United States General Accounting Office

GAO

Report to Congressional Requesters

November 2000

FEDERAL RESERVE SYSTEM

Mandated Report on Potential Conflicts of Interest

G A O

Accountability * Integrity * Reliability

GAO-01-160

Contents

Abbreviations

ACH	automated clearinghouse
BHC	bank holding companies
Board	Federal Reserve Board
DRBOPS	Division of Reserve Bank Operations and Payments Systems
EFAA	Expedited Funds Availability Act of 1987
EPN	Electronic Payment Network
FAS	Financial Accounting Standard
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Federal Reserve System
FSPC	Financial Services Policy Committee
GAAP	generally accepted accounting principles
ITS	Interdistrict Transportation System
MCA	Monetary Control Act of 1980
MICR	magnetic ink character recognition
NACHA	National Automated Clearinghouse Association
OIG	Office of Inspector General
PACS	Planning and Control System
PSAF	Private Sector Adjustment Factor
PSO	Private Sector ACH Operator
RCPC	Regional Check Processing Centers
Reserve Banks	Federal Reserve Banks

United States General Accounting Office
Washington, D.C. 20548

November 13, 2000

Congressional Requesters:

This report responds to a mandate in the Gramm-Leach-Bliley Act of 1999 for us to study the potential conflicts of interest faced by the Federal Reserve System (Federal Reserve) in its role as a central bank, payment services provider, and regulator of the banking system.[1] The payments system is the system of mechanisms, both paper-based and electronic, for moving funds among financial institutions throughout the nation. In this report, we discuss the Federal Reserve's role in providing check collection and automated clearing house (ACH) services, which are often referred to as retail payments.[2] To encourage competition between the Federal Reserve and private sector providers of payment services, the Monetary Control Act of 1980 (MCA)[3] requires that the Federal Reserve charge fees for payment services that it once provided to its members free of charge. [4]

The Federal Reserve comprises the Federal Reserve Board (Board) and Federal Reserve Banks (Reserve Banks). The Board provides oversight over the operations of the Reserve Banks and serves as a regulator of check collection in the United States. As the regulator of check collection, the Board establishes regulations for the Reserve Banks and their private sector competitors. The Federal Reserve also serves as a central bank and banking industry regulator. In fulfilling these varying roles, with their different goals, the Federal Reserve could potentially encounter conflicts of interest.

To fulfill the mandate, our objectives were to (1) identify organizational relationships and differing goals within the Federal Reserve that could

[1] Pub. L. No. 106-102 § 728 (1999).

[2] Check collection refers to the process of sorting checks according to the bank on which they are written and presenting the checks to those banks for payment. ACH is an electronic interbank payments system used for small and recurring payments, such as direct deposit of payrolls or automatic payment of other bills.

[3] Pub. L. No. 96-221, Title I, § 107 (1980); 12 USC § 248a.

[4] In addition to commercial banks, thrifts and credit unions also purchase payment services from the Federal Reserve.

present a conflict of interest and identify Federal Reserve policies for managing or avoiding any conflicts; (2) identify any competitive advantages enjoyed by the Federal Reserve compared to its private sector competitors and evaluate the extent to which the Federal Reserve, through changes to its regulations and operating policies, has or has not removed them; (3) review how the Federal Reserve has priced its services; and (4) review Federal Reserve policies for developing and marketing its services.

We focused our review on the Federal Reserve's retail payment services, which include check collection and ACH services. These activities account for almost 90 percent of the revenue generated by the Federal Reserve's payments services. In addition to Federal Reserve staff, we interviewed private sector competitors, customers, and other concerned parties. We sought any indication or evidence of breaches of the Federal Reserve's policies separating its various roles in the payments system. We also followed up on allegations raised by others of breaches of the Federal Reserve's separations. We conducted our work in Hartford, CT; Washington, D.C.; Atlanta, GA; Boston, MA; New York, NY; Pittsburgh, PA; and Dallas, TX, between March and October 2000, in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Board. The Board's comments are discussed near the end of this letter and are reprinted in Appendix IV. We incorporated the Board's technical comments where appropriate. Appendix I describes our scope and methodology.

Results in Brief

The Federal Reserve has multiple goals and internal relationships that could potentially conflict, but the Federal Reserve has taken steps to manage these conflicts by separating staff engaged in its various roles when their interests could potentially conflict. These separations are designed to prevent the passage of information within the Federal Reserve that could provide the Reserve Banks with an advantage in their competition with the private sector. The separations also serve to limit the influence the Reserve Banks can exert on the Board as a regulator of check collection. The Board provides oversight of the Reserve Banks' check collection and ACH operations and also serves as a regulator of the check collection system in the United States. In some cases, the goals of the Board as a regulator of check collection may not be consistent with those of the Reserve Banks, which compete with the private sector to maintain and/or expand their customer base. For example, to promote efficiency of the check collection system, the Board has sought to encourage competition by removing competitive advantages enjoyed by the Reserve

Banks. In addition, some of the Federal Reserve's competitors in check collection are banks that are subject to Federal Reserve examination, which may raise concerns that Reserve Bank staff involved in providing payment services could benefit from information about the operations of private sector competitors obtained during regulatory examinations.

To address potential conflicts of interest, the Board maintains policies and procedures to ensure the separation of the various roles of the Federal Reserve, including policies against inappropriate communication between Reserve Bank staff who examine banks and Reserve Bank staff who provide payment services. In providing oversight of the Reserve Banks, the Board is involved in establishing policies that govern the payments and other operations of the Reserve Banks. When addressing general oversight issues, the Federal Reserve does not have policies that establish separations between Board and Reserve Bank staff. However, during regulatory rulemaking that affects the check collection system, under Board policy, Reserve Bank staffs are kept at arm's length from the Board and are afforded no more access to the Board's deliberations than other payment system participants. During our work, we found no evidence to suggest that the Federal Reserve has not adequately separated its multiple roles.

Because of inherent differences between the Reserve Banks and their private sector competitors, it is unlikely that all competitive disparities between them can ever be removed without changing the structure or nature of the various institutions. However, the Board has tried to remove some of the competitive advantages enjoyed by the Reserve Banks in providing check and ACH services to the banking industry. For example, in 1992 the Board adopted the same-day settlement rule, which allows all check collection providers to obtain settlement for checks, without paying a fee, from any bank on the same day checks are presented. Prior to this change, only Reserve Banks could do this. The Board has proposed to remove some of the advantages Reserve Banks enjoy in providing ACH services by virtue of their dominant market share; however, private sector ACH operators (PSOs) said the proposal would not promote greater competition because it does not correct the pricing inequities that have resulted in an unfair competitive environment. Reserve Banks and their private sector competitors each have other unique advantages in competing for payments business that are likely to remain over time because the advantages are inherent to their natures and structures. Reserve Banks, for example, have automatic access to banks' reserve accounts, a dominant market presence, and a later deadline to present checks to banks for same-day payment. Conversely, private sector competitors have more flexibility in pricing their services, negotiating terms and conditions, and choosing their customers.

In setting prices, the Federal Reserve has complied with the requirement of Section 107 of MCA that the Reserve Banks recover total costs for the payment services it sells to depository institutions (priced services). MCA requires the Federal Reserve, when developing its prices, to include a private sector adjustment factor (PSAF) that is intended to simulate the costs of capital and other costs and profits that would apply to its private sector competitors. Developing the methodology for the PSAF has always been challenging because of the Reserve Banks' unique structure and operation and a lack of perfectly comparable private sector competitors. However, the consolidation of the financial services industry and the changing nature of the payments industry have renewed questions about whether the current PSAF methodology should be revised to more accurately simulate private sector pricing conditions. The Federal Reserve is in the process of its periodic review of the methodology. Although the Federal Reserve plans to publish any revisions for public comment, it has not included non-Federal Reserve participants, such as industry officials or academics, when reviewing its PSAF methodology. By limiting the involvement of these groups to a public comment period, the Federal Reserve may be missing an opportunity to build on the varying perspectives these groups could provide throughout the process. In addition to questions about the PSAF, some competitors of the Federal Reserve question its use of credits to offset expenses allocated to payment services when developing prices. Although the Federal Reserve uses generally accepted accounting principles to account for its pension credits, the Federal Reserve's use of the credits has been controversial because it has offset operating expenses for priced services and has allowed the Federal Reserve to meet its targeted return on equity, as required by MCA, without having to raise prices and/or cut costs.

The Reserve Banks have worked to actively develop and market payment products with the objective of developing a set of products and prices designed to appeal to a variety of banks, including those that operate nationally. The Reserve Banks' marketing efforts include the maintenance of nationally coordinated sales staffs. The Reserve Banks differ in how they manage their sales staffs, with some of the Reserve Banks providing bonuses to sales staff, based on preset goals. The Federal Reserve's process for approving and announcing new products varies on the basis of its assessment of the expected competitive impact of the product, or the extent to which the product represents a significant change that could have major policy or other implications. The Federal Reserve has shifted the review and approval that it requires for some products from the Board to the Reserve Banks in an effort to streamline the product development process. In addition, some products that may have once been the subject of a request for public comment in the *Federal Register* might now be introduced without a request for comment. This has raised concerns and misunderstandings among the Reserve Banks' competitors about how the Federal Reserve applies its policies and procedures. Although Federal Reserve policies in this regard have been in place for some time, Federal Reserve implementation of the policies has, in some cases, changed over time.

This report contains recommendations to the Federal Reserve to (1) solicit input from individuals from outside the Federal Reserve, including academics and industry officials, at an earlier stage in future reviews of the PSAF methodology and allow them to participate throughout the review process, perhaps including the evaluation of comments on any proposed PSAF revision, to determine if there are better ways to structure the PSAF; and (2) clarify its policies and procedures for introducing new products and product enhancements and make those policies more readily available to its private sector competitors.

Background

The Federal Reserve, the nation's central bank, consists of the Board of Governors located in Washington, D.C., and 12 Reserve Banks with 25 branches located throughout the nation. The Board is a federal agency, and the Reserve Banks are federally chartered corporations. The Board is responsible for maintaining the stability of financial markets, supervising bank holding companies and banks that are members of the Federal Reserve, and overseeing the operations of the Reserve Banks. The Board has delegated some of these responsibilities to the Reserve Banks, which also provide payment services to depository institutions and government agencies.

The Federal Reserve plays a significant role in the nation's payment system. The 12 Reserve Banks with their 25 branches offer payment services to depository institutions. The Reserve Banks distribute currency and coin; provide funds transfer, automated clearing house, and securities transfer services; collect checks; and provide settlement services for depository institutions. The terms and conditions under which they provide payment services are governed either by regulations of the Board or by internal policies adopted by the Board in its oversight capacity and by the Reserve Banks' operating circulars. Under the Federal Reserve Act, Reserve Banks are subject to the general supervision of the Board. This authority of the Board includes oversight of the Reserve Banks' services to depository institutions, which is primarily conducted by the Division of Reserve Bank Operations and Payments Systems (DRBOPS). Payment transactions initiated by banks are settled through a debit or a credit to a bank's account maintained for reserve or clearing purposes, or through the account of a designated correspondent. [5]

Section 107 of MCA requires that the Federal Reserve charge fees for payment services that it provides to depository institutions. Prior to the act, the Federal Reserve provided payment services to its members without an explicit charge. MCA identifies the following as payment services for which the Federal Reserve should charge fees: check clearing and collection services, automated clearing house, wire transfer services, currency and coin services, securities safekeeping services, settlement services, and Federal Reserve float.[6] These payment services are referred to as priced services. MCA requires that the Federal Reserve recover all costs for priced services over the long run. In addition, MCA requires that the Federal Reserve calculate a PSAF to simulate the expenses and profits of a private sector firm providing such services.

The Expedited Funds Availability Act (EFAA) gave the Board additional authority to regulate the check collection system.[7] Prior to EFAA, the Board could promulgate rules for checks collected through the Reserve Banks. The Board's Regulation CC, which implements EFAA, includes a number of provisions designed to improve and accelerate the collection and return of checks. Since the original drafting of Regulation CC in 1988, the Board has proposed a number of rule changes or amendments to the regulation. These have included various clarifying technical amendments to the regulation and other, more substantive changes. The more significant

[5] A Federal Reserve account is an account that depository financial institutions maintain with a Reserve Bank. The balance in a Federal Reserve account is maintained for purposes of (1) satisfying the Federal Reserve's reserve requirements and/or (2) settling payments cleared through the Reserve Banks. The balances in these accounts play a central role in the exchange of funds between depository institutions.

[6] Float is money that appears on the books of both the check writer (the payor) and the check receiver (the payee) while a check is being processed.

