Federal Reserve Banks

The Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 paved the way for interstate branch banking upon its 1997 implementation; it thus has significant implications for the account relationships between the Federal Reserve Banks and depository institutions. In 1996, Federal Reserve staff members conducted a series of interviews with selected depository institutions to anticipate the new account relationships that would best meet the organizational and business needs of the banking industry and the Federal Reserve as interstate branching develops. Through the interview process, the Federal Reserve devised an account model that would facilitate a single debtor–creditor relationship between the Federal Reserve and any depository institution while offering the flexible information benefits of a distributed account structure.

For a given institution, the new model provides a single (master) account, held at one Reserve Bank, where all credits and debits arising from financial transactions with the Federal Reserve would be settled and through which reserve and risk management activities would be conducted. Optional subaccounts could be used to define subsets of financial transaction information. The subaccounts could be used by depository institutions to segregate financial information by geographic region, operational function, or other criteria. Thus, an institution could centralize all financial information or could segregate information on financial transactions based on its own organizational structure.

The single-account model was approved in April and will be available in January 1998. Special transitional arrangements will allow for the temporary operation of multiple accounts. During 1996 the Federal Reserve held 10,077 accounts for financial institutions, a 0.8 percent increase over 1995.

Also in 1996, the Federal Reserve Banks completed significant milestones in their plan to transfer mainframe computer operations to the System's three consolidated data centers, managed by the Federal Reserve Automation Services (FRAS):

- Fully converted to the new centralized automated clearinghouse application (Fed ACH)
- Moved the Automated Standard Application for Payments system, which supports federal grant payments, to the central application processing environment
- Transfered applications in eleven Districts to shared processing environments (the remaining Reserve Bank, Kansas City, is scheduled to move to a shared environment in the first quarter of 1997)
- Converted four Reserve Banks to the new centralized book-entry securities application, the National Book-Entry System (the eight other Banks will convert to it by the first quarter of 1998)
- Scheduled the new Statistical Analysis and Reporting application for Systemwide implementation beginning in 1997.

In other activity, The Federal Reserve Banks essentially completed the deployment of all elements of Fednet, the new telecommunications network. Fednet provides a consistent level of service to all points in the Federal Reserve System and improves on the reliability, security, and disaster recovery capabilities of the previous system. The Federal Reserve Bank of New York, the last of the Reserve Banks to convert to the new network, plans to complete the conversion of depository institutions to Fednet in 1998.

The Reserve Banks began the development of a new version of Fedline software, which for the first time would operate under the Microsoft Windows operating system. Fedline provides the interface to Federal Reserve applications for many depository institutions. Fedline for Windows is scheduled to be available for implementation by depository institutions in 1998.

The remainder of this chapter details the 1996 results in Federal Reserve Bank priced services, currency and coin operations, and fiscal agency services, and reports on examinations, income and expenses, holding of securities and loans, and major construction activity.

Developments in Federal Reserve Priced Services

The Monetary Control Act of 1980 requires the Federal Reserve to establish fees that, over the long run, recover all the direct and indirect costs of providing services to depository institutions, as well as the imputed costs, such as the income taxes that would have been paid and the pretax return on equity that would have been earned had the services been provided by a private firm. These imputed costs are collectively referred to as the private sector adjustment factor (PSAF).[1] Over the past ten years, the Federal Reserve System has recovered 100.7 percent of its priced services costs, including the PSAF.

Overall, 1996 fees charged for priced services increased approximately 2.1 percent over the 1995 levels. This rise is the net result of several changes in fees: increases for forward collection check products, reductions for ACH

1. The imputed costs that are part of the PSAF are interest on debt, return on equity, income and sales taxes, and assessments for deposit insurance from the Federal Deposit Insurance Corporation. In addition, assets and personnel costs of the Board of Governors that are directly related to priced services are allocated to the Reserve Banks' priced services. In the pro forma statements at the end of this chapter, expenses of the Board of Governors are included in operating expenses, and assets of the Board are part of long-term assets.

Activity in Federal Reserve Priced Services, 1996, 1995, and 1994

Thousands of items except as noted

Service	1996	1995	1994	Percentage change	
				1995–96	1994–95
Commercial checks	15,486,833	15,465,209	16,479,161	.1	–6.2
Funds transfers	84,871	77,742	73,611	9.2	5.6
Securities transfers	4,125	3,689	**3,693**	11.8	**–.1**
Commercial ACH	**2,372,108**	**2,046,086**	**1,736,863**	**15.9**	17.8
Noncash collection	1,069	838	643	27.6	30.3
Cash transportation	**36**	**61**	**94**	**–41.0**	**–35.1**

NOTE. Amounts in bold are restatements due to a change in definition or to correct previously reported errors.

Activity in *commercial checks* is defined as the total number of commercial checks collected, including both processed and fine-sort items; in *funds transfers* and *securities transfers,* the number of transactions originated on line and off line; in *ACH,* the total number of commercial items processed; in *noncash collection,* the number of items on which fees are assessed; in *cash transportation,* the number of registered mail shipments and FRB-arranged armored carrier stops.

transactions, increases for ACH account servicing and non-automated products, and no change for funds transfers, book-entry securities, and electronic connections.

