FEDERAL RESERVE SYSTEM
[Docket No. R-0986]
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 1998 of $108.5 million, as well as the fee schedules for Federal Reserve priced services and electronic connections. These actions were taken in accordance with the requirements of the Monetary Control Act of 1980, which requires that, over the long run, fees for Federal Reserve priced services be established on the basis of all direct and indirect costs, including the PSAF.

DATES: The PSAF and the fee schedules become effective on January 2, 1998.

FOR FURTHER INFORMATION CONTACT: For questions regarding the Private Sector Adjustment Factor: Martha Stallard, Senior Accountant, (202/452-3758), Division of Reserve Bank Operations and Payment Systems; For questions regarding the fee schedules: Jeff Yeganeh, Senior Financial Services Analyst, Check Payments, (202/728-5801); Riaz Ahmed, Financial Services Analyst, ACH Payments, (202/452-3959); Stephen Cohen, Financial Services Analyst, Funds Transfer and Book-Entry Securities Services, (202/452-3480); Anne Paulin, Senior Information Technology Analyst (electronic connections), (202/452-2560); Michael Bermudez, Financial Services Analyst, Noncash Collection Service, (202/452-2216); or Kate Connor, Senior Financial Services Analyst, Special Cash Services, (202/452-3917), Division of Reserve Bank Operations and Payment Systems. For users of Telecommunications Device for the Deaf (TDD) only, please contact Diane Jenkins(202/452-3544).

Copies of the 1998 fee schedules for the check, automated clearing house (ACH), funds transfer and net settlement, book-entry securities, noncash collection, and special cash services, as well as electronic connections to Reserve Banks, are available from the Reserve Banks.

SUPPLEMENTARY INFORMATION:

I. PRIVATE SECTOR ADJUSTMENT FACTOR

A. Overview--The Board has approved a 1998 PSAF for Federal Reserve priced services of $108.5 million. This amount represents an increase of $7.0 million, or 6.9 percent, from the PSAF of $101.5 million targeted for 1997.

As required by the Monetary Control Act (MCA) (12 U.S.C. 248a), 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 consolidated financial data for 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 with short-term liabilities; long-term assets are assumed to be financed with a combination of long-term debt and equity derived from the BHC model.

Imputed capital costs are determined by applying related interest rates and rates of return on equity (ROE) from the BHC model. The long-term debt and equity rates are based on BHCs in the model for 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 these capital costs, as well as 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 Banks to settle transactions.

B. Asset Base--The total estimated value of Federal Reserve assets to be used in providing priced services in 1998 is reflected in Table A-1. Table A-2 shows that the assets assumed to be financed through debt and equity are projected to total $616.3 million. This represents a net decrease of $7.2 million, or 1.2 percent, from 1997 assets of $623.5 million, as shown in Table A-3. This decrease results from lower priced asset levels of Federal Reserve Automation Services (FRAS), slightly offset by an increase in the Reserve Banks’ priced asset base.

C. Cost of Capital, Taxes, and Other Imputed Costs--Table A-3 also shows the financing and tax rates and the other required PSAF recoveries proposed for 1998 and compares the 1998 rates with the rates used for developing the PSAF for 1997. The pre-tax ROE rate increased from 19.1 percent for 1997 to 22.4 percent for 1998. The increase is a result of stronger 1996 BHC financial performance included in the 1998 BHC model, relative to the 1991 BHC financial performance used in the 1997 BHC model.

The increase in the FDIC insurance assessment from $2.0 million in 1997 to $2.6 million in 1998, as shown in Table A-3, is attributable to higher clearing balance levels.

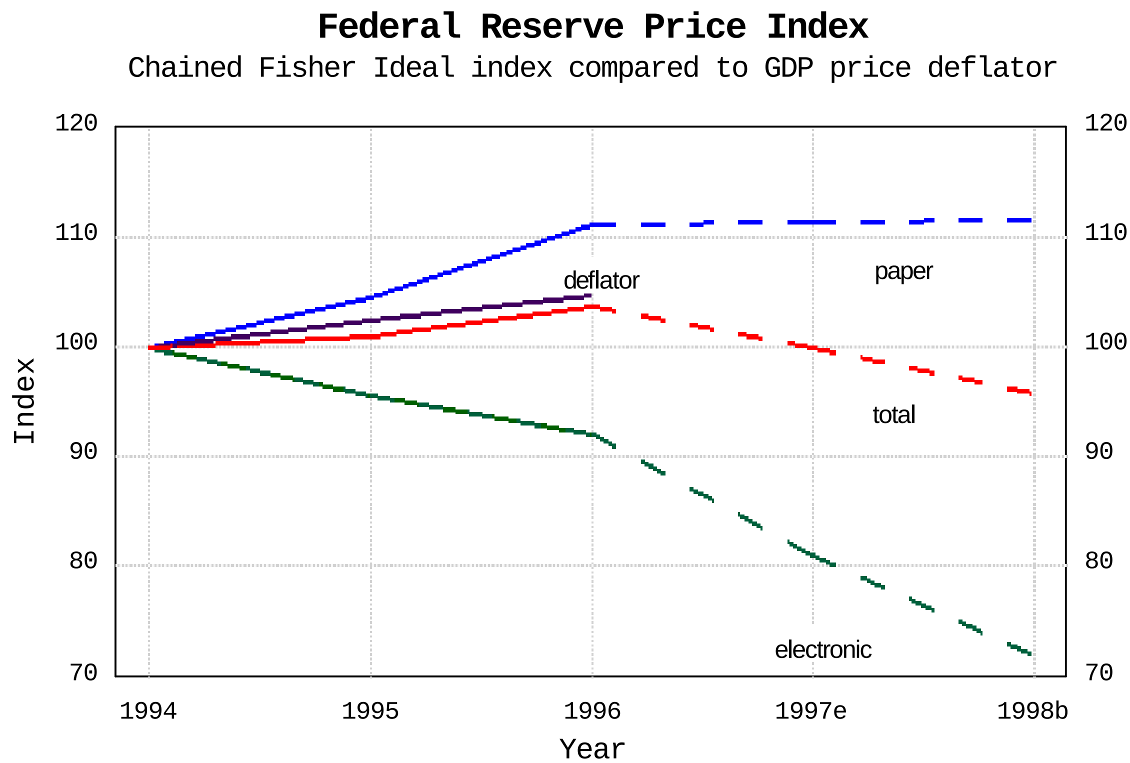
D. Capital Adequacy--As shown in Table A-4, the amount of capital imputed for the proposed 1998 PSAF totals 30.0 percent of risk-weighted assets and 3.1 percent of total assets. The capital to risk-weighted asset ratio well exceeds the 8 percent guideline for adequately capitalized state member banks and BHCs. The capital to total asset ratio exceeds the 3 percent guideline for adequately capitalized institutions that are rated composite 1 under the CAMELS rating system.

