**FEDERAL RESERVE BANK**
**OF NEW YORK**

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# PRICED SERVICES REPORT

*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 summarizing developments in the priced services areas for 1984 and providing detailed financial results of providing those services.
>
> 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.

Enclosed is a copy of the Board's report; additional copies will be furnished upon request directed to our Circulars Division (Tel. No. 212-791-5216). Questions on the report may be directed to Robert M. Abplanalp, Vice President (Tel. No. 212-791-5349).

E. GERALD CORRIGAN,
*President.*

At-Cir. No 9848

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

# ANNUAL REPORT ON PRICED SERVICES ACTIVITIES 1984

*PRINTED IN NEW YORK*

# Report on Priced Services Activities for 1984

## I. OVERVIEW

The Reserve Banks fully recovered all the costs of providing priced services to depository institutions in 1984 as required by the Monetary Control Act of 1980 (MCA). Improved operations and continued cost control measures resulted in an improvement in the Federal Reserve's priced services financial performance. For the year, the Reserve Banks recovered 103.9 percent of total operating and imputed costs for priced services, compared with 99.7 percent in 1983.

During 1984, the Federal Reserve took a number of steps to improve the nation's payments mechanism. In April, the Federal Reserve implemented a program designed to collect $1 billion in checks one day faster. In June, the Board of Governors requested comment on an amendment to Regulation J that would require institutions upon which checks are drawn to notify promptly the institution at which the check was first deposited when a large dollar check that was collected through the Federal Reserve is being returned. The Federal Reserve adopted this proposal for implementation in October 1985. Automated Clearing House (ACH) services were improved in 1984 by implementing later deposit deadlines and expanding the use of electronic transmissions. The number of depository institutions with electronic connections to the Federal Reserve continued to grow during the year. The Federal Reserve also implemented a number of enhancements to its definitive securities and noncash collection service.

## II. FINANCIAL RESULTS

The MCA requires the Federal Reserve to establish fees for its payment services that over the long-run cover the full costs of providing such services, including the cost of capital and taxes the Federal Reserve would incur if it were a private firm (Private Sector Adjustment Factor), and the cost of float. Overall, fee-generated income for Federal Reserve priced services in 1984 amounted to $574.7 million. Total production costs, net of approved subsidies, amounted to $449.3 million, thus yielding $125.5 million in income from operations. The value of float and imputed operating costs associated with the 1984 Private Sector Adjustment Factor (PSAF), amounted to $47.2 million, while the net interest income from clearing balances amounted to $3.6 million. Thus, the income before allowance for imputed income taxes was $81.8 million. Given the income tax rate assumption in the PSAF, estimated after-tax income was $50.2 million, up from $22.8 million in 1983 and $26.3 million above the targeted return on equity for 1984. A pro forma balance sheet and income statement for Federal Reserve priced services activities in 1984 and 1983 are presented in Tables 1 and 2, respectively. These statements reflect several changes in Federal Reserve practices made during the year. These changes are discussed in Section IV below.

The Board has adopted guidelines for the provision of priced services requiring revenues for each priced service to cover the costs of that service.1/ All Federal Reserve services, except the definitive safekeeping and noncash collection service, had pre-tax income that covered total targeted operating

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1/ The service lines are: (1) commercial check collection; (2) wire transfer of funds and net settlement; (3) commercial automated clearinghouse operations; (4) safekeeping of definitive securities and the collection of noncash items such as interest coupons on municipal securities; (5) the safekeeping and transfer of book-entry securities; (6) cash transportation; and (7) coin wrapping.

and imputed costs during 1984 (see Table 3). Total revenues for the definitive and noncash collection service line recovered 93.9 percent of the total operating and imputed costs of this service. Financial results for each Reserve Bank for locally priced services are presented in Table 4.

Generally, Federal Reserve priced services volumes increased during 1984 as compared to 1983. Federal Reserve check processing volume grew at a rate of 3 percent in 1984, compared to the 2 percent growth rate incurred in 1983. Volume growth for Federal Reserve funds transfer for 1984 was 9 percent, up from 7 percent in 1983. Commercial ACH grew by 37.0 percent during 1984 as compared to 48.7 percent during 1983. Continued volume declines in the number of definitive securities held in safekeeping with the Federal Reserve--which was partially offset by volume increases in noncash collection--impaired the Federal Reserve's ability to achieve a cost/revenue match in this service. Book-entry securities transfers grew 13.0 percent in 1984 as compared to 1.6 percent in 1983. Priced services volumes for 1984 are presented in Table 5.