The revenue from priced services in 1996 was $787.2 million, other income was $28.7 million, and costs were $789.3 million, resulting in net revenue of $26.6 million and a recovery rate of 103.4 percent of costs, including the PSAF.[2] In 1995 the System's revenue was $0.4 million more than total costs, resulting in a recovery rate of 100.1 percent, including the PSAF but before the cumulative effect of a change in accounting principle. The change in accounting resulted in a net loss of $18.9 million and a recovery rate of 97.6 percent.

Check Collection

Federal Reserve Bank operating expenses and imputed costs for commercial check services in 1996 totaled $570.7 million. Revenue from check operations totaled $588.1 million, and other income amounted to $22.5 million, resulting in income before income taxes of $39.9 million.

The Reserve Banks handled 15.5 billion checks, about the same number as in 1995. The volume of checks deposited in fine-sort deposit products, requiring the depositing bank to presort items by paying bank, declined 11.9 percent, compared with a 16.5 percent decrease in 1995. The volume of checks deposited that required processing by Federal Reserve Banks increased 2.8 percent.

In preparation for the 1997 implementation of interstate banking, the Federal Reserve Banks introduced the Nationwide City Sort product, their first national check product with uniform pricing. It permits collecting banks to make a single deposit of checks drawn on city institutions across the country. In addition, one District began to offer a companion product for checks drawn on institutions located in regional check processing availability zones.

To enhance the efficiency of the check collection system, the Reserve Banks continued to expand the use of electronics in check processing. During 1996, 9.3 percent (approximately 1.4 billion) of all checks presented to paying banks were presented electronically, an increase of nearly 40 percent over the 1995 level. Depository institutions also continued to expand their use of electronic information products to provide timely cash-management information to their corporate customers. Also, by year-end 1996, all Federal Reserve offices offered depository institutions the ability to make all adjustment requests electronically. Reserve Banks began to accept electronic adjustment requests from institutions within their territories in 1995.

The Reserve Banks also continued to expand their offerings of check image capture and storage products to support paying banks' use of electronic check products. At least one office in each of the Philadelphia, Atlanta, Chicago, St. Louis, Kansas City, and San Francisco Districts introduced image products during the year. The Cleveland, Minneapolis, and Dallas Banks introduced similar products in 1995.

In October 1996 the New York Bank closed the Jericho Regional Check

2. See the pro forma statements at the end of this chapter. *Other income* is the revenue from investment of clearing balances net of earnings credits, an amount known as net income on clearing balances. *Total cost* is the sum of operating expenses, imputed costs (interest on debt, interest on float, sales taxes, and the Federal Deposit Insurance Corporation assessment), imputed income taxes, and the targeted return on equity. *Net revenue* is revenue plus net income on clearing balances minus total cost.

Processing Center (RCPC) and consolidated check processing operations at its East Rutherford (N.J.) Operations Center. In addition, the Bank consolidated the processing of all adjustment requests at the Utica RCPC.

Funds Transfer and Net Settlement

Federal Reserve Bank operating expenses and imputed costs for Fedwire funds transfer and net settlement services totaled $71.1 million. Revenue from Fedwire and net settlement operations totaled $94.7 million, and other income amounted to $2.9 million, resulting in income before income taxes of $26.4 million.

Funds Transfer

The number of Fedwire funds transfers originated increased 9.2 percent, to 84.9 million—82.6 million value (monetary) transfers and 2.3 million nonvalue messages. The higher volume is due largely to sharply increased mutual fund activity, aggressive marketing of cash management services by depository institutions, and, to a lesser extent, increased mortgage activity and securities-related settlement payments. Fees charged for Fedwire transfers remained unchanged from 1995 fees.

In October 1996 the Board approved a December 8, 1997, effective date to open the Fedwire funds transfer service at 12:30 a.m. eastern time. Previously, the Board determined that expanding the Fedwire funds transfer service to eighteen hours per day, from the current ten hours per day, could be useful to the private sector in reducing settlement risk in the foreign exchange markets and eliminating an operational barrier to potentially important innovations in privately provided payment and settlement services.

Also during 1996, 475 of the approximately 8,400 on-line depository institutions began receiving funds transfers in the new expanded message format. All on-line institutions must be able to receive transfers in the new format by June 1997 and to send transfers in the new format by December 1997. The expanded format will have several benefits:

- Reduce manual interventions in the transfer process
- Eliminate the need to truncate payment-related information when forwarding through Fedwire payment orders that were received via other large-value transfer systems
- Allow additional information about the originator and beneficiary of a transfer to be included in the transfer message, as required by the Bank Secrecy Act rules adopted by the Department of the Treasury.

Net Settlement

The Federal Reserve provides net settlement services to approximately 170 local private-sector clearing and settlement arrangements and to four nationwide arrangements. These arrangements enable participants to settle their net positions either via Fedwire funds transfers using special settlement accounts at Federal Reserve Banks or via accounting entries, which are posted to participants' Federal Reserve accounts by Federal Reserve Banks.

