FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **10669**
December 3, 1993]

FEDERAL RESERVE PRICED SERVICES

• 1994 Fee Schedules and Private Sector Adjustment Factor (PSAF)

• Volume-Based Pricing for Noncash Collection Services and for Selected Check Products

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

The Board of Governors of the Federal Reserve System has announced the adoption of 1994 fee schedules, and the Private Sector Adjustment Factor (PSAF), for services provided by the Federal Reserve Banks, effective January 3, 1994. In addition, the Board of Governors announced approval of volume-based pricing for noncash collection services and selected check products offered by certain Federal Reserve Banks.

1994 Fee Schedules and PSAF

Following is the text of the Board's announcement of the new fee schedules and PSAF:

> The Federal Reserve Board has announced the 1994 fee schedules for services provided by the Federal Reserve Banks. The fees become effective January 3, 1994.
>
> The fee schedules apply to check collection, automated clearing house, funds transfer and net settlement, book-entry securities, noncash collection, and special cash services, and for electronic connections to the Federal Reserve. The 1994 fee schedules are available from the Reserve Banks.
>
> In 1994, total costs for priced services, including float, a portion of special project costs, and the Private Sector Adjustment Factor (PSAF), are projected to be $754.2 million. Total revenue is projected to be $774.4 million, resulting in net income of $20.2 million, compared with a targeted return on equity of $34.6 million.
>
> At the same time, the Board approved the 1994 PSAF for Reserve Bank priced services of $103.6 million, an increase of $12.2 million or 13.3 percent over the $91.4 million targeted for 1993.
>
> 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 provided by a private business firm.

Printed on the following pages is the text of the Board's official notice in this matter, which has been reprinted from the *Federal Register* of November 17. Questions regarding our priced services may be directed to your Account Manager (Tel. No. 212-720-6600 at the Head Office; Tel. No. 716-849-5085 at the Buffalo Branch).

New fee schedules for check services provided by this Bank were sent to you with our Circular No. 10666, dated November 26, 1993. Also, additional information regarding fee schedules for book-entry securities transactions, ACH time and fee schedules, and electronic access will be sent to you shortly.

Volume-Based Pricing

Following is the text of the Board's announcement of volume-based pricing for certain services:

The Federal Reserve Board has announced approval of volume-based pricing for the noncash collection services and for selected check products offered by the Federal Reserve Banks of Richmond and Minneapolis effective January 3, 1994.

The volume-based pricing will:

- set volume-based cash letter and coupon envelope fees for the noncash collection services, and
- permit the Minneapolis Reserve office and the Richmond Federal Reserve District to set volume-based fees for selected check products.

The specific noncash collection and check fees appear in the 1994 priced services' fee schedules, which are available from the Reserve Banks.

Beginning on page 60649 of the following *Federal Register* excerpt is the text of the Board of Governors' official notice in this matter. Questions regarding noncash collection services may be directed to Christina H. Ryan, Manager, Safekeeping Department (Tel. No. 212-720-7726); and questions on check matters may be directed to Matthew J. Puglisi, Manager, Check Services Department (Tel. No. 201-531-3410).

WILLIAM J. MCDONOUGH,
President.

[Docket R-0813]

Federal Reserve Bank Services

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board has approved a Private Sector Adjustment Factor (PSAF) for 1994 of $103.6 million, as well as 1994 fee schedules for Federal Reserve priced services. These actions were taken in accordance with the requirements of the Monetary Control Act of 1980, which requires that fees for Federal Reserve priced services be established on the basis of all direct and indirect costs, including the PSAF. The Board also has approved the elimination of the blended fee option that is currently offered in connection with the tiered prices used for some check collection products.

DATES: The PSAF, the fee schedules, and the elimination of the blended fee option for check collection products become effective January 3, 1994.

FOR FURTHER INFORMATION CONTACT: For questions regarding the Private Sector Adjustment Factor: Gwendolyn Mitchell, Senior Accounting Analyst, (202/452-3841), or Gregory Evans, Project Leader, (202/452-3945), Division of Reserve Bank Operations and Payment Systems; for questions regarding fee schedules: Edith Collis, Financial Services Analyst, Check Payments (202/452-3638), Jack Walton, Manager, Automated Clearing House (202/452-2660), Darrell Mak, Financial Services Analyst, Funds Transfer (202/452-3223), Kirstin Wells, Assistant Financial Services Analyst, Book Entry (202/452-5871), Kenneth Buckley, Manager, Information Technology (202/452-3646), Michael Bermudez, Financial Services Analyst, Fiscal Agency & Definitive Securities (202/452-2216), and Ruth Robinson, Senior Financial Services Analyst, Cash (202/452-3944), Division of Reserve Bank Operations and Payment Systems; for the hearing impaired only: Telecommunication Device for the Deaf, Dorothea Thompson (202/452-3544).

Copies of the 1994 fee schedules for check collection, automated clearing house, funds transfer and net settlement, book-entry securities, noncash collection, special cash services, and electronic connections to the Federal Reserve are available from the Reserve Banks.

SUPPLEMENTARY INFORMATION:

Private Sector Adjustment Factor

The Board approved a 1994 Private Sector Adjustment Factor (PSAF) for Federal Reserve Bank priced services of $103.6 million. This amount represents an increase of $12.2 million or 13.3 percent over the PSAF of $91.4 million targeted for 1993.

As required by the Monetary Control Act, the Federal Reserve's fee schedule for priced services includes "taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private business firm." These imputed costs are based on data developed in part from a model comprised of the nation's 50 largest (in asset size) bank holding companies (BHCs).

The methodology first entails determining the value of Federal Reserve assets that will be used in producing priced services during the coming year. Short-term assets are assumed to be financed by short-term liabilities; long-term assets are assumed to be financed by a combination of long-term debt and equity derived from the BHC model. The mix of long-term debt and equity was modified slightly to ensure an imputed equity to asset ratio of 4 percent as required for adequately capitalized institutions under provisions of Regulation F.

Imputed capital costs are determined by applying related interest rates and rates of return on equity derived from the bank holding company model. The rates drawn from the BHC model are based on consolidated financial data for the 50 largest BHCs in each of the last five years. Because short-term debt, by definition, matures within one year, only data for the most recent year are used for computing the short-term debt rate.

The PSAF comprises capital costs, imputed sales taxes, expenses of the Board of Governors related to priced services, and an imputed FDIC insurance assessment on clearing balances held with the Federal Reserve to settle transactions.

Asset Base—The estimated value of Federal Reserve assets to be used in providing priced services in 1994 is reflected in Table 11. Table 12 shows that the assets assumed to be financed through debt and equity are projected to total $651.5 million. As shown in Table 13, this represents a net decrease of $5.6 million or 0.9 percent from 1993. This decrease results primarily from lower priced asset base levels at the Reserve Banks, partially offset by higher short-term assets resulting from a revision to the estimated average level of accrued service revenue.

Cost of Capital, Taxes, and Other Imputed Costs—Table 13 shows the financing and tax rates as well as the other required PSAF recoveries

proposed for 1994 and compares the 1994 rates with the rates used for developing the PSAF for 1993. The pre-tax return on equity rate increased from 8.6 percent in 1993 to 12.7 percent for 1994. The increase is a result of stronger 1992 BHC financial performance included in the 1994 BHC model, relative to the 1987 BHC financial performance, included in the 1993 BHC model.

The decrease in the FDIC insurance assessment from $21.3 million in 1993 to $19.8 million in 1994, as shown in Table 13, is attributable to lower adjusted gross CIPC and, to a lesser extent, lower clearing balances. The FDIC rate of $0.26 for every $100 in clearing balances, remains unchanged from the 1993 final PSAF.

Capital Adequacy—As shown on Table 14, the amount of capital imputed for the proposed 1994 PSAF totals 31.6 percent of risk-weighted assets, well in excess of the 8 percent capital guideline for state member banks and BHCs.