[7] Pub. L. No. 100-86, Title VI (1987).

of these proposed and actual changes by the Board to Regulation CC are detailed later in this report. Checks collected through the Reserve Banks are governed by Regulation J and Reserve Bank operating circulars.

The paper check is the dominant noncash payment mechanism used in the United States. Although no one is certain how many checks are written in the United States each year, Board staff estimated that the number is currently between 66 and 70 billion checks. A percentage of those checks are interbank checks, which are checks for which the depositary bank (the first bank at which a check is deposited) and the paying bank (the bank on which the check is drawn) are not the same entity. Interbank checks are cleared and settled through an elaborate check-collection process. In the check-collection process, depositary banks generally deposit checks with the Reserve Banks unsorted. Depositary banks can present checks to paying banks though several methods, which may or may not include other entities, such as clearing houses, correspondent banks, or Reserve Banks.[8] A correspondent bank is a bank that holds deposits owned by other banks and performs a variety of banking services, such as check collection. In this report, we refer to competitors to the Reserve Banks in check collection as private sector competitors.

ACH is an electronic interbank payments system used for small and recurring payments, such as direct deposit of payrolls or automatic payment of utility, mortgage, or other bills. There are only four ACH operators: the Reserve Banks and three PSOs—Electronic Payment Network (EPN), VisaNet, and the American Clearing House. An ACH operator is the link between the originating and receiving points of the transactions. The ACH operator receives the payment instructions from the originating depository institution, edits the information for proper format, sorts the transactions for distribution to the appropriate receiving depository financial institution, and settles the transactions between the originating and receiving depository institutions. In recent years, ACH has seen significant growth. From 1995 to 1999, the volume of commercial ACH transactions grew from 2.2 billion transactions to 3.8 billion transactions, an increase of almost 75 percent.[9] The Reserve Banks are the dominant provider of ACH services, with an estimated 85 percent of the market. As

[8] The Federal Reserve System's check processing operations includes 45 check processing sites.

[9] As the fiscal agent for the U.S. Treasury, the Federal Reserve Banks also process all federal government ACH transactions.

one of the four ACH operators, the Federal Reserve participates in the development of new services and applications.

ACH transactions are governed by the National Automated Clearing House Association (NACHA), a nonprofit banking trade association that promulgates the rules and operating guidelines for electronic payments through the ACH network. The Reserve Banks incorporate NACHA rules by reference into their ACH operating circulars. The Reserve Banks' operating circulars, which are subject to Board review, represent the agreements between the Reserve Banks and their customers on the terms and conditions under which the Reserve Banks will provide ACH services. PSOs have similar agreements in place with their customers.

The Federal Reserve Maintains Policies to Address Potential Conflicts of Interests

The Federal Reserve has multiple, potentially conflicting roles in the payments system but generally has policies in place to address conflicts of interest that could arise. Many of the potential conflicts within the Federal Reserve derive from the goals and internal relationships of the Federal Reserve itself. The Board provides general oversight of the operations of the Reserve Banks and has a regulatory rulemaking role in check collection. The policies also separate Reserve Bank staff engaged in different types of activities, such as payments operations and supervisory examinations. The Federal Reserve maintains policies and procedures to ensure the separation of the Board and Reserve Banks when the Board is engaging in regulatory rulemaking. However, these policies and procedures allow Board staff to communicate with the Reserve Banks to fulfill its oversight responsibility.

Federal Reserve Structure Leads to Complex Relationships Between the Board and Reserve Banks in its Various Roles

The structure of the Federal Reserve, which includes the Board and the Reserve Banks, with each having different roles, contributes to the potential for conflicts of interest in the payments system. The Board provides general oversight of the Reserve Banks, but it is the Reserve Banks that provide payment services to the banking industry. The Board also has a regulatory rulemaking role for check collection. In this role, the Board serves as a regulator of both the Reserve Banks and its private sector competitors, establishing the regulations with which they must comply in check collection. Federal Reserve policies provide for separations between the Board and Reserve Banks when the Board is engaging in regulatory rulemaking for check collection. However, these separations do not apply when the Board is acting in its general oversight role.

The Federal Reserve describes its role in the payments system as providing payment services to promote the integrity and efficiency of the payments mechanism and to ensure the provision of payment services to all depository institutions on an equitable basis in an atmosphere of competitive fairness. Federal Reserve officials said that as a payments system participant and central bank, the Federal Reserve has roles that are integrally related, enhancing the integrity of the payment process. For example, the Federal Reserve's final and irrevocable Fedwire funds transfer service[10] reduces the risk that failure of one bank could be transmitted rapidly to other banks. In addition, in order to carry out its responsibilities as central bank, the Federal Reserve may provide payment services to troubled depository institutions that other providers of payment services may not serve because of the risks involved. This helps to ensure that the inability of a depository institution to make or process payments will not trigger its insolvency and that the institution's problems can be resolved in an orderly fashion with minimum disruptive effects.

The Board regulates the collection of checks with the goal of enhancing the efficiency of the check collection system. However, the goals of the Board in establishing regulations may not be the same as those of the Reserve Banks, which actually provide payment services and are competing against other entities to provide check collection. For example, the Board has engaged in rulemaking efforts in the past that were intended to remove some of the competitive advantages the Reserve Banks enjoyed over their private sector competitors in check collection. Although these efforts have addressed some competitive disparities, they have worked against the competitive interests of the Reserve Banks in their competition for check collection business.

Unlike its regulation of check collection, the Board does not exert any regulatory authority over the ACH system, but it provides general oversight over the Reserve Banks as ACH operators. The Reserve Banks' ACH service is a common enterprise among the 12 Reserve Banks and is the largest in the United States. The Reserve Banks' operating circulars affect PSOs that sometimes must use the Federal Reserve's ACH service to complete transactions for their customers. The Reserve Banks' operating

[10] The Fedwire funds transfer system is one of the two primary large-dollar electronic payments systems in the United States. Fedwire allows depository institutions to transfer funds on their own behalf or on behalf of their customers; most Fedwire payments are related to domestic transactions.

circulars represent the agreements between the Reserve Banks and their ACH customers on the terms under which the Reserve Banks provide ACH service. The operating circulars for ACH are the same for each Reserve Bank. Depository institutions are free to use any ACH operator they choose, but most use the Reserve Banks to send and receive ACH transactions. The Reserve Banks' share of the ACH market is estimated to be about 85 percent, with three PSOs sharing the remaining 15 percent. It is often the case that a depository institution that uses a PSO for its ACH transactions sends funds to a depository institution that uses the Reserve Banks for its ACH transactions. Thus, it is likely that the PSOs will have to use the Reserve Banks to complete many of their ACH transactions because a depository institution is more likely than not to be a user of the Reserve Bank's ACH service. Because PSOs are dependent on the Federal Reserve to do their business, they must abide by the Reserve Banks' operating circulars for depository institutions that use its ACH service. Reserve Bank staff have said that when the PSOs use the Federal Reserve's ACH system, they do so as agents for the Reserve Bank's customers. Therefore, the Reserve Banks' operating circulars exert influence on how their competitors provide ACH services.

In addition to its roles as a provider and regulator of the payments system, the Federal Reserve has regulatory authority over bank holding companies operating in the United States and for state banks that are members of the Federal Reserve. In exercising this authority, the Federal Reserve inspects the operations of bank holding companies and examines state banks. The Board also reviews and approves or disapproves applications from these institutions to engage in a variety of activities, including acquiring or merging with other institutions. These roles can provide the Federal Reserve with proprietary information about the operations of these institutions and could conflict with its role as a provider competing with some of these same banks for retail payments business. These roles could also provide the Federal Reserve with the ability to affect its competitors' businesses through regulatory actions or the approval or disapproval of competitors' applications to expand their operations.

Federal Reserve Policies Establish Separations Between Potentially Conflicting Roles

Because of its structure and varying roles, the Federal Reserve maintains policies and procedures that establish separations, or Chinese walls, between functions whose interests could potentially conflict or that could provide the Federal Reserve with an inappropriate advantage in competing with the private sector in selling payments services. In general, Federal Reserve policies bar Reserve Bank staff with responsibilities for priced services, unless acting in the capacity of president or first vice president in a Reserve Bank, from also having responsibility for monetary policy, bank supervision, or lending areas. These policies also explicitly state that actions relative to a bank in the monetary policy, supervisory, or lending areas will be made without regard to whether that bank uses Reserve Bank priced services or is an alternative provider of such services. Except for the Reserve Bank president, first vice president, branch manager, or persons acting in these capacities, Reserve Bank personnel involved in monetary policy, bank supervision, or the lending function may discuss payments services with a bank only when necessary to carry out their responsibilities. Other Federal Reserve staff with payments services responsibilities can discuss monetary policy, bank supervision, or lending with a bank only when the information discussed is general in nature or is public. Federal Reserve policy states that Reserve Bank personnel involved in monetary policy, bank supervision, or the lending function may provide confidential information obtained in the course of their duties to Reserve Bank priced services personnel only when such action fulfills an important supervisory objective, preserves the integrity of the payment mechanism, or protects the assets of the Reserve Banks. In such cases, information is to be provided on a need-to-know basis and only with the approval of senior management.

The Board's policies also govern its relationship with Reserve Banks when the Board is engaging in regulatory rulemaking efforts involving check collection under Regulation CC. Because these efforts can potentially affect the competitive position of the Reserve Banks as well as that of their competitors, the Reserve Banks' standing in the rulemaking process is to be no different from that of their competitors in the check collection business. The Reserve Banks are allowed to provide comments when the Board requests them in its rulemaking efforts, but they are to be afforded no additional access beyond that given to any other institution engaged in the check collection business. Board staff said that after enactment of EFAA, they consulted with Reserve Bank staff during the initial development of Regulation CC. However, as they gained experience in their role as a regulator of the check collection business, they realized that it was important to establish and maintain an arm's-length relationship. However, to their private sector competitors and other outside observers, the separation may not be apparent because the Board and Reserve Banks are not viewed as distinct entities.

Within the Board, potential conflicts are avoided through information access standards and organizational separations that determine which

Board staff are to have access to which types of information. Under these standards, supervisory information is to be provided to staff on a need-to-know basis. Board staff said that these policies ensure that staff do not have access to information that could present a conflict.

Separations Between Staff in Some Instances Do Not Apply in Others

Except as stated above, Board staff interact with Reserve Bank staff involved with check collection when the Board is considering changes to Regulation CC, but only in a manner parallel to how it would consult with another interested party. Board staff have consulted with Reserve Bank staff involved in check collection, ACH, and all other priced services with regard to the Reserve Banks' operating circulars. As stated earlier, the Board does not exert regulatory authority over the ACH system. However, the Board does exercise general oversight over the Reserve Banks in how they provide ACH services, as it does for all priced services. Therefore, Board staff interact extensively with Reserve Bank staff when reviewing changes to the Reserve Banks' ACH operating circulars. Although changes to the Reserve Bank's operating circulars are not regulatory changes, they may directly influence the ability of PSOs to compete for business. As described in more detail later in this report, the Federal Reserve has recently considered making changes to the Reserve Banks' ACH operating circulars in the areas of pricing and deposit deadlines. In the course of considering these changes, the Board has issued two requests for comment in the Federal Register. This process does not represent a regulatory change; therefore, Federal Reserve policies do not require a Chinese wall between the Board and the Reserve Banks.

Board staff said they also talk frequently with Reserve Bank staff engaged in the payments business during the process of developing and pricing Federal Reserve payment products. As described later in this report, the Board has interacted extensively with Reserve Bank staff as it oversees development of both check and ACH products and prices for those products. The Board and Reserve Bank staffs explained that they also interact in calculating the PSAF number and integrating it into the final pricing schedule, which is ultimately approved by the Board. The Board is also charged with approving new check and ACH products. However, approval authority for some product enhancements and service changes has been delegated to the Reserve Banks. Federal Reserve policy does not require separations between Board and Reserve Bank staff in these functions, but Board staff said that the different missions of the Reserve Banks, in developing prices, and the Board, in overseeing the process, serve to keep them, in effect, separate.

During our review of Board and Reserve Bank documentation from the payment service pricing and product development process, as well as requests for comment regarding possible changes to Regulation CC, and interviews with Board, Reserve Bank, and private sector competitors' staff, we found no evidence of breaches in the separations of these functions during our work.