II. PRICED SERVICES

A. Overview--Overall, prices for Reserve Bank services are projected to decline by approximately 4.0 percent in 1998, reflecting slight price increases in paper-based payment services (i.e., check, noncash collection, and special cash services) of 0.2 percent and price decreases in electronic payment services (i.e., payor bank check services, automated clearing house, funds transfer, and book-entry securities services) of 11.4 percent.[1] This compares to an overall price decline of 3.7 percent in 1997, reflecting price increases in paper-based payment services of 0.1 percent and price decreases in electronic payment services of 11.9 percent. Figure 1 provides a graphical comparison of the Federal Reserve's price index for priced services to the gross domestic product price deflator.

[1] These estimates are based on a chained Fisher Ideal price index. This index was not adjusted for quality changes in Federal Reserve priced services. Because the index was not adjusted for quality and due to lack of data in electronic check services, the index may overstate the price effects of paper-based services.

Figure 1



Broken line indicates estimated and budgeted data.

The significant decline in fees for electronic payment services reflects, in large part, the efficiencies associated with the transition to a consolidated automation environment and centralized electronic payment processing applications. Beginning in 1992, the Reserve Banks' automation-processing functions were consolidated into three sites, greatly reducing the cost of providing electronic payment services. When transition to the consolidated environment is completed in early 1998, the priced services will have recovered $129.8 million in transition costs associated with the automation consolidation project (special project costs) and $11.7 million in deferred financing costs, while achieving $41.8 million in savings for depository institutions from lower fees for electronic payment services.[2] In addition to electronic payment fee reductions, the

[2] Under an existing Board policy, the Reserve Banks may defer and finance development costs if the development costs would have a material effect on unit costs, provided that a conservative time

special project initiative has dramatically improved the Reserve Banks' disaster recovery and information security capabilities, increased the System's responsiveness to change, and enhanced the central bank's management of payment system risk.

The Federal Reserve Banks continue to meet the provisions of the Monetary Control Act, which require the Federal Reserve to recover, over the long run, all direct and indirect costs, including imputed costs and profits, of priced services. Over the period 1987 through 1996, the Reserve Banks recovered 99.9 percent of their total costs of providing priced services, including special project costs that were budgeted for recovery and targeted after-tax profits, that is, return on equity (ROE).[3,4] Because the revenue from the Reserve Banks' priced

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period is set for full cost recovery and a financing factor is applied to the deferred portion of development costs. The 1997 and 1998 financing rates of 15.1 and 16.9 percent, respectively, are the weighted-average imputed costs of the Federal Reserve's long-term debt and equity. This methodology is similar to the approach a private firm would use in financing such costs. Starting in 1992, the Reserve Banks deferred and financed special project costs for automation consolidation that were associated with employee retention and severance and excess mainframe computer capacity. Each priced service will recover fully its portion of these deferred expenses and accumulated finance charges within five years after the completion of the transition to the consolidated automation environment.

[3] The Monetary Control Act requires that, over the long run, the Federal Reserve set fees for priced services 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 earned had the services been provided 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 targeted ROE is the budgeted after-tax profit that the Federal Reserve would have earned had it been a private business firm. The targeted ROE is derived from the BHC model based on consolidated financial data for each of the last five years.

[4] In setting fees, certain costs or adjustments to costs are treated differently in the pro forma income statement for priced services that is published in the Board's Annual Report and the Board's annual Federal Register notice on priced service fees. In order to compare total expenses in the pro forma income statement with total expenses in Table 1 in this notice, the amortization of the initial retirement plan over funding required by Statement of Financial Accounting Standards No. 87, and the deferred costs of automation consolidation must be deducted from the pro forma expenses. These adjustments are detailed in Note 10 to the pro forma income statement in the Annual Report. Under the procedures used to prepare the pro forma income statement, the Reserve Banks recovered 100.7 percent of priced

services recovers imputed costs that are not actually incurred and imputed profits, the Federal Reserve's provision of priced services has consistently had a positive effect on the level of earnings transferred by the Federal Reserve to the Treasury. Over the past 10 years, priced services revenue has exceeded operating costs by $886 million. Table 1 summarizes the cost and revenue performance for priced services since 1987.

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services expenses, including targeted ROE, for the period 1987 to 1996.

Table 1[5]

Pro Forma Cost and Revenue Performance (a) ($ millions)								
Year	1 Revenue (b)	2 Operating Costs & Imputed Expenses (c)	3 Special Project Costs Recovered (d)	4 Total Expense (e) [2+3]	5 Net Income (ROE) [1-4]	6 Target ROE (f)	7 Recovery Rate after Target ROE (percent) [1/(4+6)]	8 Special Project Costs Deferred & Financed (g)
1987	649.7	598.2	0.0	598.2	51.5	29.3	103.5	0.0
1988	667.7	641.1	3.2	644.3	23.4	32.7	98.6	0.0
1989	718.6	692.1	4.6	696.7	21.9	32.9	98.5	0.0
1990	746.5	698.1	2.8	700.9	45.6	33.6	101.6	0.0
1991	750.2	710.0	1.6	711.6	38.6	32.5	100.8	0.0
1992	760.8	731.0	11.2	742.2	18.6	26.0	99.0	1.6
1993	774.5	722.4	27.1	749.5	25.0	24.9	100.0	12.5
1994	767.2	748.3	8.8	757.1	10.1	34.6	96.9	33.9
1995	765.2	724.0	19.8	743.8	21.4	31.5	98.7	36.3
1996	815.9	736.4	26.8	763.2	52.7	36.7	102.0	30.1
1997 (Est)	814.7	732.9	27.7	760.7	54.1	45.8	101.0	21.4
1998 (Bud)	816.1	733.8	23.2	757.1	59.0	52.3	100.8	1.6

