

**FEDERAL RESERVE BANK  
OF NEW YORK**

[ Circular No. **10343** ]  
April 18, 1990 ]

**Role of Federal Reserve in the Payments System**

*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 announced revisions to its general policy statement regarding the System's role in the payments mechanism.

The revised white paper, titled "The Federal Reserve in the Payments System," was first issued by the Board in 1984.

The white paper has been updated to address explicitly recommendations made by the General Accounting Office in 1989 that the Board define its commitment to competitive fairness in the check collection system and establish a forum for hearing concerns raised by the private sector.

The policy revisions apply to all Federal Reserve services.

Enclosed — for depository institutions in this District — is the text of the Board's revised policy statement, which has been reprinted from the *Federal Register* of March 29. Copies of the enclosure will be furnished upon request directed to the Circulars Division of this Bank (Tel. No. 212-720-5215 or 5216).

E. GERALD CORRIGAN,  
*President.*

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March 29, 1990  
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## The Federal Reserve in the Payments System

### FEDERAL RESERVE SYSTEM

Policy Statement—The Federal Reserve in the Payments System

On March 22, 1990, the Board of Governors of the Federal Reserve System issued the following policy statement:

The Federal Reserve's primary responsibility is to ensure the stability of the financial system and to promote the long-run growth of the economy. The Federal Reserve's role in the payments system is to provide a safe, sound, and efficient means for the transfer of funds between individuals, businesses, and government agencies.

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[Enc. Cir. No. 10343]

## FEDERAL RESERVE SYSTEM

### Policy Statement—the Federal Reserve in the Payments System

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Policy statement.

**SUMMARY:** The Board is issuing a revision to its 1984 policy statement "The Federal Reserve in the Payments System." The policy statement, which is an official statement of principles for the Federal Reserve's participation in the payments system, responds to recommendations made by the General Accounting Office in its May 1989 report, *Check Collection: Competitive Fairness Is an Elusive Goal*.

**EFFECTIVE DATE:** March 23, 1990.

**FOR FURTHER INFORMATION CONTACT:** Bruce J. Summers, Associate Director (202/452-2231), or Louise L. Roseman, Assistant Director (202/452-3874), Division of Federal Reserve Bank Operations; Oliver L. Ireland, Associate General Counsel, Legal Division (202/452-3625); for the hearing impaired only: Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3544).

**SUPPLEMENTARY INFORMATION:** In May 1989, the GAO (General Accounting Office) issued the report *Check Collection: Competitive Fairness Is an Elusive Goal*. The report was prepared in response to a requirement in the Competitive Equality Banking Act of 1987 that the GAO review issues associated with the Reserve Banks' exemption from paying presentment fees and to determine whether the Reserve Banks receive services from check clearing houses. The GAO expanded the scope of its report to encompass the broader subject of competitive fairness in the provision of check collection services. The Board provided comments on the draft GAO report in January 1989 and responded to the final report in July 1989.

The GAO recommended that the Board should define its commitment to competitive fairness and that Federal Reserve officials, when deliberating on regulatory, price, and service changes, should identify any practical and legal differences between Federal Reserve Banks and collecting banks that may hinder collecting banks' ability to effectively offer competing check collection services. The GAO believes that competitive fairness means that collecting banks should have the same abilities as Reserve Banks to collect checks unless fulfillment of payments system safety, soundness, or efficiency objectives indicate Reserve Banks should take on unique abilities. The

GAO also recommended that a forum be developed for hearing disagreements raised by private sector participants related to changes made by the Federal Reserve that may result in the private sector being precluded from effectively offering competing check collection services.

The GAO related its recommendations on competitive fairness to the development of a revised same-day payment proposal for checks. The Board originally issued a same-day payment proposal for public comment in April 1988 (53 FR 11911, April 11, 1988), and the Board staff has received input from an industry advisory group to assist in its development of a revised proposal. The Board anticipates that it will consider a revised proposal in late 1990.

In response to the GAO's report, the Board has adopted a revised policy statement on the role of the Federal Reserve in the payments system. The policy statement contains new sections on competitive impact analysis and a forum for hearing depository institutions' concerns relating to payments matters. It defines a process to be followed by the Federal Reserve in evaluating the impact of major legal or operations changes on the ability of private sector service providers to compete with the Reserve Banks by offering similar services. The process described in the policy statement is an operative, not an abstract, definition of competitive fairness. Legal changes would include, but not be limited to, certain modifications to Regulations CC, E, and J, as well as to certain aspects of programs such as payments system risk reduction. Operating changes could include, but not be limited to, new prices and services as well as methods for accessing these services. Federal Reserve internal procedures for handling price and service changes have been reviewed to ensure consistency with the policy statement.