The Board Has Removed Some Disparities between the Private Sector and Reserve Banks in Providing Check and ACH Services, but Others Remain

Because of inherent differences between the Reserve Banks and their private sector competitors, it is unlikely that all competitive disparities between them can ever be removed without changes in the structure or nature of the various institutions. They are likely to continue to enjoy certain advantages over each other in check collection and ACH. The Board has undertaken efforts to address the competitive disparities that exist between the Reserve Banks and the private sector in providing check collection and ACH services to depository institutions. Many of the competitive disparities between the Reserve Banks and the private sector banks have focused, and continue to focus, on the presentment of checks in check collection.[11] For ACH, disparities involve the ability of the Reserve Banks to charge PSOs and their customers and to require PSOs to comply with Reserve Bank deposit deadlines. PSOs, on the other hand, are unable to charge the Reserve Banks and make the Reserve Banks comply with their deposit deadlines. Although the Board has tried to address some of the disparities that have existed between itself and the private sector for both check collection and ACH, other disparities continue to exist.

Both the Reserve Banks and Their Competitors Enjoy Unique Advantages

The Reserve Banks compete against a variety of private sector providers in the payments business, and both sides have unique advantages. In check collection, the Reserve Banks compete primarily against larger banks whose correspondent banking business includes check collection; or they compete against private clearing houses whose membership includes banks of a variety of sizes. Although the Reserve Banks and their competitors provide similar services, there are certain inherent differences between them, many of which derive from the different legal responsibilities, structures, and pricing practices of the Reserve Banks and

[11] Check presentment occurs when the checks are delivered to the paying banks for payment and the paying banks must decide whether to honor or return the checks.

their competitors.[12] In ACH, the Reserve Banks compete with three PSOs.

Because it is the central bank of the United States, the Federal Reserve maintains the reserve accounts of U.S. depository institutions. This allows the Federal Reserve to settle all payments transactions by debiting and crediting the accounts of banks or their correspondents that use the Federal Reserve to provide their payments services. Competitors of the Federal Reserve do not have this option and must therefore develop alternative means to settle transactions, which will often eventually involve the Federal Reserve.[13]

The Reserve Banks' nationwide presence as a provider of both check collection and ACH services gives it an advantage in providing both services. Although there is no legal prohibition against a private sector entity developing such a presence, no other provider of either service enjoys such an advantage. A major feature of this advantage with regard to check collection is the Federal Reserve's Check Relay network, which is described in more detail in appendix II. Check Relay provides the Reserve Banks with an integrated nationwide air and ground transportation network to move checks between Federal Reserve locations. None of the Reserve Banks' competitors choose to maintain such an integrated system, although they also use commercial air transportation, most of which is provided by a single company. Although the existence of Check Relay is generally seen by its competitors as an advantage to the Reserve Banks, Reserve Bank officials said that it is necessary to maintain such a system because it is the most efficient and cost-effective way to ensure the transportation of its checks and provide rapid availability of funds, particularly for checks destined to remote areas. In addition to Check Relay, the Reserve Banks use other means to transport checks around the country. For example, they engage in "air freight forwarding," which involves putting checks on commercial flights. However, Check Relay serves as an advantage because it provides a level of certainty to the Reserve Banks' air transportation. Without it, the Reserve Banks would be more reliant on commercial suppliers of air transport, over whose schedules the Reserve Banks would have less control.

[12] *Check Collection: Competitive Fairness Is an Elusive Goal* (GAO/GGD-89-61, May 12, 1989).

[13] The Reserve Banks offer net settlement services to facilitate the final settlement in central bank money of transactions made through private sector clearing arrangements. This service makes it easier for these arrangements to compete with Reserve Banks.

Private sector payments providers also enjoy some advantages in competing for payments business. One advantage is the greater flexibility enjoyed by private sector providers in pricing their products. The Federal Reserve's pricing methodology is largely driven by MCA and its own pricing principles; however, private sector providers are generally free to price their products as they see fit, sometimes tailoring their prices to individual customers on the basis of the desirability of the customer's business. Correspondent bank officials we interviewed said that they sometimes see payment services as one part of their overall relationship with another bank and will therefore price payments services in such a way as to encourage the relationship rather than to cover the costs of providing them. A similar advantage enjoyed by competitors to the Federal Reserve is the ability to "bundle" or combine certain services for specific customers. For example, private sector competitors can price check collection services they provide to another bank at a certain level with the understanding that the bank will also purchase other services from the correspondent. The other services will often be nonpayment services that are not offered by the Federal Reserve. Private sector competitors agreed that these are advantages that they have over the Federal Reserve, which publishes standard prices for specific services. They also said that it is helpful for them to know what the Reserve Banks charge for specific services so that they can tailor their own prices when competing for business.

The Federal Reserve's competitors are free to compete for any business they desire and to refuse business that they consider unprofitable or otherwise undesirable. Because of its central bank status, the Federal Reserve seeks to ensure the efficiency of the payments system. One aspect of this is that it provides services, at its prevailing prices, to banks regardless of the attractiveness of their business. Some banks may be remotely located, have a generally low volume of payments business, or be of questionable creditworthiness and therefore may not be attractive business partners for some providers. Some correspondent bank officials said that in such instances it is unlikely that they would refuse service to such institutions, but they would probably price their services in such a way as to discourage these banks' business. However, they acknowledged their prerogative to refuse service to any bank with which they did not wish to do business.

The Board Addressed the Most Important Competitive Difference in Check Collection, but Others Remain

In 1989, we found that the most important competitive difference between the Reserve Banks and their private sector competitors in check collection was the Federal Reserve's unique ability to obtain settlement of checks from any bank on the same day that checks are presented without having to pay for the privilege.[14] Other collecting banks were generally required to pay for same-day settlement because they had no legal leverage to demand similar treatment from paying banks. In 1992, the Board amended Regulation CC by adopting the same-day settlement rule, which decreased, but did not entirely remove, this difference. The same-day settlement rule requires a paying bank to settle, or provide funds, on the day of presentment for checks presented by a private sector collecting bank, without the imposition of presentment fees, if the checks are presented at a location designated by the paying bank by 8:00 a.m. local time. After the establishment of the same-day settlement rule, the check volume presented by private sector collecting banks increased, and the Reserve Banks saw their volume decline.

The Board's same-day settlement rule did not remove all the disparities that exist between the Reserve Banks and the private sector collecting banks. For example, other disparities include differences in presentment time and location. Reserve Banks can obtain same-day settlement for checks presented to a paying bank before the Reserve Bank's cut-off hour, generally 2:00 p.m.; the presentment time for private sector competitors is 8:00 a.m. Depository institutions sometimes choose to vary these deadlines, for instance through clearing house arrangements, as permitted by Regulation CC and the Uniform Commercial Code. The Board requested comment on the effect of removing the disparity by shifting the presentment time from 8:00 a.m. to 2:00 p.m., which would provide the private sector collecting banks with the same presentment rights as the Reserve Banks. However, banks and corporate businesses who commented on these proposals generally did not favor changing the same-day settlement deadline, primarily because the additional costs incurred by paying banks and businesses would outweigh benefits gained by the collecting banks.[15] During interviews, some private sector competitors

[14] GAO/GGD-89-61.

[15] Because collecting banks are also paying banks, they must balance their competing interests. In their capacity as paying banks, the change in presentment time would have complicated their cash management, and that of some of their customers, offsetting any benefit from their collecting bank activities.

suggested that a better solution would be to hold the Reserve Banks to the 8:00 a.m. deadline rather than to extend the deadline for private sector check processors. However, Federal Reserve officials said that such a change would delay the collection of some checks and make the check clearing system less efficient overall. Reserve Banks also have more latitude than their private sector competitors in where they can present checks to banks for payment. However, in response to a Federal Reserve request for comment on this issue, most private sector competitors who commented stated that the Reserve Banks' flexibility had not significantly affected their ability to compete. Accordingly, the Board did not remove this regulatory disparity.

Proposed Changes to the Reserve Banks' ACH Operating Guidelines Address Disparities in Delivery Deadlines, but PSOs Said Pricing Disparities Remain

In response to concerns raised by NACHA and the PSOs, the Board proposed several changes to the Reserve Banks' ACH pricing structure and deposit deadlines. The Board's proposed changes to deposit deadlines appear to reduce some of the Reserve Banks' competitive advantages in providing ACH services; however, the PSOs said that the proposed pricing structure would continue to give the Reserve Banks a competitive advantage. As previously stated, the Reserve Banks process almost 85 percent of commercial interbank ACH transactions; the three PSOs (EPN, VisaNet, and American Clearing House) process the remaining 15 percent. The PSOs believe that the Reserve Banks' ACH pricing and deposit deadlines are the primary reason for the Reserve Banks' continuing dominance in the ACH market. These policies affect the PSOs' ability to compete because they often use the Reserve Banks' ACH network for interoperator ACH transactions in which either the originating bank or receiving bank is not a PSO customer. Although the PSOs agree with the Board's proposed changes to the policies on ACH deposit deadlines and eligibility, they contend that the modifications to the Reserve Banks' pricing policies would still provide the Reserve Banks with a competitive advantage over the PSOs.

In interviews with us and in comment letters to the Board, the PSOs have said that the current Reserve Bank ACH pricing policies provide the Reserve Banks with a competitive advantage over the PSOs. The Reserve Banks charge a per-file fee for each ACH file they receive, per-item fees for each transaction they process, and assess monthly servicing fees to each institution whose ACH transactions they process. Conversely, the PSOs cannot charge the Reserve Banks or their customers when the PSOs process Reserve Banks' transactions because the Reserve Banks have previously been unwilling pay such charges and can refuse to do so because of their dominant market position. The PSOs said that the pricing structure is a major competitive advantage for the Reserve Banks because any bank that uses a PSO must pay the Reserve Banks' fees in addition to the fees charged by the PSOs. The Reserve Banks' pricing structure provides an incentive for banks to choose Reserve Banks directly because depository institutions' total ACH fees would be higher if they sent transactions to the Reserve Banks through PSOs and paid fees to both the Reserve Banks and PSOs. PSOs said they were presented with a dilemma: if they want to maintain their customer base, they must either charge at a discounted rate and absorb the Reserve Banks' fees or charge a higher price, and risk losing customers.

On May 23, 2000, the Board proposed modifications to the pricing and deposit and delivery policies on ACH interoperator transactions, stating that the modifications would enhance competition. Under the Board's proposal, the Reserve Banks would be allowed to charge a monthly network access fee to PSOs to access depository institutions on the Reserve Banks' ACH network, per-item fees to PSOs for transactions they send through the Reserve Banks' ACH network, and a monthly settlement fee to depository institutions that send and receive all ACH transactions through PSOs and use the Reserve Banks' ACH service to settle some transactions. In addition, the Board proposed that Reserve Banks would be required to pay PSOs for transactions they send to banks through those PSOs, but—concerned about potential high charges—requested comments on how the fees that operators charge each other (including Reserve Banks) might be restrained.

The PSOs believe that the Board's proposed changes to the Reserve Banks' pricing policies will not significantly reduce the Reserve Banks' price advantage and may actually increase it. They are particularly concerned with the proposed monthly network access fee and the settlement fee. The PSOs believed that the proposed structure would not correct the current competitive inequities and could possibly harm competition. They suggested that the proposed price structure would permit the Reserve Banks to continue to dominate the market for ACH operator services. They also believed that the proposal's heavy reliance on volume threatened the viability of PSOs and would result in PSO customers subsidizing Reserve Bank customers. The Federal Reserve said that Reserve Banks incur costs when they accept ACH transactions from PSOs and that the Reserve Banks should be reimbursed for these costs. Moreover, the Board proposed that the Reserve Banks should charge PSOs a monthly network fee because, when an operator provides other operators' customers with access to its network, it provides value to those customers and the operators that serve them. In explaining the settlement fee, which would be paid by the respective banks, the Board said that Reserve Banks should be permitted to charge a settlement fee because the Reserve Banks are providing a service not provided by other operators when the Reserve Banks settle interoperator transactions for a depository institution that chooses to send or receive all its ACH transactions through a PSO, some of which are processed and settled through the Reserve Banks. In contrast, the PSOs believe that the Reserve Banks are subsidizing the ACH services they offer by charging fees, like the network access fee, to the PSOs and their customers that the Reserve Banks do not charge to their customers. They contend that the Board's analysis for the network access fee is flawed because it bases the value of the Federal Reserve ACH network on the number of routing numbers included in its network, not on the ACH transaction volume destined to a particular routing number.

Notwithstanding the differences over the pricing modifications, the Board and the PSOs generally agree on the Board's modifications to the Reserve Banks' policies on ACH deposit deadlines and eligibility. Because the Reserve Banks currently impose the same deposit deadlines on PSOs as they do on banks, the PSOs must set an earlier deposit deadline on their customers. The Board proposed that the Reserve Banks work collaboratively with the PSOs to establish specific interoperator deposit deadlines by which Reserve Banks and the PSOs would exchange interoperator transactions. The PSOs support this proposal, including the Reserve Banks' preliminary recommendation for the deposit deadlines.[16] On the issue of PSOs' eligibility, the Board and the PSOs agree that the Reserve Banks' deposit deadline and the pricing structure modifications should be limited to any intermediary that is defined as an operator under the operating rules of NACHA.[17] Accordingly, this proposal would exclude third-party processors or some larger private sector competitors from the modifications unless they comply with the NACHA standards for operators. The Board released its new fees and deadlines October 31, 2000.