(a) The revenues and expenses for 1987 through 1993 include the definitive securities safekeeping service, which was discontinued in 1993.
(b) Includes net income on clearing balances.
(c) Imputed expenses include interest on debt, taxes, FDIC insurance, and the cost of float. Credits for prepaid pension costs under SFAS 87 and the charges for post-retirement benefits in accordance with SFAS 106 are included beginning in 1993.
(d) Special project costs include research and development expenses for evaluating a different computer processing platform for electronic payments from 1988 through 1990, check image project costs from 1988 through 1993, and automation consolidation costs from 1992 through 1998.
(e) To reconcile total expenses to the pro forma income statement in the Board's Annual Report, sum the operating expenses, imputed costs, and imputed income taxes reflected in the pro forma income statement and subtract the adjustments shown in Note 10 to the pro forma income statement.
(f) Targeted ROE is based on the ROE included in the private sector adjustment factor and has been adjusted for taxes, which are included in column 2. Targeted ROE has not been adjusted to reflect automation consolidation special project costs deferred and financed.
(g) Totals are cumulative and include financing costs.

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[5] Calculations on this table and subsequent pro forma cost and revenue tables may be affected by rounding.

In 1996, Reserve Bank priced service revenue yielded an after-tax net income of $52.7 million, compared with a targeted return on equity of $36.7 million. The Reserve Banks recovered 102.0 percent of total expenses, including automation consolidation special project costs budgeted for recovery and targeted ROE, compared to a targeted recovery rate of 100.7 percent. The Reserve Banks' better-than-targeted performance was due primarily to higher-than-expected volumes in the check, funds transfer, book-entry securities transfer, and noncash collection services, resulting in higher net revenue. In particular, the volume of checks collected by the Reserve Banks in 1996 exceeded 1995 levels, thereby reversing the downward trend of 1994 and 1995 that resulted from the new same-day settlement rule.

In 1997, the Reserve Banks estimate that priced services revenue will yield a net income of $54.1 million, compared with a targeted return on equity of $45.8 million. The 1997 recovery rate is estimated to be 101.0 percent of the costs of providing priced services, including imputed expenses, automation consolidation special project costs budgeted for recovery, and targeted ROE, compared with a targeted recovery rate of 100.5 percent.[6] Approximately $27.7 million in automation consolidation special project costs will be recovered in 1997, leaving $21.4 million in accumulated costs to be financed and recovered in future years.

In 1998, the Reserve Banks project to recover 100.8 percent of total expenses, including automation consolidation special project costs budgeted for recovery and targeted ROE. The approved 1998 fees for priced services are projected to yield a net income of $59.0 million, compared with a targeted ROE of $52.3 million. Approximately $23.2 million of automation consolidation special project expenses will be recovered, leaving an accumulated balance of $1.6 million to be recovered in future years.[7]

Table 2 presents an overview of the projected 1997, estimated 1997, and projected 1998 cost recovery performance for individual priced services.

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[6] Through August 1997, the Reserve Banks recovered 101.1 percent of total priced services expenses, including automation consolidation special project costs and targeted ROE.

[7] New charges for the automation consolidation special project are expected to end in 1998 with the completion of the transition to the centralized application environment. The $1.6 million balance must be recovered by the book-entry securities service.

Table 2

Priced Service	1997 Budget	1997 Estimate	1998 Budget
All Services	**100.5%**	**101.0%**	**100.8%**
Check	100.2%	100.0%	100.5%
ACH	100.5%	105.3%	100.5%
Funds Transfer	102.7%	104.3%	103.1%
Book-Entry	100.0%	100.1%	100.0%
Noncash	103.8%	116.0%	125.9%
Special Cash	102.3%	99.7%	102.4%

The Reserve Banks have indicated that the most significant risk associated with the approved fee schedules is the uncertainty of 1998 check volume estimates given the current competitive environment and the effects of continuing bank consolidations.

B. Check--Table 3 presents the actual 1996, estimated 1997, and projected 1998 cost recovery performance for the check service.

Table 3

Check Pro Forma Cost and Revenue Performance ($ millions)

Year	1 Revenue	2 Operating Costs & Imputed Expenses	3 Special Project Costs Recovered	4 Total Expense [2+3]	5 Net Income (ROE) [1-4]	6 Target ROE	7 Recovery Rate after Target ROE (percent) [1/(4+6)]	8 Special Project Costs Deferred & Financed
1996	610.6	578.1	6.5	584.6	26.0	28.0	99.7	10.5
1997 (Est)	620.5	577.7	7.5	585.2	35.3	35.3	100.0	7.5
1998 (Bud)	636.4	584.2	8.4	592.6	43.8	40.9	100.5	0.0

1. 1996 Performance--The check service recovered 99.7 percent of total expenses in 1996, including automation consolidation special project costs budgeted for recovery and targeted ROE. The volume of checks collected increased 0.1 percent from 1995 levels, as volume losses associated with bank consolidations and the implementation of the same-day settlement regulation stabilized. Returned check volume increased 6.0 percent in 1996 compared to 1995 levels.

2. <u>1997 Performance</u>--Through August 1997, the check service recovered 99.6 percent of total expenses, including automation consolidation special project costs budgeted for recovery and targeted ROE. The Reserve Banks estimate that they will recover 100.0 percent of their costs for the full year, compared with the targeted 1997 recovery rate of 100.2 percent.

Also through August 1997, the volume of checks collected has decreased by 0.2 percent while the volume of returned checks processed has increased by 5.1 percent from 1996 levels. The Reserve Banks now estimate that the volume of checks collected during 1997 will decrease by 0.7 percent from 1996 levels, reflecting a 2.1 percent increase in processed volume and a 15.5 percent decrease in fine sort volume. Returned check volume is estimated to increase by 3.9 percent.

