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STATEMENT OF

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GENERAL GOVERNMENT DIVISION

BEFORE THE

JOINT HEARING OF THE SUBCOMMITTEE ON DOMESTIC

MONETARY POLICY AND THE SUBCOMMITTEE ON

COMMERCE, CONSUMER AND MONETARY AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

ON

FEDERAL RESERVE PRICING OF ITS CHECK

CLEARING SERVICES

Mr. Chairman and Members of the Subcommittees:

We are pleased to appear before this hearing of the Subcommittees of the House Banking and Government Operations Committees to discuss the Federal Reserve System's pricing of check clearing and related services. Our testimony takes as its starting point our May 1982 report to the Congress entitled The Federal Reserve Should Move Faster to Eliminate Subsidy of Check Clearing Operations (GGD-82-22, issued on May 7, 1982). As I believe the Subcommittees are aware, GAO is now doing work concerning some of the more recent actions taken by the Federal Reserve. At present, we are not at a point in our work where we can draw conclusions from our current effort, but our testimony does include comments on developments since May 1982, and I believe these comments are responsive to the purpose of this hearing.

This testimony is divided into three parts. First, I will summarize our conclusions and recommendations in the May 1982 report. Next, I will comment on actions the Federal Reserve has taken since then and the implications those actions have for the Congress' oversight of the Federal Reserve System. Finally, I want to offer some observations in three areas: float, the automated clearinghouse, and the net cost to the taxpayers of the Monetary Control Act of 1980 (the Act).

Before I begin the testimony proper, I want to point out we believe, as stated in our report, that in establishing a system for pricing its services, the Federal Reserve System generally made reasonable judgments in exercising the wide discretion given it by the Monetary Control Act. We recognize that pricing matters are inherently complex both from theoretical (e.g., pricing of products that share common facilities) and practical (e.g., data availability) points of view. We hope that by summarizing what has happened in the 3 years since pricing was authorized and by discussing issues that have arisen, we can help the Congress and the Federal Reserve System in dealing with those aspects of implementation of the Monetary Control Act's pricing provisions that have aroused some controversy.

SUMMARY OF OUR 1982 REPORT

The Monetary Control Act of 1980 mandated that check clearing and other services be priced and made available to all depository institutions. As part of the arrangements adopted for dealing with problems caused by eroding Federal Reserve membership, the Act sets forth the objective that over the long run prices for services should cover all direct and indirect expenses plus an adjustment (called the private sector adjustment factor). The adjustment was intended to cover the taxes and return on capital that would have to be financed if the services were provided by a private sector institution. The Act also stated that float was to be priced at the Federal funds rate. (Float is the interest-free advance that occurs when the Federal Reserve credits the reserve account of a depositing bank pursuant to published availability schedules before the funds are actually collected from the reserve account of the paying bank.) Although the Act is quite specific in identifying what is to be priced, evaluating compliance with the pricing provisions of the Act is not a simple matter due to the amount of discretion the Act gave to the Federal Reserve System. Thus, the Act required the Federal Reserve System to begin pricing its services by September 1, 1981--the first day of the 18th month after the Act was passed--but it did not say when all services had to be priced. Furthermore, the "long run" over which revenues should cover all costs was undefined, and the Federal Reserve in setting prices was also to consider competitive factors and provision for an adequate level of services nationwide.

In preparing our May 1982 report, the major criterion we used for evaluating the Federal Reserve's decisions and actions was whether the long run objective of the Act of recovering full costs was being achieved in as timely a manner as practicable. We felt this judgmental criterion was appropriate because failure to cover full costs has important implications for taxpayers (who must make up for revenue shortfalls that result from reduced Federal Reserve payments to the Treasury) and for private sector institutions that compete or would like to compete with the Federal Reserve System.

Our analysis of Federal Reserve pricing of check clearing services, float, and automated clearinghouse services as of the early spring of last year noted:

--In check clearing operations, we estimated revenue was running about \$40 to \$50 million less on an annual basis than that needed to cover all operating expenses plus the private sector adjustment factor. This shortfall was accounted for largely by a decline in volume that occurred when pricing began. In setting its initial volume the Federal Reserve assumed that check clearing volume would be at about the same level as in the previous year. However, in the 4-month period ending November 1981, the number of checks handled by the Federal Reserve declined by 7 percent and the number of checks handled that had to be sorted declined by 17 percent compared to the comparable period in 1980.

(Our estimate of the revenue shortfall for 1982 turned out to be low as the Federal Reserve reported it to be about $62 million.)

