# FEDERAL RESERVE BANK
# OF NEW YORK

[ Circular No. **10304**
July 7, 1989 ]

## FEDERAL RESERVE PRICED SERVICES

### Private Sector Adjustment Factor

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

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has announced revisions to the methodology for computing the Private Sector Adjustment Factor (PSAF). The methodology is essentially that as proposed for public comment on January 23, 1989 (Docket No. R-0656).

The PSAF is intended to reflect an allocation of imputed costs that takes into account the taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private business firm as required by the Monetary Control Act.

The revisions are designed to reduce the necessity for ad hoc adjustments and to respond to industry questions regarding the PSAF calculation.

The revisions become effective with the computation of the PSAF for 1990.

Printed on the following pages is the text of the Board's notice in this matter, as published in the *Federal Register* of June 22. Questions thereon may be directed to Nirmal V. Manerikar, Assistant Vice President (Tel. No. 212-720-5262).

E. GERALD CORRIGAN,
*President.*

**FEDERAL RESERVE SYSTEM**

**[Docket No. R-0656]**

**Private Sector Adjustment Factor**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Notice.

**SUMMARY:** The Board has approved revisions to the methodology for computing the Private Sector Adjustment Factor ("PSAF"). The PSAF is a computation of imputed costs that 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. The revisions will reduce volatility and the need for ad hoc adjustments in the PSAF and will modify certain calculations to conform more closely with commercial bank practices.

**EFFECTIVE DATE:** June 16, 1989.

**FOR FURTHER INFORMATION CONTACT:** Clyde H. Farnsworth, Director (202/452-2787) or Paul Bettge, Program Leader (202/452-3174), Division of Federal Reserve Bank Operations; for the hearing impaired *only:* Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3544).

**SUPPLEMENTARY INFORMATION:**

### Background

The Monetary Control Act of 1980 requires that fee schedules for the Federal Reserve's priced services include an allocation of imputed costs for "taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private business firm." These imputed costs, referred to as the private sector adjustment factor ("PSAF"), are incorporated into the cost base on which fees for Federal Reserve priced services are established.

The current methodology used to compute capital costs in the PSAF involves three steps. The first step is to detemine the value of Federal Reserve assets that will be used directly in producing priced services during the coming year, including the net effect of assets planned to be acquired or disposed of during the year. The second step is to determine the financing method. Short-term assets are assumed to be financed by short-term liabilities; long-term assets are assumed to be financed by a combination of long-term debt and equity. Third, imputed capital costs are determined by applying short and long-term interest rates and a rate of return on equity derived from a sample of bank holding companies ("BHCs") to the assumed debt and equity values. The consolidated financial data for the BHCs are drawn from the 25 largest BHCs (in terms of asset size), with all factors except the short-term debt rate averaged over three years. Because short-term debt, by definition, matures within one year, only data for the most recent year are used for computing the short-term debt rate. Capital costs, together with imputations for estimated sales taxes, FDIC insurance assessment on clearing accounts (or the clearing portion of mixed reserve/clearing accounts) held with the Federal Reserve to settle transactions, and expenses of the Board of Governors related to priced services, comprise the PSAF.

### Discussion

In January the Board requested comment on four proposed revisions to the methodology for computing the PSAF (54 FR 4074, January 27, 1989):

1. Increasing the size of the BHC sample from the 25 largest BHCs to the 50 largest BHCs;
2. Extending the sample period from three years to five years;
3. Ensuring that sufficient capital is imputed to meet the risk-based capital guidelines of 8 percent capital to risk-weighted assets, including in assets a computation of gross cash items in the process of collection; and
4. Calculating the imputed FDIC insurance assessment on the basis of clearing balances plus an esimate of deferred credits calculated on a basis similar to a commercial bank.

The Board received seven public comments in response to the proposals, two from trade associations and five from bank holding companies. The Board has considered the comments and has approved the revisions to the PSAF methodology as proposed with one modification. The Board has approved the inclusion of gross cash items in the process of collection ("CIPC"), rather than net CIPC as proposed, measured on a basis comparable with commercial bank on the pro forma priced services balance sheet. These revisions will become effective with the computation of the PSAF for 1990.

*Expansion of Sample Size and Period.* The Board has revised the PSAF methodology to extend the sample period to five years and increase the sample size to include the 50 largest bank holding companies each year. The commenters generally endorsed both expanding the sample size of BHCs used in the PSAF calculation from the 25 to the 50 largest privately-owned BHCs in each year and averaging the most recent five years of BHC data to determine the pre-tax return on equity, the long-term debt rate, and the ratio of long-term debt and equity used to compute the PSAF. Two commenters disagreed with the use of a historic five year sample period. As an alternative, one commenter suggested that the Board use projected data, and the other proposed using five years of data but eliminating the highest and lowest years and averaging the three remaining years to minimize disruptions and neutralize the effect those years have on the data. The Board believes that use of historical data is appropriate because it captures the underlying long-term trend of industry rates of return. To measure the long-term results of BHC operations, the Board believes it is necessary to reflect the activities of all years. In addition, because the Monetary Control Act requires that fees be set to recover costs over the long run, the use of historical data in the PSAF computation will, over time, include the results of each year and fees will be established appropriately. The Board believes that only historical data should be used in the computation as it is more objective than the use of projections and allows verification of the Board's computations.