Two of the national arrangements, the Clearing House Interbank Payments System (CHIPS) and the Participants Trust Company (PTC), process and net large-dollar transactions, CHIPS for interbank funds transfers and PTC for the settlement of mortgage-backed securities transactions. The two other national arrangements, Visa ACH and the National Clearing House Association, process and net small-dollar transactions—Visa for automated clearinghouse transactions and National Clearing House for check payments. The majority of local clearing arrangements are check clearinghouses.

Book-Entry Securities

Federal Reserve Bank operating expenses and imputed costs for book-entry securities transfer services totaled $16.2 million. Revenue from book-entry securities operations totaled $16.6 million, and other income amounted to $0.5 million, resulting in income before income taxes of $0.9 million. The Federal Reserve Banks processed 4.1 million transfers of government agency securities on the Fedwire book-entry securities transfer system during the year, an 11.8 percent increase over the 1995 level.[3] Fees charged for book-entry securities transfers remained unchanged from 1995.

On January 2, 1996, a firm closing time of 3:15 p.m. eastern time for the origination of securities transfers and 3:30 p.m. eastern time for reversals became effective. These closing times were implemented to reduce market uncertainty about the final closing time due to ad hoc closing hour extensions. These extensions are needed at times to accommodate significant operational problems at depository institutions or at the Federal Reserve Banks. In 1996, participants requested 62 percent fewer extensions, and the duration of extensions fell 53 percent.

Also in 1996, four Federal Reserve Banks converted their Fedwire securities transfer applications to the new centralized application known as the National Book-Entry System. The remaining Federal Reserve Banks are scheduled to convert to the new application by early 1998.

Automated Clearinghouse

Federal Reserve Bank operating expenses and imputed costs for automated clearinghouse (ACH) services totaled $63.7 million. Revenue from ACH operations totaled $77.4 million, and other income amounted to $2.4 million, resulting in income before income taxes of $16.2 million. The Reserve Banks processed 2.4 billion commercial ACH transactions during the year, an increase of 15.9 percent over 1995 volume levels. In October the Reserve Banks combined the interregional and intraregional transaction fees (representing a 16.7 percent reduction for interregional transactions) and reduced the presort deposit fee by 10 percent.

During 1996 the Reserve Banks completed their conversion to the new consolidated Fed ACH software, which is installed at FRAS. The software processes ACH transactions on a flow basis and gives customers more deposit and delivery options. Customers can trace ACH transactions or files of transactions electronically, check the status of a file in process, and obtain limited information from the Federal Reserve's database on other ACH participants. Many of these new features will be available in 1997.

The consolidated processing environment has cut processing costs, enabling

3. The revenues, expenses, and volumes reflected here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions, such as the World Bank. The Fedwire securities transfer service also provides custody, transfer, and settlement services for securities of the U.S. Treasury. The Reserve Banks act as fiscal agents when they transfer Treasury securities, and the Treasury Department assesses fees for the services. See the section on fiscal agency services in this chapter for more details.

the Reserve Banks to reduce transaction fees. It also has enabled the Reserve Banks to eliminate the interregional, presort, and local deposit deadlines. Additional changes to the ACH fee schedule that will be implemented during 1997 will fully reflect the processing efficiencies of the Fed ACH environment.

Noncash Collection

Federal Reserve Bank operating expenses and imputed costs for noncash collection services totaled $4.9 million. Revenue from noncash operations totaled $5.2 million, and other income amounted to $0.2 million, resulting in income before income taxes of $0.5 million. The number of noncash collection items (maturing coupons and bonds) processed by the Reserve Banks increased 27.5 percent, to more than 1 million items. In 1996 the Reserve Banks implemented a national fee schedule for the noncash collection service.

Two Federal Reserve sites process noncash items—the Cleveland Bank and the Jacksonville Branch of the Atlanta Bank. In 1996 the New York Reserve Bank stopped presenting noncash items to members of the New York Clearing House; the Chicago Reserve Bank continued to present noncash items through the Chicago Clearing House.

Cash Services

Federal Reserve Bank operating expenses and imputed costs for cash services totaled $5.2 million. Revenue from cash operations totaled $5.2 million, and other income amounted to $0.2 million, resulting in income before income taxes of $0.2 million. Special priced cash services include cash transportation, coin wrapping services, and the provision of nonstandard currency packaging and nonstandard frequency of access to services.

Float

Federal Reserve float increased in 1996 to a daily average of $413.4 million; it was $338.8 million in 1995. The Federal Reserve recovers the cost of float associated with priced services through fees for those services.

Developments in Currency and Coin

The Federal Reserve continued to work closely with Treasury and other agencies to deter the counterfeiting and laundering of U.S. currency. In March the Federal Reserve began distributing the new Series 1996 $100 note, the first note since the 1920s to be totally redesigned. The Series 1996 note has several new features—an enlarged portrait, color-shifting ink, a watermark, concentric fine lines, and a universal Federal Reserve seal. The distribution of the Series 1996 $50 note is scheduled for l997.

