sentence of the last paragraph should indicate the reason why the Federal Reserve System did not recover fully its 1988 costs of providing priced services. We suggest that this sentence be revised to state: "Due to the significant increase in costs associated with implementing new check return services, in 1988 the System . . ." We recognize that the reason for the 1988 underrecovery is acknowledged in the body of the report, but believe it should also be highlighted in the summary. We also suggest that the end of that sentence be revised to state: ". . . the check collection cost base (which includes imputed costs of and targeted profits from providing the service)."

See comment 2.

See comment 3.

3 The first sentence of the first paragraph states that "In calculating the costs that need to be recovered by its check collection prices, the Federal Reserve has been following a rule for accounting for checks being collected by Reserve banks that is different from the rule private banks follow." We suggest that this sentence be revised to state, "In calculating the imputed costs that need to be recovered by its check collection prices, the Federal Reserve's method of accounting did not credit the value of checks in the process of collection to depositors' account balances, while private banks include the value of such checks in these balances, which are used to calculate deposit insurance premiums."

See comment 4.

The last sentence of the first paragraph should state: "In June 1989, the Federal Reserve revised the way. . ."

See comment 5.

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See comment 12.

Since the introduction of the new return service, the Federal Reserve and depository institutions have made major strides towards improving returned check quality. The fourth sentence of the second paragraph should state that the System raised its check return prices in May 1989.

See comment 13.

The discussion about check collection cost recovery should note that the Federal Reserve strives to match costs and revenues for each calendar year. The Board believes that either an overrecovery or underrecovery of the costs of providing the check service is suboptimal in that an overrecovery results in the collection of excessive fees from the users of the service and underrecovery may adversely affect other providers of the service. Achieving an exact cost/revenue match is extremely difficult because actual volumes and costs vary from the projections that are used to set fees. In addition, the float component of costs is subject to variation based on weather conditions and transportation delays, which cannot be accurately predicted. As Table 1 indicates, the System has made continuing progress each year toward its goal of recovering 100 percent of the costs of providing the service. In 1988, despite major operational changes in the processing of returned checks, the Federal Reserve matched costs and revenues in its check collection service more closely than in any other year since the inception of pricing.

See comment 14.

9 In Table 1, the 1988 revenue in excess of cost base should be \$(9.1).

See comment 15.

Footnote b should read: ". . . float (the cost of providing funds 1 day to banks sooner than it collects the funds.)"

See comment 16.

10 The Board adopted revisions to the PSAF methodology on June 16, 1989. The last sentence of the first paragraph and the first sentence of the last paragraph should be revised accordingly.

See comment 17.

The second through fourth sentences of the second paragraph should be revised to state: "These balances include deposits arising from checks that have not yet been collected. In imputing its deposit insurance premium cost, the Federal Reserve has not been counting all checks that have been deposited with it for collection that have not yet been collected. Instead, it had counted only those checks for which credit had been passed to the depositor prior to collection."

The following are GAO comments on the Federal Reserve System's letter dated September 18, 1989.

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## GAO Comments

1. Language from our May 1989 report discussing the unique abilities of both Reserve banks and private banks and the difficulties of weighing the net effects of these advantages has been added. (See pp. 2 and 4.)
2. Attribution of the shortfall to the new check return service has been added. (See p. 2.)
3. In our opinion, the suggested change would not enhance the clarity of the statement.
4. The change was not made since the explanation is in the descriptive portion of the report (see p. 10) and the results in brief section simply summarizes the information.
5. Date changed. (See p. 2.)
6. Suggested change added. (See pp. 3-4.)
7. Suggested change made. (See p. 4.)
8. Suggested change made. (See p. 5.)
9. Our calculation of 15 percent was based on a PSAF of \$76.2 million and the cost base of \$522.8 million (rounded) as reported in the Federal Reserve's cost revenue report. (See p. 7.) Both of these figures were checked with the Federal Reserve for accuracy.
10. Suggested change made. (See p. 7.)
11. Attribution of increased costs associated with the new return service to the poor quality of returned checks has been added. (See p. 7.)
12. Suggested change made. (See p. 7.)
13. Suggested language added. (See p. 7.)
14. Our calculation was based on revenue of \$513.8 million and cost of \$522.8 million as reported in the Federal Reserve's cost revenue report.

# Major Contributors to This Report

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**General Government  
Division, Washington,  
D.C.**

Stephen C. Swaim, Assistant Director, Financial Institutions and Markets Issues  
Thomas M. Richards, Assignment Manager  
Patricia C. Zemple, Evaluator-in-Charge  
Carol M. Henn, Evaluator



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(Numbers have been rounded.) (See p. 8.) Both of these figures were checked with the Federal Reserve for accuracy.

15. Suggested change made. (See p. 8.)

16. Suggested change made. (See p. 9.)

17. Suggested change made. (See p. 9.)

18. Suggested changes made. (See app. II, p. 48.)

19. The sentence on PSAF as a percentage of total priced services has been deleted. The pretax rate of return on equity was changed to 20.1. (See app. III, p. 48.)

20. Generally speaking, cash items are checks and for reporting purposes have been referred to as checks in process of collection. (See app. III, p. 49.)

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See comment 18.

48 Footnote 11 should be revised to read: "As of June 1989, the Federal Reserve System's PSAF model contains consolidated financial data for the 50 largest bank holding companies in each of the last five years."

See comment 19.

49 The 1988 PSAF of \$76.2 million represents approximately 16 percent of projected total priced services expenses, excluding certain costs of services that do not use Federal Reserve assets, such as shipping costs. The pretax rate of return on equity was estimated at 20.1 percent, not 32.3 percent. The imputed assessment for deposit insurance in 1988 was \$1.9 million (not \$1.9 billion).

See comment 20.

50 Footnote b should read: "Net cash items in process of collection (CIPC) . . ."

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See comment 6.

4 The last sentence of the middle paragraph states that ". . . because the Federal Reserve does not maintain detailed cost data at the individual services level . . ." This should be revised to state "because the cost of resources used by the Federal Reserve to process checks are shared by many individual check products . . ."

See comment 7.

5 The first two sentences of the second paragraph state that "The Federal Reserve's exemption from presentment fees has the result of constraining the collection options open to private banks, the services they sell, and the potential efficiencies they may bring to the market. We found no compelling reason why the Federal Reserve should have this advantage . . ." These two sentences imply that "this advantage" is the exemption from paying presentment fees. In the previous paragraph and in the summary on page 2, the report indicates that the advantage is the Federal Reserve's ability to obtain same-day payment without the payment of presentment fees. Because this is stated in the previous paragraph, the second paragraph could be revised by eliminating the first sentence and revising the second sentence to read "We found no compelling reason why only the Federal Reserve should have the ability to obtain same-day payment without the imposition of presentment fees and concluded . . ." [See also comments on page 2 of the report.]

See comment 8.