3. <u>1998 Issues</u>--The total number of interbank checks will likely be flat or decline in 1998 as banks merge due to interstate branch banking and as banks continue to consolidate their payment processing operations. In addition, other service providers in the interbank check processing market are expected to compete aggressively for check collection and returned check volume. Despite the challenges posed by this environment, the Reserve Banks project modest volume increases in 1998. Total forward check collection volume is projected to increase by 1.0 percent in 1998, reflecting a projected increase of 3.2 percent in processed volume and a decrease of 12.9 percent in fine sort volume. Returned check volume is projected to increase by 0.3 percent.

The Reserve Banks continue to take steps that are expected to improve the efficiency of their check processing operations in 1998. For example, on October 24, 1997, the Federal Reserve Bank of Boston closed its Regional Check Processing Center in Lewiston, Maine, and consolidated those operations at its head office. In addition, on October 27, 1997, the System's Interdistrict Transportation System (ITS) moved one of its five airport hubs from Cleveland, Ohio, to Cincinnati, Ohio. This move allows Reserve Banks to improve deposit deadlines and funds availability for many depositors. The Reserve Banks are also reviewing whether additional changes to the Federal Reserve's infrastructure would improve efficiency and are assessing the business case for a uniform software application to process check adjustment cases.

The Reserve Banks will continue to promote electronic check products that are designed to increase operating efficiency and improve the speed of the check collection system. For example, the Reserve Banks are expanding the number of offices that offer and the number of deposit products that use electronic cash letters (ECLs).[8] Further, in early 1998, the Reserve Banks are planning to begin sending ECLs for all cash letters exchanged among Federal Reserve offices. The expanded use of ECLs is expected to improve the efficiency of the Reserve Banks' operations and may ultimately contribute to efficiencies in paying banks' operations by reducing rejects and minimizing adjustments. The Reserve Banks are also investigating the feasibility of offering standard electronic check products Systemwide during 1998 to meet the demand for greater uniformity in Reserve Bank check products.

Further, the Reserve Banks are expanding their image-enhanced check products, which have the potential to increase the use of electronic check presentment and to reduce the risks associated with it. In 1998, an increasing number of Reserve Bank offices will be able to offer image services.

4. 1998 Fees--The Reserve Banks are continuing the steps taken over the last several years to set check fees to reflect more accurately the fixed and variable costs associated with providing check services. The Reserve Banks' fees and product offerings are intended to encourage the use of electronics and to improve the efficiency of the check collection mechanism. Table 4 summarizes key check service fees.

[8] Electronic cash letters (ECLs) are deposits that are accompanied by an electronic listing of all checks included in the deposits.

Table 4

Selected Check Fees		
Products	1997 Price ranges	1998 Price ranges
Items:	(per item)	(per item)
Forward processed		
City	$0.003 to 0.080	$0.002 to 0.080
RCPC	$0.004 to 0.090	$0.003 to 0.180
Fine sort		
City	$0.003 to 0.012	$0.002 to 0.013
RCPC	$0.003 to 0.017	$0.003 to 0.018
Qualified returned checks		
City	$0.065 to 1.110	$0.065 to 1.110
RCPC	$0.068 to 1.560	$0.068 to 1.560
Raw returned checks		
City	$0.580 to 4.000	$0.900 to 5.000
RCPC	$0.650 to 4.000	$0.900 to 5.000
Cash letters:	(per cash letter)	(per cash letter)
Forward processed	$1.50 to 9.00	$1.50 to 9.00
Forward fine-sort package	$2.50 to 13.00	$3.00 to 14.00
Returned checks: raw & qualified	$1.50 to 7.00	$1.75 to 12.00
Payor bank services:	Min Per item	Min Per item
MICR information	$5-$30 $0.001-0.0050	$5-$30 $0.001-0.0060
Electronic presentment	$3-$14 $0.001-0.0045	$2-$14 $0.001-0.0045
Truncation	$3-$25 $0.010-0.0170	$2-$25 $0.004-0.0170

Overall, 1998 fees for paper-based check products are expected to increase by about 0.2 percent on a volume-weighted basis, compared with January 1997 prices.[9] Paper-based check products include both forward and return check products and are expected to account for about 80 percent of total check service revenues in 1998.

Fees for payor bank services will decline, on average, by 0.1 percent. These fees include the Reserve Banks' fees for electronic check presentment and payor bank information products, as well as for image products. Payor bank services revenue is expected to increase by 12.9 percent, however, primarily due to more widespread acceptance of electronic check presentment and image-enhanced check products. It is expected that payor bank services will account for about 10 percent of the check service's total revenues in 1998. Other operating and imputed revenues account for the remaining 10 percent of check service revenues.

The Reserve Banks project that the check service will recover 100.5 percent of total costs in 1998, including targeted ROE and all of the remaining $8.4 million in automation

[9] This volume-weighted fee increase includes an increase in ITS fees of approximately 10.0 percent on weekday routes. The Reserve Banks are continuing to investigate the possible implementation of an alternative fee structure for the ITS.

consolidation special project costs. Total check service operating costs plus imputed expenses are projected to increase by $6.5 million, or 1.1 percent above estimated 1997 expenses. Total check service revenues are expected to increase by $15.9 million, or 2.6 percent above estimated 1997 revenues.

The Reserve Banks view the effect of interstate branch banking and the growing competition in the interbank check collection market as potential risk factors in their volume projections. Nevertheless, despite this increasingly competitive market environment, the Reserve Banks believe that their projected 1998 volume levels are attainable.

C. Automated Clearing House (ACH)--Table 5 presents the actual 1996, estimated 1997, and projected 1998 cost recovery performance for the commercial ACH service.

Table 5

ACH Pro Forma Cost and Revenue Performance
($ millions)

Year	1 Revenue	2 Operating Costs & Imputed Expenses	3 Special Project Costs Recovered	4 Total Expense [2+3]	5 Net Income (ROE) [1-4]	6 Target ROE	7 Recovery Rate after Target ROE (percent) [1/(4+6)]	8 Special Project Costs Deferred & Financed
1996	79.8	63.7	9.2	72.9	6.9	3.6	104.3	16.6
1997 (Est)	72.5	53.7	11.1	64.8	7.6	4.0	105.3	10.8
1998 (Bud)	68.5	52.1	12.0	64.1	4.4	4.0	100.5	0.0

1. 1996 Performance--Revenues from the ACH service recovered 104.3 percent of total expenses, including automation consolidation special project costs budgeted for recovery and targeted ROE, during 1996. This over recovery was attributable primarily to lower-than-expected data processing costs resulting from the efficiencies realized with the new Fed ACH application software.

