FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **9464**
March 11, 1983]

CHECK FLOAT

Program To Reduce and Price Federal Reserve Float

To All Depository Institutions in the Second Federal Reserve District, and Others Concerned:

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has approved a program that represents a combination of changes in Federal Reserve operating procedures to reduce and to price Federal Reserve interterritory check float and Federal Reserve check holdover float.

The Board acted under the provisions of the Monetary Control Act of 1980 which require the Federal Reserve to charge for its services. The Monetary Control Act requires that any Federal Reserve float that remains after operational improvements also be priced. Federal Reserve float is the value of checks for which the Federal Reserve has given credit to the institution that deposited the checks with the Federal Reserve for collection, but for which the Federal Reserve has not yet received payment.

On November 1, 1982, the Board published for comment three proposals to eliminate or price about 80 percent of Federal Reserve float. The three proposals published for comment included: (1) changing crediting procedures for interterritory check deposits; (2) adopting a new accounting procedure to eliminate float associated with large dollar interterritory returned checks; and (3) pricing holdover and intraterritory check float.

After reviewing the comments, the Board approved a Reserve Bank program to reduce and to price interterritory and holdover check float. The interterritory check float program calls for:

- — all Reserve Banks to offer fixed and fractional availability crediting options with various methods of payment for float in connection with these crediting options.
- — all Reserve Banks to offer the same crediting options for interterritory check deposits at the same time.
- — all interterritory check deposits (whether processed at the sending or receiving Federal Reserve office) to be subject to the same crediting procedures.
- — all interterritory check deposits to be processed in order of receipt.

Because of the time needed by depository institutions and Reserve Banks to make changes to their systems, this portion of the program will be implemented on July 1, 1983.

Due to the operational changes resulting from the check float program, the pricing of holdover float will be phased in as follows:

February 24 — July 1, 1983	During this period the cost of holdover float above 1 percent of the value of checks collected daily by the Federal Reserve Banks will be incorporated in the cost of check services to be recovered in 1983.
July 1 — September 30, 1983	During this period the cost of holdover float above ½ percent of the value of checks collected daily by the Federal Reserve Banks will be incorporated in the cost of check services to be recovered in 1983.
October 1, 1983	At this time the cost of all holdover float will be added to the cost of check services.

(OVER)

Enclosed, for depository institutions in this District, is a copy of the Board's official notice in this matter; it will be published in the *Federal Register*, and additional copies may be obtained from our Circulars Division (Tel. No. 212-791-5216).

Questions on check float should be directed, if you are in this Bank's Head Office territory, to James O. Aston, Vice President (Tel. No. 212-791-6334) or John F. Sobala, Assistant Vice President (Tel. No. 212-791-5997). In the Buffalo Branch territory, such questions should be directed to Peter D. Luce, Assistant Vice President (Tel. No. 716-849-5013) or Robert J. McDonnell, Operations Officer (Tel. No. 716-849-5022).

ANTHONY M. SOLOMON,
President.

FEDERAL RESERVE SYSTEM

[Docket No. R-0433]

Reduction And Pricing Of Federal Reserve Float

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Approval of proposals to reduce and price Federal Reserve float.

SUMMARY: The Board of Governors has approved a program to reduce and price Federal Reserve interterritory and holdover check float. The program for pricing Federal Reserve interterritory float will be implemented on July 1, 1983, and the program to price Federal Reserve holdover float will be phased in beginning February 24, 1983. The phase-in will be completed on October 1, 1983, when the full cost of all holdover float will be added to the cost of check services.

EFFECTIVE DATE: February 24, 1983. On that date, Reserve Banks will begin phasing in pricing of check holdover float. On July 1, 1983, Reserve Banks will implement the program to reduce and/or price interterritory check float.

FOR FURTHER INFORMATION CONTACT: Elliott C. McEntee, Assistant Director (202/452-2231) or Morgan J. Hallmon, Program Manager, Payments Mechanism Planning (202/452-3878), Division of Federal Reserve Bank Operations; Gilbert T. Schwartz, Associate General Counsel (202/452-3625), Daniel L. Rhoads, Attorney (202/452-3711), or Robert G. Ballen, Attorney (202/452-3265), Legal Division, Board of Governors of the Federal Reserve System, Washington, D. C. 20551.