6 The last sentence of the first paragraph should read: ". . . a conflict between the Federal Reserve's roles as provider of services and regulator, supervisor, and lender."

See comment 9.

7 The last sentence (before the parenthetical) of the last paragraph should be revised to read: "For that year, the PSAF represented about 16 percent of the check collection cost base." (See comments to page 49.)

See comment 10.

8 The first sentence should be revised to state: "In 1988, the System as a whole and 7 of its 12 Reserve banks did not fully recover check collection costs. . ."

See comment 11.

The third sentence of the second paragraph states that the Federal Reserve's initial returned check prices were based on "cost and volume estimates that subsequent experience proved to be optimistic." The report should indicate that the primary assumption upon which the initial return prices were based that proved to be optimistic was the quality of the returned checks deposited with the Federal Reserve Banks. The poor quality of many qualified returned checks received by the Reserve Banks resulted in higher processing costs and ultimately significantly higher adjustment costs.

# Comments From the Board of Governors of the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE  
TO THE BOARD

September 18, 1989

Mr. Richard L. Fogel  
Assistant Comptroller General  
General Government Division  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. Fogel:

The Board appreciates the opportunity to comment on the draft report of the General Accounting Office (GAO) titled The Federal Reserve: Information on the System's Check Collection Service. A number of the issues that the GAO was asked to address in this report were discussed in the GAO's recent report titled Check Collection: Competitive Fairness is an Elusive Goal. The Board's comments on these issues are contained in its January 27, 1989, and July 7, 1989, letters to the GAO on that report. Enclosed are detailed staff comments on the draft report.

Thank you for this opportunity to comment.

Sincerely yours,

William W. Wiles  
Secretary of the Board

Enclosure



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July 7, 1989, Letter From the Board of  
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clearinghouses. These benefits to the Federal Reserve result from actions taken by the clearinghouse members and their respondents for their own purposes, and are not a service requested by the Federal Reserve.

With regard to the broader issue of competitive fairness that is addressed in the report, the Board agrees with the underlying theme of the report that viable competition in the provision of check collection services is important to both banks and their customers. A competitive environment creates a climate within which incentives exist for payment service providers to increase the quality of their services while minimizing their costs, and thus serves to promote payments system efficiency. In this regard:

- In 1984, the Board established policies recognizing the role of competition in promoting efficient payments services. These policies defined the role of the Federal Reserve in the payments system and established explicit standards for evaluating new services and major enhancements to existing services. The Board will clarify and refine the procedures for reviewing price and service changes, particularly with regard to the competitive equity of such changes, to ensure thoroughness and consistency when evaluating these proposals.
- In order to provide private sector participants a forum in which to raise issues related to changes made by the Federal Reserve Banks that are thought to result in the private sector being precluded from effectively offering competing check collection services, the Board will expand existing procedures to address potential conflicts between the Federal Reserve's role as provider of services and its role as a regulator, supervisor, and lender. This expanded procedure will specify what actions the complainant can take and how the Federal Reserve will proceed upon receipt of complaints on competitive issues.
- The Board is pursuing the development of a workable same-day payment proposal as recommended in the report. In April 1988, the Board issued for public comment a concept concerning the presentment abilities of private collecting banks, which would require paying banks to pay for checks presented by collecting banks prior to 2:00 p.m. in same-day funds, without the imposition of presentment fees. If adopted, the same-day payment concept would



# The Equity Capital Component of the PSAF

The following table shows that the equity reported by the Federal Reserve in 1988 would have been sufficient to meet the minimum capital requirement under both the previous method of reporting net checks in process of collection (CIPC) and the newly adopted method of reporting gross CIPC.

**Table III.1: Meeting Regulatory Capital Requirements: Effect of Using Gross or Net Checks in Process of Collection**

Dollars in millions		
<b>Balance sheet items</b>	<b>Net CIPC<sup>a</sup></b>	<b>Gross CIPC<sup>b</sup></b>
Total assets	\$3,093.3	\$6,445.8
Required primary capital (5.5%)	170.1	354.5
Equity component (67%) <sup>c</sup>	151.4	237.5
Total equity currently reported on balance sheet	240.7	240.7
Additional equity capital required	0	0

<sup>a</sup>Net checks in process of collection (CIPC) is the way in which these assets were counted by the Federal Reserve.

<sup>b</sup>Gross CIPC is the way in which banks and bank holding companies are required to count these assets and the way in which the Federal Reserve will now count CIPC starting with its 1990 PSAF.

<sup>c</sup>Primary capital is, for the most part, comprised of equity capital and loan loss reserves. Because the Federal Reserve does not incur loan losses, this analysis only considers the costs associated with the equity component. The factor varies each year and is derived by averaging ratios of equity capital to total assets of the 25 largest bank holding companies.

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information to paying banks on the amount of the checks before delivering them.

In our opinion, additional accommodations can be made to preserve the existing balance among interests of Reserve, collecting, and paying banks. For example, to ensure that paying banks would not receive checks any later than they do now, check presentment cut-off times could be set to coincide with existing Federal Reserve practices. This would also preserve the collection efficiencies achieved by the Federal Reserve from adopting the noon to 2:00 p.m. presentment policy. To meet the needs of banks purchasing automated account information totals from the Reserve banks, a provision could be phased in whereby collecting banks, as a precondition to making check presentments, could be required to provide the same kind of information on the same terms as the Reserve banks. This electronic presentment should ensure that eliminating constraints on competition is not attained at the expense of commercial bank customers who need timely information for investment purposes.

Also, by accommodating all parties, inroads can be made to achieving the efficiencies envisioned by a change from a paper-based system to electronic presentments. Currently, check collection schedules are based on banks' ability to ship bundles of paper, typically by truck or plane. This method is inefficient when compared to the speed achievable through the electronic transmission of similar information. In the current environment, however, where there are obstacles to direct presentment, collecting banks do not see a market for selling automated account information like Reserve bank payor bank services. By establishing a requirement for offering automated account information services as a precondition for making direct presentments, the Reserve would bring the payments system one step closer to an electronic system.

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- risk of a uniform 2:00 p.m. presentment time, which would upset the existing balance among the interests of collecting, paying, and Reserve banks.

In July 1986, Federal Reserve officials considered, but did not support, a proposal substantially similar to the same-day-payment concept now out for comment. According to Federal Reserve correspondence, the primary benefit of the proposal would be float reduction. Since float reduction was considered a transfer payment between collecting and paying banks rather than a savings in real resources, it was not considered a social benefit. Also, Federal Reserve officials were concerned that collecting banks would incur increased costs to reduce float and that paying bank costs would increase. In our opinion, the ability of collecting banks to reduce float—that is, accelerate the collection on checks they handle much like Reserve banks do—would also promote payments system efficiency, a goal of the Federal Reserve and the Expedited Funds Availability Act. That act mandated improving the check collection system by promoting quicker check collection and availability of funds. Moreover, it is reasonable to expect that collecting banks would make prudent business decisions regarding the costs versus benefits of reducing check float. Also, as discussed in the following paragraphs, the demands placed on paying banks need not be burdensome.