[16] The Reserve Banks' preliminary recommendation is that one interoperator deposit deadline be established at 2:30 p.m. Eastern time for an immediate settlement item and that another interoperator deposit deadline for next-day settlement item be established at 3:00 a.m. Eastern time. Currently, the PSOs must deposit their items for immediate settlement at 3:00 p.m. Eastern time.

Questions About the PSAF and Pension Cost Credits Have Raised Concerns About the Federal Reserve's Pricing

MCA delineated several broad pricing principles for the Federal Reserve. In addition, the Federal Reserve issued pricing principles to further govern how it sets prices. These statutory and additional principles give the Federal Reserve considerable latitude in pricing its services by allowing it to recover the costs of its priced services over the long run. One requirement of MCA is that the Federal Reserve is to recover all direct, indirect, and imputed costs for priced services. Imputed costs are calculated to approximate costs that would have been incurred by private businesses in providing similar services to ensure some level of pricing parity. Because the PSAF is a proxy and is based on the Federal Reserve's interpretation within the broad parameters set by MCA, certain aspects of the methodology have been criticized. In addition, the impact of the Federal Reserve's use of pension cost credits on price setting has been criticized.

Federal Reserve Pricing Practices Comply with MCA Requirements

To meet MCA's full cost recovery requirement, the Federal Reserve developed an annual pricing process. This multistep process includes the Federal Reserve's annual budgeting process, which involves the review of Reserve Bank and Board expenses, including all direct and indirect costs related to priced services, and the annual compilation of data used to calculate the PSAF. This process is discussed in greater detail in appendix III. The Federal Reserve's prices are based on estimated direct and indirect costs as well as the PSAF. The Federal Reserve determines compliance with MCA over a 10-year period on the basis of the amount of revenues generated from each service line, such as check collection and ACH, compared to costs allocated to that service line. Over the 10-year period 1990 through 1999, the Federal Reserve calculated that the Reserve Banks recovered 101.1 percent of their total costs for providing services, including

[17] To qualify as a private sector ACH operator, an entity must execute an agreement with NACHA to comply with or perform all of the following: adhere to NACHA operating rules and other applicable laws and regulations; execute agreements with a minimum of 20 independent depository institutions that bind the depository institutions to NACHA operating rules and the private sector ACH operator's rules; provide clearing, delivery, and settlement services for intraoperator transactions; exchange interoperator transactions with other ACH operators; process and edit files according to the requirements of NACHA operating rules; evaluate the creditworthiness of and apply risk control measures to their customers; adhere to the Federal Reserve's Policy Statement on Privately Operated Multilateral Settlement Systems; and adhere to any NACHA performance standards for ACH operators.

imputed expenses, special project costs targeted for recovery, and targeted return on equity.

Board policies require that fees for priced services be set to match revenues for each service line with its estimated costs. However, the Federal Reserve may not always fully recover costs for each product within a service line and has discretion in allocating certain costs across products within service lines. For example, within the check collection service line, the Federal Reserve may recover more transportation costs from "Check Product A" than "Check Product B," even though the transportation costs may be similar. Federal Reserve officials also confirmed that they engage in "market-based" pricing within service lines, which allows it to consider such factors as elasticity of demand.[18] Therefore, the Federal Reserve has discretion to set prices above costs for products that have little private sector competition and set prices to recover marginal costs for products that have greater private sector competition. For example, within the check collection service line, prices for return-item cash letters,[19] for which the Federal Reserve has limited competition, the highest fee increased 75 percent between 1995 and 2000. Conversely, for forward-processed cash letters, for which the Federal Reserve faces greater competition, the highest fee increased 16 percent over the same period.[20]

Although it is the Federal Reserve's policy to recover costs for each service line over the long run, circumstances may arise that hinder its ability to fully recover costs in a particular service. These circumstances may include changes in technology or banking structure, more efficient operations, or aggressive pricing by other service providers. In determining whether to continue to provide the service, the Federal Reserve may consider the other objectives of MCA, such as continuing to provide equitable access and an adequate level of services nationwide and giving due regard to competitive factors. In such a case, it is the Federal Reserve's policy that a decision to continue to provide a service that could not reasonably be expected to meet its long-run cost-recovery objective would

[18] Elasticity of demand measures the change in demand for a service on the basis of a change in the price.

[19] A cash letter contains a listing of individual checks and the packaged checks.

[20] Federal Reserve check collection prices are reported as ranges from low to high, because the specific price for each product varies depending on which Reserve Bank provides the service, among other factors.

be made only where there was a clear public benefit and would be publicly announced. The Federal Reserve applied this policy in the early 1980s when it subsidized the costs of ACH to encourage movement away from checks to promote a more efficient payment mechanism.

The PSAF Is Important Because it Affects Federal Reserve Prices

The PSAF is important because it affects the Federal Reserve's prices. The PSAF is considered a component of expenses when the Federal Reserve sets prices; the higher the PSAF is, the higher the Federal Reserve's prices for check collection, ACH, and other prices have to be to cover expenses and achieve the targeted return on equity. The act requires the Federal Reserve to calculate the PSAF to simulate costs that are not incurred by Reserve Banks in their operations to reduce pricing disparities between Reserve Banks and private sector entities providing similar services. The PSAF consists of imputed income taxes and a targeted return on equity as well as the imputed costs of interest on short- and long-term debt, sales taxes, and assessments for Federal Deposit Insurance Corporation deposit insurance. Once the PSAF value is calculated, it is allocated to the various service lines, such as check collection and ACH. The process the Federal Reserve uses to determine the PSAF and its incorporation into the annual pricing process is discussed in greater detail in appendix III.

Developing the PSAF methodology has always been a challenge because there are no directly equivalent private sector providers to the Reserve Banks and no set of firms whose mix of services is the same as that provided by the Reserve Banks. However, bank holding company data are used as a proxy. Private sector competitors we interviewed most frequently questioned the targeted return on equity portion of the calculation. The Federal Reserve's targeted return on equity represents an imputed after-tax profit that the Federal Reserve would expect to earn if it was a private firm. The Federal Reserve bases the targeted return on equity on the returns of equity of the 50 largest bank holding companies (by asset size) for each of the last 5 years. Therefore, the data used to calculate the targeted return on equity include returns from all bank activities, not only those associated with correspondent banking activities. The implementation of the Gramm-Leach-Bliley Act of 1999 may make bank holding company data even less comparable because it allows holding companies with more diversified firms to become bank holding companies.[21]

Some of the correspondent bank officials we interviewed said that on the basis of returns generated by their correspondent banking activities, the targeted return on equity was generally too high. However, others said that it was too low. All agreed that the returns they attributed to correspondent banking activities could vary depending on the cost accounting systems and methodologies implemented at individual banks. Federal Reserve officials said that although the PSAF methodology may be imperfect, they have been unable to develop a more accurate methodology because of the lack of publicly available information on profitability, which is most relevant to the priced services Reserve Banks provide.

The Federal Reserve has done periodic reviews of the PSAF methodology since the methodology was established in 1981. However, Federal Reserve officials said that the PSAF methodology has not been changed significantly since 1989, when the Federal Reserve revised certain aspects of the PSAF methodology. However, in 2000, the Federal Reserve began to recognize certain assets and liabilities when calculating imputed financing costs and returns on equity in the PSAF. We discuss this change in detail later in this report.

In April 2000, the Federal Reserve began one of its periodic reviews of the PSAF methodology. The group tasked to review the PSAF methodology includes Reserve Bank and Board staff members. Although the Federal Reserve has historically published substantial changes to the PSAF methodology in the Federal Register for comment, it has not historically solicited input from the private sector or academics in developing proposals that are issued for public comment. Expanding participation in the review to private sector firms and academics could result in new and innovative thinking about how to best revamp the PSAF methodology and possible data alternatives, given the changes in the market.

Competitors Question Federal Reserve Use of Pension Cost Credits

Some of the Federal Reserve's competitors have questioned its practice of allocating a portion of its pension cost credit as part of the expenses considered when setting prices. The pension cost credits result from the Federal Reserve's over-funded pension plan and the earnings generated by its pension plan assets. The Federal Reserve uses generally accepted accounting principles (GAAP) to account for its pension credits. However, the practice has drawn criticism from some of its competitors because of

[21] The Gramm-Leach-Bliley Act enables bank holding companies to opt to become financial holding companies. A financial holding company is a bank holding company that meets certain eligibility requirements. As of September 1, 2000, over half of the 50 largest U.S. bank holding companies (1999 data) had opted to become financial holding companies.

concerns that the pension cost credit reduces the Federal Reserve's expenses, which has allowed it to offer lower prices for its services. Although the Federal Reserve started allocating the pension cost credit for price-setting purposes only in 1993, the pension cost credit in the Reserve Bank's financial statements resulted from a new accounting standard implemented in 1987 that changed the way employers account for pensions.[22] Without the pension cost credit and assuming that the Federal Reserve made no other adjustments to prices or expenses, it would not have achieved its targeted return on equity for any of the years from 1993 to 1999 and would have operated at a loss in 1993 and 1994.

FAS 87 requires employers, including other private sector service providers, to (1) determine the fair market value of their pension plan assets, less estimated future obligations as of a given date; and (2) gradually recognize the resulting assets (or obligations) in their financial statements over time. As of January 1, 1987, the Federal Reserve determined that its pension plan assets exceeded its estimated future obligation for pension benefits, which resulted in an unrecognized pension asset of $681 million. In accordance with accounting rules, the Federal Reserve amortized this unrecognized pension asset over a 15-year period and began recognizing it in its financial statements in 1987. The portion allocated to priced services resulted in approximately $10 million after-tax in credits to (reductions in) expenses each year. However, the Federal Reserve did not use this portion of the pension credit to offset costs when setting annual fees for priced services until 2000.

FAS 87 also required that annual pension plan costs be included in financial statements to properly reflect the costs of a pension plan. The annual cost figure consists of several components, including the estimated cost of future retirement benefits being earned by employees during the year netted against the annual return on pension plan assets and the amortized unrecognized pension assets (credit) previously discussed. The Federal Reserve recorded a net pension cost credit in its financial statements in every year from 1987 through 1999 due to the high returns its pension assets were earning.[23]

[22] Financial Accounting Standard No. 87, *Employers Accounting for Pensions.*

[23] Because the Federal Reserve's pension assets continue to earn favorable returns and the pension fund remains over-funded, it has made only one contribution to its retirement plan since 1987. In 1998, the Banks contributed over $80 million to reimburse the plan for administrative expense and accumulated earnings.

Since 1987, the Federal Reserve has allocated a portion of this annual pension cost credit to priced services to determine recovery for MCA compliance. That is, the pension cost credit enabled the Federal Reserve to reduce the cost recovery amount and still comply with MCA.[24] However, the Federal Reserve did not reduce costs for priced services by the pension cost credit when setting annual fees for priced services until 1993, when a new accounting standard was issued that required employers to record postretirement expenses in a manner similar to pension costs.[25] The Federal Reserve has traditionally considered the pension cost credits and postretirement benefits expenses to be related types of expenses that generally offset one another. For that reason, the Federal Reserve did not include the pension cost credits when setting fees for priced services until it implemented the accounting standards for postretirement benefits in 1993.[26] In 1995, the Federal Reserve implemented a similar accounting standard for postemployment benefits.[27]

In 1995, the Federal Reserve allocated about $24 million, after tax, in pension cost credits to priced services and about $16 million, after tax, in postretirement and postemployment benefits expenses. However, since the pension plan continued to achieve returns and grow in size, the pension cost credit grew in relation to the related postretirement and postemployment benefits expenses. By 1999, pension cost credits allocated to priced services were about $72 million, after tax; and the cost of postretirement and postemployment benefits was about $16 million, after tax.

The large disparity between the amount of the Federal Reserve's pension cost credits and other related postretirement and postemployment benefits

[24] The Federal Reserve determines cost recovery on the basis of revenues divided by costs over a 10-year period, which should equal 100 percent.

[25] Financial Accounting Standard No. 106, *Employers' Accounting for Post Retirement Benefits Other Than Pensions (FAS 106)*. The purpose of FAS 106 was to improve the reporting of postretirement benefits expenses and to change the prevailing practice at the time, which was to account for postretirement benefits on a pay-as-you-go or cash basis.