## III. SERVICE-BY-SERVICE DEVELOPMENTS

### Commercial Check Operations

On April 23, 1984, the Federal Reserve implemented the High Dollar Group Sort Program--a program designed to accelerate the collection of checks drawn on certain non-city institutions. By the end of 1984, over $1 billion was being collected one day earlier as a result of this program. In conjunction with this program, the Board required the Reserve Banks to offer payor bank services to assist depository institutions in providing cash management services to their customers.

The Board requested public comment in 1984 on three proposals concerning the Federal Reserve's check collection services. In June, the Board requested comment on a proposed amendment to Regulation J that would require an institution upon which a check is drawn to provide notification to the institution at which the check is first deposited within specified deadlines when returning a check of $2,500 or more that was collected through the Federal Reserve. This proposal was designed to reduce the risk to depository institutions associated with the return of checks and allow them to make funds available to their depositors sooner. The Board adopted this proposal for implementation in October 1985.

In July 1984, the Board requested public comment on a proposal to eliminate one of the Federal Reserve's float recovery options (i.e., fractional availability) in order to ensure that float is recovered from the depository institutions generating and benefiting from the float. The Board adopted this proposal for implementation in September 1986.

In November, the Board requested public comment on two-tiered pricing--a proposal designed to assess a different fee for a check sent to a given collection zone depending on whether the check is sent to a high or low unit cost endpoint. It is anticipated that the Board will consider this proposal in 1985.

After a large number of price changes during the transition to pricing, the Federal Reserve achieved a significant measure of price stability with regard to its check collection fees. Federal Reserve check collection fees remained unchanged from December 1983 until December 1984, when the prices were increased on average by 3 percent.

## Funds Transfer

The number of depository institutions electronically on-line with the Federal Reserve rose from 4,000 to 4,500.

The basic transaction fee for the funds transfer service remained the same between April 1982 and September 1984. This fee was reduced from $.65 to $.60 in September 1984 because of higher than anticipated volume and Federal Reserve cost reductions. Effective December 27, 1984, the transaction fee was further reduced to $.55 in conjunction with the implementation of monthly electronic connection fees in January 1985. These monthly connection fees are intended to recognize the fixed costs associated with this service.

## Commercial ACH

In an effort to improve ACH services, the Federal Reserve finalized the design and moved into the advanced stages of development of a new ACH operating system. This new operating system will provide greater flexibility in the type of ACH services the Federal Reserve can provide.

In December 1984, the Federal Reserve established new and uniform deposit schedules that set later closing times for day and night cycle operations. These later deposit deadlines will provide depository institutions with a longer time to process their ACH transactions.

In accordance with the policy previously adopted by the Board to encourage the development of electronic payments, new ACH prices were set on March 29, 1984, to recover 60 percent of costs and the PSAF. A revised fee schedule was implemented on December 27, 1984, to generate revenues that would recover 80 percent of costs and the PSAF. (The ACH subsidy will cease by the end of 1985). The fee schedule implemented in December 1984 eliminated the concept of benefit-flow pricing and set explicit charges for institutions depositing paper return items.

Definitive Safekeeping and Noncash Collection

Several securities service enhancements were introduced during 1984. In noncash collection, improvements included a mixed deposit product and improved credit availability. In definitive safekeeping, improvements included offering nominee registration, an expansion of securities reregistration, and a safekeeping of mortgage-backed securities. A revised fee schedule expected to recover the costs of providing these services was issued for public comment in November 1984. This fee schedule was adopted by the Board effective February 28, 1985. Prior to this repricing, these services were last repriced in October 1983.

Book-Entry Securities

During 1984, the Treasury Department directed the Federal Reserve to treat the safekeeping and transfer of U.S. Treasury securities as a service to be provided by the Federal Reserve as fiscal agent for the Treasury rather than as a priced service. Accordingly, the Treasury will establish the fees to be charged depository institutions for those activities. In December, the Treasury proposed new fees for these services. In addition, the Board requested public comment on a proposed fee for the funds settlement transaction associated with the securities transfer.