The risk from banks becoming insolvent before checks can be paid appear to be no greater under direct presentment than in the current method of check collection. Under either method, procedures are in place for banks to receive their funds. Should the paying bank fail before checks can be presented for payment, depositing banks could recoup funds from its customers. Similarly, should the bank of first deposit fail before a check can be returned to it for payment, the paying bank could make a claim against the customer at the bank of first deposit. Alternatively, the paying bank has the option of recouping the funds from the collecting bank that presented the checks. That collecting bank could make a claim against the customer at the bank of first deposit.

The burden placed on paying banks because of a substantial increase in the number of check packages would seem to be small. It is likely that only banks with sufficient capacity to sort checks to individual paying banks will take advantage of new authorities to present checks directly. The banks that currently have this capability already present presorted packages of checks through the Federal Reserve in bundles typically

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Restricting the Federal Reserve's abilities to vary from collection terms provided in the U.C.C. is, in our opinion, undesirable and impractical. The Federal Reserve has used those abilities to fulfill its responsibility of improving the efficiency of the payments system. Restricting those abilities would eliminate a number of efficiency gains. For example, by removing the ability to offer a fine sort service, the banking system would be denied a low-cost check collection option that maximizes the amount of time available for getting checks to a Reserve bank for same-day collection. Also, by requiring Reserve banks to adhere to locally set presentment times, the banking system would potentially lose the efficiencies gained from the Federal Reserve's nationally coordinated deposit deadlines, check processing schedules, and transportation arrangements.

**Require Funds Be  
Made Available to All  
Collecting Banks on  
Equal Terms**

As discussed in chapter 2, requiring paying banks to make funds available to collecting banks, private or public, on equal terms would in our opinion best alleviate constraints on competition caused by differing rights of presentment. This requirement could hasten the speed of collection by eliminating unnecessary intermediaries. Furthermore, it provides new opportunities for collecting banks to market certain products previously sold only by Reserve banks.

Extending the right of direct presentment increases the alternatives available to banks for choosing the fastest and least costly means of collecting on checks. Because banks can receive same-day funds on checks only when paying banks consent to provide such availability, in some instances collecting banks with the capacity and desire to present directly to the paying bank are left no alternative but to use Reserve banks as an intermediary. This circuitous routing seems to occur frequently with controlled disbursement banks because these are the banks that tend to deny access.

Direct presentment could also introduce opportunities to reduce or eliminate fees associated with current bank-to-bank arrangements. Because collecting banks would be entitled to same-day funds without negotiation, the per-check fee paid to induce expedited funds availability may no longer be warranted. Furthermore, since funds could be made available through transfers of reserve account balances, banks could determine whether it was in their financial interest to maintain accounts with other banks.

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Reserve bank prices. For example, a paying bank may set its presentment fee slightly below Reserve bank fine sort prices, attract checks from other banks, and earn revenues from the presentment fees charged. Conversely, setting an uncompetitive fee would eliminate a source of income because Reserve banks—which do not pay fees—would become the more attractive collection option. However, if Reserve banks were required to pay presentment fees, paying banks could increase their presentment fee charges without fear of losing revenue. Since presentment fees can affect Reserve bank and collecting bank prices, any increases could also raise the costs of check collection to the banking system.

As a means of controlling presentment fees, one banker suggested that the Federal Reserve could be empowered to limit the amount of a presentment fee that its banks would be authorized to pay. The amount could be set to approximate the bookkeeping expenses paying banks incur when presented with checks.<sup>1</sup> In this way, Reserve banks would, in this banker's opinion, incur costs similar to those incurred by collecting banks.

Limiting the amount Reserve banks may pay, however, does not eliminate constraints on competition nor promote competitive equality. Limiting the amount would not guarantee that Reserve bank and collecting bank costs would be equal, nor would it guarantee collecting bank access to paying banks, and the issue of access—the right to present checks and obtain same-day payment—is, in our opinion, the basic dilemma faced by collecting banks.

**Federal Reserve Banks  
Could Impute  
Presentment Fees**

Instead of paying presentment fees each time it presents checks for collection, the Federal Reserve could estimate and impute the costs of such fees and set its prices to recover those costs. Precedent for such a proposal exists in the Federal Reserve's current method of imputing certain other costs that it does not incur because of its governmental status.<sup>2</sup> Such a change would tend to negate the cost avoidance difference in presenting checks but, at the same time, allow the Federal Reserve System to control the amount of fees it would pay.

<sup>1</sup>This banker suggested that these bookkeeping expenses could be estimated by deducting the Federal Reserve's transportation costs from its fine sort service price.

<sup>2</sup>The Monetary Control Act requires that Federal Reserve banks set their prices high enough to recover, among other things, the taxes that would have been paid and the profits that would have been earned had the services been provided by a private sector firm. This recovery is known as the private sector adjustment factor.

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Despite these changes, some Federal Reserve check collection products—such as the fine sort product—might not be made open to competition. Therefore, other procedures need to be in place to closely examine the price markups of those products to ensure the markups are not unreasonable and to safeguard against potential conflicts of interest.

**Recommendations to  
the Board of  
Governors of the  
Federal Reserve  
System**

We recommend that the Board of Governors clarify existing policies and procedures covering the Federal Reserve commitment to competitive fairness. Specifically, the Board of Governors should do the following:

- Define its commitment to competitive fairness by explicitly adopting the principle that collecting banks should have the same abilities as Reserve banks to collect on checks unless fulfillment of payments system safety, soundness, or efficiency objectives indicate Reserve banks should take on unique abilities.
- Require Federal Reserve officials, when deliberating on regulatory, price, and service changes, to identify any practical and legal differences between Reserve and collecting banks that may hinder collecting banks' ability to effectively offer competing check collection services. For differences that are found, Federal Reserve officials should provide the Board with proposals for eliminating the differences or an explanation of why continuation of those differences are necessary to promote the safety, soundness, or efficiency of the payments system. Full disclosure of the basis for decisions should be made to the public.
- Require Federal Reserve officials to closely oversee prices on products that cannot be offered by collecting banks on an equal basis to ensure that markups are not unreasonable and to make public disclosure of what those markups are.
- Require Federal Reserve officials to develop a forum for hearing disagreements raised by private sector participants over changes made by the Federal Reserve that may result in the private sector being precluded from effectively offering competing check collection services.

We also recommend that the Board of Governors, consistent with the recommended policy and procedural changes, develop a revised, comprehensive same-day-payment proposal that both balances the interest of paying and collecting banks and eliminates differences in presentment abilities between Reserve and collecting banks that are not necessary for the safety, soundness, or efficiency of the payments system.