--With respect to float, by early 1982 the Federal Reserve had reduced float by operational means (principally better transportation arrangements) to a level averaging from $2.5 billion to $3.0 billion a day--a significant reduction from the level of about $4 billion per day prevailing when the Monetary Control Act of 1980 was passed. The Federal Reserve system received public comment on ways to reduce float and indicated that it could be reduced to closer to $1 billion by operational improvements and policy changes, but it had not adopted a timetable and made no commitment to a time when float would be priced. Failure to eliminate or price float at the 15 percent Federal funds rate prevailing in early 1982 was resulting in an estimated loss to the Treasury of $300 to $400 million per year, the lower figure assuming continued decreases in float due to operational improvements.

--The automated clearinghouse, priced substantially below cost to encourage commercial use of this service and to help realize economies of scale, was experiencing a revenue shortfall that we estimated to be about $5 million per year. (The actual shortfall in 1982 turned out to be about $10 million.)

In short, in early 1982 we found continuing estimated revenue shortfalls at a rate of between $350 million to $450 million per year and no policies in place designed to eliminate these shortfalls. Although the net reduction in Treasury receipts might be as much as 40 percent less than this revenue shortfall due to increased income tax collections, the shortfalls represented a substantial loss to the Treasury and a degree of subsidy that could provide the Federal Reserve with a substantial advantage over private sector competitors. Accordingly, GAO recommended that to establish a price structure for its operations that fully recovered cost as soon as practicable, the Federal Reserve System should:

--eliminate promptly the check clearing subsidy that arose from declining check processing volume and rising expense;

--establish a definite timetable for pricing float; and

--raise the price of automated clearinghouse services.

IMPLICATIONS OF FEDERAL RESERVE ACTIONS TAKEN SINCE OUR REPORT WAS PREPARED

Since our May 1982 report the Federal Reserve System has taken three major actions which are responsive to the major concerns raised in the report:

--In April 1982, while our report was in final processing, the Federal Reserve announced it would abandon what amounted to its open-ended subsidy policy for its automated clearinghouse service and committed itself to progressively recovering costs from commercial users until full cost was recovered by 1985.

--In the summer of 1982, the Federal Reserve announced a combination of improved check clearing services and higher fees that it expected would achieve the balance of costs and revenues envisioned in the Monetary Control Act. After waiting to obtain industry views, the Federal Reserve implemented this plan, with some modifications, in February, 1983.

--In March, 1983, after reducing float, on the average, to less than $2 billion per day, the Federal Reserve announced procedures to reduce or price interterritorial and holdover float. In May, 1983 it announced procedures to eliminate or price the remaining categories of float by October 1, 1983.

Thus, if the Federal Reserve does what it says it will do, the major issue we addressed in our May 1982 report--the speed with which the Federal Reserve was moving to eliminate open-ended subsidies--may now be moot. In the transition period extending from the time pricing began until October 1983, we estimate that the Federal Reserve System will have incurred a total revenue shortfall of approximately $600 million on an order of magnitude basis (about $500 million of which is accounted for by unpriced float) for check clearing and automated clearinghouse operations.

The question of whether the Federal Reserve is indeed fully pricing its services in accordance with the objective of the Monetary Control Act has now become much more closely associated with another issue, discussed but highlighted less prominently in last year's report, that is now increasing in importance. This issue concerns the nature of the price and service competition between the Federal Reserve System and private sector institutions in the check clearing process. I think it is fair to say that the significance of this matter was not fully anticipated when the Monetary Control Act was passed.

The Monetary Control Act placed the Federal Reserve System in a position that is highly unusual for a governmental entity (especially one with supervisory authority)--competing actively with private sector institutions on the basis of price and quality of service. Although competition with the private sector was implicit in the previous situation in which clearing services were available without charge to member banks, the competition was more muted. Over the past year the competition between the Federal Reserve and the private sector has intensified for shares and profits in the check clearing market, a market that still seems to be growing somewhat, but which is eventually expected to decline as electronic means of payment become more widespread.

When the Federal Reserve first began to price its check clearing services, it basically priced the services it was then performing. Not surprisingly, the Federal Reserve's market share (estimated to be about 40 percent of all checks written) fell, especially with respect to processing local checks and providing detailed sorting services. The Federal Reserve's failure to price at full costs moderated the decline in volume it experienced, but taken as a whole, the Federal Reserve actions up until the summer of 1982 had little negative impact upon two major private sector check clearing submarkets--checks of relatively high value (for which faster availability is the crucial factor) and checks of those banks that obtained services through a correspondent bank rather then the Federal Reserve System.