2. 1997 Performance--Through August 1997, the ACH service recovered 106.4 percent of total expenses, including automation consolidation special project costs budgeted for recovery and targeted ROE. For the full year, Reserve Banks estimate that they will recover 105.3 percent of total expenses, compared with the targeted 1997 recovery rate of 100.5 percent. The over recovery is attributed to lower-than-budgeted ACH overhead costs, lower-than-expected data processing costs resulting from efficiency improvements to the Fed ACH application software, and the revised pension credit.

On May 1, 1997, the Reserve Banks implemented a volume-based fee schedule for the ACH service. As a result, the cost to depository institutions to originate ACH transactions declined by an average of 17 percent and the cost to receive ACH transactions declined by 10 percent. In addition, effective October 1, 1997, the Reserve Banks changed the regular billing deposit deadline for ACH items from 8:00 p.m. to 1:00 a.m. Eastern Time. The extension of the deadline reduces fees paid by customers depositing items between 8:00 p.m. and 1:00 a.m. Eastern Time by approximately $0.6 million in 1997.

Through August 1997, commercial ACH volume has increased 12.7 percent over the 1996 level. For the full year, the Reserve Banks expect commercial volume to increase 11.3 percent, compared to the 18.3 percent increase originally projected. The revised projection reflects the effects of consolidation in the banking industry and some increased use of private-sector ACH processors.

3. <u>1998 Issues</u>--The Fed ACH processing environment continues to allow the Reserve Banks to improve operating efficiencies. In 1998, the Reserve Banks plan to expand their efforts to educate depository institutions and end users about the benefits of the ACH. The Reserve Banks believe that Federal Reserve and industry marketing efforts will spur commercial ACH volume growth. As a result, the projected commercial volume growth rate for 1998 is 15.4 percent.

4. <u>1998 Fees</u>--The Reserve Banks are reducing several fees effective January 2, 1998. These changes support the System’s strategic direction to encourage the migration from a paper-based to an electronic payments system and recognize the technological and operational changes implemented during the past year.

Table 6

Fee Category	Current Fee	Approved 1998 Fee
Items Originated in Small Files[10]	$0.009	$0.008
Items Originated in Large Files[13]	$0.007	$0.006
Items Received	$0.009	$0.008
Addenda(Originated & Received)	$0.003	$0.002
Telephone Advice	$15.00	Eliminate

[10] Small files contain less than 2,500 items; large files contain 2,500 items or more.

As Table 6 indicates, the Reserve Banks will reduce origination and receipt item fees by one mill, which will decrease the total fee for each item by as much as 12.5 percent. In addition, the Reserve Banks are reducing the fee for addenda records by one mill or one-third. The reduction in the addenda record fee is intended to promote the use of the ACH for financial electronic data interchange. Finally, the telephone advice fee, which is assessed to customers seeking settlement information about processed files, is being eliminated because depository institutions are using other delivery mechanisms to obtain this information.

All customers, including customers of the private-sector ACH operators, will benefit from the approved 1998 price changes. Based on the 1998 volume projections, these changes will reduce fees to depository institutions by $6.6 million, compared to the Federal Reserve’s current ACH fees.

During 1998, the Reserve Banks plan to explore options to reduce fees further and to reduce paper processing. Board staff anticipates that the Director of the Board’s Division of Reserve Bank Operations and Payment Systems, under delegated authority, will be requested to approve further modifications to the ACH fee schedule during 1998.

The Reserve Banks project that the ACH service will recover 100.5 percent of its 1998 costs, including targeted ROE, and all of the remaining $12.0 million in automation consolidation special project costs.

D. <u>Funds Transfer and Net Settlement</u>--Table 7 presents the actual 1996, estimated 1997, and projected 1998 cost recovery performance for the funds transfer and net settlement service.

Table 7

Funds Transfer Pro Forma Cost and Revenue Performance
($ millions)

Year	1 Revenue	2 Operating Costs & Imputed Expenses	3 Special Project Costs Recovered	4 Total Expense [2+3]	5 Net Income (ROE) [1-4]	6 Target ROE	7 Recovery Rate after Target ROE (percent) [1/(4+6)]	8 Special Project Costs Deferred & Financed
1996	97.6	69.9	9.3	79.2	18.4	3.8	117.6	0.0
1997 (Est)	95.3	78.9	7.4	86.3	9.1	5.1	104.3	(0.5)
1998 (Bud)	88.8	79.7	0.3	79.9	8.9	6.2	103.1	0.0

1. <u>1996 Performance</u>--For 1996, the funds transfer and net settlement service recovered 117.6 percent of total expenses,

including automation consolidation special project costs budgeted for recovery and targeted ROE. Funds transfer origination and receipt volume increased 9.1 percent over the 1995 level, compared to a budgeted increase of 2.1 percent.

2. <u>1997 Performance</u>--Through August 1997, the funds transfer and net settlement service recovered 106.5 percent of total expenses, including automation consolidation special project costs budgeted for recovery and targeted ROE. For full-year 1997, the Reserve Banks estimate that the funds transfer service will recover 104.3 percent of total expenses, compared to a targeted recovery rate of 102.7 percent. The Reserve Banks now estimate that operating costs will be lower than the original budget estimates due to the efficiencies realized from processing funds transfers in a centralized processing environment, a decrease in allocated overhead costs, and an increase in the estimated 1997 pension credit.

Through August 1997, funds transfer volume has increased 7.7 percent relative to the same period in 1996. For the full year, the Reserve Banks expect volume to increase 4.3 percent, compared to the 4.2 percent increase originally projected. Board staff believes the Reserve Banks' 1997 volume estimate is conservative based on year-to-date experience.