1994 Fee Schedules

Overview—Based on the Reserve Banks' estimates of costs, volumes, and revenues, the proposed 1994 fees for priced services are expected to yield net income of $20.2 million for the year, compared with a targeted return on equity (ROE) of $34.6 million.[1] Thus, the Reserve Banks project that 98.2 percent of total expenses, including targeted ROE, will be recovered. In addition, during 1994, approximately $25 million of automation consolidation special project costs will be deferred and financed.[2]

Unique situations are facing the check, automated clearing house (ACH), and noncash collection services that contribute to the projected, lower-than-targeted return on equity. First, the same-day settlement (SDS) regulation will be effective on January 3, 1994. Under the SDS regulation, private collecting institutions will be able to present checks directly to payor institutions and to demand settlement in same-day funds. It is anticipated that many institutions currently using intermediaries, such as the Reserve Banks, to collect checks will begin to present checks directly to payor institutions. The Reserve Banks expect the total number of checks collected by the System to decline by approximately 10 percent.

While the Reserve Banks are taking a number of steps to control costs and to enhance their check services, the resource adjustments (both labor and equipment) that will most likely be needed can only be made over time, following actual volume losses. As a result, the Reserve Banks are proposing modest increases in check fees for 1994 and projecting net income of $14.8 million, compared with a targeted ROE of $26.3 million. In addition, all automation consolidation costs are being deferred and financed.

Experience following the initial implementation of Regulation CC in 1988 indicates that the Reserve Banks are able to adjust to structural changes and fully recover total expenses, plus targeted ROE, in a relatively short time period (see Table 1). Further, raising check fees substantially in 1994 could reduce the overall efficiency of the check collection mechanism.

Second, the ACH service continues to be affected by the one-time expenses associated with the transition to consolidated automation operations and the new Fednet® data communications network. Although priced service management may defer and finance a portion of automation consolidation special project costs, a substantial portion of the costs incurred to implement the Federal Reserve Automation Service (FRAS) and Fednet® are being charged to operating expenses as they are incurred. In addition, new ACH application software is being developed to support consolidated operations and to enhance the Reserve Banks' ACH services. All costs incurred to develop the new software are included in current expenses as well as the costs associated with maintaining the current ACH software.

The Reserve Banks are taking steps to reduce ACH direct and overhead costs, are deferring all special project costs, and are proposing to raise selected fees. Estimates indicate that these efforts will permit the ACH service to realize $1.3 million in net income, compared with a targeted ROE of $3.4 million. If fees were raised in an attempt to generate the revenue needed to realize the targeted ROE, future ACH volume growth could be negatively affected. The Federal Reserve's electronic payment services will benefit from automation consolidation and Fednet® in the future through enhanced reliability and increased efficiency. In addition, users of the System's ACH services will benefit from flow processing and enhanced delivery options when the new ACH software is implemented. Each of these efforts is expected to contribute to growth in the use of electronic payments.

Third, the noncash collection service has faced rapidly declining volume levels since the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) was enacted. Following the enactment of TEFRA, many bearer municipal securities were "immobilized," or converted to book-entry form, thus eliminating interest coupons. Largely due to significant volume losses, the Reserve Banks incurred an operating loss in 1992 and project operating losses in 1993 and 1994.

The number of institutions providing noncash collection services is dwindling. Even though the Reserve Banks are not currently among the highest volume service providers, offering noncash collection services provides a measure of stability in a volatile environment.

To address the difficulties associated with recovering noncash collection costs in a declining market, the Reserve Banks have reduced the number of operating sites to four and plan to reduce the number to three by year-end 1994 and to two by year-end 1995. In addition, the Board approved a modified fee structure that more effectively reflects the composition of costs and the demand of both low-volume and high-volume users of the service. (See Docket R–0814 elsewhere in today's **Federal Register**.) Once all operational adjustments are made, the Reserve Banks believe that the total costs of providing noncash collection services can be recovered.

The 1994 fees approved by the Board result in a projected ROE that is below the target established using the 50 bank holding company model. Both the MCA and the Board's pricing principles indicate that fees for Federal Reserve priced services should be set to recover costs, including the PSAF, over the long run. The Board believes that the Reserve Banks have demonstrated their ability to adjust to structural changes since the MCA was implemented and believes that the Reserve Banks will be able to make the appropriate adjustments in the future. In addition, the Board believes that the Federal Reserve's efforts to enhance its data processing and data communications facilities will provide

[1] As required by the Monetary Control Act (MCA), the Federal Reserve's fees for priced services are set to recover all direct and indirect costs of providing the services plus imputed costs, such as taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private business firm. These imputed costs are based on data developed in part from a model comprised of the nation's 50 largest (in asset size) bank holding companies (BHCs). The ROE is derived from the BHC model based on consolidated financial data for each of the last five years.

[2] In 1981, the Board adopted a policy that permits the Reserve Banks to defer and finance development costs if the development costs would have a material affect on unit costs, provided a conservative time period is set for full cost recovery and a financing factor is applied to the deferred portion of development costs.

significant benefits to all users of Federal Reserve payment services in the future.

Discussion—The 1993 fees approved by the Board were expected to recover 99.1 percent of the costs of providing priced services in 1993, including imputed expenses, automation consolidation special project costs, and targeted ROE. Through September 1993, the System recovered 99.7 percent of total priced services expenses plus ROE. The Reserve Banks now estimate that, priced services revenues will yield net income of $18.3 million for the year, compared with a targeted ROE of $24.8 million. The recovery rate after targeted ROE is estimated to be 99.2 percent. Approximately $27.1 million in automation consolidation special project costs will be recovered in 1993 and $12.2 million will be financed and recovered later. (See Table 1.)

Total priced services costs including special project costs recovered and ROE are expected to be 1.1 percent below original projections and total revenue is estimated to be about 1.0 percent lower than original projections.

In 1994, priced service expenses before special project costs (see Table 1, column 2) are projected to increase 2 percent compared with 1993 levels. Approximately $24.7 million of automation consolidation special project costs will be deferred and financed, resulting in accumulated special project costs to be recovered in the future of $36.9 million.

Total revenue is projected to decrease 0.3 percent compared with the 1993 level. Based on the Reserve Banks' estimates of costs, volumes, and revenues, the 1994 fees are expected to yield net income of $20.2 million for the year, compared with a targeted return on equity of $34.6 million. These estimates result in a recovery rate after targeted ROE of 98.2 percent. Table 1 highlights the cost and revenue performance for priced services since 1989.

TABLE 1.—COST AND REVENUE PERFORMANCE [1]

[$ millions]

Year	Revenue	Operating costs & imputed expenses [2]	Special project costs recovered	Total expense [2+3]	Net income (ROE) [3] [1–4]	Target ROE [4]	Recovery rate after target ROE (percent) [1÷(4+6)]	Special project costs deferred & financed [5]
	1	2	3	4	5	6	7	8
1989	718.6	691.0	4.6	695.6	23.0	32.9	98.6	0.0
1990	746.5	696.0	2.8	698.8	47.7	33.6	101.9	0.0
1991	750.2	708.4	1.6	710.0	40.2	32.5	101.0	0.0
1992	760.8	723.1	11.2	734.2	26.6	26.0	100.1	1.6
1993 (Est) [6]	776.4	730.9	27.1	758.1	18.3	24.8	99.2	12.2
1994 (Bud)	774.4	745.5	8.8	754.2	20.2	34.6	98.2	36.9

[1] Details may not sum to totals because of rounding.
[2] Imputed expenses include interest on debt, taxes, FDIC insurance, and the cost of float. Credits for prepaid pension costs under FASB 87 and the charges for post-retirement benefits in accordance with FASB 106 are included beginning in 1993.
[3] Net income was less than targeted ROE during 1989 due to structural adjustments associated with implementing Regulation CC in 1988.
[4] Targeted ROE has not been adjusted to reflect automation consolidation expenses deferred and financed. The Reserve Banks plan to recover these costs in the future.
[5] Totals are cumulative and include financing costs.
[6] The modified methodology adopted by the Board on September 28, 1993, for imputing net income on clearing balances is reflected in revenue beginning in 1993.