The change in services that the Federal Reserve System announced last summer and implemented beginning in February represented a major change in the relationship between Federal Reserve and private sector check clearing services. By accepting checks for deposit at a later time, revising its transportation network, and presenting the checks to paying banks as late as noon (in some cases 2 or 3 hours after the presentment times established by clearinghouses in Federal Reserve cities that heretofore had been followed voluntarily by the Federal Reserve) the Federal Reserve substantially improved the availability of funds on checks deposited with it for clearance. Improved Federal Reserve availability cut into the comparative advantage of some major private sector institutions. Also the financial consequences of improved Federal Reserve services were aggravated for some correspondent banks because the Federal Reserve does not pay presentment fees. Presentment fees consist principally of charges paid to paying banks by nonclearinghouse members and by members who present checks for payment outside of clearinghouse hours. In addition, the decline in short term interest rates that was occurring reduced the incentive to use more expensive private sector services to gain availability faster than that which could be obtained through the Federal Reserve System.

We pointed out in our May 1982 report that there were several options open to the Federal Reserve as it encountered a pricing environment. One option, for example, was to concentrate on becoming a clearer of last resort, providing reliable low cost service for low valued checks to all banks in the country. In this role the Federal Reserve would generally be complementing the services of private sector institutions. The option which the Federal Reserve chose--that of improving the availability schedules of its check clearing operations--caused it to become much more competitive in the submarkets also served by the private sector. We are not suggesting that the Federal Reserve has made the wrong choice. However, now that competition between the Federal Reserve and private sector institutions has become more intense, it seems appropriate to GAO that Congress review carefully the basis for this competition.

At this point as we see it Congress has three choices for dealing with this unique problem of competition between the Federal Reserve System and private sector institutions. One option is to make no changes on the assumption that the actions taken or planned by the Federal Reserve have dealt effectively with subsidy issues. The second is to specify exactly what services the Federal Reserve will provide (or, alternatively, will not provide), a task that would be very difficult in a changing environment that contains many subtle differences in service offerings. The third is to make changes in the groundrules that govern how the Federal Reserve competes with the private sector.

In evaluating which of these alternatives to follow, it would be helpful to know more definitively whether the arrangements that are now being implemented do, in fact, comply fully with the pricing objectives of the Monetary Control Act or whether they contain an element of subsidy. Work which we have underway will cast more light on this subject, but we are not now in a position to draw conclusions. There are, however, some general observations we would like to make regarding competition between the Federal Reserve and the private sector.

Rather than specifying the type and quality of services the Federal Reserve should provide, the pricing provisions of the Monetary Control Act created a situation in which market forces could determine changes in the nature of the services the Federal Reserve offers. Using what can be described as a market revenue test, the Federal Reserve can take any action it believes will improve the effectiveness or efficiency of the payments system or of the services it performs if it can get banks to cover expenses. The market revenue test by itself is not a sufficient guide for establishing the basis for competition with the private sector, for the Federal Reserve might be able to take advantage of its unique position as a government agency and underprice the private sector in situations not warranted by fundamental economic advantages. Accordingly, the Act required that the Federal Reserve apply a private sector adjustment factor to its prices (thus creating an unusual situation in which a governmental entity obtains a profit on services rendered to the public) and reduce operating budgets commensurate with actual or projected decline in services.

In our view there are legitimate questions to be addressed as to whether the guidelines that the Monetary Control Act sets forth are sufficient in the current environment for establishing a fair basis for competition with the private sector. As things stand now, the Federal Reserve System, which also has supervisory authority over banks, has a great deal of discretion in areas that can have, or can be perceived to have, a significant impact on its ability to compete with the private sector. The Federal Reserve can determine:

--how to calculate the private sector adjustment factor and other judgment matters associated with deciding the cost of resources associated with its priced activities;

--the level of resources to commit to its check clearing process;

--the level of subsidy to provide to new services or to services it determines are necessary due to competitive factors or to provide an adequate level of service nationwide;

--when to decrease the budget of any service that becomes uneconomical;

--the procedures it will follow in planning and announcing major changes in services;

--when it will accept and present checks, the services it will offer, and the prices it will charge;

--disclosure, if any, it will make of projected cost and revenue data; and

--the marketing strategy it will follow, including whether discounts should be given to certain customers.