[26] Between 1987 and 1992, neither the amortized unrecognized pension asset (credit) nor annual pension cost credit were included in pricing decisions.

[27] The Federal Reserve implemented Financial Accounting Standard No. 112 *Employers Accounting for Postemployment Benefits* on January 1, 1995. These benefits include medical and dental insurance, survivor income, disability income, and workers' compensation expenses self-insured by individual Reserve Banks.

expenses resulted in a net credit to the Federal Reserve's expenses allocated to priced services. This net credit served to reduce the total expenses allocated to priced services, while at the same time increasing the net income from priced services. If the pension cost credit had not been used to offset costs allocated to priced services, the Reserve Banks would likely have set their fees higher to recover costs. Otherwise, the Federal Reserve would not have reached its targeted return on equity in any year between 1993 and 1999. The amounts annually returned to the U.S. Department of the Treasury could have been more or less than the amounts actually returned depending on the effect higher fees would have had on the amount of Federal Reserve payment services purchased by its customers and the market.[28]

Changes in PSAF Methodology Related to Prepaid Pension Assets Result in Higher Costs for Price-Setting Purposes

In 2000, the Federal Reserve began allocating a portion of its prepaid pension asset and postretirement and postemployment benefit liabilities[29] in the asset and equity figures it used for calculating imputed financing costs and returns on equity in the PSAF. According to Federal Reserve documents, the reason for this change was largely twofold. First, the value of the prepaid pension assets began to increase significantly due to large returns generated from its substantial investments. Second, the effects of prepaid pension assets are already included in the balance sheets of the bank holding companies, which are used to compute financing rates and return on equity applied to the Reserve Banks' assets to be financed for the 2000 PSAF calculation. This change resulted in an additional $60.5 million of pretax imputed costs in the 2000 PSAF, which increased the amount to be recovered.

Prior to 2000, the prepaid pension asset and postretirement and postemployment benefits were not included in the PSAF calculation because the Federal Reserve considered the pension asset to be self-financed through income generated from pension plan investments. If the imputed costs associated with the effect of including pension assets and postretirement and postemployment benefit liabilities had been included beginning in 1997, when the assets started to became large, imputed pre-tax PSAF costs would have increased by approximately $18.2 million, $30.9

[28] The Federal Reserve returns profits generated by priced services to the Treasury.

[29] A prepaid pension asset represents the excess of the cumulative funding level of the pension plan over the accrued pension obligation.

million, and $45.7 million in years 1997, 1998, and 1999, respectively. If the costs the Federal Reserve had to recover had been increased by these amounts, Reserve Banks would likely have had to raise prices or take some other action to ensure compliance with MCA

The Federal Reserve Has Promoted the Use of its Products Through New Product Development and Marketing

The Reserve Banks have strategically developed new products and marketed them in such a way as to actively compete for payments business. However, the manner in which the Reserve Banks have done this has sometimes been criticized by their competitors. Criticisms have focused on specific products developed by the Reserve Banks and their techniques for marketing them. We found that the way in which the Federal Reserve has developed and approved new products has changed over time, resulting in confusion among its competitors about its process for bringing new products to the market. In our interviews with Federal Reserve staff and private sector competitors in the payments system, we found misunderstandings about what the Reserve Banks do and basic disagreements about the appropriate Reserve Bank approach in competing for payments business, including its product development and marketing.

The Federal Reserve Has Developed Products to Respond to Perceived Market Needs

Reserve Bank staff, in competing for payments business, have developed products and services that are designed to respond to perceived market needs. Private sector competitors have complained that some of the Reserve Banks' products are predatory in nature, fall outside the payments system, or work to diminish incentives for innovation in the payments system. However, these views were expressed by competitors to the Reserve Banks and do not represent the views of all banks we interviewed, many of whom expressed satisfaction with the Federal Reserve's products and the role it plays in the payments system. In prior years, the Reserve Banks' product offerings in check collection were locally based and varied by Reserve Bank. In recent years, the Reserve Banks have been working to make their product offerings and prices more nationally based. Because the Federal Reserve is in the midst of a transition from a locally based to a nationally based system, some of its products are available from some Reserve Banks but not others; other products are available nationally.

Certain Reserve Bank payment products, three of which are described below, have caused concern from the Reserve Banks' private sector competitors. Their concerns have generally focused on such issues as the products' pricing or the appropriateness of the Reserve Banks offering the product. Such questions of appropriateness often stem from a different understanding of the Federal Reserve's role in the payments system than that of Federal Reserve staff we interviewed. Private sector competitors of the Reserve Banks often stated that the Federal Reserve should promote the efficiency of the payments system by providing service where there are gaps in service, rather than competing aggressively for markets that are already served by others. Federal Reserve staff said that MCA is based on the premise that competition will promote the efficiency of the payments system. They believe that by actively competing for payments business, the Federal Reserve is promoting the efficiency of the payments system. This lack of consensus among payment system participants was exhibited during forums held by the Federal Reserve's Committee on the Federal Reserve in the Payments Mechanism. During the forums, held in May and June of 1997, the committee and the Reserve Banks met with representatives from 450 payment system participants, including banks of all sizes, clearing houses and other third-party service providers, consumers, retailers, and academics. Federal Reserve staff said that although a few large banks and clearing houses thought the Federal Reserve should exit the check collection and ACH business, the overwhelming majority of forum participants opposed Federal Reserve withdrawal, primarily because of concern about payments system disruptions. The question of whether, and to what degree, the central bank should be involved in the payments system may never be resolved to everyone's satisfaction. Views on these questions evolve over time and are therefore likely to remain open to debate.

Nationwide City Sort

Private sector competitors have criticized the Federal Reserve's Nationwide City Sort product as being inappropriate because it was developed to serve a market that was already served by private check processors. In March 1996, the Reserve Banks began offering the Nationwide City Sort product. This is a check-sorting product that is designed to allow a bank to deposit all of its items destined for a specific set of major cities with its local Federal Reserve check processing office. All Reserve Banks offer a uniform fee structure for the service. Prior to the introduction of this product on a nationwide basis, it was available on a limited basis in some Reserve Banks.

Some payment system participants who compete with the Federal Reserve charge that the development of the Nationwide City Sort product was an inappropriate response on the part of the Federal Reserve to the success private sector competitors were having with similar products. They also suggested that the Federal Reserve's prices for this product were too low and could not be covering costs as required by MCA. Federal Reserve documentation from the product development process notes the presence of other providers in this market and the lack of a comparable Federal Reserve product. Reserve Bank staff acknowledged that they actively seek to identify market needs and develop products for which there is a market. They see no prohibition, implied or otherwise, on developing any product to serve the market, and they said that the Nationwide City Sort product complies with their own pricing guidelines and MCA.

Explicit Float Pricing Option

The Federal Reserve's Explicit Float Pricing Option product has been criticized by private sector competitors as being a credit product rather than a payment product and representing an overly aggressive approach to competition in the payments system. The Federal Reserve's Explicit Float Pricing Option product provides banks with availability, or credit, for all of the checks they deposit with Reserve Bank offices located in the eighth and tenth Federal Reserve districts on the day that the Reserve Banks process them. Otherwise, some of the items would receive deferred availability because of the time it would take to collect the funds for the checks. Deferred availability results in the respondent bank having to make multiple bookkeeping entries as various checks are credited to the bank's reserve account, rather than a single entry. The credit is provided for funds that are not yet available and is referred to as "float." The respondent bank pays interest on the funds credited.

The Federal Reserve' s competitors have suggested that this product is a loan rather than a payment service and that it is therefore inappropriate for the Federal Reserve to provide it under these circumstances. Federal Reserve staff respond that this is a valuable service to banks because it simplifies their account reconciliation processes. They further note that "float" is listed explicitly as a product in MCA, and therefore it is not inappropriate for the Federal Reserve to price float. Federal Reserve staff explained that the float that occurs with most Federal Reserve products is generally not explicitly priced; it is considered in the development of the price for the product.

Check Imaging/Archiving

Another service that has drawn criticism from the Federal Reserve's competitors is its image archiving service, which is offered as part of several different products. This service, which supplements the Federal Reserve's electronic check presentment services, involves the capture and storage of a check image by the Federal Reserve. Competitors' criticism of this product focuses on two issues. First, they point out that this service makes technology available to banks that have not invested in its development without requiring them to pay a premium for a new innovative service. This penalizes those banks that made substantial capital investments in developing such technologies because they cannot recover enough to make future investments worthwhile. Second, competitors suggest that one element of this product, storing the image of a check for up to 7 years, takes this service out of the realm of a payment service and into that of a back-office recordkeeping service.

Federal Reserve officials respond that this product is necessary to support electronic check presentment[30] because, in the event of a problem with a given check, it is necessary to have an image of the check if the check itself is not available. They believe that the Federal Reserve's involvement in making this technology available is consistent with its stated intent to serve as a catalyst to move the payments system to more electronic media. Federal Reserve staff said that image archiving is not simply a back-office record-keeping product because of the necessity of the image for electronic check presentment. They also point out that the Federal Reserve has been providing other products similar to image archiving in which the Reserve Banks provide paying banks with the information from checks several hours before presenting the checks to allow the paying bank to anticipate its needs for funds.

The Federal Reserve's role in developing image archiving technology has raised the question of the appropriate role the Federal Reserve should play in innovation in the payments system. Competitors and other critics of the Federal Reserve suggest that the Federal Reserve's involvement in the development of imaging technology has penalized other banks that invested in this technology because it made the technology available to banks that did not make an initial investment, without requiring that they pay a premium to those that did. This means banks that did invest in the technology lose the opportunity to make sufficient profit from their investment. Competitors argue that the Federal Reserve has removed incentives for future innovation because banks that might be inclined to invest in new, untested technologies will decline to do so in anticipation of the Federal Reserve investing in and spreading the benefits of the technology. According to critics, this approach removes an important benefit of competition in the payments system.

[30] With electronic check presentment, the checks are presented electronically to the paying bank by the transmission of the magnetic ink character recognition (MICR) line data at the bottom of the checks rather than the paying banks' receipt of the paper checks. The paper checks may be sent to the paying bank at a later time or may be "truncated." When checks are truncated, the check writers do not receive the cancelled checks.

Federal Reserve staff responded to this suggestion by stating that their involvement in developing technologies such as imaging is often critical to the development of these technologies. They said that they began their initial efforts to develop imaging technology 14 years before its implementation. At that time, according to Federal Reserve staff, no banks were investing in the technology. Federal Reserve staff suggested that if the Federal Reserve had not made its initial investment in the technology, no one else would have because the expected payoff from the technology was too far in the future. They said that most private sector firms might not make major capital investments in technologies that are unproven and may not be ready for 14 years. They further note that Reserve Bank customers pay for the services they receive, including the costs of making and financing the capital investments and of research and development.

Federal Reserve staff point to their involvement in the successful development of the ACH system as an example of the role that they can play in innovation. They said that prior to their involvement, private sector firms had the opportunity to invest in the technology but did not. The Federal Reserve made the investment and developed the system. The Federal Reserve has clearly played a role in basic research and innovation in areas in which the private sector is hesitant to invest either because of uncertainty or expected length of time before payoff. However, once certain approaches appear feasible, the private sector can be much more flexible and responsive than the Federal Reserve if the private sector is not constrained by market conditions that have been altered by the Federal Reserve's dominant presence or if the benefits are not lowered by the Federal Reserve spreading the benefits of a technology faster than the market otherwise would.

The Federal Reserve Coordinates District-Based Sales Staffs to Maintain and Expand Customer Base

Each Reserve Bank maintains a business development staff that includes account representatives who work directly with banks to promote Federal Reserve payments products. Federal Reserve staff explained that the Federal Reserve's marketing staff has a dual structure. It is Federal Reserve district-based, with a national overlay. The Business Development Office located in the Federal Reserve Bank of Chicago coordinates the Federal Reserve System's marketing efforts. This office provides a national coordinating function for the marketing staffs located in each of the Reserve Banks. Each Reserve Bank marketing staff is expected to develop and maintain business relationships with banks that use Federal Reserve payments services. This maintenance of customer relationships includes occasional visits to ensure that the Federal Reserve is fulfilling its customer needs or to follow up on any problems that may arise. Federal Reserve staff explained that much of the discussion between sales staff and commercial banks surrounds the solving of problems that may arise in providing payment services rather than aggressively promoting the use of Federal Reserve services. However, proposed solutions will generally include use of Federal Reserve products.