Check

Table 2 presents the actual 1992, estimated 1993, and projected 1994 cost recovery performance for the check collection service.

TABLE 2.—PRO FORMA COST AND REVENUE PERFORMANCE

[$ millions]

Year	Revenue	Operating costs & imputed expenses	Special project costs recovered	Total expense [2+3]	Net income (ROE) [1–4]	Target ROE	Recovery rate after target ROE (percent) [1÷(4+6)]	Special project costs Dcferred & financed
	1	2	3	4	5	6	7	8
1992	578.4	552.7	6.6	559.3	19.1	19.3	100.0	(0.4)
1993 (Est)	600.6	565.4	14.2	579.5	21.0	18.6	100.4	(0.1)
1994 (Bud)	593.5	578.7	0.0	578.7	14.8	26.3	98.1	11.8

1992 Performance—Revenues from he check service recovered 100.0 ercent of total expenses, including argeted ROE in 1992. The volume of hecks collected increased 1.9 percent over 1991 levels and the volume of return items decreased 6.0 percent.

1993 Performance—Through September 1993, revenues from the check service recovered 100.7 percent of total expenses, including targeted ROE. The volume of checks collected increased less than 0.1 percent and return item volume decreased 2.1 percent, compared with 1992 volume levels. The Reserve Banks originally projected an increase of 1.9 percent for

checks collected and a decrease of 0.9 percent for return items.

The Reserve Banks now project net income to amount to $21.0 million, compared with a targeted ROE of $18.6 million. Total expenses and revenues are expected to be lower than original projections by approximately 1.0 percent and 0.4 percent, respectively. The volume of checks collected is now projected to increase only 0.3 percent over 1992 levels and return item volume is expected to decline by 4.7 percent. Because the Reserve Banks have controlled costs effectively during 1993, the Board believes that the Reserve Banks' projections are reasonable.

1994 Issues—The Reserve Banks will be challenged by a changing check environment in 1994 as a result of the implementation of the SDS regulation on January 3. The regulation will permit collecting institutions to present checks to payor institutions for payment in same-day funds without the imposition of presentment fees if the checks are presented by 8:00 a.m. local time. Many collecting banks currently using the Federal Reserve's check collection services are expected to begin presenting checks directly to payor institutions. As a result, the Reserve Banks estimate that total check collection volume will decline by 10 percent; reflecting decreases of 32.5 percent for fine sort deposits and 2.3 percent for processed deposits. Return item volumes are expected to decline by 1.9 percent.

In light of the changes in the check collection mechanism that implementation of the SDS regulation will create, the Reserve Banks are (1) instituting cost containment efforts, (2) taking steps to adjust fees to encourage more efficient use of Federal Reserve services, and (3) introducing forward collection products with attractive deadlines.

The Board also approved the elimination of the blended fee option from the check service's tiered pricing structure. Tiered pricing enables Reserve Banks to establish prices that more precisely reflect their costs to collect checks drawn on paying institutions within a given check collection zone. Under a tiered pricing structure, different fees are assessed depending on whether a check is presented to a high-cost or low-cost endpoint in a collection zone. The blended fee option is currently offered as an alternative to tiered prices within most collection zones where tiered prices have been implemented. The blended fee option was included to address the concerns raised by public commenters regarding the complexities associated with monitoring and reconciling bills for products with tiered prices. At that time, the Board committed to evaluating the need to offer the blended fee option after experience was gained with this pricing methodology.

The Board believes that the circumstances supporting the need for the blended fee option have changed. In the SDS environment, Reserve Banks expect to lose volume drawn on low-cost/low-tier endpoints. The proportional increase in volume drawn on high-cost/high-tier endpoints will result in increases in the blended fees, which will make the difference between them and the high-tier fees insignificant. Thus, the usefulness of a blended fee will be significantly reduced. In 1992, the Minneapolis Reserve Bank received approval to eliminate the blended fee alternative because the difference between the blended fee and the high-tier fee became insignificant. In addition, experience has shown that the billing reconcilement complexities associated with tiered pricing have not been an obstacle to most depositors because few depositors have chosen the blended fee option.

1994 Fees—Overall, 1994 check prices will increase 2.4 percent on a weighted average basis, compared with 1993 fees. To reflect the fixed and variable costs of providing check collection services more accurately, cash letter fees and fine sort package fees are increasing, on average, 21 percent and 46 percent, respectively. Forward processed and fine sort per-item fees are decreasing 1.4 percent and 12.6 percent, respectively. Of the 2,126 forward collection and fine-sort fees, 13 percent are lower than 1993 fees, almost 37 percent are unchanged, and 15 percent represent new product offerings. Eighty-seven forward fees have been discontinued, largely due to the elimination of the blended fee option for products with tiered prices.

Fees for return items are increasing 8.1 percent overall, reflecting in part increases in return cash letter and package fees. Of the 1,489 return fees, 6 percent will decrease, 44 percent are unchanged, 46 percent will increase, and 4 percent represent new fees.

Table 3 highlights selected price ranges for 1993 and 1994 check collection fees.

TABLE 3.—PRICE RANGES

Products	1993 Price Ranges	1994 Price Ranges
Items	(per item)	(per item)
Forward processed		
City	$0.008 to 0.049	$0.003 to 0.049.
RCPC	0.007 to 0.060	0.005 to 0.077.
Fine Sort		
City	0.002 to 0.009	0.002 to 0.012.
RCPC	0.002 to 0.015	0.002 to 0.012.
Qualified return items		
City	0.110 to 0.530	0.100 to 0.530.
RCPC	0.120 to 0.570	0.120 to 0.600.
Raw return items		
City	0.580 to 1.680	0.580 to 1.680.
RCPC	0.800 to 1,680	0.800 to 1.680.
Cash Letters	(per cash letter)	(per cash letter)
Forward processed	0.50 to 4.50	1.50 to 7.50.
Forward fine-sort package	1.50 to 4.50	3.00 to 11.00.
Return items: raw and qualified	0.50 to 4.50	1.50 to 7.50.

In order to improve the efficiency of the payments mechanism through the promotion of electronic check presentment, a revised framework for pricing electronic check products was implemented in mid-1993. Under that

framework, fees for payor bank information products are to be set at a higher level than fees for presentment products. All Reserve Banks have adopted this pricing structure for 1994. Prices for less efficient, non-electronic methods of delivery for both information and presentment services will be set higher than electronic delivery methods.

Service Level Changes—Beginning in 1994, all Reserve Banks will offer a basic electronic check presentment service (BECP) and local truncation (safekeeping) services, with the capability of handling at least two distinct customer account number ranges. Each of the electronic check presentment products will have a separate per-item fee. Fees for BECP will be set at lower levels and fees for truncation products will be set at the higher levels.

Enhancements to the minimum check service level standards approved by the Board in 1992 will be fully implemented by all Reserve Banks in 1994. These enhancements are designed to speed interdistrict check collection, to be responsive to depositors' needs for improved deadlines and availability, and to offer more uniform national check collection services.

The Reserve Banks have taken steps to control operating costs and will defer $11.8 million of automation consolidation special project costs, which will be financed and recovered later. The Board approved the 1994 fees for the check service, although net income is projected to be $11.5 million below the targeted ROE of $26.3 million. Increasing check fees more than the planned 2.4 percent could contribute to inefficiencies in check collection markets. Moreover, the Reserve Banks have demonstrated their ability to adjust to structural changes in the past, and the Board believes that the Reserve Banks will be able to make the appropriate adjustments in the future.

Automated Clearing House (ACH)

Table 4 below presents the actual 1992, estimated 1993, and projected 1994 cost recovery performance for the commercial ACH service.