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The Federal Reserve faces a dilemma in deciding what actions to take that would most benefit the payments system as a whole. In general, paying and collecting banks have opposing interests in the payments system. On the one hand, paying banks (and their customers) usually favor slower payment of checks and want presentment to take place early in the day to enhance the value of cash management services offered to customers. Collecting banks, on the other hand, want to be able to obtain funds as quickly as possible so that they and their customers can make use of deposited balances. The Federal Reserve is responsible for balancing the interests of all participants so that the system is as safe, sound, and efficient as possible.

The Federal Reserve's dilemma is further complicated by its dual role as regulator and competitor. In this case, if it adopts the concept as proposed, it will be overriding the objections of the majority of the banks and bank customers that submitted comments. However, if it rejects the concept, it may appear to be making a decision to further its own interests. Paying banks, by objecting to the same-day payment concept, are in effect arguing to preserve the unique abilities of Reserve banks to present checks for same-day payment without charge. Therefore, were the Federal Reserve to decide to uphold paying bank objections, this would also continue to enhance the competitive standing of the Reserve banks.

If the Federal Reserve System adopts the criteria and procedures for ensuring competitive fairness discussed in the previous section, we think it would be in a better position to make decisions that can clearly be defended as being in the best interest of the payments system as a whole. The criteria would enable the Federal Reserve to revise the proposal to narrow or eliminate the presentment difference while considering the viewpoints of paying banks and their customers.

In the past, the Federal Reserve has shown how paying bank interests can be considered while furthering the interests of the payments system. We see no reason why this principle could not be extended to the same-day-payment proposal. For example, in 1983 when the Federal Reserve first proposed noon to 2:00 p.m. as the time period for its Reserve banks to present checks to city and certain regional banks, many paying banks objected for the same reasons they are now objecting to the same-day payment concept. Despite those comments, the Federal Reserve found that payments system efficiency improvements warranted Reserve banks' making later presentments. However, to accommodate paying bank concerns, the Federal Reserve instituted payor bank services. Such an accommodation not only allowed paying

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**Promoting Fairness  
Through Policy and  
Procedural Changes**

In our opinion, the Federal Reserve needs to pursue two objectives to fully implement a commitment to competitive fairness. Meeting these objectives will provide criteria for balancing competing interests and reduce the appearance of conflicts of interest.

First, the Federal Reserve needs to develop a policy that provides criteria for making decisions about private sector participation in the payments system. In our opinion, the policy should explicitly state that collecting banks will have the same abilities as Reserve banks to collect on checks unless there are compelling safety, soundness, or efficiency reasons for Reserve banks to take on unique functions. With such a policy, the Federal Reserve and others will have criteria for differentiating between actions that will improve the profitability of its check collection services and actions that will improve the payments system as a whole. Moreover, the policy will promote competitive fairness by establishing a basis for limiting differences between collecting and Reserve banks.

Second, the Federal Reserve needs to implement procedures for carrying out that policy. When deliberating on changes to the payments system, Federal Reserve officials should be required to identify all differences, both practical and legal, between Reserve and collecting banks that may hinder collecting banks' ability to effectively offer competing check collection services. When they find differences, Federal Reserve officials should be required to provide the Board with either proposals for eliminating the differences or an explanation of how the differences promote the safety, soundness, or efficiency of the payments system.

We recognize, however, that some collection products, such as fine sort, might not be made open to competition because of endorsement requirements. Therefore, other procedures need to be in place to examine closely the price markups of those products to ensure that the markups are not unreasonable.

Federal Reserve procedures should also require disclosure of the rationale for decisions on competitive fairness and the price markups on those products not open to competition. The disclosure would help alleviate any concerns that proposals are developed and implemented to enhance the competitive position of Reserve banks.

As an additional safeguard against potential conflicts of interest, Federal Reserve procedures should provide a means for hearing disputes arising from private sector concerns over competitive fairness. In part, dissatisfaction with existing arrangements for negotiating disputes with



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group sort and fine sort products, (2) noon presentment, and (3) payor bank services. Additionally, Reserve banks benefit from constraints on private competition through price markups on the fine sort product.<sup>1</sup> Therefore, when evaluating changes made by the Federal Reserve to improve the payments system, it appears that proposals are designed to enhance the competitive position of the Federal Reserve.

The Federal Reserve Board has established some procedures to avoid actual or apparent conflicts of interest. For example, to provide an external check on certain proposed actions, the public has the opportunity to comment on proposed regulations and those Reserve bank service changes deemed significant by the Federal Reserve. Internally, Federal Reserve check collection officials are responsible for assessing the effect Federal Reserve actions have on competition. Additionally, these check collection officials are not permitted to participate in making decisions about bank supervision, lending matters, and merger applications. This separation is intended to avoid the possibility of check collection matters being used to influence other bank-related decisions.

In our opinion, the established procedures do not go far enough to alleviate competitors' concerns that payments system changes are implemented to enhance the competitive position of Reserve banks. In part, this is due to the vague policy and lack of explicit criteria for evaluating the commitment to competitive fairness. Also, under Federal Reserve procedures

- public comments are not obtained on all proposed service and price changes that can materially affect collecting bank abilities to compete. For example, comments were not obtained concerning the New York move.<sup>2</sup>
- deliberations on service, price, and payments system changes do not identify the practical differences, such as those discussed in chapter 2, that may limit collecting banks' abilities to provide competing services. For example, internal decision documents covering collection service and price changes associated with the New York move did not discuss the effect on competition.

<sup>1</sup>These service changes are discussed on pages 32-37.

<sup>2</sup>See page 41.

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endorsing and microfilming checks by processing them through reader-sorters. Accordingly, before collecting banks could offer a competitive fine sort service, a scheme for maintaining records of the chain of banks that is satisfactory to the banking industry and mandatory industry-wide would need to be devised. Also, any costs that collecting banks are required to incur should also be required of Reserve banks. According to Federal Reserve officials, eliminating the use of endorsements was considered when Regulation CC was being developed.<sup>14</sup> However, the Federal Reserve's industry advisory group indicated that the industry resisted such a change at this time because it found endorsement information useful for identifying the banks that handled the checks during the course of collection.

Until a new endorsement scheme can be devised so that all collecting banks face similar costs and constraints, or other measures are taken to introduce competition, close attention should be paid to how fine sort and other products with a monopoly element are priced.

## **Conclusion**

The difference between Reserve banks' and collecting banks' abilities to effectively obtain same-day payment has constrained the degree of competition that may take place in the market. By limiting the collection options available to collecting banks, the difference has also constrained the efficiencies that those banks could bring to the check collection marketplace. Moreover, this competitive difference has led to disagreements between Reserve banks and collecting banks or their clearinghouse associations.