The competitive impact analysis described in the policy statement would apply to proposed changes that would likely have a substantial effect on payments system participants. In such cases, the Board would first determine whether the proposed change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve. Second, if such an adverse effect on the ability to compete were identified, the Board would ascertain whether the adverse effect were due to legal differences or due to a dominant market position deriving from such legal differences. The latter test is intended to distinguish between situations where the Reserve Banks may

"dominate" a particular market segment simply because they are the most efficient providers of the service from situations where a legal difference gives an advantage to the Reserve Banks that clearly explains their dominance. Market dominance due to very efficient operations that would result in an adverse competitive effect would not be reason to modify a proposal for purposes of the competitive impact analysis. Third, if such differences were judged to exist, then the proposed change would be further evaluated to assess its benefits, such as contributing to payments system efficiency or integrity or other Board objectives, and determine whether the proposal's objectives could be reasonably achieved with a lesser or no adverse competitive impact. Fourth, the Board would then either modify the proposal to lessen or eliminate the adverse impact on the ability of competitors to compete or determine that the payments system objectives may not be reasonably achieved if the proposal were modified. If reasonable modifications would not mitigate the adverse effect, the Board would then determine whether the anticipated benefits were significant enough to proceed with the change even though it may adversely affect the ability of other service providers to compete with the Federal Reserve in that service.

The revised policy statement also describes a process for hearing disagreements that can be used by the public to voice concerns to senior officials in the Reserve Banks and finally, if necessary, to the Board, if they believe that the Federal Reserve's priced services policies or practices are not consistent with the competitive analysis or other criteria established in the policy statement. Basically, in the event that a payments system participant has an unresolved complaint about a change, the complaint would be submitted in writing to the First Vice President of the appropriate Reserve Bank. First Vice Presidents would forward complaints on legal matters decided by the Board to the Chairman of the Committee on Federal Reserve Bank Activities. If satisfaction was not obtained on other complaints addressed by the Reserve Bank, the complaint could then be submitted to the Chairman of the Board's Committee on Federal Reserve Bank Activities for final disposition.

The procedures for analyzing the competitive impact of legal and operating changes are intended for use by Reserve Bank and Board staff in analyzing these changes. It is intended that a rigorous process of research and analysis be followed for all major

changes that are contemplated.

In light of the foregoing, the Board is issuing the following policy statement:

### **The Federal Reserve in the Payments System**

This paper sets out the Federal Reserve's general policy regarding its role in the payments system. The Federal Reserve's objective in describing its policy is to encourage closer cooperation among all participants in improving the payments system and to facilitate the business planning of users and providers of payment services. The paper also outlines the procedure the Federal Reserve will ordinarily follow in reviewing its service offerings. The Board, in its sole discretion, will determine when the procedure is applicable and will make the decisions related to the procedure.

In summary, the role of the Federal Reserve in providing payment services is to promote the integrity and efficiency of the payments mechanism and to ensure the provision of payment services to all depository institutions on an equitable basis, and to do so in an atmosphere of competitive fairness. Given the size, speed, and interdependencies of payments, this mission is, and will likely continue to be, even more important than it was when the Federal Reserve was established in 1913.

### **Role of the Federal Reserve**

#### *Background*

Since the Federal Reserve's inception, its active involvement in payments processing has been an integral part of the development of the nation's financial system. The Congress, responding in part to the breakdown of the check collection system in the early 1900s, made the Federal Reserve an active participant in the payments system when it established the Federal Reserve in 1913. At that time the Congress envisioned that the Federal Reserve would play a dual role as an operator and a regulator of the payments system. The Congress has reaffirmed its commitment to this dual role for the Federal Reserve in the Monetary Control Act of 1980 and the Expedited Funds Availability Act, enacted in 1987.

The Federal Reserve has a wide-ranging participatory role in the payments system. Reserve Banks process checks and provide a nationwide network for the collection of items ineligible for processing through normal check-collection channels, such as matured coupons, bonds, and banker's acceptance. The Federal

Reserve assisted in developing the automated clearing house system for small-dollar electronic payments and now provides a nationwide electronic ACH network. Depository institutions transfer large-dollar payments over the Federal Reserve's nationwide wire transfer system (Fedwire). The Federal Reserve also operates a book-entry securities service for the safekeeping and transfer of United States Treasury and agency securities. Finally, the Federal Reserve supports a variety of private clearing arrangements by providing settlement services through its nationwide network of account relationships.

