



FEDERAL RESERVE BANK
OF DALLAS

TONY J. SALVAGGIO
FIRST VICE PRESIDENT

August 13, 1992

DALLAS, TEXAS 75222

Notice 92-64

TO: The Chief Executive Officer of
all financial institutions in the
Eleventh Federal Reserve District

SUBJECT

**Requests for Comments on Proposed Factors for
Evaluating Reserve Banks' Requests to Withdraw from a Priced
Federal Reserve Service Line and Request for Comments on a Proposal
by the Federal Reserve Banks to Withdraw from the Priced
Definitive Securities Safekeeping Service**

DETAILS

The Board has requested comment on proposed factors that would be used by the Board as part of its analytical framework for evaluating Reserve Banks' requests to withdraw from a priced Federal Reserve service line. These factors were developed to provide the Board with a consistent methodology for reviewing withdrawal proposals so that any public policy issues arising from such proposals receive appropriate consideration.

The Board must receive comments by September 14, 1992. Comments should be addressed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551. All comments should refer to Docket No. R-0767.

The Board has also requested comment on a proposal by the Federal Reserve Banks to withdraw from the priced definitive securities safekeeping service by year-end 1993. This proposal would eliminate the safekeeping of definitive securities pledged to state and local governments. However, the proposal would not affect the safekeeping of collateral pledged to the discount window, to the Treasury Department, or to Federal Government agencies. Secondary market purchase and sale of securities, which is currently included in the definitive securities service line, will continue to be offered but will no longer be included under this service line after 1993.

The Board must receive comments by September 14, 1992. Comments should be addressed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551. All comments should refer to Docket No. R-0768.

ATTACHMENTS

Copies of the Board's notices (Federal Reserve System Docket No. R-0767 and R-0768) are attached.

MORE INFORMATION

For more information, please contact Charles W. Bennett, Assistant Director, at (202) 452-3442, or Donna A. DeCorleto, Program Leader, at (202) 452-3956, Division of Reserve Bank Operations and Payment Systems. For the hearing impaired only, Telecommunications Device for the Deaf (TDD), please contact Dorothea Thompson at (202) 452-3544.

For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely,

A handwritten signature in cursive script, appearing to read "Tony J. Salysio".

FEDERAL RESERVE SYSTEM
Docket No. R-0767
Factors for Evaluating Reserve Bank
Requests to Withdraw from a Priced Service Line

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board requests comment on proposed factors that would be used by the Board as part of its analytical framework for evaluating Reserve Banks' requests to withdraw from a priced Federal Reserve service line. These factors were developed to provide the Board with a consistent methodology for reviewing withdrawal proposals so that any public policy issues arising from such proposals receive appropriate consideration.

DATES: Comments must be submitted on or before September 14, 1992.

ADDRESSES: Comments, which should refer to Docket No. R-0767, may be mailed to the Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551, Attention: Mr. William W. Wiles, Secretary; or may be delivered to the Board's mail room between 8:45 a.m. and 5:00 p.m. All comments received at the above address will be included in the public file and may be inspected at Room B-1122 between 8:45 a.m. and 5:15 p.m.

FOR FURTHER INFORMATION CONTACT: Charles W. Bennett, Assistant Director (202/452-3442), or Donna A. DeCorleto, Program Leader (202/452-3956), Division of Reserve Bank Operations and Payment Systems; for the hearing impaired only: Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

The Monetary Control Act of 1980 requires that the Federal Reserve price the services it provides to depository institutions in order to recover the costs incurred in providing those services. The legislative history of the Act indicates that, inter alia, Congress sought to encourage competition in order to assure provision of these services at the lowest cost to society; consequently, Congress charged the Board with adopting pricing principles that "give due regard to competitive factors and the provision of an adequate level of services nationwide."