The Federal Reserve's sales staff numbers 279 staff nationwide. However, many of these staff have other responsibilities in addition to their sales responsibilities. Reserve Bank staff said that the ratio of customers to sales staff is such that most banks receive visits from Federal Reserve sales staff only every 2 or 3 years. Although it is not a systemwide practice, two of the Reserve Banks and two Reserve Bank offices maintain a bonus system that rewards sales staff on the basis of set goals. However, Federal Reserve officials said that the sizes of the bonuses are relatively modest, generally no more than 5 percent of salary; and the goals are generally based on strategic initiatives, such as the number of new electronic check presentment customers that a member of the sales staff may have gained.

Federal Reserve Products Receive Differing Levels of Review on the Basis of Their Expected Impact

Federal Reserve policies provide for varying levels of review and approval for their retail payment products depending on the expected competitive impact of the product or the extent to which the product is considered to represent a new service line. A routine proposal would be expected to result in minimal reaction from users and other service providers, pertain to a change that does not have policy or significant competitive implications, and enable the changed product to recover incremental costs. It would not be expected to substantially change budgeted service revenues in the first year of introduction. A nonroutine service or product would represent a new service line, a new product within an existing service line that would significantly modify the service line, or a new fee structure for an existing service line.

Nonroutine proposals require approval by either the Board or the director of DRBOPS. The Financial Services Policy Committee[31] has the authority to approve routine proposals but can delegate this authority to the appropriate Reserve Bank product director. In recent years, the Federal

[31] The Financial Services Policy Committee was created in late 1994 to coordinate management and strategic planning for the provision of financial services by the 12 Reserve Banks and has oversight for ensuring quality control for Reserve Bank products.

Reserve has been attempting to minimize the bureaucratic review associated with approving routine products. In some cases, products are treated as accelerated products, which are routine products that can be approved by Reserve Bank product directors because they are considered to be very similar to already existing products. Of the 119 check products approved in 1999, 2 were treated as nonroutine, 92 were treated as routine, and 25 were accelerated. Two new ACH products were approved in 1999, and both were treated as nonroutine. Federal Reserve staff said that very few of the 119 proposals were for new products. Rather, most of the routine proposals were for small changes in fees or deposit deadlines or to offer existing products at offices that did not previously offer a particular product.

In some instances, the Board will conduct a competitive impact analysis when considering an operational or legal change, such as a change to a price or service if that change would have a direct and material adverse effect on the ability of other service providers to compete effectively with the Federal Reserve in providing similar services due to differing legal powers or constraints or due to a dominant market position the Federal Reserve has derived from such legal differences. Board policy states that all operational or legal changes having a substantial effect on payments system participants will be subject to a competitive impact analysis, even if competitive effects are not apparent on the face of the proposal. Under similar circumstances, the Board may request comment on matters related to Reserve Bank priced services, including new products or services.

The Federal Reserve maintains policies to guide its decisions with regard to the level of review that products should receive and whether to conduct a competitive impact analysis or issue matters for comment. However, Board staff said that the decision is ultimately judgmental. Federal Reserve staff said that over time, the Federal Reserve has delegated more of the authority to approve new products and product enhancements in an effort to make the process more efficient. They conceded that products that may have once been considered nonroutine may now be considered routine. They said that it is possible that a product that may have once been the subject of a request for public comment might not be today. The Board's pricing principles, which were adopted following public comment, provide that the Board will request public comment ". . . when changes in fees and service arrangements are proposed that would have significant longer-run effects on the nation's payments system."

Some competitors to the Federal Reserve we interviewed said that they were unsure of how the Federal Reserve develops and announces new products and services. Staff at one correspondent bank said that they did not know a specific Reserve Bank was offering a particular check product until they discovered it on the Reserve Bank's Web site or in pricing circulars. Other competitors said that certain products, such as the Nationwide City Sort, should have been issued for public comment before being introduced. Competitors also complained that the Board did not do competitive impact analyses when it should have. Although Board policies concerning these issues are available, they are generally not published in a manner that makes them easily available to the public.

Our interviews with Federal Reserve staff and their private sector competitors revealed very different understandings of the Federal Reserve's policies with regard to the appropriate level of review certain products should have received prior to their introduction. Generally, these different understandings resulted in the Federal Reserve's private sector competitors believing that the Federal Reserve had not followed its own policies. Meanwhile, Federal Reserve officials stated that the routine nature of these products made such review unnecessary. The Federal Reserve's change in philosophy over the appropriate level of review for some products seems to have further contributed to these differing understandings of Federal Reserve policies and procedures. Although the policies themselves have not changed over time, the Federal Reserve's judgements in implementing them appear to have changed, with increased authority delegated to the Reserve Banks. This has resulted in very different understandings of the appropriateness of the Federal Reserve's actions in competing for check clearing and ACH business.

Conclusions

The Federal Reserve plays multiple roles in the payments system by virtue of its status as central bank, banking industry regulator, and payments service provider. Where these roles overlap, conflict, or potentially complement one another inappropriately, the Federal Reserve is faced with the challenge of managing or separating them in such a way as to ensure that it is fulfilling each role without exerting undue influence or giving itself an advantage at the expense of the banking industry or its private sector competitors in providing payment services. In doing our work, we found no evidence to suggest that the Federal Reserve has not adequately separated its multiple roles.

As a central bank and banking industry regulator, the Federal Reserve is inherently different from a correspondent bank, private clearing house, or PSO. Many of the competitive disparities resulting from these differences cannot be removed without changing the structure or nature of the various institutions. In many cases, where it has been possible for the Federal Reserve to remove competitive disparities between itself and its private sector competitors, it has done so to a degree. However, some competitive disparities that the Federal Reserve could remove or decrease persist, for varying reasons.

The Federal Reserve, through MCA and its pricing principles, has broad latitude in setting prices for its services. The Federal Reserve generally uses this latitude to help ensure that its prices are competitive. Although the PSAF is supposed to ensure that the Federal Reserve's prices allow for equitable competition with the private sector, the PSAF methodology has been criticized as flawed. For example, some contend that the targeted return on equity is too low, and therefore the PSAF is too low. Others said the PSAF is too high. Federal Reserve officials acknowledge that the methodology used to simulate the costs and profits that would have to be incurred by a private sector competitor is problematic. In addition, they prefer to use publicly available data that can be disclosed to help ensure the transparency of the PSAF methodology. However, this information includes bank holding company data that are not limited to the correspondent banking activity that is most closely related to Reserve Bank payment activities. The Federal Reserve's current review of its PSAF methodology is well under way. However, in future reviews, the Federal Reserve could benefit from including a wider variety of participants in the effort, including some from outside of the Federal Reserve.

The Federal Reserve's use of pension cost credits to offset the cost of priced services has also been criticized. Initially, these pension cost credits were small and generally offset associated postretirement and postemployment expenses. However, as the pension cost credit continued to increase, the associated expenses generally remained unchanged, which resulted in a large increase in the amount of pension cost credit in excess of the expenses. The Federal Reserve is free to allocate these credits to offset costs for priced services, but in doing so it has opened itself to criticism about how it prices its services and whether such a practice is beneficial from a public policy perspective. The credits have offset operating expenses for priced services and have allowed the Federal Reserve to meet its targeted return on equity, as required by MCA, without having to raise prices and/or cut costs. However, in 2000, the PSAF increased substantially because of the recognition of certain prepaid pension assets and postretirement and postemployment liabilities in its asset and equity figures. This will serve to offset some of the benefit associated with the pension cost credit.

The Federal Reserve has developed and marketed products in such a way as to compete actively for banks' payment business. We found no evidence that its actions in this regard have been in violation of MCA. However, the Federal Reserve's policies for developing and marketing products is not well understood by its private sector competitors. Although the Federal Reserve established its policies in this area some time ago, its judgements with regard to their appropriate implementation have changed over time. For example, new products that formerly may have been subject to approval by the Board are now more likely to be approved through delegated authorities at the Reserve Bank level. The Board has also been less inclined to use the public comment process than in the past. This has resulted in misunderstandings among private sector competitors about the propriety of some of the Federal Reserve's actions in developing and marketing their products. These misunderstandings are exacerbated by continuing disagreements about whether, and to what degree, the Central Bank should be involved in the payments system.

Recommendations

Although it may be too late in the current review of its PSAF methodology for the Federal Reserve to include participants from outside the Federal Reserve throughout the review process, we recommend that in future reviews the Board solicit input from individuals from outside the Federal Reserve, including academics and industry officials, at an earlier stage in reviews of the PSAF methodology and allow them to participate throughout the review process, perhaps including the evaluation of comments on any proposed PSAF revision, to determine if there are better ways to structure the PSAF.

We also recommend that the Federal Reserve clarify policies and procedures for introducing new products and product enhancements to the payments industry and make those policies more readily available to its private sector competitors.

Agency Comments

We received written comments on a draft of this report from the Board that are reprinted in appendix IV. The Board generally agreed with our conclusions and indicated its intention to assess the role academics and industry officials could play in subsequent reviews of its PSAF methodology. The Board also said that it will clarify its priced service policies and practices and make them more accessible to interested parties. The Board provided technical comments that we incorporated where appropriate.

We are sending copies of this report to requesting congressional committees. We are also sending copies of this report to the Honorable Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System. We will make copies available to others on request.

Please contact me or Orice Williams, Assistant Director, at (202) 512-8678 if you or your staff have any questions concerning this letter. Key contributors to this report are acknowledged in appendix VI

Thomas J McCool

Thomas J. McCool
Managing Director, Financial Markets and
Community Investment

LIST OF CONGRESSIONAL REQUESTERS

The Honorable Phil Gramm
Chairman
Senator Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing and Urban Affairs
United States Senate

The Honorable James A. Leach
Chairman
Representative John J. LaFalce
Ranking Minority Member
Committee on Banking and Financial Services
House of Representatives

The Honorable Carolyn Maloney
Committee on Banking and Financial Services
House of Representatives

Objectives, Scope, and Methodology

To review the Federal Reserve's role in the payments system, our objectives were to (1) identify organizational relationships and differing goals within the Federal Reserve that could present a conflict of interest and identify Federal Reserve Policies for managing or avoiding any conflicts; (2) identify any competitive advantages enjoyed by the Federal Reserve compared to its private sector competitors and evaluate the extent to which the Federal Reserve, through changes to its regulations and operating policies, has or has not removed them; (3) review how the Federal Reserve has priced its services; and (4) review Federal Reserve policies for developing and marketing its services.

We focused our work on the retail payments services provided by the Reserve Banks, check collection and the automated clearinghouse (ACH), because these services account for over 90 percent of the Federal Reserve's revenue from payments services. Moreover, it is in the retail payments services that the Federal Reserve has received the most private sector competition and has received the most public criticism of how it has competed.

To fulfill our objectives, we interviewed

- staff from the Federal Reserve Board's Division of Reserve Bank Operations and Payment Systems, which is the Board's Division primarily responsible for overseeing the Reserve Bank's payments activities;
- Reserve Bank staff from the Atlanta, Boston, and Chicago Federal Reserve districts, because these staff are involved in providing national coordinating functions for the Federal Reserve's payment services;
- staff from various groups representing participants in the payments system, including the Independent Community Bankers Association, American Bankers Association, National Automated Clearinghouse Association, and Association of Bank Couriers;
- staff from various competitors of the Reserve Banks in providing payments services, including five large banks involved in the check collection business, representatives of two private ACH operators, and two check clearing houses;
- staff from 20 community banks located throughout the United States who had assembled in Washington, D.C. for a conference sponsored by the Independent Community Bankers Association, and
- former officials of the Federal Reserve who were active during their tenures with the Federal Reserve in payments issues.

To identify organizational relationships and differing goals within the Federal Reserve that could present a conflict of interest, we reviewed the Federal Reserve Act, Monetary Control Act, and the Expedited Funds Availability Act. In addition, we reviewed Board policies for managing and/or separating its responsibilities and roles in the payments system. During our interviews of the staff listed above, we sought any indication or evidence of breaches of the Federal Reserve's policies separating its various roles in the payments system. We also followed up on allegations raised by others of breaches of the Federal Reserve's separations.

To identify any competitive disparities between the Federal Reserve and its private sector competitors in check and ACH payment services, and the extent to which the Federal Reserve has removed them, we interviewed Federal Reserve Board and Reserve Bank officials and private sector competitors in check and ACH services. We reviewed the Board's changes to Federal Reserve policies and regulations for check and ACH services and previous GAO work on the Federal Reserve System, check collection, and other payment mechanisms. For identified check competitive disparities, we determined whether the Board addressed these disparities by making changes to Regulations CC and J to level the playing field between the Reserve Banks and the private competitors. For identified ACH disparities, we reviewed the Board's recent proposals to modify the Reserve Banks' ACH pricing and deposit deadline policies. We interviewed affected parties, including Reserve Banks, correspondent banks, and private ACH providers, along with major organizations representing banking institutions, clearinghouses, and private ACH providers. For each of these interviews, we asked similar questions to determine the respondents' views of the competitive balance between the Federal Reserve and its private sector competitors in providing payment services. We also reviewed comment letters submitted to the Board on its rulemaking efforts under Regulation CC and on its proposed modifications to the Reserve Banks' ACH pricing and deposit deadline policies.

