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UNITED STATES GENERAL ACCOUNTING OFFICE 71-102 1.11.03 36

WASHINGTON, D.C. 20548

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CIVIL DIVISION

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Dear Mr. Secretary:

In the draft of a proposed report submitted to you in November 1969, we suggested that the Treasury consider reimbursing commercial banks for fiscal services performed for the Government by direct payments rather than through the maintenance of time deposits in the banks, because of the potential savings that would accrue to the Government.

The Fiscal Assistant Secretary, by letter dated December 30, 1969, submitted the Department's comments on the draft report. The Department concluded that compensating the banks for the services provided by direct payments would be more costly than through the maintenance of time deposits, primarily because, under a direct payment plan, the banks would charge higher rates for the services provided, which would more than offset the savings through elimination from the time deposits of the legal reserves.

Because we have no basis for questioning the Department's position that the banks would increase their charges to a point that would offset any savings that would result from compensating the banks directly, we are withdrawing our suggestion. We are, however, commenting on the effect of the legal reserve requirements on the Government's costs of the services provided by the banks, the earnings rates used in computing the banks' earnings on the time deposits, and the adequacy of the reimbursements by the Unemployment Trust Fund to the Treasury for maintaining time deposits for the unemployment accounts.

With regard to the legal reserve requirements on the time deposits, the Department was correct in pointing out that our estimate of the possible savings by compensating the banks through direct payments was based on a substantial portion of the time deposits that was not subject to the reserve requirements. We estimated that, after eliminating the deposits not subject to the reserve requirements, as mentioned by the Department--deposits for providing banking facilities at Government installations and for providing bank drafts and items uncollected by the banks but for which the Treasury receives immediate credit--the total reserve requirements for fiscal year 1969 was

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about $1.6 million, $1.3 million for the Treasurer's General Accounts and $0.3 million for the unemployment accounts.

To estimate the amount of the items uncollected by the banks, we reviewed about $23.2 million, which included $10.2 million that had been reviewed by the Department, or 56 percent of the estimated average daily Treasurer's General Account time deposit balances of $41.5 million in fiscal year 1969--$8.9 million secured by 2-percent depository bonds and $32.6 million secured by other collateral. Our review showed that, of the average daily time deposits reviewed, $7.8 million represented uncollected items, of which $1.2 million was secured by 2-percent depository bonds and $6.6 million was secured by other collateral.

On the basis of the assumption that the uncollected items secured by each type of collateral was representative of the entire average daily time deposits, we estimated that about $15.8 million represented the daily uncollected items and that the remaining $25.7 million was subject to reserve requirements, of which about $7.6 million was secured by the 2-percent depository bonds and $18.1 million was secured by other collateral.

On the basis of the average legal reserve requirement percentages applicable to the time deposit balances reviewed--4 percent for banks that had deposited 2-percent depository bonds as collateral and 5.5 percent for banks that had deposited other collateral--and on the basis of the average daily time deposits subject to the reserve requirements, we estimated that the average daily legal reserves for the Treasurer's General Account time deposit balances in fiscal year 1969 amounted to about $1.3 million.

For the unemployment accounts' time deposits, we estimated that, on the basis of a review of 41 percent of the time deposits of $6.3 million allocable to the unemployment accounts, the average daily legal reserves in fiscal year 1969 amounted to about $300,000.

The Government, in addition to incurring costs for the services provided by the banks, as measured by the banks' earnings on the time deposits, also incurs interest costs on the reserves applicable to the deposits. We estimated that, on the basis of the earnings rates used by the Department in its analyses, these additional costs for fiscal year 1969 amounted to about $75,000--$7,000 for the time deposits secured by the 2-percent depository bonds and $68,000 for the time deposits secured by other collateral.

NEED TO CHANGE EARNINGS RATE FOR TIME DEPOSITS SECURED BY OTHER COLLATERAL

In our opinion, banks' earnings on time deposits secured by collateral other than 2-percent depository bonds should be determined by use of the average prevailing rate of interest on 3-month Treasury bills during the period the banks performed the services, rather than the average rate for the previous 6-month period, since this would have been the period the deposits were producing earnings for the banks. We estimated that, had such a policy been in effect during fiscal year 1969, the Treasury would have saved interest costs of about $151,000, because the time deposits could have been decreased by about $2.6 million and such funds could have been used to reduce the public debt or for other Government purposes which would have permitted a reduction in Government borrowings.