The Federal Reserve has requested public comment on a concept paper for regulatory change that, if adopted, could enable collecting banks to obtain same-day payment without charge. Although such a step will not guarantee equality of competition because of other differences described in this and the following chapters, providing similar presentment abilities to collecting banks would remove some constraints that limit their competitiveness.

<sup>14</sup>Regulation CC, effective September 1, 1988, implements the Expedited Funds Availability Act of 1987.

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**New York City Complaints**

Commencing in early 1988, the Federal Reserve Bank of New York started moving check collection operations out of New York City to New Jersey and Long Island. Regardless of the location, collecting bank members of the New York clearinghouse need access to Reserve bank services to obtain same-day payment from nonmember banks. Accordingly, when learning of the move, the clearinghouse complained that the increased costs and difficulties its member collecting banks will have in getting checks to the Reserve bank will put member collecting banks at a competitive disadvantage. Specifically, in a letter sent to the Reserve bank, the clearinghouse said:

"The most recent stage of relocation process . . . effectively change(s) [Federal Reserve Bank of New York] deadlines for the delivery of checks and it will result in a decided competitive advantage for [Federal Reserve Bank of New York] at the expense of our member banks. . . . Our members . . . simply cannot meet the [deposit] deadlines . . . for City unsorted checks without (i) establishing significantly earlier cut-off times for their own processing of City Work, (ii) setting much earlier deadlines for the receipt of City work from their correspondents and (iii) incurring large expenses."

Additionally, the clearinghouse complained about the lack of early notification of the proposed move and its exclusion from any planning, particularly planning for potential disruptions to the existing competitive balance.

To lessen the move's impact on its New York City competitors, the Federal Reserve Bank of New York decided to allow the New York City clearinghouse members to continue depositing checks at the Reserve bank's offices in New York City at approximately the same deadlines—at least temporarily—and will share in the costs of transporting the checks to New Jersey, including the cost of the helicopter service needed to meet the tight processing time frames. However, should that transportation fail to deliver the checks in time, float expenses are to be charged back to the depositing member banks.

Accordingly, for checks drawn on New York City banks that are not clearinghouse members, the move will increase New York City collecting bank costs of transportation and increase the risk of float expense. If the collecting banks had the same right to same-day payment as Reserve banks, the collecting banks could better determine whether it was more efficient or economical to present checks directly to paying banks or use Reserve bank collection services.

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Note: The remainder of this page through page 41 have been deleted from this excerpt since they contained information on clearinghouses and are, thus, not germane to this report.

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endorsements placed on a check or other agreed-to arrangements between banks may serve as the source for such recordkeeping.<sup>9</sup> Historically, banks have met the recordkeeping requirement by endorsing each check over to the next bank in the collection chain. In addition to meeting the U.C.C. recordkeeping requirements, those endorsements also passed on certain rights and protections to each succeeding holder of the checks. Moreover, under the terms of the U.C.C., paying banks retain the right to insist that a check be properly endorsed before making payment.

Even if a collecting bank could negotiate the presentment of unendorsed checks and decided to accept the risk of not being able to research checks on which it has advanced funds to depositors, it would still need to pay presentment fees. The amount of these fees, however, can come close to the Reserve banks' fine sort collection charge. As summarized by one collecting bank official, adding the cost of presentment fees to the cost of the product would prevent his bank from offering a competitively priced fine sort product.

The lack of competition provides Reserve banks with considerable flexibility in setting prices for the fine sort product. In general, Federal Reserve System pricing guidelines instruct Reserve banks to set prices to at least recover "floor costs"—the allocated costs of producing the product as identified by the Federal Reserve's cost-accounting system—and to make some contribution to recovering the remaining unallocated expenses. These unallocated expenses include overhead, imputed costs, shipping, and float. Nationwide, the 1987 floor costs amounted to about \$224 million while unallocated costs amounted to about \$257 million. About 45 percent of the unallocated costs nationwide (\$103 million in 1987) involved overhead expenses.

An examination of in-city collection charges by the Federal Reserve banks of Chicago, New York, and San Francisco shows that the Reserve banks charge a higher percentage markup over floor costs for fine sort products than for basic unsorted check collection products. (See table 2.2.)

<sup>9</sup>An endorsement signifies that a bank warrants to the next bank that it has good title to the check, has no knowledge that the signature of the maker is unauthorized, and that the check has not been materially altered. The bank is also warranting that if the check is dishonored under terms specified by the U.C.C., the bank will take back the check and return any proceeds received.

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Reserve banks sufficient time to do the work necessary to present checks for payment and obtain the proceeds.

Unlike Reserve banks, collecting banks must negotiate same-day payment agreements and therefore cannot unilaterally target these high-volume banks. Moreover, according to collecting bank officials, they have been largely unsuccessful in reaching same-day payment agreements with these high-volume banks. For example, the largest of these banks in the Federal Reserve's third district only accepts checks from the Federal Reserve. In another instance, a number of collecting banks in the Northeast have arranged private transportation to fly checks daily to North Carolina. Lacking agreements with the high-volume banks in that area, the collecting banks have had to deposit the checks for collection with the Reserve bank office in Charlotte. According to the collecting bank officials, with a same-day payment requirement they would present checks directly to these banks.

Bank officials attribute the reluctance of the high-volume banks to enter into same-day payment agreements with collecting banks to the need for those banks to satisfy corporate customer demands for early-morning notification of account balances—demands that can easily be satisfied through Federal Reserve payor bank services.

**Payor Bank Services**

To overcome problems that paying banks and their account holders could experience as a result of the later presentment of checks, the Federal Reserve introduced an information product called payor bank services. Banks purchasing this service are able to obtain information on the value of checks for each designated account holder early in the morning, usually before the physical checks are received. By purchasing this information, banks may notify corporate customers of account balances so that cash managers may make investments early in the morning while markets are most active. Providing such services—called controlled disbursement services—to corporate customers is a profitable business for banks and a service that both banks and corporate cash managers believe needs to be continued.<sup>8</sup>

<sup>8</sup>Controlled disbursement is a cash management service sold by banks to business customers. In general, under a controlled disbursement arrangement, a corporation would open a "zero-balance" checking account at the bank. Daily, as checks drawn on the account are presented to the bank, the account would become overdrawn. Sometime in the morning, generally between 8:30 and 11:00 the bank would notify the corporation of the amount needed in the account to cover the overdraft. The account may be funded by wire transfer or other arrangement. The advantage to the corporate cash managers is that they can avoid idle funds sitting in a non-interest-bearing checking account.

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**Other Terms Set by  
Reserve Banks Have  
Constrained  
Competition**

By setting other terms and conditions that are not specifically provided for under the U.C.C. for obtaining same-day payment, Reserve banks have been able to make service changes or introduce new collection products that provide its customers with same-day payment on more checks. As indicated earlier, paying banks have little choice but to comply with the change in terms; the alternative involves noncompliance with federal rules and the U.C.C. and potential loss of public confidence in the bank. However, collecting banks—lacking similar abilities to unilaterally set terms and conditions for payment—have not been able to make similar service changes or introduce comparable products. In turn, their ability to offer competitive check collection services is constrained.