3. <u>1998 Issues</u>--Funds transfer origination and receipt volume is expected to increase 3.8 percent over 1997 estimated levels, lower than the ten-year average annual growth rate of 4.7 percent. The Reserve Banks consider the strong volume growth of the last two years to be unsustainable due to the effects of interstate branch banking and continuing bank merger activity. Board staff believes the anticipated 1998 volume effects of such merger activity may be overstated.

Total costs are expected to decrease 6.1 percent from the 1997 estimate due in part to lower special project costs allocated to the service as well as to operating efficiencies associated with automation consolidation. The Fedwire funds transfer operating hours will be expanded from a ten-hour to an eighteen-hour day beginning in December 1997. The Reserve Banks expect that this expansion of operating hours will not materially increase the service's costs.

4. <u>1998 Fees</u>--The projection of lower total expenses combined with continued volume growth will enable the Reserve Banks to reduce the funds transfer fee by 11.1 percent from $0.45 to $0.40 in 1998. Additionally, the Reserve Banks will increase the off-line transaction surcharge from $10.00 to $12.00 to reflect more fully the costs of processing off-line transfers and to encourage higher volume off-line customers to install electronic connections. Based on 1998 volume projections, these fee changes will reduce fees to depository institutions by approximately $9.0 million, compared to the Federal Reserve's

current funds transfer fees. All net settlement fees will remain unchanged.

Reserve Banks project that 1998 revenues will recover 103.1 percent of total funds transfer expenses, including targeted ROE and all automation consolidation special project costs.

E. Book-Entry Securities[11]--Table 8 presents the actual 1996, estimated 1997, and projected 1998 cost recovery performance for the book-entry securities service.[12]

Table 8

Book-Entry Securities Pro Forma Cost and Revenue Performance ($ millions)

Year	1 Revenue	2 Operating Costs & Imputed Expenses	3 Special Project Costs Recovered	4 Total Expense [2+3]	5 Net Income (ROE) [1-4]	6 Target ROE	7 Recovery Rate after Target ROE (percent) [1/(4+6)]	8 Special Project Costs Deferred & Financed
1996	17.1	14.5	1.7	16.2	0.9	0.8	100.9	3.0
1997 (Est)	16.8	14.4	1.5	15.8	1.0	0.9	100.1	3.6
1998 (Bud)	16.3	12.9	2.5	15.3	1.0	1.0	100.0	1.6

1. 1996 Performance--The book-entry securities service recovered 100.9 percent of total expenses in 1996, including automation consolidation special project costs budgeted for recovery and targeted ROE. Origination volume increased 11.8 percent above the 1995 level, compared to a budgeted decrease of 0.4 percent. This substantial volume increase is partially the result of increased securities movements associated with mergers, and higher-than-expected mortgage refinancing activity, which in turn affects activity in the mortgage-backed securities market.

2. 1997 Performance--Through August 1997, the book-entry securities service recovered 102.4 percent of total

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[11] Includes purchase and sale activity.

[12] The Reserve Banks provide securities transfer services for securities issued by the U.S. Treasury, federal government agencies, government sponsored enterprises, and certain international institutions. The priced component of this service, reflected in this memorandum, consists of the revenues, expenses, and volumes associated with the transfer of all non-Treasury securities. For Treasury securities, the Reserve Banks act as fiscal agents for the Treasury Department, which assesses fees for those transfer services.

expenses, including automation consolidation special project costs budgeted for recovery and targeted ROE. For the full-year 1997, the Reserve Banks estimate that revenues will recover 100.1 percent of total costs, compared to a targeted recovery rate of 100.0 percent.

Through August 1997, book-entry securities volume declined 1 percent, compared to the same period in 1996. For the full year, the Reserve Banks estimate that transfer volume will decline 3.3 percent, which is consistent with the budgeted target.

3. 1998 Issues--The Reserve Banks expect book-entry securities transfer origination volume to decline 0.8 percent in 1998 from the 1997 estimated level. This volume projection reflects the potential effect of Participants Trust Company's (PTC) expansion of its mortgage-backed securities business to include Fedwire-eligible securities issued by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. PTC's service expansion is currently expected to occur by late 1998 and, depending on the timing of the implementation, may not have a material effect on 1998 book-entry securities volume.

Book-entry service revenue is expected to decline 2.4 percent in 1998 from the 1997 estimate as both account maintenance and transaction revenues decrease.[13] Total expenses are projected to decrease 3.1 percent in 1998 versus the 1997 estimate. Centralized and local data processing costs are expected to decrease by almost $1 million compared to the 1997 estimate reflecting the benefits from the transition to the centralized application environment.

4. 1998 Fees--The Reserve Banks are retaining 1997 fees in 1998. The Reserve Banks project that the book-entry securities service will recover 100.0 percent of costs, including targeted ROE and $2.5 million in automation consolidation special project costs.

F. Electronic Connections--The Reserve Banks charge fees for the electronic connections used by depository institutions to access priced services and allocate the cost and revenue associated with electronic access to the various priced services. The Reserve Banks are retaining the current 1997 electronic access fee schedule in 1998 with the addition of a new connection fee for Link Encrypted Dial connections.

Currently, Link Encrypted Dial connections are assessed the same standard fee as that used for Receive and Send Dial

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[13] The decrease in account maintenance revenue is associated with a 1997 decision to waive certain joint custody account maintenance fees during the Reserve Banks conversion to the National Book-Entry System.

connections. This $75 per month fee does not reflect fully the costs to install, configure, and maintain the unique hardware equipment required by Link Encrypted Dial connections. Accordingly, the Reserve Banks are establishing a new connection fee of $200 per month for Link Encrypted Dial connections. Only twelve of the approximately 12,000 current connections would be affected by this change.

In addition, the Reserve Banks plan to change their policy for ownership of the encryption boards used by depository institutions with dial and multi-drop connections. These encryption boards are currently purchased and owned by the depository institutions. With the replacement of the encryption boards beginning in the second half of 1998 to enhance the security of the Federal Reserve’s communications network, the Reserve Banks plan to purchase and assume ownership of these boards. This approach is consistent with Reserve Bank ownership of other equipment at depository institutions that is required for electronic connections to the Federal Reserve, specifically link encryptors and signaling equipment. Reserve Bank ownership should improve management of the security of the network and facilitate the implementation of an all-electronic key distribution system. This change in policy may affect future-year electronic connection fees, as priced services must recover depreciation costs associated with the new encryption boards.