For the time deposits secured by collateral other than the 2-percent depository bonds, the banks' earnings are based on the amount of the time deposits, less uncollected items and the amount of the reserve requirements, multiplied by the average annual interest rate--rounded off to the next lower one eighth of 1 percent--on the 3-month Treasury bills outstanding at the end of the preceding 6 months, or 2 percent whichever is greater. The earnings rate established by the Treasury for use in fiscal year 1969 averaged 5.375 percent on the basis of the calendar year 1968 average interest rates for 3-month Treasury bills of about 5.424 percent. In contrast, the average interest rate prevailing during fiscal year 1969 for the 3-month Treasury bills was about 5.893 percent.

During fiscal year 1969, the average daily Treasury time deposits secured by collateral other than 2-percent depository bonds was about $41 million, of which $25.1 million was the amount on which the banks' earnings were computed. By applying the average interest rate of 5.893 percent prevailing during that period to the $25.1 million, we estimated that the banks earned about $130,000 more than the earnings computed by the Department. Had the Department based its computation on the average interest rate prevailing during that period, the indicated increased earnings by the banks would have permitted the Department to reduce the average daily time deposits by about $2.6 million, including the reserve requirements. The Government's interest costs for fiscal year 1969 on the $2.6 million was about $151,000 based on the prevailing average interest rate on 3-month Treasury bills.

In commenting on our draft report, the Department stated that it recognized the disparity between prevailing interest rates and those applicable to the Treasury time deposits during fluctuations in the money market. The Department stated also that, because of the deferred adjustments in the rates applicable to Treasury time deposits, the Department would pay more for funds than the rate applicable to the time deposits during a period of rising interest rates and, conversely, would pay less during a period of decreasing interest rates. The Department believes that such inequities will be equalized as rates are stabilized.

We believe, however, that the Department's interest costs will not be reduced sufficiently during a period of declining interest rates to offset the increased costs incurred during a period of rising interest rates.

To compensate a bank for a given amount of activity, the Department must maintain a greater amount of time deposits during a period of rising interest rates than during a period of declining interest rates, because of the use of a prior period's interest rate in computing the bank's earnings on the deposits. Thus the savings accruing to the Department during a period of declining interest rates would be less than the increased costs incurred during a period of rising interest rates. This is illustrated in the following table which is based on the assumptions that:

--Treasury average interest rates, rounded off to the next lower one eighth of 1 percent, decreased during fiscal year 1970 at the same rate that the interest rates, similarly rounded off, increased during fiscal year 1969.

--The banks' earnings on the time deposits in each 6-month period of fiscal year 1970 was the same as in each 6-month period in fiscal year 1969.

Six-month period ended	Average interest rates: Earnings rate	Prevailing rate	Difference	Time deposits subject to earnings (millions)	Banks' earnings	Treasury interest costs	Treasury (increased) or reduced interest costs
Fiscal year 1969:							
Dec. 1968	5.250	5.500	0.250	$25.7	$675,400	$707,500	$(32,100)
June 1969	5.500	6.250	0.750	24.6	675,400	767,500	(92,100)
Fiscal year 1970:							
Dec. 1969	6.250	5.500	-0.750	21.6	675,400	594,400	81,000
June 1970	5.500	5.250	-0.250	24.6	675,400	644,700	30,700

The table shows that the Treasury's reduced interest costs of $111,700 in fiscal year 1970 were not sufficient to offset the increased interest costs of $124,200 in fiscal year 1969. The difference between the increased costs of $124,200 in fiscal year 1969 and the previously mentioned banks' increased earnings of $130,000 (see p. 3) was due to the rounding off of the prevailing rates of interest.

Moreover, a continuation of the constant decline in the time deposit activity experienced during the most recent 5-year period would result in an additional insufficiency of the interest costs during a period of declining interest rates to offset the interest costs incurred during prior periods of increasing interest rates.

For calendar years 1965 through 1969, the following table shows, by 6-month increments, the average rate used by the Treasury in computing the banks' earnings on the time deposits, the average prevailing interest rate on the outstanding 3-month Treasury bills, the amount of time deposits secured by collateral other than 2-percent depository bonds, and the interest costs to the Treasury on such time deposits based on the prevailing interest rate.