The Federal Reserve's cost to print new currency in 1996 was $403 million. Treasury's Bureau of Engraving and Printing produced 9.8 billion Federal Reserve notes in 1996 and charged the Federal Reserve $40 per thousand notes. During 1996, 13 percent of the notes produced were the new Series 1996 $100 note, 45 percent were the $1 denomination, and the remaining 42 percent were the $2 through $50 denominations.

Reserve Bank operating expenses for processing and storing currency and coin, including priced cash services, totaled $279 million. The Federal Reserve supplies currency and coin to the public through approximately 9,500 depository institutions throughout the United States. The value of currency and coin in circulation increased 9 percent in 1996 and exceeded $440 billion by year-end. During 1996, the Reserve Banks received more than 23.7 billion Federal Reserve notes in deposits from depository institutions and paid more than 24.3 billion Federal Reserve notes to depository institutions.

The Federal Reserve Banks continued converting their currency processing operations to the Banknote Processing Systems (BPS) 3000. Before a recent upgrade, the equipment was referred to as ISS 3000 machines. At the end of 1996, 126 of the BPS 3000 machines were in use at the Reserve Banks. The Federal Reserve plans to install a total of 128 processors at the Reserve Banks and to complete the conversion in 1997.

In April the Board approved a new cash access policy, to be effective in May 1998, that provides greater consistency in Reserve Bank cash service levels. It establishes a base level of currency access to all depository institutions at no charge 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. Additional access, beyond the free service level, will be priced.

Developments in Fiscal Agency and Government Depository Services

The Federal Reserve Act provides that, when required by the Secretary of the Treasury, Federal Reserve Banks will

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 1996, 1995, and 1994

Thousands of dollars

Agency and service	1996	1995	1994
DEPARTMENT OF THE TREASURY			
Bureau of the Public Debt			
Savings bonds	78,765.8	80,934.6	86,216.0
Treasury Direct	26,788.8	30,117.4	23,865.3
Commercial book entry	27,009.0	27,705.9	22,950.5
Marketable Treasury issues	22,349.9	22,830.3	19,813.4
Definitive securities and Treasury coupons	3,498.5	3,860.6	3,924.2
Total	158,502.0	165,448.8	156,769.4
Financial Management Service			
Treasury tax and loan and Treasury general account	38,828.2	35,749.3	34,487.1
Government check processing	22,604.1	24,347.4	22,998.9
Automated clearinghouse	20,557.0	22,238.0	24,502.0
Government agency deposits	3,366.1	3,823.5	4,602.2
Fedwire funds transfers	455.3	357.9	416.9
Other services	17,346.3	16,376.7	13,842.9
Total	103,157.1	102,892.8	100,850.0
Other			
Total	3,554.6	4,017.5	3,545.7
Total, Treasury	265,213.6	272,359.1	261,165.1
OTHER FEDERAL AGENCIES			
Securities services	18,788.8	18,547.2	15,282.7
Food coupons	25,287.6	24,251.4	22,653.9
Postal money orders	5,722.9	5,467.8	5,486.3
Total, other agencies	49,799.3	48,266.4	43,422.9
Total	**315,012.9**	**320,625.5**	**304,588.0**

act as "fiscal agents" and "depositories" of the United States. As fiscal agents for the Department of the Treasury, Reserve Banks provide debt-related services, such as issuing, servicing, and redeeming marketable Treasury securities and U.S. savings bonds, and processing secondary market transfers initiated by depository institutions. As depositories, Reserve Banks collect and disburse funds on behalf of the federal government. The Reserve Banks also provide fiscal agency services on behalf of several domestic and international government agencies.

In October 1996 a new fiscal agency policy was adopted to clarify the Reserve Banks' unique statutory relationship with the Treasury and other government entities. The policy identifies guidelines for managing a request or directive for new services (without competitive bidding) from a government agency; outlines the criteria for determining whether to respond to a competitive procurement request from a government agency for financial services; establishes uniform and consistent practices for cost accounting, reporting, and billing for fiscal and depository services on a full-cost or other appropriate basis; and defines the terms and conditions for providing services to government agencies.

In 1996 the total cost of providing fiscal agency and depository services to Treasury amounted to $265.2 million. In addition, the Reserve Banks provide services to other government agencies; the cost of providing services to other government agencies was $49.8 million in 1996.

Fiscal Agency Securities Services

The Federal Reserve Banks handle marketable Treasury securities and savings bonds and monitor collateral pledged to the federal government by depository institutions.

Marketable Treasury Securities

Reserve Bank operating expenses for activities related to marketable Treasury securities amounted to $52.6 million. The Reserve Banks processed more than 445,000 commercial tenders for government securities in Treasury auctions. In 1996 the volume of commercial tenders decreased 26.2 percent from 1995 volume levels. Commercial tender processing was consolidated at the New York, Chicago, and San Francisco Banks in 1996.

The Reserve Banks operate two book-entry securities systems for the custody and transfer of Treasury securities—the Fedwire book-entry securities transfer system and Treasury Direct. Almost all book-entry Treasury securities—97.6 percent of the par value outstanding at year-end 1996—were maintained on Fedwire, and 2.4 percent of the total was maintained on Treasury Direct.