This participatory role has served the nation well, contributing directly and indirectly to widespread public confidence in a payments system that is quick, sure, and efficient. The Federal Reserve's participatory role is well-suited to the structure of the United States' financial industry. This country has a highly fractionalized banking system spread over wide areas with different types of institutions having differing payments needs. As interstate banking spreads, the underlying public policy rationale for the Federal Reserve's operational presence in the payments system will continue to be an important consideration. The Federal Reserve will continue to bring to payments markets an overall concern for safety and soundness, promotion of operating efficiency, and equitable access. Indeed, those considerations relating to integrity, efficiency, and access to the payments system will remain at the core of the federal Reserve's role and responsibilities regarding the operation of the payments system.

#### *Integrity of the Payments System*

A reliable payments system is crucial to the economic growth and stability of the nation. The smooth functioning of markets for virtually every good and service is dependent upon the smooth functioning of banking and financial markets, which in turn is dependent upon the integrity of the nation's payments system. History shows that fragility of a country's payments system can precipitate or intensify a general economic crisis.

The breakdown of the payments machinery in the United States during the panic of 1907, which helped to precipitate the creation of the Federal Reserve System, is a case in point. More recently, the 1974 failure of a relatively small German financial institution, Bankhaus I.D., Herstatt, and the consequent uncertainty regarding

payments through private clearing networks, temporarily caused substantial disruption in the United States payments system. This clearly demonstrated that financial failures, including those abroad, can transmit systemic effects, via the payments system, to financial institutions in all parts of the world.

As payments system participant and central bank, the Federal Reserve's roles are integrally related. The Federal Reserve's direct and ongoing participation in the operation of the payments system enhances the integrity of the payment process. For example, the Federal Reserve's final and irrevocable Fedwire funds transfer service reduces the risk that failure of one institution could be transmitted rapidly to other institutions. In addition, in order to carry out its responsibilities as central bank, the Federal Reserve frequently provides payment services to troubled depository institutions that other providers of payment services may not serve because of the risks involved. This helps to ensure that the inability of a depository institution to make or process payments will not trigger its insolvency and that the institution's problems can be resolved in an orderly fashion with minimum disruptive effects.

#### *Efficiency of the Payments System*

Federal Reserve involvement in the payments system promotes efficiency for a variety of reasons. The Federal Reserve has a public-interest motivation in seeking to stimulate improvements in the efficiency of the payments system. The Federal Reserve has worked closely with other providers of payment services to develop and use advanced technology and procedures. Because of its day-to-day operating presence in the payments system, it has the know-how to contribute to technical advances as well as the ability to help promote their implementation. Federal Reserve involvement may be particularly appropriate for advances that require widespread cooperation among depository institutions (for example, the introduction and implementation of MICR encoding of checks). Moreover, Federal Reserve involvement as a neutral and trusted intermediary can facilitate acceptance of innovations that improve the efficiency of the payments system. Additional efficiencies result from the scope of the Federal Reserve's participation in the payments system.

As the Congress anticipated in the Monetary Control Act of 1980, competition between the Federal Reserve and other providers of payment services has resulted in a more efficient payments system. Both the Federal

Reserve and other service providers have been prompted by competition to process payments as efficiently as possible and to improve the quality of the services offered.

It is recognized that the most significant further gains in payment efficiency are likely to come from the application of advances in electronic technology. These gains will become more widespread as new technology becomes available to all depository institutions, regardless of their size or location. The Federal Reserve will continue to promote the use of electronics in providing payment services where it can demonstrate that this technology will enhance the efficiency or effectiveness of its services.

#### *Provision of Payment Services to All Depository Institutions*

Federal Reserve payment services are available to all depository institutions, including smaller institutions in remote locations that other providers might choose not to serve. Under the Monetary Control Act, in making payment services available to depository institutions, the Federal Reserve must give due regard to the provision of an adequate level of services nationwide.

Since implementation of the Act, the Reserve Banks have provided access to Federal Reserve services to nonmember banks, mutual savings banks, savings and loan associations, and credit unions.

#### *Fiscal Agency Functions*

In addition to providing payment services to depository institutions, the Federal Reserve, as fiscal agent, provides a variety of services on behalf of the United States Treasury and other government agencies. These include the creation, safekeeping, and transfer of book-entry records evidencing ownership of the public debt and the processing of government payments.

Depository institutions benefit from production efficiencies that result when the facilities and expertise required to provide these fiscal agency services are used to produce other similar services for depository institutions. Similarly, paper and electronic payment services are supplied to the Treasury and other government agencies more efficiently because the Federal Reserve also offers these services to depository institutions.

