# FEDERAL RESERVE BANK
# OF NEW YORK

[ Circular No. **9751**
November 9, 1984 ]

## DETERMINATION OF FEES FOR PRICED SERVICES

### — Policy Statement on Surpluses and Shortfalls
### — Establishment of Private Sector Adjustment Factor for 1985

*To All Depository Institutions, and Others Concerned,
in the Second Federal Reserve District:*

The Board of Governors of the Federal Reserve System has issued a statement of policy concerning the treatment of surpluses and shortfalls that arise from the provision of priced services to depository institutions. The statement formalizes the Federal Reserve's current practice of establishing fees for its services designed to recover projected costs for the calendar year, rather than to offset prior years' surpluses or shortfalls.

In addition, the Board of Governors has approved a Private Sector Adjustment Factor for 1985. Following is the text of a Board statement announcing this action:

> The Federal Reserve Board has approved a Private Sector Adjustment Factor (PSAF) for 1985 of $61.1 million. The PSAF for 1985 represents an increase of $2.3 million, or approximately four percent, from the 1984 target PSAF.
>
> The PSAF is an allowance for the taxes that would have been paid and the return on capital that would have been provided had all of the Federal Reserve's priced services been furnished by a private business firm.
>
> The PSAF is determined by applying the Federal Reserve's pre-tax cost of capital to the assets used by the Federal Reserve in the production of priced services. These assets are determined on a direct basis and include the net effect of those assets expected to be acquired and disposed of during the year. Short-term assets are assumed to be financed by short-term debt and long-term assets are assumed to be financed by a combination of equity and long-term debt.
>
> The ratio of long-term debt to equity and the rates for short-term debt, long-term debt, equity, and income taxes are based on the experience of the 25 largest U.S. bank holding companies. Also included in the PSAF are imputations for estimated sales taxes, insurance assessment by the Federal Deposit Insurance Corporation, and the expenses and fixed assets of the Board of Governors related to the development of priced services.

Enclosed — for depository institutions in this District — is the text of (a) the Board's policy statement on surpluses and shortfalls and (b) the Board's official notice on the PSAF for 1985. Additional copies will be furnished upon request directed to our Circulars Division (Tel. No. 212-791-5216). Questions on these matters may be directed to Robert M. Abplanalp, Vice President (Tel. No. 212-791-5349).

Anthony M. Solomon,
*President.*

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Policy Statement on Surpluses and Shortfalls that Arise From the Provision of Federal Reserve Priced Services

The Monetary Control Act of 1980 requires that "over the long run, fees shall be established on the basis of all direct and indirect costs actually incurred. . ." Consequently, the Board has established the policy that Reserve Bank fees for Federal Reserve services will be established in order to generate sufficient revenue to cover the anticipated costs of providing services to depository institutions for the calendar year, rather than to offset prior years' surpluses and shortfalls.

The Board believes that this policy better advances the Federal Reserve's objective of promoting efficiency in the payment mechanism than does the alternative approach of accumulating surpluses and shortfalls. If, for example, the Federal Reserve were to establish a lower price to compensate for a previous year's surplus, inefficiencies could result as below cost pricing might lead to services being produced by the Federal Reserve at a higher societal cost than if they had been produced by other service providers. In addition, the short-term fluctuations in Federal Reserve fees that could result from compensating for previous years' surpluses or shortfalls could be disruptive to the Federal Reserve, other providers of payment services, and users of such services. Moreover, other providers of payment services do not typically establish prices in order to eliminate surpluses or shortfalls incurred in prior years. Finally, if the Federal Reserve seeks to match costs and revenues each year, any surpluses or shortfalls incurred should be reduced, if not eliminated, over time.

Accordingly, the Board has determined that it is appropriate to continue the current policy of establishing Reserve Bank fees for Federal Reserve services in order to generate sufficient revenue to cover the anticipated costs of providing services to depository institutions for the calendar year, rather than to offset prior years' surpluses and shortfalls.

FEDERAL RESERVE SYSTEM

[Docket No. R-0531]

1985 Private Sector Adjustment Factor

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Approval of a Private Sector Adjustment Factor for 1985.

SUMMARY: The Board of Governors of the Federal Reserve System ("Board") has approved a Private Sector Adjustment Factor ("PSAF") for 1985 of $61.1 million. This represents an increase of $2.3 million, or approximately four percent, from the 1984 target PSAF of $58.8 million. The PSAF is a recovery of the imputed costs which takes into account the taxes that would have been paid and the return on capital that would have been provided had the Federal Reserve's priced services been furnished by a private business firm.

EFFECTIVE DATE: January 1, 1985.