The Board subsequently adopted pricing principles that incorporate both the specific statutory requirements of the Act and provisions intended to fulfill its legislative intent. The principles require among other things that services be explicitly priced, that fees be based on all direct and indirect costs actually incurred in providing the services, and that fees be set so that revenues for major service line categories match costs. If, in the interest of providing an adequate level of services nationwide, the Board determines to authorize a below-cost fee schedule for a service, the pricing principles require that the Board announce its decision. Finally, the principles direct that service arrangements and fee schedules be responsive to the changing needs for services in particular markets.

The pricing principles established an important foundation for the conduct of priced services, but did not

specifically address the issues that should be considered when a service no longer could comply with the principles. The Board has indicated that any withdrawal from a service line would have to be undertaken in an orderly way, giving due regard to the transition problems associated with the discontinuation of a service. The Board, however, previously has not identified specific factors to consider in evaluating whether to withdraw from a service line.

The question of withdrawal from a priced service line has recently arisen with respect to one of the paper-based securities services offered by the Federal Reserve. The Board believes that a consistent methodology for reviewing Reserve Bank proposals to withdraw from a priced service line is needed to ensure that any public policy issues arising from such proposals receive appropriate consideration. The Board is proposing to use the following factors in evaluating Reserve Bank proposals to withdraw from a priced service line.

1. It is likely that other service providers would supply an adequate level of the same service (i.e. access, price, and quality) in the relevant market(s) if the Federal Reserve withdraws from the service.

As noted above, Congress, in requiring that the Federal Reserve price its services, was attempting to encourage competition, provision of services at the lowest cost to society,

and nationwide availability of an adequate level of service. This factor considers whether other service providers are likely to supply an adequate level of the same service in terms of access, price, and quality. Restricted access, prices significantly higher than Reserve Bank full-cost-based fees, or material degradation in the quality of service would weigh in favor of the Reserve Banks continuing to provide the service. A relevant market would be the region that is accessible to the depository institution using the service at a cost and within a time frame that is reasonable for the service involved.

2. If other service providers are not likely to provide an adequate level of the same service in the relevant market(s), it is likely that users of the service could obtain other substitutable services that could reasonably meet their needs.

A substitutable service would be an alternative service that would achieve the same or a comparable outcome for the service user at a cost commensurate with that service. For example, providing access to a securities depository could be considered a substitutable service to providing definitive securities safekeeping on premises. The existence of adequate substitutable services would weigh in favor of Reserve Banks withdrawing from the service even if adequate levels of the service were not available from alternate sources.

3. Withdrawal from the service would not have a material, adverse effect on the Federal Reserve's ability to provide an adequate level of other services.

A material, adverse effect would be any consequence of withdrawal that would seriously impede or undermine the Federal Reserve's ability to provide an adequate level of other services. For example, if withdrawal from one service caused a shift of large overhead costs to another service, it could necessitate a fee increase large enough to adversely affect provision of that other service. These circumstances would weigh in favor of the Reserve Banks continuing to provide the service.

4. Withdrawal from the service would not have a material, adverse effect on the Federal Reserve's ability to discharge other responsibilities.

A material, adverse effect would be any consequence of withdrawal that would seriously impede or undermine the Federal Reserve's ability to discharge its other responsibilities as central bank or fiscal agent of the United States. For example, if Federal Reserve withdrawal from a payment service would seriously jeopardize its ability to carry out its fiscal agency responsibilities, this circumstance would weigh in favor of the Reserve Banks continuing to provide the service.

5. There are no public benefits of continued Federal Reserve provision of the service that outweigh the reasons for withdrawing from the service.

The Board would consider whether there was any other public benefit, not addressed under the previous factors, that could be achieved through continued provision of the service. If any could be identified, the Board would consider whether the public benefit outweighed the withdrawal benefits.