**Noon Presentment**

To be able to provide customers with same-day funds on more checks, the Federal Reserve changed the time at which it presents checks to banks in Federal Reserve cities. Rather than present checks for payment at times set by local custom—generally in the morning—the Federal Reserve adopted the policy of dispatching checks from Reserve banks by noon with delivery to be made to the paying banks no later than 2:00 p.m.<sup>6</sup> The change, called noon presentment, enabled the Reserve banks to adjust their deposit deadlines to give their customers more time to get checks to the Reserve banks and provide the Reserve banks ample time to do the necessary work to present checks for payment and obtain the proceeds.<sup>7</sup> As indicated earlier, paying banks have little choice but to adjust to the changes in check collection practices implemented by Reserve banks.

Unlike Reserve banks, collecting banks do not have the ability to make banks accept checks as late as noon or 2:00 p.m. for same-day payment. Under the U.C.C., collecting banks may obtain same-day payment through agreements with other banks. However, it is customary for same-day payment agreements, like those developed by clearinghouses, to specify a presentment deadline earlier than noon. (See fig. 2.1.)

One clearinghouse president that we spoke with summarized the difference between collecting banks and Reserve banks in the following manner: One reason the Federal Reserve adopted noon presentment was to

<sup>6</sup>Alternatively, a paying bank may pick up its checks from a Reserve bank at the dispatch time.

<sup>7</sup>These changes, in part, enabled Reserve banks to reduce the amount of their check float from about \$2.2 billion a day in 1982 to about \$0.3 billion a day in 1984. Assuming a 6-percent interest rate for both 1982 and 1984, the float reduction would amount to an annual financing cost savings of over \$100 million. Without such savings, the cost of producing 1984 levels of check collection would have been about 39 percent higher.

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Table 2.1: Range of Per-Check  
 Presentment Fees Paid by One  
 Collecting Bank in 1987

State	Number of banks	Range of per item fees
1	5	\$.0100 to .0800
2	1	.0165
3	3	.0100 to .0150
4	1	.0250 to .0780
5	5	.0190 to .1200
6	2	.0050 to .0762
7	1	.0210
8	1	.1200
9	1	.0130
10	2	.0170 to .0220
11	1	.0100
12	1	.0250
13	10	.0300 to .1700
14	1	.0150
15	2	.0250 to .0600
16	3	.0120 to .0140
17	1	.0230
18	1	.0230
19	4	.0150 to .0230
20	2	.0140 to .0300
21	1	None

Given the large number of checks presented, per-check fees incurred by collecting banks—even when amounting to as little as 1/2 of 1 cent per check—may add significantly to the cost of doing business. Other charges also add to the cost of collecting checks. According to price lists we examined, charges can range from \$7.50 to \$100 per month for account maintenance, 50 to \$125 per month for balance reporting, and \$5.50 to \$16 for each funds transfer.

We were not able to examine bank records to verify the extent to which presentment fees increase collecting bank costs. However, an analysis prepared by one collecting bank regarding its presentments to other banks within the same Federal Reserve district showed that fees paid to these other banks amounted to about 18 percent of its check collection costs. Other collecting bank officials we spoke to estimated that the costs associated with presentment were much higher. They said presentment fees constituted about 40-50 percent of the cost of collecting an average check.

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- present checks to paying banks through account relationships. Collecting banks may open accounts at paying banks and deposit checks into those accounts much like any bank customer. Under the terms of the U.C.C., paying banks could take up to 2 days to make funds available for withdrawal provided that the paying banks make provisional settlement by midnight of the day of deposit.
- present checks to paying banks without having established account relationships. In turn, paying banks have until midnight of the day of presentment to make payment or dishonor the checks. Payment, however, may take the form of a remittance instrument, which is, in essence, a check drawn on another bank. Such a form of payment can delay the payout of usable funds for another day or more because the instrument is subject to the same type of collection processes as the original check.
- present checks to paying banks without having account relationships but, as an alternative to accepting remittance instruments, demand cash. Accepting cash can entail hiring a courier to go to the bank and present checks one at a time to that bank's teller. Since tellers verify the authenticity of checks before releasing funds, such an "over-the-counter presentment" would amount to a time-consuming, costly undertaking without a guarantee that sufficient time would be available to cash all checks the same day. Moreover, collecting banks may need to hire armored trucks and guards to transport the cash received. The banks then would have to convert the cash to some interest-bearing asset. Furthermore, any collecting bank that participates in such a tactic could be subject to the same tactic in retaliation.

Each day's delay in obtaining payment from paying banks diminishes a collecting bank's ability to compete with Reserve banks. For example, on an average check, it would cost a collecting bank about 22 cents if it made funds available to a depositing bank 1 day before obtaining funds from the paying bank.<sup>3</sup> In comparison, Reserve banks generally charge between 0.5 and 5 cents per check for collection services depending on the location of the banks and the level of service required. Accordingly, setting collection prices competitive with Reserve bank prices while incurring such interest costs is not a practical option available to collecting banks.

<sup>3</sup>The cost was computed using the average 1987 interest rate (federal funds rate) for interbank borrowing—6.7 percent—against the average value of checks written in 1987—about \$1,188. See David B. Humphrey and Allen N. Berger, Market Failure and Resource Use: Economic Incentives to Use Different Payment Instruments. Paper presented at the Federal Reserve Bank of Richmond Payment System Symposium, May 1988.



Chapter 2

## Differences in Ability to Obtain Payment on Checks Affect the Competitive Balance

To operate a competitive check collection business, a collector—either a Reserve or collecting bank—must provide same-day funds on most checks deposited by its customer banks. Providing same-day funds in a competitive market involves giving customer banks as much time as possible to get checks to the collector yet leaving sufficient time for the collector to present checks to the paying banks and obtain same-day payment. Collectors need to obtain same-day payment because float expenses—the interest cost of making funds available to customer banks before collection from paying banks—could readily exceed the earnings from collection prices in today's competitive market.

In this chapter, we analyze differences between Reserve and collecting bank abilities to present checks to other banks for same-day payment and the effects these differences have on competition.

### Only Reserve Banks Can Require Same-Day Payment Without Charge

The terms and conditions under which Reserve banks require payment are specified by the Board of Governors in Federal Reserve Regulation J and bank operating circulars. These terms are

- a paying bank must pay for all checks that it has not returned before the close of its banking day of receipt;
- payment is to be made in an amount equal to the amount of the checks;
- payment is to be made (1) by debit to an account at a Reserve bank, (2) by cash, or (3) at a Reserve bank's discretion, by another form of payment; and
- payment proceeds are to be available to the Reserve bank before the close of its banking day.