FOR FURTHER INFORMATION CONTACT: David L. Robinson, Associate Director (202/452-3806), or Anne Debeer, Assistant Director (202/452-3915), Division of Federal Reserve Bank Operations; Gilbert T. Schwartz, Associate General Counsel (202/452-3625), or Robert G. Ballen, Attorney (202/452-3265), Legal Division, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

[Enc. Cir. No. 9751]

SUPPLEMENTARY INFORMATION: Background -- The Monetary Control Act of 1980 (Title I of Pub. L. 96-221) requires that in establishing fee schedules for priced services, the Federal Reserve recover the imputed taxes that would have been paid and the return on capital that would have been provided had the Federal Reserve's priced services been furnished by a private business firm. The PSAF is intended to reflect these imputed costs.

The methodology previously adopted by the Board for calculating the PSAF for 1984[1/] was used to determine the PSAF for 1985. The PSAF is determined by applying the Federal Reserve's pre-tax cost of capital to the assets used by the Federal Reserve in the production of priced services. These assets are determined on a direct basis and include the net effect of those assets expected to be acquired and disposed of during the year. Short-term assets are assumed to be financed by short-term debt and long-term assets are assumed to be financed by a combination of equity and long-term debt. The ratio of long-term debt to equity and the rates for short-term debt, long-term debt, equity, and income taxes are based on the experience of the 25 largest U.S. bank holding companies. Also included in the PSAF are imputations for estimated sales taxes, FDIC insurance assessment, and the expenses and fixed assets of

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1/ 49 Fed. Reg. 11251 (March 26, 1984).

the Board of Governors related to the development of priced services.

Asset Base -- As indicated in Tables 1 and 2, priced service assets for 1985 that must be financed through the PSAF are projected to be $313.1 million, which reflects an increase of $7 million from 1984. This increase is attributable largely to the increase in planned 1985 capital expenditures.

Cost of Capital -- Rates for those portions of the asset base financed by short and long-term debt are derived from the experience of the 25 largest U.S. bank holding companies for the period October 1983 to June 1984. (The bank holding companies with the highest and lowest returns are eliminated from the sample in order to avoid distortions from institutions at the extremes.) The Board has approved the use of rates of 9.93 percent for short-term debt and 10.38 percent for long-term debt, which reflects the average rates paid by the bank holding companies in the sample. This compares with rates of 9.23 percent and 10.14 percent respectively for 1984.

Reference is also made to the experience of the 25 largest U.S. bank holding companies to determine the rate to apply to those portions of the asset base financed by equity. Using last year's method would result in a pre-tax rate of return on equity of 14.7 percent for 1985 compared with a rate of 20.9 percent for 1984. However, the Board believes that this 14.7 percent rate reflects abnormal performance during the period. In order to obtain a more representative cost of equity, the Board has determined to use a three year average of the experience of the 25 bank holding companies in the sample to determine the cost of equity for 1985. Use of the three year average results in a cost of equity of 20.55 percent for 1985. (It is not necessary to exclude the bank holding companies with the highest and lowest return on equity as has previously been done because three year averages smooth the results.)

Taxes -- An income tax rate based on the taxes paid by the bank holding companies in the sample is used to approximate an imputed income tax rate for the Federal Reserve. The PSAF effective tax rate is based upon the taxes actually paid by these bank holding companies and takes no advantage for tax-exempt securities. If the 1984 procedure were used for 1985, the tax rate would be 33.7 percent as compared with 38.6 percent in 1984. However, in order to be consistent with the use of the three year average for the cost of equity, the Board has determined that for 1985 it is appropriate to use a three year average of taxes paid by the 25 largest U.S. bank holding companies. This results in a tax rate of 36.9 percent.

Other Imputed Costs -- Other PSAF recoveries for sales taxes, an FDIC assessment and Board of Governors expenses rose from $8.0 million in 1984 to $10 million in 1985. This increase results primarily from an increase in sales taxes, which can be attributed, in part, to the capital expenditures planned for 1985. The FDIC assessment is down slightly, due to a reduction in float.

By order of the Board of Governors, November 2, 1984.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board

Table 1

Changes between 1984 and 1985 Balance Sheet
(millions of dollars--average for year)

| | 1984 | | 1985 | |
|---|---|---|---|---|
| **Short-term assets** | | | | |
| Imputed reserve requirements on clearing balances | $ 147.4 | | $ 156.0 | |
| Investment in marketable securities | 1,080.6 | | 1,144.0 | |
| *Receivables | 23.7 | | 24.4 | |
| *Materials and supplies | 4.3 | | 4.4 | |
| *Prepaid expenses | 4.3 | | 6.9 | |
| Net items in process of collection (float) | 477.0 | | 247.5 | |
| Total short-term assets | | $1,737.3 | | $1,583.2 |
| **Long-term assets** | | | | |
| *Premises 1/ | $ 176.7 | | $ 166.0 | |
| *Furniture and equipment | 95.6 | | 110.2 | |
| Leases | 0.9 | | 0.7 | |
| *Leasehold improvements | 1.5 | | 1.2 | |
| Total Long-Term Assets | | $ 274.7 | | $ 278.1 |
| Total assets | | $2,012.0 | | $1,861.3 |
| **Short-term liabilities** | | | | |
| Clearing balances | $1,228.0 | | $1,300.0 | |
| Balances arising from early credit of uncollected items | 477.0 | | 247.5 | |
| Short-term debt 2/ | 32.3 | | 35.7 | |
| Total short-term liabilities | | $1,737.3 | | $1,583.2 |
| **Long-term liabilities** | | | | |
| Obligation under capital leases | $ 0.9 | | $ 0.7 | |
| Long-term debt 2/ | 87.1 | | 92.9 | |
| Total long-term liabilities | | $ 88.0 | | $ 93.6 |
| Total liabilities | | $1,825.3 | | $1,676.8 |
| Equity 2/ | | 186.7 | | 184.5 |
| Total liabilities and equity | | $2,012.0 | | $1,861.3 |