The Reserve Banks processed 9.0 million Fedwire transfers of Treasury securities, a decrease of 1.6 percent from the 1995 level. In addition, the Banks processed 21.6 million interest and principal payments for both Treasury and agency securities. The fees charged to depository institutions for sending and receiving Fedwire transfers of Treasury book-entry securities are the same as those charged to them for transfers of government agency securities. The Federal Reserve keeps a portion of the fee for transfers of Treasury securities to cover its settlement expenses; the remainder of the fee is remitted to Treasury.

The Philadelphia Bank operates Treasury Direct, a system of book-entry securities accounts for nondepository institutions and individuals planning to hold their Treasury securities to maturity. The Treasury Direct system contains more than 1.8 million accounts. During 1996 the Reserve Banks processed 450 thousand tenders for Treasury Direct customers seeking to purchase Treasury securities at Treasury auctions, and they handled 2.0 million reinvestment requests. The volume of tenders decreased 44.3 percent, and the volume of reinvestment requests increased 14.5 percent, compared with 1995 levels. In addition, the Philadelphia Bank issued 7.3 million payments for discounts, interest, and redemption proceeds; 2.7 million payments for savings bonds; and more than 61 thousand interest payments for definitive Treasury issues.

The Federal Reserve also worked with Treasury's Bureau of the Public Debt to implement, on a pilot basis, an option that permits selected Treasury Direct investors to pay for securities with an ACH debit to their bank account.

Savings Bonds

Reserve Bank operating expenses for savings bond activities amounted to $78.8 million. The Reserve Banks printed and mailed 55.1 million savings bonds on behalf of Treasury's Bureau of the Public Debt, a decrease of 9.6 percent from 1995. The Banks processed 8.2 million original-issue transactions. Redemption, reissue, and exchange transactions totaled 664,000, an increase of 4.3 percent over 1995. The Reserve Banks also responded to 1.7 million service calls from owners of savings bonds, an increase of 12.7 percent from 1995.

Savings bond operations are performed at five Reserve Bank offices: Buffalo, Pittsburgh, Richmond, Minneapolis, and Kansas City. All of these offices process savings bond transactions; only the Pittsburgh and Kansas City offices print savings bonds.

Other Initiatives

The Reserve Banks maintain custody of definitive (physical) and book-entry securities pledged as collateral by depository institutions holding deposits from Treasury and other government agencies. In 1996 the Reserve Banks monitored the value of the definitive securities by pricing them according to their market value (marking them to market). The Reserve Banks will mark book-entry securities to market after completion of the conversion to the National Book-Entry System.

The Federal Reserve also worked with Treasury's Financial Management Service to expand the Treasury Offset Program on a pilot basis. The Offset Program electronically compares information about delinquent debts owed to the U.S. government with information about payments being issued by the government. If a match occurs, the program applies the payment to the delinquent debt.

Depository Services

The Reserve Banks maintain Treasury's funds account, accept deposits of federal taxes and fees, pay checks drawn on Treasury's account, and make electronic payments on behalf of Treasury.

Federal Tax Payments

Reserve Bank operating expenses for federal tax payment activities were $38.8 million. The Reserve Banks processed 6.3 million advices of credit from depository institutions accepting tax deposits from businesses and individuals. The Reserve Banks also received a small portion of tax payments directly, representing about 1 percent of the total value. Depository institutions that receive tax payments may place the funds in a Treasury tax and loan account or remit the funds to a Reserve Bank.

The Reserve Banks assisted with the implementation of the Treasury's Electronic Federal Tax Payment System (EFTPS), which automates the flow of federal tax deposits from businesses. The system became operational in October. Tax payments made via EFTPS flow to Treasury one day sooner than they do under the paper-based process, improving Treasury's investment opportunities and enabling it to manage its cash flows more efficiently. The Reserve Banks have developed and implemented new payment mechanisms for use by taxpayers who must send their payments on the same day their tax liability is established.

Payments Processed for Treasury

Operating expenses for government payment operations amounted to $47 million. During the year, Treasury continued to increase the proportion of its payments made electronically. The number of ACH transactions processed for Treasury amounted to 625 million, an increase of 4.4 percent over the 1995 volume. The majority of government payments made via the ACH are for social security, pension, and salary payments. Treasury also uses the ACH to make some payments to vendors.

The Reserve Banks processed 436 million government checks, a decrease of 5.2 percent from 1995. The Reserve Banks also issued 1.3 million fiscal agency checks, which are used primarily to pay semiannual interest on registered, definitive Treasury notes and bonds and Series H and HH savings bonds. They are also used to pay the principal of matured securities and coupons and discounts to first-time purchasers of government securities through Treasury Direct. All recurring Treasury Direct payments and many definitive securities interest payments are made via the ACH.

Following successful tests of digital imaging technology, Treasury's Financial Management Service issued their specific requirements for the use of check images archived at Reserve Banks, which will improve the Treasury's check reconciliation and claims processing. In response, the Reserve Banks, as fiscal agents, designed and began to build a check imaging system composed of two fundamental elements: (1) a capture subsystem, consisting of image-enabled check reader–sorters and temporary image storage facilities, and (2) an archive and retrieval subsystem, containing an indexed database configured for long-term storage and retrieval of images of paid Treasury checks. The image-based system will replace the existing microfilm-based check truncation service, eliminate the manual research associated with microfilm, and reduce the time required to make paid Treasury check information available for research and inquiry.