SUPPLEMENTARY INFORMATION: The Monetary Control Act of 1980 (P. L. 96-221) ("MCA") requires that fees be established for Federal Reserve Bank services and that the Board shall begin putting into effect a schedule of fees not later than September 1, 1981. The MCA sets forth specific services to be priced and requires the Board to establish principles on which the schedules of fees for priced services are to be based. The MCA requires that the Reserve Banks price for Federal Reserve float that remains after operational means to reduce float are implemented.[1]

On December 31, 1980, the Board adopted a set of pricing principles and fee schedules for certain Federal Reserve services. Subsequently, the Board adopted fee schedules for Reserve Bank services in accordance with the MCA. In its December 31, 1980, action, the Board determined, in response to comments received on the Board's proposals to reduce and price float (45 F.R. 58689), to proceed with internal operational improvements with high benefit/cost ratios to reduce float before initiating changes in availability schedules and explicitly pricing float.

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[1] 126 Cong. Rec. S3167 (daily ed. March 27, 1980) (statement of Senator Proxmire).

On November 1, 1982, the Board requested comment on proposals to eliminate or price approximately 80 percent of Federal Reserve float by: (1) changing crediting procedures for interterritory check deposits; (2) adopting a new accounting procedure to eliminate float associated with large dollar interterritory returned items; and (3) pricing holdover and other intraterritory check float. 47 F.R. 50342 (November 5, 1982).

Under the proposal to change crediting procedures for interterritory check deposits, Reserve Banks would offer two or more of the following options for eliminating and/or pricing interterritory check float:

1. Credit would be given on the day the checks are received on a timely basis by the collecting Federal Reserve Bank ("actual availability");

2. Credit would be given on the basis of a fixed availability schedule (unique to each institution) so that part of an institution's credit for a deposit is deferred an additional day, and, on average, float is zero ("fractional availability"); and

3. Credit would be given on the basis of a fixed availability schedule, with compensation for float being made through either:

   a. "as of" adjustments to correct for float after it occurs ("fixed availability with 'as of' adjustments"); or

   b. earnings credits on a clearing balance maintained by the depository institution at the Federal Reserve, with the value of float determined at the federal funds rate.

Under the proposal for large dollar interterritory returned items, changes would be made to Federal Reserve Bank accounting procedures in order to eliminate such float by charging the depositing institution's account for large dollar interterritory returned items on the basis of a wire notification. The depositing institution whose account was being charged would receive from its Reserve Bank the wire notifications as they become available, but in no event later than 3:00 p.m. local time. As an alternative to having its account debited immediately, a depository institution could compensate the Federal Reserve for returned item float through an "as of" adjustment to its account. Currently, the institution depositing the check is not charged for a returned item until the item is received by that institution.

The third proposal was to price, at the federal funds rate, holdover and other intraterritory float. Holdover float occurs when a Reserve Bank receives a check shipment by its deposit deadline but is unable to process the shipment for collection on a timely basis. Generally, holdover float occurs as a result of sharp daily volume fluctuations and check processing equipment malfunctions. Other intraterritory float occurs primarily as a result of local transportation delays. The value of both types of float would be added to the costs of the check collection service.

Summary of Comments.

The Board received 173 comments on the proposals.

Crediting procedures for interterritory check deposits. The majority of commenters that discussed the crediting options for interterritory check deposits were in favor of the Reserve Banks' providing interterritory crediting options. Commenters in favor of options indicated that this approach permitted institutions with different accounting procedures and systems to select the option that best met their needs. Fixed availability with "as of" adjustments received more support than the other proposed interterritory crediting options.

Fifty-four commenters were opposed to all of the proposed interterritory crediting options, stating that less costly alternatives were available, such as changing availability schedules or explicitly pricing float. Commenters also expressed concern about the lack of uniformity among the crediting options to be offered by Reserve Banks, the difference in treatment of float arising from consolidated shipments and direct-send deposits, and the lack of clarity regarding the crediting procedures for mixed and other Fed cash letters.