In conclusion, all of these factors would serve as part of the analytical framework that the Board would consider when evaluating a proposal by a Federal Reserve Bank to withdraw from a priced service line. The Board would request comment the first time a Federal Reserve Bank or Banks proposed withdrawing from any Federal Reserve priced service line. In addition, the Board would provide at least a 60-day transition period following approval of a request to withdraw from a priced service line to enable users and other providers of the service a reasonable period of time to prepare for the change. If the Board determined that withdrawal from a service line was inappropriate, the Board's pricing principles, including the principles applicable to cost recovery, would continue to apply to the service. The Board has applied these proposed factors in its request for comment on the proposal to withdraw from priced definitive securities safekeeping, which is also being issued

today (see Docket No. R-0768 elsewhere in today's Federal Register).

The Board requests comments on the proposed factors that would be used by the Board as part of its analytical framework for evaluating Reserve Banks' requests to withdraw from a priced service line.

By order of the Board of Governors of the Federal Reserve System, July 8, 1992.

(signed)

William W. Wiles
Secretary of the Board

FEDERAL RESERVE SYSTEM

Docket No. R-0768

Withdrawal From Priced Definitive Securities Safekeeping Service

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice.

SUMMARY: The Board requests comment on a proposal by the Federal Reserve Banks to withdraw from the priced definitive securities safekeeping service by year-end 1993. This proposal would eliminate the safekeeping of definitive securities pledged to state and local governments, but would not affect the safekeeping of collateral pledged to the discount window, to the Treasury Department, or to Federal Government agencies. Secondary market purchase and sale of securities, which is currently included in the definitive securities service line, will continue to be offered but will no longer be included under this service line after 1993.

DATES: Comments must be submitted on or before September 14, 1992.

ADDRESSES: Comments, which should refer to Docket No. R-0768, may be mailed to the Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551, Attention: Mr. William W. Wiles, Secretary; or may be delivered to the Board's mail room between 8:45 a.m. and 5:00 p.m. All comments received at the above address will be included in the public file and may be inspected at Room B-1122 between 8:45 a.m. and 5:15 p.m.

FOR FURTHER INFORMATION CONTACT: Charles W. Bennett, Assistant Director (202/452-3442), or Donna A. DeCorleto, Program Leader (202/452-3956), Division of Reserve Bank Operations and Payment Systems; for the hearing impaired only: Telecommunications Device for the Deaf, Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: The definitive securities service line consists of the definitive securities safekeeping service and the purchase and sale service. Definitive securities safekeeping consists of the storage of certain types of physical securities, such as registered and bearer municipal securities, mortgage certificates, and other commercial paper, that are ineligible for Federal Reserve Bank book-entry securities safekeeping.^{1/} The purchase and sale service consists of performing secondary market securities purchases and sales on behalf of depository institutions. All of the Reserve Banks, with the exception of the Federal Reserve Bank of San Francisco, offer the priced definitive securities safekeeping service and most Reserve Banks also offer the purchase and sale service. From the inception of pricing in 1981, the long-term role of the Federal Reserve Banks in priced definitive securities safekeeping was uncertain because the industry was slowly moving its municipal securities, which represented the bulk of Reserve Bank priced vault holdings, to depositories to facilitate secondary

^{1/} A book-entry security is a certificate-less security represented by an accounting entry maintained electronically on the books of the security issuer or the issuer's agent.

market trading and settlement of these securities. (Similarly, the purchase and sale service was evolving from the purchase and sale of definitive and book-entry securities to primarily book-entry securities.) In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act which, in effect, eliminated the Federal tax advantages for bearer municipal securities issued after July 1, 1983. This change essentially shifted the demand for new issues of municipal securities from bearer, definitive form to book-entry form; the Reserve Banks do not offer book-entry municipal securities safekeeping. As a result, as the municipal securities held in Reserve Bank vaults matured or were moved to depositories, they were not replaced by new definitive securities. Consequently, the volume of priced definitive securities safekeeping holdings steadily declined and per-deposit costs began to rise. Reserve Banks continued their on-going efforts to contain safekeeping costs, but a large portion of the cost associated with operating a securities vault is fixed. Eventually, high fixed costs and declining volume necessitated fee increases in order to achieve full-cost recovery. It is now apparent that further fee increases will only accelerate withdrawals.