I raise these factors at this point strictly on the basis that these all involve matters where it is important to be sure that the unusual competition between the Federal Reserve System and the private sector is as fair as possible. It may also be the case that detailed review of specific matters such as the appropriateness of certain types of presentment fees in today's environment, the impact that reserve requirements have on effective prices, and the manner in which the Federal Reserve charges for float may reveal opportunities for legislative action that can help assure equitable competition.

In short, GAO believes that it is reasonable for Congress to give attention to the groundrules with respect to how the Federal Reserve and the private sector are to compete with each other. While we do not now have recommendations to offer the Congress on how to simultaneously retain the benefits of the Federal Reserve System, continue to improve the payments network, and assure fair competition, our future work may lead to some specific recommendations.

In closing the discussion of competition I want to make two additional comments. First, since check clearing in private banks is a part of a business that is very different from a Federal Reserve bank, it is difficult to make exact comparisons between the two. I do not want to leave the impression, however, that the Federal Reserve necessarily has all of the advantages in a competitive situation. Private institutions are able to consider broader set of relationships when pricing their services to other institutions, have more experience in surviving in a competitive market, and can be selective in deciding what banks to deal with. Second, Federal Reserve actions appear to have improved the service available to many banks, and the objective of making further changes should be to assure the best possible results for an unsubsidized payment system. Actions that have the effect of subsidizing or protecting the market shares of uneconomic private services should be avoided just as much as ones that would allow the Federal Reserve to provide unwarranted subsidies or allocate resources to clearing checks in amounts that are socially wasteful.

To illustrate how pricing and competitive factors are intertwined, I think it is useful to see how things stood with respect to check clearing costs and revenues at the close of 1982. In the 4th quarter of 1982, Federal Reserve records indicate that the system spent $79.4 million on check clearing services (not including float)and collected $74.2 million in revenue. Had the system collected the revenue needed to cover costs and the private sector adjustment factor (which the Federal Reserve does not apply to contracted transportation expenses), the revenue collected in that quarter would have been $90.0 million or 21.3 percent higher than the amount actually collected.

Looking ahead to 1983, the system could count on some increase in volume due to expected increases in the number of checks written. However, even if the economy recovered, the increase in checks written would not likely exceed 5 percent and some increase in expenses would likely be associated with a volume increase. Unless productivity improvements occurred or volume actually declined, pay raises alone would raise the percentage increase in revenue needed to cover all costs (including the private sector adjustment factor) above the 21 percent figure noted in the previous paragraph. In addition, prices would have to increase substantially if float were to be priced. Unless it was reduced further by operational improvements or policy changes, pricing the $1.8 billion in float that existed at the end of 1982 would add another $36 million (at an 8% Federal funds rate) to the revenue needed by the 4th quarter of 1983. Pricing this level of float would raise the percentage increase in revenue needed for 1983 to around 70 percent.

The strategy implemented by the Federal Reserve in February was to simultaneously raise prices and improve services (at modest increases in cost) on the apparent assumption that customers would be willing to pay more for the higher quality of service. With respect to float, the Federal Reserve adopted policies which have the effect of actually pricing, as part of its basic service, only about 15 to 25 percent of the float that existed at the end of 1982. When the cost of this amount of float ($300 million to $500 million per day that is principally holdover float) is added to the cost base in October, increases in check clearing prices, if needed, should be no more than about 10 percent. The interterritory and other float that the Federal Reserve is eliminating by delaying availability of funds diminishes the overall attractiveness of check clearing services to customers, but it dampens down the increase in price that would otherwise be needed. Banks that continue to receive interterritory float under the new arrangements will, however, be charged individually for this float, but this charge will be handled as an adjustment item and not as part of the basic price of service. The amount of these charges is difficult to estimate at this time, but it could amount to about 10 percent of check clearing revenues.

The competitive impact of the Federal Reserve action is complex and cannot be definitively gauged at this point. If the volume of checks handled by the Federal Reserve increase by more than about 5 percent or so, this increase in volume would no doubt represent business diverted from the private sector.

However, even if volume does not increase that much, this may reflect price-cutting or service changes by private sector institutions rather than lack of competitive impact. Furthermore, if the new services attract checks into the Federal Reserve System at an earlier stage in the collection process, some private sector institutions could experience significant loss of business even if the total checks handled in some way by the Federal Reserve System increases only modestly.

COMMENTS ON FLOAT, AUTOMATED CLEARINGHOUSE, AND THE NET COST OF THE MONETARY CONTROL ACT

In closing, I want to make some brief observations about float, the automated clearinghouse, and the net cost of the Monetary Control Act that I hope will contribute to the Committees' deliberations.