Federal Reserve Float

Federal Reserve float declined from a daily average of $1.5 billion in 1983 to a daily average of $400 million in 1984. The Federal Reserve implemented a program in April 1984 to eliminate the midweek closing float arising from its check collection service. The cost of float associated with the check collection and book-entry securities transfer services were recovered for the entire year. The cost of float associated with the collection of coupons and noncash items was recovered beginning in May. The recovery of delayed file float from ACH operations was phased in during 1984. The only remaining Federal Reserve float to be priced includes small amounts of ACH return item and holiday float, which will be included in the cost base for this service beginning in January 1985.

## IV. OTHER DEVELOPMENTS

### Pricing Policy Statements

Two papers were issued by the Board in August 1984: "The Federal Reserve in the Payment System" and "Standards Related to Priced Services Activities of the Federal Reserve Banks." The first paper defined the role of the Federal Reserve in the payments mechanism and established criteria that will be used in determining whether to provide new services or major service enhancements. The second paper established standards to avoid conflicts or the appearance of conflicts between the Federal Reserve's role as a provider of services and its role as a supervisor, regulator, and lender.

In November 1984, the Board adopted a policy statement on surpluses and shortfalls in revenue that arise from the provision of priced services. This statement clarified the policy stating that Federal Reserve fees for priced services will be established based on projected costs and volumes, rather than to offset prior year's surpluses of shortfalls.

PSAF Methodology and Clearing Balances

During 1984, the Board refined the method used to calculate the PSAF. The Board determined that imputed sales taxes, an imputed FDIC assessment on clearing balances, and the expenses of the Board associated with the development of fees for Federal Reserve priced services would be included in the PSAF in 1984, which added $8.0 million to required recoveries for the year.

The Federal Reserve adjusted the calculation of earnings credits on clearing balances to reflect the reserve requirements that would apply if these balances were held with a correspondent bank. Similarly, the Federal Reserve changed the way it imputes income on clearing balances to reflect the effect of reserve requirements that it would be subject to if it were a correspondent bank.

Reviews of Priced Services

A number of external reviews of Federal Reserve priced services were conducted during 1984, including a congressional review and a review by the General Accounting Office. In addition, the Federal Reserve retained an independent accounting firm to review the Federal Reserve's pricing methodology and cost accounting procedures. These groups either completed their preliminary or final reviews and concluded that the Federal Reserve was in compliance with the Monetary Control Act. Further, they concluded that the actions of the Federal Reserve were reasonable. These reviews yielded a number of suggestions that the Federal Reserve has implemented or is studying.

## V. OUTLOOK FOR 1985

The Federal Reserve anticipates that during 1985 it will continue to meet the MCA's cost recovery requirements. Priced services revenue should increase by approximately two percent during 1985, which reflects a modest increase in anticipated fees. With the exception of the electronic connection fees effective January 1, 1985, and the repricing of the definitive safekeeping and noncash collection service effective February 28, 1985, no major fee changes are anticipated. The Board of Governors expects to announce applicable 1986 fee changes in November 1985. Total production costs are projected to increase by about 5 percent and imputed costs are projected to decrease 6 percent in 1985.

In addition, the Federal Reserve anticipates implementing a number of service enhancements during 1985 to improve the payments mechanism. The Federal Reserve intends to work closely with industry groups to implement these changes. With regard to the check collection service, the Federal Reserve anticipates implementing changes in procedures to improve return item processing and also anticipates implementing a pilot program involving the truncation of commercial checks.

The Federal Reserve expects that the number of depository institutions that have on-line electronic connections with Reserve Banks will continue to increase during 1985. It is anticipated that these electronic connections will be used for a wide variety of electronic services, including the origination and delivery of ACH payments. Finally, because of the continuing volume loss in definitive safekeeping service, the Federal Reserve is continuing to evaluate its long-run role in this service.