#### **Criteria for Evaluating Proposed Payments System Changes**

##### *Cost Recovery*

In offering payment services, the Federal Reserve must satisfy the cost-recovery objective of the Monetary Control Act: in the long run, aggregate

revenues should match costs. The pricing principles adopted by the Board of Governors in 1980 added to the aggregate cost-recovery objective specified in the Monetary Control Act the more stringent objective of full-cost recovery (including all operating and float costs and imputed taxes and return on capital) for each service line.<sup>3</sup> This internal objective of cost recovery for each service line was subsequently modified to provide that revenues for each service line must cover all operating costs, float costs, and certain imputed costs, such as the cost of interest on short- and long-term debt, as well as make some contribution to the pre-tax return on equity. Thus, each service line must be at least marginally "profitable" and all service lines combined must, in the aggregate, cover all production costs, float costs, and the private sector adjustment factor.

The Federal Reserve establishes cost-recovery objectives, rather than targeted volume objectives, for its services. In a dynamic payments environment, circumstances might arise, such as changes in technology or banking structure, that could jeopardize the Federal Reserve's ability to meet its cost-recovery objectives in a particular service. If a service experiencing such developments can be improved to be responsive to the market, it would continue to be offered. If it becomes clear, however, that the service cannot be expected to meet cost-recovery objectives, the Federal Reserve would reassess the appropriateness of continuing to provide the service after taking into account its other objectives, including the requirement to provide equitable access and an adequate level of services nationwide. For example, several Reserve Banks have stopped offering cash transportation in areas where an adequate level of this service is otherwise provided by the private sector.

More efficient operations or aggressive pricing by other service providers could also result in the Federal Reserve's failing to meet cost-recovery objectives. Because the Monetary Control Act directs the Federal Reserve to give due regard to competitive factors, a decision would have to be made whether the public benefits of continuing to offer the service justify the shortfall. The Federal Reserve might also continue to provide a service that did not meet cost-recovery objectives if the revenue shortfall were caused by a temporary situation that could be corrected. In any event, a

<sup>3</sup> See the appendix for details on calculation of costs and fees.

decision to continue to provide a service that could not reasonably be expected to meet cost recovery objectives would be made by the Federal Reserve Board only after seeking public comment and only where there were clear public benefits to such a course of action. Similarly, any decision to withdraw from a particular service line would have to be undertaken in an orderly way, giving due regard to the transition problems associated with the discontinuation of a service.

#### *New Services and Service Enhancements*

The Federal Reserve's operational presence in the payments system can be expected to change as the payments system evolves. Increased interstate banking activity, technological developments, developments in law and regulation, and the entry of new participants in the payments system will all influence the evolution of the Federal Reserve's role.

As the Federal Reserve considers the introduction of new services or major service enhancements, all of the following criteria must be met:

- The Federal Reserve must expect to achieve full recovery of costs over the long run.
- The Federal Reserve must expect that its providing the service will yield a clear public benefit, including, for example, promoting the integrity of the payments system, improving the effectiveness of financial markets, reducing the risk associated with payments and securities transfer services, or improving the efficiency of the payments system.
- The service should be one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity. For example, it may be necessary for the Federal Reserve to provide a payment service to ensure that an adequate level of service is provided nationwide or to avoid undue delay in the development and implementation of the service.

#### *Competitive Impact Analysis*

The Board will also conduct a competitive impact analysis when considering an operational or legal change, such as a change to a price or service, or a change to Regulation J, if that change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services due to differing legal powers or constraints or due to a dominant market position of the Federal Reserve deriving from such legal differences. All operational or legal

changes having a substantial effect on payments system participants will be subject to a competitive impact analysis, even if competitive effects are not apparent on the face of the proposal.

In conducting the competitive impact analysis, the Board would first determine whether the proposal has a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services. Second, if such an adverse effect on the ability to compete is identified, the Board would then ascertain whether the adverse effect were due to legal differences or due to a dominant market position deriving from such legal differences. Third, if it were determined that legal differences or a dominant market position deriving from such legal differences were judged to exist, then the proposed change would be further evaluated to assess its benefits, such as contributing to payments system efficiency or integrity or other Board objectives, and to determine whether the proposal's objectives could be reasonably achieved with a lesser or no adverse competitive impact. Fourth, the Board would then either modify the proposal to lessen or eliminate the adverse impact on competitors' ability to compete or determine that the payments system objectives may not be reasonably achieved if the proposal were modified. If reasonable modifications would not mitigate the adverse effect, the Board would then determine whether the anticipated benefits were significant enough to proceed with the change even through it may adversely affect the ability of other service providers to compete with the Federal Reserve in that service.