G. <u>Noncash Collection</u>--Table 9 presents the actual 1996, estimated 1997, and projected 1998 cost recovery performance for the noncash collection service.

Table 9

Noncash Collection Pro Forma Cost and Revenue Performance
($ millions)

Year	1 Revenue	2 Operating Costs & Imputed Expenses	3 Special Project Costs Recovered	4 Total Expense [2+3]	5 Net Income (ROE) [1-4]	6 Target ROE	7 Recovery Rate after Target ROE (percent) [1/(4+6)]	8 Special Project Costs Deferred & Financed
1996	5.4	5.0	0.0	5.0	0.4	0.2	102.4	0.3
1997 (Est)	4.5	3.3	0.3	3.6	0.8	0.2	116.0	0.0
1998 (Bud)	3.4	2.5	0.0	2.5	0.9	0.2	125.9	0.0

1. <u>1996 Performance</u>--The noncash collection service recovered 102.4 percent of total expenses, including automation consolidation special project costs budgeted for recovery and targeted ROE, compared to a target of 100.0 percent. Volume

increased 34.2 percent over 1995 levels, compared to the budgeted increase of 22.5 percent. This volume increase was attributable to the withdrawal of other service providers from this business. Effective cost containment measures enabled the Reserve Banks to recover fully all service costs, including targeted ROE, for the first time since 1990.

2. 1997 Performance--Through August 1997, the noncash collection service recovered 118.5 percent of total expenses including automation consolidation special project costs budgeted for recovery and targeted ROE. For the year, the Reserve Banks now estimate that the noncash collection service will recover 116.0 percent of total costs, including automation consolidation special project costs budgeted for recovery and targeted ROE, compared with the targeted full-year recovery rate of 103.8 percent. The higher recovery rate reflects aggressive cost-containment and recognized efficiency gains from the centralization to one office, the Jacksonville Branch of the Federal Reserve Bank of Atlanta. Noncash collection volume continues its long-term contraction and all of the former national providers, except the Depository Trust Company (DTC), have withdrawn from providing noncash collection services.[14] The Reserve Banks estimate that 1997 volume will decline by 17.6 percent from 1996 levels, slightly less than the 19.6 percent decline originally budgeted; estimated 1997 volume is less than 20 percent of the peak volume processed in 1985.

3. 1998 Issues--The Reserve Banks project that 1998 volume will decline 20 percent from estimated 1997 levels. This decline generally reflects the decline in total noncash collection volume, rather than a shift in volume from the Federal Reserve to other service providers. The centralization of the noncash collection service in one office will enable the Reserve Banks to improve the cost effectiveness of this service in a declining market.

4. 1998 Fees--Centralization of the noncash service in one Reserve Bank office eliminates the need to distinguish between local and out-of-region items; therefore, the Reserve Banks are eliminating the out-of-region fees in 1998 and retaining other fees at their current levels, effectively reducing the price of collecting noncash collection items previously categorized as out-of-region. The Reserve Banks project that 1998 revenue will recover 125.9 percent of total

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[14] The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) imposed a tax disadvantage to the holding of bearer securities, which has resulted in the virtual elimination of new issues. Following the enactment of TEFRA, many bearer municipal securities were "immobilized" in depositories, such as DTC, further reducing the demand for noncash collection services.

costs, including targeted return on equity. While the projected 1998 recovery rate is high, if achieved the service's ten-year recovery rate will be 95.5 percent. Given the focus of the Monetary Control Act and the Board's pricing principles on long-run cost recovery, the Board believes the 1988 fees are reasonable.

H. Special Cash Services--Priced special cash services represent a very small portion (approximately 1.0 percent) of overall cash services provided by the Reserve Banks to depository institutions. Special cash services include cash transportation, coin wrapping, and nonstandard packaging of currency orders and deposits.

Table 10 presents the actual 1996, estimated 1997, and projected 1998 cost recovery performance for the special cash services.

Table 10

Cash Pro Forma Cost and Revenue Performance
($ millions)

Year	1 Revenue	2 Operating Costs & Imputed Expenses	3 Special Project Costs Recovered	4 Total Expense [2+3]	5 Net Income (ROE) [1-4]	6 Target ROE	7 Recovery Rate after Target ROE (percent) [1/(4+6)]	8 Special Project Costs Deferred & Financed
1996	5.4	5.3	0.0	5.3	0.1	0.2	97.5	0.0
1997 (Est)	5.1	4.9	0.0	4.9	0.2	0.3	99.7	0.0
1998 (Bud)	2.7	2.5	0.0	2.5	0.1	0.1	102.4	0.0

1. 1996 Performance--The special cash services recovered 97.5 percent of total expenses, including targeted ROE, in 1996. Costs were higher than budgeted and priced volumes were lower than budgeted in certain offices.

2. 1997 Performance--Through August 1997, the special cash services recovered 102.6 percent of total expenses, including targeted ROE. For full-year 1997, the Reserve Banks estimate that special cash services will recover 99.7 percent of total expenses, compared to a targeted recovery rate of 102.3 percent. Priced volumes are lower than budgeted in certain offices.

3. 1998 Issues--Projected revenue is expected to decrease by approximately 45 percent due to plans to discontinue special cash services at some Reserve Bank offices in 1998, and the reclassification of cash access as a nonpriced service. Several Reserve Bank offices currently assess fees for access to

cash services above the free standard level; this nonstandard access has been treated as a priced service.[15] In light of the upcoming implementation of the uniform cash access policy for all Reserve Banks, Board staff has determined that, due to the governmental nature of this service, the costs and income associated with nonstandard access more appropriately should be treated as a nonpriced service.[16]

4. 1998 Fees--For 1998, the Reserve Banks project that special cash services will recover 102.4 percent of costs, including targeted ROE. The Detroit office is increasing its nonstandard packaging fee from $5.00 to $12.00 per order or deposit to reflect more accurately the cost of providing this service.