Attachments

Table 1

Pro Forma Balance Sheet
For Priced Services
Federal Reserve Banks
December 31, 1984 and 1983
(in millions)

| | 1984 | | 1983 | |
|---|---|---|---|---|
| **Short-term assets (Note 1)** | | | | |
| Imputed reserve requirements on clearing balances | $166.9 | | $147.4 | |
| Investment in marketable securities | 1,224.0 | | 1,080.6 | |
| Receivables | 54.0 | | 49.0 | |
| Materials and supplies | 4.7 | | 4.4 | |
| Prepaid expenses | 2.1 | | 2.3 | |
| Net items in process of collection (float) | 524.8 | | 720.7 | |
| Total short-term assets | | $1,976.4 | | $2,004.4 |
| **Long-term assets (Note 2)** | | | | |
| Premises | 172.9 | | 168.7 | |
| Furniture and equipment | 100.9 | | 91.9 | |
| Leases and leasehold improvements | 2.2 | | 2.5 | |
| Total long-term assets | | 276.0 | | 263.1 |
| **Total assets** | | $2,252.5 | | $2,267.5 |
| **Short-term liabilities** | | | | |
| Clearing balances and balances arising from early credit of uncollected items | $1,915.7 | | $1,948.7 | |
| Short-term debt | 60.8 | | 55.7 | |
| Total short-term liabilities | | $1,976.4 | | $2,004.4 |
| **Long-term liabilities** | | | | |
| Obligations under capital leases | 0.4 | | 0.4 | |
| Long-term debt | 87.6 | | 83.5 | |
| Total long-term liabilities | | 88.0 | | 83.9 |
| **Total liabilities** | | 2,064.5 | | 2,088.3 |
| **Equity** | | 188.0 | | 179.2 |
| **Total liabilities and equity (Note 3)** | | $2,252.5 | | $2,267.5 |

Details may not add due to rounding.

Accompanying notes are an integral part of these financial statements.

Table 2

Pro Forma Income Statement for Priced Services
Federal Reserve System
For the years ending December 31, 1984 and 1983
(in millions)

| | 1984 | | 1983 | |
|---|---|---|---|---|
| Income (Note 4): | | | | |
| Services provided to depository institutions | | $574.7 | | $496.2 |
| Expenses (Note 5): | | | | |
| Production expenses | $455.9 | | $442.1 | |
| Less: Board approved subsidies | 6.7 | 449.2 | 9.7 | 432.4 |
| Net income from operations | | 125.4 | | 63.8 |
| Imputed costs (Note 6): | | | | |
| Interest on float | 29.3 | | 19.7 | |
| Interest on short-term debt | 3.0 | | 10.4 | |
| Interest on long-term debt | 8.5 | | 10.1 | |
| Sales taxes | 4.9 | | -- | |
| FDIC insurance | 1.2 | 47.2 | -- | 40.2 |
| Net income from operations after imputed costs | | 78.2 | | 23.7 |
| Other income and expenses (Note 7): | | | | |
| Investment income | 122.3 | | 84.9 | |
| Earnings credits | 118.7 | 3.6 | 71.8 | 13.1 |
| Net income before income taxes | | 81.8 | | 36.8 |
| Imputed income taxes (Note 8) | | 31.6 | | 14.0 |
| Net income after taxes | | $50.2 | | $22.8 |
| Memo: | | | | |
| Targeted return on equity (Note 8) | | $23.9 | | $24.6 |

Details may not add due to rounding.

Accompanying notes are an integral part of these financial statements.

Table 3

Income Statement for Priced Services
Federal Reserve System
For the year ending December 31, 1984
(in millions)

| | Total | Commercial Check Collection | Wire Transfer and Net Settlement | Commercial ACH | Definitive Safekeeping and Noncash Collection | Book-Entry Securities | Cash Services |
|---|---|---|---|---|---|---|---|
| Income from services (Note 9) | $574.7 | $436.7 | $62.0 | $11.4 | $19.0 | $24.1 | $21.6 |
| Operating expenses, net of subsidies | 449.2 | 335.1 | 48.5 | 10.0 | 18.5 | 16.1 | 21.0 |
| Income from operations | 125.4 | 101.6 | 13.4 | 1.4 | 0.5 | 7.9 | 0.6 |
| Imputed costs | 47.2 | 39.6 | 2.5 | 0.8 | 1.2 | 3.0 | 0.1 |
| Income from operations after imputed costs | 78.2 | 62.1 | 10.9 | 0.6 | (0.7) | 5.0 | 0.5 |
| Other income and expenses, net | 3.6 | 2.7 | 0.4 | 0.1 | 0.1 | 0.2 | 0.1 |
| Income before income taxes | $81.8 | $64.8 | $11.3 | $0.6 | $(0.6) | $5.1 | $0.6 |

Details may not add to totals due to rounding.

Accompanying notes are an integral part of these financial statements.