TABLE 4.– PRO FORMA COST AND REVENUE PERFORMANCE

[$ millions]

Year	Revenue	Operating costs & imputed expenses	Special project costs recovered	Total expense [2+3]	Net income (ROE) [1 – 4]	Target ROE	Recovery rate after target ROE (percent) [1÷(4+6)]	Special project costs deferred and financed
	1	2	3	4	5	6	7	8
1992	60.2	60.6	0.0	60.6	(0.4)	2.4	95.6	2.3
1993 (Est)	60.1	62.9	0.0	62.9	(2.7)	2.5	92.0	10.9
1994 (Bud)	67.9	66.6	0.0	66.6	1.3	3.4	96.9	19.9

1992 Performance—Revenues from the ACH service recovered 95.6 percent of total expenses, including targeted ROE, during 1992. The principal factors contributing to the revenue shortfall were (1) higher than planned automation consolidation-related expenses and (2) lower than anticipated non-automated revenue due to a more rapid conversion to the all electronic ACH than planned. Commercial ACH volume increased 18.6 percent, compared with 1991 volume levels.

1993 Performance—Through September 1993, revenues from the ACH service recovered 92.1 percent of total expenses plus ROE, compared with a targeted recovery rate of 92.3 percent for the year. Commercial ACH volume increased 16.4 percent, compared with 1992 volume levels.

Consistent with their original projections, the Reserve Banks now project an operating loss of $2.7 million, compared with a targeted ROE of $2.5 million. Total expenses and revenues are expected to be lower than original projections by 2.1 percent and 2.4 percent, respectively. Commercial ACH volume is now anticipated to increase 14.6 percent above 1992 levels, compared with an original projection of 16.3 percent.

While the Reserve Banks' revised volume projections appear somewhat pessimistic, the implementation of two additional ACH processing cycles on October 1, 1993, could increase operating costs. In addition, revenues could decline because the new processing schedules enable some originating institutions to avoid the surcharge on debit transactions processed on the last, or premium, cycle.

1994 Issues—Several significant factors continue to affect the costs of the ACH service and its ability to recover total expenses, including the targeted ROE allocated to the service. First, the Reserve Banks are continuing their multi-year effort to implement FRAS and the improved data communications network, Fednet®. Both of these efforts will enhance the reliability and the quality of the ACH service. While all automation consolidation special project costs are being deferred and financed, all other costs associated with the implementation of FRAS and Fednet® are expensed in the year they are incurred.

Second, the ACH service is in the midst of a multi-year effort to develop application software designed to operate in the consolidated processing environment. The software, known as FedACH, will also provide enhanced services, such as flow processing, to depository institutions. The development costs of the FedACH software are being expensed as they are incurred, while the Reserve Banks continue to incur expenses to maintain and operate the current ACH application software.

Third, the projected 13.8 percent increase in commercial ACH transaction volume reflects a continuing reduction in the growth rate of commercial ACH transactions. At the same time, total expenses are projected to rise by only 5.9 percent due to the Reserve Banks' cost control programs.

1994 Fees—Given the magnitude and nature of the one-time expenses described above, the Board continues to believe that increasing ACH fees by the amount necessary to recover the targeted ROE in 1994 would have a negative effect on the continued growth of the ACH because it would introduce short-term price aberrations into the market.[4] This conclusion is supported by the scale economies that exist in producing ACH services, which are demonstrated by the 12.1 percent average annual decrease in per-item

[4] Docket R–0779, 57 FR 53740, November 10, 1992.

ACH processing costs from 1988 through 1992. If the Federal Reserve were to raise ACH transaction fees substantially in 1994 and 1995, the potential to realize the long-term benefits of this efficient payment mechanism would likely be diminished.

At the same time, the Board believes that it is beneficial to structure fees for the ACH service in a manner that more accurately reflects the service's underlying cost structure and that will facilitate the transition to the future operating environment. In particular, a significant proportion of the costs incurred in providing ACH services are fixed, but the majority of ACH revenues are derived from transaction fees. As a result, the current fee structure may discourage use of ACH services because transaction fees are considerably higher than average variable costs. Further, the eventual consolidation of ACH processing will eliminate the differences in processing local and interregional transactions. Thus, when the new FedACH processing system is implemented, only one transaction fee would be assessed. The Reserve Banks' staffs are currently developing a proposal to modify the ACH fee structure and are planning to request that the Board issue it for public comment during early 1994.

The 1994 price changes are listed in Table 5.

TABLE 5.—PRICE CHANGES

Product	1993	1994 (proposed)
Interregional Transaction Fee	$0.015	$0.014
Account Servicing Fee (monthly)	10.00	20.00
File Processing Fee	1.50	1.75
Discrete File Delivery	NA	10.00

In addition, the premium processing cycle surcharge of $0.01 on all items processed on the fourth exchange (last processing exchange of the day) will go into effect January 3, 1994.[5] All other ACH transaction fees, such as the local, presort, and return item fees, will remain unchanged in 1994.

Each of the fee changes listed above was designed to meet System pricing goals. First, lowering the interregional (IRE) transaction fee to $0.014 from $0.015 per transaction begins the transition to a single transaction fee, which is consistent with the consolidated processing environment that will exist when the FedACH software is implemented.

Second, the Account Servicing Fee (ASF), previously referred to as the "Participation Fee," will be increased from $10 to $20 per month per routing transit number (RTN). The ASF is intended to recover a greater portion of the fixed costs incurred in providing ACH services. Third, increasing the input file fee from $1.50 to $1.75 per file will better reflect the incremental cost of processing ACH files. Finally, one of the service improvements offered beginning October 1, 1993, is a value-added delivery service that will allow receiving institutions, such as third-party processors and correspondent banks, to receive ACH transactions sorted separately by individual institutions. A subscription fee of $10 per month per file requested will be assessed for this service. For example, if a correspondent bank receives commercial ACH transactions for 10 institutions, including itself, and requests to receive files sorted by individual institution, the monthly cost for the service would be $90.

The effect of the fee changes on depository institutions' monthly ACH charges will be small. For example, the ASF will increase annual charges for the large majority of depository institutions by only $120. The increase in the file fee will have a negligible effect (ranging from an average of $0.16 per month for low-volume institutions to approximately $30 per month for the highest volume institutions).

The discrete file fee will not affect the ACH costs for most receiving institutions, but will provide enhanced services to the institutions that select this delivery option. And, the reduction in the IRE transaction fee will benefit all users of Federal Reserve ACH services. The cumulative effect of these proposed fee changes vary based on individual depository institutions' volume levels. On average, low-volume institutions will face an average monthly increase of about $10, or 42 percent of their current ACH charges. Conversely, high-volume institutions should realize a reduction of about 2 percent in their monthly ACH charges.

Although net income is projected to be $2.1 million below the targeted ROE of $3.4 million, the Board approved the 1994 fees for the ACH service.

Funds Transfer and Net Settlement

Table 6 presents the actual 1992, estimated 1993, and projected 1994 cost recovery performance for the funds transfer and net settlement service.

TABLE 6.—PRO FORMA COST AND REVENUE PERFORMANCE

[$ millions]

Year	Revenue	Operating costs & imputed expenses	Special project costs recovered	Total expense [2+3]	Net income (ROE) [1–4]	Target ROE	Recovery rate after target ROE (percent) [1÷(4+6)]	Special project costs deferred & financed
	1	2	3	4	5	6	7	8
1992	85.6	73.3	3.8	77.1	8.5	3.3	106.5	(0.4)
1993 (Est)	88.6	75.0	11.2	86.2	2.5	2.9	99.5	0.3
1994 (Bud)	86.5	75.6	7.2	82.7	3.8	3.8	100.0	3.4

[5] The premium processing cycle surcharge, effective October 1, 1993, was approved by the Director of Reserve Bank Operations and Payment Systems under delegated authority on March 18, 1993. Due to concerns expressed by the private-sector about the ability of receiving institutions to post payments timely under the new operating schedule, an announcement was issued on August 27, 1993, delaying the implementation of the surcharge until January 1, 1994.

1992 Performance—Revenues from the funds transfer and net settlement service recovered 106.5 percent of total expenses, including targeted ROF. Funds transfer volume increased 4.4 percent over 1991 levels.