Total Reserve Bank holdings in priced definitive securities safekeeping declined by 65 percent between 1987 and 1991. Through cost containment efforts, higher fees, and revenue generated by vault withdrawals, the Reserve Banks in total were

able to achieve full-cost recovery for the definitive securities service line until 1991, when the recovery rate declined to 91 percent. The recovery rate for the definitive securities service line in 1992 is currently projected to be approximately 84 percent; gross revenue for 1992 is projected to be \$3.3 million. The definitive securities safekeeping service is projected to comprise 81 percent of the service line's total 1992 costs, but only 77 percent of its total revenue.

Given the definitive securities safekeeping service's declining volume and its negative impact on the service line's recovery rate, the Reserve Banks evaluated several alternatives. One alternative considered was for the Reserve Banks to join a depository and offer depository access. This alternative would have enabled the Reserve Banks to achieve full-cost recovery and would have promoted securities immobilization at a depository. The Reserve Banks concluded that this alternative, however, did not meet two of the Board's criteria for establishing new services or major service enhancements. Specifically, offering depository access would not provide a clear public benefit, given the small market share of eligible definitive securities held by the Reserve Banks. In addition, depository access is widely available either directly or indirectly through depository participants. Therefore, this service enhancement would not meet the criterion that the enhancement be one that other providers

alone cannot be expected to provide with reasonable effectiveness, scope, and equity.

The Reserve Banks considered remaining in the definitive securities safekeeping service at less than full-cost recovery. Under this alternative, the Reserve Banks could avoid the expense of withdrawing and shipping securities back to the depositor or to a successor custodian. In addition, this service would continue to share costs that would otherwise have to be redistributed to other priced and non-priced services. However, further analysis revealed that withdrawal from the definitive securities safekeeping service would increase the total costs borne by other priced and non-priced services by no more than 0.03 percent. Also, the Reserve Banks did not believe that they could remain in this service at less than full-cost recovery, as provided in Section 11A(c)(3) of the Federal Reserve Act (12 U.S.C. § 248a), because they believed that the definitive securities safekeeping service is available nationwide from a range of alternate service providers.

A third alternative considered was to increase fees further to offset the revenue lost through declining volume. This alternative had been successful until 1991, when the Reserve Banks did not achieve full-cost recovery despite fee increases. The Reserve Banks' experience with this service in recent years, however, indicates that 1991 was the pivotal year for this service and that, in the future, further fee increases will not

achieve full-cost recovery, but instead will accelerate the volume decline and increase the shortfall for this service.

The fourth alternative considered was to move the purchase and sale service, which now involves primarily book-entry securities trades, to a different service line and to withdraw from the definitive securities service line and absorb the cost of returning the securities held in priced safekeeping to the depositors or the depositors' designated agent. The Federal Reserve Banks surveyed institutions regarding the possible impact of withdrawal from priced definitive securities safekeeping and determined that withdrawal would be acceptable to the majority of service users. Consequently, the Reserve Banks requested that the Board approve their request to move the purchase and sale service to another service line and withdraw from the definitive securities service line.

In light of the Reserve Banks' request to withdraw from the definitive securities service line, the Board believed that a consistent methodology for reviewing Reserve Bank proposals to withdraw from a priced service line would help ensure that any public policy issues arising from such proposals would receive appropriate consideration. Therefore, the Board has requested comment on factors that it would consider in its evaluation of a Reserve Bank proposal to withdraw from a priced service line. (See Docket No. R-0767 elsewhere in today's Federal Register.)

Since the definitive securities safekeeping service comprises the large majority of the costs and revenue of the definitive securities service line, the Board has evaluated the Reserve Banks' proposed withdrawal from the definitive securities safekeeping service in the context of these proposed factors and, based on this analysis, believes that the Reserve Banks should be permitted to withdraw. The Board requests comment on the application of the proposed factors or other appropriate factors to this proposal to withdraw. The Board will consider the factors, as finally adopted, in its evaluation of whether to approve the Reserve Banks' proposal to withdraw from the definitive securities safekeeping service.

