The Pricing of Float and an Efficient Payments Mechanism

by Jim Winner

Most checks are deposited in a bank other than the one on which they are drawn. In such instances, the bank in which the check is deposited (the payee bank) must collect the funds from the bank on which the check is drawn (the payor bank). In the United States, check collection services are provided by both private and public institutions. The private sector collects checks via local clearinghouses, bank service corporations, and an extensive network of correspondent banks; the public sector is represented by the Federal Reserve System, which, until this year, provided check collection services, free of charge, to its member banks.

Because the collection of checks requires the use of real resources (for example, personnel, transportation, and computing), the question arises as to whether the extent to which these resources are employed in collecting checks constitutes an efficient use of the nation’s scarce resources. The quantity of resources employed in clearing checks depends both on the number of checks written and the speed with which the checks are collected. In addition to being underpriced because of interest rate ceilings on demand deposits and encouraged by the pricing practices of the banking industry, the use of checks and similar paper instruments has been subsidized by the Federal Reserve System’s free check collection services. As a result, the extent to which checks and similar paper instruments (and resources employed in processing these paper instruments) are used is widely recognized as being inefficient. To increase the efficiency of the payments mechanism, the Depository Institutions Deregulation and Monetary Control Act of 1980 requires the Federal Reserve System to charge for its check collection services and for float. This Economic Commentary examines the pricing of float and the related issue of the efficiency of the payments mechanism.

Economic Efficiency and Check Collection

Economic efficiency in allocating the nation’s scarce resources requires that an additional unit of a good be produced only if the additional social benefit (marginal social benefit) of the unit is greater than or equal to the additional social cost (marginal social cost) associated with its production. As long as private benefits and social benefits do not converge, there is that is, there are no “externals,” the interaction of private producers because of interest rate ceilings on demand deposits and encouraged by the pricing practices of the banking industry, the use of checks and similar paper instruments has been subsidized by the Federal Reserve System’s free check collection services. As a result, the extent to which checks and similar paper instruments (and resources employed in processing these paper instruments) are used is widely recognized as being inefficient. To increase the efficiency of the payments mechanism, the Depository Institutions Deregulation and Monetary Control Act of 1980 requires the Federal Reserve System to charge for its check collection services and for float. This Economic Commentary examines the pricing of float and the related issue of the efficiency of the payments mechanism.

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bank depositing a check and the Federal Reserve Bank increasing its reserve account is determined largely by the geographical location of the payor bank. The payee bank has an "availability schedule," constructed by the Federal Reserve Bank, that gives the approximate time it has taken the Federal Reserve Bank to collect checks from the payor bank in question. After this scheduled time has elapsed, the Federal Reserve Bank will automatically increase the reserve account of the payor bank; the payor bank's reserve account, on the other hand, is not decreased until the check is actually collected. For a variety of reasons, the check may not be collected in the scheduled time, and for a period of time both banks will have credit for the reserves represented by the amount of the check. The float generated by this "double counting" constitutes one source of total bank reserves supplied by the Federal Reserve System.

Payor banks benefit from float, since they can invest these funds in interest-bearing assets. Congress reasoned that float constituted an "interest-free" loan to the banking industry, because the same amount of total bank reserves could be supplied to the banking system if float were reduced and Federal Reserve holdings of U.S. government securities increased by equivalent amounts. The government would then receive interest on the additional holdings of securities through the annual transfer of Federal Reserve Bank deposits to the Treasury. This federal "float tax" would have to be weighed against the cost of collecting charges on float. The Pricing of Float and Efficiency of Payment by Check through a Federal Reserve Float would eliminate the incentive of payee banks to speed check collection, and charging payor banks for float would impose a higher cost on delayed collection. Payor banks could not avoid the float tax by shifting to private-sector collection services, because the choice of collection services is at the discretion of payee banks, and, all other things equal, payee banks would choose the system that grants the fastest availability of reserves.

Payors and their banks would bear the float tax, because banks would be forced to encourage payees to accept payment by the Federal Reserve instead of funds among banks—a service provided by automated clearingshouses. In addition, remote disbursement and other costly practices adopted to increase float would become unprofitable, thus reducing their use and improving the allocational efficiency of the payments mechanism. Charging payors for float and payees for the actual cost of collection would serve consistent with these targets. Granting immediate availability and collecting at a slightly lower amount of reserves, in the form of float, that would exceed the reserves consistent with the monetary targets, the Federal Reserve would attempt to supply an amount of nonborrowed reserves consistent with these targets. Targeting immediate availability and collecting at a slightly lower amount of reserves, in the form of float, that would exceed the reserves consistent with the monetary targets, the Federal Reserve would attempt to supply an amount of nonborrowed reserves consistent with these targets. Targeting immediate availability and collecting at a slightly lower amount of reserves, in the form of float, that would exceed the reserves consistent with the monetary targets, the Federal Reserve would attempt to supply an amount of nonborrowed reserves consistent with these targets.