Table 4

Revenue and Expense of Locally Priced Services at Federal Reserve Banks, 1984

Millions of Dollars

(Note 10)

| | Commercial Check Collection | | | | | Definitive Safekeeping and Noncash Collection | | | | | Cash Services | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Operating Cost | Float Cost | Total Cost | Total Revenue | Net Revenue | Operating Cost | Float Cost | Total Cost | Total Revenue | Net Revenue | Total Cost | Total Revenue | Net Revenue |
| Boston | 20.6 | 1.8 | 22.4 | 25.2 | 2.8 | 0.8 | -0.0 | 0.8 | 1.1 | 0.4 | 0.5 | 0.6 | 0.1 |
| New York | 52.4 | 1.6 | 53.9 | 58.5 | 4.5 | 3.7 | 0.1 | 3.8 | 3.1 | -0.7 | 2.8 | 3.0 | 0.2 |
| Philadelphia | 13.7 | 0.3 | 14.1 | 16.5 | 2.5 | 1.0 | -0.0 | 1.0 | 1.1 | 0.1 | 1.3 | 1.3 | 0.1 |
| Cleveland | 19.3 | 1.8 | 21.1 | 26.0 | 5.0 | 1.6 | 0.0 | 1.6 | 1.7 | 0.1 | 1.7 | 1.8 | 0.1 |
| Richmond | 27.6 | 2.8 | 30.4 | 40.1 | 9.7 | 0.9 | -0.0 | 0.8 | 1.0 | 0.2 | 1.3 | 1.4 | 0.0 |
| Atlanta | 36.1 | 1.8 | 37.9 | 51.2 | 13.3 | 2.1 | -0.0 | 2.1 | 3.0 | 0.9 | 0.0 | 0.1 | 0.0 |
| Chicago | 48.3 | 5.5 | 53.8 | 59.9 | 6.1 | 3.4 | 0.1 | 3.5 | 2.8 | -0.7 | 1.0 | 0.9 | -0.0 |
| St. Louis | 16.1 | 2.0 | 18.1 | 23.3 | 5.2 | 1.1 | 0.1 | 1.2 | 1.1 | -0.1 | 1.0 | 1.0 | 0.0 |
| Minneapolis | 21.5 | 1.2 | 22.7 | 26.9 | 4.2 | 0.8 | 0.2 | 1.0 | 0.7 | -0.3 | 1.5 | 1.7 | 0.2 |
| Kansas City | 23.5 | 2.0 | 25.4 | 32.0 | 6.6 | 1.7 | 0.0 | 1.7 | 1.8 | 0.1 | 0.8 | 0.8 | -0.0 |
| Dallas | 23.0 | 1.5 | 24.5 | 29.9 | 5.3 | 1.0 | 0.0 | 1.0 | 1.1 | 0.1 | 2.7 | 2.6 | -0.1 |
| San Francisco | 31.5 | 4.0 | 35.5 | 47.1 | 11.5 | 0.5 | -0.0 | 0.4 | 0.5 | 0.1 | 6.3 | 6.5 | 0.1 |
| System Total | 333.7 | 26.3 | 360.0 | 436.7 | 76.7 | 18.4 | 0.4 | 18.8 | 19.0 | 0.2 | 21.0 | 21.6 | 0.6 |

Details may not add to totals due to rounding.

Accompanying notes are an integral part of these financial statements.

Table 5

## PRICED SERVICE VOLUMES

(Items in Thousands)

(Note 11)

| Priced Service | 1984 | 1983 | Percent Change 1984 vs. 1983 | 1982 | Percent Change |
|---|---|---|---|---|---|
| Funds Transfers | 42,602.6 | 38,021.0 | 9.4 % | 35,381.0 | 7.5 % |
| Commercial ACH | 214,400.5 | 156,474.2 | 37.0 | 105,243.0 | 48.7 |
| Commercial Checks | 14,697,542.0 | 14,270,015.0 | 3.0 | 13,929,959.0 | 2.4 |
| Securities Transfers | 5,656.4 | 5,005.2 | 13.0 | 4,928.5 | 1.6 |
| Definitive Safekeeping | 151.4 | 159.4 | -5.0 | 178.6 | -10.8 |
| Noncash Collection | 4,302.0 | 2,929.7 | 46.8 | 2,115.5 | 38.5 |
| Cash Transportation | 503.2 | 564.9 | -10.9 | 607.5 | -7.0 |

Accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

## The Balance Sheet (Table 1)

### Note 1: Short-term Assets

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 in a manner comparable to the way correspondent banks report compensating balances held with them by respondent institutions. That is, respondent balances held with a correspondent are subject to a reserve requirement established 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 are subjected to imputed reserve requirements. Therefore, a portion of the clearing balances held with the Federal Reserve is classified on the asset side of the balance sheet as required reserves and is reflected in a manner similar to vault cash and due from bank balances normally shown on a correspondent bank's balance sheet. The remainder of clearing balances is assumed to be available for investment. For these purposes, the Federal Reserve assumes that all such balances are invested in three-month Treasury bills.