New accounting procedures on large dollar returned items. Most of the commenters that discussed the proposal for wire notification of charge on large dollar interterritory returned items supported the option. However, many of these commenters expressed reservations about the adequacy of data to be supplied by the notification and about their legal liabilities, as well as those of the Reserve Banks. In addition, those commenters who discussed the option of using "as of" adjustments favored it over the proposed immediate charge.

Institutions opposed to this proposal cited operational and legal concerns. For example, many of the commenters questioned their legal authority to charge a customer's account prior to receipt of the returned item. In addition, these commenters offered alternatives to the Federal Reserve's proposal that would involve establishing availability schedules for returned items, or explicitly charging for returned item processing.

Holdover and other intraterritory check float. More than 70 commenters favored the proposal to charge explicitly for holdover and other intraterritory float. These commenters believed that the proposal was fair and reasonable, that it provided incentives to Reserve Banks to reduce float and encourage competition, and that it was consistent with private sector procedures.

Many commenters opposed to explicitly pricing holdover and other intraterritory float felt that the Federal Reserve should consider these float components as a cost of doing business and stated that the Federal Reserve should not price this float category. Some stated that the proposal was premature in light of the recently adopted proposal to accelerate the collection of checks. Alternatives suggested by commenters included: (1) excluding this float from pricing; (2) pricing only a portion of this float; or (3) changing availability schedules to compensate for this float.

Discussion.

After consideration of the comments on these proposals and further analysis, the Board has determined to approve implementation of a program with regard to interterritory and holdover float. Action on the proposal to change crediting procedures for large dollar interterritory returned items (the second proposal) and the proposal with regard to other intraterritory float, is being delayed pending further analysis of the issues raised by the commenters. It is anticipated that these issues will be presented to the Board in April, 1983.

Interterritory crediting options. A number of commenters suggested alternatives to the Board's proposals. Some commenters suggested that interterritory check float be priced by including the cost of float in the per item fee for check collection services. They argue that assessing float costs through per item fees would be less burdensome operationally than the proposed options. This method of pricing would, however, create equity problems because float costs are a function of the dollar value of the checks rather than the number of checks cleared. For example, the cost of one day's float at a federal funds rate of 8.25 per cent is approximately $220 for a $1 million check and 11 cents for a $500 check (the average dollar value of all checks deposited at Reserve Banks). Since a relatively small percentage of checks account for a large percentage of interterritory check float, unless each check had a separate price, a per item charge for float would represent a subsidy by institutions and their customers collecting small dollar checks to institutions collecting large dollar checks.

Another alternative suggested by some commenters was for the Federal Reserve to change availability schedules in whole-day increments to eliminate float since, in their opinion, the proposed crediting procedures were designed to compensate for availability schedules that could not be achieved consistently. The on-time performance of the Federal Reserve's Interdistrict Transportation System (ITS) exceeds 95 percent, and checks sent by direct sending institutions generally are received on a timely basis. Based upon these factors, the Board believes that Federal Reserve availability schedules are, on the whole, reasonable. If Federal Reserve availability schedules were changed in whole day increments as suggested by these commenters, significant amounts of credit float would result. This would inappropriately increase costs to collecting institutions.

About 60 percent of the commenters expressed views on the actual availability option. Commenters favoring this option stated that this approach is used in their own correspondent-respondent relationships. Several of these commenters also indicated that this option would provide an effective method for allocating float back to the appropriate customers. The majority of these commenters, however, expressed concern with this option primarily because it would not provide them with the degree of predictability they find necessary. Commenters also stated that crediting information must be provided by the Reserve Banks early in the day if timely investment decisions are to be made. The cash letter monitoring system developed by the Reserve Banks is designed to provide the necessary information by midday; however, based on comments received, it is likely that banks would not regard this as early enough to meet their needs. Thus, it is anticipated that institutions would choose other options that they perceive as better meeting their needs.