1993 Performance—Through September 1993, revenues from the funds transfer and net settlement service recovered 101.1 percent of total expenses, including ROE. During the same period funds transfer volume increased 1.4 percent, compared with a projected increase of 4.7 percent for the year. The decline in the volume growth rate is due to a variety of market factors, including merger activity and shifting payment patterns.

The Reserve Banks now project net income of $2.5 million, compared with a targeted ROE of $2.9 million. Total expenses are expected to be about 1.7 percent lower than original projection and revenue is anticipated to be approximately 2.2 percent below original estimates. Funds transfer volume is now projected to increase only 0.5 percent over 1992 levels.

1994 Issues—The Reserve Banks expect funds transfer volume to decline nearly 2 percent in 1994, due to continuing volume shifts to CHIPS related to format differences between the two funds transfer networks and the implementation of charges for intraday overdrafts in Federal Reserve accounts in April 1994. In light of declining volume levels, the Reserve Banks are taking steps to control costs and plan to defer approximately $3.1 million of automation consolidation special project costs for recovery in the future.

1994 Fees—The Board approved the Reserve Banks' maintaining the current funds transfer and net settlement fees in 1994.

Book-Entry Securities

Table 7 presents the actual 1992, estimated 1993, and projected 1994 cost recovery performance for the book-entry securities service.[6]

TABLE 7.—PRO FORMA COST AND REVENUE PERFORMANCE

[$ millions]

Year	Revenue	Operating costs & imputed expenses	Special project costs recovered	Total expense [2+3]	Net income (ROE) [1–4]	Target ROE	Recovery rate after target ROE (percent) [1÷(4+6)]	Special project costs deferred & financed
	1	2	3	4	5	6	7	8
1992	13.1	11.8	0.7	12.5	0.6	0.4	101.2	(0.1)
1993 (Est)	14.2	11.8	1.8	13.6	0.7	0.4	101.7	0.8
1994 (Bud)	15.9	13.5	1.7	15.2	0.7	0.7	100.3	1.6

1992 Performance—Revenues from the book-entry securities service recovery 101.2 percent of total expenses, including targeted ROE, in 1992. Government agency securities transfer volume increased 16.7 percent over 1991 levels, reflecting an increase in mortgage refinancings.

1993 Performance—Through September 1993, revenues from the book-entry securities service recovered 100.6 percent of total expenses, including ROE. The volume of on-line book-entry securities transfers originated increased 10.7 percent, compared with an original projection of 9.7 percent for 1993.

The Reserve Banks now project net income of $0.7 million, compared with a targeted ROE of $0.4 million. Total expenses are expected to be about 1.4 percent below original estimates and revenue is projected to equal original projections. Despite a higher than projected volume growth through September, the Reserve Banks now project that on-line book-entry securities transfers will increase only 8.6 percent over 1992 levels.

1994 Projections—Total 1994 expenses for the book-entry securities service are projected to increase 13.6 percent, reflecting the increasing costs associated with the continued implementation of Fednet® and the development of the new book-entry applications software. Securities transfer volume is projected to increase 9.1 percent, reflecting continued increases in the trading of agency mortgage-backed securities.

1994 Fees—To reflect the increasing costs of handling telephone requests for book-entry securities transfers, the Board approved an increase in the current off-line transfer fee of $8.50 to $10.00, and the retention of all other fees at 1993 levels.

Purchase and Sale

On September 24, 1993, the Board approved the consolidation of purchase and sale activities at the Federal Reserve Bank of Chicago, effective on January 1, 1994. Consolidation is expected to reduce purchase and sale costs in 1994 by 16.1 percent. The increase in the purchase and sale fee to $34.00 from $30.00, which was approved under delegated authority, and the cost reductions related to consolidation should result in full cost recovery for the service. The purchase and sale activities will be transferred to the book-entry securities service line for cost recovery reporting purposes in 1994.

Electronic Connections

The Federal Reserve charges fees for electronic connections to the Reserve Banks for accessing priced services. The costs and revenues associated with electronic access are allocated to the various priced services based on the relative number of endpoints that access each service.

The Board approved retaining most electronic connection fees at their 1993 levels for 1994. In particular, the monthly fees for Receive Only Dial, Receive and Send Dial, Multi-Drop Leased, and Dedicated Leased (up to and including speeds of 9.6 Kbps) connections will be retained at $30, $65, $300, and $700, respectively.

The Board also approved the following new standard monthly fees for several categories of high-speed connections: $850 and $1000 for High-Speed Dedicated Leased connections with speeds of 19.2 and 56 Kbps, respectively, and $350 for High-Speed Dial connections. The Board believes it

[6] These financial data reflect the costs and revenues for book-entry transfers of government agency securities, which are priced by the Federal Reserve. The U.S. Treasury establishes fees for book-entry transfers of Treasury securities.

is appropriate that uniform national prices be adopted for high-speed connections, consistent with the treatment of other types of electronic connections.

Finally, the Board approved the elimination of the monthly Gateway Connection surcharge. A gateway connection allows a depository institution (or its designated processor) to have electronic access to Federal Reserve services at more than one Reserve Bank via a single physical connection. Because processing for most payment services and the accounting system is being centralized at a single site, the Gateway Connection surcharge is no longer appropriate. The costs for activities related to initiating a gateway connection to support non-centralized applications, such as check, however, will continue to be incurred by the Reserve Banks. Therefore, the Board approved retaining the current Installation and Software Certification charges for initiating such gateway connections.

Definitive Safekeeping

Table 8 presents the actual 1992 and estimated 1993 cost recovery performance for the definitive safekeeping service.

TABLE 8.—PRO FORMA COST AND REVENUE PERFORMANCE

[$ millions]

Year	Revenue	Operating costs & imputed expenses	Special project costs recovered	Total expense [2+3]	Net income (ROE) [1–4]	Target ROE	Recovery rate after target ROE (percent) [1+(4+6)]	Special project costs deferred & financed 1992
	1	2	3	4	5	6	7	8
1992	3.1	3.8	0.0	3.8	(0.7)	0.2	78.4	0.0
1993 (Est)	1.6	3.9	0.0	3.9	(2.3)	0.2	40.4	0.0

1992 Performance—Revenues from the definitive safekeeping service recovered 78.4 percent of total expenses, including targeted ROE in 1992.

1993 Performance—Through September 1993, revenues from the definitive safekeeping service recovered 49.7 percent of total expenses, including targeted ROE. Reflecting the Reserve Banks' withdrawal from the definitive safekeeping service, volume decreased 49 percent, compared with 1992 volume levels.

The Reserve Banks will complete full withdrawal from the definitive safekeeping service by year-end 1993. The Reserve Banks now project an operating loss of $2.3 million, compared with the planned operating loss of $2.1 million. The increase in the projected operating loss results from the faster than anticipated withdrawals of securities and the absorption of associated processing and shipping costs.

Noncash Collection

Table 9 presents the actual 1992, estimated 1993 and projected 1994 cost recovery performance for noncash collection.

TABLE 9.—PRO FORMA COST AND REVENUE PERFORMANCE

[$ millions]

Year	Revenue	Operating costs & imputed expenses	Special project costs recovered	Total expense [2+3]	Net income (ROE) [1–4]	Target ROE	Recovery rate after target ROE (percent) [1+(4+6)]	Special project costs deferred & financed
	1	2	3	4	5	6	7	8
1992	7.5	8.3	0.0	8.3	(0.8)	0.3	86.6	0.0
1993 (Est)	4.9	5.7	0.0	5.7	(0.8)	0.2	83.3	0.2
1994 (Bud)	4.5	5.0	0.0	5.0	(0.5)	0.2	85.5	0.2

1992 Performance—Revenues from the noncash collection service recovered 86.6 percent of total expenses, including targeted ROE, during 1992. The principal factor contributing to the revenue shortfall was the 28 percent decrease in the volumes of coupons and bonds deposited for collection, compared with 1991 levels.