To review how the Federal Reserve has priced its services, we reviewed the requirements placed on the Federal Reserve by the Monetary Control Act of 1980 (MCA) and the Federal Reserve's own pricing principles. We also reviewed the Federal Reserve's Private Sector Adjustment Factor (PSAF) methodology and its pro forma financial statements and other pricing information contained in the Federal Reserve Board's annual reports, the Federal Reserve's fee schedules for priced services, and the Federal Reserve's Planning and Control System (PACS). In addition, we reviewed Financial Accounting Standards Board standards, including Financial

Accounting Standard No. 87, *Employers Accounting for Pensions*; and Financial Accounting Standard No. 106, *Employers' Accounting for Post Retirement Benefits Other Than Pensions*. We reviewed our previous work on the Federal Reserve's pricing for priced services and on the PSAF, the Federal Reserve Board Office of Inspector General's (OIG) report on the Board's compliance with MCA, and OIG's follow-up work on its recommendations. We discussed all of this material with the Federal Reserve Board and Reserve Bank staff involved in the pricing process. We also interviewed individuals from outside the Federal Reserve who have publicly expressed opinions about the Federal Reserve's pricing practices.

To review how the Federal Reserve has developed and marketed its check and ACH services, we reviewed Board policies on its delegated authorities for approving payment products and on soliciting public comments for product proposals. We also interviewed Reserve Bank staff to ascertain how these policies are implemented. To determine the level of understanding of these processes in the private sector, we interviewed private sector payments participants.

We received written comments on a draft of this report from the Board that are reprinted in appendix IV. The Board also provided technical comments that we incorporated where appropriate.

Check Relay

The Reserve Banks have contracted with private-sector couriers to provide centrally managed air and ground transportation system for checks since the mid-1970s. Until 1998, the Reserve Banks' retail payment management and management of the air transportation system, the Interdistrict Transportation System (ITS), was located at the Federal Reserve Bank of Boston, where questions were raised about its cost recovery and how its operations were managed.[1] In 1998, the retail payment function, including ITS, was moved to the Federal Reserve Bank of Atlanta, and ITS was renamed Check Relay. However, controversy persists about how the Federal Reserve recovers costs associated with the transportation of checks. Although Check Relay is very similar to its predecessor system, Reserve bank officials said they reevaluated the check transportation system at the time it was moved to Atlanta and will continue to evaluate its purpose and function. Recent changes have included allowing their contracted air couriers to carry non-Federal Reserve freight, called conjunctive work, and increasing the number of commercial vendors it used for certain routes.

Background

In 1985, we issued a report that addressed concerns raised about the Federal Reserve's pricing of check clearing activities.[2] This report included a discussion of the Reserve Banks' air transportation system for checks, then called ITS. Several air couriers who competed with ITS complained that the Federal Reserve's method of pricing can impede competition. Federal Reserve officials said that their decisions for accounting for transportation revenues and costs paralleled those of the private sector. In our 1985 report, we reported that the Federal Reserve had established interterritory transportation surcharges to help offset the cost of transportation and to help equalize check processing prices for all institutions using Federal Reserve services, whether the Federal Reserve's transportation was used or whether an institution's own transportation was used. We agreed that the way the Federal Reserve priced its services could pose a problem for private sector courier firms that did not have Federal

[1] On January 5, 1996, the Democratic Staff of the Committee on Banking and Financial Services, U.S. House of Representatives, released a report entitled *Waste and Abuse in the Federal Reserve's Payment System* that detailed a number of managerial problems with ITS. These problems were further explored in hearings before that same committee's Subcommittee on Domestic and International Monetary Policy held on September 16, 1997.

[2] *An Examination of Concerns Expressed About the Federal Reserve's Pricing of Check Clearing Activities* (GAO/GGD-85-9, Jan. 14, 1985).

Reserve contracts. However, we recognized that requiring the transportation surcharge to exactly cover costs for each market area would be difficult to administer, is not required under existing law, and would not necessarily be effective. In 1983, we found that transportation surcharges did not cover costs. Complaints about ITS pricing practices have persisted since the mid-1980s. Problems with ITS were most recently explored in hearings before the Committee on Banking and Financial Services, House of Representatives, on September 16, 1997.

Structure and Operation of Check Relay

Check Relay, formerly ITS, is managed by the Federal Reserve Bank of Atlanta. Like its predecessor, Check Relay provides routine ground and air transportation service to 45 Regional Check Processing Centers (RCPC) or check offices throughout the country. Although Check Relay's seven vendors generally provide exclusive air transportation service to the Federal Reserve for its specified routes, the network is managed by the Federal Reserve.[3] As part of the management function, the Federal Reserve establishes flight schedules and routes, transfers cargo from plane to plane at the hubs, tracks the cargo, and performs periodic reviews. In addition to the seven vendors mentioned previously, several other contract vendors provided airfreight forwarding, which was managed by a private sector firm under contract with the Reserve Banks.

Check Relay is used to transport checks from one Reserve office to another and between Reserve offices and financial institutions. On weekdays, it uses a centrally managed hub and spoke network to connect all Federal Reserve offices, except those in the Twelfth district. Because of the time difference on the West Coast, checks from other districts are sent to the Twelfth District via commercial air freight forwarding that ties into Check Relay at Cincinnati. Reserve Bank officials said that commercial transportation is used to transport checks to and from the Twelfth district because time zone differences prevent the Federal Reserve Bank of San Francisco from providing same-day availability for out of district banks. Therefore, the transportation of the checks is less time critical. These officials also said that they use a commercial vendor to provide air freight forwarding service for all checks on the weekend instead of a dedicated network because these checks have longer time windows between deposit and delivery deadlines.

[3] In 1999, the Federal Reserve began a pilot program permitting vendors to carry conjunctive work. In addition, one of the vendors was allowed to sublease a route to another air courier.

How the Federal Reserve Recovers Transportation Costs

The Federal Reserve's recovery of transportation costs has been the subject of controversy since the passage of the Monetary Control Act of 1980. Its competitors believe that the Federal Reserve subsidizes the costs associated with air transportation. Over the years various legislative proposals have been introduced that would have required the Federal Reserve to treat transportation as a separate product and recover its costs separately from other costs associated with check collection.[4] Federal Reserve officials believe that transportation is not a distinct product; rather, they see it as one component of check collection. For example, Federal Reserve officials said that they consider check transportation similar to other components of the check service, such as data processing and telecommunications, which are not separate services subject to separate cost recovery requirements.

The Federal Reserve's policy is to match revenue and cost by service line, such as check collection, rather than individual categories of costs, such as transportation. This means that check transportation costs are recovered within the check service line, not per individual check product. Federal Reserve officials said that they do not view check transportation costs as a direct component of each product; instead, they are allocated and recovered by service line. Federal Reserve officials said that Check Relay's goal is to contribute to the recovery of total costs for the check service line.

Air couriers who provide transportation services to collecting banks point out that the Federal Reserve's method of pricing can make a difference in their efforts to compete with Check Relay. For example, some complain that the Federal Reserve's transportation costs must be higher than those reflected in its prices, which makes it difficult for air couriers to compete. Aside from Check Relay, only one air courier offers nationwide service carrying checks. As of September 2000, it carried about three times as much volume as Check Relay on any given night. Reserve Bank officials estimate that they transport about 15 to 20 percent of nonlocal checks.

Check Relay costs allocated to priced services are recovered by fees for those services. Reserve Bank officials said that its transportation costs are

[4] These legislative proposals have included, among others, H.R. 1442, "The Federal Reserve Free Enterprise Act," introduced in 1997, which would have included the transportation of paper checks as a separately priced service; and H.R. 2119, "the Efficient Check Clearing Act of 1997," which would require cost-revenue matching for specific Federal Reserve-provided services, including check transportation.

recovered through a surcharge on certain products and included as a flat rate for others. Check Relay officials estimated that air and ground transportation costs represent about 3 to 4 percent of the Reserve Banks' cost of check collection. The Federal Reserve generally does not price according to distance but instead uses the average cost of providing transportation nationwide. According to some of the correspondent bank officials we spoke with, average costing is consistent with the transportation costing methodology used by correspondent banks. In 1999, improved information systems demonstrated that Check Relay transportation components in check product prices independently covered the service line's national transportation costs.

Federal Reserve Decision to Allow Conjunctive Work

In December 1999, at the urging of correspondent banks and Federal Reserve air vendors, the Federal Reserve instituted a pilot program that would allow its air transportation vendors to carry non-Federal Reserve cargo, known as conjunctive work, on Federal Reserve routes. This type of arrangement is not new to the Federal Reserve; conjunctive work was once allowed on Federal Reserve air routes, and it has always been allowed on its ground routes. However, for decades prior to December 1999, the Federal Reserve required its air transportation vendors to carry Federal Reserve cargo exclusively. In the 1990s, the Federal Reserve solicited comments on a proposal to allow Federal Reserve vendors to carry conjunctive work once again. On the basis of comments received, the Federal Reserve decided not to permit conjunctive work at that time.

In the late 1990s conjunctive work became an issue once again as the Federal Reserve looked for ways to lower its operating expenses. At the prompting of its vendors and at least one large correspondent bank, the Reserve Banks implemented a pilot program in 1999 that would allow conjunctive work. Reserve Bank officials also estimated that most of its vendors fly with 75 percent excess capacity. As part of its 1998 request for bid process, the Federal Reserve published an amended request for bids, following its bidding conference, which included the option to submit alternative proposals based on conjunctive work. Although respondents were required to submit proposals that did not include conjunctive work, they were invited to submit alternative proposals that included conjunctive work. Reserve Bank officials said that they received three proposals with the alternative included.[5] Officials said that the pilot program became permanent in the Spring of 2000. As of June 2000, only one air transportation vendor routinely carried conjunctive work.

Reserve Bank officials said that a portion of fees generated by vendors for conjunctive work will be used to offset the contract costs of transportation incurred by the Reserve Banks. For example, if the current rate used to calculate the fee is $1.25 per pound of conjunctive work carried, and a vendor carries 400,000 pounds of conjunctive work annually, and the Federal Reserve contract cost is $2 million, the contract costs after the adjustment for the conjunctive work would be $2 million minus $500,000, or $1.5 million. According to officials, the vendor that carried conjunctive work as of June 2000 carried an average of 2,000 pounds of conjunctive work daily (compared to 50,000 pounds carried overall).

Reserve Bank officials said that its current system is well suited to manage this program and that it has various mechanisms in place to monitor its usage. For example, Federal Reserve cargo is to remain the vendor's first priority, and the Federal Reserve plans to monitor conjunctive work through the Federal Reserve's weight tracking system and by the fact that cargoes are transferred from plane to plane by Reserve Bank personnel. The vendors also have to disclose what non-Federal Reserve cargo they are carrying.

Federal Reserve Extends Existing Contracts

As mentioned previously, the Federal Reserve Bank of Atlanta plans to continuously reevaluate the current transportation system in search of more cost-effective alternatives. The movement toward conjunctive work was identified as one way to cut costs. Reserve Bank officials said that they also plan to thoroughly reevaluate the system over the next several years to measure the benefits of the system versus the costs. These officials also said that as electronic payments continue to grow, the need for air transportation to move paper checks will likely decrease over time. As part of the Federal Reserve Bank of Atlanta's planned efforts to review Check Relay, Reserve Bank officials said that they opted to extend the expiration dates of existing contracts so that all the contracts expire at the same time. These officials said that they felt that 2003 would be sufficient time for them to review various alternatives to the existing transportation structure. However, at least one air courier has criticized the Reserve Bank's decision to extend the existing contracts rather than requesting new bids for all contracts in light of the new policy concerning conjunctive work.

[5] Although three alternative bids were submitted, officials said that none were selected on the basis of the alternative proposal for various reasons.

In addition to allowing conjunctive work, the Reserve Bank has taken other steps to lower its transportation costs. In June 2000, it approved a sublease arrangement between one of its vendors and another air courier to cover one of its routes because both the Reserve Bank vendor and the other air courier were flying the same route with excess capacity of over 75 percent. Reserve Bank officials said that they are open to similar arrangements, provided the arrangement would lower costs without hampering service. Further, they said that all options would be considered over the next few years, including abandoning Check Relay. However, these officials cautioned that any alternative system would have to enable the Reserve Banks to provide service to all depository institutions on an equitable basis. Reserve Bank officials said that their biggest concern with the Reserve Banks not having their own network is that commercial air couriers can exit the market or drop a service at any time, and there is only one commercial national air courier currently dedicated to check collection. They also said that one air courier had recently stopped providing a service, which resulted in Check Relay having to fill the void.