FACTOR 1: It is likely that other service providers would supply an adequate level of the same service (i.e. access, price, and quality) in the relevant market(s) if the Federal Reserve withdraws from the service.

Yes. The Reserve Banks' survey of service users indicated that a range of alternate service providers exists, including depository institutions and securities depositories.

FACTOR 2: If other service providers are not likely to provide an adequate level of the same service in the relevant market(s), it is likely that users of the service could obtain other substitutable services that could reasonably meet their needs.

Since other service providers can reasonably be expected to provide an adequate supply of definitive safekeeping services in the event of the Reserve Banks' withdrawal, a substitutable service is not needed.

FACTOR 3: Withdrawal from the service would not have a material, adverse effect on the Federal Reserve's ability to provide an adequate level of other services.

Withdrawal from priced definitive securities safekeeping should have no material, adverse effect on the Reserve Banks' ability to provide an adequate level of other services. A large percentage of the costs of this service are fixed. These costs, plus the cost of moving the securities to other custodians, would have to be redistributed to other services, priced and non-priced, but the additional costs that would be borne by the other services as a result of withdrawal would increase the total costs for these other services by no more than 0.03 percent. Approximately 10 percent of the volume in the noncash collection service comes from securities held in Reserve Bank vaults. The Reserve Banks anticipate that any increase in unit cost in the noncash collection service resulting from a volume decline attributable to withdrawal from the definitive securities safekeeping service would be offset by cost savings associated with the interdistrict consolidation of the noncash collection service.

FACTOR 4: Withdrawal from the service would not have a material, adverse effect on the Federal Reserve's ability to discharge other responsibilities.

There are no material linkages between this service and any other Federal Reserve responsibilities except non-priced (i.e. collateral) safekeeping. If the priced definitive securities safekeeping service is eliminated, securities held in priced safekeeping would no longer be immediately available on Reserve Bank premises for pledge, but could still be pledged using a depository institution or depository as third-party custodian.

FACTOR 5: There are no public benefits of continued Federal Reserve provision of the service that outweigh the reasons for withdrawing from the service.

As part of priced definitive securities safekeeping, the Federal Reserve Banks serve as custodian for collateral pledged to state and local governments; however, Federal Reserve Bank withdrawal from priced safekeeping would not leave state and local governments without alternative custodians for their collateral. Institutions surveyed by the Reserve Banks indicated that there are numerous alternate service providers available to them. Further, the Board believes that the public may benefit from the Reserve Banks' withdrawal through accelerated migration of securities to depositories.

As noted earlier in this notice, the revenue from the Reserve Banks' definitive securities safekeeping service no longer fully recovers the costs of providing this service. The Board anticipates that the cost-recovery for this service will continue to decline in the future. The Board believes that full-cost recovery in this service cannot be achieved in 1993, even assuming significant price increases. Moreover, the Board is concerned that significantly higher fees may hamper an orderly withdrawal from this service by encouraging depositors to demand immediate relocation of their safekeeping holdings. The Board also considered pricing the definitive securities safekeeping service to recover only its variable costs during the transition year, but concluded that this alternative also would hamper an orderly withdrawal by encouraging depositors to delay movement of their securities until the Reserve Banks ceased offering this service. For these reasons, the Board believes that definitive securities safekeeping fees should be maintained at current levels until withdrawal is completed.

The Board requests comment on the proposal by the Federal Reserve Banks to withdraw from the priced definitive securities safekeeping service by year-end 1993 and to absorb the cost of returning securities held in priced safekeeping to the depositors or the depositors' agent.

By order of the Board of Governors of the Federal
Reserve System, July 8, 1992.

(signed)

William W. Wiles
Secretary of the Board