Receivables represent: 1) amounts due the Reserve Banks for priced services which have been provided to institutions for which payment has not yet been received; and, 2) that share of suspense account and difference account balances related to priced services.

The amount shown for materials and supplies represents the inventory value of such short-term assets necessary for the ongoing operations of priced service areas. Prepaid expenses represent 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 as of the balance sheet date and is the difference between the value of items in the process of collection (including checks, coupons, securities, and ACH transactions) and the value of deferred availability items. The cost base for providing services that must be recovered under the Monetary Control Act includes the cost of float incurred by the Federal Reserve during the year and is valued at the Federal funds rate. Conventional accounting procedures would call for the gross amount of items in the process of collection and deferred availability items to be included on a balance sheet. However, because the gross amounts have no implications for income, costs, or the private sector adjustment factor (PSAF), and because the inclusion of these amounts could lead to distortions and misinterpretations of the assets employed in the provision of priced services which must be financed, only the net amount is shown. The net amount represents the assets that involve a financing cost.

Note 2: Long-term Assets

Long-term assets reflected on the balance sheet have been allocated to priced services using a direct determination basis. The direct determination method uses the Federal Reserve's Planning and Control System (PACS) to ascertain directly the value of assets used solely in priced services operations and to apportion the value of jointly-used assets between priced and nonpriced services. Additionally, as a result of changes to the 1984 PSAF methodology, an estimate of the assets of the Board of Governors directly involved in the development of priced services is included in long-term assets in the premises account in 1984 but not in 1983.

Long-term assets also include an amount for capital leases. In accordance with generally accepted accounting principles, the Federal Reserve capitalizes leases that qualify for capitalization. Prior to 1984, the value of such leases were not shown on Federal Reserve balance sheets because they had no material effect on either assets or expenses. While the impact in the future is also likely to be immaterial, procedures have been established in order to present these assets on a basis consistent with accounting and reporting practices of private sector firms. These assets also include leasehold improvements. The current portion of leasehold improvements has been included in prepaid expenses.

Note 3: Liabilities and Equity

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 PSAF 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.

## The Income Statement (Table 2)

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

Note 4: Income

Income represents charges to depository institutions for priced services. This income is realized through one of two methods: direct charges to an institution's account or charges against accumulated earnings credits. Income includes charges for per-item fees, package fees, explicitly priced float, account maintenance fees, shipping and insurance fees, and surcharges.

Note 5: Production Expenses and Subsidies

Production expenses include direct, indirect, and other general administrative expenses of the Federal Reserve Banks for providing priced services. Also included in expenses for 1984 are the expenses of staff of the Board of Governors working directly on the development of priced services which, in 1984, amounted to $1.9 million.

Board-approved subsidies consist of programs established for the commercial automated clearinghouse and cash transportation services. The incentive pricing program established for the ACH service provides for fee structures designed to recover an increasing share of expenses. In 1984 and 1983, ACH revenues are intended to recover 60 percent and 40 percent, respectively, of costs plus the PSAF. This incentive pricing program is being phased out with complete elimination planned by the end of 1985. The subsidy for ACH operations amounted to $6.7 million in 1984, and $8.1 million in 1983. The transitional support program adopted for the cash transportation service was concluded at the end of 1983. The cash transportation subsidy for 1983 totaled $1.6 million.

Note 6: Imputed Costs

Imputed float costs represent the value of float to be recovered, either explicitly or through per-item fees, during the period. Float cost recovery for book-entry securities, ACH, and noncash collection services was implemented in 1984. Cost recovery of check float was implemented in 1983. In

1983, recovery for the value of imputed float costs in the commercial check service was phased in as follows: for the period February 24 through June 30, 1983, the value of holdover check float in excess of one percent of the total dollar value of checks received was included in the commercial check cost base; for the period July 1 to September 30, 1983, the value of holdover check float in excess of one-half of one percent of the value of checks received, plus the value of interterritory check float was included in the commercial check cost base; and, effective October 1, 1983, the value of all check float was included in the commercial check cost base.