The Federal Reserve's Pricing Process

Since the implementation of the Monetary Control Act of 1980 (MCA), the Federal Reserve has charged fees for providing payment services. The act required the Federal Reserve to charge fees to cover the costs of those services it provides to depository institutions. In setting prices, the Federal Reserve is bound by several broad pricing principles. To ensure some level of price parity, the act requires that the Federal Reserve recover its total direct, indirect, and imputed costs for priced services, including check collection and ACH, over the long run.[1] These imputed costs represent the private sector adjustment factor (PSAF). Although the act requires the Federal Reserve to recover all implicit and explicit costs over the long run, it also gives the Federal Reserve the flexibility to consider other factors when setting its prices, such as market efficiency, equity, and competitive impact.

Pricing Principles

In setting its prices, the Federal Reserve considers several broad principles, including explicitly pricing services and recovering cost "over the long run." The Federal Reserve explicitly prices and annually publishes its fees for priced services in the *Federal Register*. It has also defined the long run as 10 years. MCA requires that the Federal Reserve follow certain principles when pricing its products. These broad statutory principles include the following:

- All Reserve Bank services covered by the fee schedule shall be priced explicitly.
- All Reserve Banks services covered by the fee shall be available to nonmember depository institutions, and such services shall be priced at the same fee schedule applicable to member banks, except that nonmembers shall be subject to any other terms, including a requirement of balances sufficient for clearing purposes, that the Board may determine are applicable to member banks.
- Over the long run, fees shall be established on the basis of direct and indirect costs actually incurred in providing priced services, including

[1] The act also lists the following services: currency and coin services, wire transfer services, settlement services, securities safekeeping services, Federal Reserve float, and any new services that the Federal Reserve offers.

interest on items credited prior to actual collection, overhead, and an allocation of imputed costs (PSAF), which is to include 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. However, the pricing principles shall give due regard to the provision of an adequate level of services nationwide as well as competitive factors when setting prices.

- Interest on items credited prior to collection shall be charged at the current rate applicable in the market for federal funds.

In addition to the statutory principles delineated in MCA, the Federal Reserve adopted additional pricing principles it is to follow when setting pricing. These broad principles are:

- Fees are to be set so that revenues for major service lines match explicit and imputed costs. If, in the interest of providing an adequate level of services nationwide, the Board determines to authorize a fee schedule below cost, it will announce its decision.

- Service arrangements and related fee schedules shall be responsive to the changing needs for services in particular markets. Users and providers of similar services will be given advance notice for changes in fees and significant changes in service arrangements to permit orderly adjustments.

- The structure of fees and service arrangements may be designed to both improve the efficient utilization of Federal Reserve services and to reflect desirable longer run improvements in the nation's payments system. Public comment will be requested when changes in fees and service arrangements are proposed that would have significant longer run effects on the nation's payments system.

In 1984, the Federal Reserve also implemented a policy regarding the treatment of surpluses and shortfalls that may arise in providing priced services. This policy states that the Federal Reserve sets fees to recover projected costs for the calendar year rather than to offset prior years' surpluses or shortfalls.

Private Sector Adjustment Factor Based on Bank Holding Company Model

As previously mentioned, MCA requires the Federal Reserve to calculate certain implicit costs that are incurred by private sector service providers but not the Reserve Banks. The purpose is to ensure that the Federal Reserve does not enjoy a price advantage based on its quasi-governmental status. The PSAF includes costs associated with taxes, Federal Deposit Insurance Corporation (FDIC) premiums, financing costs, and imputed profit. The PSAF is calculated annually by the Federal Reserve from information provided by the Reserve Banks. The calculation process starts as part of the Federal Reserve's annual budget process and the final PSAF amount is usually announced in November. The year 2000 PSAF allocated to priced services was $192.6 million, an increase of 66 percent, or $76.8 over the 1999 amount. According to Federal Reserve documents, the large increase was mainly attributed to the identification of additional costs related to certain pension assets and benefits.

The first step in the methodology for calculating the PSAF involves determining the average book value of Federal Reserve assets that will be used in providing priced services during the coming year. Second, 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 average of the largest 50 bank holding companies (BHC). Third, imputed costs are determined by applying related interest rates and rates of return on equity from the BHC model. The long-term debt and equity rates are based on BHCs in the model for the last 5 years. Because short-term debt, by definition, matures within 1 year, only data for the most recent year are used for computing the short-term rate. In addition to these capital costs, the PSAF comprises imputed sales taxes, expenses of the Board related to priced services, and an imputed FDIC insurance assessment on clearing balances held with the Reserve Banks to settle transactions.

The BHC model used to derive the ratios used in the PSAF includes financial data obtained from the annual reports and Securities and Exchange Commission filings of the 50 largest BHCs from each of the last 5 years. The Federal Reserve derives the long-term debt and equity rates based on the average of the last 5 years' bank holding company data; the short-term debt rates are based on the most recent year's data used. Federal Reserve officials indicated that BHC information used for the PSAF calculation contains a 2-year lag due to the timing of information availability.

The Federal Reserve Bank of Kansas City develops the PSAF recommendation that is then reviewed and approved by the Financial Services Policy Committee (FSPC) and Board along with the fee schedules. To determine full cost recovery, the PSAF is allocated across priced services.

Federal Reserve Pricing Process

The Federal Reserve's pricing process begins in June as part of its annual budgeting process. Each Reserve Bank produces estimated costs and pro forma revenue statements. Board staff provide the initial estimates of pension cost credit, and the Federal Reserve Bank of Kansas City staff and FSPC staff provide the estimates of the PSAF. Fees are set to match revenues for major service lines with their costs. However, the Federal Reserve does not always fully recover costs by product line and has discretion in allocating certain costs across products within a service line.

The Federal Reserve gathers expense data using PACS, a centralized, uniform cost accounting system used by all Federal Reserve Banks. The pro forma statement of priced service performance uses PACS data to report operating expenses by priced service.

If a depository institution or other payments system participant believes that the Federal Reserve's priced services policies or practices are not in accord with the competitive analysis or other criteria described above, Federal Reserve policy instructs it to communicate its concerns to the first vice president of the local Reserve Bank. If the institution wishes to pursue the complaint, it may address the concern to the designated Board member.

Federal Reserve Uses Full-Cost Recovery to Price its Services

When setting prices for its services, the Federal Reserve uses full-cost recovery, which means it accumulates all direct and indirect costs, including the PSAF for the services identified in MCA. Indirect costs include support and overhead,[2] which cannot be directly attributed to priced services. Indirect costs are allocated to priced services in total and to other Reserve Banks activities on the basis of their proportion of total Reserve Bank costs.

[2] These costs include total Federal Reserve administrative functions, central mail operations, legal, budget preparation and control, expense accounting, records management and contingency planning, motor vehicles, and audit.

The Federal Reserve's pricing principles require that revenues for each service line, such as check collection and ACH, match total costs for that service line over a 10-year period. Federal Reserve policy is to set prices to recover its costs by service line. However, under certain circumstances, it may set prices below costs to encourage use of a service or in response to a temporary situation that could be corrected. For example, during the early 1980s, the Federal Reserve set prices below costs for ACH to encourage its development and use.

Comments From the Federal Reserve System

Note: GAO comments supplementing those in the text appear at the end of the appendix.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

LOUISE L. ROSEMAN
DIRECTOR
DIVISION OF
RESERVE BANK OPERATIONS
AND PAYMENT SYSTEMS

October 19, 2000

Mr. Thomas J. McCool
Managing Director, Financial Markets
and Community Investment
United States General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

See GAO comment.

Thank you for the opportunity to comment on the GAO's draft report entitled Federal Reserve System: Policies in Place to Manage Potential Conflicts of Interest. We believe that the GAO's conclusions recognize the importance the Federal Reserve places on providing payment services in an environment of competitive fairness. To this end, we have been careful to take steps to separate our roles as regulator and payments service provider in order to manage potential conflicts of interest. We agree with the GAO's assessment that these steps have been effective in avoiding such conflicts of interest.

The GAO's draft report recognizes that, as the central bank, the characteristics of the Federal Reserve are inherently different from those of its private-sector competitors. As the GAO notes, both the Federal Reserve Banks and private-sector service providers have competitive advantages and disadvantages vis-a-vis each other. The GAO in its draft report describes several important steps we have taken to reduce competitive disparities in payments services provided by the Reserve Banks. To reduce the competitive advantages of the Federal Reserve Banks due to differing legal powers, the Board adopted the same-day settlement rule for checks, which became effective in 1994. A further step the Federal Reserve has taken to reduce competitive disparities, not discussed in the draft report, is the enhanced net settlement service the Reserve Banks began offering last year. This enhanced service is designed to facilitate the final settlement of transactions cleared through private-sector arrangements, including those with a large number of settling participants and those that are cross-district in nature. In addition, the Board's recent proposal to modify the Reserve Banks' deadlines and price structure for ACH transactions involving a private-sector operator responds to competitive concerns raised by some private-sector ACH participants. We are currently refining the ACH interoperator proposal, taking into consideration the comments received, and plan shortly to recommend Board approval of a modified approach that should foster enhanced competition in the provision of ACH services to depository institutions. Although we have taken a number of significant steps over the years to reduce competitive disparities between the Reserve Banks and private-sector service providers, we agree with the GAO's conclusion that it is impractical to eliminate these disparities entirely.

Note: We did not reproduce the technical comments.

2

The GAO also concludes that Federal Reserve pricing practices comply with the requirements of the Monetary Control Act (MCA). We have placed considerable Board and Reserve Bank senior management attention on ensuring MCA compliance and are proud of our track record in this regard. The draft report notes the challenges associated with imputing the costs the Reserve Banks would have incurred and the profits that they would have earned had their payments services been provided by a private-sector firm. MCA requires that the Federal Reserve set fees to recover these imputed costs and profits, in addition to its actual costs of providing payment services, over the long run. As you know, the Board requested public comment on the initial methodology to calculate the Private Sector Adjustment Factor, or PSAF, as well as subsequent modifications to this methodology. Earlier this year we undertook a fundamental review of the PSAF methodology and plan to recommend that the Board request comment on changes to that methodology in the near future. In future PSAF reviews, we will obtain external input on possible changes to the methodology before developing a specific proposal for public comment, consistent with the GAO's recommendation. We will assess the role academics and industry officials could also play in subsequent stages of our review process that would avoid inappropriate influence of these few individuals in the development of the final recommendations to be considered by the Board.

Finally, the draft GAO report indicated that the Federal Reserve's policies for developing and marketing products are not well understood by its private-sector competitors. To address this concern, we will clarify our priced services policies and practices and make them more accessible to interested parties. This information will be available within the next several months on the Board's web site at http://www.federalreserve.gov and on the Reserve Banks' financial services web site at http://www.frbservices.org.

We have also provided technical comments on the draft report under separate cover.

Sincerely,

The following is GAO’s comment on the Federal Reserve System’s letter dated October 19, 2000.

GAO Comment

The report is now titled *Federal Reserve System: Mandated Report on Potential Conflicts of Interest.*

GAO Contacts and Staff Acknowledgments

GAO Contacts

Thomas J. McCool, (202) 512-8678

Orice Williams, (202) 512-5837

Acknowledgments

In addition to those named above, Toayoa Aldridge, Thomas L. Conahan, Nancy Eibeck, Jeanette M. Franzel, Rosemary Healy, Robert Pollard, John H. Treanor, and Paul Thompson made key contributions to this report.

Ordering Information

The first copy of each GAO report is free. Additional copies of reports are $2 each. A check or money order should be made out to the Superintendent of Documents. VISA and MasterCard credit cards are accepted, also.

Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:
U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013

Orders by visiting:
Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders by phone:
(202) 512-6000
fax: (202) 512-6061
TDD (202) 512-2537

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

Orders by Internet:
For information on how to access GAO reports on the Internet, send an e-mail message with “info” in the body to:

info@www.gao.gov

or visit GAO’s World Wide Web home page at:

http://www.gao.gov

To Report Fraud, Waste, or Abuse in Federal Programs

Contact one:

- Web site: http://www.gao.gov/fraudnet/fraudnet.htm
- e-mail: fraudnet@gao.gov
- 1-800-424-5454 (automated answering system)

United States
General Accounting Office
Washington, D.C. 20548-0001

Official Business
Penalty for Private Use $300

Address Correction Requested

Bulk Rate
Postage & Fees Paid
GAO
Permit No. GI00

[redacted]