III. 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, Board 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.

Assuming the Reserve Banks' volume and cost projections are accurate, the proposed fees are set to provide the Federal Reserve a return on equity at least equal to that earned by large bank holding companies during the past five years. Moreover, the recommended 1998 fee schedules enable the Reserve Banks to continue to recover all actual and imputed costs of providing priced services over the long run (i.e., 1989 through 1998); these proposed fees also provide for projected full cost recovery in 1998. Therefore, the Board believes the recommended 1998 Reserve Bank price and service levels will not adversely affect

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[15] Priced cash access services are currently offered by the Detroit Branch and all Ninth and Twelfth District offices.

[16] In April 1996, the Board approved a new cash access policy for the Reserve Banks that becomes effective on May 4, 1998. The policy provides for a base level of free currency access to all depository institutions, but restricts the number of offices served and the frequency of access. Depository institutions that meet minimum volume thresholds will be able to obtain more frequent free access. Fees will be charged for additional access beyond the free level.

the ability of other service providers to compete effectively with the Reserve Banks in providing similar services.

Table A-1
Comparison of Pro Forma Balance Sheets
for Federal Reserve Priced Services
(millions of dollars--average for year)

	1998		1997	
Short-term assets				
Imputed reserve requirement on clearing balances	$ 750.4		$ 545.7	
Investment in marketable securities	6,753.5		4,911.3	
Receivables [1]	69.0		64.3	
Materials and supplies [1]	4.3		11.6	
Prepaid expenses [1]	14.1		14.6	
Items in process of collection	2,922.8		2,548.2	
Total short-term assets		$ 10,514.1		$ 8,095.7
Long-term assets				
Premises [1] [2]	$ 360.4		348.0	
Furniture and equipment [1]	145.2		167.0	
Leasehold improvements and long-term prepayments [1]	23.3		18.0	
Capital leases	---		0.7	
Total long-term assets		528.9		533.7
Total assets		$ 11,043.0		$ 8,629.4
Short-term liabilities				
Clearing balances and balances arising from early credit of uncollected items	$7,503.9		$5,457.0	
Deferred credit items	2,922.8		2,548.2	
Short-term debt [3]	87.4		90.5	
Total short-term liabilities		$ 10,514.1		$ 8,095.7
Long-term liabilities				
Obligations under capital leases	$ ---		$ 0.7	
Long-term debt [3]	185.1		180.5	
Total long-term liabilities		185.1		181.2
Total liabilities		$ 10,699.2		$ 8,276.9
Equity [3]		343.8		352.5
Total liabilities and equity		$ 11,043.0		$ 8,629.4

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 $0.5 million for 1998 and 1997.

[3] Imputed figures represent the source of financing for certain priced services assets.

Table A-2
Derivation of the 1998 PSAF
(millions of dollars)

A. Assets to be Financed [1]				
Short-term		$ 87.4		
Long-term [2]		528.9		
			$616.3	
B. Weighted Average Cost				
1. Capital Structure [3]				
Short-term debt		14.2%		
Long-term debt		30.0%		
Equity		55.8%		
2. Financing Rates/Costs [3]				
Short-term debt		5.1%		
Long-term debt		6.8%		
Pre-tax equity [4]		22.4%		
3. Elements of Capital Costs				
Short-term debt	$ 87.4 x	5.1% =	$ 4.5	
Long-term debt	185.1 x	6.8% =	12.5	
Equity	343.8 x	22.4% =	77.0	
				94.0
C. Other Required PSAF Recoveries				
Sales taxes		$ 9.1		
Federal Deposit Insurance assessment		2.6		
Board of Governors expenses		2.8		
				$ 14.5
D. Total PSAF Recoveries				$108.5
As a percent of capital				17.6%
As a percent of expenses [5]				18.1%

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[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 self financing capital leases.

[3] All short-term assets are assumed to be financed with short-term debt. Of the total long-term assets, 35% are assumed to be financed with long-term debt and 65% with 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 1998 budgeted priced service expenses less shipping are $598.1 million.

Table A-3
Comparison between 1998 and 1997 PSAF Components

		1998	1997
A.	Assets to be Financed (millions of dollars)		
	Short-term	$ 87.4	$ 90.5
	Long-term	528.9	533.0
	Total	$616.3	$623.5
B.	Cost of Capital		
	Short-term Debt Rate	5.1%	5.2%
	Long-term Debt Rate	6.8%	7.1%
	Pre-tax Return on Equity	22.4%	19.1%
	Weighted Average Long-term Cost of Capital	16.9%	15.1%
C.	Tax Rate	32.1%	32.1%
D.	Capital Structure		
	Short-term Debt	14.2%	14.5%
	Long-term Debt	30.0%	29.0%
	Equity	55.8%	56.5%
E.	Other Required PSAF Recoveries (millions of dollars)		
	Sales Taxes	$ 9.1	$ 11.6
	Federal Deposit Insurance Assessment	2.6	2.0
	Board of Governors Expenses	2.8	2.9
F.	Total PSAF		
	Required Recovery	$108.5	$ 101.5
	As Percent of Capital	17.6%	16.3%
	As Percent of Expenses	18.1%	16.6%

Table A-4
Computation of Capital Adequacy
for Federal Reserve Priced Services
(millions of dollars)

	Assets	Risk Weight	Weighted Assets
Imputed reserve requirement on clearing balances	$ 750.4	0.0	$ 0.0
Investment in marketable securities	6,753.5	0.0	0.0
Receivables	69.0	0.2	13.8
Materials and supplies	4.3	1.0	4.3
Prepaid expenses	14.1	1.0	14.1
Items in process of collection	2,922.8	0.2	584.6
Premises	360.4	1.0	360.4
Furniture and equipment	145.2	1.0	145.2
Leases & long-term prepayments	23.3	1.0	23.3
Total	$11,043.0		$1,145.7

Imputed Equity for 1996	$343.8
Capital to Risk-Weighted Assets	30.0%
Capital to Total Assets	3.1%

By order of the Board of Governors of the Federal Reserve System, November 5, 1997.

Jennifer J. Johnson,
Deputy Secretary of the Board.