

By using the federal funds rate, the Reserve Banks are calculating earnings credits using a rate that is higher than typical market practice. The Reserve Banks could better align their rates with those of the marketplace and lower their cost of clearing balances, which must be recovered via fees, by changing to a Treasury-bill-based rate. The Board has approved that the earnings credit rate be changed to 90 percent of a rolling 13-week average of the annualized coupon equivalent yield of three-month Treasury bills in the secondary market

to better align Federal Reserve policy with market practice.

The Board also approved changing its policy on the frequency with which depository institutions can change their contracted clearing balances. The new policy will permit changes more frequently, as often as each maintenance period. Under this new policy, any change would still need to be made before the beginning of the reserve maintenance period to which it applies. Advance agreement on the amount of the contracted balance ensures that

variations in contracted clearing balances are not a source of uncertainty for the conduct of open market operations during a reserve maintenance period. Depository institutions, through the Reserve Banks, have expressed interest over the years in being able to make more frequent changes to their contracted level.

C. *Check*—Table 3 below shows the 2002, 2003 estimate, and 2004 budgeted cost recovery performance for the check service.

Table 3

Check Pro Forma Cost and Revenue Performance (\$ millions)					
YEAR	1 REVENUE	2 TOTAL EXPENSE	3 NET INCOME (ROE) [1-2]	4 TARGET ROE	5 RECOVERY RATE AFTER TARGET ROE [1/(2+4)]
2002	760.9	751.2	9.7	78.2	91.7%
2003 (Estimate)	744.5	805.8	-61.2	89.4	83.2%
2004 (Budget)	776.1	751.1	25.0	93.6	91.9%

1. *2002 Performance*—The check service recovered 91.7 percent of total costs in 2002, including imputed expenses, and a portion of targeted ROE, which was less than the targeted recovery rate of 95.5 percent. The volume of checks collected decreased 1.9 percent from 2001, consistent with nationwide trends away from the use of paper checks and toward greater use of electronic payment methods. Revenue fell from 2001 levels primarily due to declining volume combined with a customer shift to lower priced products. Customer demand for these lower priced products grew and the value of premium priced accelerated availability products diminished as interest rates

declined. Revenue was \$44.3 million less than budget. Costs were \$13.6 million less than budget due to local cost reductions, which were largely offset by lower-than-budgeted pension credits.

2. *2003 Estimate*—Through August 2003, the check service has recovered 84.3 percent of total costs, including imputed expenses, and targeted ROE. For the full year, the Reserve Banks do not expect to recover fully their costs of providing check services. Specifically, the Reserve Banks estimate that the check service will recover 83.2 percent of its total costs for the full year compared with the budgeted 2003 recovery rate of 92.5 percent, for an

operating loss of \$61.2 million. The lower-than-budgeted recovery rate is driven by lower-than-anticipated NICB and pension credits, which account for \$59.4 million of the financial shortfall. Additional contributing factors include costs of \$39.0 million associated with the check restructuring and check modernization initiatives that were not included in the original budget, and less-than-budgeted operating revenue of \$26.9 million.⁸ The service revenue shortfall reflects a continued trend of customers towards the use of lower priced products, which are more attractive in a low interest rate environment. The budget variances are summarized in table 4.

correspondent rather than the Federal Reserve would free up \$30,000 if its marginal reserve ratio were 3 percent.

The formula used by the Reserve Banks to calculate earnings credits can be expressed as $e = [b * (1 - FRR) * r] + [b * (MRR) * f]$ where e is total earnings credits, b is the average clearing balance maintained, FRR is the assumed Reserve Bank

marginal reserve ratio (10 percent), r is the earnings credit rate (currently equal to f), MRR is the marginal reserve ratio of the depository institution holding the balance (either 0 percent, 3 percent, or 10 percent) and f is the average federal funds rate. A depository institution that meets its reserve requirement entirely with vault cash is assigned a marginal reserve requirement of zero.

⁸ The check modernization initiative, which is largely completed, is comprised of four individual projects to standardize the Reserve Banks' hardware and software platforms for check processing and adjustments, for check imaging and archiving, and to develop a Web-based delivery platform.