The terms and conditions established by the Federal Reserve require quicker payment than banks are required to give other banks under the terms of the Uniform Commercial Code (U.C.C.).<sup>1</sup> Under certain circumstances, the U.C.C. provides that funds availability may be withheld for as long as 2 days. The U.C.C. also provides, however, that its terms, such as the timing of payment, may be varied by agreements among banks, such as in a clearinghouse arrangement, or by Federal Reserve regulation and operating circular. These Federal Reserve issuances are deemed by the U.C.C. to be agreements even if they are not agreed to by all parties.

<sup>1</sup>The U.C.C. is a codification of commercial law established as a model for state adoption. Commercial codes patterned after the U.C.C. and governing commercial transactions such as check collection and settlement have been adopted by the 50 states and the District of Columbia. See pages 27-28 for a description of U.C.C. payment terms.

Executive Summary

Promoting Competition

GAO found no compelling reason why differences between the collecting and Reserve banks' abilities to present checks are essential for the safety, soundness, or efficiency of the check collection system. However, the Federal Reserve faces a difficult task in changing presentment rights to try to enhance the operation of the check collection system and achieve competitive fairness. The difficulty arises because paying and collecting bank interests are in direct opposition. Also, although it has expressed a fundamental commitment to competitive fairness, the Federal Reserve has not further defined this policy or developed criteria for evaluating competitive fairness. Without such criteria, it is harder for the Federal Reserve to deal with the potential conflicts of interest between its roles as competitor and overseer of the payments system. (See pp. 55-59.)

During the course of our work, the Federal Reserve sought public comment on allowing collecting banks to present checks up to 2:00 p.m. without paying presentment fees. Many paying banks opposed the proposal because the 2:00 p.m. deadline would disrupt cash management services. However, these objections in effect argue to preserve the Reserve banks' unique check presentment ability. Since the Federal Reserve does not have specific criteria for evaluating competition, it could appear that the Federal Reserve was acting merely to preserve its competitive position if it supported the views of paying banks. (See pp. 59-61.)

GAO agrees that the interests of paying banks need to be considered when the Federal Reserve implements changes to the check collection system. However, it does not follow that the only way to do this is to preserve all the Federal Reserve's presentment advantages. For example, collecting banks could be required to notify paying banks early in the day about check presentments that would be forthcoming—a service that is now provided by the Federal Reserve. (See p. 61.)

Recommendations

GAO recommends that the Federal Reserve Board of Governors adopt a policy and implementing procedures under which collecting banks have the same abilities to provide check collection services to their customers as Reserve banks unless the safety, soundness, or efficiency of the payments system demand otherwise. (See p. 62.)

GAO also recommends that the Federal Reserve apply the new policy to develop a revised, comprehensive same-day payment proposal. (See p. 62.)

# Excerpts From Check Collection: Competitive Equality Is an Elusive Goal (GAO/GGD-89-61)

## Executive Summary

### Purpose

When a check written on one bank is deposited in another, funds must be collected from the paying bank, the bank on which the check was written. To collect these funds, some banks—called collecting banks—and all Federal Reserve banks provide a check collection service for a fee.

Some collecting banks have asserted that competition with the Reserve banks for check collection business is unfair because Reserve banks operate under different rules that, among other things, enable them to avoid bank fees that collecting banks incur. As part of the Competitive Equality Banking Act of 1987, Congress asked GAO to determine the validity of the assertions.

### Background

In 1987, an estimated 31 billion checks, or about two-thirds of all checks written, were initially deposited in a bank other than the paying bank. The Federal Reserve handled about 55 percent of these checks, a percentage far greater than any private sector bank. (See pp. 12-15.)

The Board of Governors of the Federal Reserve System performs two different roles in the check collection system. First, the Board is responsible for overseeing the business aspects of the Reserve banks' check collection operations. Second, the Board is responsible for overseeing the operation of the check collection system as a whole. In this connection, as a result of the Expedited Funds Availability Act of 1987, the Board is empowered to regulate the collection of checks by private banks. It used this power to change the way dishonored checks are returned to the bank of first deposit. (See pp. 15-16.)

In operating their businesses, collecting banks and Reserve banks are governed by different rules. Collecting banks are governed principally by state laws that stipulate rights for accepting and paying on checks. Reserve banks operate under rules set by the Board of Governors that in many instances vary from state laws. (See pp. 26-27.)

### Results in Brief

Owing to the differences in the rules under which they operate, Reserve and collecting banks each have unique abilities to attract customers. However, the inability of collecting banks to match Reserve bank collection terms, especially obtaining same-day payment without incurring bank fees, has constrained the collection options open to collecting banks; the collection services they may sell; and, in turn, the potential efficiencies they may bring to the market. GAO found no evidence that

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Reserve bank even though the checks may be shipped via the Federal Reserve's own transportation system. This would be analogous to a private bank that hires a courier and allows other banks to use it as well.

This change in methodology, proposed after we had brought to the attention of the Federal Reserve the effect of using a netted amount of checks in process of collection as their base for calculating the imputed deposit insurance premiums, will eliminate deposit insurance cost differences between Federal Reserve and private banks when implemented in 1990.

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## Equity Capital Costs

The change in the methodology for counting checks in process also has potential implications for the equity component of the PSAF.<sup>9</sup> Accounting for checks in process of collection in a way comparable to a bank's method increases the Federal Reserve's total assets.<sup>10</sup>

We checked to see if this increase in assets would create a situation in which the Federal Reserve would need more imputed equity capital to conform to the minimum capital requirements imposed by federal regulators on banks and bank holding companies. Under capital adequacy rules that have been in effect since 1985, banks and bank holding companies must hold 5.5-percent primary capital to total assets.<sup>11</sup> Although the purpose of the requirement is to ensure that banks have sufficient capital to cover such high-risk assets as commercial loans, the formula applies equally to all assets, including such low-risk assets as checks in process of collection.

Because they are governmental entities, the Federal Reserve banks are not subject to the minimum capital requirements that apply to bank holding companies and banks. However, if they were considered to be covered by such requirements for purposes of the PSAF calculation, the increase in assets associated with the change in accounting for checks in process of collection discussed above is not sufficient to trigger an

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<sup>9</sup>Equity capital is used to finance assets. Equity capital consists of such items as perpetual preferred stock and common stock.

<sup>10</sup>Under capital adequacy rules, banks and bank holding companies are to count checks in the process of collection as assets; that is, from the time a bank accepts checks for collection to the time funds are actually collected from the paying bank and credited to the depositing bank.

<sup>11</sup>The components of primary capital are common stock, perpetual preferred stock, loan loss reserves, mandatory convertible instruments, and perpetual debt instruments. On average, in 1988, 67 percent of required primary capital held by the top 25 bank holding companies was equity capital.

Philadelphia, Richmond, Chicago, Minneapolis, and Dallas. The biggest shortfall occurred in New York.