Many of the larger institutions (over $3 billion in deposits) and some of the smaller institutions (under $50 million in deposits) supported the fractional availability option because it allows an institution to determine float costs at the time interterritory checks are deposited with the Federal Reserve. In addition, these institutions often indicated that this option would make it easier to allocate the cost of float to individual customers than would the other options. Nevertheless, many depository institutions commenting on the fractional availability option opposed it because of concern about the costly and complex system changes that a depository institution would have to make and concern with the number of fractions that would be used and the frequency with which the fractions would be calculated and applied.

Fractional availability is the only crediting option that allows a depository institution, a priori, to determine those float costs associated with interterritory check shipments. Also, fractional availability maintains the same basic features of existing Reserve Bank availability schedules in that the availability granted for check deposits is predetermined. Thus, it is possible for depository institutions to assess the precise availability obtained for each customer. The cost and complexity of implementing this option would depend upon how a depository institution applies it in allocating float to its customers. Furthermore, the cost to depository institutions of using this option can be reduced by minimizing the number of fractions and the frequency with which those fractions are changed. The current reliability of the ITS network and the on-time performance of most direct sending institutions suggest that the number of fractions and the frequency of change should be relatively small.

The majority of commenters who addressed the fixed availability crediting option with "as of" adjustments supported it as being inexpensive to implement and use. Commenters opposed to this option indicated concern about the difficulties inherent in processing "as of" adjustments on a lagged basis. They stated that using "as of" adjustments would require depository institutions to either absorb the float costs, allocate float costs arbitrarily over their entire customer base, or develop expensive and complex allocation procedures. These commenters also expressed concern that this option could increase problems in managing reserve accounts.

The "as of" approach would require no significant changes in current check clearing procedures by either Reserve Banks or depository institutions. If receipt of a check shipment were delayed and credit were deferred, the deferral would be made through an "as of" adjustment in whole-day increments. The "as of" adjustment procedure is a well-established accounting practice between the Reserve Banks and depository institutions since it is currently used to correct for errors in cash letter handling. Although "as of" adjustments would be made on a lagged basis, depository institutions would be informed of the float generated by particular check deposits on the day the float was created.

Fixed availability with "as of" adjustments also would not make the task of reserve management more difficult under either the current lagged reserve requirement system or the contemporaneous reserve requirement system scheduled for implementation in February 1984. The adjustments to required reserve balances would generally be known in advance because the collecting institution would be notified promptly of the receipt or non-receipt of cash letters.

Commenters that favored the option of fixed availability with payment for float through earnings credits on a required clearing balance cited operational simplicity as a primary reason for their support. Many commenters, however, expressed concern about the feasibility of charging the appropriate depositors' accounts and the difficulty in managing required balances at Reserve Banks with this option. They also stated their belief that this option would provide a competitive advantage to Reserve Banks since it would increase the difficulty of comparing the costs of check collection services provided by both Reserve Banks and the private sector. Some commenters suggested that this option would be more attractive if they were permitted to pay for float through explicit charges to their reserve or clearing accounts instead of with credits earned on a clearing balance.

The use of clearing balances to pay for float charges should not complicate price comparisons between the Federal Reserve and correspondent banks, however, since it is common practice in the banking industry to use balances to compensate for services provided by correspondents. Further, the monthly statement provided by the Reserve Banks will show explicitly the float charges assessed during the billing cycle. As discussed previously, this payment method should not increase a depository institution's difficulty in managing required balances or in making necessary adjustments to depositors' accounts.

A number of commenters indicated that, unless all Reserve Banks offered the same crediting options, a depository institution could be competitively disadvantaged, particularly if the crediting options offered by its local Federal Reserve office did not include those desired by its corporate customers. Concern was expressed that, in such cases, a customer might transfer its account to an institution in a Federal Reserve District offering the desired option. Further, a depository institution may not be able to take advantage of its least cost option if that option is not offered by its local Federal Reserve office. Based upon the comments received, the Board has determined that Reserve Banks should offer identical options.