Time period		Average interest rates			Amount (millions)	
From	To	Earnings rate	Prevailing rate	Difference	Time deposits	Interest costs
Jan. 1965	June 1965	3.625	3.974	0.349	$104.5	$2.1
July 1965	Dec. 1965	3.875	4.035	0.160	106.2	2.1
Jan. 1966	June 1966	4.000	4.679	0.679	98.1	2.3
July 1966	Dec. 1966	4.625	5.190	0.565	90.4	2.3
Jan. 1967	June 1967	5.125	4.474	-0.651	76.1	1.7
July 1967	Dec. 1967	4.375	4.457	0.082	51.9	1.2
Jan. 1968	June 1968	4.375	5.335	0.960	48.5	1.3
July 1968	Dec. 1968	5.250	5.513	0.263	41.1	1.1
Jan. 1969	June 1969	5.500	6.274	0.774	41.0	1.3
July 1969	Dec. 1969	6.250	7.200	0.950	38.7	1.4

The above table shows that, except for one period January to June 1967, the prevailing interest rates exceeded the rates used by the Department in computing the banks' earnings on the time deposits. The table shows also that during the 5-year period the earnings' rate increased by 72 percent; the prevailing rate on Treasury bills increased by 81 percent; the amount of time deposits decreased by 63 percent; and the Treasury's interest cost decreased by 33 percent, as a result of the decrease in the time deposit program. Therefore it appears to us that, even though the interest rates may decline, the resultant reduced interest costs would not be sufficient to offset the interest costs incurred during prior periods of increased interest rates unless there was a substantial increase in the time deposit program.

In summary, we believe that the prevailing rate of interest on the 3-month Treasury bills for each earnings period would be more indicative of the banks' earnings on the time deposits than the prior period's interest rate on such bills. The use of the prevailing interest rate on 3-month Treasury bills also results in a rather conservative estimate of the banks' earnings on the time deposits, since other eligible obligations which the banks can use for collateral generally have higher yields than the 3-month Treasury bills. We believe that the Department's application of the prevailing interest rate to the banks' analyses of expenses and earnings would not necessitate a change in the banks' reporting procedures or result in an increase in the Department's administrative costs. If the banks submit their analyses prior to the Department's determination of the prevailing interest rate, the Department could make the necessary adjustment during its review of the banks' analyses.

Recommendation

We recommend to the Secretary of the Treasury that the Department base its computation of the banks' earnings on the time deposits secured by collateral other than 2-percent depository bonds on the prevailing interest rate on 3-month Treasury bills. Since the interest rates on the 3-month Treasury bills have been generally increasing since fiscal year 1961 until recently, when the rates have tended to decline, we recommend that the Department initiate such change in its method of computing the banks' earnings on the time deposits when it believes that the interest rates have stabilized or are increasing.

TREASURY'S COST OF MAINTAINING TIME DEPOSITS FOR UNEMPLOYMENT ACCOUNTS NOT FULLY REIMBURSED

The Unemployment Trust Fund is required to reimburse the Treasury for its cost of maintaining time deposits for unemployment accounts (42 U.S.C. 1101). We noted, however, that the Treasury did not recover its interest costs pertaining to the banks' reserve requirements for the time deposits.

During fiscal year 1969, $1.3 million of the Treasury's time deposits was for unemployment accounts' purposes. Before the banks' earnings on the time deposits were computed, a deduction for the reserve requirements, about $300,000 as estimated by us (see p. 2), was made. The amount of the Fund's reimbursements to the Treasury did not, however, include the Treasury's cost of maintaining the time deposits allocable to the reserves. By use of the 2-percent rate for deposits secured by depository bonds and of the prevailing interest rates on 3-month Treasury bills during fiscal year 1969 for deposits secured by other collateral, we estimate that the Treasury's interest costs for the time deposits of $300,000 allocable to the reserves were about $17,300 for that fiscal year.

Recommendation

We recommend that the Treasury recover from the Unemployment Trust Fund the costs for maintaining the time deposits allocable to the banks' reserve requirements.

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We appreciate the courtesy extended to our staff, and we shall appreciate a reply on the matters discussed.

Copies of this report are being sent to the Director, Office of Management and Budget; the Fiscal Assistant Secretary; and the Commissioner of Accounts, Bureau of Accounts.

Sincerely yours,

A T Samuelson
Director, Civil Division

The Honorable
The Secretary of the Treasury