Services Provided to Other Entities

When required to do so by the Secretary of the Treasury or when required or permitted to do so by federal statute, the Reserve Banks perform fiscal agency securities services and depository services for other domestic and international agencies. Depending on the authority under which services are provided, the Reserve Banks may (1) facilitate the issuance of government agency book-entry securities that are eligible to be transferred over Fedwire, (2) provide custody for the stock of unissued, definitive securities, (3) maintain and update balances of outstanding book-entry and definitive securities for issuers, (4) perform various other securities servicing activities, and (5) maintain funds accounts for some government agencies.

Food Coupons

Reserve Bank operating expenses for food coupon services were $25.3 million in 1996. The Reserve Banks redeemed 3.6 billion food coupons, a decrease of 7.1 percent from 1995.

The Account Management Agent (AMA) system was completed in March. The AMA system is used by the Department of Agriculture's Food and Consumer Service to establish and monitor adherence to limits on federal funding to states for food coupons. The Federal Reserve, the Department of Agriculture, and the Department of the Treasury are continuing to work on enhancements in the area of fraud detection.

Examinations

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once per year, and the Board assigns this responsibility to its Division of Reserve Bank Operations and Payment Systems. Since 1995 the division has engaged a public accounting firm to audit the combined financial statements of the Reserve Banks. In addition, for 1996 the firm audited the year-end financial statements of the Dallas, Richmond, and New York Reserve Banks; the division audited the year-end financial statements of the other nine Banks and conducted reviews of their administrative controls and their compliance with federal statutes and regulations and with policies of the System.

Each year, the division assesses compliance with the policies established by the Federal Open Market Committee (FOMC) by examining the accounts and holdings of the System Open Market Account (SOMA) at the Federal Reserve Bank of New York and the foreign currency operations conducted by the Bank. In addition, a public accounting firm certifies the schedule of participated asset and liability accounts and the related schedule of participated income accounts at year-end. Division personnel follow up on the audit results. Copies of the external audit reports are furnished to the FOMC as are reports on the division's follow-up.

Income and Expenses

The accompanying table summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 1996 and 1995.

Income was $25,164 million in 1996 and $25,395 million in 1995. Total expenses were $2,111 million ($1,639 million in operating expenses, $309 million in earnings credits granted to depository institutions, and $163 million in assessments for expenditures by the Board of Governors). The cost of new currency was $403 million. Revenue from financial services was $787 million. Unreimbursed expenses for services provided to Treasury amounted to $38 million.

The profit and loss account showed a net loss of $1,639 million. The loss was primarily a result of realized and unrealized losses on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends to member banks totaled $256 million, $25 million more than in 1995. This rise reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to Treasury totaled $20,083 million, compared with $23,389 million in 1995. The payments consist of all net income after the deduction of dividends and after the deduction of the amount necessary to bring the surplus of the Reserve Banks to the level of capital paid-in. Also in 1996, the System made a lump-sum payment of $106 million to the U.S. Treasury from the surplus account of the Federal Reserve Banks, as required by statute.

In the Statistical Tables chapter of this REPORT, table 6 details income and expenses of each Federal Reserve Bank for 1996, and table 7 shows a condensed statement for each Bank for the years 1914 to 1996. A detailed account of the assessments and expenditures of the Board of Governors appears in the next chapter—Board of Governors Financial Statements.

Holdings of Securities and Loans

Average daily holdings of securities and loans by Federal Reserve Banks during 1996 were $390,268 million, an increase of $14,199 million from 1995 (see accompanying table). From 1995 to 1996, their holdings of U.S. government securities increased $14,196 million, and loans increased $4 million.

Also during the period from 1995 to 1996, the average rate of interest decreased from 6.34 percent to 6.12 percent on holdings of government securities and decreased from 5.62 percent to 5.27 percent on loans.

Volume of Operations

Table 9, in the Statistical Tables chapter, shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 1993 through 1996.

Federal Reserve Bank Premises

Construction continued in 1996 on the new headquarters building for the Minneapolis Bank and the expansion and renovation of the headquarters building of the Cleveland Bank.

Income, Expenses, and Distribution of Net Earnings of Federal Reserve Banks, 1996 and 1995

Millions of dollars

Item	1996	1995
Current income	25,164	25,395
Current expenses	1,948	1,818
Operating expenses [1]	1,639	1,568
Earnings credits granted	309	251
Current net income	23,216	23,577
Net additions to (deductions from, –) current net income	–1,639	896
Cost of unreimbursed services to Treasury	38	38
Assessments by the Board of Governors	565	531
For expenditures of Board	163	161
For cost of currency	403	370
Net income before payments to Treasury	20,975	23,903
Dividends paid	256	231
Transferred to surplus [2]	635	283
Payments to Treasury [2]	20,083	23,398

NOTE. Components may not sum to totals because of rounding.