#### Process for Communicating Concerns

If a depository institution or other payments system participant believes that the Federal Reserve's priced services policies or practices are not in accord with the competitive analysis or other criteria described above, it should communicate its concerns to the First Vice President of the local Federal Reserve Bank. If the institution wishes to pursue the matter further after discussing the issue with the Reserve Bank staff, it may address its concern to the Board member designated as Chairman of the Board's Committee on Federal Reserve Bank Activities.

#### Conclusion

The Federal Reserve recognizes its responsibilities to cooperate with other providers in improving the payments system and, through the procedures described above, to maintain a fundamental commitment to competitive fairness. These responsibilities must, in the final analysis, be viewed as an extension of the Federal Reserve's underlying responsibility for preserving the safety and soundness of, and public confidence in, the payments system.

#### Appendix—Methodology for Computing Federal Reserve Bank Costs and Fees

In accordance with the Monetary Control Act, the Federal Reserve establishes prices for its payment services in order to recover costs and a private sector adjustment factor (PSAF). The PSAF is an allowance for the taxes that would have been paid and the return on capital that would have been provided had the Federal Reserve's priced services been furnished by a private-sector firm.

Costs for providing services are derived from the Federal Reserve's Planning and Control System (PACS). PACS is the uniform cost accounting system Reserve Banks use for determining the full costs of fulfilling their four basic areas of responsibility: (1) Monetary policy, (2) supervision and regulation, (3) fiscal agency services, and (4) services to financial institutions and the public (the last includes both priced and nonpriced services). The system was developed in the mid-1970s to serve as a cost-accounting system, similar to systems used in the private sector, and also to serve as a vehicle for evaluating the cost-effectiveness and relative efficiency of the Reserve Banks.

PACS provides the Federal Reserve with an important management tool for budgeting and expense control by ensuring that similar expenses are recorded by Reserve Banks in the same way and that all Reserve Banks report operating expenses under a set of common and uniform definitions.

Like most expense-accounting systems used in the private sector, expenses under PACS are classified by type or "object" of expense, such as salaries, supplies, equipment and travel, and by the "output" to which the expense is related, such as fiscal services to the Treasury or the provision of check collection services to depositing institutions. Classification of expenses by type enables the Federal Reserve to collect necessary information for external and internal financial reporting and control purposes. Classification of expenses by output service enables Federal Reserve management to analyze the overall costs of Reserve Bank operations in terms of ongoing service responsibilities, the programs

instituted to fulfill these service responsibilities, and the basic activities or processes included in the provision of each service.

There are subsidiary services within each area of responsibility (service line). "Services to financial institutions and the public," for example, encompasses priced services such as commercial check, electronic funds transfer, securities, and noncash collection. Within each of these subsidiary services, PACS identifies specific "activities" that reflect the basic operations or processes within the services.

PACS classifies all costs into three categories: direct, support, and overhead costs. Direct costs are those costs directly attributable to a given service. Support costs are those costs, such as computer programming and building operations, that, although not directly used in priced service operations, are required to support such activities. All support costs are fully charged to the benefiting activities on a usage basis. Overhead costs represent all remaining Federal Reserve costs that cannot be charged directly to an output service on a usage basis. Examples of overhead functions include the personnel department, protection, and budget control. Overhead costs are allocated to benefiting services based upon formulas that reflect relative usage.

All Federal Reserve fees are reviewed annually and revised, if necessary. The annual review takes place during the third quarter of the year. Each Reserve Bank forecasts its costs and volumes for each priced service for the upcoming year. Included in the cost estimate are all direct, support, overhead, and float costs that are to be allocated to each priced service. The cost and volume estimates are based on a combination of historical experience and projections. At the same time, the Federal Reserve calculates a proposed PSAF for the year.

Aggregate cost and volume estimates for nationally priced services are based on estimates made by the individual Reserve Banks.

The proposed Reserve Banks fees are reviewed by the System's Pricing Policy Committee and the staff of the Board of Governors. The purpose of the review is to ensure that the cost and volume estimates are reasonable, that the PSAF calculation is consistent with System guidelines, and that proposed prices meet the cost-recovery policies of the Board of Governors. Finally, the Board of Governors reviews and approves the proposed prices and PSAF.

By order of the Board of Governors of the Federal Reserve System, March 23, 1990.

**William W. Wiles,**  
*Secretary of the Board.*

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