As calculated by the Federal Reserve, for the period 1984 through 1987, the System as a whole had revenues that exceeded the costs for check collection. In 1987, for example, the System recovered about \$17 million or about 3.6 percent more than its cost base. During this 3-year period, each Reserve bank met its cost recovery goal except for two banks in 1984. (See table 2.)

**Table 1: Revenues Received From Check Collection: 1984-88**

Dollars in millions

Year	Revenue	Cost base <sup>a</sup>	Revenue in excess of cost base	Excess revenue or deficit as percent of cost base
1988	\$513.8	\$522.8	\$(9.0)	-1.8%
1987	500.6	483.2	17.4	3.6
1986	483.4	460.1	23.2	5.1
1985	454.6	429.8	24.8	5.8
1984	421.9	388.5	33.4	8.6

<sup>a</sup>Cost base includes the PSAF plus float (the cost of providing funds to banks sooner than it collects the funds).

**Table 2: Federal Reserve Bank Check Collection Revenue as Percent of Cost Base, Including the PSAF: 1984-88**

Reserve Bank	1988	1987	1986	1985	1984
Boston	94	100	102	102	100
New York	92	101	104	103	96
Philadelphia	107	109	104	105	104
Cleveland	99	102	102	105	111
Richmond	102	103	105	107	119
Atlanta	98	106	107	107	124
Chicago	102	104	107	107	99
St. Louis	96	102	103	106	117
Minneapolis	101	104	105	103	105
Kansas City	96	101	102	108	113
Dallas	101	101	104	104	107
San Francisco	98	109	108	109	119

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Although presentment fees can influence the time of day private banks present checks to each other, we think it inappropriate to look to presentment fees—including authorizing Federal Reserve payment of such fees—as a way to make check processing more efficient. One problem with presentment fees is that they relate only to the check processing activities of individual banks. The concept of efficiency also needs to be considered from the point of view of the check collection system as a whole. From this broader perspective, the relationship between presentment time and efficiency cannot be reduced to the idea that earlier presentments are always more desirable. For example, because payment on checks presented after an early presentment cut-off time would be delayed a full day, the relationship of presentment time to the speed of collection is also an important consideration. There are also impediments to the efficient collection of checks that are not affected by prices. Our study showed that some private banks will not accept checks from other private banks even if those banks are willing to pay presentment fees.

In evaluating the merits of authorizing Federal Reserve payment of presentment fees, we encountered yet another problem in trying to link presentment fees to efficiency. Economic theory suggests that prices are most likely to lead to efficiency when they are set under conditions that tend to make prices reflect production costs. We have, however, been unable to find a cost basis for presentment fees. This means that if the Federal Reserve were to be authorized to pay presentment fees, some sort of regulatory procedure would have to be set up to determine what price the Federal Reserve should pay. But even then, it is unclear how prices charged to the Federal Reserve would contribute to making the check collection system more efficient.

The opportunity for paying banks to charge presentment fees that vary by time of day arises from the rules and practices associated with the presentment of checks by private and federal reserve banks. Given this, together with the problems in linking presentment fees with the efficiency of the Nation's check collection system, we think that efforts to make the check collection system both fairer and more efficient should be directed toward an examination of basic presentment policies and practices. The Federal Reserve System's review of presentment issues reflects our recommended approach.

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the cost of resources used by the Federal Reserve to process checks is shared by many of its individual check products.

Our work was done in Washington, D.C., where we interviewed officials of the Federal Reserve Board and FDIC. Our work was done between September 1987 and October 1989 using generally accepted government auditing standards.

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## Presentment Issues

Our May 1989 report discussed the question of whether the Federal Reserve's statutory exemption from paying certain fees, known as presentment fees, gives the Federal Reserve a material advantage over its private sector competitors in providing certain kinds of check collection services. Relevant excerpts from that report are included in appendix I.<sup>4</sup>

In summary, we concluded that while both Reserve banks and collecting banks have unique abilities to attract customers and that the net effects of these advantages are difficult to weigh, the Federal Reserve's exemption from presentment fees provides it with an important advantage. Because collecting banks must pay to obtain same-day payment and even then can be refused same-day payment, their abilities to operate a competitive check collection business are constrained. We found no similar constraints placed upon the Federal Reserve—which is entitled to receive same-day payment on all checks presented—even though it does not share in all collecting bank abilities.

We found no compelling reason why only the Federal Reserve should have the ability to obtain same-day payment without the imposition of presentment fees. We also concluded that the best way to narrow the differences is to allow private banks to present checks on terms similar to those of Federal Reserve banks, not to authorize Federal Reserve payment of presentment fees. We therefore recommended that the Federal Reserve design a workable same-day payment proposal.

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<sup>4</sup>The appendix contains the following:

- most of the executive summary;
- substantial portions of chapter 2, "Differences in Ability to Obtain Payment on Checks Affect the Competitive Balance;"
- chapter 4, "Conclusions and Recommendations;" and
- appendix IV "Alternative for Reducing Differences in Banks' Abilities to Collect on Checks."



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more active competition between Federal Reserve banks and private sector banks. This competition, which hinges on the relative price and quality of service offered by each competitor, has generated concerns about competitive fairness that have interested your Subcommittee and other congressional committees.

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## Results in Brief

Owing to the differences in the rules under which they operate, Reserve and private banks each have unique abilities to attract customers. However, the Federal Reserve has a unique presentment advantage compared to private banks: it can collect funds from any bank on the same day it presents checks and not pay a presentment fee for such a privilege. Because private banks do not have this advantage, their options for providing a competitive service are constrained. To foster competitive fairness in the check collection system, we think private banks should have the same abilities to provide check collection services to their customers as Reserve banks unless the safety, soundness, or efficiency of the payments system can be demonstrated to demand otherwise.

As calculated by the Federal Reserve, in 1988 the System as a whole did not recover all its costs; its revenues fell about \$9 million (almost 2 percent) short of the amount needed to cover the check collection cost base. In particular, revenues obtained by 7 of the 12 Reserve banks did not meet 1988 cost recovery goals. The Federal Reserve attributes the shortfall to significant increases in costs associated with implementing new check return services. For calendar years 1985 through 1987, the System as a whole and each Reserve bank fully recovered all check collection costs. The System as a whole had total revenues that exceeded costs in 1984, though two banks did not recover all costs.

In calculating the costs that need to be recovered by its check collection prices, the Federal Reserve has been following a rule for accounting for checks being collected by Reserve banks that is different from the rule private banks must follow. Because of this difference, the Federal Reserve has imputed lower deposit insurance costs than what private banks would have had to pay for the same level of check collecting effort. Had the Federal Reserve followed the same rule, its imputed deposit insurance premium in 1988 would have been \$3.4 million higher. In June 1989, the Federal Reserve revised the way it accounts for checks in process, thus eliminating the difference in the deposit insurance cost calculation.