1993 Performance—Through September 1993, revenues from the noncash collection service recovered 85.3 percent of total expenses plus ROE, compared with a targeted recovery rate of 97.3 percent for the year. Noncash collection volumes decreased 42.6 percent, compared with 1992 volume levels.

The Reserve Banks now project an operating loss of $0.8 million, compared with a targeted ROE of $0.2 million. The Reserve Banks have reduced the number of offices providing noncash collection services from eight in 1992 to four at present, contributing to a reduction in total expenses of about 3.3 percent, compared with original estimates. Revenues, however, are now expected to decline nearly 17 percent, due to continuing volume declines.

1994 Issues—Since the mid 1980s, the noncash collection service has faced rapidly declining volume levels. Following enactment of the Tax Equity and Fiscal Responsibility Act of 1982, many bearer municipal securities have been "immobilized," or converted to book-entry form, thus eliminating interest coupons. In addition, the number of institutions providing noncash collection services is dwindling.

To address the difficulties associated with recovering costs in a declining market, the Reserve Banks are planning to reduce the number of operating sites to three by year-end 1994 and to two sites by year-end 1995. Through the

consolidation of operating sites, the Reserve Banks have been able to reduce operating costs by approximately 48 percent since 1991. Nevertheless, because of the continuing rapid decline in volume and the complications in processing caused by the increasing number of changes in paying agents, the Reserve Banks do not expect to recover costs in 1994.

1994 Fees—Because of the volatility in the current market, the System's noncash collection service offers a measure of stability even though the Reserve Banks are not among the highest volume service providers. To improve the ability of the Reserve Banks to recover costs, the Board approved 1994 fees which are based on a modified fee structure that more effectively reflects the composition of costs and the demand of both low-volume and high-volume users. (See Docket R–0814 elsewhere in today's **Federal Register**.) Once the new fee schedule is implemented and all operational adjustments are made, the Reserve Banks believe that the total costs of providing noncash collection services can be recovered.

Cash Services

Cash services that are priced by the Federal Reserve Banks include cash transportation, coin wrapping, nonstandard packaging of currency orders and deposits, and nonstandard frequency of access to cash services.

Data on priced cash services are being included to provide a complete view of Reserve Bank priced service performance. Cash transportation fee changes do not require Board approval. The staff, however, is notified when changes occur. The fees for the other priced cash services have been approved by the Director of the Division of Reserve Bank Operations and Payment Systems under delegated authority.

Table 10 presents actual 1992, estimated 1993, and projected 1994 cost recovery performance for the priced cash services.

TABLE 10.—PRO FORMA COST AND REVENUE PERFORMANCE

[$ millions]

Year	Revenue	Operating costs & imputed expenses	Special project costs recovered	Total expense [2+3]	Net income (ROE) [1 – 4]	Target ROE	Recovery rate after target ROE (percent) [1÷(4+6)]	Special project costs deferred & financed
	1	2	3	4	5	6	7	8
1992	12.9	12.6	0.0	12.6	0.3	0.1	102.0	0.0
1993 (Est)	6.2	6.3	0.0	6.3	(0.1)	0.1	97.8	0.0
1994 (Bud)	6.0	6.0	0.0	6.0	0.0	0.1	98.7	0.0

The operating loss of $0.1 million for 1993 reflects the full-year effect of the discontinuation of transportation services in the Cleveland office and the San Francisco District. By mid-year 1994, the Chicago office plans to discontinue offering registered mail shipments, which contributes to the projected recovery rate after targeted ROE of 98.7 percent for 1994.

The 1994 fees for wrapped coin, nonstandard packaging, and nonstandard access, as well as fees for other cash transportation services and registered mail fees can be obtained by contacting the individual Reserve offices.

Competitive Impact Analysis

All operational and legal changes considered by the Board that have a substantial effect on payment system participants are subject to the competitive impact analysis described in the March 1990 policy statement "The Federal Reserve in the Payments System." In this analysis, staff assesses 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 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.

The Board believes that the price and service level changes would not have a substantial effect on payments system participants and would not have a direct and material effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services. The Board recognizes that the 1994 fees proposed by the Reserve Banks result in a projected ROE that is below the target based on the 50 bank holding company model. The Board believes, however, that the Reserve Banks have demonstrated their ability to adjust to structural changes since the MCA was implemented and believes that the Reserve Banks will be able to make the appropriate adjustments in the future. The Board believes that the approach that is being recommended to set fees for the ACH, check, and noncash collection services is consistent with the approach that would be used by a private-sector firm, which would absorb the results of one-time structural changes through its retained earnings account or would borrow funds to finance capital improvements. Therefore, the Board does not believe that the 1994 fees for Federal Reserve priced services should have an adverse affect on the ability of other service providers to compete with the Reserve Banks.

By order of the Board of Governors of the Federal Reserve System, November 10, 1993.

William W. Wiles,

Secretary of the Board.

TABLE 11.—COMPARISON OF PRO FORMA BALANCE SHEETS FOR FEDERAL RESERVE PRICED SERVICES

[Millions of dollars—average for year]

	1994	1993
Short-term assets:		
Imputed reserve requirement on clearing balances	$593.6	$534.8
Investment in marketable securities	5,342.3	5,465.2

TABLE 11.—COMPARISON OF PRO FORMA BALANCE SHEETS FOR FEDERAL RESERVE PRICED SERVICES—Continued

[Millions of dollars—average for year]

	1994	1993
Receivables [1]	64.3	32.6
Materials and supplies [1]	5.5	5.4
Prepaid expenses [1]	16.1	9.3
Items in process of collection	3,198.9	3,826.4
Total short-term assets	$9,220.7	$9,873.7
Long-term assets:		
Premises [1 2]	$349.9	$359.0
Furniture and equipment [1]	183.1	201.0
Leasehold improvements and long-term prepayments [1]	32.1	49.8
Capital leases	0.6	0.0
Total long-term assets	565.6	609.8
Total assets	$9,786.4	$10,483.5
Short-term liabilities:		
Clearing balances and balances arising from early credit of uncollected items	$5,935.9	$6,652.4
Deferred credit items	3,198.9	3,174.1
Short-term debt [3]	85.9	47.3
Total short-term liabilities	$9,220.7	$9,873.7
Long-term liabilities:		
Obligations under capital leases	$0.0	$0.0
Long-term debt [3]	174.1	201.8
Total long-term liabilities	174.1	201.8
Total liabilities	$9,394.8	$10,075.5
Equity [3]	391.5	408.0
Total liabilities and equity	$9,786.4	$10,483.5

Note: Details may not add to totals due to rounding.
[1] Financed through PSAF; other assets are self-financing.
[2] Includes allocations of Board of Governors' assets to priced services of $0.4 million for 1994 and $0.4 million for 1993.
[3] Imputed figures represent the source of financing for certain priced services assets.

TABLE 12.—DERIVATION OF THE 1994 PSAF

[millions of dollars]

A. Assets to be Financed [1]			
Short-term	$85.9		
Long-term [2]	565.6		$651.5
B. Weighted Average Cost:			
1. Capital Structure [3]			
Short-term Debt	13.2%		
Long-term Debt	26.7%		
Equity	60.1%		
2. Financing Rates/Costs [3]			
Short-term Debt	4.3%		
Long-term Debt	8.7%		
Pre-tax Equity [4]	12.7%		
3. Elements of Capital Costs			
Short-term Debt	$85.9	× 4.3% =	$3.7
Long-term Debt	174.1	× 8.7% =	15.2
Equity	391.5	× 12.7% =	49.7
			$68.6
C. Other Required PSAF Recoveries:			
Sales Taxes	$12.5		
Federal Deposit Insurance Assessment	19.8		
Board of Governors Expenses	2.7		$35.0
D. Total PSAF Recoveries			$103.6
As a percent of capital			15.9%
As a percent of expenses [5]			17.0%

[1] Priced service asset base is based on the direct determination of assets method.

[2] Consists of total long-term assets, including the priced portion of FRAS assets, less capital leases, which are self financing.

