FEDERAL RESERVE BANK
OF NEW YORK

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FIRST QUARTER REPORT ON PRICED SERVICES

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

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

> The Federal Reserve Board has issued a report providing financial results of Federal Reserve priced service operations for the quarter ended March 31, 1984.
>
> The Board issues a report on priced services annually and a priced service balance sheet and income statement quarterly. The financial statements are designed to reflect standard accounting practices, taking into account the nature of the Federal Reserve's activities and its unique position in this field.

Printed on the following pages are the balance sheet and income statements for the quarter ended March 31, 1984. Additional copies of this circular will be furnished upon request directed to our Circulars Division (Tel. No. 212-791-5216). Questions regarding the statements may be directed to Robert M. Abplanalp, Vice President (Tel. No. 212-791-5349).

ANTHONY M. SOLOMON,
President

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Table 1
Pro Forma Balance Sheet
For Priced Services
Federal Reserve Banks
March 31, 1984
(in millions)

Short-term assets		
Imputed reserve requirements on clearing balances	$ 147.4	
Investment in marketable securities	1,080.6	
Receivables	50.1	
Materials and supplies	4.3	
Prepaid expenses	3.5	
Net items in process of collection (float)	312.4	
Total short-term assets		$1,598.3
Long-term assets		
Premises	169.1	
Furniture and equipment	99.2	
Leases and leasehold improvements	2.3	
Total long-term assets		270.6
Total assets		$1,868.9
Short-term liabilities		
Clearing balances	$1,228.0	
Balances arising from early credit of uncollected items	312.4	
Short-term debt	57.9	
Total short-term liabilities		$1,598.3
Long-term liabilities		
Obligations under capital leases	0.4	
Long-term debt	85.9	
Total long-term liabilities		86.3
Total liabilities		1,684.6
Equity		184.3
Total liabilities and equity		$1,868.9

Accompanying notes are an integral part of these financial statements.

Table 2

Pro Forma Income Statement for Priced Services
Federal Reserve Banks
For the quarter ended March 31, 1984
(in millions)

Income:		
Services provided to depository institutions		$139.6
Expenses:		
Production expenses	$111.0	
Less: Board approved subsidies	1.5	109.5
Income from operations		30.1
Imputed costs:		
Interest on float	12.2	
Interest on short-term debt	0.8	
Interest on long-term debt	2.2	
Sales taxes	1.2	
FDIC insurance	0.3	16.7
Income from operations after imputed costs		13.4
Other income and expenses:		
Investment income	27.9	
Earnings credits	26.4	1.5
Income before income taxes		14.9
Imputed income taxes		5.8
Net income		$ 9.1
Memo:		
Targeted return on equity		$ 5.9

Details may not add to totals due to rounding.

Accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

Balance Sheet (Table 1)

Federal Reserve assets are classified as short- or long-term. Short-term assets represent assets such as cash and due from balances, marketable securities, receivables, materials and supplies, prepaid expenses, and items in the process of collection. Long-term assets are primarily fixed assets such as premises and equipment.

The imputed reserve requirement on clearing balances and investment in marketable securities reflect the Federal Reserve's treatment of clearing balances maintained on deposit with Reserve Banks by depository institutions. For balance sheet and income statement presentation, clearing balances are reported comparable to reporting of compensating balances held by respondent institutions with correspondents. That is, respondent balances held with a correspondent are subject to a reserve requirement as determined by the Federal Reserve. This reserve requirement must be satisfied with either vault cash or with non-earning balances maintained at a Reserve Bank. Following this model, clearing balances maintained with Reserve Banks for priced service purposes should also be subject to reserve requirements. Therefore, a portion of the clearing balances held with the Federal Reserve are identified on the balance sheet as imputed reserve requirements on clearing balances, representing vault cash and due from balances. The remaining amount would be available for investment. For these purposes, the Federal Reserve assumes that all such balances would be invested in three-month Treasury bills.

Other short-term assets reflect the total of: 1) assets directly used in providing priced services, or 2) an allocation of the portion of joint assets used in providing priced services. Receivables primarily reflect amounts due the Reserve Banks for priced services which have been provided to institutions for which payment has not yet been received. Receivables also include that share of suspense account and difference account balances related to priced services.

Materials and supplies reflect short-term assets necessary for the ongoing operations of priced service areas for which payment has been made. Prepaid expenses represent other prepaid items such as salary advances and travel advances for priced service personnel and the portion of priced service leasehold improvements which will be amortized to current expense during the year.