A number of commenters stated that there are significant differences between users of Federal Reserve transportation (consolidated shipments) and users of privately arranged transportation (direct shipments) that justify different crediting procedures. Direct senders state that, when they meet deposit deadlines of the receiving Federal Reserve office, they should receive 100 percent availability. Under all of the proposed crediting options, direct senders meeting the deposit deadlines of the receiving Reserve office would receive the benefit of their on-time performance and would incur no float charges.

A number of commenters expressed concern that the proposals were not in compliance with the MCA and represented unfair competition. In addition to several of the issues previously discussed, concern was expressed that: (1) the Federal Reserve would shift overhead costs to float charges resulting in generally lower prices for services; (2) the Reserve Banks would use clearing balances to provide mixed check depositors with 100 percent guaranteed availability, thus creating float and using earnings credits on clearing balances to compensate for the float created; and (3) the Federal Reserve was competing unfairly because it was both a regulator and a competitor.

With regard to the concern that overhead costs will be shifted to float charges, the MCA sets forth the standards on which fees are to be based. Further, the Board's Pricing Principle 5 states that the Board intends that fees be set so that revenues for major service categories match costs (46 F.R. 1338 (January 6, 1981)), and there are extensive mechanisms in place throughout the System for determining costs and establishing fee schedules. Additionally, the General Accounting Office has audited such pricing to ensure compliance with the MCA.

The concerns that Reserve Banks would provide mixed check depositors with 100 percent guaranteed availability and that no charges would be assessed for float arising from items sent between Reserve Banks stem from a misunderstanding of the proposals. It was intended that interterritory transportation float generated by Other Fed items and mixed check deposits be priced in the same manner as float arising from other interterritory check shipments. Reserve Banks would therefore have no competitive advantage with regard to pricing of float arising from these deposits.

The concern that the Federal Reserve has a competitive advantage because it is both regulator and competitor was carefully reviewed. This action does not, however, represent any regulatory change and is being implemented in accordance with the pricing requirements of the MCA. With regard to the more specific issue that the crediting of earnings credits on clearing balances at the federal funds rate (unadjusted for required reserves) provides Reserve Banks a competitive advantage, the Federal Reserve does not believe that, on balance, such an advantage exists. The competitive impact of paying an earnings credit rate unadjusted for reserves is minimized by several factors: (1) respondents may deduct balances "due from" their correspondents from their gross transaction accounts while balances "due from" the Federal Reserve may not be deducted by respondents; (2) significant restrictions are placed on the administration of clearing balances for monetary policy reasons (e.g., balances must be maintained on a weekly average basis); (3) Reserve Banks do not pay earnings credits on balances in excess of those required as correspondents typically do; and (4) Reserve Banks do not offer the broad range of commercial services to depository institutions that correspondent banks offer.

Several commenters also suggested that the Board's request for comment on the proposals did not contain sufficient information to enable them to comment on the proposals in a meaningful way. After a review of this matter, the contents of the notice requesting comment on the proposals, the diversity of commenters and the scope of their responses, the Board has concluded that the notice and comment procedures adopted by the Board fully complied with applicable law.

Holdover float. About half of the one hundred and forty-three commenters that discussed this issue were generally in favor of the proposal to price check holdover float explicitly at the federal funds rate. They stated their belief that it was reasonable and appropriate to allocate holdover float to overhead costs and to recover the costs through per item prices. Some commenters stated that the proposal provided incentives to the Reserve Banks to reduce float and that the proposal was consistent with the method used by the private sector to recover float costs.

Seventy-two commenters expressed concern about pricing holdover float. Some commenters opposed this proposal because they believe that pricing holdover float, which is due to Federal Reserve operations, is unfair; others argued that pricing of holdover float could lead to Reserve Bank operating inefficiencies unless holdover targets were established. Some commenters stated that the proposal was contrary to the intent of Congress and would represent another "tax" on banks, that pricing holdoverlfloat would result in higher Reserve Bank prices and could diminish the Federal Reserve's role in the payments mechanism, or that the proposal was premature and deserved more study in light of other Reserve Bank changes, such as uniform later presentment and new deposit deadlines.