[3] All short-term assets are assumed to be financed by short-term debt. Of the total long-term assets, 31 percent are assumed to be financed by long-term debt and 69 percent by equity.

[4] The pre-tax rate of return on equity is based on the average after-tax rate of return on equity, adjusted by the effective tax rate to yield the pre-tax rate of return on equity for each bank holding company for each year. These data are then averaged over five years to yield the pre-tax return on equity for use in the PSAF.

[5] Systemwide 1994 budgeted priced service expenses less shipping are $608.5 million.

TABLE 13.—COMPARISON BETWEEN 1994 AND 1993 PSAF COMPONENTS

	1994	1993
A. Assets to be Financed (millions of dollars):		
Short-term	$85.9	$47.3
Long-term	565.6	609.8
Total	$651.5	$657.1
B. Cost of Capital:		
Short-term Debt Rate	4.3%	6.2%
Long-term Debt Rate	8.7%	9.0%
Pre-tax Return on Equity	12.7%	8.6%
Weighted Average Long-term Cost of Capital	11.5%	8.8%
C. Tax Rate	30.4%	29.5%
D. Capital Structure:		
Short-term Debt	13.2%	7.8%
Long-term Debt	26.7%	30.5%
Equity	60.1%	61.7%
E. Other Required PSAF Recoveries (millions of dollars)		
Sales Taxes	$12.5	$11.4
Federal Deposit Insurance Assessment	19.8	21.3
Board of Governors Expenses	2.7	2.3
F. Total PSAF:		
Required Recovery	$103.6	$91.4
As Percent of Capital	15.9%	13.9%
As Percent of Expenses	17.0%	15.1%

TABLE 14.—COMPUTATION OF CAPITAL ADEQUACY FOR FEDERAL RESERVE PRICED SERVICES

[millions of dollars]

	Assets	Risk weight	Weighted assets
Imputed reserve requirement on clearing balances	$593.6	0.0	$0.0
Investment in marketable securities	5,342.3	0.0	0.0
Receivables	64.3	0.2	12.9
Materials and supplies	5.5	1.0	5.5
Prepaid expenses	16.1	1.0	16.1
Items in process of collection	3,198.9	0.2	639.8
Premises	349.9	1.0	349.9
Furniture and equipment	183.1	1.0	183.1
Leases & long-term prepayments	32.7	1.0	32.7
Total	$9,786.4	.....	$1,239.9
Imputed Equity for 1994	$391.5	.....	.....
Capital to Risk-Weighted Assets	31.6%	.....	.....
Capital to Total Assets	4.0%	.....	.....

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(Docket No. R–0814)

Federal Reserve Bank Services

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board has approved the use of volume-based cash letter and coupon envelope fees for the Reserve Banks' noncash collection service; option pricing for the following check products offered by the Federal Reserve Bank of Minneapolis—weekday and weekend Other Fed deposits, City Fine Sort deposits, and payor bank truncation products; and option pricing for two payor bank products offered by all offices in the Richmond Federal Reserve District—Account Total and Account Total Plus products. The specific noncash collection and check fees appear in the 1994 priced services' fee schedules, which are available from the Reserve Banks.

DATES: January 3, 1994.

FOR FURTHER INFORMATION CONTACT: Florence M. Young, Assistant Director, Division of Reserve Bank Operations and Payment Systems (202/452–2745). For questions regarding noncash collection services: Michael Bermudez, Financial Services Analyst, Fiscal Agency & Definitive Securities (202/452–2216); for questions regarding check services: Edith Collis, Financial Services Analyst, Check Payments (202/452–3638). For the hearing impaired *only:* Telecommunications Device for the Deaf, Dorothea Thompson (202/452–3544).

SUPPLEMENTARY INFORMATION:

Introduction

The Monetary Control Act (MCA) requires the Federal Reserve to set fees for its payment services based on all direct and indirect costs actually incurred in providing the services plus imputed costs that would be incurred by a private-sector service provider, such as interest on debt, taxes, and return on capital. These imputed costs are called the private sector adjustment factor (PSAF). While the MCA also indicates that due regard should be given to competitive factors and the provision of an adequate level of service nationwide, it does not indicate how the Reserve Banks should accomplish these goals.

In setting fees to recover the total costs of payment services, the Reserve Banks have tended to use cost-based pricing methodologies. Because the technologies for providing payment services generally require fairly large capital expenditures and there can be increasing returns to scale associated with the provision of such services, the Reserve Banks have developed fee schedules for most services that consist of a combination of fixed and variable fees. This approach provides a means to set variable fees near the incremental costs of providing the service and to recover total costs, including the PSAF. Using such combinations of fees contributes to efficient use of services.

In some cases, the Reserve Banks have modified the cost-based methodology to reflect premium service levels and demand considerations. It is not clear, however, that the approaches that have been used by the Reserve Banks to set fees address competitive factors effectively nor result in the most economically efficient prices. The depository institutions that comprise the customer base for Federal Reserve priced services range from large money-center banks with affiliates nationwide to small credit unions and one-office rural community banks. Such widely divergent institutions have vastly different business needs. While significant attention has been given to increasing the sophistication of cost-based pricing methodologies, the Reserve Banks have generally attempted to address demand considerations through product design. For example, the mixed check deposit product was designed for smaller depository institutions for whom any amount of sorting would be burdensome. These institutions deposit a single cash letter that contains both local items and items payable in other Federal Reserve territories. The per-item fees for this product are high, relative to other check products, because the Reserve office performs all check sorting. On the other hand, check deposit products called "group sorts" have been designed to appeal to larger institutions that typically have the technological capability and capacity to perform a substantial amount of check sorting. Depositors are charged lower per-item fees or are offered later deposit deadlines for these products because Reserve offices perform less sorting and can use their check sorting equipment more efficiently.

It is difficult, however, to satisfy the needs of both high-volume and low-volume institutions solely through differing product offerings. High-volume users typically have the ability to select among a number of sources to obtain payment services, including acquiring expensive equipment to perform functions in-house or purchasing the services from a variety of suppliers. Fewer options are available to low-volume users because the costs associated with many of the alternatives are relatively high. In part, it appears that some of the differences in the alternatives available to smaller institutions reflect the higher costs associated with providing service to large numbers of institutions depositing small transaction volumes. Fee structures that do not reflect such cost differences result in competition among service providers for the low-cost customers, but not for the high-cost customers. Similar situations exist in other industries. For example, in the telecommunication area, AT&T charged that MCI eschewed high-cost, low-return services for more profitable services. AT&T also alleged that Comsat syphoned off low-cost customers.[1]

Providing services that meet the needs of low-volume customers, in particular, may require a pricing methodology that addresses the demands of both high- and low-volume users. Specifically, without high-volume customers, all of the fixed costs associated with the provision of services would have to be borne by the low-volume customers. Thus, low-volume customers would face either higher prices or lower quality services. This conclusion reflects the level of fixed costs required to provide payment services and the fact that, at low-volume levels, scale economies could not be achieved.

The distributors of natural gas face similar pricing concerns. The 1978 Natural Gas Policy Act created the possibility for industrial plants to bypass local distribution utilities by building direct connections to pipelines, gas producers, or intermediaries.[2] Without big industrial customers, however, all of the fixed costs associated with local gas distribution would be borne by the smaller industrial plants and consumers. The loss of the high-volume customers would raise the rates of low-volume commercial and residential users or would reduce the quality of their service because economies of scale could not be attained without both user groups. Thus, social costs would be higher because scale economies would not be achieved and, most likely, some pipeline capacity would remain idle. On the other hand, a volume-based pricing strategy could be used to retain high-volume customers and achieve scale economies.

Several automated clearing house (ACH) service providers that have a customer base of both low- to high-volume users offer volume-based pricing strategies. Visa U.S.A., a national service provider, offers a transaction discount of 10 percent to institutions with transactions volumes greater than 500,000 transactions per month. Deluxe ACH Services, a regional service provider, charges lower transaction fees for transaction volumes over 5 million items per month, and still lower fees for transactions in excess of 10 million items.[3] In each case the price structure is designed to meet different customers' needs for essentially the same product.