Net items in the process of collection is the amount of float which will be added to the cost base subject to recovery. Thus, it is the difference between cash items in the process of collection and deferred availability cash items. Therefore, the asset item on the balance sheet corresponds to the amount of float that the Federal Reserve must recover through fees to satisfy the Monetary Control Act. Conventional accounting procedures would call for the gross amount of cash items and deferred availability items to be included on a balance sheet. However, because the gross amounts have no implications for income or costs and no implications for the PSAF calculation, they are not reflected on the pro-forma balance sheet.

Long-term assets that are reflected on the balance sheet have been allocated to priced services using a direct determination basis. This approach was adopted along with other changes in calculating the PSAF for 1984. The direct determination method utilizes the Federal Reserve's Planning and Control System (PACS) to directly associate single-purpose assets and to apportion assets used jointly in the provision of different services to priced and non-priced services. Additionally, also resulting from changes to the PSAF methodology, an estimate of the assets of the Board of Governors related to the development of priced services has been included in long-term assets in the premises account.

Long-term assets also include an amount for capital leases. In accordance with generally accepted accounting principles, the Federal Reserve in 1984 has begun to capitalize leases that qualify for capitalization. Leases had not been shown previously on Federal Reserve balance sheets due to immateriality. While the impact in the future is also likely to be immaterial, procedures have been established in order to disclose these assets on a basis consistent with accounting and disclosure practices of private sector firms. These assets also include leasehold improvements. The current portion of leasehold improvements has been included in prepaid expenses.

A matched-book capital structure for those assets that are not "self-financing," has been used to determine the liability and equity amounts. Short-term assets are financed with short-term debt. Long-term assets are financed with long-term debt and equity in a proportion equal to the ratio of long-term debt and equity of the bank holding companies used in the private sector adjustment model.

Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of obligations on capital leases.

<u>System Income Statement</u> (Table 2)

The income statement reflects the income and expenses for priced services. Included in these amounts are Board approved subsidies, imputed float costs, imputed financing costs, and the income and cost related to clearing balances.

Revenues reflect charges to depository institutions for priced services. These revenues are realized through one of two methods: direct charges to an institution's deposit account or charges against accumulated earnings credits. Income includes charges for per-item fees, package fees, explicitly priced interterritory check float, account maintenance fees, shipping and insurance fees, and surcharges. Production expenses include direct, indirect, and other general administrative expenses generated by priced service activities. Other expenses relate to the expenses of Board staff working directly on the development of priced services and amounted to $0.4 million in the first quarter of 1984.

Board approved subsidies consist of a program established for the commercial automated clearinghouse service. The incentive pricing program established for the ACH service provides for fee structures designed to recover an increasing share of expenses. In 1984, ACH revenues are intended to recover 60 percent of costs plus the private sector adjustment. This incentive pricing program is being phased out with complete elimination planned in 1985.

Imputed float costs include the value of float that was intended to be recovered, either explicitly or through per-item fees, during the first quarter of 1984 for the commercial check, automated clearinghouse, and book-entry securities transfer services. In the second quarter of 1984, float recovery for the noncash coupon collection service will be implemented. Also included in imputed costs is the interest on short and long-term debt used to finance priced service assets through the PSAF and the sales taxes and FDIC insurance which the Federal Reserve would have paid had it been a private sector firm.

Other income and expenses are comprised of income on clearing balances and the cost of earnings credits granted to depository institutions. Income represents the average coupon equivalent yield on three-month Treasury bills applied to the total clearing balance maintained, adjusted for the effect of reserve requirements. Expenses for earnings credits were derived by applying the average Federal funds rate to the required portion of the clearing balances. The Federal Reserve is committed to adjusting the Federal funds rate at which earnings credits are paid on clearing balances in order to take into account the effect of reserve requirements. The software changes necessary to implement this adjustment are complex and will take some time to complete; however, the adjustment is expected to be made starting November 1, 1984. Had the reserve adjustment to earnings credits been in place in the first quarter, and assuming no resulting shift in clearing balances, the expenses of earnings credits would have been about $24.6 million with a resulting increase in net clearing balance income of $1.8 million and an increase in net income of $1.2 million to $10.3 million.

Imputed income taxes are calculated at the effective tax rate used in the PSAF calculation applied to the net income before taxes.

The targeted return on equity represents the after-tax rate of return on equity that the Federal Reserve would have earned based on a model of bank holding companies.