Reflecting the sizable gains in the effectiveness of check operations in the Federal Reserve Banks over the past few years, holdover float is currently small and represents only about 1 percent of the value of checks collected daily by the Federal Reserve Banks. While continuing efforts should be made to reduce even further the amount of holdover float, further significant reductions could be expensive to achieve.

In view of the small amount of float involved, the Board believes it is appropriate to add the cost of holdover float to check collection charges in general rather than attempt to allocate it back to specific depositors. Further, since holdover float primarily occurs as a result of Federal Reserve equipment breakdown and fluctuation in volume, it is appropriate to consider holdover float as a cost of doing business and include it in the check collection charges. Reserve Banks will also be provided the incentive to monitor the cost impact of holdover float on unit fees and to make operational changes when such action will reduce float costs.

The changed deposit and presentment hours implemented by the Federal Reserve Banks on February 24, 1983, should not increase daily average holdover float because of several factors. First, the reconfigured ITS network has been operational since August 1982, and the network is expected to continue to operate in a reliable manner. Second, the Reserve Banks have estimated that the new program will have minimal impact on volume. Finally, in many cases premium prices will be charged for checks deposited at the later deadlines. These higher prices will act as an incentive for institutions to limit the number of checks deposited at the later deadlines. Reserve Banks have the flexibility to increase the premium prices if the volume deposited during the later deadlines results in increased holdover float.

After review of the comments, the Board has determined to approve the following program to reduce and/or price interterritory check float and holdover float.

1. <u>Interterritory Check Float</u>

   a. All Reserve Banks will offer the same crediting options for interterritory check deposits. Further, each option will be made available by all Reserve Banks with the same effective date.

   b. Mixed deposits and Other Fed deposits will be subject to the same interterritory crediting procedures applicable to consolidated and direct send deposits, with Reserve Banks having the same options for crediting as are available to depository institutions.

   c. When consolidated and/or direct shipments arrive at the receiving Federal Reserve office after the published deposit deadline but in time for same-day processing, such shipments will continue to be processed in order of receipt.

d. Although actual availability is conceptually attractive to some depository institutions, as a practical matter, it is unlikely that many institutions would utilize it. Accordingly, this option will not be offered at this time but will be reconsidered at some future date.

e. Because fractional availability provides depository institutions with a predictable basis for determining the amount of credit they will receive when they make a deposit and because it provides an effective mechanism for depository institutions to pass float costs to depositors, all Reserve Banks will offer this option.

f. Because depository institutions are familiar with fixed availability schedules, all Reserve Banks will offer this option.

g. The comments did not indicate a clear consensus on the best method of paying for float. Therefore, all Reserve Banks will offer the following payment methods in connection with the crediting options:

-- For depository institutions choosing the fractional availability option, payment could be made by deferring for an additional day a fraction of an institution's credit.

-- For depository institutions electing the fixed availability option, payment could be made through an "as of" adjustment to their reserve or clearing accounts to correct for float after it has occurred.

-- Under either crediting option, depository institutions could choose to pay for float by an explicit charge.

-- Under either crediting option, depository institutions could pay for float with credits earned on their required clearing balances.

h. Because of the amount of time needed by depository institutions and Reserve Banks to make changes to their systems, this program will be implemented July 1, 1983.

2. Holdover Float

A significant amount of holdover float has been eliminated as a result of Reserve Bank operational improvements, and such improvements will continue to be emphasized in the future. In view of the operational changes arising from implementation of the check float program, holdover float pricing will be phased in as follows:

February 24 - July 1, 1983 -- During this period, the cost of holdover float above 1 percent of the value of checks collected daily by the Federal Reserve Banks will be incorporated in the cost of check services to be recovered in 1983.

July 1 - September 30, 1983 -- During this period, the cost of holdover float above 1/2 percent of the value of checks collected daily by the Federal Reserve Banks will be incorporated in the cost of check services to be recovered in 1983.

October 1, 1983 -- At this time the cost of all holdover float will be added to the cost of check services.

By order of the Board of Governors of the Federal Reserve System, March 8, 1983.

(signed) William W. Wiles
William W. Wiles
Secretary of the Board

[SEAL]