The Clearing House Interbank Payment System (CHIPS), operated by the New York Clearing House Association, allocates its total costs for operations among the participants according to usage, that is, the number of messages sent and received during the previous month. There is a minimum charge of $1,500 per month. High-volume users with over 80,000 messages a month are charged $0.13 to send a message and $0.13 to receive a message. Senders of fewer than 80,000 messages per month are charged $0.18 to $0.40, depending upon whether their messages are coded with the receiver's identification.[4]

In approving the use of volume-based pricing for the noncash collection service and for selected check products at the Federal Reserve Banks of Richmond and Minneapolis, which is discussed below, the Board requested the staff to recommend principles that

[1] Jean-Jacques Laffont and Jean Tirole, "Optimal Bypass and Cream Skimming," American Economic Review, vol. 80 (December 1990), pp. 1042–1061.

[2] Ibid., p. 1042.

[3] Woolworth/Dudley Associates, "Comparative Analysis of ACH Service Providers," April 1991.

[4] New York Clearing House Association.

would be used in the future to determine when and how volume-based pricing might be used in setting fees for Federal Reserve priced services. Following review by the Board, public comment will be requested on the proposed principles.

Discussion

Noncash Collection Service—Noncash collection volume levels began to decline rapidly after 1983, when the issuance of bearer securities was discontinued following the enactment of the Tax Equity and Fiscal Responsibility Act of 1982. Since that time, many bearer municipal securities have been "immobilized," or converted to book-entry form. Moreover, recent low interest rates have prompted many municipalities to call outstanding bonds and reissue securities in either registered or book-entry form. Largely due to the significant reduction in volume, the Reserve Banks incurred an operating loss in 1992 and project an operating loss in 1993.

To address the difficulties associated with recovering the Reserve Banks' costs in a declining market, the Reserve Banks (1) have reduced the number of noncash operating sites to four offices (Cleveland, Jacksonville, New York, and Chicago) and plan to reduce the number of offices to three by year-end 1994, and to two by year-end 1995 and (2) are adopting a modified fee structure that more effectively reflects the composition of the Reserve Banks' costs and the demand of both low- and high-volume users.

Currently, the Reserve Banks assess a variable fee for each envelope containing matured coupons that is deposited. Higher fees are generally assessed for interregional deposits than for local deposits and some Reserve offices apply separate postage and insurance charges. As is the case for other services, there are fixed and variable costs associated with processing coupon deposits. An analysis of the costs incurred in processing coupon deposits indicated that approximately 35 percent of the costs is associated with cash letter processing. Because these costs do not vary significantly across the volume of coupon envelopes received, the costs incurred in providing coupon collection services cannot be recovered effectively solely by charging variable fees. As a result, the Board approved a fee structure under which both cash letter and coupon envelope fees will be assessed. In addition, shipping expenses will be recovered through the coupon envelope fees.

Further, a wide variety of depository institutions use the noncash collection service. Implementing cash letter fees will raise the cost of using this service for institutions that deposit relatively few coupon envelopes and should reduce the cost for institutions that deposit relatively higher volumes. To address the potential cost increase for low-volume depositors and the price sensitivity of high-volume depositors, the Board approved cash letter and coupon envelope fees that vary based on the number of coupon envelopes included in a deposit. For example, for local deposits containing five or fewer coupon envelopes, the cash letter fee would be $7.50 and coupon envelope fees would be $4.25 or $4.50. For local deposits containing more than five coupon envelopes, the cash letter fee would be $15.00 with coupon envelope fees of $2.50 or $3.00. Higher coupon envelope fees would be assessed for interregional deposits. (The 1994 fee schedules with the specific fees to be assessed by each of the four offices providing noncash collection services are available from the Reserve Banks.)

The noncash collection service faces significant uncertainty due to declining volumes, a dwindling number of other service providers, and the adjustment to a more consolidated operating environment. The Board believes that implementing a combination of cash letter and coupon envelope fees, which vary based on the size of the deposit, will improve the Reserve Banks' ability to recover the costs of providing noncash collection service over the longer run.

Check Service

The Board approved the use of option pricing for the following deposit products and payor bank services—the Minneapolis office's weekday and weekend Other Fed deposits, its City Fine Sort deposits, and its payor bank truncation products and the Richmond District's Account Total and Account Total Plus payor bank services.

Traditionally, the Reserve Banks have charged the same price for a given check product, regardless of the number of items processed for an individual depository institution. As noted above, some products have been designed to appeal either to high-volume or low-volume institutions. Nevertheless, a single fee is assessed for each Federal Reserve product without regard to the number of items that are processed. Private-sector service providers frequently set prices that take into account the efficiencies that can be realized in handling high transaction volumes. Option pricing will allow the Reserve Banks to recognize these economies in the fees charged for check services.

Option pricing for deposit products and payor bank services will be structured similarly. Each depository institution will be presented with the same set of pricing options. One option will combine a relatively low cash letter fee (for deposit products) or daily minimum fee (for payor bank services) with a relatively high per-item fee. The other option will combine a relatively high cash letter or minimum fee with a relatively low per-item fee. It is expected that low-volume institutions would find the first alternative more attractive, while high-volume institutions would prefer the second option. Both options, however, will be presented to every institution, and the user will decide which option is more appropriate for the institution's business needs.

The following table demonstrates how option pricing would affect a depository institution's costs over a range of transaction volumes. In this example, Option I would consist of a $1.50 fixed fee and a $0.05 per-item fee. Option II would combine a $7.50 fixed fee with a per-item fee of $0.044. At volumes under 1,000 items, a user would face lower costs by selecting Option I. At volumes above 1,000 items, a user would incur lower charges by selecting Option II.

Number of items	Option I		Option II	
	Total cost	Unit cost	Total cost	Unit cost
100	$6.50	$0.065	$11.90	$0.119
500	26.50	0.053	29.50	0.059
1,000	51.50	0.052	51.50	0.052
2,000	101.50	0.051	95.50	0.048
10,000	501.50	0.050	447.50	0.045

The application of option pricing would be most beneficial for check products that are used by institutions of varying sizes, such as the city, RCPC, country, and Other Fed deposit options and most payor bank services. It would provide little benefit for products that were designed specifically to appeal to a single user class, such as mixed deposits.

The Board believes that option pricing is an efficient pricing methodology and that it should ultimately benefit both high- and low-volume users.

Competitive Impact Analysis

In assessing the competitive impact of implementing a volume-based pricing alternative, the staff considered whether there would be a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services and, if so, whether the effects are due to legal differences or to a dominant market position deriving from such differences. The Board believes that use of volume-based pricing in the noncash collection service and for selected check products at the Richmond and Minneapolis Reserve Banks should not adversely affect the ability of private-sector providers to compete with the Federal Reserve in providing similar services. A number of private-sector service providers use comparable pricing methodologies.

Noncash Collection Service—The Federal Reserve does not have a dominant market position in the noncash collection business although the number of service providers is diminishing. The System's efforts to reduce operating costs by consolidating processing sites and to set fees that are attractive to both high- and low-volume users is intended to provide a stabilizing presence in the market. Because there are very few competing service providers, the use of volume-based pricing should be viewed positively by institutions collecting municipal coupons.

Check Service—Although the Federal Reserve is currently a dominant provider of interterritory check collection services, the implementation of the same-day settlement regulation provides private-sector banks the right to present checks directly to payor banks and should enhance the ability of private-sector banks to compete with Federal Reserve check collection services. The Board believes that the use of volume-based pricing for selected check products by the Richmond and Minneapolis Reserve Banks will not have a direct and material adverse effect on the ability of other service providers to compete with the Federal Reserve. Permitting the Reserve Banks to implement volume-based fees should stimulate competition and lead to more efficient use of check services.

By order of the Board of Governors of the Federal Reserve System, November 10, 1993.

William W. Wiles,

Secretary of the Board.

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