1. Includes a net periodic credit for pension costs of $140.5 million in 1996 and $119.2 million in 1995.

2. In addition to the amounts shown, $106 million in Federal Reserve Bank surplus was transferred to the Treasury as statutorily required.

The Atlanta Bank purchased property for its new Birmingham Branch building and began the project's design phase. The Atlanta Bank also retained design consultants for its new headquarters building project in Atlanta.

Multiyear renovation programs continued for the New York Bank's headquarters building, the Kansas City Bank's Oklahoma City Branch, and the San Francisco Bank's Seattle, Portland, and Salt Lake City Branches.

The New York Bank closed its Jericho, New York, check processing facility, and the Kansas City Bank sold its old Omaha, Nebraska, Branch building. The Chicago Bank contracted to lease space for processing checks in a new building that is under construction in Des Moines, Iowa.

Securities and Loans of Federal Reserve Banks, 1994–96

Millions of dollars except as noted

Item and year	Total	U.S. government securities[1]	Loans[2]
Average daily holdings[3]			
1994	354,001	353,740	261
1995	376,069	375,867	202
1996	390,268	390,063	206
Earnings			
1994	19,259	19,247	11
1995	23,837	23,826	11
1996	23,895	23,884	11
Average interest rate (percent)			
1994	5.44	5.44	4.39
1995	6.34	6.34	5.62
1996	6.12	6.12	5.27

NOTE. Components may not sum to totals because of rounding.

1. Includes federal agency obligations.

2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.

3. Based on holdings at opening of business.

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 1996 and 1995

Millions of dollars

Item	1996		1995	
Short-term assets (Note 1)				
Imputed reserve requirements on clearing balances	658.3		504.2	
Investment in marketable securities	5,924.7		4,537.8	
Receivables	69.0		63.7	
Materials and supplies	3.2		10.6	
Prepaid expenses	26.5		19.4	
Items in process of collection	7,548.4		2,397.4	
Total short-term assets		14,230.1		7,533.1
Long-term assets (Note 2)				
Premises	393.5		356.6	
Furniture and equipment	171.1		170.3	
Leases and leasehold improvements	31.0		24.2	
Prepaid pension costs	287.4		242.1	
Total long-term assets		883.0		793.1
Total assets		**15,113.1**		**8,326.2**
Short-term liabilities				
Clearing balances and balances arising from early credit of uncollected items	12,366.3		5,154.8	
Deferred-availability items	1,765.1		2,284.5	
Short-term debt	98.7		93.7	
Total short-term liabilities		14,230.1		7,533.1
Long-term liabilities				
Obligations under capital leases	2.3		3.8	
Long-term debt	196.9		164.3	
Postretirement/postemployment benefits obligation	178.6		176.1	
Total long-term liabilities		377.8		344.3
Total liabilities		**14,607.9**		**7,877.4**
Equity		505.2		448.8
Total liabilities and equity (Note 3)		**15,113.1**		**8,326.2**

NOTE. Components may not sum to totals because of rounding.

The priced services financial statements consist of these tables and the accompanying notes.

Pro Forma Income Statement for Federal Reserve Priced Services, 1996 and 1995

Millions of dollars

Item	1996		1995	
Revenue from services provided to depository institutions (Note 4)		787.2		738.8
Operating expenses (Note 5)		666.0		655.2
Income from operations		121.2		83.6
Imputed costs (Note 6)				
Interest on float	21.9		19.0	
Interest on debt	17.3		16.2	
Sales taxes	11.6		22.1	
FDIC insurance	0.0	50.8	6.3	63.7
Income from operations after imputed costs		70.4		19.9
Other income and expenses (Note 7)				
Investment income	315.8		259.6	
Earnings credits	−287.1	28.7	−233.2	26.4
Income before income taxes		99.1		46.3
Imputed income taxes		29.6		14.4
Income before cumulative effect of a change in accounting principle		69.5		31.9
Cumulative effect on previous years from retroactive application of accrual method of accounting for postemployment and vacation benefits (net of $8.7 million tax) (Note 9)		. . .		19.4
Net income (Note 10)		**69.5**		**12.6**
MEMO: Targeted return on equity (Note 11)		42.9		31.5

NOTE. Components may not sum to totals because of rounding.

The priced services financial statements consist of these tables and the accompanying notes.

Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 1996

Millions of dollars

Item	Total	Commercial check collection	Funds transfer and net settlement	Book-entry securities	Commercial ACH	Noncash collection	Cash services
Revenue from operations	787.2	588.1	94.7	16.6	77.4	5.2	5.2
Operating expenses (Note 5)	666.0	527.0	68.2	15.6	60.8	4.4	5.0
Income from operations	121.2	61.1	26.4	1.0	16.6	.8	.2
Imputed costs (Note 6)	50.8	43.7	2.9	.6	2.9	.5	.2
Income from operations after imputed costs	70.4	17.4	23.5	.4	13.7	.4	.0
Other income and expenses, net (Note 7)	28.7	22.5	2.9	.5	2.4	.2	.2
Income before income taxes	99.1	39.9	26.4	.9	16.2	.5	.2

NOTE. Components may not sum to totals because of rounding.