1. Although float pricing affects the earnings that the Federal Reserve System turns over to the Treasury, the impact of float on the private banking system needs to be evaluated in terms of how monetary policy is being implemented. The interest free advance that float represents accounts at the present time for about 8 percent of the reserve balances of banks and other institutions. This advance does not, however, increase total reserve balances of all banks added together when the Federal Reserve conducts monetary policy, as it has during the recent period, by trying to restrict reserve account balances to certain ranges. To achieve a given reserve target, the Federal Reserve must offset an increase in float (which increases

reserves) by the sale of securities (which decreases reserves). The institution that receives float benefits financially from it because it obtains a larger share of a given total of bank reserves.

Reducing float by operational improvements or by being less generous in granting availability allows the Federal Reserve to increase its earnings because the system has to buy more securities (which pay interest to the Federal Reserve) to offset the decline in float. Pricing float or eliminating it are thus alternative ways of increasing Federal Reserve revenues, and the reduction in float that has occurred since the Monetary Control Act was passed has thus partly accomplished the revenue goals implicit in float pricing.

Failure to price a level of float has been an important, although now diminishing factor, in maintaining the competitive position of the Federal Reserve System. A private sector institution that credits a customer's account with funds it has not yet collected must finance the float that this creates as a cost of doing business. Until it has priced or eliminated float, the Federal Reserve will be offering a service whose quality is not fully reflected in the prices charged.

2. We were requested to comment specifically on several matters associated with the Federal Reserve's pricing of its automated clearinghouse (ACH) services. Although below cost pricing for the automated clearinghouse was justified by the Federal Reserve to encourage private sector use of a technology

which was expected to produce substantial economies of scale, we pointed out in our May 1982 report that this justification needed to be evaluated very carefully. We shared the concern of the Justice Department and three Federal agencies that the deep subsidy of the automated clearinghouse that Federal Reserve access to funds permitted could in practice discourage private investment in more efficient competing systems. We think it is significant that there is already evidence that the Federal Reserve's policy of progressively eliminating subsidy to commercial users is encouraging development of private sector alternatives.

Evaluation of the technological merits of the Federal Reserve's automated clearinghouse system in today's rapidly changing world of electronic banking was outside the scope of our review. Although commercial use of the automated clearinghouse increased rapidly from 64.5 million images in 1980 to 164.3 million in 1982, this increase was once again below earlier projections. In 1982 the U.S. Treasury still accounted for more than one half of all ACH transactions. Continued high interest rates which make float more desirable no doubt have contributed to slowing down commercial use of the ACH system, but the Federal Reserve seems now to be taking a more realistic approach to forecasting ACH volume. The goal of 2 billion items by 1986 has been dropped and the percentage increase in total volume expected for 1983, 16 percent, is less than that which occurred in 1982.

One reason for our concern with the automated clearinghouse system is that expenses for the system continue to increase rather sharply. From 1980 to 1982 total use of the ACH increased by about 65 percent--but so did expenses. The full cost of an ACH transaction (including a 16 percent PSAF) was thus still approximately 8 cents in 1982, although in real terms this represents a modest reduction in cost due to inflation. For 1983, once again, the 16 percent increase in volume that is projected is associated with an increase in expenses of about 15 percent. We think the discipline of having to recover costs is an appropriate guide for the Federal Reserve to follow in deciding the nature of future resource commitments to the ACH system.

3. The net impact of the Monetary Control Act on the payment each year by the Federal Reserve to Treasury was given considerable attention by the Congress during its deliberation on the legislation. It was expected that the revenue obtained from pricing services and float would offset the loss of revenues resulting from the Act's reduced reserve requirements.

Assessing the net costs of the Monetary Control Act is a difficult task because many different factors must be evaluated--for example, changes in inflation and deposit growth from what was assumed when the Act was passed, estimates of the erosion in membership that would have occurred in the absence of the Monetary Control Act, changes in interest rates, and shifts in the composition of deposits that have accompanied changes in deposit regulations. Although our May 1982 report did not assess the net revenue impact of the Monetary Control Act, it did point out that the Federal Reserve reconciled delay in recovering the full cost of float with revenue expectations by pointing to higher than anticipated bank reserve balances. We suggested that if the net revenue impact of the Monetary Control Act were evaluated in real rather than nominal dollars, the revenue cushion used to justify refraining from pricing float would have been much less. In the time available to prepare for this hearing we have not attempted to update the discussion on the net revenue impact of the Monetary Control Act.

Mr. Chairman, this completes my prepared statement; I will be pleased to respond to any questions that you might have.