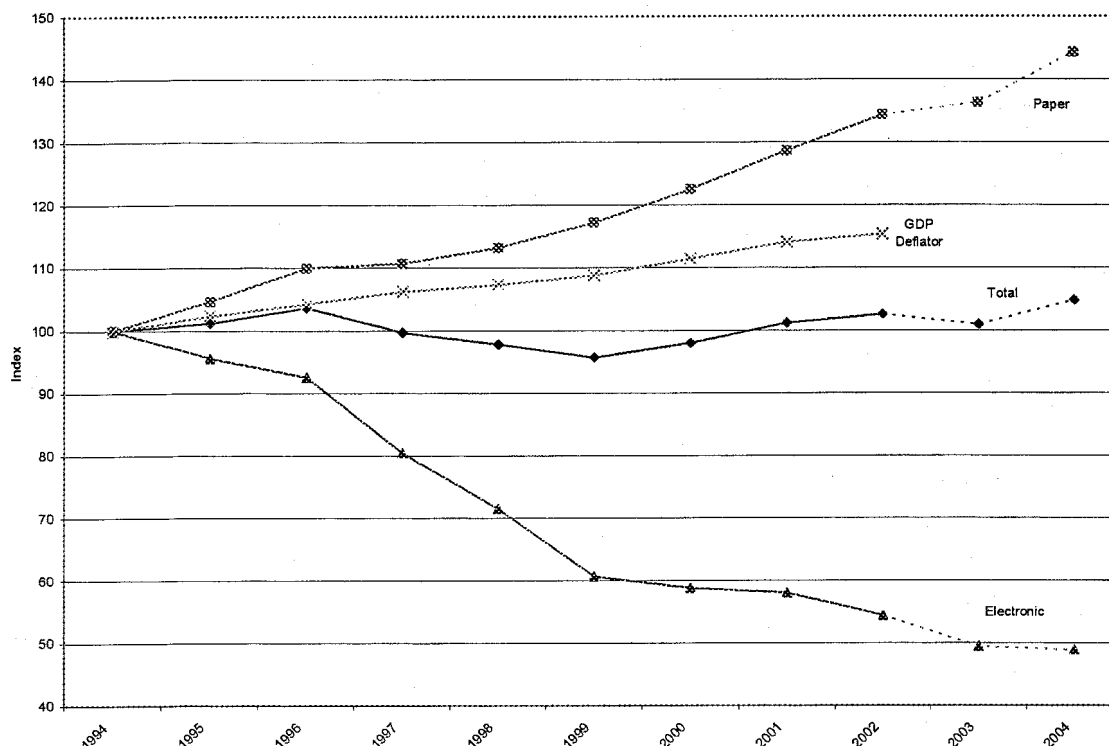


FIGURE 1
PRICE INDICES FOR FEDERAL RESERVE PRICED SERVICES



B. Earnings Credits on Clearing Balances—The Board has approved changing the rate used in calculating earnings credits on clearing balances from the federal funds rate to 90 percent of the three-month Treasury bill rate, effective January 8, 2004. The “marginal reserve requirement” adjustment in the earnings credit calculation will continue to be made using the federal funds rate.

Clearing balances were introduced in 1981, as a part of the Board’s implementation of the Monetary Control Act, to facilitate the access to Federal Reserve priced services by institutions that either did not have an account at a Reserve Bank or did not have a sufficient required reserve balance to support the settlement of their payment transactions. Reserve Banks have calculated earnings credits based on the effective federal funds rate since the inception of the clearing balance program over twenty years ago. Earnings credits can be used only to offset charges for priced services, are calculated monthly, and expire if not used within one year.⁵

⁵ A band is established around the contracted clearing balance to determine the maximum balance on which credits are earned as well as any deficiency charges. The clearing balance allowance is 2 percent of the contracted amount, or \$25,000, whichever is greater. Earnings credits are based on

The most common practice at private-sector correspondent banks is to calculate earnings credits on compensating balances using a rate discounted from the lagged three-month Treasury bill rate. Discounts are expressed either as a percentage reduction or a level (basis-point) reduction from the base rate. Even so, almost one-quarter of large correspondent banks no longer explicitly tie the earnings credit rate to an external benchmark. Correspondent banks generally do not establish required compensating balance levels and they generally do not allow earning credits to accumulate to future months, like the Federal Reserve.⁶ Earnings credits on balances held at correspondent banks generally must be used in the month earned.

Under current procedures, the earnings credits on clearing balances held at the Federal Reserve are based on

the period-average balance maintained up to a maximum of the contracted amount plus the clearing balance allowance. Deficiency charges apply when the average balance falls below the contracted amount less the allowance, although credits are still earned on the average maintained balance.

⁶ A minimum balance may be established in specific cases, depending on the creditworthiness of the customer.

the average effective federal funds rate, the average clearing balance maintained, the imputed reserve requirement adjustment, and the marginal reserve requirement. These two adjustments are applied so that the return on clearing balances at the Federal Reserve is comparable to what the depository institution would have earned had it maintained the same balance at a private-sector correspondent.⁷

⁷ The “imputed reserve requirement” adjustment is made because a private-sector correspondent would be required to hold reserves against the respondent’s balance with it. As a result, the correspondent would reduce the balance on which it would base earnings credits for the respondent because it would be required to hold a portion, determined by its marginal reserve ratio, in the form of non-interest-bearing reserves. For example, if a depository institution held \$1 million in clearing balances with correspondent bank and the correspondent had a marginal reserve ratio of 10 percent, then the correspondent bank would be required to hold \$100,000 in reserves, and it would grant credits to the respondent based on 90 percent of the balance, or \$900,000. This adjustment imputes a marginal reserve ratio of 10 percent to the Reserve Bank.

The “marginal reserve requirement” adjustment accounts for the fact that the respondent can deduct balances maintained at a correspondent, but not the Federal Reserve, from its reservable liabilities. This reduction has value to the respondent when it frees up balances that can be invested in interest-bearing instruments, such as a federal funds. For example, a respondent placing \$1 million with a