The priced services financial statements consist of these tables and the accompanying notes.

FEDERAL RESERVE BANKS

Notes to Financial Statements for Priced Services

(1) Short-Term Assets

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as nonearning balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. The remainder of clearing balances is assumed to be invested in three-month Treasury bills, shown as investment in marketable securities.

Receivables are (1) amounts due the Reserve Banks for priced services and (2) the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection is gross Federal Reserve cash items in process of collection (CIPC) stated on a basis comparable to that of a commercial bank. It reflects adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with nonpriced items, such as those collected for government agencies; and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

(2) Long-Term Assets

Consists of long-term assets used solely in priced services, the priced-services portion of long-term assets shared with nonpriced services, and an estimate of the assets of the Board of Governors used in the development of priced services. Effective Jan. 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). Accordingly, the Reserve Banks recognized credits to expenses of $45.3 million in 1996 and $35.4 million in 1995 and corresponding increases in this asset account.

(3) Liabilities and Equity

Under the matched-book capital structure for assets that are not "self-financing," short-term assets are financed with short-term debt. Long-term assets are financed with long-term debt and equity in a proportion equal to the ratio of long-term debt to equity for the fifty largest bank holding companies, which are used in the model for the private-sector adjustment factor (PSAF). The PSAF consists of the taxes that would have been paid and the return on capital that would have been provided had priced services been furnished by a private-sector firm. Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of accrued postemployment (see note 9) and postretirement benefits costs and obligations on capital leases.

(4) Revenue

Revenue represents charges to depository institutions for priced services and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits.

(5) Operating Expenses

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were $2.8 million in 1996 and $2.7 million in 1995. The credit to expenses under SFAS 87 (see note 2) is reflected in operating expenses.

The income statement by service reflects revenue, operating expenses, and imputed costs except for income taxes. Total operating expense does not equal the sum of operating expenses for each service because of the effect of SFAS 87. Although the portion of the SFAS 87 credit related to the current year is allocated to individual services, the amortization of the initial effect of implementation is reflected only at the System level.

(6) Imputed Costs

Imputed costs consist of interest on float, interest on debt, sales taxes, and the FDIC assessment. Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for checks, book-entry securities, noncash collection, ACH, and funds transfers.

Interest is imputed on the debt assumed necessary to finance priced-service assets. The sales taxes and FDIC assessment that the Federal Reserve would have paid had it been a private-sector firm are among the components of the PSAF (see note 3).

Float costs are based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each service to the total expenses for all services less the total shipping expenses for all services.

The following list shows the daily average recovery of float by the Reserve Banks for 1996 in millions of dollars:

Total float	795.4
Unrecovered float	12.4
Float subject to recovery	783.0
Sources of recovery of float	
Income on clearing balances	78.4
As-of adjustments	382.0
Direct charges	116.4
Per-item fees	206.2

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges are midweek closing float and interterritory check float, which may be recovered from depositing institutions through adjustments to the institution's reserve or clearing balance or by valuing the float at the federal funds rate and billing the institution directly. Float recovered through per-item fees is valued at the federal funds rate and has been added to the cost base subject to recovery in 1996.

(7) Other Income and Expenses

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances represents the average coupon-equivalent yield on three-month Treasury bills applied to the *total* clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. Expenses for earnings credits granted to depository institutions on their clearing balances are derived by applying the average federal funds rate to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

Because clearing balances relate directly to the Federal Reserve's offering of priced services, the income and cost associated with these balances are allocated to each service based on each service's ratio of income to total income.

(8) Income Taxes

Imputed income taxes are calculated at the effective tax rate derived from the PSAF model (see note 3). Taxes have not been allocated by service because they relate to the organization as a whole.

(9) Postemployment and Vacation Benefits

Effective Jan. 1, 1995, the Reserve Banks implemented SFAS 112, *Employers' Accounting for Postemployment Benefits,* and SFAS 43, *Accounting for Compensated Absences.* Accordingly, in 1995 the Reserve Banks recognized a one-time cumulative charge of $28.1 million to reflect the retroactive application of these changes in accounting principles.

(10) Adjustments to Net Income for Price Setting

In setting fees, certain costs are excluded in accordance with the System's overage and shortfalls policy and its automation consolidation policy. Accordingly, to compare the financial results reported in this table with the projections used to set prices, adjust net income as follows (amounts shown are net of tax):

	1996	1995
Net income	69.5	12.6
Amortization of the initial effect of implementing SFAS 87	−10.5	−10.4
Deferred costs of automation consolidation	−6.3	−.1
Cumulative effect of retroactive application of SFAS 112 and SFAS 43	. . .	19.4
Adjusted net income	52.6	21.5

(11) Return on Equity

The after-tax rate of return on equity that the Federal Reserve would have earned had it been a private business firm, as derived from the PSAF model (see note 3). This amount is adjusted to reflect the recovery of $6.3 million of automation consolidation costs for 1996 and $0.1 million for 1995. The Reserve Banks plan to recover these amounts, along with a finance charge, by the end of the year 2001. After-tax return on equity has not been allocated by service because it relates to the organization as a whole.