The expansion of the sample size and period should significantly reduce the volatility of the PSAF, as each BHC will have a less dramatic impact upon the overall average. This change should reduce the frequency of ad hoc adjustments. The larger sample size will also serve to include a number of regional correspondent banks and will increase the geographical diversity of the group.

Two commenters suggested that the BHC model provides an inappropriate basis for determining the components of the PSAF. Public comment on this issue has been requested on two prior occasions. On both occasions, the Board considered the comments offered and decided that the BHC model was the most appropriate. The Board, however, again considered alternative models upon which to base the PSAF and determined that none offered clear benefits over the BHC model and, in some instances, introduced additional implementation difficulties. The Board continues to believe that the BHC model is appropriate because BHCs offer services most comparable to those offered by the Federal Reserve Banks. The two commenters generally endorse the plan to expand both the sample size and period if the Board continues use of the BHC model.

Two commenters also suggested that the sample for the PSAF be comprised of the 50 largest check processors and BHCs that provide check collection services. Specific data clearly identifying these organizations does not appear to be readily available. Using the largest banks, in terms of domestic correspondent balances, as a proxy for these organizations, the Board has found that there is a great deal of overlap between the two samples. Further, the Board believes the 50 largest BHCs is the appropriate sample because these organizations, as well as the Reserve Banks, provide payments services other than check collection.

*Capital Adequacy*. The Board has determined that the Federal Reserve will meet the risk-based capital guideline of 8 percent capital to risk-weighted assets and that the Federal Reserve will disclose on its pro forma priced services balance sheet gross CIPC, a basis comparable with a commercial bank. Commenters endorsed the proposal that the Federal Reserve meet the Board's risk-based capital guideline of 8 percent capital to risk-weighted assets for state member banks and BHCs. In meeting this guideline, the Board proposed that the Federal Reserve include in assets a computation of CIPC on a basis comparable to a commercial bank. On this basis, the amount of capital imputed for the 1989 PSAF totaled nearly 22 percent of risk-weighted assets. Had the newly-approved modifications to the PSAF been used for 1989, this percentage would have been nearly 25 percent.

The Board had proposed that net, rather than gross, CIPC should be included on the Federal Reserve's consolidated pro forma priced services balance sheet because the balance sheet is intended to identify priced services assets, and only the net amount of CIPC (float) requires financing. Some commenters suggested that gross CIPC should be reflected on the priced services balance sheet because generally accepted accounting principles require such treatment by the BHCs.

The Board believes that reflecting gross CIPC on the pro forma priced services balance sheet is acceptable, as long as readers of the statements understand that the majority of gross CIPC is offset by deferred credits. The portion of CIPC not offset by deferred credits represents float and, as required by the Monetary Control Act, is valued at the Federal funds rate for recovery and does not affect the PSAF. In determining the amount of CIPC to be shown on the pro forma priced services balance sheet, the same adjustments should be made to gross CIPC as discussed in the FDIC assessment section below. That is, CIPC arising from central bank activities, items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet, and items that have been recorded prior to actual receipt and processing would be excluded from gross CIPC.

In the past, some groups have suggested that the Federal Reserve should impute a level of equity on its pro forma priced services balance sheet sufficient to meet the current equity to total assets ratio including CIPC, stated on a basis similar to that reported by commercial banks. The Federal Reserve imputes equity for priced services by assuming that long-term assets are financed by long-term debt and equity in the proportion of long-term debt and equity of the BHCs in the model. Using the proposed sample size and sample period, this imputation will result in over 70 percent of depreciable priced services assets being financed by equity. Because of the high percentage of depreciable assets that will be financed with equity, the Board believes that the current methodology for imputing equity capital is appropriate and results in a level of equity capital that is sufficient to support priced services operaitons.

*FDIC Assessment*. The Board has approved a modification, as proposed, to calculate the imputed FDIC assessment on the basis required of a commercial bank. The computation will include applying the required FDIC assessment rate to the projected level of clearing balances held with the Federal Reserve plus a projection of deferred credits. Accordingly, the following deferred credits will be excluded: intra-System deferred credits that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; deferred credits associated with nonpriced items, such as deferred credits to government agencies; and deferred credits associated with providing fixed availability or credit prior to receipt and processing of items. In general, the commenters endorsed the conceptual approach to the calculation of the imputed FDIC insurance assessment.

This change in methodology for computing the FDIC insurance and calculation of a consolidated priced CIPC amount will result in an increase to the PSAF amount to be recovered. One commenter suggested that the Board "phase-in this increase over a three year period to avoid unnecessary volatility in a component of the PSAF and be more consistent with the Board's intention of decreasing overall volatility of the PSAF." The Board believes that, although the percentage increase in this one component of the PSAF will be quite large, the dollar impact of making this change on the overall PSAF will be fairly small, and should not result in significant price changes. Therefore, the Board will not phase-in the modification.

By order of the Board of Governors of the Federal Reserve System, June 16, 1989.

**William W. Wiles,**

*Secretary of the Board.*

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