1/ Includes allocations in Board of Governors' assets to priced services of $500 thousand for 1984 and $400 thousand for 1985.
2/ Imputed figures representing the means through which certain priced service assets are financed.
* Financed through PSAF; other assets are self-financing.
Note: Details may not add to totals due to rounding.

Table 2

Derivation of the 1985 PSAF
(millions of dollars)

A. Assets to be Financed 1/

| | | |
|---|---|---|
| Short-Term | $ 35.7 | |
| Long-Term | 277.4 2/ | |
| Total | | $313.1 |

B. Weighted Average Cost

1. Capital Structure 3/

| | |
|---|---|
| Short-Term Debt | 11.4% |
| Long-Term Debt | 29.7% |
| Equity | 58.9% |

2. Financing Rates/Costs 3/
Average rates paid by the bank holding companies included in the sample

| | |
|---|---|
| Short-Term Debt | 9.93% |
| Long-Term Debt | 10.38% |
| Pre-Tax Equity 4/ | 20.55% |

3. Elements of Capital Costs

| | | | | | |
|---|---|---|---|---|---|
| Short-Term Debt | $ 35.7 | X | 9.93% | = | $ 3.5 |
| Long-Term Debt | 92.9 3/ | X | 10.38% | = | 9.7 |
| Equity | 184.5 3/ | X | 20.55% | = | 37.9 |
| | | | | | $51.1 |

C. Other Required PSAF Recoveries

| | | |
|---|---|---|
| Sales Taxes | $ 7.2 | |
| Federal Deposit Insurance Assessment | 1.1 | |
| Board of Governors Expenses | 1.7 | $ 10.0 |

D. Total PSAF Recoveries — $61.1

| | |
|---|---|
| As a percent of capital | 19.51% |
| As a percent of expenses 5/ | 15.20% |

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1/ Priced service asset base is based on direct determination of assets method.

2/ Consists of total long-term assets less capital leases which are self-financing.

3/ All short-term assets are assumed to be financed by short-term debt. Of the total long-term assets, 33.5 percent are assumed to be financed by long-term debt, and 66.5 percent by equity.

4/ The pre-tax rate of return on equity is based on average after-tax rates of return on equity for the bank holding company sample, adjusted by the effective tax rate to yield the pre-tax rate of return on equity. The 1985 figure for pre-tax equity and the tax rate is based upon a three-year average of these rates.

5/ Systemwide 1985 budgeted priced service expenses less shipping were $401.9 million.

Table 3

## Changes between 1984 and 1985 PSAF Components

| | 1984 | 1985 |
|---|---|---|
| **I. Assets to be Financed (million)** | | |
| Current | $ 32.3 | $ 35.7 |
| Long-term | 273.8 | 277.4 |
| **II. Cost of Capital** | | |
| Short-Term Debt Rate | 9.23% | 9.93% |
| Long-Term Debt Rate | 10.14% | 10.38% |
| Pre-Tax Equity Rate 1/ | 20.90% | 20.55% |
| Weighted Average Cost of Capital | 16.61% | 16.32% |
| **III. Tax Rate 1/** | 38.6% | 36.9% |
| **IV. Capital Structure** | | |
| Short-Term Debt | 10.6% | 11.4% |
| Long-Term Debt | 28.4% | 29.7% |
| Equity | 61.0% | 58.9% |
| **V. Other Required PSAF Recoveries (million)** | | |
| Sales Taxes | $ 4.9 | $ 7.2 |
| Federal Deposit Insurance Assessment | 1.2 | 1.1 |
| Board of Governors Expenses | 1.9 | 1.7 |
| PSAF Recovery | $ 58.8 | $ 61.1 |
| As Percent of Capital | 19.21% | 19.51% |
| As Percent of Expenses | 15.25% | 15.20% |

1/ The 1985 figure for pre-tax equity and the tax rate is based on a three-year average of these rates:

| | 1981 | 1982 | 1983 | Average |
|---|---|---|---|---|
| Pre-tax equity rate | 23.6 | 21.6 | 16.8 | 20.55 |
| Tax rate | 38.3 | 38.5 | 33.9 | 36.9 |

Details may not add to totals due to rounding.