The following table depicts the Federal Reserve's float performance and float recovery for 1984. The amount of float recovered through charges is valued at the Federal funds rate. The value of this float is then billed directly to depository institutions or added to the cost base subject to recovery for each appropriate service.

Float Recovery
Federal Reserve Banks
1984
(Daily average figures in millions)

| | |
|---|---|
| Total float | $677.9 |
| Unrecovered float 1/ | 107.0 |
| Float subject to recovery | 570.9 |
| Float recovered through "as of" adjustments 2/ | 281.4 |
| Float recovered through direct charges 2/ | 145.1 |
| Float recovered through per-item fees 3/ | 144.4 |

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1/ Includes float generated in providing services to government agencies or in other central bank services and float not recovered as a result of the ACH subsidy and the phase-in of other float recovery.

2 Midweek closing float and interterritory check float may be recovered from depositing institutions through adjustments to the institution's reserve or clearing balance or by valuing the float at the Federal funds rate and billing the institution directly.

3/ This float is valued at the Federal funds rate and has been added to the cost base subject to recovery in 1984.

Also included in imputed costs is the interest on short- and long-term debt assumed necessary to finance priced service assets and the sales taxes and FDIC insurance assessment that the Federal Reserve would have paid had it been a private business firm.

Note 7: Other income and expenses

Other income and expenses are comprised of income on clearing balances and the cost of earnings credits granted to depository institutions on their clearing balances. As a result of financial reporting changes approved by the Board in March, 1984, income on clearing balances for 1984 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 on clearing balances. Expenses for earnings credits were derived by applying the average Federal funds rate to the required portion of the clearing balances. Beginning October 25, 1984, earnings credits granted to depository institutions were adjusted for the net effect of reserve requirements on clearing balances. In 1983, neither income nor expense was adjusted for the net effect of reserve requirements on clearing balances.

Note 8: Income Taxes and Return on Equity

Imputed income taxes are calculated at the effective tax rate derived from a model consisting of the 25 largest bank holding companies.

The targeted return on equity represents the after-tax rate of return on equity that the Federal Reserve would have earned had it been a private business firm based on the bank holding company model.

## Income Statement by Service (Table 3)

(Note 9)

The income statement by service reflects revenue, operating expenses adjusted for Board approved subsidies, and imputed costs except for income taxes.

Imputed costs include float and the interest on short- and long-term debt, sales taxes, and the FDIC assessment as calculated for the PSAF. Float costs are based on the actual float incurred in each priced service. Other imputed costs are allocated among priced services based on the ratio of the operating costs less shipping costs in each priced service to the total cost of priced services less total priced services shipping costs.

Other income and expenses consist of income on clearing balances and the cost of earnings credits for the Federal Reserve. Because clearing balances relate directly to the Federal Reserve's offering of priced services, the income and cost associated with these balances are spread to each service based on the ratio of income from each service to a total income.

Taxes and the after-tax targeted rate of return on equity, as shown on the aggregate income statement, have not been spread by service since these elements relate to the organization as a whole.

## Statement of Revenue and Expense For Locally Priced Services (Table 4)

(Note 10)

This table depicts the financial results for each Reserve Bank in providing locally priced services. The financial results for each Reserve Bank do not include the dollars to be recovered through the PSAF and the net investment income on clearing balances. As such, in order to reconcile Table 4 net revenue data with that disclosed in Table 3, adjustments must be made for imputed interest on short- and long-term debt, sales taxes, FDIC assessment, priced service Board expenses and net income on clearing balances.

## Priced Service Volumes (Table 5)

(Note 11)

This table shows the absolute volume and percentage change in the number of items handled by the Federal Reserve in its priced service operations. Wire transfer of funds volume is the number of basic transactions originated; ACH volume is the total number of commercial items processed; commercial check reflects the total commercial checks collected, including both processed and fine sort items; securities transfers volume consists of the number of basic transfers originated on-line; definitive safekeeping is the average number of issues or receipts maintained; noncash collection volume is the number of items assessed fees; and cash transportation volume is the number of armored carrier stops.